



Thinking  
ahead

# Budget 2009 and Pensions

May 2009

## Introduction

The 2009 Budget was always going to be crucial for Alistair Darling and the government. As well as introducing a new 50% rate of tax for the very highest earners, people may remember the 2009 Budget for breaking the link between paying pension contributions and receiving tax relief at the highest marginal rate.

This factsheet explains how the changes to pensions tax relief will work, and considers the short, medium and longer-term implications for pension customers.

The legislation for these pension changes hasn't been passed yet. The government is pushing forward with a Finance Bill to bring in the changes, but it will face strong resistance from some. Therefore, it's possible some details may change.

## The main points

- From 2011, those whose income is £150,000 or more will receive reduced tax relief on their personal contributions. Some employer contributions for this group of people will also attract a new tax charge.
- In the meantime, HMRC has introduced a new special annual allowance for the next two years on pension savings paid by people whose income is £150,000 or more. This allowance is £20,000 or their normal ongoing regular pension saving if higher.
- Those who make more irregular pension savings, including yearly contributions, may find the tax benefits on their pension savings restricted over the next two years.
- People who change job or transfer administrator may find they breach the new special annual allowance, and incur a tax charge.
- Those whose income is £150,000 or more need to consider their pension contributions over the next two years, especially if they're self-employed and/or their contribution pattern is more irregular than monthly or quarterly. They also need to consider whether they continue to save for their retirement in a pension.
- These changes only affect a small minority of people. However, there's a danger it sends out a wider message that the government can alter the rules, so reducing the trust people have in pension saving in the future.



## Reduced tax relief for the highest earners

From 2011, those people whose income is £150,000 or more will receive reduced tax relief on their personal pension contributions. But instead of a 'cliff edge', the reduction in tax relief will be on a sliding scale, so those who earn £180,000 or more will receive only 20% tax relief. People whose income is between £150,000 and £180,000 will receive tax relief of between 50% and 20%. We believe their tax relief will be reduced by 1% for each £1,000 of income above £150,000.

HMRC wants to introduce equality between those who personally pay contributions and those whose employers pay sizeable contributions. Therefore, it will also apply the restriction on tax relief for the highest earnings to employer contributions. As employees aren't currently taxed on these contributions, this new rule could introduce an additional tax charge on employees.

These changes will become effective in April 2011. Schemes in future will have to let people know the value of their total contributions. For defined contribution arrangements, this is straightforward. But for defined benefit schemes, the process of valuing the total contribution could be complicated. HMRC intends to consult with the industry over the next year on the best way of doing this.

It's important to emphasise that pensions will remain a highly tax-efficient way of saving for the majority of people, and that these changes will only affect a small number of people. But the combination of these two tax changes will significantly reduce the appeal of pensions for the very highest earners in the UK.

## New special annual allowance

As there'll be a two-year gap before the new pension tax rules become effective, HMRC is concerned people may use the opportunity to pay very large contributions into pensions to take advantage of current tax relief levels. To prevent this, it has introduced, with immediate effect, a new special annual allowance on pension savings paid by people whose income is £150,000 or more, to restrict tax relief.

**Below is a brief overview of the rules. For more details, please see our [Budget 2009 - Special annual allowance](#) note, which describes these rules in detail, as the conditions vary according to the type of scheme, and how many people are in the scheme or arrangement.**


The special allowance is £20,000 or 'normal regular ongoing' pension saving if higher. If the allowance is breached, then any excess will receive a tax charge of 20% in the tax year 2009/10, paid through self-assessment. (HMRC has yet to confirm the tax charge for the tax year 2010/11.)

If someone currently saves less than £20,000, they can increase their pension saving to £20,000 with no implications. If they currently regularly save more than this amount, then any new savings will attract a tax charge of 20% in 2009/10.

Any normal regular ongoing pension savings will be protected, and won't count as new or additional savings. For defined contribution schemes, this includes regular pensions contributions paid at least quarterly. But, currently, this doesn't include contributions paid every six months, yearly contributions, recurring single contributions, or ad-hoc single contributions. This will create problems for those who pay on a less regular basis, for example the self-employed, who may not pay contributions until their profits are known, or those who regularly pension their bonus, possibly through bonus-sacrifice.

Any pre-determined increases, such as automatic increases set up for tiered contributions (either age or service), should be treated as normal pension savings.

For defined benefit schemes, generally as long as there have been no material changes to the way benefits are calculated since 22 April, then these will count as normal pension saving. Examples of a



material change could be an increase in the accrual rate or including bonuses in the calculation of pensionable salary for the first time.

However, material changes will be allowed as long as either the increase in pension saving wasn't a result of the change, or there are at least 50 active members in the scheme and the change applies to all of them.

## Examples of how the special annual allowance could work

### Example one – Alan

Alan has a yearly income of £200,000 and his normal regular pension savings are £15,000 a year. After 21 April 2009, he makes additional pension savings of £10,000.

He's liable to the special annual allowance charge on his total savings over £20,000, in other words, on £5,000.

### Example two – Brenda

Brenda has a yearly income of £175,000 and her normal regular pension savings are £25,000 a year.

After 21 April 2009, she makes additional contributions of £10,000. As her normal pension savings were greater than £20,000, she is liable to the special annual allowance charge on all of her increase in savings, in other words, on £10,000.

## Changing jobs and transfers

HMRC has also considered the position if the person changes job. Pension saving will be protected when the individual moves to a new arrangement, generally, as long as there are at least 20 other members under the same scheme who have the same pension basis and there are no material changes. This covers the situation where someone joins a new company and is included in the company scheme. It doesn't, however, cover someone who joins a small company, or who joins a new scheme that covers only a few employees (which may well be the case for very high earners).

This also creates questions for people who are currently paying into a regular saving individual pensions contract and simply decide to transfer or switch administrator. It appears that these people may fall foul of the new special annual allowance rules even if they don't increase their pension saving above the pre-22 April level.

## Refunds

If someone pays a contribution that will breach the special annual allowance, and so attracts the additional tax charge, then HMRC will allow their contribution to be refunded, as long as the individual provides evidence to the scheme administrator.

However, the final decision of whether the refund will be allowed lies with the scheme administrator. The scheme administrator will have to change scheme rules and processes to allow the refund. The scheme administrator can refund a lower amount than the original contribution, if the investment value has dropped or if charges are applied. It's up to the individual to check this before receiving the refund and to decide whether they want to go ahead with the refund or not.

Only personal contributions can be refunded – not employer contributions. And the refund will be taxed to reclaim income tax relief. Individuals must make an amendment to their self-assessment form if they want to claim back the 20% they may have already paid as a special annual allowance tax charge.



## Who does this affect?

The new special annual allowance will only affect those people whose income is £150,000 or more in the current tax year and/or either of the previous two tax years.

Very simply, the income figure is calculated by:

- + adding in earned income
- + adding in most savings and investment income
- + adding in rental income
- + adding in income received by an individual from a trust
- + adding in most pension income (state pensions, occupational pensions and personal pensions)
- + adding in any pension salary sacrifice agreements entered into since 22 April 2009
- deducting the individual's own relievable pension contributions paid (subject to a maximum of £20,000)
- deducting any donations made in that tax year for the purposes of gift aid

The income figure includes any pension salary sacrifice agreements entered into since 22 April 2009, to stop people seeking ways of avoiding the rules.

We don't yet know if these same rules of calculating income will be adopted for the purposes of working out if anyone is subject to the reduced tax relief from 2011.

## What are the implications?

There is no doubt these tax rules will have significant implications for pensions, and especially for very high earners.


### In the short-term

In the period up to 2011, those whose income is £150,000 or more will need to consider whether they wish to make the full use of their special annual allowance of £20,000 for new or additional pension savings. In doing so, they need to be aware of whether their pension saving may breach the lifetime allowance.

These people also need to be careful when making any changes to their pension provision – especially if they've previously made irregular contributions or contributions on a yearly basis. Any break with 'normal regular pension savings' could mean they face a very unwelcome tax charge.

Those who are considering transferring and currently pay a regular contribution of more than £20,000 a year may wish to reconsider their plans, if they're transferring to a small arrangement with fewer than 20 members.

People who earn more than £100,000 may also wish to reconsider their pension saving. Although they're unaffected by the current rule changes, if they believe they may in future earn more than £150,000, then they may want to accelerate their pension funding now while they receive higher rate tax relief.



The Budget also announced changes to personal allowances. From 2010 onwards, the basic personal allowance will be subject to an income limit of £100,000. Those whose 'adjusted net income'<sup>1</sup> is above £100,000 will have their allowance reduced by £1 for every £2 above the income limit, to a maximum reduction of the full allowance. These changes may mean those earning over £100,000 would benefit from considering using pension salary sacrifice.

Scheme administrators – including providers - will also have to take action to consider whether they will allow refunds of personal contributions. If so, communications, processes, and scheme rules will also need to be changed to highlight the refund option. Scheme administrators will also have to change other communications to refer to the new special annual allowance.

## **In the medium term**

In 2011, the tax advantages for pension saving for the very highest earners will be hit. This group of people needs to consider the relative attractiveness of continuing to save in a pension compared to alternative methods of saving. For those in defined contribution schemes, the combination of the reduced tax relief on personal contributions and the new tax on employer contributions probably means that many will stop their contributions.

Those in defined benefit schemes will need to weigh up whether the reduction in their take-home pay plus the new additional tax charge they face on employer contributions is worth it compared to the benefit they will receive. That decision will probably depend upon the benefit the scheme promises them (for example whether any spouse's pension is promised or whether the pension increases in payment), and how far away from retirement date they are.

Again, there are changes scheme administrators have to make in time for 2011. These include changing all communications to reflect the fact that tax relief will no longer be given at the highest marginal rate.

## **How will these changes affect pension saving?**

These proposed changes undermine the A-day agreement, which was designed to promote long-term pension saving, using the standard lifetime allowance to prevent abuse of the system by the rich. That major overhaul of the pensions tax rule was meant to last 30 years rather than three years. Pensions are for the long term so consistency is essential to give people confidence to plan for the future.

Reducing tax benefits may seem a relatively easy way of raising cash but the Budget changes send a message that goes wider than the people directly affected. We can't afford a vicious circle of less engagement with pensions leading to increased temptation for politicians to cut their value.

The Budget only targeted a small minority and, fortunately, for the vast majority of people, pensions are still a good deal. But it sends a wider message, and the more the government alters the rules the less trust people will have in pension saving in the future. That's not conducive to encouraging long-term saving. People need to have confidence in the pension system and certainty the rules won't change so they can plan for their future.

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<sup>1</sup> 'Adjusted net income' is the measure of an individual's income used for the calculation of personal allowances. Broadly, it is the individual's income subject to income tax less specified deductions, including trading losses and payments made gross to pension schemes, individual's Gift Aid contributions and grossed-up amount of the individual's pension contributions which have received tax relief at source. Any relief for payments to trade unions or police organisations is then added back in.



## What this means for you

Advisers need to be aware of the proposed changes, and, once the Finance Bill becomes an Act, of the final rules for tax relief for pensions.

They will need to work with individual clients to establish what it means for their current pension savings, especially where the highest earners pay on a yearly or ad-hoc basis or where they pension bonus payments. Highest earners will also need guidance if they plan to:

- pay additional or higher contributions
- alter benefit structures
- transfer administrators, or
- join new employers' schemes

Trustees and employers will also need help in understanding the new rules, and what action they need to take in both the short term, for example on refunds, and in 2011.

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