

Talking points – Reaction to PBR

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Only the change to the level of VAT announced in the recent Pre Budget Report (PBR) will have an immediate impact on pensions, as all other measures take effect from 2010 or later.

A precedent has been set by effectively eroding the level of pension funds that can be tax sheltered as well as making tax and retirement planning for high earners more complicated – a further step away from the stated goal of “simplification”. Fortunately, clever planning will help clients mitigate some of the impact of the PBR.

Winners

VAT savings

As of 1 December 2008 VAT has been reduced from 17.5% to 15%, reducing the cost of administration and advice where they are subject to VAT. The impact of this will be small but it will be to the client’s benefit. For example on a fee of £500 the client will save £12.50; on a £2,500 fee they will save £62.50. Property acquisition is also affected with a significant impact for those close to certain thresholds. Where properties are VAT elected, investors have to pay VAT on the purchase price. This is added to the purchase price of the property and stamp duty land tax (SDLT) is calculated on the combined amount. The change in the level of VAT could prove beneficial if the now lower VAT calculation results in the total acquisition cost being below one of the SDLT thresholds.

Purchase price of property £216,000.00 - VAT elected:

	SDLT %	SDLT	Total
Pre-PBR VAT: £253,800	3%	£7,614	£261,414.00
Post-PBR VAT: £248,400	1%	£2,484	£250,884.00
Total Saving £10,530.00			

Income tax

Whilst the new level of income tax at 45% for earnings over £150,000 has been confirmed, it should be noted that the reclaim of tax relief at this level for pension contributions has not. However, if this were the case then pension contributions would be an obvious way for top earners to mitigate some or all of the impact of the new higher tax rate.

Of course, the freezing of the Lifetime Allowance (LTA) from 2010 caps the total pension fund that can be sheltered from tax, increasing the risk of incurring the Lifetime Allowance Charge (LAC) for some clients. However, if tax relief is available, high earners may be encouraged to contribute irrespective of the potential LAC they could incur.

The 55% lifetime allowance charge was set to be tax neutral, based on 40% tax relief and the value of the pension’s tax shelter. With 45% tax relief potentially newly available, and growth in the pension fund sheltered from income and capital gains tax, the 55% LAC may represent better “value” where the funds over the LTA are taken as a lump sum. However, if the excess is taken as an income from the SIPP the overall tax charges including income tax may be more than the intended 55%.

National Insurance Contributions (NICs)

The 0.5% increase in National Insurance rates will boost the attractions of “salary sacrifice” and “bonus waiver” arrangements for pension contributions. As well as the potential to make further income tax savings, further savings can also be made on the level of NI paid.

The increase in employer and employee NICs of 0.5% will be introduced in 2011. This is likely to accelerate employer (and employee) interest in salary sacrifice arrangements. The delay in the implementation of the increase in NI will give employers time to start making preparations to introduce more tax-efficient schemes by offering salary sacrifice arrangements around pensions, to off-set the rising costs.

Pension commentators are already predicting the number of people sacrificing their salaries to fund a pension to soar given the increase in NIC, as someone earning over £100,000 could save up to £1,200 a year.

Losers

Following pension simplification, LTA was introduced and initially set at £1.5 million. It has since risen to £1.65 million and will now be frozen at £1.8m in 2010/11.

The tax charges vary depending on how the investor wishes to take their benefits. If the excess fund is taken as a cash lump sum, a 55% tax charge will be deducted prior to the payment. If the individual opts to take the excess as income the individual will be subject to an initial lifetime allowance charge of 25% and then the residual will be taxed as earned income, which could result in a higher overall tax charge.

With the LTA being frozen, there will be effective erosion of pension funds, and possibly reduced contributions from higher earners and subsequently reduced retirement income. Should salaries and subsequent contributions continue to rise, there is the risk that high earners will exceed the LTA limit. It is also possible that some had previously calculated that they did not need to register for protection.

Take a 60 year old with a current pension fund totaling £600,000 earning a salary of £200,000. Over the next five years (up until retirement) they wish to contribute the maximum relievable amount into their pension fund. Assuming a gross 7% increase of the fund over the following 5 years the projected fund value would be over £2m. As the LTA threshold would be frozen at £1.8 million, the individual would be liable to pay tax charges on the excess as described above.

The annual allowance will be frozen at £255,000 from 2010-2011

This will affect high earners who are looking to maximise tax relief on their contributions. If an individual's total pension input exceeds the annual allowance they will be subject to a 40% tax charge. Also, if the employer is making large contributions this will reduce the amount the individual could contribute that would qualify for tax relief.

For example:

An individual currently earns a salary of £230,000 and expects to see this rise by 3% per annum. With the annual allowance threshold being capped for five years from 2010/11, by 2014/15 the salary would have risen to nearly £275,000, resulting in £20,000 of earnings that will not qualify for tax relief.

This only considers the scenario for one year. Whilst no prediction can be made on what the level of annual allowance will be post 2015/16, if individuals' net relevant earnings continue to increase and the annual allowance remains fairly static, individuals are likely to be missing out on the ability to maximise their contributions and benefit from tax free growth within their pension.

Trivial Commutation

The restrictions on the annual allowance will also affect pension funds at the other end of the scale. If an individual's total pension benefits are less than 1% of the LTA it is possible for the total benefit to be paid as a cash lump sum rather than as income.

When the lifetime allowance was introduced, the government set out what the increase would be for the next 5 years. It was widely assumed that this would continue to increase in a similar way; until, that is, the recent announcement that LTA will be frozen for 5 years from 2010/11.

This means, for those individuals with small funds close to 1% of the LTA, any increase in value may take their pension funds over the threshold forcing them to purchase an annuity that may not meet their needs. However, normal rules apply to ill health cases which will not be affected.

Comments – our view

In terms of VAT, pension administrators are now essentially facing the same problems as retailers. Advisers will have to be confident their SIPP provider is able to effectively handle the immediate reduction in VAT without costly errors, especially when dealing with VAT elected commercial property. Just as importantly, their SIPP provider will need to be prepared to act in 13 months time when VAT is returned to its previous levels, or even increased higher.

Whilst the increase in higher rate income tax to 45% could possibly be offset by higher contributions, the reduction of both annual and lifetime allowance levels in real terms could dissuade higher earners from maximising their pension contributions.

Above all, the ability for investors to access quality financial advice has never been more important.