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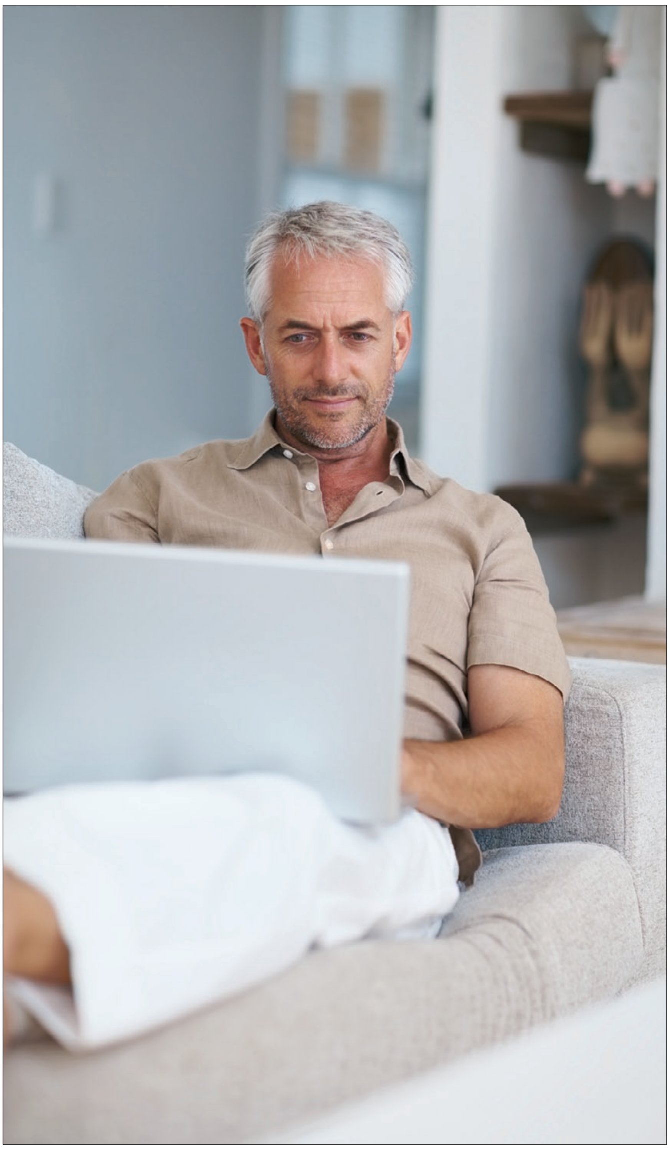
Pension Legislation Changes



STOP and think carefully before paying your redundancy payment into your pension – you may land yourself with an unwanted tax bill!

Pension tax relief currently costs the treasury around £30 billion a year, with the level of tax relief on pension savings doubling since 1998-99. Of the relief given, 25 percent goes to people on incomes over £150,000, who represent only 1.5 percent of pension savers.

With the new 50 percent additional rate of income tax being brought in for the tax year 2010-11, this advantage would be even greater. The Government have therefore introduced changes with a view to making the rules fair, affordable and sustainable.

The new rules, which will apply from 6th April 2011, restrict the availability of higher rate tax relief for those earning more than £150,000. The amount of relief available will be tapered to the point where those earning over £180,000 will only benefit from 20 percent tax relief, although the exact way that the tapering is to work has yet to be determined.

One very important feature of the new rules, which is easily overlooked, is the definition of 'income' that the Revenue are using to determine whether or not you are in breach of the £150,000 limit. Their definition is all encompassing, basically taking into account anything that you would normally put on your tax return, not just your salary.

It is therefore vital to remember that any redundancy payment over £30,000, which as we know is taxable, must also be added back into these figures. For example, someone on a salary of £80,000, with a redundancy payment of £130,000 will be in breach of the limit and therefore have their tax relief restricted on any pension contributions.

This can be particularly damaging if they choose to pay some of the redundancy payment into their pension scheme, as they could end up with a tax bill from the Revenue that cannot be satisfied from cash flow, as the money has been tied up in the pension scheme.

For those that are affected by the rule change, the Government is keen to prevent the inevitable rush of people increasing pension contributions above their normal funding rates. Consequently, before these rules come into being, temporary Anti-Forestalling Measures took effect from 22nd April 2009.

The temporary rules are very complex and take into account more than just personal contributions. They will apply to individuals with "relevant income" in excess of £150,000 per annum, not just in the current tax year BUT in either of the last two years.

Broadly speaking full tax relief can be gained on pension contributions for those with incomes up to £150,000. However, once the £150,000 barrier has been breached, a special annual allowance charge (SAAC) will apply, effectively reducing the tax relief on the excess pension contribution to the basic rate of 20 percent. This is the difference between the higher 40 percent rate and the lower 20 percent rate.

Although the legislation has not specified the charging level for the tax year 2010/2011, the Revenue have indicated it will be at or near 30 percent – that is 50 percent -20 percent.

The first step is to assess what is an excess contribution. There are two criteria which need to be breached to trigger this. Firstly the special annual allowance limit, which is the amount you can pay into a pension and gain full tax relief, regardless of income levels. This starts at £20,000 but is reduced by any amounts that qualify as protected pension input amounts. Secondly the protected pension input amount, which is basically any existing (pre 22nd April 2009) regular ongoing pension savings - although regular means at least quarterly.

A footnote to add on the special annual allowance is that although the level is normally set at £20,000, it may rise to as much as £30,000 to reflect "infrequent money purchase contributions". This surprise late addition to the legislation is worked out as an average of any contributions paid into money purchase arrangements over the 2006/7, 2007/8 and 2008/9 tax years which were paid less frequently than quarterly, however, the maximum average is limited to £30,000.

In summary, the complexity of the regulations means that it is vital that anyone who breaches the earnings threshold and who wishes to make pension contributions over £20,000 seeks professional advice to assess the full impact and the tax implications.

To find out more about how Birchwood Investment Management can help you, contact us:

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