

Guidance note:

Budget Announcement – Changes to pension tax relief

As you may have seen or heard in the press, in his Budget speech on 22 April 2009 and Pre-Budget report on 9 December 2009, the Chancellor announced some changes to the treatment of tax relief on pension contributions.

This message may be important to you if:

- **Your total *Relevant Income* is at least £130,000 in the current tax year (2009/10) or in either of the two previous tax years;**
- **Total *pension savings by you and on your behalf* this year exceed £20,000*; and**
- **You increase your *normal ongoing relevant pension savings*.**

Definitions for all of the terms in italics can be found in the appendix attached to this document. The appendix and the attached flowchart should be read in conjunction with this guidance note.

The changes to tax relief on pension contributions may affect you now or in the future so it is important that you read this note carefully to avoid inadvertently incurring a tax charge. This guidance doesn't just apply to those who earn a high salary; you need to look at ALL your taxable income, not just the salary you receive from O2.

The following is based on Mercer's current understanding of the Finance Act 2009 and the proposals, which could be changed following the consultation process.

From 6 April 2011 (subject to consultation)

The Government intends to restrict tax relief on pension contributions for individuals with an annual total Gross Income* of £150,000 or more for the tax year in question. Relief will be tapered away so that those with total Gross Income* over £180,000 will effectively only obtain relief at 20%, the basic rate of tax for the tax year 2009/10.

It is also apparent from the Pre-Budget Report that employees with pre-tax income of over £130,000 will need to add employer contributions paid on their behalf to their pre-tax income to assess whether this pushes them over the £150,000 limit. The purpose of this is to restrict higher rate relief on all pension scheme contributions (employer and employee).

This is summarised in the tables on the following page.

Pre-tax income

What is your pre-tax income? (e.g. total taxable income prior to deduction of your own pension contributions and charitable donations)	If less than £130,000	<ul style="list-style-type: none"> ▪ No requirement to add the value of any employer pension contributions. ▪ Tax relief would be applied at your highest marginal rate.
	If over £130,000	<ul style="list-style-type: none"> ▪ Employer pension contributions need to be added to your total income. If this then exceeds £150,000 see "Gross Income" below

Gross Income

What is your Gross Income? (e.g. total taxable income prior to deduction of your own pension contributions, charitable donations and including any employer pension contributions)	If less than £150,000	<ul style="list-style-type: none"> ▪ Tax relief would be applied at your highest marginal rate.
	If between £150,000 and £180,000	<ul style="list-style-type: none"> ▪ Tax relief will be tapered away so those earning £180k or more will only receive tax relief at the basic rate of 20%.
	If over £180,000	<ul style="list-style-type: none"> ▪ Tax relief only at the basic rate of 20%.

The mechanism for applying the tax relief restrictions from 6 April 2011 onwards is unclear at present. In any event, the Government has announced that it will consult on these changes with the pensions industry and so the proposals may change. We will continue to keep you informed on this issue but, under current proposals, tax efficient pension savings for those with Gross Income* exceeding £150,000 will become much more restricted.

* 'Gross income' includes any taxable income **plus** both the value of the individual's own pension contributions and any pension benefit funded by the employer on their behalf. It is also calculated before any deductions for charitable donations.

Transitional Arrangements (in force)

The Government has also introduced new transitional arrangements to apply from 22 April 2009 onwards. These arrangements are designed to reduce the opportunity for individuals to increase their pension contributions in excess of their normal pattern in anticipation of the 2011/12 tax year change.

Originally, the Budget changes from 22 April 2009 stated that the transitional arrangements would apply to individuals with Relevant Income in excess of £150,000. In the Pre-Budget Report, the Chancellor announced that this would change from 9 December 2009 to affect individuals with Relevant Income in excess of £130,000.

For affected individuals, a "Special Annual Allowance" (SAA) of £20,000** has been introduced which sets an upper limit on the amount of pension savings on which full tax relief can be given.

The regular (quarterly or more often) amount of pension provision made for an individual **before 22 April 2009 (or before 9 December 2009** for individuals earning between £130,000 and £150,000), including any subsequent contractual increases i.e. pay rises, will be a Protected Pension Input Amount (PIIA).

The transitional arrangements will restrict higher rate tax relief for individuals:

- whose total *Relevant Income* is at least £150,000 in the current tax year (2009/10) or in either of the two previous tax years; and
- whose total *pension savings* in that year exceed £20,000*; and
- who have increased their normal ongoing relevant pension savings to more than £20,000 or above their PPIA (if this is greater than £20,000*) since 22 April 2009.

OR; from 9 December 2009

- whose total Relevant Income is at least £130,000 in the current tax year (2009/10) or in either of the two previous tax years; and
- whose total pension savings in that year exceed £20,000*; and
- who have increased their normal ongoing relevant pension savings to more than £20,000 or above their PPIA (if this is greater than £20,000*) since 9 December 2009

If the above apply, a *Special Annual Allowance* tax charge (20% for the 2009/10 tax year) is payable on the excess contributions. Any tax payable is levied on the employee, not on O2, and will be collected via the individual's self-assessment tax return.

It should also be noted that the existing Annual Allowance (£245,000 for the 2009/10 tax year) and Lifetime Allowance (£1,750,000 for the 2009/10 tax year) continue to apply and additional charges may be applied if these are exceeded. There is existing guidance on the Annual Allowance and the Lifetime Allowance on www.o2pensions.com which remains relevant.

** In certain circumstances, where contributions have been made to a money purchase arrangements less frequently than quarterly over the three tax years 2006/7, 2007/8 and 2008/9, the special annual allowance that applies to the individual may increase up to a maximum of £30,000.

Such contributions include annual bonus sacrifices for both Section 1 and Section 2/3 members. This is a potentially complex area so you may wish to seek independent financial advice if you think this might apply to you.

Summary

The Appendix to this note provides further details of the transitional arrangements, including an explanation of the terminology used and an example of how the *Special Annual Allowance* (SAA) Charge might be calculated. In addition, a Flowchart is attached to help you identify if you might be affected.

Ultimately, if your total *Relevant Income* is likely to exceed £130,000 in this tax year, or has exceeded this figure in at least one of the previous two tax years, you may trigger a tax charge if you increase your *pension savings* between 22 April 2009 and 5 April 2011. Thereafter, subject to the Government's consultation, higher rate tax relief on pension contributions is likely to be restricted.

Therefore, you should seek independent financial advice before increasing your pension contributions, paying an AVC or making a bonus sacrifice to establish the tax implications of these actions. Please note that O2 cannot provide individuals with personal financial advice, but the internal pensions 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/budget2009/tax-relief-pen-cont.htm>

If you would like to discuss this note in more detail you should contact the internal pensions team:

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Appendix

Further details of the Transitional Arrangements

This appendix provides further explanation of the terminology used in relation to the transitional arrangements announced in the Budget together with details of how this might relate to your O2 arrangements.

Relevant Income is calculated as:

- total income within the charge to income tax for the tax year in question before pension contribution deduction. As well as any income you receive from O2, such as your basic salary and bonus, this also includes income from any external sources e.g. rental income from property, dividend income from shares etc

LESS

- any normal deductions for reliefs (such as trading losses) and up to £20,000 in pension contributions paid by yourself (including Additional Voluntary Contributions (AVCs))
- any gift aid deductions

If your Relevant Income is greater than £150,000 and you entered into the salary sacrifice arrangement under the O2 Pension Plan on or after 22 April 2009, you will also need to add in any amount of your O2 employment income foregone in return for employer pension contributions under the salary sacrifice arrangement.

If your Relevant Income is greater than £130,000 and you entered into the salary sacrifice arrangement under the O2 Pension Plan **on or after 9 December 2009**, you will also need to add in any amount of your O2 employment income foregone in return for employer pension contributions under the salary sacrifice arrangement.

Pension Savings

If you are a member of Section 1 of the O2 Pension Plan, *pension savings* are the total of your contributions and O2's contributions into your pension in the relevant tax year. If you are a member of Section 2 or 3 of the O2 Pension Plan, *pension savings* are defined as the increase in the pension you have built up over the relevant tax year multiplied by 10. In all cases, any contributions you are making to any other UK pension arrangement will also be taken into account.

Normal ongoing relevant pension savings

If you make no changes to your pension provision, then your *normal ongoing relevant pension savings* will be deemed to continue. This includes the situation where your pension provision increases as a result of an increase in your salary. Likely situations where your *normal ongoing relevant pension savings* will be considered to have increased are where:

- You are a member of Section 1 of the O2 Pension Plan and opt to increase your contribution rate from 22 April 2009 onwards (or from 9 December 2009 if your Relevant Income is between £130,000 and £150,000).
- You start paying or increase your AVCs from 22 April 2009 onwards, unless it is being paid under an agreement made before 22 April 2009. In order to qualify as a regular *pension saving*, the agreement must state that AVCs are paid at least quarterly. AVCs must continue to be paid at the same rate as before, unless a written notice to change the agreement was received by the Scheme administrator prior to noon on 22 April 2009. This applies from 9 December 2009 if your Relevant Income is between £130,000 and £150,000.
- You make a bonus sacrifice, even if you made a bonus sacrifice last year. In order to qualify as regular *pension savings*, payments must be made at least quarterly and bonus sacrifices do not meet this requirement. * See note below regarding irregular contributions.

It should also be noted that, for some individuals, starting salary sacrifice may be disadvantageous. This is because the amount sacrificed is added back on to your total income to arrive at your *Relevant Income*. This could have the effect of tipping your Relevant Income over the £150,000 (£130,000 post 9 December 2009) threshold.

However, if your contributions were to be deducted from salary in the normal way, their value up to £20,000 would be deducted from your total income to arrive at your *Relevant Income* and potentially bringing your *Relevant Income* below the £150,000 (£130,000 post 9 December 2009) threshold.

Special Annual Allowance Charge

If any pension contributions you or O2 make are classed as "new" according to the above definition i.e. your total *Relevant Income* exceeds £150,000 (£130,000 post 9 December 2009) in the current (2009/10) or one of the last two tax years, your *pension savings* for the current tax year exceed £20,000* and you have increased your *normal ongoing relevant pension savings*, the new contributions will be subject to the SAA Charge.

The regular contributions you were paying before you initially increased them will be protected from the SAA Charge and can be deducted from your total *pension savings* before it is calculated.

Also, each individual has a *pension savings* SAA of £20,000* which is not subject to the tax charge described above. Your protected regular *pension savings* will use up some or all of this allowance, but any remaining allowance can also be deducted from your increased pension contribution savings before the tax charge is calculated. The remaining *pension savings* after these deductions have been made will be taxed at 20% where made in the current tax year (2009/10). An example of this calculation is in the section below.

The tax charge is levied on the increase in both your pension contributions and any O2 make. So, for example, if you increase contributions to Section 1 of the O2 Pension Plan, then both your and O2's contributions will increase and the tax charge will apply to both of the increases.

As the new rules had immediate effect, the Government has recognised that some people may have inadvertently triggered a SAA Charge before they were aware of the new rules. As such, in certain circumstances and if the Trustees of the pension scheme agree, an individual can seek a refund of their own contributions, subject to certain HM Revenue & Customs (HMRC) conditions being met. Any refund will be paid as a lump sum to you and can only be paid after the end of the tax year in which the contributions were made. This type of refund will be paid after deducting 40% tax.

If you believe you have already triggered the tax charge and would like to investigate the possibility of a refund, please contact Jo Christie (joanna.christie@o2.com).

- * Where money purchase contributions have been made less frequently than quarterly, and the 'relevant mean' (which is defined broadly as the average amount of the payments made less frequently than quarterly over the three tax years 2006/7, 2007/8 and 2008/9) exceeds £20,000, then the special annual allowance that applies to the individual will be the lesser of £30,000 and the relevant mean. For the purpose of calculating the relevant mean, the contributions can be paid by, or on behalf of, the individual and include employer contributions. Such contributions include annual bonus sacrifices for both Section 1 and Section 2/3 members.

Example of Calculation of Special Annual Allowance Charge

Example 1

Suppose your O2 pensionable salary is £130,000 per annum (but you have other earnings which result in your *Relevant Income* exceeding £150,000 for the tax year 2009/10) and you are a member of Section 1 of the O2 Pension Plan where you accrue money purchase benefits. In this example you pay 4% of your pensionable salary and O2 pays 4%.

Therefore, if no changes are made, your current annual *pension savings* will be calculated as 8% of £130,000 = £10,400 for the tax year 2009/10.

However, on 6 July 2009 (i.e. 3 months into the tax year) you decide to increase contributions to 7% of your pensionable salary with O2 increasing its contribution on your behalf to 7%. Also, you decide to pay your bonus of £10,000 into AVCs. Your new *pension savings* will be calculated as (8% of £130,000 x $\frac{3}{12}$) plus (14% of £130,000 x $\frac{9}{12}$) plus £10,000 = £26,250. Since these contributions when paid will exceed £20,000, plus your *Relevant Income* exceeds £150,000 and you have increased your *normal ongoing relevant pension savings*, the SAA charge will apply.

The regular contributions paid prior to the increase i.e. £10,400, will be protected from the tax charge. Your Special Annual Allowance is £20,000, meaning you can have total *pension savings* up to £20,000 without incurring the SAA charge. Part of this allowance will be used up by your protected regular *pension savings* of £10,400, leaving £9,600 of your SAA remaining.

The contributions subject to the tax charge are equal to the total contributions paid less your protected regular *pension savings* paid less the remainder of your SAA i.e. £26,250 - £10,400 - £9,600 = £6,250. The SAA Charge is 20% of £6,250 = £1,250 and you would need to pay this tax charge via your self-assessment tax return.

Example 2

You are a member of Section 1 of the O2 Pension Plan where you accrue money purchase benefits. In the 2008/2009 tax year, your pensionable salary was £155,000. In 2008/2009, you paid pension contributions of 13% of pensionable salary, and O2 paid 10% of capped salary. Therefore, if no changes are made, your current annual *pension savings* would be calculated as 23% of £155,000 = £35,650 for the tax year 2008/09.

With effect from 1 April 2009, you receive a pay rise so that pension contributions are now based on your new pensionable salary of £195,000.

As contributions are based on a percentage of pensionable salary, contributions could continue at the same percentage of salary as before. Therefore, although total contributions have increased from £35,650 to £44,850, this still falls within your *normal ongoing relevant pension savings* amount and would not be subject to the SAA charge.

Any increase to the percentage paid or any one-off contributions would, however, be subject to the SAA charge.

Example 3

You are a member of Section 1 of the O2 Pension Plan where you accrue money purchase benefits. In the 2008/2009 tax year, your pensionable salary was £195,000. In 2008/2009, you paid pension contributions of 6% of salary, and O2 paid 6% of salary (£23,400). In addition, you paid a single contribution via bonus waiver of £40,000. You had not paid any single contributions in previous tax years.

In 2009/10 tax year, you can pay contributions based on the greater of the SAA that applies to you or *normal ongoing relevant pension savings*. As you have only paid one single contribution of £40,000, the "relevant mean" (e.g. the average amount of payments made less frequently than quarterly over the three tax years 2006/7, 2007/8 and 2008/9) is £13,333 so you do not qualify for the increased SAA of £30,000 that applies to irregular contributions.

However, as your *normal ongoing relevant pension savings* exceeds the SAA of £20,000, these can be maintained and, as long as the overall percentage does not change, can increase in line with any salary increases.

Example 4

You are a member of Section 1 of the O2 Pension Plan where you accrue money purchase benefits. In the 2008/2009 tax year, your pensionable salary was £195,000. In 2008/2009, you paid pension contributions of 7% of salary, and O2 paid 7% of salary (£27,300). In addition, you paid a single contribution via bonus waiver of £40,000 in June 2008, having also paid £30,000 in June 2007 and £25,000 in June 2006.

In 2009/10 tax year, you can pay contributions based on the greater of the SAA that applies to you or *normal ongoing relevant pension savings*. As you have paid single contributions over the last 3 tax years, the "relevant mean" (e.g. the average amount of payments made less frequently than quarterly over the three tax years 2006/7, 2007/8 and 2008/9) is £31,667 so you qualify for the increased SAA of £30,000 that applies to irregular contributions.

As your *normal ongoing relevant pension savings* (£27,300) is less than the SAA of £30,000, you could pay total contributions of £30,000. However, if your salary increases to such an extent that the regular monthly contributions (totalling 14% of salary) are greater than £30,000, then these can be maintained.

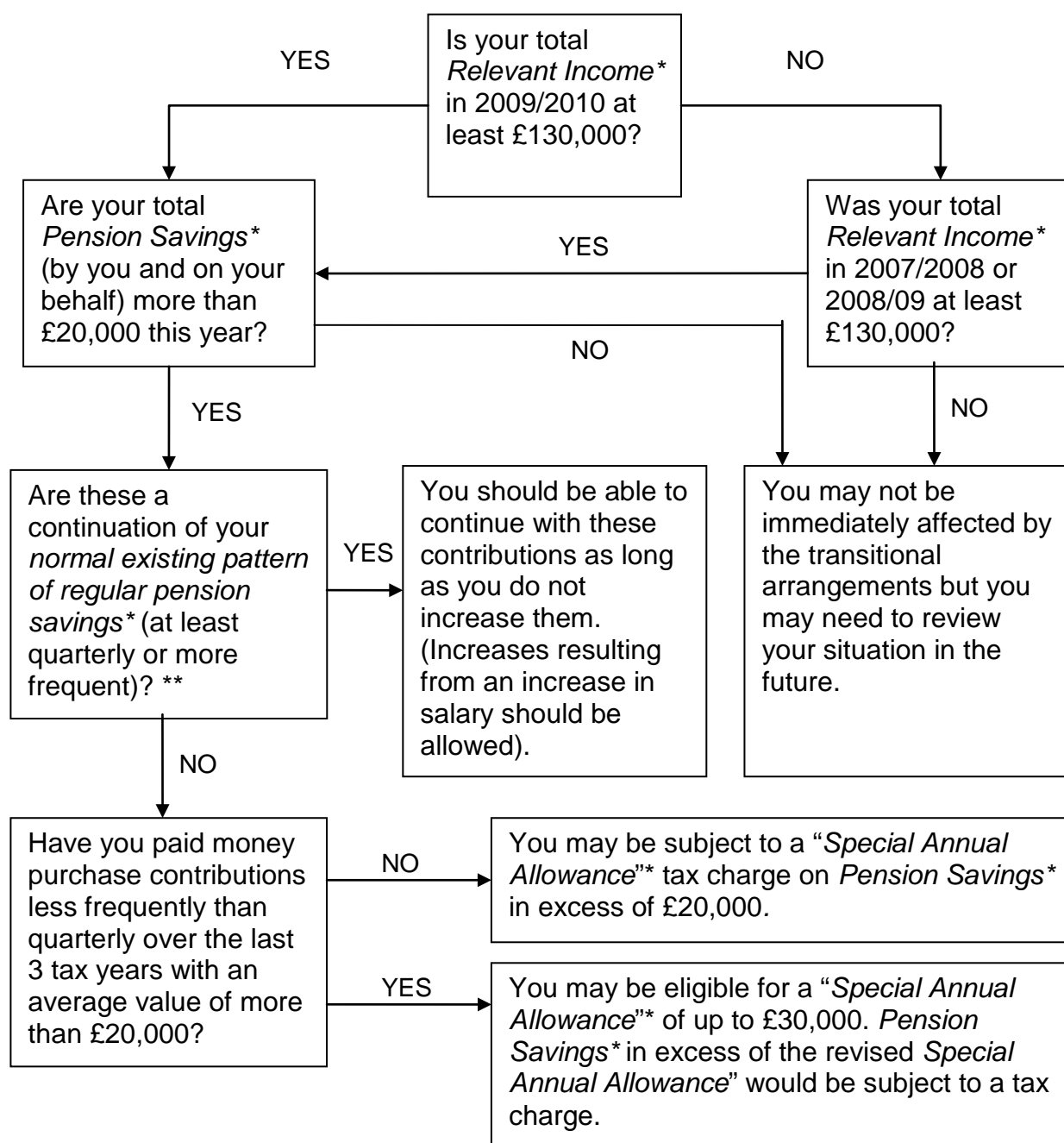
Example 5

You are a member of Section 2 (final salary section) of the O2 Pension Plan. As at 6 April 2009, your pensionable salary was £180,000 and you had completed 22 years service. On this basis, your accrued pension at 6 April 2009 was £66,000 per annum ($22/60 \times £180,000$). By 5 April 2010, your pensionable salary increases to £189,000 and you pensionable service is 23 years. Therefore your accrued pension will be £72,450 per annum ($23/60 \times £189,000$).

As a member of Section 2, *pension savings* are defined as the increase in the pension you have built up over the relevant tax year multiplied by 10. In this case, the increase is £6,450 (£72,450 - £66,000) so your *pension savings* are £64,500 (10 x £6,450). Although this is well in excess of the SAA, as long as you make no changes to your pension provision, then this will be deemed to be a continuation of your *normal ongoing relevant pension savings*.

The above is based on Mercer's current understanding of the changes introduced under the Finance Act 2009.

Budget Announcement – Flowchart

**Important notes:**

- i. The Flowchart should be read in conjunction with the Guidance Note.
 - ii. In certain circumstances, where contributions have been made less frequently than quarterly over the three tax years 2006/7, 2007/8 and 2008/9, the special annual allowance that applies to the individual may increase up to a maximum of £30,000.
 - iii. The Flowchart is for guidance only. If you are in any doubt as to whether you are affected by the announcement in the Budget, you should seek Independent Financial Advice
- * Asterisked terms are defined and explained in the Appendix earlier in this document.
 ** If you have made annual bonus sacrifices, you must answer 'NO' to this question.