Workplace Pension

We outline an employer's obligations when looking at Workplace Pensions, and what the limit is on an employee's tax relief

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It is now compulsory in the UK for an employer to offer an employee membership of a pension scheme but care should be taken over the tax consequences.

Types of pension scheme

Pension schemes broadly fall into two categories:

- Net pay pension – the monthly pension contribution is deducted from the monthly gross salary before calculating the taxable income. Tax relief is claimed automatically since the income was not taxed in the first place. This is also referred to as an 'occupational pension'

- Relief at source – the gross income is subject to income tax, a portion of the after-tax net pay is then contributed to the pension scheme. The pension scheme claims 20% tax relief on the employee contribution automatically i.e. for every £80 net pay contributed by an individual the actual pension contribution is £100.

  For individuals who pay a marginal rate of 40% or 45%, the additional tax relief available of 20% or 25% will need to be claimed through their UK self-assessment tax return. This type of pension can also be referred to as a 'private pension'.

Once individuals reach age 55 (planned to increase to age 57 from 2028) pension savings can be withdrawn as a lump sum, used to buy an annuity or taxed as regular pension income.

If you have a defined contribution (DC) pension (where you've built up pension savings over your working life), you can take a 25% lump sum tax-free; you can take more, but you'll pay income tax on anything above 25%. However, you won't be able to make any more tax-free withdrawals in future.

If you leave your pot invested and take out smaller amounts, ad hoc, you'll get 25% of each withdrawal tax-free.

Auto enrolment

Employers have a legal obligation to automatically enrol all of of their 'eligible jobholders' into a qualifying scheme and it is necessary to certify that the scheme meets certain conditions as set out by the Pensions Regulator.

An eligible jobholder is a worker who is aged between 22 and state pension age and earns more than £10,000 per year, provided that they work/ordinarily work in the UK. Anyone automatically enrolled under these rules has a right to opt out.

Employers must provide the option to enrol whenever they hire a new employee.

Under current legislation, every three years there is an obligation for the employer to review the workforce. An employer must re-enrol all eligible jobholders who not currently active members of a qualifying scheme including those who have previously opted out. Again, jobholders have the right to opt out.

The only exceptions are if the employee is ending the employment or if they have applied for lifetime allowance protection.

Mandatory pension contribution levels

The minimum contribution levels are currently 8% of 'qualifying earnings' (before tax) between the lower earnings limit and upper earnings limit for National Insurance purposes. Of the 8% the employer must pay at least 3% with the employee making up the difference.

Many employers offer higher contribution levels or base the contribution on full salary rather than the qualifying earnings.

How much can individuals save?

Annual Allowance

The annual allowance is the maximum combined amount that a person can save into their pension scheme(s) in a UK tax year (6 April to 5 April) that will qualify for full tax relief.

This includes contributions from all parties and applies to all schemes – it is not an allowance per scheme. For 'relief at source' pensions the gross contribution after the 20% tax relief is taken into account, so if the contribution is £80, the true contribution is £100.

The standard annual allowance is £40,000. However, the annual allowance is reduced for high earners if:

- 'threshold income' is over £200,000 – this is the net taxable income less the gross amount of personal pension contributions; and
- 'adjusted income' is over £240,000 – this is the net taxable income plus occupational employee and employer pension contributions.

For every £2 the adjusted income goes over £240,000, the annual allowance for the current tax year reduces by £1.

The minimum reduced annual allowance one can have in a current tax year is £4,000 which equates to an adjusted income of at least £312,000.

Lifetime allowance

In addition to the annual allowance, individuals are subject to a lifetime allowance, currently £1,073,100. A lifetime allowance charge is payable where pension pots are worth more than the lifetime allowance.

If an individual's pension savings are close to the current lifetime allowance limit and HMRC reduces the limit in the future, an application can be made by the individual to protect the pension pot so there is no detrimental effect.

This essentially allows the lifetime allowance to remain at the current limit rather than move to the lower limit, so the "pot" is protected from any allowance charge that may arise because the limit has been reduced.

What happens if pension contributions exceed the annual or lifetime allowance?

If the pension savings made in the tax year exceed the available annual allowance, any unused allowances from the previous three tax years can be used to offset against the current year contribution. If there is still an excess contribution, an Annual Allowance Charge will be incurred at the individuals' marginal rate of tax (usually at 45%).

Individuals are responsible for reporting the Annual Allowance Charge on their Self-Assessment tax return and can opt for the pension fund to pay the charge, often referred to as "fund pays".

Approval to opt for "fund pays" must be obtained from the pension provider in advance and it is important to understand that payment comes from the individual's pension pot which will then decrease proportionately.

Any amounts above the annual allowance that are subject to the annual allowance charge on the way in are still taxable when paid out, so in reality if the annual allowance is exceeded there is a "double tax charge".

Additionally, it is very important not to exceed the lifetime allowance. The rates of tax payable on pension savings above the lifetime allowance depend on how the money is paid out.

Currently the rates are:

- 55% if the monies are paid out as a lump sum
- 25% if the monies are paid out as pension payments or cash withdrawals, this is in addition to the income tax payable (up to 45%)

Review of pension contribution levels

It is important to make your employees aware of the pension contribution limits. If the Annual Allowance Charge is payable, it defeats the purpose of paying less tax now to save for retirement.

PKF Littlejohn is happy to work with you to review the UK tax position on the pension contribution levels of senior employees and provide central communication tailored to your needs.

Advice from a pension consultant is highly recommended before committing to setting up a pension fund.

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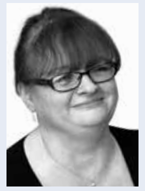

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