



## New attack on Defined Benefit Pension Schemes

Read this briefing if:

- You are a member of a final salary or similar pension scheme;
- Your normal retirement date is on or after 6 April 2011;
- Your income exceeds or is likely to exceed £130,000 p.a. before you retire; and
- You are concerned about new penal tax charges on your pension accruals.

Also read this briefing if you or your clients are involved in a scheme whose members are in this situation.

### "Implementing the restriction of pensions tax relief"

Under this relatively innocuous heading, the 2009 pre-Budget report gave further details of proposals first announced a year earlier. These proposals will, from 6 April 2011, limit tax relief on pension contributions to 20% for those earning more than £180,000 p.a.. They also implement a phased restriction for those earning between £150,000 and £180,000<sup>1</sup>.

The proposals are still at consultation stage – see [http://www.hm-treasury.gov.uk/d/pbr09\\_consult\\_pensions.pdf](http://www.hm-treasury.gov.uk/d/pbr09_consult_pensions.pdf).

But lurking within the consultation is a new proposal to bring defined benefit (or DB) schemes under the same restrictions. These include traditional final salary schemes.

In one sense this is understandable: after all why restrict relief just for one type of pension arrangement?

However, DB schemes have a number of features which make it difficult to charge tax in the same way as money purchase (defined contribution or DC) schemes.

The most notable difference is that there is no obvious "contribution" on which to impose the tax charge. DB pensions may be funded, unfunded, over-funded or under-funded by the employer – but this makes little difference (at least in the short-term) to the value of the individual member's benefits.

### Valuing the promise

What the member really receives is a promise.

That promise in its simplest form is:

- from a future date
- to pay an annual amount
- until the death of the member

The value of that promise changes from time to time. It will typically increase as years of service are built-up; as pensionable income rises; if enhancements or augmentations are made; or if pension age is brought forward.

It is also clear that the value of a promise increases the older the recipient: a promise to pay £1,000 starting next year is clearly worth more than a promise to pay £1,000 starting in 40 years.

### Consulting on valuation methods

The above discussion about value is somewhat abstract. But from 6 April 2011, an exact value will need to be agreed.

This is because HMRC propose from April 2011 to impose a tax charge on scheme members<sup>2</sup> by reference to a deemed contribution equal to the annual increase in value.

Much of the consultation is about how this valuation will be done. The preferred method is likely to involve multiplying the increased pension by an age-related factor (ARF) (for example 6 if you're 35; 10 if you're 45; 17 if you're 55).

*continued overleaf*

<sup>1</sup> Certain anti-forestalling measures were also announced in April 2009 and updated in the 2009 pre-Budget report. We do not consider these further in this briefing.

<sup>2</sup> The tax charge will apply only to members whose basic income is above £130,000 and whose income (including the deemed pension contribution) is above £150,000.

## Why this matters

Lost in the details of the consultation is the potential for very large tax charges. Take the following example:

Jim is 52 and due to retire in 8 years time. As at 6 April 2011 he has just finished his 15th year of service. His salary increases from £180,000 to £200,000.

The extra year of service and the salary increase mean that his pension increases from  $14/60 \times £180,000$  to  $15/60 \times £200,000$ . That is an increase from £42,000 to £50,000.

Using an ARF of say 15 and multiplying it by the extra £8,000 pension gives a deemed contribution to the scheme of £120,000.

Had Jim made a contribution of £120,000 to a DC scheme, his tax relief would have been restricted from 50% to 20%. So applying a 30% clawback to £120,000, Jim faces a tax charge of £36,000.

As Jim's salary has risen by only £10,000 after tax this gives an effective tax rate of 360%!

## How will this tax charge be paid?

Short of paying £36,000 through self-assessment, the consultation offers Jim two potential alternatives. Unfortunately neither of them is particularly satisfactory.

The first suggestion is that if the clawback is above £15,000, Jim can opt to have the pension fund pay it for him (with a corresponding reduction in his rights). The problem with this is likely to be that the fund may be prevented from doing so: either due to its rules or due to liquidity problems.

The second suggestion is that Jim can spread the charge over 3 years. But this will be little comfort as each successive year may generate its own tax charge too.

Worse still the consultation suggests that Jim will get no rebate if his salary subsequently falls or if the pension is, for whatever reason, unable to pay out.

## What are Jim's options?

Pension decisions are complex and Jim will need to consult a financial advisor to understand the position in the round. He will need to balance the tax charges against the relative security that a DB pension gives him.

Possible options might include:

- Jim might consider retiring early but this is clearly a much bigger decision with many other consequences. Jim needs to be aware, however, that from 6 April 2010 the minimum retirement age increases from 50 to 55. So at 52 he either needs to leave very shortly, or he may be "trapped" for the next 3 years.
- Jim's employer and scheme trustees may want to consider amending their rules and consider providing other benefits to senior employees instead.
- Jim, his employer and the scheme trustees might want to consider a robust response to the consultation!

## How can Burges Salmon help?

Working together with your financial advisor, Burges Salmon's tax lawyers can help those in Jim's position to understand the rules of your scheme; the likely impact of the proposals and the options you have.

Our dedicated pensions team can help sponsoring employers and scheme trustees assess their options and any rule changes which may be needed.

For further information contact:



**John Barnett (for advice to individuals)**

Direct Dial: (0117) 902 2753  
john.barnett@burges-salmon.com



**Tim Illston (for advice to sponsors and trustees)**

Direct Dial: (0117) 939 2284  
tim.illston@burges-salmon.com