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Briefing note

Pensions tapered annual allowance / transitional provisions for aligning pension input periods

When the concept of a Pension Input Period (PIP) was first introduced in April 2006 as part of the 'A-Day' pension taxation regime, it could be argued that HM Revenue & Customs (HMRC) missed an opportunity at the time, to align all PIPs with the tax year, going forward.

> One of the 'golden rules' concerning PIPs to date, is that an individual pension arrangement must not have more than one PIP ending in a particular tax year.

Instead, an array of PIP permutations were permitted by HMRC, triggering complication and confusion amongst individuals - particularly where concurrent pension arrangements each had different PIP-end dates.

HMRC subsequently (partly) missed another opportunity in April 2011. Even though all new pension arrangements opened after 5 April 2011 had a default PIP-end date of 5 April, legislation still allowed an individual to override this, as well as offering scope to make the PIP-length less than, or greater than, a year. As a consequence, confusion continued to reign, exacerbated by the added complexity of 'carry-forward'.

Finally, (as part of this year's Summer Budget) the Chancellor announced that with effect from 6 April 2016, all PIPs will be aligned with the tax year - both for Defined Contribution (DC) and Defined Benefit (DB) pensions. Although this really arrives ten years too late, it should make dealing with PIPs far easier than has been the case to date.

Before then, however, scheme administrators, advisers and their clients are all going to have to accept and deal with a raft of complicated transitional provisions for aligning PIPs to the tax year.

This briefing note provides an overview of those provisions, as well as outlining another Summer Budget proposal that explains why PIPs are being aligned to the tax year; namely, the proposed tapering of the Annual Allowance (AA) for 'higher earners', which will add further complication and may result in discouraging the high earners from contributing to pensions altogether. This will be covered further in the conclusion.

A Tale of Two PIPs

One of the 'golden rules' concerning PIPs to date, is that an individual pension arrangement must not have more than one PIP ending in a particular tax year.

The reason for this is that a PIP measures the total amount of contributions paid into that pension arrangement, and compares it with the prevailing AA for the tax year in which it ends, to see if an excess tax charge has arisen.

Immediately after George Osborne concluded his Budget speech, HMRC released a Technical Note entitled 'Pensions: Transitional provisions for aligning pension input periods'. One of the crucial announcements was, in order to achieve the realignment, the 2015/16 tax year will be split into two 'mini-tax years' - called the 'pre-alignment tax year' (PrATY) and the 'post-alignment tax year' (PoATY) – with the PrATY ending on 8 July 2015 (Summer Budget day) and the PoATY running from 9 July 2015 to 5 April 2016.

The result of this is that all existing pension arrangements will have at least two – and possibly three – PIPs ending within the 2015/16 tax year; a complete change from the 'golden rule' outlined above.

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> The legislation which underpins the transitional provisions is still in draft form and, therefore, liable to change until the point where the Finance Bill (No. 2) 2015 receives Royal Assent, which is anticipated to be later this year.

As well as this, with effect from 6 April 2016, all PIPs will be aligned with the tax year, with no opportunity to vary the length of a PIP, as has been the case to date.

An initial reading of this 17-page Technical Note revealed a number of typographical errors, and some of the sentences appeared to contradict others which begged the question, whether it had even been peer-reviewed.

One main question appeared unanswered, in fact. Did the Technical Note apply to those whose PIPs are already aligned with the tax year? After all, they don't have to go through a transitional process as they're already where HMRC require them to be.

However, the document does refer to 'everyone' and where this is most significant is with respect to the AA amounts within the two mini-tax years. Whereas the AA for the PoATY is nil, the AA for the PrATY is £80,000. This is because, for those individuals whose PIP is not aligned to the tax year, it is perfectly possible for them to have contributed two gross amounts of £40,000 (the prevailing AA) within the PrATY before the Summer Budget, based on the 'golden rule' belief that the two amounts would be allocated to two separate tax years.

Therefore, if HMRC did not allow an AA of £80,000 within the PrATY, those individuals may be faced with an excess tax charge on £40,000 which would be grossly unfair, as they were basing their contributions on the legislation that prevailed at the time.

Another feature of the transitional rules is the possibility to carry forward up to £40,000 of the AA from the PrATY into the PoATY, depending on how much has already been contributed within the PrATY. And - because the rules apply to 'everyone' – someone with their PIP already aligned with the tax year could unexpectedly find themselves in a 'double dip' scenario. This might see them already having contributed £40,000 gross within the PrATY, in the expectation that any further contributions couldn't be made until the next tax year (and I'm purposefully ignoring carry forward here).

Instead, they now have the potential to contribute a further £40,000 into their pension arrangement, during the PoATY, with no adverse tax consequences. This may be of particular interest to 'higher earners' (see below), who are keen to maximise their contributions, before the tapering of their AA commences from 6 April 2016.

Initial suspicions about the haste in which the Technical Note was thrown together were reinforced when HMRC then released their 'Pension Schemes Newsletter 70' a few weeks later.

It contained a number of notable points – '…a few changes to the technical note as first published'; namely, the correction and embellishment of certain parts of it, and an additional example ('Example 11A'), which – finally – clarifed those sentences within the original document that had caused much head-scratching amongst advisers and providers since Summer Budget day. It is very clear that initial inclusion of Example 11A would have undoubtedly helped.

Space does not allow me to go into detail about the transitional provisions for DB and cash balance arrangements, or for those who – having flexibly accessed their benefits this tax year – are now subject to the Money Purchase Annual Allowance. Suffice to say, the provisions are detailed and complex.

The final point to note is that the legislation which underpins the transitional provisions is still in draft form and, therefore, liable to change until the point where the Finance Bill (No. 2) 2015 receives Royal Assent, which is anticipated to be later this year.

This creates a frustrating scenario for advisers and providers when explaining the provisions to their clients. Clients who are likely keen to know how much they can contribute and by when, as there is currently a risk that, should the draft legislation change during its passage through Parliament, unanticipated tax consequences may follow. Is is evident that a need to caveat advice and guidance at the current time is paramount.

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> From 6 April 2016, individuals with income in a tax year of over £150,000 will have their AA reduced by £1 for every £2 of income that they have in excess of £150,000, up to a maximum tapering of £30,000.

Great Expectations?

As promised in the introduction, the reason why all PIPs are being aligned to the tax year, is because of another (widely-trailed) Summer Budget proposal ; namely, the proposed tapering of the AA for 'higher earners' (as the government are keen to call them).

From 6 April 2016, individuals with income in a tax year of over £150,000 will have their AA reduced by £1 for every £2 of income that they have in excess of £150,000, up to a maximum tapering of £30,000. This means that those with income of £210,000 gross per tax year, will then be limited to a maximum AA of just £10,000.

In addition to this, as an individual will need to know what their income (and by default their tapered AA) is before making a new contribution, their PIP will need to be aligned to the tax year in order to achieve this.

In order to ascertain if an individual's AA will be subject to tapering, the technical note defines two measures of income - 'adjusted income' and 'threshold income'.

If an individual's adjusted income for a tax year exceeds £150,000 their AA will be tapered, using the formula outlined above. However, if an individual's threshold income is £110,000 or less, their AA will not be tapered.

Complex sums are outlined to enable the two types of income to be calculated but, in essence, adjusted income includes the value of all pension contributions, whilst threshold income excludes them.

If enacted, the tapering mechanism will undeniably add yet more complication, but a further unintended consequence may be to turn those higher earners away from contributing to pensions altogether. In the worse case scenario, it could reduce their willingness to promote generous pension arrangements to their employees.

In conclusion, clients will be looking to their advisers to help steer them through this extraordinary tax year, and the possible tapering landscape beyond, as someone will need to help them keep tight control over their PIPs.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact James Jones-Tinsley via the following:

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