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News letter 1-3-2011

Pension funding - the 2011 annual allowance rules

Appendix

What are the pension annual allowance rules from 2011?

Although the basic annual allowance framework remains in place, there are some important changes to the rules from tax year 2011/12 onwards:

- The annual allowance from tax year 2011/12 is £50,000 (significantly lower than the previous £255,000). This will initially be a fixed amount, but may increase over the longer term.
- For tax year 2011/12 only, special transitional rules allow pension input amounts of up to £255,000 in some circumstances without any annual allowance tax charge.
- Unused annual allowance from the previous three tax years can be carried forward to offset excess provision in the current tax year.
- The value of defined benefit increases is calculated using a factor of 16:1 (rather than the previous 10:1 basis) for testing against the annual allowance. To help balance this, the opening benefit value is increased in line with CPI before the year's pension input is valued.
- A variable annual allowance tax charge of up to 50% applies to pension provision above the annual allowance (not the fixed 40% charge that applied in tax years before 2011/12).
- There will only be exemptions from the annual allowance test on death, serious ill-health or severe ill-health.

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How are increases in defined benefit pensions tested against the annual allowance from 2011?

The annual allowance test for defined benefit pensions will continue to be based on the value of the increase in defined benefit rights over each pension input period (rather than the contributions paid to the scheme).
The value of the increase is known as the pension input amount.
There are, however, two important changes to the details of the calculations from tax year 2011/12 onwards:

1. The fixed factor for valuing defined benefit accrual will increase from 10:1 to 16:1; and
2. The opening value of the individual's defined benefits rights will be revalued in line with CPI (based on the increase in the CPI index for the year to the September before the start of the tax year in which the pension input period ends).

Special transitional rules apply for 2011/12 pension input periods that started before 14 October 2010.

Preserved benefits

There is no pension input amount for preserved defined benefits so long as they don't increase by more than CPI (or, if greater, in line with the provisions of the scheme rules as at 14 October 2010).

Example: calculation of defined benefit pension input amount

Dr Ian Froggatt is a member of a defined benefit pension scheme providing a pension of 1/60th of pensionable salary for each year of membership. Over his latest pension input period, Ian completed 20 years pensionable service and his pensionable salary increased from £60,000 to £66,000. His pension input amount for the tax year is calculated as follows:

	Start of input period	End of input period
Pensionable service completed (years)	19	20
Pensionable salary	£60,000	£66,000
Accrued pension (years x salary/60^{th})	£19,000	£22,000
Accrued pension revalued by CPI (assume 2.5%)	£19,475	n/a
Increase in accrued pension over input period		£2,525
Value for testing against the annual allowance (x16)		£40,400

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What are the transitional pension annual allowance rules for tax year 2011/12?

Significant changes to the annual allowance rules for tax year 2011/12 onwards were announced on 14 October 2010. In particular, it was announced that the allowance would reduce from £255,000 to £50,000.

As the pension input period for a pension arrangement is not necessarily the same as the tax year, some individuals could already have made pension provision of more than £50,000 for 2011/12 before 14 October 2010 (because their pension input period ends in tax year 2011/12).

•Up until 5 April 2011 they may, of course, be able to change their pension input period so that it ends in tax year 2010/11 (so that their pension provision is tested against the 2010/11 annual allowance of £255,000). However, this won't always be possible.
•Accordingly, to make sure these individuals are not unfairly punished by having an annual allowance tax charge applied to the excess provision over £50,000 (which, after all, was made in good faith based on the rules as they stood at the time), special transitional rules have been introduced for tax year 2011/12.
For 2011/12 pension input periods that started before 14 October 2010, the maximum pension input amount allowed under these transitional rules without facing an annual allowance tax charge is:

- £255,000 for the whole pension input period;
- including a maximum of £50,000 made after 13 October 2010.

Of course, for high income individuals, contributions or accrual during the 2010/11 tax year will still be subject to the anti-forestalling rules.

Defined benefits
For defined benefit arrangements, the transitional rules mean the pension input amount (i.e., the value of the increase in benefits during the pension input period) has to be calculated in two parts, which are then added together:

- Benefits built up from the start of the pension input period up to 13 October 2010 are valued using a factor of 10:1.
- Benefits built up from 14 October 2010 until the end of the pension input period are valued using a factor of 16:1.
- **This also means that any increases in pensionable salary of more than £3,125 (£3,125 x 16 = £50,000) have potential tax implications once the transitional period has ended.**

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To work out the input amounts for these two periods, the pensionable earnings as at 13 October 2010 and the end of the input period will need to be known.

Example: calculation of defined benefit pension input for 2011/12 under transitional rules
Jane Wilson is a member of a defined benefit pension scheme providing a pension of 1/60th of pensionable salary for each year of membership. The pension input period for the scheme runs from 1 July to 30 June, in line with both the scheme and employer accounting year.

Over the 2011/12 pension input period (1 July 2010 to 30 June 2011), Jane completed 6 years pensionable service and her pensionable salary increased from £36,000 to £38,000 due to a promotion on the 1 April 2011. This means that the salary increase only affects the second part of the input period. Because the 2011/12 scheme input period straddles 14 October 2010, accrual before that date has to be valued using a 10:1 factor with the balance being valued using a 16:1 factor.
This means that Jane's pension input amount for the 2011/12 tax year is calculated as follows:

	Start	End
First part	01/07/10	13/10/10 (105 days)
Pensionable service completed (years)	5	5+(105/365)
Pensionable salary	£36,000	£36,000
Accrued pension	£3,000	£3,172.60
Accrued pension revalued by CPI (Sept 10, 3.1%)	£3,093	n/a
Increase in accrued pension over input period		£79.60
Value of accrual using 10:1 factor		£796.00
Second part	14/10/10	30/06/11
Pensionable service completed (years)	5 + (105/365)	6
Pensionable salary	£36,000	£38,000
Accrued pension	£3,172.60	£3,800
Accrued pension revalued by CPI (Sept 10, 3.1%)	£3,270.95	n/a
Increase in accrued pension over input period		£529.05
Value of accrual using 16:1 factor		£8,464.80
Total value for testing against the annual allowance		**£9,260.80**

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What are the pension annual allowance carry forward rules from 2011?

From tax year 2011/12, in some circumstances any unused annual allowance from the previous three tax years can be carried forward to the current tax year. This can allow pension provision valued above the standard annual allowance to be made in a tax year without triggering an annual allowance tax charge.

The carry forward rules are intended to help people whose pension provision is normally within the annual allowance, but who have an unusually high level of pension savings in a tax year. This might happen, for example, where:

- a member of a defined benefit scheme has a spike in their pension accrual due to a promotion, or
- someone pays a large pension contribution to make up for previous under-provision.

Carry forward and tax relief

Where unused annual allowance carried forward from an earlier tax year is being used up, the usual pension tax relief rules still apply to any contribution above the standard annual allowance:

- Tax relief only applies to personal contributions up to 100% of the individual's relevant UK earnings for the current tax year; and
- Relief against corporation tax on employer contributions is subject to the usual wholly and exclusively test.

The carry forward framework

Unfortunately, working out how much annual allowance can be carried forward is not simply a case of looking at how much was paid in each of the previous three tax years and then carrying forward the balance (if any) from each year to the current year. There are strict rules governing how carry forward works:

- Three year carry forward window: Unused annual allowance can only be carried forward to the current tax year from the previous three tax years. Any unused allowance is lost after the three year window closes.
- Was a scheme in place during the earlier year(s)?: Annual allowance can only be carried forward from a tax year if the individual was a member of a registered pension scheme at some point during the year in question (but there's no need for any contributions to have been made to the scheme in that year).
- Deemed £50,000 allowance for 2008-2011: To work out the amount that can be carried forward, it is assumed that the annual allowance for tax years 2008/09, 2009/10 and 2010/11 was £50,000.

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- Impact of excess provision in earlier years: Where there is unused annual allowance to carry forward from a tax year, but the annual allowance has been exceeded in a later year within the three year carry forward period (known as an intervening year), the excess will use up some of the unused allowance from the earlier year. The second example calculation below illustrates this.
- Using-up carried forward allowance: Unused annual allowance carried forward from earlier tax years can only be used once the current year's annual allowance has been fully used up. The carried forward allowance is then used-up starting with the oldest unused allowance first.

The carry forward calculation

As well as the rules summarised above, there are a couple of other important points to be aware of when carrying out carry forward calculations:

Pension input periods:
To work out the amount of unused annual allowance for an earlier tax year, the amount of pension savings for that year (known as the pension input amount) is based on the savings made in pension input periods which end in the tax year. These periods will not always correspond with the tax year. For example, if the pension input period for an arrangement is the calendar year, the pension input amount tested against the annual allowance for the 2011/12 tax year will be based on provision made between 1 January 2011 and 31 December 2011.

Defined benefit accrual for years before 2011/12:
For tax years before 2011/12, the fixed factor for valuing defined benefit accrual for annual allowance purposes was 10:1. However, for annual allowance carry forward calculations the 2011/12 rules for valuing defined benefit accrual should always be used (i.e., based on a 16:1 valuation factor and with the opening value revalued in line with CPI).
It is possibly easiest to understand how the carry forward calculations work by looking at some examples:

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Example 1: carry forward calculation - money purchase
Bryana Halpin is a self-employed media consultant earning around £300,000 a year. Over the years Bryana has paid periodic large single contributions to her SIPP, but only paid £30,000 in 2009/10 and 2010/11 because of the impact of the special annual allowance rules for those years.

Bryana is looking to take advantage of the carry forward rules in 2011/12 to catch-up on some of her missed pension provision. Her recent contribution history, and carry forward calculation, are as follows:

Tax year	Pension input amount	Unused allowance	Cumulative carry forward
2008/09	nil	£50,000	£50,000
2009/10	£30,000	£20,000	£70,000
2010/11	£30,000	£20,000	£90,000

This means that, on top of her standard £50,000 annual allowance, Bryana could pay up to another £90,000 to her SIPP for 2011/12 without facing an annual allowance tax charge. Because of her earnings level, Alison will get 50% income tax relief on the full £140,000 contribution.

Example 2: carry forward calculation - money purchase with excess provision in intervening year
Karen Regan earns £80,000 a year and has already paid £50,000 to her SIPP to use up her annual allowance for the tax year 2011/12. She has recently received a large inheritance and would like to make a further pension contribution to use up unused annual allowance from previous years.

Karen's history of pension funding for the last three tax years, and her carry forward calculation, are as follows:

Tax year	Pension input amount	Unused allowance	Cumulative carry forward
2008/09	£10,000	£40,000	£40,000
2009/10	£70,000	(£20,000)	£20,000
2010/11	£15,000	£35,000	£55,000

The key point to note is that, because Karen's contributions for 2009/10 (an intervening year) were more than £50,000, this has used up some of her unused allowance from the previous (2008/09) year.

Karen decides to pay a further £30,000 to her SIPP, giving her a total pension input amount of £80,000 for tax year 2011/12 (the largest personal contribution she can obtain tax relief on). This will use up the £20,000 unused allowance remaining from 2008/09 plus £10,000 of the unused allowance from 2010/11, leaving £25,000 of unused allowance from 2010/11 available for future years.

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Example 3: carry forward calculation - defined benefits
Iain Fleming is a member of a defined benefit pension scheme providing a pension of 1/60th of pensionable salary for each year of membership. Over the scheme's 2011/12 pension input period, Iain completed 30 years pensionable service and his pensionable salary increased from £80,000 to £95,000 following his promotion to the board. His pension input amount for the 2011/12 tax year is calculated as follows:

2011/12	01/04/11	31/03/12
Pensionable service completed (years)	29	30
Pensionable salary	£80,000	£95,000
Accrued pension	£38,666.67	£47,500
Accrued pension revalued by CPI (Sept '10, 3.1%)	£39,865.34	n/a
Increase in accrued pension over input period		£7,634.66
Value for testing against the annual allowance (x16)		£122,154.56
Excess over annual allowance		**£72,154.56**

On the face of it, this leaves Iaani facing a hefty annual allowance tax bill on his excess provision of £72,154.56 as a reward for his promotion!

However, because his salary growth was limited during the worst years of the recession, Iain has unused annual allowance of £96,467.20 available to carry forward from the previous three tax years (see calculations below). This is sufficient to cover his excess provision for 2011/12 and remove the risk of a tax charge.

2008/09	01/04/08	31/03/09
Pensionable service completed (years)	26	27
Pensionable salary	£75,000	£78,000
Accrued pension	£32,500	£35,100
Accrued pension revalued by CPI (Sept '07, 1.8%)	£33,085	n/a
Increase in accrued pension over input period		£2,015
Value for testing against the annual allowance (x16)		£32,240
Unused allowance available to carry forward from 2008/09		£17,760

2009/10	01/04/09	31/03/10
Pensionable service completed (years)	27	28
Pensionable salary	£78,000	£80,000
Accrued pension	£35,100	£37,333.33
Accrued pension revalued by CPI (Sept '08, 5.2%)	£36,925.20	n/a
Increase in accrued pension over input period		£408.13
Value for testing against the annual allowance (x16)		£6,530.08
Unused allowance available to carry forward from 2009/10		£43,469.92
Cumulative carry forward available		£61,229.92

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2010/11	01/04/10	31/03/11
Pensionable service completed (years)	28	29
Pensionable salary	£80,000	£80,000
Accrued pension	£37,333.33	£38,666.67
Accrued pension revalued by CPI (Sept '09, 1.1%)	£37,744.00	n/a
Increase in accrued pension over input period		£922.67
Value for testing against the annual allowance (x16)		£14,762.72
Unused allowance available to carry forward from 2010/11		£35,237.28
Cumulative carry forward available		£96,467.20

What is the pension annual allowance tax charge from 2011?

From tax year 2011/12, any pension provision above an individual's annual allowance will suffer a variable annual allowance tax charge of up to 50% (not the fixed 40% charge that applied in tax years before 2011/12).

- For personal contributions, the tax charge cancels out some (or all) of the individual's tax relief on the excess contribution;
- For employer contributions, the tax charge is effectively a type of benefit in kind tax on excessive employer pension provision.

The precise tax rate levied on an individual, known as the appropriate rate, depends on the rate(s) of income tax they would pay if the excess amount was included in their reduced net income for the tax year and treated as the top slice of that income. The appropriate rate is:

- 50% on any of the excess amount that falls into the additional 50% income tax bracket;
- 40% on any of the excess amount that falls into the higher 40% income tax bracket; and
- 20% on any of the excess amount that falls into the basic 20% income tax bracket.

An individual's reduced net income is, broadly, their gross income subject to income tax from all sources, less their gross pension contributions, allowable trade losses, gifts to charities in the form of shares, securities and real property (not gifts made under gift aid), personal allowances and blind person's allowance.

The tax charge is normally collected through the self-assessment process. However, the Government is consulting on options to allow annual allowance charges to be paid from pension benefits in some circumstances.

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Example 1: tax calculation for 2011/12 - money purchase contributions
Peter Regan has total taxable income of £180,000 in tax year 2011/12.

Peter's total pension provision in pension input periods ending in the 2011/12 tax year are personal contributions of £3,000 a month to his SIPP, plus an employer contribution of £30,000 in December 2011- giving him a total pension input amount of £66,000 for tax year 2011/12. Peter has no unused annual allowance available to carry forward from previous years, and does not benefit from the transitional rules for 2011/12, so he will incur an annual allowance tax charge on the £16,000 excess pension provision above his annual allowance.

Peter's reduced net income for the tax year (after deducting his £36,000 personal contributions) is £144,000. To work out the appropriate rates of Peter's annual allowance tax charge, the £16,000 excess contribution is added to his reduced net income so that he is treated as if he has total income of £160,000 subject to income tax.

- £10,000 of the excess amount is treated as falling into the 50% additional rate income tax bracket; and
- the remaining £6,000 is treated as falling into the 40% higher rate income tax bracket.

So Peter's annual allowance tax charge for 2011/12 is calculated as:

- 50% x £10,000 (i.e., £5,000) +
- 40% x £6,000 (i.e., £2,400)

giving a total tax charge of £7,400 on the £16,000 excess contribution for tax year 2011/12.

Peter will, of course, receive income tax relief on his own £36,000 SIPP contributions in the usual way (50% relief on £30,000 and 40% relief on the £6,000 balance).

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Example 2: tax calculation for 2011/12 - defined benefit accrual
Bryan Halpin is a member of a non-contributory defined benefit pension scheme providing a pension of 1/30th of pensionable salary for each year of membership. Over the 2011/12 pension input period, which runs from 1 April 2011 to 31 March 2012, Bryan completed 16 years pensionable service and his pensionable salary increased from £100,000 to £120,000 following a promotion.

His pension input amount for the tax year is calculated as follows:

	01/04/11	31/03/12
Pensionable service completed (years)	15	16
Pensionable salary	£100,000	£120,000
Accrued pension	£50,000	£64,000
Accrued pension revalued by CPI (Sept '10, 3.1%)	£51,550	n/a
Increase in accrued pension over input period		£12,450
Value for testing against the annual allowance (x16)		£199,200

Bryan has no unused annual allowance available to carry forward from previous years, so he will incur an annual allowance tax charge on the £149,200 excess pension provision.

This excess is added to Bryan's reduced net income of £106,000 for the 2011/12 tax year, treating him as if his taxable earnings were £255,200. This means £105,200 of the excess is taxed at 50%, with the remaining £44,000 taxed at 40%, giving Bryan an annual allowance tax charge of £70,200 for the tax year.

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Can the annual allowance tax charge be paid from pension benefits?

For the 2011/12 tax year onwards, it will sometimes be possible for a person's annual allowance tax charge liability to be met from their pension benefits, meaning they wouldn't have to find the money to pay the tax charge during self-assessment.

A pension scheme will have to pay the charge on behalf of a member where:

- the charge is more than £2,000;
- the pension input amount to that specific scheme was more than the annual allowance; and
- the member elects for the charge to be met from their pension benefits under the scheme. The deadline for an election is 31 July immediately following the relevant tax year (or 31 December 2013 for charges in respect of the 2011/12 tax year).

The effect on pension benefits

For money purchase schemes, the member's pension pot will simply be reduced by the amount of the charge paid by the scheme.

Defined benefit schemes will have to account for the charge by some form of reduction to the member's accrued pension rights. There won't be any set method for doing this - it'll be down to the trustees, with advice from the scheme actuary, to decide on an appropriate basis.

If getting a scheme to pay the charge is an option, the member should, of course, contact the scheme provider or trustees to find out what impact this would have on their benefits.

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Are there any exemptions from the pension annual allowance test from 2011?

From tax year 2011/12 onwards, there are very few circumstances where pension input amounts will not be tested against the annual allowance. Exemptions from the annual allowance test will only apply on:

•Death;
•Serious ill-health (life expectancy of under a year); or
•Severe ill-health (unlikely to ever be able to work again, in any capacity).

The exemption in the year of retirement that applied up to tax year 2010/11 does not apply from tax year 2011/12 onwards. In addition, taking benefits in full from an arrangement will no longer automatically close the pension input period.

Any reference to legislation and tax is based on Seven Financials understanding of United Kingdom law and HM Revenue & Customs practice at the date of production. These may be subject to change in the future. Tax rates and reliefs may be altered. The value of tax reliefs to the investor depends on their financial circumstances. No guarantees are given regarding the effectiveness of any arrangements entered into on the basis of these comments.

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