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Client Alert
Commentary

Latham & Watkins Benefits, Compensation and Employment Practice

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Tax-efficient Pension Savings in the UK: Government Applies Further Restrictions

Employers may want to adjust compensation packages, and high-earners may want to revise their retirement savings strategies.

In recent years, the UK government has reduced the lifetime and annual thresholds up to which individuals can make tax advantageous pensions saving across UK registered pension plans.

Effective 6 April 2016, further reductions will be implemented to these two thresholds, as summarized below. Employers may wish to review their employee remuneration strategy in light of this to determine whether they could provide benefits to staff in a more tax efficient way. Any individuals who believe that they could be affected personally by the pension changes may wish to take independent financial advice to assess their options to limit the impact of the changes.

These changes could affect:

- Individuals whose accrued pension benefits exceed (or could in the future exceed) £1 million
- Individuals who have an annual income of more than £150,000 (including employer pension contributions)
- Employers who employ individuals who fall into either of the above two categories

What are the two allowances in question?

The two relevant statutory allowances are:

- The lifetime allowance (the LTA)
- The annual allowance (the AA)

The LTA is the total amount of tax advantageous pension accrual which an individual can benefit from in his/her lifetime. If the LTA is exceeded when an individual takes his pension benefits on retirement, the individual is liable to pay a tax charge of up to 55% on the value of any benefits which exceed the LTA.

The AA is the total amount of tax advantageous pension accrual which an individual can benefit from each year. An individual’s pension accrual for these purposes is tested in an annual Pension Input Period.

The government is simplifying Pension Input Periods from 6 April 2016 to align them with the UK tax year (at the moment, Pension Input Periods can begin and end at different times in any given calendar year).

If the AA is exceeded, a tax charge (at the individual's marginal income tax rate) is applied to the value of the benefit accrual which exceeds the AA. Individuals can carry forward any unused AA from the previous three years in order to increase their AA for any year in which they might otherwise exceed the AA.

Impact of the April 2016 changes

LTA

Effective 6 April 2016, the LTA will be reduced from £1.25 million to £1 million. The LTA has decreased several times in recent years, from its highest point of £1.8 million. This decrease has resulted in many more individuals coming within the potential scope of the LTA.

Individuals who believe that they might be affected by the forthcoming reduction in the LTA, are able to apply to HM Revenue and Customs (HMRC) for either Fixed or Individual Protection 2016. If either of those protections is utilised, an individual will have his/her pension benefits tested on retirement against the current LTA of £1.25 million.

In order to apply for either Fixed or Individual Protection 2016, the individual in question must meet certain conditions, including:

- The individual must not have applied to HMRC for previous protections which have been available in relation to any earlier reduction in the LTA.

- In order to apply successfully for Individual Protection 2016, an individual must have pension benefits across UK registered pension plans with a value in excess of £1 million as at 5 April 2016. In contrast, there is no minimum fund value requirement to apply for Fixed Protection 2016.

- An application for either protection must be made by an individual to HMRC prior to retirement.

An individual who applies for Fixed Protection 2016 will no longer be able to make or receive any contributions to a defined contribution plan that is a UK registered pension arrangement after 5 April 2016. UK defined benefit pension accrual will also be restricted to certain limited benefit increases (such as CPI inflation increases to deferred benefits). In contrast, Individual Protection 2016 allows an individual to continue to accrue pension benefits across UK registered pension arrangements, although his/her benefits will be subject to an LTA of £1.25 million on retirement.

AA

The AA has also decreased in recent years, from its highest point of £255,000. The AA is currently set at £40,000 and up until now, has always been applied at the same level to each individual who is accruing pension benefits in the UK (regardless of an individual's income).

However, effective 6 April 2016, the AA will be subject to a tapered reduction for those individuals who have both an annual "*adjusted income*" of £150,000 or more (including the value of employer pension contributions) and an annual "*threshold income*" of at least £110,000 (excluding the value of non-salary sacrifice employer pension contributions).

The taper will apply to reduce the AA by £1 for every £2 of income above £150,000. In other words, an individual with an annual income of £210,000 or more will have an AA of £10,000 (£210,000 being an income which is *£60,000* more than £150,000, so that the AA is reduced by *£30,000*). As is the case at the moment, an individual will be able to carry forward unused AA from the last three years (even when the AA was higher in those years than the tapered level).

The government has implemented certain anti-avoidance provisions to prevent arrangements which might reduce artificially an individual's "*adjusted*" or "*threshold*" income so as to seek to avoid the tapered AA reduction. Any measures taken by employers or individuals to combat the reduction in the AA should be assessed against these anti-avoidance provisions.

The anti-avoidance provisions will apply when all of the following conditions are met:

- An individual enters into any "*arrangements*" which can reasonably be assumed to have as their main purpose (or one of their main purposes) a limitation in the level of the reduction applied to the individual's AA under the taper. "*Arrangements*" for this purpose includes "*any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable)*".

- The arrangements involve a reduction in either or both of the individual's "*adjusted*" or "*threshold*" income.

- These reductions are redressed in another tax year.

Recommended next steps

In light of the forthcoming changes, we recommend that:

- Employers undertake a review of their remuneration strategies for high earners to determine whether they employ any individuals who could be affected by the reductions in the LTA and/or the AA.

- Although any tax charges which arise as a result of an individual having exceeded the LTA or AA will be the responsibility of that individual (unless otherwise agreed with his/her employer), as a matter of best practice in terms of employee relations and discharging the duty of good faith which employers owe to their staff, employers should engage with employees who may be affected by the changes. Employers may wish to offer a different remuneration package to any affected individuals to ameliorate the impact of the LTA and AA reductions.

- Individuals who could be affected by the reduction in the LTA and/or the AA should review (and where appropriate, take independent financial advice in relation to) their retirement savings strategy to determine whether they may wish to apply for Fixed or Individual Protection 2016, make use of the current LTA and AA thresholds prior to 6 April 2016 or use any carry forward allowances to boost their AA despite a tapered AA reduction applying to them from 6 April 2016.

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