

Proposed pension tax changes – impact on civil servants

In Budget 2010, the Government confirmed its intention, from April 2011, to restrict tax relief on employer and employee pension contributions for certain high earners. This information note is intended to provide an idea of what may be coming, not to give all the answers – some detail remains outstanding. The proposed changes will require primary legislation.

Will this affect me?

You are not affected if your **pre-tax income** is less than £130,000 (or if you retire before April 2011).

You will be affected if:

- Your **pre-tax income** (in any tax year from 2011-12) is **£130,000** or more; and
- Your **gross income** (**pre-tax income** and **deemed employer contributions**) exceeds **£150,000**

Pre-tax income means (for this purpose) taxable income before any deduction for pension contributions or gift aid payments. As such, it includes (among other things) salary, bonus, benefits in kind, dividend payments, bank interest and so on. Note that it is **not just earnings**.

For money purchase pensions such as the **partnership** pension account, “employer contributions” means just that. For defined benefit pensions, such as the Civil Service scheme, the **deemed employer contribution** will be determined by valuing the real (after allowing for inflation) increase in pension over the year, using standard factors reflecting both your age and the scheme pension age. This would mean that, generally, an older person would have a higher factor than a younger person. And people in **nuvos** (with a pension age of 65) would have lower factors than people of the same age in **premium** or **classic** (with a pension age of 60). Higher factors would also apply where pension benefits are taken on early retirement. The Government will take advice from the Government Actuary before setting the factors.

Example 1:

Jane’s salary is £120,000. She gets a £6,000 bonus and has investment income of £4,000. Jane makes Gift Aid donations totalling £2,000. Jane’s “pre-tax income” is £130,000 (£120k + £6k + £4k), so her tax relief may be restricted.

Jane’s pension at the end of the tax year = £30,000.

Jane’s pension at the start of the tax year (after adjustment for inflation) = £27,000.

Total deemed contribution into Jane’s pension = £3,000 x 15 = £45,000.

Contributions paid by Jane = £5,000

Jane’s **deemed employer contribution** = £45,000 - £5,000 = £40,000.

This means that Jane’s **gross income** is £170,000 so her tax relief will be restricted.

What happens if I am affected?

If you think you might be affected, you will need to provide information on Self Assessment (starting with returns completed during 2012-13). You will need a special benefit statement from the pension scheme, showing the **deemed employer contribution** for the relevant tax year. As you will have already received tax relief through PAYE, you will pay a **recovery charge** through Self Assessment so as to restrict the tax relief on pension contributions (both your contributions and the **deemed employer contribution**). The rate of tax relief you are allowed depends on your **gross income** (including the **deemed employer contribution**). This tapers from 50% at £150,000 down to 20% at £180,000. The **recovery charge** depends on the marginal tax relief originally received (see Example 4).

Example 1 (cont’d)

Jane’s **gross income** is £170,000. This means that she will receive a tapered rate of tax relief on pension contributions - 30% in this case.

Are there any exemptions?

The recovery charge will not apply when pension is increased on ill-health retirement.

What sort of recovery charge might I be looking at?

The following examples show how this might work. All examples use an illustrative age-related factor of 15 and RPI of 2.5%. **Note that the recovery charges can be substantial.**

Example 2 – long service, pay freeze, no other income

Geoff's pension at start of year = $30/60 \times \text{£}160,000 = \text{£}80,000$. Adjusted by inflation to $\text{£}82,000$
Pension at end of year = $31/60 \times \text{£}160,000 = \text{£}82,667$, so real increase in pension = $\text{£}667$

Total deemed contribution = $\text{£}667 \times 15 = \text{£}10,005$

Employee contributions = $3.5\% \times \text{£}160,000 = \text{£}5,600$, so **deemed employer contribution** = $\text{£}4,405$

Gross income = $\text{£}164,405$.

This income implies tapered tax relief of c36%, so a restriction of 14% (50% - 36%) applies

Recovery charge = $14\% \times \text{£}10,005 = \text{£}1,400$ (restriction applies to total deemed contribution)

Example 3 – long service, 3% pay rise, no other income

Freda's pension at start of year = $30/60 \times \text{£}160,000 = \text{£}80,000$. Adjusted by inflation to $\text{£}82,000$
Pension at end of year = $31/60 \times \text{£}164,800 = \text{£}85,147$ – real increase in pension = $\text{£}3,147$

Total deemed contribution = $\text{£}3,147 \times 15 = \text{£}47,205$

Employee contributions = $3.5\% \times \text{£}164,800 = \text{£}5,768$, so **deemed employer contribution** = $\text{£}41,437$

Gross income = $\text{£}160,000 + \text{£}41,437 = \text{£}201,437$.

This income means tax relief is restricted to 20%, so a restriction of 30% (50% - 20%) applies.

Recovery charge = $30\% \times \text{£}47,205 = \text{£}14,162$

Example 4 – short service, salary of £140,000, pension restricted by the earnings cap

Carole's pension at start of year = $5/60 \times \text{£}123,600 = \text{£}10,300$. Adjusted by inflation to $\text{£}10,558$
Pension at end of year = $6/60 \times \text{£}127,200 = \text{£}12,720$ (*the earnings cap has gone up with RPI*)

Total deemed contribution = $\text{£}2,162 \times 15 = \text{£}32,430$

Employee contributions = $3.5\% \times \text{£}127,200 = \text{£}4,452$, so **deemed employer contribution** = $\text{£}27,978$

Gross income = $\text{£}140,000 + \text{£}27,978 = \text{£}167,978$.

This income implies tapered tax relief of c32%. The income over $\text{£}150,000$ has had marginal tax relief of 50%, so there is a restriction of 18% on this slice ($\text{£}17,978 = \text{£}167,978 - \text{£}150,000$) and 8% on the slice under $\text{£}150,000$ ($\text{£}14,452 = \text{£}32,430 - \text{£}17,978$) which has received marginal tax relief of 40%.

Recovery charge = $18\% \times \text{£}17,978 + 8\% \times \text{£}14,452 = \text{£}4,392$

Example 5 – long service, promotion

Bernard's pension at start of year = $30/60 \times \text{£}180,000 = \text{£}90,000$. Adjusted by inflation to $\text{£}92,250$
Pension at end of year = $31/60 \times \text{£}200,000 = \text{£}103,333$

Total deemed contribution = $\text{£}11,083 \times 15 = \text{£}166,245$

Income level means tax relief is restricted to 20%, so a restriction of 30% applies.

Recovery charge = $30\% \times \text{£}166,245 = \text{£}49,874$

Note: if the promotion was mid-year, the effect would be spread over 2 years but he would not escape

What happens if I get a very large recovery charge?

A "scheme pays" option is proposed for recovery charge bills over $\text{£}15,000$ (for instance, Example 5). The scheme would pay the tax upfront and reduce your pension benefits by an actuarially-appropriate amount. Recovery charges under $\text{£}15,000$ would be paid according to the normal tax timetable.

Where do I find out more?

This note sets out our understanding of how the Government's proposals may apply to civil servants but you should not rely on information in this note when making financial decisions. More information is available on www.hm-treasury.gov.uk and www.hmrc.gov.uk or consult your financial adviser. We will provide further information in due course.

Civil Service Reward, Cabinet Office