May 2010

Review

Pensions

Looking ahead to 6 April 2011

Taxation of Pensions for "High Income Individuals" and Employer Financed Retirement Benefit Schemes (EFRBS)

INTRODUCTION

With effect from 6 April 2011 individuals with income of £180k or more will become subject to legislation which is designed to reduce the value of the tax relief on their pension contributions to registered pension plans from 50% to 20%. Individuals with income in the range between £150k and £180k will be subject to a phased restriction, with the relief tapering down from 50% to 20%. The legislation contains measures to block attempts to side step these rules by putting individuals whose pension input is funded by employer contributions in a similar position to individuals whose pension input is funded from employee pay.

The legislation will give effect to the restriction on the tax relief by making individuals subject to a tax charge on their pension contributions whether the pension contributions are made by the individual or the employer. The tax charge is imposed on the pension contributions (whether made by the employer or the employee) at the 1% rate for an individual with income of £151k rising to 30% for an individual with income of £180k. Further the employee and the employer contributions are added back in when determining whether an individual is a "high earner" for these purposes.

Many companies have begun researching unregistered pension plans (or EFRBS) as an alternative tool for remunerating high earners. This note summarises a number of the key tax issues associated with EFRBS. It assumes that EFRBS will only provide pension benefits and that they will not loan the trust funds to prospective pensioners - in other words the EFRBS will act akin to a registered pension plan and not as a general employee benefit trust.

This note is intended as a general guide only. It does not constitute tax advice. Each specific circumstance needs to be considered on a case by case basis.

TAXATION OF CONTRIBUTIONS INTO AN EFRBS (INDIVIDUAL'S PERSPECTIVE)

All contributions to an EFRBS have to be made by the employer. Where the funding would otherwise come from the employee, a salary sacrifice arrangement can be put in place to convert the income into an employer contribution.

Employer contributions to an EFRBS can be received free of income tax and national insurance.

This contrasts favourably with the post 6 April 2011 tax position where high earners are charged to income tax on employer contributions to registered pension plans (with the tax being collected through self-assessment). Please see the illustrations in the Appendix.

TAXATION OF CONTRIBUTIONS INTO AN EFRBS (EMPLOYER'S PERSPECTIVE)

No corporation tax deductions will be available for payments into EFRBS until pension benefits are paid out. By contrast, registered pension plans offer immediate corporation tax relief. Employers therefore need to make sure that any EFRBS they establish maintain records of the pensions benefits paid out in order to enable the crystallisation of the tax deductions. The delay in claiming the deduction will be less of an issue if the employer is currently loss making and/or the beneficiary is close to retirement.

It may also be possible to structure the employer contributions so that they do not crystallise into a profit and loss charge until pension benefits are paid out.

TAXATION OF FUNDS IN AN EFRBS

Unlike registered pension plans, EFRBS are not governed by a special taxation regime. The precise tax treatment will depend upon whether it is set up on-shore or off-shore and where its beneficiaries are based.

If an EFRBS is set up off-shore, it will not pay UK tax on its capital gains and will not be taxed on non-UK source dividend income. An off-shore EFRBS will, however, be taxed on UK source dividend income if it has UK beneficiaries.

An EFRBS can be structured so that it avoids inheritance tax charges. However, there are specific inheritance tax issues for "family" or "close" companies which need to be considered on a case by case basis.

TAXATION OF BENEFITS PAID FROM AN EFRBS

UK tax residents will be subject to income tax on pension benefits paid to them by an EFRBS. It may be possible to plan the timing of the benefit payments so that they are paid out when the individual is subject to a lower income tax rate, see the illustration below.

If the pension benefits are provided by an EFRBS in a similar fashion to the pension benefits provided by a registered pension plan there will be no national insurance to pay on such benefits. This could prove to be very attractive to the employer - from 6 April 2011 it is proposed that the employer's national insurance rate will rise from 12.8% to 13.8%.

ILLUSTRATION OF A POST 6 APRIL 2011 EMPLOYER EFRBS CONTRIBUTION

X is aged 54 and employed by ABC PLC. X is entitled to £200k salary and a £100k EFRBS contribution.

(a) The EFRBS receives the £100k free of income tax and national insurance.

(b) If X had taken the £100k as salary instead, ABC PLC would have incurred an employer's national insurance cost of £13.8k. X would have received £48k net (£50k of income tax and £2k of employees' national insurance would have been deducted).

X ceases to be a higher rate tax payer on retirement at the age of 55.

X uses the £100k in the EFRBS to buy an annuity for £75k and he takes the £25k balance as a lump sum. This produces the following benefits:

(a) X is charged to income tax on the lump sum and the annuity at the 40% rate rather than the 50% rate;

(b) There is no employees' national insurance at the 2% rate for X;

(c) ABC PLC has mitigated the 13.8% employer's national insurance cost;

(d) A corporation tax deduction crystallises for ABC PLC because X has taken pension benefits from the EFRBS.

APPENDIX

This appendix contains 3 illustrations on how the high earners charge will operate from 6 April 2011. The illustrations show the impact of employer pension contributions to registered pension plans being treated identically to employee contributions.

Illustration 1

A has income of £140k and receives an employer contribution of £40k. A has deemed income of £180k. A incurs an income tax charge of £11k on the employer contribution.

Working:

- £30k taxed at 30% (£9k) restricting the value of the 50% relief on the pension input between £150k and £180k to 20%;
- £10k taxed at 20% (£2k) restricting the value of the 40% relief on the pension input between £140k and £150k to 20%.

Illustration 2

B has income of £135k and he receives an employer contribution of £20k. B's deemed income is £155k. B incurs an income tax charge of £250 on the employer contribution.

Working:

- The object of tapering is to restrict B to 45% tax relief. This is because B has taxable pension income of £155k (B is £5k away from £150k where the full 50% relief is available).
- B gets a 5% charge on £5k. Therefore B has a £250 tax bill. The 5% charge on the input between £150k-£155k cuts the rate of relief to 45%.
- NB: There is no additional tax charge on the input between £135k and £150k. This is because B's deemed income is less than £160k and the contribution has received relief at a 40% rate, which is lower than the 45% rate which the relief is restricted to.

Illustration 3

C has income of £140k and receives an employer contribution of £30k. C has deemed income of £170k. C incurs a £5k income tax charge on the employer contribution.

Working:

- The object of tapering is to restrict C to 30% tax relief on the entire £30k contribution. (NB: C is £10k away from £180k where just 20% relief is available).
- There are special rules which apply where an individual has deemed income of £160k or more (i.e. there is a restriction of the tax relief to below 40%). These rules require that the pension input between £140k and £150k, which is relieved at the 40% rate, is taxed to reduce the value of the relief to below 40%.
- £20k (i.e. the difference between £150k and £170k) taxed at 20% = £4k (this cuts the rate of the relief on the pension input between £150k and £170k to 30%)
- £10k (i.e. the difference between £140k and £150k) taxed at 10% = £1k (this cuts the rate of the relief on the pension input between £140k and £150k to 30%).

CONTACT DETAILS

For further information please contact:

Francois Barker
Head of Birmingham Pensions
T: +44 (0)121 222 3584
francois.barker@hammonds.com

Catherine McKenna
Head of Leeds Pensions
T: +44 (0)113 284 7045
catherine.mckenna@hammonds.com

Wendy Hunter
Head of London Pensions
T: +44 (0)207 655 1119
wendy.hunter@hammonds.com

Steve Southern
Head of Manchester Pensions
T: +44 (0)161 830 5172
steve.southern@hammonds.com

Emma King
Head of Pensions Disputes
T: +44 (0)121 222 3103
emma.king@hammonds.com

Timothy Jarvis
Chartered Tax Advisor
T: +44 (0)113 284 7214
timothy.jarvis@hammonds.com

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