SLAUGHTER AND MAY/

CLIENT BRIEFING

MARCH 2023

CHANGES TO PENSIONS TAX ALLOWANCES: AN UPDATE

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INTRODUCTION

Following the announcement of radical and far-reaching changes to pensions tax allowances in the Budget, summarised in our HR Budget Briefing, further details were set out in the recent Finance Bill. There is helpful further clarification of how the lifetime allowance (LTA) charges will be removed and the pensions tax system will operate for the 2023/24 tax year. However, this is still just the beginning of the journey - a future Finance Bill will be needed fully to remove the LTA framework and to set out replacement provisions governing matters such as tax-free cash. In the meantime, the Labour Party has said a future Labour government would re-instate the LTA and propose a targeted solution for doctors, creating additional uncertainty for pensions savers.

Whilst the direct impact of these changes will be on individuals, there will be issues for employers and trustees to consider in the short term, not least the communication of the changes to members.

REMINDER OF THE PROPOSED CHANGES

- **LTA charges:** to be removed from 6 April 2023. Where lump sum benefits are currently "tax free" within the LTA, the 55 per cent. LTA charge on any excess is replaced by income tax at the individual's marginal rate of tax. This will apply to, for example, LTA excess lump sums and certain death benefit lump sums. Where benefits are currently subject to the 25% LTA charge, for example member pensions that are in excess of the LTA, or on a transfer to a QROPS (qualifying recognised overseas pensions scheme), there will be no tax charge.
- **LTA framework:** to remain in place in tax year 2023/24. Trustees will still need to make LTA checks before paying benefits and report the percentage of allowance used to members.
- **Tax-free cash** (the pension commencement lump sum (PCLS)): the maximum amount for those without relevant protections will be frozen at £268,275 (25 per cent. of the current standard LTA of £1,073,100).
- **Protected right to higher PCLS:** protected rights to higher tax-free cash will continue. A recent HMRC newsletter confirmed that, where the protection held is enhanced or fixed protection, it will be possible to accrue new pension benefits, join new arrangements or transfer and still keep the protection, including the entitlement to protected tax-free cash. This is achieved in the Finance Bill by amending the "loss of protection" provisions so that they do not apply where the protection was applied for before 15 March 2023.
- **Abolition of LTA:** the LTA framework is expected to be fully removed from the 2024/25 tax year, but the current changes will run on until those next steps are taken. We can expect more details of how it is proposed that the LTA framework will be removed in Summer 2023, when draft legislation is published for the next Finance Bill. For example,

how tax-free cash, and the availability of tax-free allowances for lump sum death benefits, will be tracked once the LTA framework is removed, and how the income tax charges on excess benefits will be levied from 2024/25 onwards.

- **Standard annual allowance:** this will increase from £40,000 to £60,000 from 6 April 2023. Individuals will continue to be able to carry forward unused annual allowance from the three previous tax years.
- **Money purchase annual allowance:** where individuals have already flexibly accessed money purchase pensions, and are subject to the money purchase annual allowance, this will increase to £10,000 (from £4,000) from 6 April 2023.
- **Annual allowance taper:** the taper will start kicking in at an "adjusted income" of £260,000 from 6 April 2023 (up from £240,000). The minimum tapered annual allowance will increase to £10,000 (from £4,000). This means that individuals with adjusted incomes of £360,000 or more will have the lowest tapered annual allowance of £10,000. Adjusted income is a broad measure that includes, for example, rental income, and adds in the value of employer funded pension savings.

WHAT DOES THIS MEAN IN PRACTICE?

Initial communications

The changes will impact members in different ways; for example, there will be an increased capacity for tax efficient pensions savings for individuals who had built up benefits close to the LTA, whilst individuals who had accessed benefits and are subject to the money purchase annual allowance will have more annual allowance capacity. Individuals who claimed enhanced protection, and remain in employment, will be able to build up tax advantaged pensions savings in registered pension schemes for the first time.

Employers and trustees may want to send out an initial communication explaining the changes in general terms to employees and scheme members. Any communications should make it clear that these are currently only proposed changes, legislation containing the changes has not yet been enacted, and the proposals could be subject to change - either before or after enactment. Retrospective effect of any changes post-enactment also remains a possibility (albeit this would be unusual).

Individuals due to retire before 6 April 2023 with an LTA charge to pay may wish to push back retirement.

Member handbooks, retirement packs and other member communication materials will need reviewing and updating to reflect the proposed removal of the LTA charge, and other tax changes. In the short term, a cover note could be sent out with materials explaining the proposed changes in general terms.

Changes to pension or life cover benefits?

Where pension contributions have been capped by reference to the £4,000 tapered annual allowance, with cash allowances in lieu of higher contributions, it may be appropriate to adjust these for 2023/24 to reflect the higher minimum £10,000 tapered annual allowance.

Where pension benefits are provided through flexible benefit schemes, consideration should be given as to whether any adjustments are appropriate following the changes to the allowances, remembering that where salary sacrifice is operated, there is no tax requirement to limit changes to arrangements to, for example, lifestyle changes.

Some scheme designs include benefits that are capped by reference to the LTA or the annual allowance. These should now be reviewed and revised so that they work as expected once the changes are made to the tax allowances.

Employers should consider whether the current terms of any matching contributions remain appropriate with the rise in the annual allowance and removal of the LTA.

To manage LTA issues, many employers currently provide life cover partly through registered pension schemes and partly through top up life cover arrangements, using excepted group life policies, which are not within the LTA regime. This will remain the tax efficient option in the 2023/24 tax year, as lump sum death benefits that would previously have attracted the 55% LTA charge will still be taxed, but at the recipient's marginal tax rate. The position should be kept under review for future tax years.

Other impacts

For the next tax year, the usual LTA checking processes will need to continue. Whilst it will no longer be necessary to collect and report on LTA charges, these processes will help identify the maximum PCLS that can be paid, and where income tax is due on benefits such as LTA excess lump sums and lump sum death benefits. In due course, we expect that a new statutory system will be needed to track usage of the (frozen) tax-free cash allowance, and to work out whether lump sum death benefits are tax free or subject to income tax.

Trustees will also need to revise their administration practices around accounting for tax on those lump sums where an income tax charge at the recipient's marginal rate arises in place of an LTA charge. In HMRC's Lifetime Allowance guidance, published on 27 March 2023, HMRC confirm that, from 6 April 2023, where that charge arises, normal PAYE rules will apply to those lump sums and they will be treated as pension income. The newsletter sets out in more detail how to identify the correct PAYE code to apply in various circumstances – and the changes that will be required to the processes for dealing with, in particular, uncrystallised funds lump sum death benefits and defined benefit lump sum death benefits.

Tax allowances have caused headaches in various pension scheme exercises. Where these are underway, any constraints created by tax allowance issues should now be reviewed. For example:

- Where schemes are in the earlier stages of GMP equalisation exercises, and have not yet settled on an equalisation method, conversion may look more attractive. The potential loss of fixed protections for deferred members when using the conversion method has been a concern for many schemes.
- On the move from buy-in to buy-out, careful thought has been required to manage the risk of loss of fixed protections for certain members.
- Both annual allowance and LTA issues can arise when considering member options such as pensions increase exchanges and bridging pensions.

Currently, the exemptions from auto-enrolment for members holding tax protections continue, so there is no requirement to enrol these members.

The terms of any top up pension promises provided through non-registered arrangements such as an unfunded EFRBS (employer financed retirement benefit scheme) should be reviewed, for example to check if the source of funding will now change. If these have been provided on a "wrap around" basis, it may now be the case that more or all of the top up will fall due to be paid by the registered pension scheme.

SUMMARY

The proposed changes, if enacted, will remove the many complexities of the LTA in particular. But the changes are conditional on:

- the detail of the 2024/25 legislation (expected in draft in July).

  Comment: HMRC has said it will publish updated guidance for **members** on 6 April 2023, and that it will provide future updates on the LTA changes through a new series of Lifetime Allowance newsletters. But these will not be reflected in formal guidance until the changes are enacted so the uncertainty remains, and
- a future Government not reversing them.

The latter point is a relevant consideration, both in terms of member communications, for example if members take steps in reliance on these which later prove problematic, and in relation to whether to continue to apply procedures currently used in pension scheme exercises to avoid adverse tax consequences.

ACTION POINTS

ACTION	DETAIL	COMMENT
Member communications	• Initial communication explaining changes • Review member handbooks, retirement packs and other communications	Be clear that those are only proposals, and highlight the political risk
DC matching contribution rates	Consider changes to reflect higher AAs/removal of LTA charge	Particularly relevant for those currently affected by AA taper
Scheme designs where benefits capped by reference to LTA/AA	Consider amendments to remove	Await further details of 2024/25 changes
Top-up life cover arrangements	Review whether still required	For tax years from 2024/2025
Administration procedures	Revise procedures; amend accounting for tax on certain lump sum benefits	Applicable from 6 April 2023 under current proposals
Consider impact on pension scheme exercises	Procedures put in place to avoid adverse LTA/AA impacts may no longer be necessary	For example in relation to GMP equalisation exercises, moving from buy-in to buy-out, and member options such as PIEs and bridging pensions

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