Introduction

Even with the recently introduced restrictions to tax relief for high income individuals, pensions still offer a tax-efficient vehicle to fund for retirement. A summary of the tax privileges available are:

- Tax relief on contributions (subject to certain limits).
- Investments grow free of income and capital gains tax (CGT) (apart from some withholding tax and the tax credit on UK dividends which is not reclaimable).
- Tax-free cash lump sum at retirement.

This chapter considers how pensions can also be used as effective tax planning tools.

Income tax

There have been significant changes to the income tax regime resulting in a much more complex system. Some of the changes that are relevant for this chapter are as follows:

- The additional 50% tax rate for individuals with taxable income over £150,000.
- For individuals with adjusted net income over £100,000, the reduction of their personal allowance by £1 for every £2 of excess income – meaning that in the 2011/12 tax year, anyone with adjusted net income of £114,950 or more will have no personal allowance.
- From 6 April 2011, an additional 1% on current levels of national insurance contributions (NICs), the current levels being
  - For employees, 12% on earnings between the primary threshold and the upper earnings limit (£7,225 and £42,475 respectively for the tax year 2011/12), and 2% on earnings above the upper earnings limit.
  - For the self-employed, 9% on earnings between the primary threshold and upper earnings limit, and 2% on earnings above the upper earnings limit.
  - For employers, 13.8% on all earnings over the secondary threshold (£7,072 for the tax year 2011/12).
- A new dividend tax rate of 42.2% for 50% taxpayers.

Before being able to start any tax planning, it is essential to understand the definitions used by HM Revenue & Customs (HMRC) to measure income against the various thresholds.

Adjusted net income

Adjusted net income is used to calculate the threshold for age- and salary-related personal allowances. It is calculated as follows:

- Take total income chargeable to income tax for the tax year, less specific deductions (the most important being trading losses and payments made gross to pension schemes, as well as the gross amount of any chargeable gains from life assurance policies) – this gives 'net income'.
- Then deduct the grossed-up amount of gift aid contributions and the individual's pension contributions made under relief at source.
- Finally add back any relief for payments to trade unions or police organisations deducted in arriving at net income – this gives 'adjusted net income'.

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Loss of personal allowance

The withdrawal of the basic personal allowance at £1 for every £2 of adjusted net income above £100,000 means that individuals whose adjusted net income is £114,950 or more have no personal allowance. The individuals have to pay additional income tax of £2,990 (20% of £14,950) plus the higher rate tax of 40% giving an effective rate of tax on the income between £100,000 and two times the personal allowance of 60%.

With full personal allowance		**No personal allowance**	
Adjusted net income	£114,950	Adjusted net income	£114,950
Income taxed at 0% – £7,475 =	£0	Income taxed at 0% – nil =	£0
Income taxed at 20% – £35,000 =	£7,480	Income taxed at 20% – £35,000 =	£7,480
Income taxed at 40%	£28,990	Income taxed at 40%	£31, 980
Total tax =	**£35,990**	**Total tax =**	**£38,980**

As personal (including third-party) pension contributions are deducted when calculating the adjusted net income figure, which is used to measure against the £100,000 threshold, paying such a contribution provides an individual with an opportunity to avoid this additional tax.

Example 15.1 – Tax relief on contributions

Martin's adjusted net income for the 2011/12 tax year is £115,000, and as such he loses all his personal allowance (£1 for every £2 over the £100,000 limit).

He makes a gross pension contribution of £18,000 to his self-invested personal pensions (SIPP), which has the effect of reducing his adjusted net income to £97,000 – meaning he keeps his full personal allowance. The net cost of making this pension contribution is:

- £18,000

less

- tax relief @ 40% – £7,200,
- the additional tax saving of £2,990 from retaining the personal allowance of £7,475.

Salary or bonus sacrifice can also be an effective planning tool for protecting the basic personal allowance (see section below).

Salary or bonus sacrifice

With this type of arrangement, an employee agrees to a reduction in salary or bonus in return for a benefit paid for by their employer, and this is normally entered into to create tax and/or national insurance savings without reducing the overall value of the individual's benefit package.

This is a legal agreement where the employee is agreeing to a change in their terms and conditions of employment, and to be valid it must meet the following HMRC guidelines:

- There has to be a formal employer/employee relationship;
- The pension scheme must be able to accept an employer contribution and be an occupational pension scheme, a group personal pension scheme or a stakeholder pension scheme (individual or group); and
- The terms of employment must be changed before the salary or bonus sacrifice arrangement commences. An employee may request a change to arrangements as a result of 'lifestyle

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changes', but this can only be implemented by the employer and must be accompanied by new terms and conditions of employment.

Failure to comply with the HMRC guidelines could lead to the arrangement being treated as invalid, and the amount sacrificed will be treated as having been paid to the employee as earnings. The employer and employee would be subject to NICs on the amount sacrificed, and the employee would be subject to income tax. Where a pension contribution has been made this would be treated as a personal contribution and the employee would receive tax relief subject to the usual rules and limits.

The salary or bonus sacrifice rules apply only to contractual benefits. If, for example, an employee agrees to have a pension contribution paid instead of a discretionary bonus, HMRC do not consider this to be a bonus sacrifice.

The possible tax planning opportunities of this type of arrangement include:

- Taking the employee's income below the £100,000 threshold, so preserving their full personal allowance.
- Reducing earnings below the 50% tax threshold, currently £150,000.
- Creating NI savings for both employer and employee.
- Pension contributions made by the employer under a valid salary or bonus sacrifice arrangement are guaranteed to receive tax relief.

Example 15.2 – Salary sacrifice

Sara's adjusted net income in the 2011/12 tax year is £115,000. Her employer has suggested a salary sacrifice arrangement where she would give up £17,000 of her salary in return for a pension contribution of the same amount. Sara wants to consider the implications of this arrangement before agreeing.

	Before salary or bonus sacrifice	After salary or bonus sacrifice of £17,000
Adjusted net income	£115,000	£98,000
Personal allowance	Nil	£7,475
Tax payable	£39,000	£29,210
NIC	£5,122	£4,782
Disposable income	£70,878	£64,008
Pension contribution	Nil	£17,000

The net effect is that the £17,000 pension contribution will have cost Sara £6,870 (the reduction in her disposable income). Her employer will save £2,346 (£17,000 @ 13.8%) and will also receive guaranteed tax relief on the pension contribution paid. Sara's employer could also opt to add the NICs savings to the pension contribution, increasing the overall benefit to Sara at no additional cost to the business.

A salary or bonus sacrifice arrangement could also be used when planning for the 50% tax band.

A salary or bonus sacrifice arrangement for pension contributions is not effective when planning for the special annual allowance, as any amount of income sacrificed for a pension contribution must be added back when calculating relevant income.

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There are some drawbacks to a salary or bonus sacrifice arrangement that the employee should carefully consider before entering into an agreement:

- They will normally only be able to make changes to the arrangement once a year (more frequent change may be possible if they have undergone a lifestyle change). Their ability to borrow could be reduced as their salary will be lower.
- Other salary-related elements of their benefit package could be affected, for example private health insurance, death-in-service benefits, contractual pension contributions, overtime and future salary rises,
- Entitlement to state benefits could be affected.

Special annual allowance

The special annual allowance was introduced as an anti-forestalling measure following the 2009 Budget announcement limiting higher rate tax relief for high income individuals. It was withdrawn from 6 April 2011 and replaced by a lower annual allowance and is of historic interest only. As previously described, it affected anyone who qualified as a high-income individual and who made changes to their regular contribution patterns.

Maximising use of personal allowances

An individual over age 65 has a personal allowance of £9,940 (assuming adjusted net income of not more than £100,000). Within a couple, where there is a non-earning spouse/civil partner, some or all of this personal allowance may be unused. By directing part of the earner's income to pay pension contributions for the non-earning spouse (up to £3,600 gross per tax year), the non-earner will be able to build up pension provision in their own right, and the income can be set against their own personal allowance.

This could provide additional tax-free income if within allowances, and/or additional income taxed at the basic rate rather than at 40% or 50%.

Capital gains tax

Since the 22 June 2010 Budget, CGT has been charged at two rates – 18% for basic rate taxpayers and 28% for higher rate taxpayers. Paying a tax-relievable pension contribution to a scheme operating relief at source (such as a personal pension scheme) extends the band on which an individual pays basic rate tax. So where someone's income is around the higher rate tax band, paying a personal contribution may help them remain basic rate taxpayers and keep them in the 18% capital gains tax bracket.

In specie contributions

Individuals can make in specie contributions to pension schemes, meaning that instead of paying cash to settle a contribution due, they hand over a different type of asset – for example, a property.

The contribution must still be expressed in cash terms, and the value of the asset handed over must be the net contribution amount. There may be a CGT charge and/or a stamp duty charge when title to the asset is transferred to the pension scheme.

It is also possible to transfer certain shares from SAYE option schemes or share incentive plans and have them treated as net personal contributions (thus eligible for tax relief).

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Some of the benefits of an in specie contribution compared with selling the asset to the pension scheme are:

- Transaction costs may be lower.
- Tax relief may be granted on the value of the contribution.
- The individual’s pension pot will be increased by the gross value of the contribution.
- The pension scheme does not need to have the cash or raise additional funds in which to purchase the property.
- The asset is sheltered from future capital gains and income tax.
- The value of the contribution can be used for the tax planning purposes mentioned in this chapter.

The disadvantages include:

- The member will not receive any consideration in return for the asset.
- Disposal of the asset may create a CGT liability.
- There is no guarantee that tax relief will be granted on the contribution.

Inheritance tax

Lump sum death benefits

Uncrystallised benefits from a registered pension scheme are normally paid out free of income or CGT on death, and if paid under the terms of a discretionary trust are also free from inheritance tax (IHT).

Although the benefits are paid outside of the estate, they will be included in the estate of the beneficiary. Where this is the surviving spouse or civil partner, an opportunity to pass assets free of IHT to the next generation may have been lost. If a nomination were made for the benefit of children or other beneficiaries, the lump death benefits could pass to them directly saving on IHT which may become payable later.

The main disadvantage with this approach is that the surviving spouse/civil partner may need access to these funds in order to maintain their standard of living. By using a spousal by-pass trust, this can be overcome. The member creates a discretionary trust with a nominal gift, which includes the spouse as a potential beneficiary. They then complete a death benefit nomination form, naming the trust as the beneficiary of any lump sum death benefits.

On the death of the member, benefits are payable to the trust. The surviving spouse/civil partner will be able to access the funds as a potential beneficiary and could receive awards of income, capital and interest-free loans. Receiving interest- free loans from the trust can have the additional benefit of creating a debt against the survivor’s estate, further reducing IHT liability on their subsequent death. Awards of capital and income can also be made to any of the other potential beneficiaries without any IHT liabilities being incurred. Anything left after the death of the survivor can be distributed amongst the remaining potential beneficiaries.

Third-party pension contributions

Any third-party pension contributions are deemed to be outright gifts and therefore are treated as PETs for IHT purposes. This could be useful for making gifts to children or grandchildren, where they have no earnings: £2,880 net (£3,600 gross) can be paid to a pension scheme on their behalf

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and benefit from basic rate tax relief. As long as the donor survives seven years, there will be no inheritance tax implications.

Tax planning key points

There is a great deal of scope for the interplay between pension provisions and tax planning. This by no means covers all the possible uses of pensions for tax planning purposes, but summarises those which would be of most relevance in today's market. No doubt future changes in taxation and pension legislation will lead to further planning opportunities.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2011, which are subject to change.

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