Pension primer

Employment Tax | Tax voice



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Teresa Preece brings us up-to-date on pensions

It is rare today for there to be no pressing legislative issues relating to pension schemes. In this article we will look at automatic enrolment, the imminent reduction in the tax-effective pension savings allowances and the government's consultation on pension tax relief.

Automatic enrolment

The Pensions Acts of 2008 and 2011, together with associated regulations, set out the legislative framework for automatic enrolment. The provisions are being phased in, applying to the largest employers from 1 October 2012 and extending to all employers by 2018. That means we are currently in an interesting period when the smallest employers are just starting auto-enrolment.

The Pensions Regulator (TPR) estimates that 1.8 million small and micro employers will start to automatically enrol their employees into pension schemes over the three years from 2015 to 2018. As part of a general awareness campaign, TPR has been involved in the development of "Workie", the physical manifestation of the workplace pension. There is also more traditional guidance available on TPR's website. Auto-enrolment duties apply to employers with effect from their staging date, which can be found from TPR's website if employers have not been formally

notified of it. TPR estimates that employers should choose a suitable pension scheme approximately six months before their staging date, to allow sufficient time to put the proper processes in place.

Employers are required to automatically enrol any ‘eligible jobholders’ not currently in a ‘qualifying scheme’ into an ‘automatic enrolment’ scheme. As is often the case with pension legislation, these terms are not simple to understand. It is not surprising, therefore, that TPR estimate that 68% of small and 64% of micro employers plan to seek help with automatic enrolment from a business adviser, with accountants and IFAs likely to be the most commonly used. However, for the remainder there are step-by-step guides on TPR’s website, including direct links to schemes (such as NEST, which was set up by government, The People’s Pension and NOW: Pensions).

There is also an explicit reference to the difference between schemes using the net pay arrangement and the alternative (relief at source), which includes the observation that “you should check that your lower paid staff are not worse off under net pay arrangements”. This is because contributions paid under relief at source are automatically credited with basic rate tax in the scheme, even if the member is not a taxpayer. This issue could become more or less important in the future, depending on the outcome of the government’s consultation on tax relief (see below).

Reduction in the tax-effective allowances

The Finance Act 2004 was supposed to usher in an era of “simplified” pension tax. Unfortunately, successive governments have taken the view that the initial upper limits (or allowances) on annual savings and lifetime accrual of benefits were too generous and those allowances have been reduced.

The latest changes take effect on 6 April 2016, when the lifetime allowance (LTA) will reduce from £1.25 million to £1 million. In pure monetary terms this sounds generous. However, for defined benefit schemes (where a prescribed valuation factor of 20 for each £1 of pension applies), the limit will be exceeded for those with an annual pension over £50,000.

As in previous years, transitional protection from the additional tax charge that applies when the LTA is exceeded will be available for those who either have savings

already in excess of the LTA or might expect to do so in the future (up to a maximum of £1.25 million). These protections will be similar to those available in 2014 and will be known as Individual Protection 2016 (IP) and Fixed Protection 2016 (FP).

For IP, the individual must have pension savings of at least £1 million on 5 April 2016. The protected amount will be the value of the savings at that date, up to a maximum of £1.25 million. The protected amount then becomes the individual's LTA, which means that the maximum pension commencement lump sum (or PCLS, often referred to as the tax-free cash sum) will be 25% of the personal LTA. People with IP are permitted to make further pension savings after 5 April 2016.

For FP, the individual must have no benefit accrual nor make contributions to a money purchase scheme after 5 April 2016 or the protection will be lost. Their LTA will be £1.25 million and their maximum PCLS will be £312,500.

Individuals will need to apply for these protections online, although special interim measures will be in place between 5 April 2016 and the time the Finance Act 2016 receives Royal Assent.

There are more fundamental changes to the annual savings limit, or annual allowance (AA). For the highest earners, the AA will be reduced to a maximum of £10,000. In broad terms, those with total income (including the value of pension savings) exceeding £210,000 will have an AA of £10,000. Those with total income exceeding £150,000 will have an AA of £40,000 reduced by £1 for every £2 of income above £150,000. No reduction applies for those whose total income (excluding pension savings) does not exceed £110,000. The main problem with this test is that, for many people, the relevant amount of income will not be known until after the end of the tax year to which the AA applies.

The government's consultation on pension tax relief

At the time of the Chancellor's summer budget last year, he announced a consultation on pension tax relief. The consultation asked wide-ranging questions, put forward no specific proposals and was described as genuinely open minded. However, the Chancellor's statement in his budget speech that "pensions could be

taxed like ISAs” (that is, moved to a Taxed-Exempt-Exempt, or TEE, system) has led some to believe that such treatment is the government’s preferred option.

The other widely-mooted possibilities are:

- to retain the current system (broadly EET), possibly with some changes to address the difference between money purchase and defined benefit schemes;
- different systems for money purchase and defined benefit schemes (possibly with the former having annual contribution limits and the latter having a lifetime limit) and
- a flat rate of tax relief for all individuals.

None of the proposals is without challenges for government, employers and employees.

The consultation period closed on 30 September 2015 and many people thought an announcement would be made in the Chancellor’s autumn statement. It was not, but he did say that the Treasury were considering the responses to the consultation and the government will publish its response in the 2016 budget. Therefore, 16 March could be a watershed day for pension savings.