WHITE & CASE

Filling the UK pensions gap

Tweaks to UK pensions policy may send top earners and their employers looking for alternatives

Exploring alternatives to traditional pensions

Employers are scrambling to placate top earners with more attractive options for tax relief following the introduction of a tapered annual allowance, as **Nicholas Greenacre** and **Edward Jackson**, of global law firm White & Case, explain.

The speculated sweeping pensions tax relief measures in the 2016 budget failed to materialise, much to the relief of nervous benefits managers across the United Kingdom. Although this major overhaul has been averted (or, perhaps, only forestalled), a significant change, the introduction of a tapered annual allowance and the reduction of the lifetime allowance, came into effect on 6 April 2016, making traditional pensions less appealing to high earners, such as senior executives.

Coupled with other major changes in recent years, which leading pensions authority Lord Holmes of Richmond describes as "a negative downward spiral for pensions as a proposition", these changes may send employers scrambling to placate their top earners with more attractive options for tax relief and for building a retirement nest egg.

Tapered annual allowance saps tax-relieved savings

The base annual allowance is still £40,000 per tax year. An individual can also carry forward any unused annual allowance from up to three previous tax years. Contributions exceeding the allowance are taxed as income.

From 6 April 2016, changes came into effect that apply to individuals with "adjusted income" exceeding £150,000 a year and whose "threshold income" exceeds £110,000 a year.

For such individuals, the annual allowance is reduced by £1 for every £2, up to a maximum reduction of £30,000. The annual allowance for an individual with adjusted income exceeding £210,000 thus falls to a mere £10,000 a year, dramatically undermining high earners' ability to build savings or to reduce their taxes.

It's unclear now how income lost under salary sacrifice arrangements made on or after 9 July 2015 will affect the threshold income calculation, given that some salary sacrifice arrangements renew annually.

£10,000

The new annual allowance per tax year for individuals with adjusted income over £210,000

Source: 2015 Summer Budget

Interaction with "flexible access"

Since the reforms in the 2014 budget, individuals aged 55 or older or those who meet ill-health criteria have had the option of "flexible access" to their defined contribution pension benefits. In particular, individuals may designate a flexi-access drawdown fund or take an uncrystallised funds pension lump sum.

Those who do so are assigned a "money purchase annual allowance" of £10,000 in tax-relieved savings they can contribute to a pension, although they still get the remainder of their £40,000 annual allowance for accruals in their defined benefit plan, the "alternative annual allowance."

What is adjusted income and threshold income?

Adjusted income is all taxable income for a tax year including employer and executive pension contributions.

Threshold income is all taxable income for a tax year excluding employer and executive pension contributions.

Pension flexibilities go hand in hand with the tapered annual allowance

A person with adjusted income exceeding **£210,000** and threshold income exceeding **£110,000** will have a tapered annual allowance of only **£10,000**.

If such individuals also flexibly access their pension benefits, they will only have a **£10,000** money purchase annual allowance, and no alternative allowance if they max out the money purchase annual allowance (although any unused annual allowance from the previous three tax years can be carried forward).

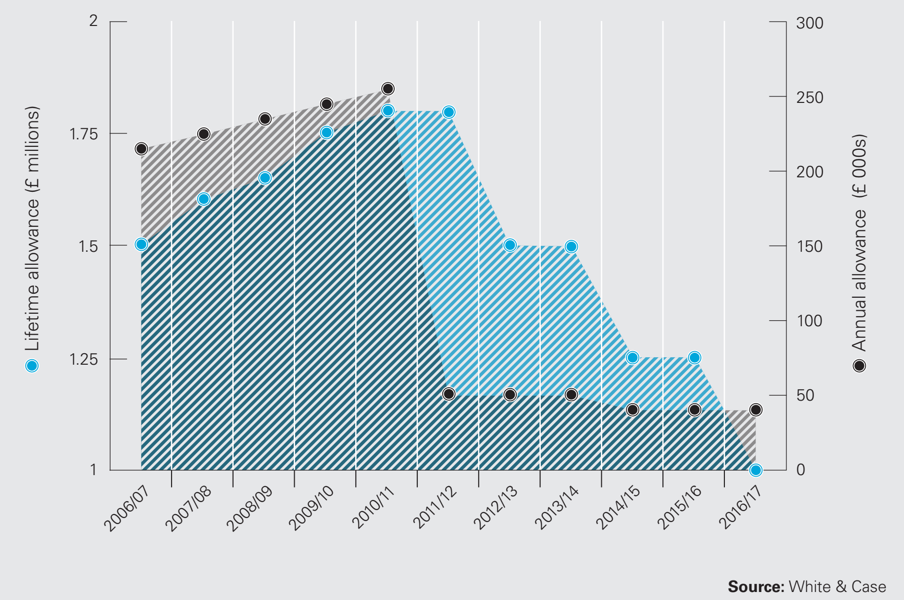
> "Proposals [by previous governments for the pensions regime of "simplicity, security and choice"] have been replaced by a reality of complication, chaos and chance
>
> Chris Holmes, Lord Holmes of Richmond MBE

The lifetime allowance is down as well

The lifetime allowance—the total fund an individual can build up in a registered pension plan receiving favourable tax treatment—has been reduced from £1.25 million to £1 million as of 6 April 2016.. Starting two years from then, the lifetime allowance will be uprated according to the change in the Consumer Price Index.

Individuals who exceed the lifetime allowance are subject to a 55 per cent charge on the excess if drawn as a lump sum, or 25 per cent of the excess if drawn as a pension. An individual can apply for Fixed Protection 2016 or Individual Protection 2016, subject to certain conditions, and, if this is granted, will not incur a lifetime allowance charge on any benefits up to £1.25 million.

Progression of the lifetime allowance and annual allowance since 2006/07



Source: White & Case

More changes may be on the way

In the build-up to the March 2016 budget, the Chancellor was said to be strongly considering three options for sweeping reform.

Under the flat-rate option, higher-rate and additional-rate taxpayers would be taxed twice: once on their contributions going into a pension plan, and again when they withdraw those funds as taxable income.

According to a Treasury source, these proposals were dropped in the end because 2016 was "not the right time" to make major changes to pension tax relief. However, although no changes were made in the 2016 budget, Lord Holmes says, in the future "more radical changes are likely".

Employers have options, and risks

These cumulative changes have not only further complicated the pensions landscape, but also eroded the long-term appeal of saving into a registered pension scheme for high earners. Employers looking to keep their senior executives are already exploring alternative replacement structures to fill the void.

The 2016 budget has further strengthened the cause of these alternative structures, by extending the ISA limit to £20,000 per annum from 6 April 2017 and reducing the higher rate of capital gains tax to 20 per cent, which makes share-based alternatives a more attractive proposition. Viable alternative structures include: a company-sponsored ISA; unregistered pension plans; employee benefit trusts; CSOP options; EMI options and restricted shares. A lifetime ISA will also be introduced from 6 April 2017 for those individuals under 40. The maximum amount that an individual can save into the ISA per year is £4,000, and the government will top up the amount an individual puts in by 25 per cent. It is unlikely that such an option will be viable for the majority of senior executives due to the majority being over the age of 40.

Employers should evaluate options cautiously. Anti-avoidance provisions have been introduced to combat arrangements whose main purpose would appear to be reducing the amount of the annual allowance taper. And packages whose "sole or main purpose," as determined by the Pensions Regulator (TPR), is to induce workers to opt out of an auto-enrolment scheme can invoke compliance notices, penalties of up to £50,000 and escalating penalty notices with a daily rate of up to £10,000 from TPR.

Capital gains tax (higher rate) from 6 April 2016

Source: 2016 Budget

£20,000

ISA limit per annum from 6 April 2017

Source: 2016 Budget

Three options for future Government reform

1. Removing the tax-free pension commencement lump sum
2. Withdrawing upfront tax relief, but making pension withdrawals tax-free (i.e., taxed in the same way as ISAs)
3. Setting a flat rate of tax relief, between 25 and 35 per cent

> "Another nail in the lid of a coffin already pretty well fastened down
>
> Chris Holmes, Lord Holmes of Richmond MBE

Retirement planning for high earners: Alternative solutions

New tapered annual allowance: Impact on individuals

Source: HM Revenue & Customs

New lifetime allowance: Impact on individuals

Source: Brewin Dolphin, Office for National Statistics

Benefit	Variable by employer?	Limits	Tax on employee contributions?	Tax before drawdown/ realisation?	Tax on drawdown/realisation?	Relative investment risk	Drawdown flexibility	Notes
Registered Pension Plan	✓	£10,000–£40,000 p.a. (dependent on earnings)	✗	✗	✓ Varies depending on how benefits accessed	Variable	From age 55 or earlier if meet ill-health condition Needs to be permitted by Plan rules No annual limits on withdrawals	If an employer has passed their staging date, they are required to enrol employees into a pension scheme Employees can opt out
Unregistered Pension Plan/EBT	✓	✗	✓ Taxed as income	Not usually, unless assets provided for use	Income tax on growth in value of assets since contribution	Variable	May be fully flexible	
ISA	Employee's choice	£15,240 p.a. £20,000 p.a. from 6 April 2017	✓ From taxed pay	✗	✗	Variable	Fully flexible	
Lifetime ISA (available from 6 April 2017)	Employee's choice	£4,000 p.a. The Government will top up the amount an employee saves by 25%	✓ From taxed pay	✗	✗	Variable	Available for the purchase of first residential property or at age 60	Available to those under the age of 40 Contributions can be made up to age 50
SAYE	✗	£6,000 p.a. over 3 or 5 years	✓ From taxed pay	✗	CGT, unless transferred to an ISA or contributed to registered pension plan	Low	Savings can only normally be withdrawn to exercise the discounted option after 3 or 5 years	Depending on ownership and share structure, this may not be available to privately held companies
SIP	✗	£1,800 p.a. for employee contributions to purchase shares, up to £7,200 p.a. in value for further shares from employer	✗ From gross pay	✗	CGT, unless transferred to an ISA or contributed to registered pension plan	High	Shares can normally be sold after 5 years	Depending on ownership and share structure, this may not be available to privately held companies
CSOP options	✓	Shares cannot be worth more than £30,000 when option granted	✗ Up-front contribution Exercise price paid from taxed pay	✗	CGT	Low	Can normally be exercised after 3 years	Depending on share structure, this is often not available to privately held companies
EMI options	✓	Shares cannot be worth more than £250,000 when option granted	✗ Up-front contribution Exercise price paid from taxed pay	✗	CGT, easier to obtain tax rate of 10%, provided option has been had for 12 months, as entrepreneur's relief is available even if 5% threshold not met	Low	Variable Depends on option vesting rules and liquidity Typically, value would be realisable over a 3 to 5 year timescale	Only available to smaller companies (<£30 million assets) in qualifying trades
Restricted Shares (non-ESS)[1]	✓	None	✓ Initial value of shares taxed as employment income	Dividends taxed at dividend rates[2]	CGT	High	Variable Depends on option vesting rules and liquidity Typically, value would be realisable over a 3 to 5 year timescale	Relatively complex to operate Initial value of shares may be low, to minimise tax charge
Restricted Shares (ESS)[3]	✓	Shares must be worth £2,000–£50,000	No contribution by employee Shares given in return for waiver of employment rights	Dividends taxed at dividend rates[4]	CGT payable on gains in excess of £100,000	High	Variable Depends on option vesting rules and liquidity Typically, value would be realisable over a 3 to 5 year timescale	Not available for individuals who hold more than 25% of the voting rights
Venture Capital Trust	✓	£200,000 p.a.	✓ From taxed pay Income tax relief at 30%	✗	Exempt from CGT on chargeable gains	High	Shares normally sold after 5 years	
Enterprise Investment Scheme	✓	£1 million p.a.	✓ From taxed pay Income tax relief at 30%	✗	Exempt from CGT on chargeable gains	High	Shares can normally be sold after 3 years	Investor and associates must not control more than 30% of the company The investor must not be an employee of the company (can be a director)

1. Assumes employee does not pay for shares and signs an election under s431(1) ITEPA
2. 7.5%, 32.5% or 38.1% above £5,000 allowance
3. Assumes employee does not pay for shares and signs an election under s431(1) ITEPA
4. 7.5%, 32.5% or 38.1% above £5,000 allowance

Source: White & Case

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