

# Pensions Tax Relief

## - Reduced Annual Allowance from 6 April 2011

One of the major changes announced by the previous Labour Government was the intention to restrict the availability of higher rate tax relief on pension savings made to registered pension schemes with effect from 6 April 2011, for high earners with gross taxable income of £150,000, or more.

The effect of this would have meant that the annual allowance of £255,000 would have remained unchanged, but the availability of higher rate tax relief for high earners would have gradually been withdrawn for those with gross income between £150,000 and £180,000, with no higher rate relief being available at all if gross income exceeded £180,000.

However, on 14 October 2010, the new Coalition Government announced that it was scrapping this planned change, and that in its place from 6 April 2011, there will now simply be a reduced annual allowance of £50,000 for everyone, regardless of their level of income.

The current 'special' annual allowance rules that might affect you if you have total taxable income of £130,000, or more, will also cease to apply from 6 April 2011.

### What is the annual allowance?

The annual allowance (AA) effectively places an annual limit on the total amount of tax efficient 'pension savings' that can be made to registered pension schemes (occupational and personal).

Since its introduction in 2006/07, when the initial annual allowance was



£215,000, the annual allowance has increased by £10,000 each tax year, but from 2011/12 it will be reduced to £50,000 and remain frozen at this level until at least 2015/16.

This means that from 2011/12, if the total contributions to all registered money purchase schemes made by, or on behalf of an individual (including by an employer), when aggregated with the increase in the capital value of any benefits held under a final salary scheme exceeds this annual limit, the individual will be subject

to a tax charge on the excess (see below for details of the carry forward facility that will be introduced from 2011/12).

### How are final salary scheme members affected?

When valuing the increase in value for active members of a final salary scheme, the current conversion factor of £10 capital for each £1 of accrued pension will be replaced by a higher flat rate factor of 16:1. This represents a significant

increase, although to soften the blow the "opening value" of an individual's final salary scheme rights will first be revalued in line with inflation (CPI) for the purposes of this test – thus meaning that only accrued pension above this amount will actually count towards the annual allowance.

So, for example, if at the start of a tax year, a member of a final salary scheme has accrued pension rights of £12,500 pa (after allowing for indexation) but by the end of

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that tax year, after receiving a pay rise and accruing an additional years service this has risen to £16,000 pa - the difference of £3,500 based on the valuation factor of 16:1 has a capital value of £56,000, and therefore exceeds the annual allowance for 2011/12 by £6,000.

If the member has no 'unused' annual allowance to carry forward from a previous tax year to offset against this £6,000 excess, as a 40% higher rate taxpayer, the tax charge would therefore be £6,000 x 40% = £2,400.

### What changes are being made to the tax charge and how will it be paid?

The tax charge is currently set at a flat rate of 40% but from 6 April 2011 this will be replaced by a tailored tax charge of up to 50% in order to cancel-out any tax relief on any excess pension savings made above the annual allowance.

Like now, any tax charge will be met by individuals out of their current income, via self-assessment, although the Government has said that where the charge is above a certain level that is not manageable out of current income (this level is not currently specified), there should be the option to spread the tax charge over a number of years or allow the member's pension scheme to pay the charge on their behalf.

### Carry Forward

It is important to remember that it will be possible to carry-forward any 'unused' annual allowance from up to three previous tax years to offset against any pension savings amount in excess of the £50,000 annual allowance before a tax charge applies - but only if the individual was a member of a registered pension scheme at some point in the tax year that the unused annual allowance is being carried forward from.

So, if despite being a member of a registered pension scheme for a number of years no pension savings are made by or on behalf of an individual for 3 years in a row, a pension input amount of £200,000 could be made in the 4th year without incurring a tax charge!

### Action Points

Speak to your adviser if you think you might be caught out by the new, significantly reduced AA of £50,000. This is most likely to impact on higher earning members of money purchase schemes who benefit from employer contributions and higher earning members of final salary schemes.

The fact that the valuation factor for active members of final salary schemes is rising from 10:1 to 16:1 means that an increase in scheme pension rights of over £3,000 between the start and end of the schemes 'pension input period' will leave little or no scope to make

any additional money purchase contributions without incurring a tax charge (unless there is some unused AA to carry forward from previous years).

Higher earners in particular may also want to speak to their employer regarding the option of capping pensionable salary increases (i.e. so only part of any pay increase is actually pensionable) in which case it may be possible to negotiate a higher pay increase to compensate for the fact that not all of it is pensionable.

Ensure that you have records of the amount of pension savings being made by you, and on your behalf, so you can calculate what scope you have (if any) for making additional contributions. In some cases, it might be necessary for the total amount of pension savings to be reduced.

If you are not caught by the 'special' annual allowance, speak to your adviser about the opportunities to maximise pension savings to schemes whilst the AA for the current 2010/11 tax year remains at £255,000. It should be noted, however, that if you are already a member of a scheme that has a 'pension input period' that will end in 2011/12, and the 'end date' cannot be brought forward to end in this tax year, any pension savings made on or after 14 October 2010 that exceeds £50,000, will give rise to a tax charge to the extent that any excess cannot be reduced or eliminated by carrying forward an 'unused' AA from a previous tax year.

This is a potentially complicated area so advice should definitely be sought from your adviser if you think you could be affected.

You may wish to consider maximising contributions to tax-free ISAs because these do not count towards the annual allowance. And remember, from 6 April 2011/12, the overall ISA contribution limits is going up to £10,680, of which £5,340 can be paid into a cash ISA.

### Summary

The Government has been quite clever. It put forward proposals to reduce the annual allowance to between £30,000 and £45,000 and so a reduction to only £50,000 is seen by many in the industry as a "success". However, this is still a reduction of £205,000! It is good news though that tax relief will continue at a person's highest marginal income tax rate and the new regime will certainly be simpler than the one that had been proposed by the previous Labour Government.

**Levels and bases of and reliefs from taxation are subject to change and their value depends on the individual circumstances of the investor**

**The value of your investment can go down as well as up and you may not get back the full amount invested.**

## Making sure you know the risks

The effect of the credit crunch has led most people to re-assess the level of risk associated with investing as some products that were perceived to carry minimal risk actually resulted in investors losing some or all of their capital. The most-high profile example was the impact on some products which relied on guarantees provided by Lehman Brothers.



If all this bad news has passed you by relatively unnoticed you may be one of the fortunate investors for whom the financial crisis may have had little significant impact, other than the "standard fare" of reduced investment returns.

So what can we learn from this? First of all it is important to stress that the Lehman's collapse was an extreme case which was unforeseen by the investment markets. However, it does emphasise that investors should always make sure they fully understand the risks associated with any investment. There are also some high-level questions you can consider before investing into a particular scheme or fund:-

## 1. Is the scheme regulated by the FSA?

One thing to be aware of is that not all 'collective investment schemes' or 'CIS' (a term for investments where money is 'pooled' by different investors and invested by a fund manager) are regulated by the Financial Services Authority. Almost all funds marketed in the UK fall into this category (unit trusts are a good example).

A regulated CIS will either be an authorised (UK scheme) or a recognised scheme (a non-UK scheme). In both cases, however, regulated schemes need to meet certain minimum requirements in terms of legal structure, the types of assets they can invest in, and also ensure that they have an adequate 'spread' of investments to reduce (although obviously not eliminate) the risks.

Although the fact that a fund is regulated does not necessarily eliminate any investment risk – the value can still go up and down and you could still get back less than you have paid in – it does mean that there are certain basic safeguards. For example, operators of regulated funds must ensure the fund assets are segregated from their own assets and held by an independent custodian.

CIS schemes that are not regulated cannot be promoted to the general public and are likely to be suitable only for more experienced investors – These schemes will often either invest in niche assets not available within regulated schemes or have highly focused investment strategies which increase the investment risk.

To make things slightly more

confusing, some 'funds' will not actually meet the definition of a 'collective investment scheme' at all and are again therefore unlikely to be regulated by the FSA.

## 2. What does the scheme invest in and what are the risks?

This might seem a straightforward question, however some investment funds/products continue to employ ever-more complex strategies to try and maximise returns. Such techniques could include 'gearing' (the fund borrowing to invest), short-selling (selling shares and then 'betting' that they fall in value before buying them back), and the use of derivatives (complex financial instruments linked to the performance of a particular asset).

Even some regulated funds may (to a degree) employ these and other techniques and therefore it is important you understand the key risks, although there are restrictions in terms of the extent to which regulated funds can be exposed to a particular underlying investment.

Ensuring you have a diversified portfolio, spread across different asset types such as cash, bonds, property and equities is, as always, key but it is also important to be aware that there are a wide variety of investment strategies within each area. Consider, for example, a commercial property fund – A mainstream 'regulated' fund will invest across a range of properties (spreading the risk) and perhaps even in the shares of property companies. Contrast this with an 'unregulated' fund which might look to invest in a single commercial development opportunity – This may offer the

potential for significantly higher returns but, due to the risks being concentrated on one development, also the risk of greater (even total) loss of capital in the event that the development is unsuccessful.

## 3. Would I have access to the Financial Services Compensation Scheme (FSCS) if things do go wrong?

The FSCS is the UK's statutory fund of last resort for customers of financial services firms. This means the FSCS can pay compensation to consumers if a firm is unable, or unlikely to be able, to pay claims against it – This is known as being in 'default'.

Whether you would be covered by the FSCS in various scenarios is, however, a complex question and would need to be considered on a scheme-by-scheme basis. In the context of an investment fund recourse to the FSCS may be available if the operator of the scheme 'defaults' but what the FSCS will not cover, however, are losses resulting simply from the inherent investment risks associated with the scheme.

Some scenarios that might at first appear to be covered are in fact investment risks associated with the product:- Capital-protected (or 'structured') products are a good example because the capital protection would usually be provided by a 3rd party and the FSCS would not cover the loss of capital as a result of a 3rd party (the "counterparty") not meeting its obligations.

It should, however, be noted that there are also limits to the level of payout in relation to any 'default'

where the FSCS does apply. This is currently £50,000 for investments but one thing to be aware of is that this would apply per fund management group and a fund management group may operate a number of funds.

The location of the scheme also has to be considered in the context of any compensation that may be available. For example, 'recognised schemes' based overseas may conduct business in the UK – This means they will be a member of their home territory compensation scheme, which will protect customers in that country. Where the financial services firm's home state scheme provides a lower limit of compensation than the FSCS the investment services firm may choose to join the FSCS to 'top up' the limit of protection to the level available in the UK (although not all 'recognised' schemes will choose to top up in this way).

For some products it may be the case that there is no compensation available at all. For example, in the case of overseas based operators of unregulated collective investment schemes, which are often based in far flung locations for tax reasons, there may be no compensation available at all in the event of the provider defaulting unless local provisions exist.

## Summary

As mentioned previously, all investments carry risk – you should not invest if you cannot accept any loss to your capital – but it is worth considering that not all investments are the same.

As a general rule the 'keep it simple' principle applies to those investors who want to minimise the chances of any nasty surprises later down the line and it is also important to have a 'diversified' portfolio to ensure you are not unduly exposed to one specific risk or investment.

Although it is difficult to generalise, specialist funds which invest in 'alternative' assets, complex derivatives, or offer attractive 'headline' double-digit returns are unlikely to fall within the norm and may prompt you to consider the questions mentioned above. Of course these types of funds are not necessarily unsuitable investments but will not be right for everyone.

The golden rule is to ensure that you seek advice before investing. Your Financial Adviser will be able to discuss the options and also help you find the right investment solutions.

**The value of your investment can go down as well as up and you may not get back the full amount invested.**



# The Child Trust Fund is dead: Long live the Childrens ISA!

One of the casualties of the Con-Lib Government's programme of spending cuts was that children born after 31 December 2010 will no longer be eligible for a Child Trust Fund (CTF) account.

The CTF (formally introduced in Budget 2003) was initially introduced for children born on or after 1 September 2002 as a way of giving children a financial headstart in a tax-efficient savings environment. The key benefit was that the Government provided an initial contribution of £250 for each eligible child (with the possibility of an additional £250 payment at age 7) but it was also possible for friends and family to contribute up to an additional £1200 each tax year on behalf of the child.

Not surprisingly, the necessity for public expenditure cuts has meant that the £250 Government contribution to CTF accounts was seen as one of the luxuries that the public purse could no longer afford – According to Mark Hoban, Treasury Minister, scrapping the CTF contribution will save around half a billion pounds per year. What was surprising, perhaps, was that the CTF was not simply retained (without the initial contribution) as a simple tax-efficient childrens savings plan going forward.

The good news is that the Government have indicated that, as an alternative, they intend to extend the ISA (Individual Savings Account) regime with the introduction of a 'Childrens ISA'. Although there will of course be no Government contribution, this will be a tax-efficient way of saving in much the same way as the abandoned CTF.

The Childrens ISA is likely to be available from Autumn 2011 and although finer details such as the contribution limits are not yet clear, one piece of good news is that the Treasury has indicated that the scheme will be backdated to ensure that no child born too late to be eligible for a CTF will not miss out on the new tax efficient savings scheme.

The Children's ISA is expected to offer a choice between a cash or stocks and shares option (the latter will not be suitable for everyone due to the risks involved) with any returns being tax-free for the child. It is also expected that, as with its predecessor, the child will not be able to take the money out until he or she reaches 18.

Of course, it is worth remembering



that CTF accounts will still be available for children born before January 2011, although the Government contribution has now been reduced to £50. The child, friends and family will still continue to be able to contribute up to an overall total of £1,200 a year, and it will still be possible to change the type of account and/or move it to another provider.

**Unit Trusts:-** A 'unit trust' is simply a 'pooled' investment fund where your contributions are invested with those from other investors – enabling the fund manager to spread risk and reduce costs. It is possible to 'designate' unit trusts in the name of another person (including a child) and, provided this designation is irrevocably in favour of the individual any income or capital gains are usually treated as theirs – The only thing to bear in mind is that, where a parent applies for (or makes the contributions to) the investment, if the income exceeds £100 per year this would be taxed as the parents income. There is no such issue, though, for a designated unit trust set up by (say) a grandparent.

Although these investments are not tax free, it is important to remember even a child has an annual personal income allowance (£6,475 for 2010/11) and the availability of an

annual capital gains tax allowance (£10,100 for 2010/11).

Unlike the CTF or proposed Childrens ISA, there are also no upper limits on the amount you can contribute.

**Stakeholder Pensions:-** Up to £2,880 per year can be invested in a stakeholder pension in a child's name (to which 20% tax relief is added making a gross contribution of up to £3,600). One thing to bear in mind however, is that this would not be suitable if you wanted to give the child funds for say, university fees or a new car as they would not be able to access the fund until age 55 and even then are currently restricted to taking 25% as a lump sum.

It might seem premature to consider retirement planning for a child but consider this – Starting a stakeholder plan for a child age 1 with a contribution of just £50 per month paid until they reach 18 could produce a fund (adjusted for inflation) of around £45,700\* (assuming an annual investment return of 7% and that they take benefits at age 55). Saving for them now in a stakeholder could therefore be a great way of providing the child with a good head start.

You should note that the value of all investments can go down as well

as up and therefore professional financial advice is essential. Your financial advisor will be able to offer specific guidance on the best way of saving for your child's (or grandchild's) future.

\*Assumptions used:-

- Child will receive basic rate tax relief on the contributions.
- Contributions continue to the child's 18th birthday and then cease.
- Inflation is assumed to be 2.5% per annum.
- The figure assumes 7% investment growth per annum. The actual rate of return and therefore the actual pension fund value could be higher or lower than the illustrative figure quoted.
- The total value of their pension benefits from all registered schemes will not exceed the current lifetime allowance (£1.8m for 2010/11).

**Levels and bases of and reliefs from taxation are subject to change and their value depends on the individual circumstances of the investor.**

**Investments in stocks and shares do not have the same degree of capital security as investments in deposits.**