The changing UK pension landscape - What next?
Simply taking no action in response to the latest changes may lead to very inefficient reward costs or unhappy senior employees or both.
Employers who make pension provision for their employees are probably becoming accustomed to reviewing their pension policy in response to changing tax rules. The 2015 Summer Budget continues a recent trend of almost annual changes to the UK tax rules for pensions and the pipeline of annual upheaval shows no signs of abating with two new consultations raising the spectre of more changes to come. Depending on the direction of those reforms, they may have significant implications for employment taxation.

The latest modifications sounded fairly straightforward when announced by the Chancellor, but the detailed provisions and the way they will apply create considerable challenges.

► New approaches to annual caps in defined benefit pension schemes may be needed
► Employers with defined contribution schemes will need to rethink employee communications and pension matching arrangements to help avoid unexpected annual allowance charges
► Cash alternative arrangements may need to be considered

Employers should:
► Ensure they have an appreciation of the specific challenges created by the complexity in the new rules
► Give thought to the wider impact of pension policy responses on employee reward, recruitment and retention
► Consider the opportunities a revised pension policy could offer, in terms of happier employees and more efficient reward spend

A snapshot of the latest changes

From 2016/17, the effective cap on tax relief in relation to registered pension schemes (known as the annual allowance) will be reduced by £1 for every £2 of income over £150,000, subject to a minimum annual allowance of £10,000.

Income for this purpose includes most taxable income, not just earnings, as well as pension contributions and accruals. There are actually two separate tests to be done and they include calculations that would not otherwise be required. Suffice to say the detail is complex and outside the scope of this article.

Of course, most people do not need to ‘worry’ that their income might exceed £150,000 regardless of how it is measured. The new law will not create issues for the average person.
Some of the issues employers may face are as follows:

1. **Defined benefit accruals**
   An increase in annual defined benefit (DB) pension entitlement of more than £625 could create an immediate tax cost for the employee.

   An employer’s policy might already cap annual DB pension increases at the level of the annual allowance to avoid such tax charges arising, but making a cap work will not be straightforward when the level of the employee’s annual allowance is not known until near, or even after, the end of the tax year. Currently, the annual allowance is not dependent on the individual’s income but from 2016/17 this will need to be considered.

2. **Defined contribution matching contributions**
   Employer policies will typically match employee contributions to defined contribution (DC) schemes. If employees limit regular contributions to avoid exceeding the £10,000 minimum annual allowance, they could miss out on some of the matching employer contribution. If the employer’s policy caps the total matching contribution in any one year, it might not be possible for the employee to increase contributions in subsequent years and recover the lost employer match. As a consequence, the employer’s pension policy could result in the employee realising little value from what can be an expensive employer benefit (see example across).
Example

Consider an employee who currently contributes £15,000 per year and gets a matching £15,000 from her employer. Let’s assume she will have the annual allowance limited to £10,000 as income is in excess of £210,000. The employee may decide to continue to contribute the full £15,000 in order to keep the full £15,000 employer match despite the fact that £20,000 will then be liable to an annual allowance charge at 45% (see illustration). The position gets more complicated when you consider that the funds in the pension will be taxed again when they are paid out in retirement.

Scenario 1: Under the rules from 2016/17 onwards an employee has a £10,000 annual allowance and limits contributions.

- Employee contribution - £5,000
- Employer matching contribution - £5,000
- Annual allowance charge - £0
- Increase in pension value - £10,000
- Employer cost - £5,000
- Value employee gets from the employer matching contribution - £5,000

Scenario 2: Under the rules from 2016/17 onwards an employee has a £10,000 annual allowance but does not limit contributions.

- Employee contribution - £15,000
- Employer matching contribution - £15,000
- Annual allowance charge - £9,000
- Increase in pension value (assuming the scheme pays any annual allowance charge) - £21,000
- Employer cost - £15,000 (extra £10,000 of employer cost compared to Scenario 1)
- Value employee gets from the employer matching contribution - £6,000 (delivers an extra £1,000 to the employee compared to Scenario 1)

This illustration shows the employee is likely to prefer not to limit contributions but, as a consequence, the extra £10,000 of employer costs in Scenario 2 delivers only £1,000 of additional employee value.
3. Tax equalised internationally mobile employees

Many employers will operate a tax equalisation policy whereby employees on an international assignment have their pay adjusted so as not to benefit or suffer from any difference in tax rates between countries. This policy may or may not take account of the annual allowance tax charge, which may cause complications because of the new rules.

**UK-based employees working abroad**

The reduction in the annual allowance entitlement is based around income liable to tax in the UK. This creates immediate distortions in an internationally mobile employee context. For example, a UK employee sent on assignment overseas whilst remaining UK tax resident could suffer from a reduced annual allowance as a result of any increase in pay or benefits which might otherwise be designed to keep employees ‘whole’ to their home country standard of living. In contrast, employees who cease to be UK tax resident could benefit from additional annual allowance for tax years spent on assignment if their UK taxable income is reduced. The resulting impact on the employee’s UK tax liabilities, pattern of pension contributions or available annual allowance carried forward to later tax years will be impossible to know in advance. This could lead to ambiguity or animosity on the part of the employee which is obviously what assignee programmes generally aim to avoid.

**Employees coming to the UK**

In another example, where an assignee comes to the UK from overseas, the new rules effectively limit the UK tax relief for contributions to non-UK pension schemes. Many equalised assignees coming to the UK who do not normally earn more than £150,000 will have taxable income and pension contributions over that amount once all elements of the assignment package are taken into account. In these circumstances, an annual allowance charge may be difficult or impossible to avoid leading to an increase in assignment costs if employees are allowed to maintain pension contributions at their normal home country levels.
4. Other issues

Employers will also need to consider:

► The impact for the pension scheme as a whole, in terms of costs, should a large number of its members with the largest contribution levels decide to exit.

► The need for employees to consider taxable income from all sources (which includes personal income) when determining whether the new rules affect them and the fact that they may prefer such information to remain confidential from their employer. Coupled with this is a timing issue, bonuses or share incentive payments causing the £150,000 income test to be exceeded could happen towards the end of the tax year when pension contributions have already been made.

► Whether the anti-avoidance rule relating to salary sacrifice or flexible benefit arrangements applies in respect of their employees and, if so, whether it matters.

► Whether another anti-avoidance rule might apply that will block any arrangements intended to manage income levels for the purpose of increasing the available annual allowance.
In the past, some employers have used unapproved pension arrangements to top-up provision for employees whose relief under the registered plan is restricted. Since 2011, this can only be achieved tax efficiently via a limited form of unfunded promise. However, the Government is going to issue a consultation paper shortly on the tax treatment of such arrangements which may or may not affect their use going forward.

The following ideas explore a range of potential pension policy responses an employer could adopt. They fall into three broad categories:

1. The simpler options of taking no action or closing schemes and leaving only the benefits required by auto-enrolment

2. Introducing cash alternatives to employer matching contributions so that employees are not forced to choose between the risk of an annual allowance charge and a reduction in their overall reward in the form of a matching pension contribution foregone

3. Developing more complex pension arrangements that include adjustable caps of annual pension accrual and carry forward of benefits into years where the employee’s income level may allow greater accrual

### The simpler options

<table>
<thead>
<tr>
<th>Take no action and leave the pension policy as it is</th>
<th>Close existing pension schemes and only offer the minimum required by auto-enrolment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advantages:</strong></td>
<td><strong>Advantages:</strong></td>
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<tr>
<td>This approach acknowledges that the annual allowance is the employee’s personal tax issue</td>
<td>This approach avoids the need to consider employee circumstances</td>
</tr>
<tr>
<td>Reduced pension participation could mean cost savings for the employer</td>
<td>It removes the annual allowance issue completely for the employer</td>
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<tr>
<td></td>
<td>The employer saves money</td>
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<tr>
<td><strong>Disadvantages:</strong></td>
<td><strong>Disadvantages:</strong></td>
</tr>
<tr>
<td>This is an inefficient reward policy as the employee is incentivised to continue contributing in order to retain the matching employer contribution which then suffers a very high effective tax cost (see the example above)</td>
<td>This approach risks making employees unhappy if employer contributions are reduced</td>
</tr>
<tr>
<td>It could negatively impact recruitment and retention in some circumstances</td>
<td>Possible contractual barriers may mean that employees need to be compensated, for example with a one off pay rise</td>
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<tr>
<td></td>
<td>It is likely to negatively impact recruitment and retention</td>
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In lieu of pension offer a lower amount in cash but only to affected employees

**Advantages:**
- This approach resolves the issue illustrated in the example above where the employee is incentivised to accept a very high effective tax cost in order to retain a matching employer contribution.
- It can save the employee and the employer money.
- It may have a positive impact on recruitment and retention.

**Disadvantages:**
- The employer may not be able to identify in advance all employees affected so will need to decide how to identify who is eligible for the cash.
- This approach may be considered unfair by employees who want cash but are excluded.
- Compatibility with the auto-enrolment rule prohibiting any incentive to opt out will need to be considered.

In lieu of pension offer a lower amount in cash to all employees

**Advantages:**
- This approach resolves the issue illustrated in the example above where the employee is incentivised to accept a very high effective tax cost in order to retain a matching employer contribution.
- It avoids any need to consider employee circumstances.
- It can save the employee and the employer money.
- Likely to have a positive impact on recruitment and retention.

**Disadvantages:**
- This approach could be expensive for the employer if there are employees who opt out of the pension.
- Compatibility with the auto-enrolment rule prohibiting any incentive to opt out will need to be considered.

For DB schemes: build in an adjustable cap and carry forward for annual accrual

Amend the scheme rules to cap the annual accrual at the level of the employee’s annual allowance as notified by the employee to the scheme before a specified deadline (which could be after the end of the tax year). The onus would be on the employee to assess his or her own annual allowance and notify the scheme before the specified deadline. If the employee does not notify the scheme before the deadline, the default position could be to assume he or she has an annual allowance of either £10,000 or £40,000. The default assumption could be by reference to total employment income (for example, perhaps assume £10,000 only where basic salary exceeds £150,000). The employer could allow the accrual foregone due to the cap to be carried forward and accrued the following year subject to continued service. This carry forward would be especially helpful where employees have been subject to a default £10,000 cap but later discover they had annual allowance in excess of £10,000. This helps to resolve the employers’ issues created by the new rules and allows employees to maximise use of their annual allowance. Avoids any need for the employer to consider the employee’s circumstances. Would require legal input as it would amend the scheme rules. Need to consider accounting impact.

For DC schemes: allow employees to carry forward unused matching contributions

Employees could limit their contributions to £10,000 plus annual allowance carried forward from earlier years. To the extent this causes the employee to forego matching employer contributions, the employer could allow enhanced matching contributions in subsequent years. This solves the employers’ issues created by the new rules and allows employees to maximise use of their annual allowance. Avoids any need for the employer to consider the employee’s circumstances.

For more substantial pension policy changes:

- Employees could limit their contributions to £10,000 plus annual allowance carried forward from earlier years.
- To the extent this causes the employee to forego matching employer contributions, the employer could allow enhanced matching contributions in subsequent years.
- This solves the employers’ issues created by the new rules and allows employees to maximise use of their annual allowance.
- Avoids any need for the employer to consider the employee’s circumstances.

Cash alternatives:
- More substantial pension policy changes.

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For many employers, simply taking no action in response to the annual allowance changes will not be a desirable policy option as it will lead to very inefficient reward costs or unhappy senior employees or both. That said none of the alternatives are easy wins.

Employers will probably prefer to avoid having responsibility for determining their employee’s exposure to the annual allowance charge. The Government is considering how the current reporting obligation, for pension scheme administrators to notify members whose pension savings exceed the annual allowance in that scheme, could be adapted in light of the annual allowance changes. The new rules can be extremely complex in relation to the calculation of the two income thresholds and those calculations require a detailed knowledge of the employee’s personal financial circumstances. An employee may not be able to assess his or her own exposure to the annual allowance charge until after the end of the tax year. It would be wise to ensure pension policy reflects these new realities.

These issues will start to take effect from 2016/17 which means employers have only a matter of months to weigh up the choices and take action. During that process, it is worth keeping in mind that the Government has issued a new consultation paper on the future of pensions tax relief generally, which includes proposals for a range of further comprehensive changes. Ideas being mentioned in the financial press include eliminating tax relief for pension contributions or introducing flat rate tax relief, either of which would presumably lead to some form of tax charge on employer pension contributions. It is clear that pension policy is likely to remain in a state of flux for some time to come; this might lead employers to conclude that a more simple policy response to the recent developments is prudent, at least in the short term.

Individuals facing uncertainty over their exposure to annual and lifetime allowance charges may prefer alternative investments as a means of making provision for retirement and could decide to exit pension plans completely. Employers will need to carefully consider what this would mean in terms of wider reward policy objectives and should still ask whether the existing pension policy remains viable and whether it offers value for money as part of the overall employee reward package.
We can help employers understand the new rules and the likely impact on specific pension provision. Our international pensions and pension advisory services teams can provide valuable assistance to employers wanting to analyse the costs, both tangible and intangible, of various potential pension policy responses. The ideas outlined above offer only a high level indication of the range of opportunities available to employers and we would welcome the opportunity to discuss these opportunities with employers at an early stage.

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