Practical TAX Newsletter

Finger on the trigger

Simon Nicol explains new limits for pension contributions.

Planning opportunities

The Chancellor introduced the revolutionary concept of pension flexibility in March 2014 and proposed that full access to pension funds would be available from the 2015/16 tax year. It very quickly dawned on the industry that this freedom could give rise to a very worthwhile tax planning opportunity (see example 1).

Example 1
Say I am over age 55. I ask my employer to divert £40,000 of my income into a pension plan on my behalf. My employer is happy to oblige avoiding employers NIC on the pension contribution. Once the funds are in the plan I withdraw the full amount under my new flexible options and receive 25% of the fund tax free and pay income tax but not NIC on the remainder. As a 40% taxpayer I save £2,500 income tax and NIC and my employer has saved £5,520 in employer NIC.

Clearly the Treasury was never going to let such a revenue loss get off the ground and it was flagged early on that steps would be taken to deter this course of action. The pensions industry waited with some apprehension to see what the Government's response would be.

When the new rules were announced those steps turned out to be surprisingly measured and are generally regarded as a reasonable response to the potential problem. They do however add another degree of complexity to the new rules and contain sufficient pitfalls into which, no doubt, some unwary pension holders will inadvertently fall.

Money purchase annual allowance

The new rules introduce a new type of annual allowance (AA), known as the money purchase annual allowance (MPAA). This does not replace the existing AA but is a new limit that applies to (and only to) members making money purchase contributions who have triggered this lower annual contribution limit by availing themselves of the new pension flexibilities.

Those triggers are detailed below, but the effect of a trigger is to immediately reduce the pension member's contribution allowance to the MPAA of £10,000. This means that from that date all further money purchase contributions are tested against this reduced annual allowance. Moreover, it also prohibits the individual from carrying forward unused relief to increase the contributions under the MPAA.

However, an individual's AA of £40,000 remains for accrual in other types of pension arrangements. These are likely to be primarily final salary type arrangements. A member of a final salary scheme could therefore continue to accrue (ignoring carry forward) benefit value of up to £40,000, of which £10,000 could be money purchase contributions, such as additional voluntary contributions (AVC). Carry forward remains available for the standard AA.

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The triggers

The principle behind the MPAA is to restrict further contributions for those who take advantage of withdrawals under the new flexible rules after 5 April 2015. Therefore the MPAA is primarily triggered when income taken is not just a tax free lump sum.

The trigger for the MPAA is when the individual first uses any of the following methods to withdraw income.

UFPLS

This is an uncrystallised funds pension lump sum. This method of taking benefits automatically involves receiving a mixture of tax free cash and taxable income, the latter being the trigger for the MPAA.

FAD

This is a flexi-access drawdown fund. Withdrawals from a FAD can be either tax free cash or taxable income or both, again it is the income part that would be the trigger.

Those currently in flexible drawdown with access to unlimited income will have their funds converted to a FAD on 6 April 2015. They will also automatically come under the MPAA limits which, ironically, will give the ability to recommence the limited contributions where none are currently permitted.

Flexible annuity

This is broadly an annuity where the income levels can reduce over time.

Small scheme

This is where the payment is received from a scheme pension with fewer than 12 pensioner members. This will primarily be payments from small self-administered schemes (SSAS).

What to do

It is important to note that triggering the MPAA puts the individual under the lower MPAA immediately and permanently. The reduced allowance will be triggered during an existing pension input period (PIP) and for the purposes of testing in that first year of the MPAA it is necessary to consider pension contributions made before and after the MPAA trigger.

Broadly, money purchase contributions and other pension accruals made within the PIP will still be tested against the standard AA in the normal way. In addition, any money purchase contributions made after the trigger date will be tested against the MPAA (see example 2).

Example 2

John has a SIPP with a PIP end date of December 31 and a company group pension plan (GPP) with a PIP end date of 5 April. His contributions to the GPP are £1,000 per month. He also paid a £20,000 one off contribution to the SIPP on May 1.

John designates his SIPP for flexi-access drawdown on November 1 and takes some income. He is subject to the MPAA from November 2.

During the 2015/16 PIP period he will have paid £20,000 + £1,000 × 12 = £32,000, within the standard AA. He will have paid five months of £1,000 = £5,000, after the MPAA trigger, within the MPAA. So John faces no excess tax charges.

However, John can’t continue to make the £1,000 a month contribution to the GPP for the following tax year without exceeding the MPAA.

Tax charge

The tax charges for exceeding the MPAA are as for the standard AA. The excess contribution is added to the individual’s income for the year and taxed accordingly. Note that there are no “scheme pays” options for the MPAA, and the individual will be personally liable for any tax charges arising.

Individuals who trigger the MPAA must take action. They will receive, within 31 days, a statement from the pension scheme administrators to that effect. The Government requires individuals to inform active schemes, i.e. those to which they are accruing benefits, within a further 91 days that they are subject to the MPAA, as well as any new schemes they may set up.

This may seem onerous but the requirement was watered down from the original proposal to inform all schemes of which they were ever a member, backed by somewhat draconian financial penalties for failure to do so.

Not triggering the MPAA

There are withdrawals from a pension fund that will not trigger the MPAA. These are broadly withdrawals which would have been permissible before the introduction of the flexible regime, such as the following.

Only tax free cash

Taking tax free cash alone will not trigger the MPAA. Even if a pension is designated a FAD under the new rules as long as no *income* is taken the MPAA will not be triggered

Capped drawdown

Those with funds under the drawdown rules in place before 6 April 2015 can continue (or commence) thereafter to take income within the maximums permitted under the GAD rules without a trigger. This could be useful for a few individuals in the right circumstances. It is possible for those who are partially in capped drawdown under a single fund to bring more of that fund into capped drawdown after 5 April 2015 without a trigger.

Small pots rule

This allows pension arrangements holding less than £10,000 to be cashed in without a trigger.

Conventional annuity

Taking tax free cash and purchasing a conventional annuity with the residual fund will not trigger the MPAA.

Defined benefit

Apart for the SSAS exception mentioned above, receiving income from a final salary (defined benefit) scheme does not subject the pensioner to the MPAA.

Inherited pension funds

A beneficiary can take unlimited income from a dependant’s flexi access drawdown without a trigger.

Conclusion

The threat to tax revenues through a pension contribution arbitrage may have been more perceived than real. Thus I believe the Government's fairly sanguine approach has been a reasonable response. However, the Treasury has made it clear that further action will be taken if there does prove to be significant tax loss.

It will be possible for some people to churn through an annual £10,000 contribution and generate some tax saving. But, in my experience, the tax saving for those in a position to take advantage of this has been watered down to the extent that most feel it is hardly worthwhile going through the cost and administration of the exercise.

There will no doubt be some people who will inadvertently fall into the MPAA by cashing-in that extraneous £12,000 pension fund that has been languishing in an old policy.

The MPAA does add more complexity, and it is another point to be considered for those accessing pensions. Time will tell if any unforeseen consequences arise. **TPT**

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