WHAT NEEDS TO BE CONSIDERED?

Since 2010 various changes have been made to the initial A-Day pension regime provisions in order to restrict the tax relief available to higher earners, adding to the complexity of the pension savings rules. The following changes will take effect from 2014/15:

- The "lifetime allowance" (see A2) will be reduced from £1.5 million to £1.25 million unless: (i) the individual concerned has already (by a valid election under earlier transitional provisions) secured a higher protected lifetime allowance figure; or (ii) makes an election under the 2014 transitional provisions for either (or both) of the two new forms of protection: Fixed Protection 2014 (FP14); and Individual Protection 2014 (IP14).
- The annual allowance is reduced from £50,000 for 2013/14 to £40,000 from 2014/15 onwards.

This briefing provides an overview of the regime that will be in place from 6 April 2014 and a final reminder of the 5 April 2014 deadline for making the FP14 election.

Section A provides an overview of the initial A-Day regime; section B discusses the changes made since 2010 (with particular emphasis on the 2014/15 changes: section B3 considers the FP14 issues and section B4 covers IP14). Finally, section C provides a brief outline of potential future changes.

A The "A" day regime

A1. Overview

From what was known as A-Day (6 April 2006), the tax regime for pensions savings changed radically. The concepts of the "lifetime allowance" and the "annual allowance" are central to this regime.

A2. The "lifetime allowance"

The lifetime allowance (initially set at £1.5 million for 2006/07) was introduced as the maximum amount of UK tax-relieved pension savings an individual can have at the time of a benefit crystallisation event without having to pay the lifetime allowance charge. There can be multiple such events, as not everyone draws down all pension benefits at the same time and individuals may have a number of different pension arrangements.

The lifetime allowance charge was introduced from 6 April 2006 as a new tax charge, where the value of the pension fund, on a benefit crystallisation date, was

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deemed to exceed the "lifetime allowance". The tax rate was set at 55%, if the excess was taken as a lump sum, and 25% if used to provide taxable pension income. These rates have not changed.

As part of the A-Day package, two transitional reliefs were introduced: Enhanced Protection and Primary Protection. Both required elections to be made by 5 April 2009.

Where an election for Enhanced Protection has been validly made, it provides absolute protection against the lifetime allowance charge (whatever value the pension assets appreciate to). However, to retain Enhanced Protection:

- From 6 April 2006 no further pension contributions could be made for or on behalf of the individual.
- Where the individual is a member of a defined benefit/final salary pension scheme, the deemed increase in pension funds has to be within the specified de minimis limits.

Primary Protection was only available where pension funds at 5 April 2006 exceeded £1.5 million. Primary Protection gives the individual a higher personal lifetime allowance (that will always be higher than the standard lifetime allowance), rather than exemption from the lifetime allowance charge, and individuals could continue to build up pensions provision both by further contributions and through accruing additional pension benefits. It works by increasing the standard lifetime allowance (in respect of the year in which the benefits crystallisation event occurs) in line with the percentage by which the pension scheme assets at 5 April 2006 exceeded the £1.5 million lifetime allowance.

Where an individual had pension funds in excess of £1.5 million at 5 April 2006 it was possible to make both the Enhanced and Primary election. In such cases the Primary Protection is dormant unless and until Enhanced Protection is lost.

A3. Relief for pension contributions and the "annual allowance"

Overview

There is a £3,600 (gross) de minimis pension contribution amount, which can be made regardless of whether an individual has earnings. This means that, with the current 20% basic rate of tax, those with little or no earned income (including minors) can make contributions of £2,880 (net) and an amount equivalent to the basic rate tax (£720) is claimed from HMRC by the pension provider and added to the individual's pension pot, regardless of the level of income or tax paid for the year.

Pension contributions in excess of the de minimis amount can be made provided an individual has sufficient annual earnings and, if personal pension contributions are made, tax relief for personal contributions at the individual's highest Income Tax rate can be claimed. However, a new tax charge, referred to as the "annual allowance charge" was, introduced as part of the A-Day changes. Payable at the individual's highest marginal Income Tax rate for the relevant tax year, the annual allowance charge can be viewed as a claw back charge that effectively sets a cap on the overall tax relief available on pension contributions.

The charge is levied on the excess where the "pension input amount" (explained below) exceeds the level of the "annual allowance" for the tax year in which the "pension input period" (also explained below) ends. Depending on when the contributions are made, where the pension input period does not align with the tax year there is a potential for tax relief on the pension payments to be claimed in a different tax year to that in which an annual allowance charge is triggered. If the taxpayer has a different marginal Income Tax rate in the two years concerned, this may or may not be beneficial and is another factor that needs to be taken into account.

Terminology

The" pension input period" (PIP) concept was introduced when the A-Day rules came in. Different schemes can have different PIPs, and an individual who is a member of a number of schemes may have a different PIP for each scheme. When this concept was introduced, the date on which each PIP ends was seldom a matter of concern, as the level of the annual allowance meant that few individuals needed to worry about making excess contributions. With the reduction of the annual allowance in 2011/2012 (see B5) the risk of making excess contributions increased significantly. It is now important that individuals know the PIPs for each of their pension schemes and that this information is provided to their tax advisers. This is of increased importance, now that the annual allowance has been reduced further, from £50,000 to £40,000 for 2014/15 (see the example in B5).

Where an individual is a member of a personal pension scheme or a defined contribution employer scheme, their "pension input amount" is the aggregate gross contribution figure for the PIP. It is more complicated for defined benefit/final salary schemes; in such cases, it is the difference between the individual's entitlement at the beginning and end of the PIP (if the entitlement has dropped then the pension input amount is deemed to be nil).

No refunds where contributions are in excess of the annual allowance

Where pension contributions have been validly made, but are in excess of the annual allowance, the annual allowance charge cannot be avoided by a refund of pension contributions. Taxpayers, therefore, need to be very careful when making pension payments. Especial care is needed on the part of those who have more than one scheme and different PIP year-ends.

No initial carry-forward provisions

When the pensions' regime was changed in 2006, it was felt that the annual allowance was set at a sufficiently generous level not to require a -forward facility for unused allowances. However, with the reduction of the annual allowance, such provisions were re-introduced from 2011/12 onwards to allow unused relief to be carried forward for three tax year (as explained in B5 below).

B Changes

B1. Overview

To encourage individuals to save for their pensions, the "lifetime allowance" and the "annual allowance" were initially set at relatively high levels with provisions for annual increases. The economic downturn led to the regime being reconsidered by successive Governments from 2010 onwards. This has resulted in restrictions of tax relief for wealthier taxpayers. Very broadly, the concepts of the lifetime allowance and the annual allowance remain, but the figures are lower. The latest changes come into effect for tax year 2014/15 with further reductions to both the lifetime allowance and the annual allowance.

B2. The lifetime allowance from 6 April 2014

From 2014/15 onwards the lifetime allowance is reduced to £1.25 million from £1.5 million, with no provision for future increases. This is the second reduction in the level of this allowance, the first having happened in 2012/13 when it was reduced to £1.5 million (having been £1.8 million for 2010/11 and 2011/12).

Just as there was transitional relief (Enhanced Protection and Primary Protection) to prevent individuals losing out as a result of the initial introduction of the lifetime allowance:

- there was relief (Fixed Protection 2012, referred to as FP12) when the lifetime allowance was first reduced; and
- with the 2014/15 changes there are two new forms or protection: Fixed Protection 2014, (referred to as FP14); and Individual Protection 2014, (referred to as IP14).

Individuals who made the FP12 election and do not breach the conditions have a minimum personal lifetime allowance of £1.8 million (if the standard lifetime allowance ever exceeds this amount then they would be entitled to the higher figure). To retain protection:

- no further pension contributions can be made to personal pension plans/defined contribution schemes after 5 April 2012; and
- for defined benefit/final salary schemes the "benefit accrual test" must not be breached (generally meaning that the individual had to opt out of future benefit accrual).

FP14 is similar to FP12, except that the minimum personal allowance that can be secured is £1.5 million. IP14 is different as those making the election will secure a personal lifetime allowance equal to the lower of £1.5 million and the value of their pension benefits on 5 April 2014, but will still be able to make pension contributions/accrue pension benefits as active pension scheme members. This allows those whose pension fund declines in value to make contributions to restore its value up to the amount of protected allowance.

B3. Fixed Protection 2014 (FP14) - election deadline 6 April 2014

Who can make the FP14 election and what are the benefits?

The level of pension savings built up at 5 April 2014 is not relevant to determining whether an individual can make the election (though it is of course a relevant consideration when deciding whether the election should be made). A valid FP14 election can be made by anyone provided he or she does not have a valid existing form of protection already in place. An individual who made an election for Enhanced Protection or FP12 but forfeited that protection can now election for FP14.

Provided the conditions are not breached, an FP14 election will mean that the individual has as a minimum a personal lifetime allowance of £1.5 million (if the actual lifetime allowance has been increased by the time benefits are taken, they will be entitled to the higher figure).

If the conditions are breached, the individual will no longer have the benefit of a minimum allowance of £1.5 million. All pension benefit crystallisation events subsequent to the loss of FP14 will be tested by reference to the standard lifetime allowance figure, unless the person had also made an IP14 election. In such a case, IP14 protection would apply to replace the lost FP14 allowance (see below for a discussion of IP14).

Losing FP14

The FP14 protection will be lost if after 6 April 2014:

- further pension contributions are made by or on behalf of the individual to a defined contribution/money purchase pension scheme (that is not a cash balance arrangement); or
- the benefit accrual level for a cash balance arrangement or defined benefit/final salary scheme, breaches narrowly defined limits.

In practical terms, to keep FP14 a person should ensure that:

- Any direct debits or standing orders in place are cancelled, so that pension contributions are not made inadvertently after 6 April 2014. HMRC has stated that, provided the contribution is refunded and any tax relief claimed repaid, FP14 will not be lost if an individual had told a bank or building society in good time that he or she wants to stop a payment and the instruction is not acted upon.

- Steps are taken to opt out of any active scheme membership of an employer sponsored pension plan. This is because the benefit accrual for an active scheme member will probably exceed the permitted de minimis level at some point in the tax year. Depending on the scheme formula for benefit accrual and the scheme rules it might be possible to ascertain when the permitted accrual level would be breached and remain in the scheme until just before that time.

FP14 will generally be lost if:

- an individual joins a new pension scheme; or
- there is a transfer of sums or assets that is not a permitted transfer.

There are three situations were an individual can join a new pension scheme without forfeiting FP14 protection. These are where the reason for joining the new arrangement is:

- to receive a permitted transfer (the most common forms of permitted circumstance being: to receive a transfer of pension rights from another pension scheme; and various transfers of pension rights following a pension sharing order made as part of divorce proceedings);
- as part of a retirement-benefit activities compliance exercise; or
- as part of an age-equality compliance exercise.

Care needs to be taken with respect to pension auto-enrolment. Phased in from 1 October 2012, affected employers must automatically enrol their employees into a pension scheme. Employees with FP14 who are auto-enrolled will lose their FP14 protection unless they opt out within a month of being auto-enrolled. This is also an issue for individuals with Enhanced Protection and FP12. Such individuals need to ensure that they know if they are auto-enrolled into a pension scheme and that they take the necessary prompt action to opt out within the allotted month.

Advice should be taken where your current pension scheme provides death benefits and the policy was established after 6 April 2006. Continuing to pay premiums for such cover could result in FP14 being lost.

Whatever the reason, if protection is lost HMRC must be informed within 90 days of the affected individual becoming aware that there has been an event leading to the loss of protection.

Who should consider making the FP14 election?

FP14 is only available to individuals who have not secured a higher personal lifetime allowance as a result of making (and not forfeiting) Enhanced Protection, Primary Protection or FP12.

Individuals, without a valid existing form of pension protection, who know for certain that at 5 April 2014 they will have current pensionable savings in excess of £1.5 million should claim IP14 instead as this will secure the £1.5 million lifetime allowance whilst retaining the ability to make pension contributions/accrue pension benefits.

The FP14 election should be considered by individuals:

- whose current pensionable savings are less than £1.25 million but who have realistic expectations that the value of their pensionable savings will increase to more than £1.25 million by the time they take their benefits; or
- whose current pensionable savings are in excess of £1.25 million but less than £1.5 million (in such cases, an IP14 election should also be made as a fall back should it be necessary to resume pension contributions/benefit accrual).

The decision should not be made focussing solely on tax considerations. The overall objective has to be to ensure that the individual is in the best overall financial position possible rather than just to minimise the potential tax liability. Specialist pension advice is, therefore of crucial importance and cases may need to be considered in the light of the specific facts. However, the prohibition on making future pension contributions or benefitting from benefit accrual (beyond narrowly defined limits) will make FP14 unattractive to many individuals. This will particularly be the case for active members of employer sponsored final salary schemes.

It would be pointless to make the FP14 election in the certain knowledge that the terms will be breached. However, it is important to remember that the election does not commit the individual to staying within the conditions. He or she can breach the conditions at any time without any penalty other than loss of the protection. As such, the election is in practical terms revocable so if it is initially thought that it will be of benefit it can be made and the terms breached if it becomes apparent later that it would be better for the individual to do so.

Making the FP14 election

The election is made by completing form APSS228. This is a simple form that requires just the individual's name, national insurance number, address and confirmation that he or she does not hold Enhanced Protection, Primary Protection of FP12. The application form is available from the HMRC website (www.hmrc.gov.uk/pensions chemes/apss228.pdf). There is also an on-line version of the form, which can be completed and submitted on-line (www.hmrc.gov.uk/pension schemes/fp14online.htm). The on-line version of the form requires an e-mail address to send the acknowledgment receipt to.

Whichever method is used the completed form needs to reach HMRC by the end of 5 April 2014.

B4. Individual Protection 2014 (IP14) - election deadline 6 April 2017

Who can make the IP14 election?

A valid IP14 election can be made by individuals who:

- do not hold Primary Protection; and
- have total pension savings in excess of £1.25 million on 5 April 2014.

Individuals who make this election can continue to build up their pension provision and will have an enhanced lifetime allowance equal to the lower of £1.5 million and their pension savings on 5 April 2014.

Who should make the IP14 election?

Where the choice is between FP14 and IP14, the IP14 election is clearly the better option for individuals who have total UK tax relieved savings in excess of £1.5 million on 5 April 2014, as they keep the £1.5 million lifetime allowance and, should they so desire, can continue to build up their pension provision.

In addition, regardless of whether they make the FP14 election, the IP14 election should be made by all individuals who have pension savings in excess of £1.25 million on 5 April 2014. If they do not make a FP14 election, the IP14 election will secure a higher personal allowance than the standard £1.25 million with no downside for the individual. If they do make a FP14 election, then the IP14 protection will be dormant, as FP14 takes priority (securing as it does a higher minimum lifetime allowance), but IP14 will be secured as a fall-back should the FP14 conditions be breached. This is best explained by way of an example:

Christopher has pension benefits to the value of £1.45 million at 5 April 2014. He anticipated that, by retirement, the value would have risen to more than £1.5 million so he would cease from making additional contributions. He made the FP14 election and (for backup) he also made the IP14 election.

However, the fund performed badly and fell to £1 million in May 2017. The standard lifetime allowance for the tax year was still £1.25 million. He then wanted to make further contributions to restore the fund's value.

Making new pension contributions would mean the loss of FP14 protection, but as he had also made an election for IP14, he had a fall back which secured his minimum personal lifetime allowance at £1.45 million. If he had not made the IP14 election, the loss of FP14 protection would have left him with the standard £1.25 million lifetime allowance.

The IP14 election should also be considered by those who:

- currently have total UK tax relieved savings in excess of £1.5 million; and
- have either made valid Enhanced Protection or Fixed Protection 2012 elections.

This is because such individuals may through making additional pension contributions (possibly inadvertently) find that they forfeit their Enhanced or Fixed Protection 2012 and so will want to use the IP14 election to secure the £1.5 million lifetime allowance as a fall-back position.

Making the IP14 election

The IP14 election cannot be made until after the 2014 Finance Act receives Royal Assent and it is understood that the required form of election (referred to as form APSS240) will not be available until August 2014. As with FP14, it will be possible to print out the form, and send a completed hard copy to HMRC or to complete it on-line. HMRC want to encourage on-line submissions, and as an incentive, offer the benefit of immediate confirmation of receipt.

Whichever method is used the completed form needs to reach HMRC by the end of 5 April 2017.

B5. The annual allowance for tax year 2014/15 onwards

The de minimis pension contribution, which can be made whether or not there are earnings, remains at £3,600 gross (equating to £2,880 net).

For 2014/15, the annual allowance is reduced to £40,000 (from £50,000). This is the second reduction in the level of the annual allowance, the first having occurred in 2011/12, when it was drastically reduced, having been £255,000 in 2010/11 (though there were complex anti-forestalling rules involving a special annual allowance tax charge).

When this reduction occurred in 2011/12, there was a partial reinstatement of the carry forward concept. Any unused annual allowance can be carried forward for up to three tax years, but only if the individual is enrolled in a pension scheme. If an individual is not a member of any pension scheme the carry forward amount available for any year is nil.

The annual allowance for the year of payment is deemed to be used first, and then the unused annual allowance for the prior years (the unused amounts in prior years being used on a first in, first out basis).

The amount of any unused allowances for tax years before 2011/12 (ie for 2008/09, 2009/10 and 2010/11) is determined using an annual allowance amount of £50,000, rather than the higher annual allowance amounts applicable to pension payments made within those years.

The reduction in the annual allowance for 2014/15 to £40,000 does not impact on the carry-forward figure for previous years, as the following example shows:

Mary's PIP year-end coincides with the tax year. In 2014/15 she receives a cash windfall as a result of a lottery win and decides to make the maximum possible pension contribution for the tax year. Her earnings for the tax year are £187,000. In the preceding three years she had made the following contributions:

- *2013/14 £12,000*
- *2012/13 £12,000*
- *2011/12 £12,000*

As such she has brought forward unused relief of £114,000 ((£50,000 - £12,000) x3) and the current year annual allowance of £40,000. This means that without being subject to the annual allowance charge she can make pension contributions of £123,200 (equating to £154,000 gross).

There is a risk of inadvertent over contributions (resulting in an Income Tax charge at the taxpayer's marginal rate) as a result of the decrease in the annual allowance. The risk is greatest where the pension input period (PIP) begins in one tax year and ends in the next (but is not co-terminous with the tax year itself). It is best explained by way of an example:

Katie is an additional rate taxpayer. She has no brought forward unused annual allowance. She contributes (in equal monthly amounts on the 11th of each month) £40,000 net (so £50,000 gross) for tax year 2013/14. In 2014/15, she reduces her contributions to £32,000 net (so £40,000 gross), imagining that this will qualify for relief.

She has a PIP year-end of 31 August. The 2014/15 reduction of the annual allowance, therefore, applies for that tax year with respect to contributions made in the PIP ending 31 August 2014.

As at 6 April 2014, Katie will already have made seven month's contributions amounting to £29,166.67 gross ((£50,000 x 7/12). If she makes the monthly contributions planned for April to August 2014 she will have made further contributions of £16,666.67 gross (£40,000 x 5/12), meaning that:

- *in total she would have made gross pension contributions of £45,833.34 for the PIP ending 31 August 2014; and*
- *she will be subject to an annual allowance charge for 2014/15 at the rate of 45% on £5,833.34.*

C The future

Before both the Autumn Statement and the 2014 Budget there was intense press speculation that the Chancellor might announce a reduced cap on the tax free lump sum cash that pensioners can receive. No such changes were made; instead, the Chancellor announced radical plans for reform (the most far reaching of which will not take effect until April 2015), which would relax rules governing the taking of pension benefits. These changes are outlined in our Budget Summary.

These plans have been widely welcomed but they are clearly meant as an incentive to voters to return the Government in the next General Election, set for May 2015. By contrast, recent announcements suggest that if the Labour Party wins, those with income in excess of £150,000 (and thus subject to Additional Rate Income Tax) will only be entitled to Basic Rate relief on their pension contributions. Anyone who could be affected by this may want to consider maximising tax relievable pension contributions in 2014/15.

Rawlinson & Hunter
Chartered Accountants

Eighth Floor
6 New Street Square
New Fetter Lane
London EC4A 3AQ

And at

Lower Mill
Kingston Road
Ewell
Surrey KT17 2AE

T +44 (0)20 7842 2000
F +44 (0)20 7842 2080
firstname. lastname@rawlinson-hunter.com
www.rawlinson-hunter.com