

**Note:**

The government intends to repeal and replace the taxation changes which will affect high earners from April 2011 however the detail of replacement provisions has not been finalised. The consultation – Restriction of pensions tax relief – which sets out the proposed changes can be found at the following link.

[http://www.hm-treasury.gov.uk/d/consult\\_pensionsrelief\\_discussion.pdf](http://www.hm-treasury.gov.uk/d/consult_pensionsrelief_discussion.pdf)

A revised document on the changes will be prepared as soon as possible after the taxation changes are finalised.

The anti-forestalling provisions will remain in place and therefore the guidance contained in this document specifically in relation to anti-forestalling is still relevant.

August 2010



## **Information for high earners in USS**

The new tax changes, and how they fit into the overall picture of pensions taxation for high earning scheme members

**February 2010**

## Information for high earners in USS

### Introduction

You may be aware that, in recent months, the government has implemented a series of measures which affect the tax treatment of pension contributions to schemes such as USS. In the main, these changes will come into force in April 2011, so one might be forgiven for thinking that the changes can be noted for now, and then reviewed as and when they become effective. However, things aren't quite that straightforward, and for scheme members there are a number of issues that need to be thought about sooner rather than later, and some pitfalls to be aware of.

These changes are happening alongside more general changes to income tax, which will come into effect from April 2010. In this article we will explain about those changes too, because it forms part of the overall picture, and there are some important links to some of the April 2011 changes. Finally, we will also explain about the rules about the overall size of pension pots, as any commentary on these issues would be incomplete without some analysis of the current position in that area.

The details are complex, and the situation is made more difficult given the fact that the legislation is far from finalised (further revisions were announced in the Chancellor's Pre-Budget Report in December 2009, and a Revenue consultation entitled "*Implementing the restriction of pensions tax relief*"<sup>1</sup> is due to end on 3 March 2010), however we hope that this provides a timely and informative update for high earning members of USS.

We would emphasise that this note is not intended to offer *advice* to scheme members. As mentioned, the issues are complex and very much depend on individual circumstances, and a member should take independent financial advice before taking any decisions as a consequence of these changes (and indeed USS has a list of independent advisers that might be used, at the USS website at <http://www.uss.co.uk>).

Summary of the changes:

6 April 2010	Introduction of 50% tax band for taxable income in excess of £150,000 pa Personal Allowances reduced where taxable income is in excess of £100,000 pa (personal allowance is reduced by £1 for every £2 of taxable income in excess of £100,000 pa)
6 April 2011	Tax relief to be restricted for those with Gross Income in excess of £150,000 pa AND Relevant Income in excess of £130,000 pa Tax relief reduced through tapering from 50% to 20% for Gross Income in excess of £150,000 pa, so that those with income in excess of £180,000 will receive only 20% tax relief Gross Income for these purposes will include the value of the pension benefit funded by the employer but Relevant Income will not include the value of such benefit.

On the face of it these are fairly straightforward changes, but unfortunately there is a significant amount of detail which results in this becoming extremely complex, but we hope that this short

<sup>1</sup> The consultation can be found at [http://www.hm-treasury.gov.uk/d/pbr09\\_consult\\_pensions.pdf](http://www.hm-treasury.gov.uk/d/pbr09_consult_pensions.pdf)

guide offers some help through what is a challenging maze of pensions regulation and Revenue guidance.

### **What is anti-forestalling?**

You may have inferred from the introduction that until April 2011 there is an opportunity to benefit from 50% tax relief if you were to pay additional contributions to a pension scheme. However, HM Revenue & Customs has introduced measures to prevent tax-payers benefitting from the potential extra tax relief, and it refers to these measures as 'anti-forestalling'.

To explain further, there are changes to the tax rules that come into force in April 2010, which essentially mean that a new income tax rate of 50% will apply to taxable incomes over £150,000<sup>2</sup>. There are then further changes down the line in April 2011, which will directly affect the rate of tax relief that is available on pension contributions for high earners.

However, in advance of these changes the government has – with immediate effect – implemented measures to prevent those likely to be affected from seeking to 'forestall' the changes.

It is perhaps helpful to consider how this forestalling would work – if it were applicable – as this can help the reader to understand the reason and design of the changes. Up until now, pension contributions have attracted tax relief in full, which means that a person's income is reduced by the value of pension contributions to a registered pension scheme before it is subject to income tax. So, for example, a person with a salary of £200,000 per annum would pay his/her normal USS contribution of £12,700 per annum (6.35%), and the member's taxable pay for the year (ie the amount subject to income tax) would be the gross salary less the pension contributions, ie £187,300.

It can be seen therefore that pension contributions attract valuable tax concessions in that they reduce an individual's pay for tax purposes. However, government has identified that the benefit of tax relief "is not spread evenly"<sup>3</sup> and that high earners claim a disproportionately high portion of the overall relief available, and it plans to reduce that benefit from April 2011. In the meantime however, it wants to make sure that high earners are not able to put higher amounts of contributions into their pension schemes in anticipation of the tax relief changes in April 2011 whilst still gaining full tax relief. So, we now have anti-forestalling arrangements, designed to neutralise any advantage that high earners might have thought was available to maximise their pension contributions before 6 April 2011.

### **Who is affected by the anti-forestalling provisions?**

This is an area where there have been very recent revisions by government. The following analysis explains the terms that are anticipated to be in operation, but the reader should recognise the uncertainties that will exist until those revisions are incorporated into statute.

After those preliminaries, the anti-forestalling provisions will not apply where a high earning member continues to make their normal, ongoing pension contributions at the level or rate they were prior to 22 April 2009 (this is the date of the first Budget announcement on this issue). So, in the period prior to April 2011, a member will continue to receive tax relief on their pension

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<sup>2</sup> The changes to tax rates are more detailed in that there is also a change to the personal allowance from April 2010, in that it will be reduced at a scale rate of £1 for every £2 of earnings above £100,000 of income, and will be completely lost from around £112,950 (based on the current allowance of £6,475). This will result in an effective tax rate of 60% in the income band between £100,000 and £112,950.

<sup>3</sup> For details see Box 2A in chapter 2 of [http://www.hm-treasury.gov.uk/d/pbr09\\_consult\\_pensions.pdf](http://www.hm-treasury.gov.uk/d/pbr09_consult_pensions.pdf)

contributions at their marginal rate so long as they do not change their pattern of regular pension saving.

What constitutes a change to the regular pattern of pension saving is defined further in schedule 35 to the Finance Act 2009 and the Revenue's consultation documents, but the following points are hopefully helpful in clarifying the government's intentions:

- If a member pays additional voluntary contributions (AVCs) by regular instalment (which in USS means on a monthly basis), which commenced prior to 22 April 2009, then a continuation of these AVCs will not trigger the anti-forestalling provisions. Under schedule 35 to Finance Act 2009 contributions are regarded as 'regular' if they are made on a quarterly or more frequent basis.
- AVCs paid other than by regular instalment are more complicated, and generally there is a risk that they will be considered to be subject to the anti-forestalling provisions as they are not part of regular pension saving. Extreme caution is needed here, and independent advice is essential before making payment of a lump sum AVC payment (the consequences of doing so from 22 April 2009 are set out below).
- Care is also needed in relation to salary sacrifice for pension contributions arrangements. Any salary sacrifice arrangements which an individual makes on or after 22 April 2009 could trigger the anti-forestalling provisions.

**All of the anti-forestalling provisions affect high earners, but exactly who is a "high earner" for these purposes?**

There have been two phases to the introduction of the anti-forestalling provisions, and the details (in chronological order) are as follows:

**Introduced with effect from 22 April 2009 in the 2009 Budget**

*The anti-forestalling provisions will apply to any person who has 'income' which is more than £150,000. The key issue is what measure of 'income' is to be used in this scenario, and in simple terms it is the amount on which an individual is assessable to income tax, from all sources. For example, it includes all earnings from employment, together with instalments of pension and interest on savings. Dividend income (including corresponding tax credits) and rental income also count, as do redundancy / termination payments to the extent they exceed £30,000, charitable donations that do not reduce income assessable to income tax are, if they qualify the member for Gift Aid relief for that year, grossed up and deducted. Donations made in the tax year that count for 'gift aid' are deducted.*

*Bear in mind that, if any income is sacrificed by an employee in exchange for pension contributions under an arrangement made after 12 noon on 22 April 2009, the sacrifice is not recognised for the purpose of measuring income ie the pre sacrifice amount is counted. There is also a limit of £20,000 on the amount of pension contributions that may be deducted in calculating 'income' for these purposes.*

And then further changes were made in the 2009 Pre-Budget Report ...

**Introduced with effect from 9 December 2009 in the Pre-Budget Report**

*It was announced that the anti-forestalling provisions will be extended from 9 December 2009 to any individual whose relevant income is **£130,000** or more, and these revised provisions will operate in the same way as for those mentioned above, except that the references to salary sacrifice will be amended to refer to those arrangements made on or after 9 December 2009 where an individual has relevant income of more than £130,000 but less than £150,000.*

Importantly, the income tests mentioned above will apply to the income for the current year and also to the income for the preceding two tax years, and therefore the anti-forestalling provisions may be triggered by a payment in a year in which the income test above is not satisfied, but due to the fact that it was satisfied in one of the preceding two tax years.

### **So, what happens if the anti-forestalling provisions are triggered?**

If a member makes a pension contribution – or makes a salary sacrifice arrangement which constitutes a change to the pattern of ongoing, regular pension saving, and the income tests are satisfied, then the Special Annual Allowance test will apply. The amount of the regular ongoing pension saving is known as the “protected pension input amount”. All individuals have an allowance – which is generally £20,000 – and it is only where the value of the “protected pension input amount” plus the additional contributions paid exceeds the £20,000 threshold that a tax charge will be applicable. The following example, which is similar to that used by the Revenue in its technical documentation<sup>4</sup>, is helpful in understanding the principles:

#### **Example 1:**

Dr Frank has relevant income of £200,000 in 2009-2010 and makes overall pension contributions of £2,000 per month to the scheme (which comprise the regular USS contribution of £1,058, plus a further £942 per month by way of a monthly AVC payment to the scheme’s in-house facility with Prudential).

Although Dr Frank’s pension contributions are more than £20,000, they will not be subject to the special annual allowance charge because they only reflect his continuing, regular, pension savings that is a protected pension input amount for the tax year. Dr Frank’s special annual allowance is £20,000 but his special annual allowance for 2009-2010 is reduced by the amount of his protected pension input amount for the same tax year. As Dr Frank’s protected pension input amount is £24,000 for 2009-2010 (12 x £2,000) this has the effect of reducing his special annual allowance to nil for 2009-2010.

Dr Frank pays a further, one-off lump sum contribution of £5,000 in 2009-2010 to the Prudential AVC facility, which is not a protected pension input amount. As Dr Frank’s special annual allowance for 2009-2010 is nil he is liable to a special annual allowance tax charge based on the whole of the £5,000 payment; the charge being £1,000 (£5,000 x 20%).

It is clearly important for individuals to think very carefully before they take any action which might be considered to be a change to their regular, ongoing pattern of pension saving.

**Note:-** in calculating the amount of pension input for a **tax year** one should exclude provision under any arrangement if all of its benefits begin to be paid in that year, unless the Revenue determines that such payment arises from a transaction of which one of the main purposes is to avoid a relevant tax charge (e.g., special annual allowance charge). This is especially important for members who may receive an augmentation to benefits upon retirement from their employer, or make AVC payments in the final year in which retirement occurs.

<sup>4</sup> Examples shown in <http://www.hmrc.gov.uk/manuals/rpsmanual/RPSM15102080.htm>

**So, if I maintain regular, ongoing pension saving (and ensure that I don't trigger the anti-forestalling provisions), what will happen in April 2011?**

From April 2011 the government proposes to restrict the amount of tax relief that is available to those with gross incomes of £150,000 or more. Tax relief will be tapered away so that for those with gross incomes of £180,000 or more, it is worth 20%, the same as that for a basic rate taxpayer. These are the general principles, however it is important to understand that in the Pre-Budget Report of December 2009 the government introduced a new £130,000 threshold which is also relevant (and which is explained in more detail below). All of this is the subject of a Revenue consultation, and might therefore change.

**Who will be affected by the post April 2011 changes to tax relief?**

The following individuals will be affected:

Those who have "relevant income" that is at the level of £130,000 or more, with "relevant income" meaning that on which an individual is assessable to income tax plus the value of his/her own pension contributions, plus any charitable donations not otherwise counted and any income sacrificed in exchange for pension contributions under an arrangement made after the relevant date;

*and*

have "gross income" at the level of £150,000 or more, where "gross income" means the value of the relevant income of the individual above plus the value of any pension benefit funded by the employer.

The details are the subject of the current consultation by the Revenue. In particular the way that "the value of the pension benefit funded by the employer" is calculated is yet to be defined, but it is clear that those with income levels around the £130,000 level may well be affected. You should bear in mind that income includes not just earnings from employment but is specified as total income subject to tax (which would include, for example, interest from savings and rental income). The effect of all of this is that from April 2011 high earning individuals may have the tax relief on their pension contributions restricted, on a tapered basis.

**Example 2:**

Dr Jones works for University A and earns a salary of £135,000 in 2011/12, and he pays his 6.35% contribution on this salary (which equates to £8,573 per annum). He has no income from other sources, and makes no other pension contributions. His "relevant income" for these purposes is his taxable pay £126,427 (which is £135,000 – £8,573), and if you add back the value of his own pension contributions (the £8,573) then Dr Jones' relevant income for these purposes is £135,000.

**Example 3:**

Professor Smith works for University B and earns a salary of £125,000 in 2011/12. She pays her standard 6.35% contribution (£7,938), plus she pays additional voluntary contributions to purchase added years by regular instalment, at a further 4% of salary (£5,000). Professor Smith also owns a second property which she offers for letting, and she has received £8,000 in the relevant tax year in rental income. Professor Smith's relevant income is her taxable pay, which is £112,062 from her employment (£125,000 – £7,938 – £5,000), plus the £8,000 which is her rental income – which

results in total taxable pay of £120,062 – plus the value of her own pension contributions (£7,938 + £5,000 = £13,573), bringing a total relevant income of £133,000.

### **How do you measure “the value of any pension benefit funded by the employer”?**

It seems clear from the Revenue’s consultation that it will not be simply the value of the employer contributions in a DB scheme such as USS (which are currently 16% of salary). The Revenue’s preferred option is to use age-related factors, which would be used to apply a multiplier to the value of the pension (and lump sum, in the case of USS) earned in a specific tax year, to derive a figure which represents the “value of the pension benefit funded by the employer”. We must wait to see the method enacted in due course by Parliament.

### **How will the restriction of higher rate tax relief work?**

The government proposes that the restriction will be introduced through the self-assessment process, and therefore it will not be undertaken as part of the net pay arrangements through the payroll.

Individuals currently receive tax relief on their pension contributions at their marginal rate of tax (which will become 50% for incomes above £150,000 from April 2010). From April 2011, a restriction will be applied to the levels of tax relief available to high earning individuals, and the outline proposals from the Revenue are that the restriction will be equal to 1% for every £1,000 of income that an individual has over the £150,000 level. This means that for the very highest-earning individuals, who have income over £180,000, tax relief will be available at the 20% basic rate only (ie a full 30% reduction/recovery charge will apply from the then marginal rate of 50%), whilst for those with incomes between £150,000 and £180,000 an appropriate level of tapering will be derived from the 1% for every £1,000 principle.

The most important issue however is that “income” for these purposes will, as mentioned, include the value of the pension benefit funded by the employer.

Special arrangements are proposed for those who, in any particular year, have circumstances which generate very high recovery charges (the ‘recovery charge’ is the name for the charge which claws back higher rate tax relief previously granted in relation to high earners’ pension contributions).

### **What other tax issues need to be taken into account by high earners (relating to pensions)?**

The above changes are extremely important for high earning individuals, and they add another layer of complexity to the pre-existing rules for those with large pension values. These changes have been covered in detail by USS in earlier literature, notably in factsheet 16 entitled “additional information for high earners” which can be found at <http://www.uss.co.uk>.

The general principle is that the value of an individual’s pension benefits under all registered pension schemes is now able to be established using factors provided by the Revenue, and since 2006 tax charges have applied where the value exceeds the “lifetime allowance” level, which was initially £1.5 million, and which for the year 2010/11 will be £1.8 million. Special protections were available to individuals to preserve the value of their pension benefits under the special rules introduced in April 2006 (these are known as ‘primary protection’ and ‘enhanced protection’).

A key point however is that the lifetime allowance threshold will be frozen at the £1.8 million level for five years (through to 2016), which means that more people will find themselves in the position

that tax charges apply to the overall value of their pension benefits, and for those who already have pension benefits which exceed the lifetime allowance, the amount subject to tax will increase with the freezing of that allowance.

### **Opting out of USS**

With all of these changes affecting high earners, some might believe that it is appropriate to consider opting-out of USS. A decision to opt-out of a scheme such as USS is a major decision that requires very careful thought, and we would wish to make it very clear that the mention of it here does not suggest – in any way whatsoever – that it should be considered, and in any event independent financial advice is absolutely essential.

The trustee company's role here is to ensure that members are informed about the consequences of actions and decisions, and the following points should be noted:

- (a) If a member opts-out of USS, he/she becomes entitled to deferred benefits in the scheme which are only payable once the member has left all employment that gives eligibility for USS membership.
- (b) Opting out of the scheme means that a member relinquishes the very important rights that exist for active members in the event of their death. The lump sum death benefits are considerably lower for deferred members, as well as the pensions potentially payable to spouses, civil partners, children and other dependants.
- (c) Where a member opts out, it may not be possible to re-join the scheme if he/she wishes to rejoin after a period of six months has elapsed since opting out, or alternatively there may be restrictions imposed upon re-entry.
- (d) It is not permissible for an institution to establish, maintain or contribute to another pension arrangement for USS eligible employees, except where consent has been received from the trustee company.
- (e) The age at which you may receive USS benefits, and the rules for their calculation, are generally different from those that apply on retirement from active membership, and will often be less generous.

It is reiterated that opting out of USS is an extreme option which should only be considered after very careful analysis, and after having taken independent financial advice which takes full account of the consequences.

### **Summary**

The current arrangements affecting the pension rights of high earning individuals are extremely complex, and the government's new proposals add further layers of complication which affected individuals will need to consider. It is hoped that this update provides a useful analysis of the current position, however it is not intended to be a substitute for specialist advice, especially where AVCs or salary sacrifice arrangements are involved.

**Universities Superannuation Scheme Limited**  
**February 2010**



*You should be aware that this note has been prepared based, in certain areas, on draft legislation that has been put forward by Government and on draft guidance published by the Revenue, both of which are subject to change.*

**Technical reference material:**

The Revenue has prepared a number of guidance notes which may be of interest, as follows:

<http://www.hmrc.gov.uk/budget2009/pensions-technical-1550.pdf>

<http://www.hmrc.gov.uk/pbr2009/pen-annual-allow-2020.pdf>

<http://www.hmrc.gov.uk/pbr2009/pen-high-income-2020.pdf>

[http://www.hmrc.gov.uk/pbr2009/pension\\_factsheet.pdf](http://www.hmrc.gov.uk/pbr2009/pension_factsheet.pdf)

[http://www.hm-treasury.gov.uk/d/pbr09\\_consult\\_pensions.pdf](http://www.hm-treasury.gov.uk/d/pbr09_consult_pensions.pdf)

[http://www.hm-treasury.gov.uk/d/pbr09\\_consult\\_pensions\\_technote.pdf](http://www.hm-treasury.gov.uk/d/pbr09_consult_pensions_technote.pdf)