MERCER

Guidance note

Changes to pension tax relief from April 2011

What's changed?
At the end of 2010, the Government announced final details of the way it intends to restrict tax relief on pension savings. From April 2011 there will be changes to:

- Your **Annual Allowance** (the maximum tax-free build up of pension savings you can make each year)

- Your **Lifetime Allowance** (the overall value of pension savings that you can build up over your entire working lifetime before a tax penalty applies).

Am I impacted?
Whether these changes affect you will depend on a range of factors such as how much you earn, how long you have been a member of the O2 Pension Plan (**"the Plan"**), the pay rises you receive and the extent to which you sacrifice your bonus or salary or make extra payments into personal pensions. In the appendix to this note, we have set out a summary of what these changes are, when they apply and how you may be affected.

Broadly the changes could impact you if:

- You are a member of Section 1 of the Plan (the Defined Contribution arrangement) and have employee and employer contributions approaching or exceeding £50,000 a year; or
- You are a member of Section 2 of the Plan (the Defined Benefit arrangement where you accrue benefits on a 1/60 basis linked to your earnings) and have a high number of years of pensionable service and/or have received an above inflationary pay rise; or
- You are a member of Section 3 of the Plan (the Defined Benefit arrangement where you accrue benefits on a 1/80 basis linked to your earnings) and have a high number of years of pensionable service and/or have received an above inflationary pay rise; or
- You have received an uplift in your pension benefits as a result of redundancy

What's currently in place until April 2011?
Since 2009 transitional arrangements known as 'anti-forestalling' measures have been in place. This legislation exists to discourage individuals whose income is above a certain level from paying substantial contributions before the rule changes on tax relief take effect from April 2011. These temporary, "anti-forestalling" measures limit full tax relief for employees who:

- have total relevant income of at least £130,000 in the current tax year (or in either of the last two tax years) – broadly this is your total income that is chargeable to income tax less up to £20,000 of your pension contributions; and
- increase their usual pension savings; and
- have total pension savings of more than £20,000 in the tax year.

If all three conditions apply, a Special Annual Allowance tax charge applies on any new pension savings made by you or your employer (existing contributions are unaffected until April 2011). The rules around anti-forestalling are complex. Further details are available on the O2 Pensions Website via the link below:

http://www.o2pensions.co.uk/.download/pdf/Budget-Guidance-Note-PBR-update.pdf

Remember, these rules are still in place until April 2011 so please use the contact details below to speak to a member of the O2 pension's team if you are concerned that you may have breached the anti-forestalling rules.

What should I do next?

This communication aims to give you a broad overview of the tax changes that will take effect from April 2011. If you think it is likely that you will be impacted by the changes, it's important that you consider taking financial advice.

The Appendix to this note provides further information on the Annual Allowance and Lifetime Allowance along with example calculations for each Section of the Plan.

You should seek independent financial advice before deciding to opt out of the Plan as a result of the changes to the Lifetime Allowance or Annual Allowance limits. Please note that O2 cannot provide individuals with personal financial advice, but the O2 pension's team can help you to understand these changes and will keep you updated as further details become available.

More details of the new tax rules can be found here:

http://www.hmrc.gov.uk/budget-updates/autumn-tax/tiin2680.pdf

If you would like to discuss this note in more detail or have any questions you should contact the O2 pensions team:

Email: joanna.udall@o2.com; Tel: 07595 212420
Email: james.kirkland@o2.com; Tel: 07725 495075

January 2011

Please note that the information provided in this communication is based on Mercer's interpretation of the changes in pension legislation announced by Her Majesty's Revenue & Customs (HMRC) in October 2010 and published in the 2011 Finance Bill which we envisage will receive royal assent in July 2011 with the changes being backdated to 6 April 2011. The information should be used for guidance purposes only and does not constitute financial advice.

Appendix

Annual Allowance

What is your Annual Allowance?
This is an annual limit on how much your pension savings can grow in a year before being subject to tax.

How much is the Annual Allowance?
For the tax year 2010/2011 it is £255,000, but it will reduce to £50,000 for the 2011/12 tax year (and will then be fixed until at least 2015/16).

The figure to compare with the Annual Allowance is the sum of all your "*pension savings*" paid into all your pension plans during each "*pension input period*" ending in the tax year.

What are my "pension savings"?
Your pension savings could be as follows:

- You are a member of Section 1 of the Plan – the Defined Contribution arrangement. The relevant pension savings figure is simply the total gross contributions (including tax relief) made over the tax year (year ending 5 April) by you and O2.
- You are a member of Section 2 of the Plan – Defined Benefit arrangement. Your pension savings will be based on the increase in your annual pension at retirement above inflation, as measured by the Consumer Price Index (CPI) over the course of the tax year (year ending 5 April), multiplied by a factor of 16.
- You are a member of Section 3 of the Plan – Defined Benefit arrangement. Your pension savings will be based on the increase in your annual pension at retirement above inflation, as measured by the Consumer Price Index (CPI) over the course of the tax year, multiplied by a factor of 16. This figure is then added to the increase in your tax free cash entitlement above inflation.
- You may choose to make further pension savings by way of sacrificing some of your salary or bonus. The pension savings would then be the calculated pension savings above added to the total gross contributions via salary or bonus sacrifice.

You may have personal pension arrangements in addition to being a member of the Plan. Any contributions into such arrangements will also form part of your pension savings. Increases in benefits from membership of other pension plans (e.g. Defined Benefit arrangements from prior employment) will not normally be included in the calculation of annual pension savings

You can request details from the Plan Administrator of the amount that will be assessed against the Annual Allowance.
Examples of how to calculate the value of your pension savings in relation to the Annual Allowance for each Section within the Plan are included at the end.

What is my "Pension Input Period"?
For any tax year, the Annual Allowance test is assessed against the pension savings in the Pensions Input Period (PIP) that ends in that tax year. Each plan has its own PIP, so if you are a member of more than one plan, then you have to add up all the pension savings for each plan.

For your administrative ease the PIP for the Plan follows the tax year - 6 April to 5 April. Thus, your PIP for the 2011/12 tax year will commence on 5 April 2011.

Are there situations when the Annual Allowance does not apply?
All benefits earned will be subject to the Annual Allowance, except in the cases of death or retirement in serious (that is, terminal) ill health.

The application of the Annual Allowance will apply in every year that pension savings are made, including:

- The year in which benefits are drawn
- If you retire early or are made redundant

Read only: If you have applied for Enhanced Protection
If you elected for Enhanced Protection under the 'A-day changes' back in April 2006 you were previously exempt from testing against the Annual Allowance. The 2011 Finance Bill states that you will now need to consider the new Annual Allowance limit of £50,000 for any relevant benefit accrual. This does not necessarily mean that you will be forced to opt out of pension savings in order to retain Enhanced Protection. We recommend that as this is a complex area of pension planning that you seek financial/ tax advice, should this apply to you.

What if my pension savings exceed the Annual Allowance?
If your pension savings exceed the £50,000 Annual Allowance a special tax charge is payable that is linked to your marginal rate of tax. We recommend that you seek financial/tax advice if you think you will be likely to exceed this Allowance. Any tax charge will effectively cancel out the tax relief you receive when you make pension savings. Therefore, as the pension you receive in retirement is taxable, it will usually not be tax-efficient to make pension savings above the Annual Allowance.

If your pension savings exceed the Annual Allowance in any one year, you may offset the potential tax payable by carrying forward any unused Allowance from the previous three years (using the reduced Allowance of £50,000 to determine the amount which can be carried forward to tax year 2011/12 from each of the tax years 2008/09, 2009/10 and 2010/11). If, for example, you made gross pension savings of £30,000 in each of 2008/09, 2009/2010 and 2010/2011 tax years you will have underutilised allowances of £20,000 for each tax year. It should therefore be possible to make pension savings of £110,000 in the 2011/12 tax year i.e. £50,000 + £60,000 (3 x £20,000).

In order to determine contributions made in previous years, please follow the guidance noted in the "pension savings" section above and the examples below.

Annual Allowance examples

<u>Section 1 – worked example</u>

Suppose your O2 pensionable salary remains at £50,000 throughout the 2011/12 tax year and you are a member of Section 1 of the Plan. In this example, you pay 4% of your pensionable salary and O2 matches this and pays a further 4%. You also have a personal pension and make annual payments amounting to £1,000 gross (£800 Net) annually.

Pensionable salary	x	Employee contribution + Employer contribution	=	Total pension contribution in Section 1 of the Plan	+	Payments to personal pension	=	Annual pension savings
Example								
£50,000	x	(4% + 4%)	=	£4,000	+	£1,000	=	£5,000
You				(a)		(b)		(a) + (b)
	x		=		+		=	
……………….		…………………		……………….		……………		………….

In this example, the value of annual pension savings includes both the overall pension contributions to Section 1 of the Plan as well as gross personal pension contributions. As the contributions combined amount to £5,000, this is below £50,000 so no Annual Allowance tax charge will apply.

<u>Section 2 – worked example</u>

(For simplicity, we have used a slightly different method than HMRC to illustrate this example but this method still results in exactly the same answer)

Our example employee begins the year with 20 years' membership of Section 2 providing 1/60 of final pensionable salary for each year of pensionable service. Suppose the O2 pensionable salary rises from £56,000 to £60,000 over the course of the year. Please note that the measure for the rate of inflation, the Consumer Price Index (CPI) for the 2011/12 tax year is 3.1%, the rate will change in the future and can be found on http://www.statistics.gov.uk/CCI/nugget.asp?ID=19 and will be the prevailing rate in September of the applicable tax year.

Pensionable service at year end	x	Final Pensionable salary at year end	x	Pension build up rate	=	Pension income at year end (a)
Example						
21	x	£60,000	x	1/60	=	£21,000
You						(a)
	x		x	1/60	=	
……………….		…………………				…………

Pensionable service at start of year	x	Final Pensionable salary at start of year	x	Pension build up rate	+	Uplift of Price inflation	=	Pension income at start of year (b)
Example								
20	x	£56,000	x	1/60	+	3.1%	=	£19,245
You								(b)
………………	x	………………	x	1/60	+	3.1%	=	……………

Year end amount	-	Start amount	=	Real pension increase	x	Multiply by 16	=	Annual pension contribution
Example								
£21,000	-	£19,245	=	£1,755	x	16	=	£28,080
You (a)		(b)						
………………	-	………………	=	………………	x	16	=	………………

In this example, the value of the annual pension contribution is based on the increase in the annual pension at retirement above inflation, as measured by the Consumer Price Index (CPI) over the course of the year, taking the pay rise into account, multiplied by a factor of 16. As the contribution is calculated to be £28,080, no Annual Allowance tax charge will apply as it is below £50,000.

If you also make contributions to a private pension or via salary/bonus sacrifice then you will also need to add the value of such contributions using the calculation method as demonstrated in the first example.

Section 3 – worked example

Our example employee begins the year with 30 years' membership of Section 3 providing 1/80 of final pensionable salary for each year of pensionable service. Suppose the O2 pensionable salary rises from £70,000 to £80,000 over the course of the year. The rate of inflation is 3.1% over this period. Please note that the measure for the rate of inflation, the Consumer Price Index (CPI) for the 2011/12 tax year is 3.1%, the rate will change in the future and can be found on http://www.statistics.gov.uk/CCI/nugget.asp?ID=19 and will be the prevailing rate in September of the applicable tax year.

The method to calculate the annual savings is to keep separated the pension income and tax free tax entitlement at the beginning and end of the tax year.

Pension accrual at end of the year:
This calculation is slightly more complex as you need to add in the tax free cash entitlement. The first element of this calculation involves calculating the pension benefits at the end of the year, so that you get to figure (c).

Pensionable service at year end	x	Final Pensionable salary at year end	x	Pension income build up rate	=	Pension income at year end (a)
Example						
31	x	£80,000	x	1/80	=	£31,000
You						(a)
………………	x	…………………	x	1/80	=	…………

Pensionable service at year end	x	Final Pensionable salary at year end	x	Pension build up rate for tax free cash entitlement	=	Tax free lump sum at year end (b)
Example						
31	x	£80,000	x	3/80	=	£93,000
You						(b)
………………	x	…………………	x	3/80	=	…………

Pension income at year end (a)	x	Multiply by 16	=	Real pension increase	+	Tax free lump sum at year end (b)	=	Total pension value at year end (c)
Example								
£31,000	x	16	=	£496,000	+	£93,000	=	£589,000
You (a)						(b)		(c)
………………	x	16	=	………………	+		=	…………………

Pension accrual at start of the year:
The second element of this calculation involves calculating the pension benefits at the start of the year and then taking an inflation adjusted valuation as highlighted in (f).

Pensionable service at start of year	x	Final Pensionable salary at start of year	x	Pension income build up rate	+	Uplift of Price inflation	=	Pension income at start of year (d)
Example								
30	x	£70,000	x	1/80	+	3.1%	=	£27,064
You					+			(d)
	x		x	1/80		3.1%	=	
………………		……………...						…………………

Pensionable service at start of year	x	Final Pensionable salary at start of year	x	Pension build up rate for tax free cash entitlement	+	Uplift of Price inflation	=	Tax free lump sum at start of year (e)
Example								
30	x	£70,000	x	3/80	+	3.1%	=	£81,192
You								(e)
	x		x	3/80	+	3.1%	=	
………………		……………...						…………………

Pension income at start of year (d)	x	Multiply by 16	=	Real pension increase	+	Tax free lump sum at year end (e)	=	Total pension value at start of year (f)
Example								
£27,064	x	16	=	£433,024	+	£81,192	=	£514,216
You (d)						(e)		(f)
	x	16	=		+		=	
……………...				………………..				………………….

Annual pension savings:
The final element to determine the growth of the total benefits over the whole year is the difference between the pension benefits at the end of the year in relation to the start (c) - (f).

Total pension value at year end (c)	-	Total pension value at start of year (f)	=	Annual pension savings
Example				
£589,000	-	£514,216	=	£74,784
You (c)		(f)		
	-		=	
....		....		....

In this example, the value of the annual pension contribution is based on the increase in the annual pension at retirement above inflation, as measured by the CPI over the course of the year, taking the pay rise into account, multiplied by a factor of 16. You will also note that real growth in tax-free cash entitlement has also been considered. As the contribution is calculated to be £74,784, an Annual Allowance tax charge will apply as it is above £50,000.

The tax charge will be applied at the marginal rate which in our examples case is assumed to be 40%. The tax charge will be £9,914 (£74,785 - £50,000) x 40%. This payment would not fall due until 31 January 2013 although HMRC are still reviewing their options as to how this tax will be collected. There are methods to mitigate this tax charge that are included in the "*What if my pension savings exceed the Annual Allowance*" section. However, we always recommend that you seek financial/ tax advice if you think you will be likely to exceed the Allowance.

Lifetime Allowance

What is your Lifetime Allowance?
This is the overall value of pension benefits you can build up over your working lifetime without further tax charges applying.

How much is the Lifetime Allowance?
From April 2012 the Lifetime Allowance is to reduce from £1.8m to £1.5m.

Exceeding the Lifetime Allowance
Individuals who have successfully registered for Primary and Enhanced protection (for benefits built up prior to 6 April 2006) will continue to benefit from protection and are unaffected by this change in legislation (assuming they remain eligible for protection).

Those with a pension currently valued above £1.5m or who believe their pension pot will rise to above this level through investment growth but without any further contributions or pension savings, will be able to apply for a new fixed Lifetime Allowance of £1.8m.

This new fixed Lifetime Allowance of £1.8m will exist providing you cease accruing benefits in all registered pension plans before 6 April 2012. Further guidance will be issued on the notifications that will need to be made in writing to HMRC by 5 April 2012 to qualify for the new fixed Lifetime Allowance.

One option you might have when exceeding the Lifetime Allowance is to opt out of the Plan. There are significant risks and loss of benefits by opting out of any pension plans, so we would always recommend that you take financial/tax advice before making your decision.

Calculating pension benefits to test against the Lifetime Allowance?
If you are worried about exceeding the Lifetime Allowance, you should compare the value of your existing benefits against the Lifetime Allowance. If the total value of your pension benefits exceeds £1.5 million, you should immediately seek financial/ tax advice.

If the value is currently below the Lifetime Allowance but you believe that there is a possibility of you breaching the Lifetime Allowance (taking into account the current combined value of all of your pension benefits, the current level of contributions and future growth) in the future, we advise that you also consult a financial/tax adviser.

You will be given an annual statement of your pension benefits, however, should you wish to calculate your pension benefits from the Plan, this can be done as follows:

- You are a member of Section 1 of the Plan – the Defined Contribution arrangement. The fund value of your pension at the time you wish to take your pension benefits is the figure you use to compare against the Lifetime Allowance.
- You are a member of Section 2 of the Plan – 1/60 Defined Benefit arrangement. The value of your pension benefits are calculated by working out the pension income you would be entitled to at the point at which you will take your pension benefits, multiplied by a factor of 20.

- You are a member of Section 3 of the Plan – 1/80 Defined Benefit arrangement. The value of your pension benefits are calculated by working out the pension income you would be entitled to at the point at which you will take your pension benefits, multiplied by a factor of 20. This figure is then added to your tax free cash entitlement which accrues on a 3/80 basis.

Please note that should you take tax-free cash from Section 2 of the Plan or take additional tax-free cash up to the maximum permitted within the Plan from Section 3 that this will have an impact on the overall value of your pension benefits.

If the value of your pension is deemed to be in excess of the Lifetime Allowance you will be subject to a Lifetime Allowance charge of 25% plus income tax which means, on current tax rates, an effective tax charge of 55% for a higher rate tax payer or 62.5% for a 50% tax payer.

Examples of how to calculate the value of your pension benefits in relation to the Lifetime Allowance value for each Section within the Plan are included below.

Lifetime Allowance examples

Section 1 – worked example

In this example, we assume our employee has three pension funds. The first pension membership is within Section 1 of the Plan with a fund value of £200,000. They also have two private pension arrangements, one a stakeholder pension plan with a value of £50,000 and a self-invested personal pension with a value of £400,000.

The total value of these three pension funds is £650,000. As the value of these combined funds are in below the Lifetime Allowance there will be no tax charge.

Section 2 – worked example

In this example, our employee has 21 years' membership of Section 2 within the Plan. Their final pensionable salary will be £110,000. The pension in retirement will be calculated on a 1/60 accrual based on the final pensionable salary for each year of pensionable service.

The pension entitlement will be as follows:

No of years membership of the Plan	x	Final Pensionable salary	x	Pension build up rate	=	Pension income in retirement (a)
Example						
21	x	£110,000	x	1/60	=	£38,500
You						(a)
	x		x	1/60	=	
……………….		……………...				………………………………

Pension in retirement	x	Multiply by 20	=	Valuation of pension in relation to Lifetime Allowance
Example (a)				
£38,500	x	20	=	£770,000
You (a)				
	x	20	=	
………………				………………………………………

In this example, the value of pension benefits is below the Lifetime Allowance. You will also need to consider the value of all pension benefits including those of salary/bonus sacrifice, personal pension plans and deferred pension benefits when determining the value of your overall value of pension benefits.

In our example, our employee did not take any tax-free cash entitlement. We have not provided an example showing someone taking tax-free cash from Section 2 as it will generally result in the value of their pension benefits reducing. Should you be close to the Lifetime Allowance limit, taking tax-free cash is one method to reduce the value of your benefits, but you should take financial advice before making any definite decision.

Section 3 – worked example

Our example employee has 40 years' membership of Section 3 within the Plan (the maximum permitted). Their final pensionable salary will be £110,000. The pension in retirement will be calculated on a 1/80 accrual for pension income and 3/80 for tax free cash, based on the final pensionable salary for each year of pensionable service.

The pension entitlement will be as follows:

No of years membership of the Plan	x	Final Pensionable salary	x	Pension build up rate	=	Pension income in retirement (a)
Example						
40	x	£110,000	x	1/80	=	£55,000
You						(a)
	x		x	1/80	=	
………………		………………				……………………………

Pension in retirement	x	Multiply by 20	=	Valuation of pension income entitlement in relation to Lifetime Allowance (b)
Example (a)				
£55,000	x	20	=	£1,100,000
You (a)				(b)
....	x	20	=	....

No of years membership of the Plan	x	Final Pensionable salary	x	Pension build up rate for tax free cash entitlement	=	Tax free cash entitlement (c)
Example						
40	x	£110,000	x	3/80	=	£165,000
You						(c)
....	x	....	x	3/80	=	....

Valuation of pension income entitlement in relation to Lifetime Allowance (b)	+	Tax free cash entitlement (c)	=	Valuation of pension in relation to Lifetime Allowance
Example (b)		(c)		
£1,100,000	+	£165,000	=	£1,265,000
You (b)		(c)		
....	+	....	=	....

In this example, the values of pension benefits are below the Lifetime Allowance. You will also need to consider the value of all pension benefits including those of salary/ bonus sacrifice, personal pension plans and deferred pension benefits when determining the value of your overall value of pension benefits. We always recommend that you seek financial/tax advice if you think you will be likely to exceed the Lifetime Allowance.

Please note that the calculations provided in these examples are based on Mercer's interpretation of the changes in pension legislation announced by Her Majesty's Revenue & Customs (HMRC) in October 2010 and published in the 2011 Finance Bill which we envisage will receive royal assent in July 2011 with the changes being backdated to 6 April 2011. The information should be used for guidance purposes only and does not constitute financial advice.