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Organon Newsletter

Summer 2009

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Budget Summary - Pension U-Turn

In the aftermath of the 'credit crunch' and as the colossal cost of bailing out the banks and averting a depression begins to be appreciated, Budget 2009 signalled a sharp u-turn in the principles underlying so-called Pension Simplification.

The top 1% of earners (with incomes over £150,000 per annum) have been targeted with measures which are not only complex and difficult to understand but which, once they take effect in 2011, will undermine the fundamental principle of tax relief at marginal rate on contributions on the one hand and tax on pension income at marginal rate on the other, at least for this top 1% .

Political change may well intervene, but in the meantime there are opportunities for tax planning this year and next which we summarise in this Newsletter.

Individuals with income over £150,000 per annum

"Individuals with income over £150,000 per annum will be subject to the tapering down of tax relief"

From April 2011 individuals with income over £150,000 per annum will be subject to the tapering down of tax relief to 20%. Anyone with income less than £150,000 will be unaffected. Anyone with income over £180,000 will only get 20% tax relief.

In anticipation of this The Treasury is introducing temporary rules (see below) known as 'Anti-Forestalling Measures'.

These restrictions will apply to anyone with 'relevant income' of £150,000 or more, either in the current tax year or the previous two tax years.

Relevant Income

Calculating "Relevant Income" requires a six-step process:

1. TOTAL income (not just earnings)
2. PLUS individual pension contributions under 'net pay' arrangements
3. LESS income tax deduction or relief other than for pension contributions
4. LESS total individual relievable pension contributions up to a maximum of £20,000 (i.e. contributions either under relief at source or net pay)
5. PLUS any salary sacrifice arrangement post-22 April
6. LESS grossed up amount of any gift qualifying for GIFT AID

For a contribution in the current tax year, this exercise will also need to be carried out for 2007/8 and 2008/9.

Anti-Forestalling Measures

Anyone with Relevant Income of over £150,000 in any year from 2007/8 onwards will be subject to these measures and in particular a Special Annual Allowance of £20,000 which effectively replaces the existing Annual Allowance. The Annual Allowance, currently £245,000, remains in place for anyone in receipt of income of £150,000 or less in the current and previous two tax years.

However, where regular savings to a pension were previously in place ('normal pension savings') these become a Protected Pension Input Amount, which is deducted from the Special Annual Allowance (subject to a minimum of zero).

For money purchase arrangements normal savings means regular contributions made prior to 22 April 2009 on at least a quarterly basis.

For final salary arrangements normal savings means the basis on which accrual was calculated before 22 April 2009, unless the change affects at least 50 active members.

Annual, regular single or one-off contributions are all excluded.

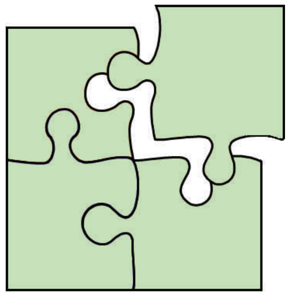
The practical effect of all this is that annual pension contributions of over £20,000 will be subject to tax penalties unless they consist entirely of pre-existing monthly or quarterly contributions.

The rule whereby the Annual Allowance does not apply in the tax year all pension benefits come into payment or the member dies will not apply to the £20,000 limit unless:

The arrangement is a final salary scheme with at least 20 members and the taking of benefits was not for the purpose of avoiding the Special Annual Allowance;

OR

Benefits are paid due to ill health from a final salary, public service or group personal pension scheme.



Examples

The Treasury have confirmed that people whose total income is above £150,000 p.a. will be paying a marginal tax rate of 50% from April 2010. Tax relief will not be based on today's maximum of 40% but upon the new 50% tax rate and that those who earn between £150,000 and £170,000 will gain full tax relief at 50%, thus saving 50p tax in every £1 contribution.

This effectively means that anyone with total income of £170,000 could pay a pension contribution of £20,000 and gain £10,000 tax relief. Their employer could then top this amount up to next year's annual allowance of £255,000 without a tax charge being levied. This assumes their Relevant Income did not exceed £150,000 in 2007/8, 2008/9 or 2009/10.

The difference can be seen if we take a high earner with a total income of £200,000 p.a. If they contributed £20,000 and their employer £20,000 their tax relief would only be £4,000 on their individual contribution but they would face a new tax charge of

"Annual pension contributions of over £20,000 will be subject to tax penalties"

possibly 30% on their employer's contribution, meaning an extra £6,000 penalty.

An added twist is provided by the deduction of any gift qualifying for Gift Aid. In the previous example someone with income just over £170,000 could reduce their Relevant Income to £170,000 by making a gift to charity of sufficient size, in order to escape the £20,000 Special Allowance (again assuming Relevant Income had not exceeded £150,000 in the previous three years).

Similar contrasts will apply in the current tax year, but with the marginal tax rate being still 40%.

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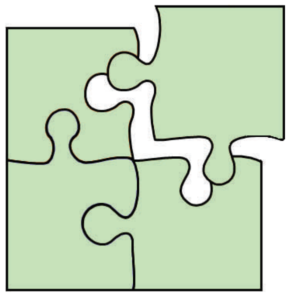
Individuals with income of £100,000 to £150,000 per annum

From 2010 individuals earning over £100,000 will see their personal allowance reduced by £1 for every £2 of income above £100,000.

Anyone finding themselves in this position should carefully consider the use of pension contributions.

Someone earning £110,000 p.a. will have lost £5,000 of their personal allowance. A pension contribution of £10,000 will generate tax relief @ 40% of £4,000. This also has the advantage of reinstating £5,000 of the personal allowance. That £5,000 reduces the tax bill by an extra £2,000. In total 60% tax relief is achieved.

A salary sacrifice arrangement could also be considered to reduce income to below £100,000; one of the best methods is through giving up salary in exchange for an employer's pension contribution.



Scheme Pensions for anyone aged 75 or over

Individuals in this age group with larger funds who are loath to purchase an annuity should seriously consider a Scheme Pension. The advantages of this over Alternatively Secured Pension ('ASP') are:-

- A higher income than the maximum allowed under ASP
- Availability of a 10-year guarantee (which is not available under ASP)
- The possibility of taking additional income in the year in which the Scheme Pension commences (that year only)
- As a result of the above advantages combined, a major reduction in the residual fund on death which will suffer tax charges of up to 82%

Under ASP income is restricted to 90% of the prevailing annuity rates for a 75 year old irrespective of actual age. Scheme Pensions can be calculated actuarially with the aim of using up the entire fund by the member's (or surviving spouse's) death. This inevitably means a higher income can be justified, which over time reduces the residual fund on death.

If the member is in poor health, any limited life expectancy can be factored into the level of pension. Alternatively a 10-year guarantee can be put in place and should the member or surviving spouse) die prematurely their chosen beneficiary/ies can continue to receive the pension for the rest of the guarantee period, taxable only at their marginal income tax rate.

With the exception of members who were over 75 at A-Day, anyone in ASP will start a new pension year on their birthday. HMRC regulations allow a full year's ASP to be taken in advance, even if at

"This inevitably means a higher income can be justified, which over time reduces the residual fund on death"

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Or-ga-non (n) "An instrument through which knowledge is acquired" *(Oxford English Dictionary)*

Scheme Pensions for anyone aged 75 or over (continued)

some point during that year a Scheme Pension is taken out. If a Scheme Pension is taken out shortly after the pensioner's birthday then it is possible to take almost two years' pension in the same tax year. This helps to further reduce any eventual residue in the fund.

With the income tax changes promised for next year on incomes of £100,000 or over it would seem particularly attractive from an income tax point of view to switch from ASP to a scheme pension in the current tax year if this is possible. Someone currently aged 74 could also benefit from this quirk in the regulations.

Organon are able to offer Scheme Pensions through both a SSAS and a SIPP.

SSASs and Loans

Finally, in brief, in current conditions of very low interest rates and a shortage of bank credit, the ability of a SSAS to lend, albeit on a secured basis, to a sponsoring employer is doubly valuable.

50% of the SSAS's net assets can be loaned to a sponsoring employer as long as the following conditions are met:-

- Maximum 5-year term
- Equal annual or more frequent repayments
- Minimum interest rate of 1% over the average of the leading 6 banks' base rates when the loan is taken out (interest is calculated on the initial capital amount so this is nearer 3% over base on a daily balance basis)
- Loan to be secured by a first charge over property with sufficient value to cover both capital and interest over the term (can be lodged by a third party and can be residential).

Third party loans can be advanced by both SSASs and SIPPs and these do not need to be secured (although of course they can be).

Please contact us if you would like further information on any of the issues raised:

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