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Review

Pensions and Tax

Clearing a way through the tax jungle

The Budget 2009 introduced a series of reforms to the UK's income tax and pensions tax relief rules. From 6 April 2010 the income tax rate on income of £150k or more will be increased to 50%. From 6 April 2011 the rate of tax relief on pension contributions for those with income of over £180k will be restricted to 20% with the relief tapering from 40% to 20% on income between £150k - £180k.[1] Further, to combat measures taken to minimise the effects of the post 6 April 2011 changes, the Finance Act 2009 has implemented anti-forestalling rules.

The challenge facing high earners, those who employ high earners, and trustees of pension schemes whose members include high earners, is that these different sets of rules do not operate in isolation to each other. If an individual wishes to implement an effective income tax planning strategy the impact on his pension position must be considered and vice versa.

Our first article "Anti-what???" (good question!) looks at the anti-forestalling provisions, giving examples of how individual high earners are affected by these rules. We follow this with a strategic assessment of ways in which income can be structured under "Remuneration strategies" and consider how HMRC may view these in the light of its anti-avoidance measures.

"The 60% income tax trap" highlights the pitfall for those earning between £100k - £113k. We conclude by taking a look at the opportunities for tax refunds. Trustees may be able to gain a refund of withholding tax on dividends received from investments in other EU countries. There is also the opportunity for reclaiming VAT on investment management fees. Our VAT experts advise trustees to "pursue this matter without delay".

We hope that you find this a thought provoking read.

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Anti-what???

The Government intends to limit the tax relief on pension contributions for high earners from April 2011. To prevent taxpayers accelerating contributions to beat the change, special rules have been introduced to impose a tax charge on "excess" contributions. As a result, taxpayers and the pensions industry have been introduced to the concept of "anti-forestalling" legislation: rules designed to block action that might have been taken to take the sting out of a future change in tax law.

1 No published legislation or guidance has as yet been received on the post 6 April 2011 pensions tapering. However, Mr John Whiting of the Chartered Institute of Taxation has provided some helpful insights on how the 6 April 2011 rules might work. Assume that an individual with income of £200k makes a post 6 April 2011 pension contribution of £100k. Mr Whiting speculates that the £20k excess over £180k will attract 20% relief, that the £30k between £150k and £180k will attract 30% relief and that the £50k between £100k and £150k will attract 40% relief.

The anti-forestalling legislation contained in this year's Finance Act is so complex that it has resulted in the issue of some 50 pages of guidance from HMRC. Individuals who are likely to be caught by the rules, as well as employers and pension scheme trustees who have scheme members who may be caught, need to pay close attention to the way the rules operate. Particular care is needed where enhanced contributions may be made or the pension scheme is to be amended to alter members' entitlement to benefits.

In this article, we attempt to cut through the jargon to identify how the rules will operate in practice.

Summary

Key points on the anti-forestalling rules:

- They apply to individuals whose relevant income exceeds £150,000 in the current or earlier tax years.
- The rules are expected to apply in 2009-10 and 2010-11 only.
- They impose a 20% special annual allowance charge ('SAAC') on contributions that exceed a special annual allowance (which can vary according to the taxpayer's circumstances).
- Some taxpayers may be able to withdraw contributions already made to their pensions.

The overall effect is to limit the tax relief on excess contributions to the basic rate of 20% in 2009-10. It seems likely that the rate of the SAAC will increase to 30% in April 2010 to take account of the 50% tax band (assuming the basic rate remains at 20%).

Who is caught?

The rules apply to anyone whose "relevant" income exceeds £150,000 in the current tax year or either of the previous two tax years. This involves taking taxable income from all sources, adding back pension contributions paid under net pay or salary sacrifice arrangements, then deducting personally funded pension contributions (subject to a cap of £20,000), charitable donations and certain other tax reliefs. If HMRC considers that the taxpayer has entered into a scheme or arrangement to reduce his relevant income below £150,000, then it can deem his relevant income for the year to be £150,000.

The way the test looks backwards could operate harshly in the current economic climate. An individual whose income is below £150,000 in the current year (perhaps because there is no entitlement to a bonus), will nevertheless be caught if his income last year or the year before was above this amount.

Protected pension inputs

Broadly speaking, someone whose income is above the £150,000 threshold will get full tax relief on pension contributions up to £20,000 in 2009-10 and 2010-11. The limit will, however, vary depending on the individual's personal circumstances and could be higher than £20,000. This is because the rules protect regular (ie, quarterly or more frequent) contributions at a higher level, provided these were set up before Budget Day (22 April 2009). There are also special rules where contributions have been made less frequently than quarterly. In this case, the limit is the lower of £30,000 and the individual's average contributions made in the three years from April 2006 to April 2009.

The way the various aspects of the rules work in relation to defined contribution pension schemes is best illustrated with some examples.

Example	Effect
Amy was making monthly contributions of £3,000 before Budget Day and continues to contribute at this level throughout 2009-10.	Amy's contributions are "protected pension inputs" and, although they will total £36,000, Amy will not be subject to the SAAC on them. However, if she makes additional contributions during the year (but see below in respect of increments attributable to pay rises), these will be subject to the charge. This is because Amy has used up her £20,000 allowance.
Ryan makes monthly contributions of £1,000. In previous years, he has also made lump sum top up contributions: £32,000 in 2006-07, £9,000 in 2007-08 and £25,000 in 2008-09.	Ryan's average lump sum contribution over the relevant three years is £22,000 so this is the limit on contributions he can make without incurring the SAAC. After deducting the £12,000 regular contributions he will make in 2009-10, he could make a further lump sum contribution in the current year of £10,000 before incurring the SAAC.
Peter makes annual contributions of varying amounts but no monthly contributions.	Peter's protected pension inputs will be the average of the contributions made between April 2006 and April 2009, subject to a cap of £30,000. If he contributed £200,000 in 2006-07, nothing in 2007-08 and £100,000 in 2008-09, his average contributions are £100,000. Since this exceeds £30,000, he can contribute up to £30,000 in 2009-10 without incurring the SAAC.
Elaine joins a non-contributory scheme in June 2009 and her employer makes contributions of £50,000 before April 2010.	The contributions exceed Elaine's allowance of £20,000 so the excess of £30,000 is subject to the SAAC.

With defined contribution schemes, it is reasonably easy to identify the amount of contributions made by or on behalf of an individual to the scheme. In the case of defined benefit schemes, more complex rules apply. Generally speaking, if contributions were set up before Budget Day and these continue in 2009-10 and 2010-11 to purchase "added years", then those contributions will be "protected". However, there is an additional condition that there must not be a material change in the scheme that, broadly, allows the individual to accrue greater benefits from the scheme.

The anti-forestalling rules take account of contributions made by the individual as well as their employer. As we have seen, regular and irregular contributions are looked at. This will include Additional Voluntary Contributions as well as contributions made through salary sacrifice arrangements. Increased contributions that are linked to pay rises or that are spiked because of a bonus payment should count as protected inputs but only where these increases were built into the pension scheme rules before Budget Day. For example, if Amy's monthly contributions increased in October 2009 to £3,300 as a result of a pay rise awarded to her, those additional contributions made in 2009-10 would not be subject to the SAAC if the pension scheme rules already provided for such an increase before 22 April 2009. If the pension scheme is subsequently amended to allow for the increase or to change the rate of contributions, the additional contributions will not be protected.

Great care should be exercised where scheme amendments or revised contribution rates are proposed over the next two years to ensure that the potential application of the SAAC is considered.

How does it work?

The SAAC will be collected directly from taxpayers through their self-assessment tax returns. It will be imposed for the current year at the rate of 20% (and can be expected to rise to 30% next year when the 50% income tax rate comes into effect).

The SAAC does not affect the availability of tax relief on pension contributions up to the annual allowance of £245,000 (or the individual's income, if lower) in the current tax year. Where contributions exceed the special annual allowance, full tax relief should still be claimed on the annual tax return. The SAAC will then effectively negate the higher rate tax relief that the individual has claimed. The net effect is to limit tax relief to the basic rate of 20% on contributions that exceed the special annual allowance in 2009-10. In the case of employer contributions and contributions under salary sacrifice arrangements, the SAAC will represent a real cash cost to the individual.

Refunds

Since the SAAC will be collected under self-assessment, employers and pension scheme trustees will not generally be directly involved in the calculation of the SAAC or its collection but may need to give affected employees guidance. However, there is one aspect of the rules that employers and trustees do need to consider: the possibility of refunds of contributions made in 2009-10 to affected individuals.

The SAAC was introduced with immediate effect at noon on 22 April 2009. It is therefore possible that someone may be unexpectedly caught by the anti-forestalling rules because of contributions made between 5 April and 22 April. To cater for this, the anti-forestalling rules permit pension scheme trustees to refund contributions (assuming the scheme rules allow this) to reduce the total contributions made in the current tax year. The refund cannot be made before 6 April 2010 and cannot include employer contributions. The pension scheme will be subject to tax at 40% on the amount refunded. Trustees should therefore approach this issue with great care.

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Remuneration strategies

Relevant income

As discussed in our first article "Anti-what???", Schedule 35 of the Finance Act 2009 ('Schedule 35') imposes a special annual allowance charge where an individual's total adjusted pension input amount exceeds the special annual allowance. As a pre-condition, the individual must have relevant income of £150k and will be treated as being "caught" by this limit if he has relevant income of £150k in the current and/or any of the two preceding tax years. Therefore, individuals with a variable income profile, such as the self-employed, may inadvertently find themselves caught by the new rules.

The definition of relevant income covers all of an individual's income and not just income derived from an employment or a trade. The receipt of dividend income could result in individuals inadvertently falling within Schedule 35. This is because UK (and now non-UK source) dividends are grossed up for income tax purposes by the fraction 100/90 in order to give the individual recipient a tax credit. Therefore a cash dividend of £9k would be treated for tax purposes and for relevant income calculation purposes as having a value of £10k.

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The onset of the recession has tragically led to many individuals in the UK facing redundancy and/or being dismissed. Assume that an individual is entitled to £50k as part of a termination settlement and this £50k is paid into his pension scheme. The risk is that the £50k will be treated as a salary sacrifice (see the discussion below) and will be added to an individual's income for the purposes of calculating the £150k threshold. Further, the £50k contribution will be treated as part of the individual's total adjusted pension input – it cannot be a contribution of a regular nature due to the one off nature of the payment.

Salary sacrifice arrangements

Schedule 35 includes a salary sacrifice arrangement within the definition of relevant income for the £150k test. A salary sacrifice arrangement is a scheme "… in pursuance of which the individual gives up the right to receive general earnings or specific employment income, and an employer of the individual or any other person agrees to pay contributions to a pension scheme in respect of the individual..." Clearly this will catch a conventional salary sacrifice arrangement. However, it may also catch a broader scope of arrangements.

There was some uncertainty over whether the salary sacrifice definition would catch a discretionary bonus arrangement. Under the terms of a discretionary bonus arrangement an individual would inform his employer that, rather than receiving a bonus, he would take a payment into his pension scheme instead. The argument was, that as the individual had no entitlement to the bonus, the arrangement fell outside the definition of a salary sacrifice. HMRC's guidance notes indicate[2] that this type of approach must be treated with caution and implies, without discussing the technical details, that bonus sacrifice arrangements are caught.

Hammonds' understanding is that the definition of salary sacrifice is being closely looked at in the Owner Managed Business sector. Assume that there is an individual who regularly takes substantial income payments (whether dividend or salary) from the company which the individual controls. The individual may elect not to declare bonus payments and/or dividends and to have the company make payments into a pension scheme instead. The argument here is that the employer contributions will not be salary sacrifices because the individual is not giving up a legal right to income against the company. It should be noted, however, that even if this argument is successful, Schedule 35 contains anti-avoidance provisions which apply where the main purpose or one of the main purposes of a scheme is to bring the relevant income below £150k. In such circumstances the relevant income is treated as being £150k (this is discussed further below).

Income acceleration

Income acceleration is a possible planning tool to mitigate the effects of the 50% tax rate applying from 6 April 2010.

In essence, an income acceleration arrangement is straightforward. A company which would, but for the proposed tax rate increases, be looking to pay a dividend or bonus payment on or after 6 April 2010 looks to accelerate the payment before that date to lock into the lower tax regime. Typically the acceleration arrangement would be accompanied by a mechanism under which the individual loans the after-tax amount back to the payer company with the loan being unwound when the dividend or the bonus would have otherwise been payable and, potentially, the arrangement may contain a facility for the payee to fund any accelerated PAYE and employee national insurance costs.

Assume that an employee is entitled to a bonus of £100k on 1 October 2010, conditional on him being an employee on that date. The bonus is accelerated to 1 April 2010 and the employee receives £59k, net of PAYE and employees' national insurance contributions. The £59k is lent back to the company. Arrangements may be put in place to require the employee to fund the cash flow cost for the company of the PAYE and employees' national insurance contributions.

The consequence of an income acceleration arrangement is that it results in the payee recognising more income than would otherwise have been the case in 6 April 2009 - 5 April 2010 creating a greater risk of the £150k relevant income limit being passed.

The main purpose tests

HMRC has recognised that taxpayers will attempt to structure their financial arrangements around the Schedule 35 anti-forestalling rules. The legislation contains its own "mini anti-avoidance provisions" which are designed to prevent this. Paragraph 2 of Schedule 35 provides that where the main purpose or one of the main purposes of a scheme is to secure that the individual's relevant income is below £150k, then it is assumed to be £150k. Further, paragraph 6 of Schedule 35 provides that if there is an arrangement which has as its main purpose or one of its main purposes the avoidance of a special annual allowance charge then this arrangement

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2 See HMRC's guidance note - RPSM15101070

is to be set aside. The risk is that many of the income tax planning techniques, which have the effect of minimising the income amount which is subject to the 50% tax rate, could have the effect of an individual falling inadvertently within these provisions.

The main purpose tests are not, however, a general anti-avoidance antibiotic for HMRC. They must be applied within the boundaries set out by case law. The operation of a main purpose test received its most recent judicial consideration by the Special Commissioners in *Prudential v IRC 2008*[3]. Here the Special Commissioners discussed with approval the test set out by Lightman J in *IRC v Sema*: "The tax advantage may not be a relevant factor in the decision to purchase or sell at a particular price. Obviously if the tax advantage is mere "icing on the cake" it will not constitute a main object". The Special Commissioners took the view that a "main object" in this case has parallels with the "main purpose" test for anti-avoidance, and unless it can be demonstrated that the tax advantage is only the "icing on the cake" in relation to a transaction then it will be caught by the main purpose tests. The Special Commissioners' analysis was not discussed at the High Court level where judgment was handed down in favour of HMRC on different grounds. However, the Special Commissioners' analysis is likely to be favoured by HMRC because it subtly departs from earlier versions of the test which focussed primarily on a person's subjective intentions. The remainder of this sub-section discusses income tax arrangements that could be caught by the main purpose tests.

Income deferral. Taxpayers who are considering avoiding the 50% tax rate may wish to consider an income deferral arrangement. Taxpayers may wish to defer the receipt of taxable income until their income tax liability falls to a lower rate than 50%. Alternatively, 50% taxpayers who are approaching retirement may wish to defer the recognition of taxable income until their retirement. For example, a bonus which would otherwise be payable in the year before retirement could be paid to the relevant individual on a "drip" during the retirement period in order to enable it to be recognised when the individual is subject to a lower rate of tax. Income deferral arrangements are relatively easy to structure. In general terms, income is recognised for employment income purposes when the taxpayer has an unconditional right to it. A bonus award can, therefore, be deferred by making it subject to conditions. In the Owner Managed Business context the position may be even more straightforward. The proprietor could simply elect for the company not to pay out dividends or declare a bonus. Although these arrangements are designed with the purpose of avoiding the 50% tax rate, they will also have the consequence of deferring the recognition of income for the £150k test. HMRC may therefore seek to argue that a main purpose test should be applied in order for this income to be added back for calculating the £150k limit.

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Loans. There is no general rule of UK tax law which reclassifies loans from employers to employees as being remuneration payments. Normally, if an employer makes a loan to an employee the income tax charge is calculated on the difference between HMRC's official rate of interest and the interest actually paid by the employee in a tax year. Hammonds is aware of loans to employees being marketed as a 50% income tax rate planning tool. There are different versions of these arrangements. For example, if an employer makes a loan to an employee and there is an understanding that the loan will be written off at a future stage, HMRC may argue that this is not a loan within the meaning set out in the legislation, with the consequence that the arrangement should be treated as a remuneration payment. However, even if the taxpayer argues successfully that the loan should be treated as a loan, HMRC may respond by saying that it is part of an arrangement which has as its main purpose, or one of its main purposes, the reduction of relevant income to below £150k.

Income shifting. This is being promoted as a method of mitigating the effects of the 50% income tax rate. At its simplest, income shifting involves an individual transferring assets which generate a right to income to a person with a lower effective tax rate. Examples of income shifting arrangements are discussed below.

- Assume that A and B are partners in an unincorporated business. From 6 April 2010 they will incur income tax at the 50% rate on the income which they derive from the partnership in excess of £150k. The individuals may wish to incorporate their business and there are provisions within tax legislation which allow this to occur on a tax neutral basis. The key advantage to incorporation is that income profits which accrue in the corporate vehicle will be taxed at a maximum rate of 28%. There will be a further income tax charge when the profits are distributed from the company. However, this need not be an issue if A and B are looking

3 Special Commissioners Decisions SpC 636

to retain profit in the business and/or if A and B can control the payment of the income to them so that it is only received when they are subject to lower income tax rates.

- Continuing with the example, a further illustration of income shifting would be if A and B decided to transfer shares in their company to their spouses/civil partners, A1 and B1. This transfer could occur on a no gain/no loss basis. Assuming that A1 and B1 have no other income, they could receive dividends up to the basic rate limit with no income tax to pay due to the availability of tax credits. HMRC challenged this income tax planning in the *Arctic Systems* litigation and it was unsuccessful in the challenge. The House of Lords held that so long as the shares transferred held other rights apart from dividend rights (such as voting rights and the ability to participate in capital growth) then the income transferred could not be re-attributed back to the transferor.

The income shifting arrangements described above are being widely considered and, if implemented properly, they would appear to have a good chance of success under current law. However, the Schedule 35 implications of these arrangements would need to be considered to see if they form part of an arrangement which has as its main purpose bringing relevant income below the £150k limit.

Capital gains

Tax treatment

The UK currently taxes capital gains accruing to individuals at a flat rate of 18%. In certain circumstances, individuals may be able to qualify for entrepreneurs' relief from capital gains tax which will cut the effective tax rate on the first £1m of gain to 10%. All UK taxpaying individuals are better off paying capital gains tax than paying the basic rate of income tax which is set at 20%.

An effective remuneration strategy may therefore be to structure much of an individual's reward as capital gain. This will mitigate the consequences of the 50% tax rate. Further, to the extent to which an individual's relevant income can be pushed below £150k, then it may be possible to mitigate the effects of the anti-forestalling measures set out in Schedule 35 and the restrictions on the availability of pension tax relief which will apply with effect from 6 April 2011.

An effective remuneration strategy may be to structure much of an individual's reward as a capital gain.

Individuals can use a combination of the different tax rates on income and capital gains and pension contributions to generate an effective tax saving. Assume that an individual has relevant income of £150k and capital gains (after the capital gains annual allowance) of £50k. The individual makes a pension contribution of £41k of income ie at an amount equal to 82% of the capital gain. The £41k pension payment will attract tax relief at the 40% rate. £41k x 100/60 = £68.33k.

Therefore the tax saving of £27.33k can be used to finance the £9k tax liability on the £50k of capital gains leaving the individual with a £18.33k reduction in tax on his income tax bill.

Can income be turned into a capital gain?

This section sets out a number of the structures which could be used to ensure that amounts which would otherwise be part of an individual's relevant income are taxed as capital gains. The structures cover a wide variety of different situations. What they generally have in common is that they require the relevant individual to hold share capital or an equity instrument.

HMRC has approved products which are designed to enable individuals to be rewarded with capital treatment on their gains. For example, HMRC has established Company Share Option Plans and Enterprise Management Initiative Option Arrangements where all, or a significant part of, an individual's reward can be taxed as a capital gain.

In general terms, if an employee is rewarded in share capital, any increase in the value of the share capital (unless it occurs as a consequence of artificial operations) is taxed as capital gain rather than as income. If an individual can be rewarded with a class of equity which has a low value on acquisition then any upside will be taxed as capital gain. This technique could be used to incentivise new managers to turn around a distressed corporate. Further, it is possible to structure a company's share capital so that it is divided into different classes of share. Even if the company's ordinary shares have an equity value it is possible to create other classes of share, which could include new shares with very limited economic rights, which would only become more valuable if the company's equity value increases.

There are also planning structures which are designed to enable owner managers to turn income into capital in respect of the companies which they own. It may be possible for an owner manager to sell his company to a Newco in return for an equity interest in that company and for a cash or a cash equivalent payment. This is a complicated area in its own right. However, depending upon the factual position, these arrangements can be structured so that all or a significant part of the cash-out payment can be taxed as a capital gain rather than as income.

It may also be possible to structure an individual investor's return to maximise capital gains rather than income. For example, it may be possible to establish an investment fund with a fixed life after which it would be liquidated. If the fund does not pay out any distributions during its life and the income is only paid out in the liquidation then, so long as the fund is structured as a UK corporate, the liquidation distributions would be taxed as capital gain rather than income.

How might HMRC respond to all of this?

It is interesting to speculate on HMRC's possible response to these income into capital structures. The main purpose tests discussed above should not be forgotten. As a rule of thumb, HMRC would stand a better chance of arguing successfully that a bespoke planning arrangement had as its main purpose, or one of its main purposes, the avoidance of the £150k limit and/or the special annual allowance charge than one which is widely used across a company's workforce and which benefits a variety of different individuals who are taxed at different rates.

A further response may be legislative. It may be anomalous that the rate of capital gains tax (I8%) is lower than the basic rate of income tax (20%). A move to harmonise the income and capital gains tax rates would make income into capital planning less attractive. However, Schedule 35 and the proposed 6 April 2011 pension changes are calculated using relevant income. Therefore, a move to harmonise income and capital gains tax rates could still result in an income into capital arrangement being an effective pensions planning strategy, unless the £150k limit were to be calculated by reference to both income and capital gains.

Employer-Financed Retirement Benefit Schemes

The pension changes and the proposed introduction of the 50% income tax rate have led to Employer-Financed Retirement Benefit Schemes ('EFRBS') being revisited as a pension and an income tax planning tool. Payments into EFRBS are not subject to the annual allowance and further payments into EFRBS are not subject to the special annual allowance charge. The EFRBS enjoys considerable commercial flexibility. For example, there are no restrictions on what EFRBS can invest in. They can invest in residential property. Further, when the retirement benefits crystallise, there is no requirement for the pensioner to take an annuity. HMRC's guidance notes[4] indicate that it will not regard an EFRBS structure as an arrangement which has as its main purpose or one of its main purposes the avoidance of the special allowance charge so long as it has been set up solely for the provision of pension benefits.

Characteristics

An EFRBS has the following characteristics.

- The employer company does not obtain a tax deduction for the payment into the EFRBS until the EFRBS pays out pension benefits.
- The contributions made by the employer company to the EFRBS will not be treated as income for income tax purposes or as earnings for national insurance purposes.
- The payments which a former employee receives from the EFRBS will be taxed as if they were employment income.
- However, the payments to the pensioner will be ignored for national insurance purposes

4 See HMRC's guidance note - RPSM15104580

if, had the scheme been a registered pension scheme, the payment would have been a permitted type of payment (eg an allowable pension or lump sum) and payment is made after the employment has ended without the former employee having been re-engaged by his employer under the terms of a consultancy agreement.

Retirement planning

There are a number of different ways in which an EFRBS can be used as a retirement planning tool.

Assume that an individual who is close to retirement pays the 50% tax rate.

- The individual's package is restructured so that £100k of remuneration which would otherwise be paid to him subject to the 50% tax rate is paid into an EFRBS.
- The EFRBS receives £100k gross and this amount is not taxed in the EFRBS.
- The individual structures his retirement arrangements so that the £100k is drawn down when he is subject to the 40% tax rate. This gives the individual £10k of tax saving.
- The company does not take a tax deduction until the EFRBS pays out retirement benefits. However, this need not be an issue if the individual is close to retirement.
- The payment to the EFRBS and the corresponding payment out may have the added attraction for the company of being free from employer's national insurance. The employer's national insurance is charged at the 12.8% rate. This saves the company £12.8k of national insurance in this example.

Individuals who are a long way off retirement may see some attractions in using EFRBS as their own personal roll up funds. This can be best illustrated using an example.

Assume that a company pays £100k into an EFRBS.

- If retirement is far off, the company should not factor tax deductions into the EFRBS payment but rather should treat it as an appropriation of profit. The after-tax cost of paying the £100k into the EFRBS is £100k x 100/72 = £138.8k.
- However, assuming that the individual pays income tax at the 50% tax rate, the cash cost to the company of actually paying the individual £100k (after tax) amounts to £225.60k (taking into account the income tax and national insurance). Assuming that the £225.60k is tax deductible at the 28% corporation tax rate, the after-tax cost to the company of making the EFRBS payment would be £162.4k. The EFRBS is a cheaper way of providing the individual with £100k than salary. The individual may be able to structure his relationship with the company so that part of the benefit of this saving is passed on to him as an enhanced EFRBS payment.

Trust structure

EFRBS are traditionally structured as trusts. Unlike conventional pension schemes EFRBS do not enjoy any specific tax advantages and they are subject to the tax rates applicable to trusts. Trusts, like individuals, are able to benefit from the 18% flat capital gains tax rate. Therefore the EFRBS trustees may wish to maximise the portion of their return which attracts capital gains tax treatment.

An EFRBS may also be structured as an offshore trust. The tax advantage of an offshore trust structure is that it should not be subject to UK capital gains tax. However, if an offshore trust is used it will still be subject to UK income tax on its UK dividend and UK interest income (but not on non-UK source income). This is because non-resident offshore trusts are subject to UK income tax to the extent to which they have UK source income and UK beneficiaries. In deciding whether or not to implement an offshore EFRBS it will be necessary to consider whether the extra professional costs outweigh the tax saving on gains.

It should be noted that if a pension is paid by an offshore EFRBS then only 90% of the pension is subject to UK income tax. This may be a factor in using an offshore EFRBS in pre-retirement planning where the objective is for amounts which would otherwise have been paid out as salary to be taken over the course of retirement and to be dripped out at lower income tax rates.

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The 60% income tax trap

Extra tax for key employees!

From April 2010, individuals whose income is above £100,000 will lose the right to claim some or all of their personal allowance. They will effectively lose £2 of the £6,475 personal allowance[5] for every pound they earn above £100,000. Once their income exceeds just under £113,000, they will not be entitled to any personal allowance. This means that income in this band will be taxed at an effective rate of 60% - *higher than the 50% rate being introduced for people earning more than £150,000!*

The new rules will come as an unpleasant surprise to many people and could be demotivating for anyone caught in the “trap”. Any pay rise or bonus that pushes someone’s taxable income (from all sources – salary, share schemes, interest, dividends and property) above £100,000 will be much less valuable to them. A rise of £10,000 will only be worth £3,900 after tax and national insurance contributions. Employees may seek higher pay rises to compensate for the extra tax they will suffer.

Employees may seek higher pay rises to compensate for the extra tax they will suffer.

Planning is essential

Fortunately, it will often be possible to avoid the worst effects of the trap by engaging in some straightforward tax planning to ensure that the personal allowance remains fully available. This can include:

- Changing salary payment dates.
- Accelerating or deferring bonus payments and share scheme payouts.
- Extra pension contributions – if made under a salary sacrifice arrangement this can also save national insurance contribution costs for both company and employee.
- Charitable donations – an ideal opportunity to promote Give As You Earn.

For many employees, this will be the first time they have had to consider actively planning their tax affairs and many will need guidance. An active approach to helping employees understand and manage the issue could significantly improve the motivation and incentive value of current remuneration or any pay rise. Employers should consider identifying those likely to be affected well before next April, alerting them to the effect of the change and helping them plan to reduce their tax bills.

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5 The personal allowance for 2009-10 is £6,475. By default, allowances are indexed each year by reference to the September RPI. This would result in there being no increase in the allowance in 2010-11 since the September 2009 RPI showed a fall. However, the Chancellor could override this and set the allowance at a different amount.

Reclaiming tax on dividends paid to pension schemes

The European Court of Justice recently ruled that EU pension schemes should not be subject to withholding tax on dividends received from investments in other EU countries, unless that country applies such withholding tax in its own country to its own pension schemes. The higher taxation of non-domestic pension schemes results in a restriction of the free movement of capital which is contrary to Article 56 of the EU Treaty.

The Netherlands responded by changing its law so that since 1 January 2007 the Netherlands has not withheld tax on dividends. However, it may be possible for pension schemes to request a refund of Dutch dividend tax levied prior to 1 January 2007 and possibly as far back as 2002.

It is likely that requests for a refund of Dutch dividend tax for periods prior to 2006 will be less straightforward due to legislative and limitation problems, however it is hoped that forthcoming litigation will resolve these issues conclusively.

Pension scheme trustees should liaise with their investment managers or custodians now to ascertain whether such withholding tax has been applied and to consider making refund claims for periods prior to 1 January 2007. This can be done by lodging a letter of claim to the Dutch tax authorities. It is likely such claims will be stayed pending the outcome of any test case.

As the European Commission is currently taking measures against a number of other EU Member States including Bulgaria, Spain, Portugal and Romania to request the elimination of the discriminatory taxation, it seems likely that similar claims will be possible once these States become compliant.

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Pension scheme trustees should liaise with their investment managers or custodians now to ascertain whether withholding tax has been applied and to consider making refund claims.

Significant VAT recovery opportunity – have you claimed your refund yet?

As a result of a European Court of Justice decision, it may now be possible for pension schemes to reclaim VAT paid in recent years on investment management fees. Successful claims could result in a cash boost for pension schemes at a time when investment returns have been adversely affected by the current economic situation. Interest should also be due, possibly at compound rates.

Background

Currently VAT is chargeable in the UK on pension fund management fees and since most pension schemes are unable to reclaim VAT, this is an additional cost to the fund. This is not the case throughout the EU and recently the European Court of Justice has decided that the provision of investment management services to collective investment funds should be VAT exempt.

Despite this, HMRC has so far refused to extend the benefit of this decision to pension schemes, arguing that they do not fall within the definition of collective investment funds. However a test case on this issue will soon come before the UK courts and many pension schemes and investment managers have lodged protective claims behind the test case. The existence of a test case will allow other pension schemes to benefit from this potential opportunity without being an active participant in litigation.

What trustees should do now

Approach Fund Managers and monitor their action. The initial claim against HMRC should be made by the investment manager(s) but in our experience they are unlikely to take action without a considered approach by the pension scheme trustees. Trustees should ensure the initial refusal of the claim by HMRC is the subject of a protective appeal which is stood behind the test case. Trustees should also ensure that the interest position is addressed.

Ensure that both the tax and the contractual positions are addressed. It is important to appreciate that the pension scheme trustees may also have a contractual claim against the fund managers who charged the VAT. This aspect is not part of the test case, but will also need careful consideration and the best outcome negotiated.

Pursue this matter without delay. Currently, claims for overpaid VAT may be made back to April 2006. However it may take some years before the test case is finally decided and schemes that wait until the outcome of the case will have their retrospective claims restricted to a period of four years from the final decision. Some periods may therefore drop out of the claim against HMRC with a corresponding loss of refund. Different time periods apply to any contractual claim against the fund managers and the various options need to be balanced to achieve the optimum position for each pension scheme.

In summary, it would be unwise merely to await the outcome of any test case before taking action. The initial costs involved in protecting a pension fund's position will be relatively small compared to the potentially significant benefit.

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How the Tax Strategies team can help

Our Tax Strategies team has the experience and knowledge to advise on the complex tax issues arising from the rules introduced in this year's Finance Act and proposals for April 2011. They can also help pension scheme trustees to take advantage of the tax recovery opportunities identified in this Review. Working with the Pensions team, they can assist employers and trustees to identify the best way forward. For further information, please contact Mark Simpson or Timothy Jarvis or your usual pensions contact.

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