

## Changes to the tax regime for individuals

As you may be aware, the Chancellor has announced significant changes to the tax regime for individuals. Some of these changes are already in place, whilst others take effect in future years. The Chancellor has not only brought forward proposals which were to take place in 2011, he has also made changes to his original announcements.

We thought you may find it useful to have a summary of the major changes.

### Changes to the personal allowance

For **2010/11**, the personal allowance will be subject to an income limit of £100,000. An individual's personal allowance will be reduced by £1 for every £2 of adjusted net income above the income limit. Also, the personal allowance may be reduced to nil from this income limit instead of the proposed two stage reduction announced in 2008. Adjusted net income for these purposes is broadly all income after adjustment for pension payments, charitable giving and relief for losses.

### Changes to the rates of tax

Instead of introducing a 45% top rate of tax in 2011, a new rate of income tax will be introduced of 50% from **6 April 2010**. This will apply to taxable income above £150,000.

Dividend income is currently taxed at 10% where it falls within the basic rate band and 32.5% where liable at the higher rate of tax. A new rate of 42.5% will be introduced for dividends which fall into the income band above £150,000.

### Example

The effect of these changes can be illustrated as follows:

	2009/10		2010/11	
	£	Tax £	£	Tax £
Non dividend income	200,000		200,000	
Personal allowance	(6,475)		Nil	
Taxable income	193,525		200,000	
Taxable at 20%	37,400	7,480	37,400	7,480
Taxable at 40%	156,125	62,450	112,600	45,040
Taxable at 50%			50,000	25,000
Total tax liability		£69,930		£77,520

The previous example assumes that the basic rate band remains unchanged from 2009/10 to 2010/11.

## National Insurance Contributions

The national insurance thresholds have been increased for 2009/10 but the rates of Class 1 and 4 contributions have been held at their 2008/09 levels.

An increase in the rates of national insurance is proposed from **April 2011**. The 0.5% increase will apply to the rates applicable to employers, employees and the self-employed.

## Removal of higher rate relief on pension contributions

Pension contributions made by an individual are usually paid net of basic rate tax and where the individual is a higher rate taxpayer, further relief is due which significantly reduces the net cost of the premium. For example, a cash contribution of £100 receives a basic rate credit of £25 which is added into the pension fund. The gross contribution of £125 generally attracts relief at 40%, totalling £50. After taking into account the basic rate relief already given, the individual is entitled to claim further tax relief of £25 which takes the net cost of the contribution down to £75.

Whilst 50% tax relief may be available for 2010/11, under the changes to the tax rates detailed above, the government has announced its intention to restrict tax relief on pension contributions with effect from **6 April 2011** for people with taxable income of £150,000 or more. The tax relief will be tapered down until it is 20%.

In addition, legislation is introduced to prevent those potentially affected from seeking to forestall this change by increasing their pension contributions in excess of their normal regular pattern, prior to that restriction taking effect.

The forestalling measures will apply to individuals with relevant incomes of £150,000 or more who from Budget Day (**22 April 2009**) change:

- their normal pattern of regular pension contributions, or
- the normal way in which their pension benefits are accrued, and
- their total pension contributions or benefits accrued exceed generally £20,000 a year.

The appendix at the end of this document sets out the details of this complex legislation

## Will these changes affect you?

Most of these changes are dependent on the level of your income, although the definition of 'income' is different for the purpose of the personal allowance change, the tax rate change and the pension forestalling rules. So much for tax simplification!

It may be possible to avoid the effect of some or all of these changes with proactive planning, so please do get in touch if you would like to discuss any of these issues in more detail.

## **Appendix - Pension Changes**

Set out below are the technical details, with examples where appropriate, of the forestalling legislation for pension contributions.

### **Higher rate relief for pension payments**

The government has announced its intention to restrict, to the basic rate of income tax, tax relief on pension savings with effect from 6 April 2011 for individuals with taxable income of £150,000 or more. It is understood that the relief will be tapered out between £150,000 and £180,000 so that, above that figure, only basic rate relief will be available. There is no legislation yet introduced on this.

### **Immediate effect**

Complex provisions have been introduced to prevent individuals who are likely to be affected from making significant additional pension contributions in the next two years in anticipation of the above changes.

The rules that deal with this are tortuous and are dependent upon some complex definitions which will be explained below. The essence is that a charge will arise if:

- the total adjusted pension input amount (TAPIA) of an individual whose relevant income is £150,000 or more exceeds
- the amount of the special annual allowance (SAA).

The amount of the SAA is generally set at £20,000 but this can be reduced where so-called 'protected' pension inputs have been deducted in arriving at the TAPIA. It is possible for the SAA amount to be reduced to nil.

Where the mean of the infrequent (less frequently than quarterly) money purchase contributions for 2006/07, 2007/08 and 2008/09 exceeds £20,000, but is less than £30,000, the SAA will be the mean figure. Where the mean is £30,000 or more, the SAA will be £30,000. The remainder of this note uses the £20,000 as the SAA for simplicity.

### **What is the charge?**

The charge is 20% of the excess of the TAPIA over the SAA. The charge is payable by the individual irrespective of whether or not they are UK resident or domiciled and irrespective of where the pension scheme is located. It is deemed to form part of the individual's tax liability for the year but is not part of their income.

### **Meaning of 'relevant income'**

This is the critical issue because unless the relevant income is £150,000 or more the charge cannot apply. It is not, however, simply a case of looking at the calculation for the tax year. The legislation requires that the calculation has to be considered for the two preceding years as well and if the £150,000 limit is breached in any of the years then the relevant income for the tax year will be deemed to exceed £150,000.

The position can be summarised as follows:

- 2007/08 relevant income £150,000+ then the rules have to be considered for 2009/10;
- 2008/09 relevant income £150,000+ then the rules have to be considered for 2009/10 and 2010/11;
- 2009/10 relevant income £150,000+ then the rules have to be considered for 2009/10 and 2010/11.

## Basic calculation of relevant income

Step 1		Identify total income for the year.
Step 2	ADD	Any pension contributions which were deducted from income in determining total income because they were included under a net pay arrangement.
Step 3	DEDUCT	Any reliefs which are deductible in arriving at total tax liability. The main example will be loss reliefs.
Step 4	DEDUCT	Total pension contributions made in the year subject to a maximum of £20,000. Note: This figure is not affected by the 'infrequent contributions' rule detailed above.
Step 5	ADD	Amount of salary sacrificed for additional pension contributions or an enhancement of pension benefits where the scheme started after 22 April 2009.
Step 6	DEDUCT	Grossed up Gift Aid payments.

## Example

Step 1		Taxable employment income is £142,000 and other income is £20,000. <i>Total income = £162,000</i>
Step 2	ADD	Contributions of £9,000 were made to a registered pension scheme under net pay arrangement. <i>Running total = £171,000</i>
Step 3	DEDUCT	No other reliefs to deduct. <i>Running total = £171,000</i>
Step 4	DEDUCT	In addition to the payments of £9,000, contributions made of £10,000 to a personal pension plan. These gross up to £12,500 making the total relievable contributions £21,500. Only £20,000 can be deducted. <i>Running total = £151,000</i>
Step 5	ADD	No salary sacrifice scheme was in place. <i>Running total = £151,000</i>
Step 6	DEDUCT	Gift Aid payments made of £500 in the year. This grosses up to £625. <i>Running total = £150,375</i> <i>This exceeds the limit and the potential of a charge still needs to be considered.</i>

## **Total adjusted pension input amount**

On the assumption that relevant income breaks the £150,000 limit, it becomes necessary to consider whether the TAPIA is greater than £20,000. If it is, then the SAA charge will arise.

The starting point will be to consider the total pension input amount in the tax year. For defined benefits schemes, the basic calculation of pension input will consider the increase in the value of rights during the year. For money purchase schemes, the basic calculation of pension input is the total of contributions made in the period by the individual and, if they have one, their employer.

Having established the total pension input, it is to be reduced by three further amounts to arrive at the TAPIA for the year. The deductions are made in respect of:

- protected pension inputs which are defined for each type of scheme;
- relevant refunded amounts; and
- for 2009/10 only any pension input relating to the period from 6 April 2009 to 22 April 2009.

## **Protected pension inputs – general**

The protected pension inputs appear twice in the calculation of a SAA charge. They are:

- deducted in calculating the TAPIA; but
- also deducted from the SAA of £20,000.

So if an individual has protected pension inputs in any year of say £10,000 out of total pension inputs of £30,000 the position on the charge will be:

### ***Calculation of TAPIA***

Total pension inputs – protected pension inputs = £30,000 - £10,000 = £20,000

### ***Calculation of charge***

SAA for year = £20,000 – protected pension inputs = £20,000 - £10,000 = £10,000

Charge = TAPIA – adjusted SAA = £20,000 - £10,000 = £10,000 x 20%

What constitutes a protected pension input will depend on the type of pension scheme. The arrangements for defined benefit schemes and money purchase schemes are set out below.

## **Protected pension inputs – defined benefit schemes**

For the purpose of calculating the TAPIA, the legislation specifies that certain contributions made to purchase added years may be treated as protected contributions.

General contributions to a direct benefit scheme are protected if the scheme was in place before 22 April 2009 and there is no material change in the rules for calculating benefits after 22 April 2009. If a change has occurred then the level of inputs not attributable to the change remains protected. No adjustment is needed if the change in the scheme affects at least 50 active members of the scheme.

## **Protected pension inputs – money purchase schemes**

Where the money purchase scheme is an occupational scheme, a public service pension scheme or a group pension scheme, any AVCs paid in the period may be protected pension inputs.

For all money purchase schemes, contributions will be regarded as protected pension inputs where the individual has been an active member of the scheme since before 22 April 2009 and the payments have been paid:

- at least quarterly without any failure to pay except on an insignificant number of occasions; and
- at a rate that has not increased otherwise than in accordance with an agreement made before 22 April.

This latter condition will cause problems where a company has made annual contributions to a pension scheme for a director in the past. There will be no pattern of normal contributions in such a case and any contributions made after 22 April 2009 will not be protected pension inputs.

### **Example**

Alastair is a director of Midlothian Ltd. He has a money purchase pension arrangement into which he has made monthly contributions of £200 net (£250 gross) since the scheme started in March 2001. Each year the company has made a significant pension contribution once the profits for the year are known. In its year to 31 March 2010 Alastair continues his contributions and the company makes a payment of £100,000.

The total pension inputs in the year will be £103,000 and of these only £3,000 will be protected, making the TAPIA £100,000. The SAA charge for the year will be £100,000 less £17,000 (£20,000 - £3,000) i.e. £83,000.

## **Protected pension inputs – new and re-activated schemes**

An individual may start to make pension contributions to a new scheme or re-activate contributions to an existing scheme on or after 22 April 2009. The contributions to that scheme will be protected provided a number of conditions are satisfied.

These conditions effectively mean that where a self employed individual begins to make payments under a personal pension plan after 22 April 2009 those contributions will not be protected inputs. Similarly, a new employer's scheme with less than 20 members will not qualify for protected inputs.

## **Relevant refunded amounts**

The amounts of relevant refunds are deducted from the normal pension inputs in arriving at TAPIA and in consequence will not be subject to the SAA charge. The definition of a relevant refund is complex but it must relate to contributions paid in a year which is not earlier than 2009/10 and must be paid in the year following the contribution year eg refund of 2009/10 contributions must be paid in 2010/11.

## **Pre-22 April 2009 inputs**

A deduction is made from the TAPIA and SAA in respect of amounts paid between 6 and 21 April 2009. The precise definition depends on the type of scheme.

### **An HMRC example**

H had normal, ongoing, regular pension contributions into his scheme in 2008/09 of £55,000. He therefore has a protected pension input of £55,000. As his protected pension input is greater than the special annual allowance of £20,000, he has no special annual allowance remaining and any non-protected pension input will be liable to the special annual allowance charge.

H pays £65,000 contributions to his scheme in 2009/10, an increase of £10,000. This increase is therefore a non-protected pension input. Higher rate tax relief on the excess will be recovered by a charge to tax at 20% on £10,000.

### **Conclusion**

As can be seen, the rules are complex and punitive if they apply. Detailed calculations may need to be undertaken for individuals who are potentially affected by these changes.