

PENSIONS IN 30 PODCASTS

30 Pension schemes and tax for individuals

Please note: pension tax rules are very detailed and complex. For those with high value pension benefits, specialist tax planning advice is strongly recommended

Main sources

- Finance Acts 2004, 2011, 2013 and 2014.
- IR12 Practice Notes (old Inland Revenue regime).
- HMRC's Pensions Tax Manual: link is <https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual>.

Key points

- Tax relief in the context of pensions (both during the saving phase and at the point of access) requires care and attention.
- Under the current UK tax regime, pension savings which exceed the "Annual Allowance" or "Lifetime Allowance" are subject to taxation. Employers may want to consider altering benefit structures for high earners.
- Taxation at the point of accessing pension savings depends upon the manner in which those savings are accessed. There are "unauthorised payments" and "authorised payments", with tax levied depending on the precise type of payment.
- From 6 April 2015 changes were made to make access to DC pension savings more flexible (with taxation rules also changed).

Possible reform of pensions tax relief

In 2015, the Government consulted on various options for reform to encourage savings into pensions in the longer term, with both fundamental and less radical changes mooted. Options included the removal of tax relief from the accrual phase, with benefits being paid tax free instead, and a new system based on the ISA model. At Budget 2016, the Chancellor confirmed that no consensus had emerged on reform of the pensions system, so decided not to make any changes at that time.

Instead, Budget 2016 announced the introduction of a "Lifetime ISA" (LISA) for adults under the age of 40. While not a tax relief as such, it allows individuals to save up to £4,000 each year and receive a 25% bonus from the government, with contributions possible up to the age of 50. The bonus would only be retained where the LISA is used for buying a first home or after age 60 (as retirement savings). The LISA will not be regulated as a pensions product, so is not strictly a pensions arrangement.

It isn't yet clear whether this marks the introduction of a "dual-system" or is merely a stay of execution for traditional pension taxation whilst the LISA system beds in. Consequently change to the current system of allowances and charges is still possible.

Why provide retirement benefits through a pension scheme?

One of the main reasons for using an HMRC-registered pension scheme as a way of providing retirement or death benefits lies with potentially favourable tax treatment. For example, tax relief is available on the member and employer contributions as well as on the investment income and capital gains. There may also be an ability to take part of the member's pension savings as a tax free lump sum or to provide lump sum death benefits payable under discretionary trusts, ensuring that no income tax or inheritance tax is payable.

More information

Find out more about our Pension team at gowlingwlg.com/pensions-uk.

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The old tax regime

Under the old tax regime (prior to 6 April 2006), certain conditions (known as "IR limits") had to be met in order to achieve HMRC approval. Broadly speaking, under the old IR limits there was a limit on how much members could contribute (15% of remuneration), a limit on how much pension could be provided (broadly, 2/3 of final remuneration), a maximum lump sum and a maximum death in service benefit. Added to this, for many members the limits were subject to a cap on what the member could be treated as having earned.

The current tax regime

The old IR limits have been replaced. Under the current tax regime, which has applied since 6 April 2006, there are allowances and charges (see details of the lifetime and annual allowances below), but there are no other limits on how much can be paid into a pension during the saving phase. As and when members access pension savings, the taxation consequences will depend upon whether the payment is an authorised payment or an unauthorised payment and upon the form of payment.

HMRC's Pensions Tax Manual (PTM) gives a helpful overview of the taxation of pension schemes. This replaced HMRC's Registered Pension Scheme Manual (RPSM).

Since 6 April 2015, members of defined contribution schemes have greater flexibility over how they access their pension savings. They can use their DC pension savings to purchase an annuity, enter into drawdown, or take one or a number of cash lump sums. There have also been changes to the tax treatment of lump sums and annuities on the death of a member with DC pension pots.

To qualify for tax relief on pension savings, certain conditions apply. For example, the member must be a "relevant UK individual" and within the "annual limit for relief" (broadly, 100% of earnings or £3,600, whichever is the greater).

Lifetime allowance

The lifetime allowance is a cap on the amount of tax relieved pension savings an individual can make in their lifetime. If pension savings exceed the cap, a tax charge is payable. The lifetime allowance has been reduced over time and transitional protections made available to individuals (primary protection, enhanced protection, fixed protection and individual protection). Certain conditions must continue to be met in order to benefit from (and not lose) these protections.

Annual allowance

The annual allowance is a cap on the amount of tax relieved pension savings an individual can make in any one year. Broadly, "savings" are contributions to a defined contribution scheme and increases in the value of the individual's rights in a defined benefit scheme. Where the individual exceeds the annual allowance, the excess is subject to tax ("the Annual Allowance Charge").

Under the "scheme pays" rules, an individual incurring an Annual Allowance Charge exceeding £2,000 can ask the pension scheme to pay some or all of that charge, subject to accepting a corresponding reduction in benefits. An individual can increase his annual allowance by carrying forward unused allowances from the three preceding years, provided the individual was a member of a registered pension scheme during the relevant year.

Where defined contribution pensions are accessed flexibly under the changes introduced from 6 April 2015 a new money purchase annual allowance ("MPAA") applies and an alternative (reduced) annual allowance regime may apply.

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Carry forward does not apply to MPAA. The MPAA was originally £10,000 in 2015. The Government announced in the March 2017 Budget that the MPAA would be reduced to £4,000 from April 2017.

However, the provisions in Finance Bill 2017 to effect this change were removed on 25 April (to enable a shorter bill to be enacted ahead of the 2017 General Election). It is not yet clear whether the reduction will be introduced later in the year but with retrospective effect to 6 April 2017.

For tax years 2016-17 onwards, the annual allowance is further reduced for those with income over £150,000 (reducing by £1 for every £2 of income – a tapered annual allowance).

Implications for employers

The annual and lifetime allowances have an impact on employees with higher salaries (referred to in this note as "high earners").

Employers may wish to look at simpler employment rewards for high earners, such as salary increases, rather than making higher, but taxable, pension provision (although these may also be taxable).

Alternatively, employers may wish to alter pension benefit structures so that high earners do not exceed the annual allowance or lifetime allowance, subject to ensuring that arrangements do not fall foul of the complex anti-avoidance rules designed to prevent abuse.

In the sphere of automatic enrolment, employers may wish to ensure that high earners with one or more of the protections mentioned above do not make any further pensions savings. If the individual is automatically enrolled into a pension scheme they may need to "opt out" of scheme membership in a timely fashion.

It is now possible for employers to exempt high earners from automatic enrolment, but not a requirement. So care is required in the area of both automatic enrolment or, if relevant, automatic re-enrolment, for high earners. For further information on automatic enrolment, please see the "automatic enrolment" fact card.

Unregistered schemes

Apart from the registered scheme arrangements, there is another category of schemes which receive limited tax advantages because they do not meet the conditions for 'full' tax breaks. These are known as employer financed retirement benefit schemes.

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