Special Annual Allowance

Tech Talk 6 (2009)

The announcement that tax relief on a pension contribution will be reduced to 20% for those with earnings of at least £180,000 from 6th April 2011, has prompted the Government to introduce anti-forestalling provisions that are designed to stop people from increasing their normal rate of pension savings in advance of the new limitation.

How this will be achieved is by introducing a new ‘special annual allowance’ along with a new ‘special annual allowance charge’ of 20%. We will also have ‘protected pension input amounts’ that will protect the pre 22nd April 2009 pension savings rate and also the ‘total adjusted pension input amount’ that will be assessed to the special annual allowance charge.

Who is caught by these new provisions?

It is any individual who in the tax years 2007/08 up to and including 2010/11 has received total relevant income (not just earnings) of at least £150,000.

Total relevant income includes:-

1. All earned income - earnings from employment and self employment, bonus, taxable redundancy payments, pension in payment etc
2. All unearned income - interest, dividends, rental income, trust income, bond encashments

Adjustments are made to the above:-

3. Additions to be made in respect of pension contributions made under net pay arrangements (only applicable to occupational and statutory pension schemes)
4. Additions for salary sacrifice agreements dated 22nd April or later
5. Deductions that are allowable as per section 24 of the Income Taxes Act 2007, e.g. deduction for trade and property losses
6. Deductions for individual pension contributions paid under relief at source up to a maximum of £20,000 gross
7. Deductions for gift aid

The following example will help demonstrate how the above works in practice.

Example 1

Client with total earned and unearned income of £160,000 in 2009/10 tax year and is a member of a non contributory defined benefit scheme. If a net pension contribution of £8,001 is paid the gross contribution is £10,001.25. Deduct this gross contribution from £160,000 and the total relevant income is £149,998.75. Provided the total relevant income in the 2007/08 and 2008/09 tax year is less than £150,000 then the client’s pension contributions will not be assessed against the special annual allowance.
It will be noted from Example 1 that it is not just the tax year that the pension contribution is made that is taken into account in determining total relevant income but also the two immediate preceding tax years.

The next example demonstrates how wide ranging the rules are.

Example 2

A senior manager in a bank is being made redundant after 30 years service having received earnings and bonus of £80,000 in the 2009/10 tax year. The redundancy payment is £120,000, £30,000 tax free £90,000 taxable. The client will have total relevant income of at least £150,000. Any action taken to sacrifice part of the taxable redundancy payment, for example to provide a pension contribution will not reduce the total relevant income.

Anti avoidance provisions have been introduced here in that if HM Revenue and Customs considers that an individual has entered into an agreement to try and reduce their total relevant income below £150,000 then the legislature will assume that they earn £150,000. Examples given include reducing the income by moving some of this into another scheme year, turning income into capital, and using artificial losses.

If the total relevant income in the respective tax year is at least £150,000 how much of the pension saving is assessed?

Thankfully valuing pension savings is the same as for the annual allowance i.e. the gross contribution when it is a money purchase arrangement and 10 times the increase in the defined benefit. What is different is the period that the pension savings are valued. It is the tax year and not the pension input period ending in the tax year. This will cause a problem for defined benefits scheme with pension input periods that do not end on 5th April. So if you have already calculated the value of pension savings for annual allowance purposes this is unlikely to be the same as the value for the special annual allowance.

Example 3

A client who has total relevant income in excess of £150,000 is a member of a defined benefit scheme and receives the annual member statement showing that on 6th October 2009, the annual pension of £20,500 based on 20.5 years service and a pensionable salary of £60,000. The accrual rate has been 1/60th throughout. The previous statement as at 6th October 2008 quoted an annual pension of £18,525 based on salary of £57,000. Therefore for annual allowance purposes the pension saving is valued at £19,750. For special annual allowance purposes the pensionable salary on 5th April 2010 is used and 21/60th is used to calculate the pension benefit and 20/60th is used for the pensionable salary on 6th April 2009. If we assume that the salary of £57,000 increased to £60,000 on 1st May 2009, then the pension on 6th April 2010 is £21,000 (21/60 x £60,000), and on 6th April 2009 is £19,000. Therefore for special annual allowance purposes the pension savings is valued at £20,000.

There are deductions that apply that will reduce the value of the pension savings to be tested against the special annual allowance:

1. 'Protected pension input amount', which represents the regular savings made during 2009/10 and 2010/11 in respect of an arrangement that started prior to 22nd April 2009. Regular savings in respect of money purchase arrangements and AVCs are those paid no less frequently than quarterly.

2. Refund of certain personal contributions can be made in respect of the individual for the tax year in question.

3. For the 2009/10 tax year only, certain pension savings made in the period 6th April 2009 to 21st April 2009.
A protected pension input amount is the amount of the ongoing regular pension savings that was established prior to 22nd April 2009. If there is a material change to the pension savings then this change will not normally be included in the protected pension amount. In a defined benefits scheme a material change would include an increase in the accrual rate, a change in the definition of pensionable salary, an extension of pensionable service. The material change can be ignored where it applies to at least 50 members of the scheme.

After applying any deduction to the total pension input amount the balance known as ‘the total adjusted pension input amount’ is tested against the special annual allowance.

Can I get a refund of my contribution?

A refund of personal contribution (or as HM Revenue and Customs call it 'contribution refund lump sum') can be paid from personal pension schemes (including retirement annuity contracts) and additional voluntary contribution schemes if the scheme rules allow payment of a refund of the pension contribution that would attract the special annual allowance charge. The refund will be made in the tax year following the tax year that the contribution was paid in and will have tax deducted at 40%. If a client with enhanced protection pays a contribution that would suffer a special annual allowance tax charge and applies for a refund, enhanced protection will not be re-instated.

Will I be able to avoid the Special Annual Allowance Charge in the last year?

Contributions paid in a tax year to an arrangement where all of the benefits are crystallised are not assessed against the annual allowance in that tax year. This exception does not apply to the special annual allowance. The rules for the special annual allowance are more restrictive. The following circumstances will not cause the contribution to be assessed against the special annual allowance:-

A defined benefits arrangement where there are at least 20 members (active and pensioner members only) in the scheme, and the main reason for taking benefits is not to avoid the special annual allowance.

Benefits are being paid as a result of ill health from an arrangement in an occupational scheme, public service pension scheme, or a group personal pension scheme.

Specific mention is made of the special annual allowance applying on death and on payment of a serious ill health lump sum.

How is the special annual allowance tax calculated?

The maximum special annual allowance threshold is £20,000. If the total pension savings are greater than £20,000 then the total adjusted pension input amount above the £20,000 threshold is taxed at 20%. To determine the amount of special annual allowance that can be set against the total adjusted pension input amount, the maximum special annual allowance is reduced by the protected pension input amount and pre 22nd April 2009 contributions to a money purchase arrangement paid less frequently than quarterly. Where the protected pension input amount is greater than £20,000 then the special annual allowance reduces to £0, and all the adjusted pension input amount will be taxed at 20%.

The scheme member is liable for the tax charge and it will be collected via the self assessment tax return.

The current annual allowance remains unchanged. It is possible that a client could suffer a special annual allowance charge and not an annual allowance charge. Where both charges apply then the excess adjusted pension input amount is reduced by the pension saving that is subject to the 40% annual allowance charge.

Example 4
A client has relevant income of at least £150,000 and that the pension input period is the same as the tax year. The pension input amount for 2009/10 tax year is £295,000. The annual allowance tax charge is £20,000 \[40\% \times (£295,000 - £245,000)\]. The pension input amount is not a protected pension input amount and so the special annual allowance charge is based on the value above the special annual allowance threshold i.e. £275,000 (£295,000 - £20,000). However this amount is reduced by the amount that is subject to the annual allowance charge i.e. £50,000. So the special annual allowance charge is £45,000 \[20\% \times (£275,000 - £50,000)\].

Example 5

If we use example 4, but add that the £295,000 comprises of a regular employer contribution of £20,000 per month that started before 22\textsuperscript{nd} April 2009 and a bonus sacrifice agreement of £55,000 was made after this date, the regular employer contribution will be a protected pension input amount. The annual allowance tax charge is £20,000 as per example 4. However the special annual allowance threshold is reduced to £0, and the special annual allowance would be based on £55,000, but this is reduced to £5,000 by the amount subject to the annual allowance charge. Therefore the special annual allowance charge is £1,000.

The special annual allowance has been introduced as a disincentive for those with income of at least £150,000 from taking advantage of the marginal rate relief by increasing their normal pension savings. However the special annual allowance can be more penal than removing the marginal tax relief. Consider the following example.

Example 6

Client earns £150,000 and pays a net contribution of £120,000 on 1\textsuperscript{st} July 2009. Assuming a personal allowance of £5,000 the tax liability is £50,520 before payment of the pension contribution and £29,000 after payment of the pension contribution.

A special annual allowance charge of £26,000 is due \[20\% \times (£150,000 - £20,000)\]. This is greater than the marginal rate tax relief of £21,520 saved as a result of the payment of the pension contribution. Put another way the client has lost more than the marginal rate relief.

Obvious comment would be for the client not to pay the maximum of £120,000 net and limit the contribution to the higher rate tax band of £107,600, which is £86,080 net. But what if the employer pays £42,400 gross, this produces the same result!

**What planning opportunities will this affect?**

The following apply to those clients who have total relevant income in excess of £150,000.

Clients with pension savings paid less frequently than quarterly e.g. annual contributions, regular singles, and half yearly contributions.

Clients who at the end of the tax year decide how much to invest once total taxable income is known. For them a regular variable annual contribution is not a regular contribution.

Members of defined benefits scheme need to be careful. For example a client with pensionable salary of £120,000 with an accrual rate of 1/60\textsuperscript{th} will have used all of their special annual allowance if they gain benefit in the scheme for not less than one year. As per example 3 above the longer pensions service requires a lower pensionable salary to exhaust the special annual allowance.

Paying personal contributions on a bi-annual basis where more than one annual allowance used in a tax year.

Paying large pension contributions prior to retirement.
Clients who are in receipt of pension and re-invest the excess pension as an annual pension contribution.

These are our initial thoughts on who will lose out, I am certain that time will uncover more.

**Future**

We do not know if similar rules will apply from 6th April 2011 using the special annual allowance to reclaim the marginal rate of tax. In particular will the protected pension input amounts be retained? Or will the £20,000 threshold be retained? Also what happens to defined benefit scheme members who leave the pension scheme without preservation but suffer a special annual allowance charge during membership of the scheme?

**Conclusion**

The Government have obviously put a great deal of thought into this (although I could say not enough) given the detail produced that contains a number of anti-avoidance rules. It does seem overly complicated but the plus side is the increase in the need for financial advice. However giving advice during a tax year could be complicated based given the fact that an educated guess is going to have to be made with regards to other relevant income that an individual may receive during the remainder of the tax year. There will be certain occasions where this will not be possible e.g. redundancy. Why penalise pension savers who pay contributions less frequently than quarterly? The rules regarding recycling of pension commencement lump sum allow for regular contributions on an annual/regular single basis, why can’t the proposed legislation include something similar? It is proposed legislation that has been produced hopefully the Government will listen and not penalise those that were not intended to be caught by this.

Please note that every care has been taken to ensure that the information provided in this guide/article is correct and in accordance with our understanding of current law and HM Revenue & Customs practice. You should note however, that James Hay cannot take upon itself the role of an individual taxation adviser and independent confirmation should be obtained before acting or refraining from acting upon the information given. The law and HM Revenue Customs practice are subject to change.

**Fraser Grant - April 2009**