

# The Impact of Tax Changes to U.K. Pension and Stock Plans

By Alan M. Judes

STRATEGIC REMUNERATION

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**A**pril 6, 2006, saw the arrival of “A” Day for pensions in the United Kingdom—a new system of taxation, with a very simple and generous tax-relief system replacing a myriad of former tax systems.

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## Implications for the Majority

Broadly speaking, savings for retirement will be tax favored, provided that annual savings amounts are limited, and the total capital accumulated in pension plans for any individual—the lifetime allowance—is also limited. The annual limits for tax relief on contributions are 100 percent of annual earnings up to an annual allowance set at 215,000 pounds in 2006-2007 and increasing each tax year through 2010-2011. Even nontaxpayers can get tax relief; a contribution of 2,808 pounds in any one tax year will be matched by a U.K. government contribution of 792 pounds, giving total pensions savings with tax relief of

3,600 pounds a year. U.K. tax relief for pension plans is very generous, as shown in the sidebar, “U.K. Tax Relief for Pension Plans,” on page 18.

The lifetime allowance is 1.5 million pounds as of April 6, 2006, rising to 1.8 million pounds by 2010-2011 and will be reviewed thereafter. Pension assets for any individual in excess of the lifetime allowance are permitted, but excess assets will be subject to a penalty tax within the pension plan, amounting to a combined 55 percent for the employee. This is 15 percent more than the current U.K. maximum income-tax rate of 40 percent. For defined contribution pension plans, the assets are measured at market value; for defined benefit pension plans, the pension payable at retirement is multiplied by 20 to calculate the asset equivalent. Thus, a 1.5 million pound lifetime allowance permits a defined benefit pension of 75,000 pounds a year, to be paid without any penal tax charges arising.

Most actions of companies and consultants in dealing with the new legislation have focused on the top earners for whom the lifetime allowance creates a real problem. This is understandable, as the issues were urgent, and tax filings to protect existing funds



## U.K. Tax Relief for Pension Plans

- Contributions paid by an employer are tax deductible, with no income tax arising to the employee.
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- Income arising inside the pension plan is exempt from U.K. income tax, and gains realized in the pension fund are exempt from U.K. capital gains tax.
- One-quarter of the fund can be drawn by the employee after retirement as a tax-free lump sum. The remaining fund must be used to provide for a retirement income, which will be liable to income tax in the hands of the retired employee.

## Key Features of a Share Incentive Plan

- Companies can give shares as a stock bonus (maximum of 3,000 pounds a year per employee).
- Employees can use pretax, pre-FICA equivalent income to buy shares (maximum of 1,500 pounds a year per employee).
- A company can match employees' share purchases at any fraction up to a maximum of two matched shares for every purchased share (maximum of 3,000 pounds a year per employee). Thus, if all three components of the share incentive plan are used, some 7,500 pounds a year can be set aside in the plan.
- Employees can take dividends paid on their shares in stock instead of cash, and hold the stock dividends tax free in the plan (maximum of 1,500 pounds a year per employee).
- If shares are held for a qualifying period—generally five years—then they can leave the plan completely tax free. There is no U.K. income tax and no U.K. capital gains tax irrespective of their value at date of leaving.

in excess of the lifetime allowance were necessary. However, this has also meant that real opportunities to communicate the very significant benefits of pension simplification to all employees have not been taken; now is the time. U.K. government statistics show that median gross hourly earnings for some 25 million U.K. employees were just 8.84 pounds an hour, so the vast majority of employees will never, in practice, be affected by the Lifetime Allowance.

### Stock Plan Opportunities

There is even better news for companies that have qualifying stock plans. There are two that are designed for participation by all eligible employees. The amounts that can be invested are modest in the context of executive compensation but can allow average employees to build up significant asset holdings. The first qualifying stock plan is a share incentive plan, which is

broadly analogous to a U.S. 401(a) stock bonus plan and a U.S. 401(k) plan. The second is a Save as You Earn (SAYE) stock option plan that is very similar to a U.S. Section 423 stock purchase plan. "Features of a Share Incentive Plan," as shown above, and "Key Features of an SAYE Stock Option Plan," on page 19, contain brief details of each plan.

Finance Act 2004 introduced new tax relief for contributions of shares emerging from these two stock plans if they were transferred into qualifying pension plans. The simplification of U.K. pensions on "A" day in 2006 now means that the 2004 relief can be utilized to the fullest.

Simply put, a transfer of shares of company stock from one of the two stock plans to a pension plan is treated as though it was the payment of a contribution by the individual employee. The amount of the contribution for tax-relief purposes is the market value of

the shares on the date of transfer.

Income tax relief, is given in two stages.

In the first stage the market value of the shares transferred is deemed to be a contribution net of basic rate income tax (currently at 22 percent but reducing to 20 percent in 2008-2009). The Pension Plan administrator gets a cash payment from the U.K. revenue authorities of this 22 percent of the gross sum: 22/78ths is in excess of 28 percent of the net value of shares transferred in. (Next year, at the new basic rate of tax of 20 percent, the pension plan administrator will receive a cash payment of 20/80ths, being 25 percent of the net value of shares transferred in.) The second stage of tax relief is given to the employee upon making a claim by filing a tax return at the end of the income-tax year. A 40-percent taxpayer will receive an additional 18 percent of the gross value of the shares, or 23 percent being

## Key Features of an SAYE Stock Option Plan

- It has two distinct features: a savings contract and an option plan.
- Under the savings contract, the employee can save from post-tax pay a maximum amount of 250 pounds a month and earn a guaranteed tax-free rate of interest (at time of writing, about 4.2 percent).
- Because the company knows in advance exactly how much the savings contract will produce, it can grant an option over precisely the number of shares that the savings contract can purchase. The share price can be set at a discount of up to 20 percent of the market value of the shares at the date of invitation to participate.

### An example follows:


- The employee chooses to save 40 pounds per month under a three-year contract ( $36 \times 40$  pounds = 1,440 pounds).
- At maturity, the tax-free bonus (interest) would be added ( $2.4 \times 40$ ) = 96 pounds.
- **Total in the savings account = 1,536 pounds.**
- If the option price is 80 pence (1 pound less a 20-percent discount) = 80 pence. Number of shares (1,536 pounds / 80 pence) = 1,920.
- If the share price rose to 1.25 pounds after three years ( $1,920 \times 1.25$  pounds) = 2,400 pounds.
- In this example, this represents an increase of 960 pounds on the original savings of 1,440 pounds—a 66.67-percent gain.

18/78ths of the net value transferred into the pension plan from the stock plan. Next year, when the basic rate tax is 20 percent, the figures will be an additional 20 percent of the gross value of the shares, or 25 percent being 20/80ths of the net value transferred.

In summary, everyone gets tax relief at a basic income-tax rate of 22 percent of the gross value. The pension plan administrator reclaims 22/78ths from the U.K. revenue authorities, and higher-rate taxpayers get relief at up to 40 percent of the gross value of the shares by assessment. Next year, the basic rate of tax reduces to 20 percent.

### Conclusion

This additional tax relief can make a significant increase to the value of

the retirement fund that employees are building up during their careers. It also gives the company the opportunity to enhance and communicate the value of the stock plans that are available to employees. From a U.S. perspective, the arrangements can be designed to be very similar to the 401(k) plan with a stock match or a section 423 stock purchase plan, thus allowing replication of design philosophy in both jurisdictions. This can be very useful for U.S. parent companies with U.K. subsidiaries. 

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