Northumberland County Council

The Local Government Pension Scheme – Smart AVC's

What Are Smart Benefits?

The County Council operates a SMART Benefits scheme which allows an employee to give up part of their salary or pay. That employee will then be entitled to a lower gross salary and in addition to the new salary s/he will receive a benefit from the employer (e.g. the person agrees to take £4,000 a year less in salary and the Council provides them with a car (subject to conditions regarding the type and value of the car – see the Flexible cars scheme on the Intranet)). This is sometimes referred to as Salary Sacrifice. The benefits of doing this are that both the employer and employee will pay less in National Insurance (e.g. the National Insurance will be based upon the new lower gross salary or pay) and there can be tax advantages.

What Are Smart AVC's?

A good place to start is; what are AVC's?

AVC's are **additional voluntary contributions** that a person makes in order to increase their pension benefits at retirement.

AVCs in the LGPS

AVC's are part of the Local Government Pension Scheme – LGPS and the Council has a contract with the Prudential to provide this service to the Northumberland Pension Fund. AVC's are a tax efficient way to save for retirement because they attract tax relief. The person paying the AVC's has a choice of funds in which they can invest. These funds range in risk from higher risk funds, where the money is invested in stock and shares, to low risk funds where the money is held as a cash deposit. The person can use the invested fund to buy additional pension or, subject to certain limits imposed by the tax authorities, take their AVC's fund as an additional tax free lump sum at retirement. Taking the fund as a tax free lump sum is now the most popular option.

How does this work? Bill has paid £10,000 in AVC's over a number of years (AVC's must be paid as a payroll deduction). He is paying tax at 20%. AVC's attract tax relief so Bill has received £2,000 in tax relief meaning that the £10,000 investment has only cost him £8,000 in net or take home pay terms, but £10,000 has gone into his AVC fund. At retirement £10,000 is within Bill's lump sum limit allowed by HMRC so Bill opts to take the £10,000 as an additional tax free lump sum, effectively saving himself £2,000 in income tax deductions.

What’s the catch, you’re thinking; this seems too good to be true? The catch, if you want to call it that, is that once you’ve put money into an AVC scheme it must stay there until retirement i.e. it’s locked up and you can’t get access to your money until you retire and your LGPS pension becomes payable.

Smart AVC’s

If you like the sound of the tax savings with normal LGPS AVC’s you’ll like the idea of Smart AVC’s even more because they allow you to save on your National Insurance as well as your income tax!

Under the terms of the LGPS an employer can establish “Shared Cost” AVC arrangements. Normally the employer does not contribute to the AVC scheme but under the Smart AVC’s they would contribute to your AVC fund in return for you agreeing to take a reduction in your pay, equivalent to the contribution the Council would make to your AVC fund.

Here is an example:-

Jane wants to pay £5000 a year into the LGPS AVC scheme. She earns £40,000 a year. She could simply agree to pay the £5000 by regular monthly deductions from her pay and she would get tax relief on the AVC payments, but her National Insurance would be based on gross earnings of £40,000. If, however she agrees to her salary being reduced to £35,000 a year and the Council pays £5000 into the AVC fund on her behalf, her income tax and NIC calculation would now be based upon earnings of £35,000.She would still enjoy a tax saving equivalent to the tax relief available from normal AVC’s, but her National Insurance deductions would be based upon her new lower earnings of £35,000 so she would also pay less in NI.

That is, via Smart AVC’s she would pay less tax and National Insurance.

Smart AVC’s need to be established on a “shared cost” basis, this means that both the employer and employee have to pay into the arrangement. Looking at the earlier example of Jane reducing pay from £40,000 to £35,000 and the Council paying £5000 into the AVC scheme, to comply with the “shared cost” requirement the employee would also need to pay at least £1 a month into the AVC fund via a payroll deduction. This would be additional to the £5000 AVC payment made via SMART AVCs.

This means Jane’s new, reduced salary is £35,000 i.e. £40,000 - £5,000 reduction in pay . She has to pay £12 p.a. “shared AVC” (£1 x 12 months) as well so effectively her “pay” becomes £34,988.

Example

A person earning £40,000.

Monthly pay =	£3,333

Less Tax	=	£538
Less NI	=	£281
Less LGPS Contribution	=	£226
Less AVC	=	£417
Pay to bank account	=	£1871

Same person after they agree to reduce their annual pay to £35,000

Monthly pay	=	£2,916
Less Tax	=	£538
Less NI	=	£238
Less LGPS Contribution	=	£226
Less shared AVC		£1.00
Pay to bank account	=	£1913

As you will see their take home pay has gone from £1,871, to £1,913, That is they are taking home £42 more each month. They have still had £417 (£5,000 ÷ 12 + £1) paid into their AVC fund for that month and their LGPS contribution is still based upon the reference pay of £3,333 (£40,000 a year)

Interest and Income earned on the AVC Investment

Any interest, income, or capital gain earned on the invested AVC also accrues tax free.

Tax Advantages of Smart AVC's

1) If you are a tax payer you will save on your tax deductions from your salary or wages. If you pay National Insurance you will pay less in NI.
2) Any interest, income or capital gain earned on the investment will accrue free of tax.
3) *Subject to limits imposed by the tax authorities*, you will be able to access your invested AVC fund as a tax free lump sum payment at retirement. If you invest more in the arrangement than the lump sum limit allowed by the tax authorities any excess invested funds would have to be used to buy you an additional pension at retirement. That additional pension would however be taxable.

The Annual Allowance

On the 6th April 2011 the annual allowance reduced from £255,000 to £50,000. The annual allowance is the amount by which the value of a person's accrued pension rights can grow in one year free of tax. In a final salary scheme, like the LGPS, we do not allocate an individual with a pension fund and the tax authorities have determined that the growth in your pension rights will be taken as 16 times the amount by which your accrued pension has increased in a year (i.e. as compared with the previous year) **plus** any increase in your retirement lump sum **plus** any AVC's paid.

<u>Example</u>

John has 25 years in the LGPS. At the year ended 31st March 2011 his accrued pension was £14,000 and his lump sum £40,000. During the year ended 31st March 2012 he gets a large pay increase. The impact upon his accrued pension is that it is now worth £19,000 and his lump sum is worth £54,000.

In this case the value of his accrued pension has increased by

£19,000 - £14,000 = £5,000 x 16 = £80,000
Plus: the increase to his lump sum £54,000 - £40,000 = <u>£14,000</u>
Increase in the value of his pension = £<u>94,000</u>

As the increase exceeds the annual allowance of £50,000 by £44,000 John could effectively be looking at tax charge on £44,000.

(Please note that this example is simplified and should not be relied upon as an accurate method of calculating the increase in the value of your pension fund. In practice inflation is taken into account when comparing the value of accrued pensions in one year compared with the next. In addition, John would also have been able to carry forward any unused annual allowances, from the previous 3 years to offset against some or all of the excess amount over his annual allowance, which would reduce his tax charge.)

What this example however illustrates is that if John had been paying AVC's these would have been **<u>added</u>** to the £94,000 increase in the value of his pension and therefore the AVC's would potentially have increased his tax bill. The £50,000 annual allowance should be sufficient for the majority of scheme members to stay within their annual allowance limit. However it will be the responsibility of scheme members paying AVC's or Smart AVC's to monitor their position, particularly when they get a salary increase in excess of CPI inflation.

<u>What are the Tax authority limits on taking AVC's as a tax free lump sum?</u>

This can be complex. In simple terms, HMRC will allow you to take up to 25% of your LGPS pension fund as a tax free lump sum.

As we said previously the LGPS does not allocate each scheme member with their own fund. In these circumstances, for the purposes of working out your maximum lump sum, your fund will be calculated as:

Your annual pension x 20 + your LGPS lump sum.

Example

Mary retires at age 60 with a pension of £10,000 a year and a lump sum of £26,000. She has also paid £20,000 in Smart AVC's

Her pension fund is:

Pension £10,000 x 20 = £200,000 + £26,000 lump sum = £226,000.

She can take 25% of the fund as tax free cash:-

Pension fund £226,000 x 25% = £56,500 is available to her as a tax free lump sum under current tax rules (but please note that these are subject to change).

Mary will get a lump sum automatically from the LGPS of £26,000. This leaves her £56,500 **-** £26,000 = <u>£30,500</u> which she can further access as a lump sum payment if she wishes. As her AVC fund is less than £30,500 she can take the whole £20,000 AVC fund as an additional tax free lump sum at retirement.

Does sacrificing pay reduce the amount used to calculate my pension?

No! The employer contribution to the Smart AVC scheme is classed as a contractual benefit in kind under the rules of the LGPS which means that the full pay would still count for pension purposes.

In an earlier example Jane was entitled to an annual salary of £40,000 but chose to make a salary sacrifice of £5,000 so that she was entitled to a lower salary of £35,000 plus an employer pension contribution of £5,000 paid by the Council into the Smart AVC scheme. Jane would however still have her normal pension contributions based on £40.000. This is because the Council have introduced the concept of reference pay, which is the original amount of gross salary before salary sacrifice was entered into. Jane's reference pay is therefore £40,000, even though her new contractual entitlement is £35,000. Her LGPS pension benefits would therefore still be based upon earnings of £40,000.

Does sacrificing pay reduce the amount used to calculate any redundancy payment?

No! Any redundancy payment would be based on the original gross salary before salary sacrifice for SMART AVCs was entered into.

In the example Jane had an entitlement to an annual salary of £40,000 but chooses to become entitled to a lower amount of £35,000 and have a £5,000 employer contribution made by the Council into the Smart AVC scheme. In this case Jane's redundancy payment would be based upon the weekly equivalent of the a reference salary of £40,000.

Are there any limits on taking part in SMART AVCs?

Yes, you cannot sacrifice pay under the Smart benefit scheme if that would reduce your new gross pay entitlement to less than the minimum wage.

Also the advantages of Smart AVC's are the savings available on tax and National Insurance. Therefore, if you are not paying tax or National insurance you would not benefit in this way from Smart AVC's. Equally if you are a low earner and only pay a small amount in tax and National insurance it may not be in your interests to agree to a Smart AVC deduction which would take your earnings below the tax and National Insurance earnings thresholds. For this reason the Council have decided to operate a Minimum Pay Threshold (MPT) of £11,500 p.a. to ensure that your state related benefits are not affected.

Does paying less in National Insurance have an impact upon any State Benefits?

Please see the above question. It can do. You should satisfy yourself that paying less in national insurance will not have a detrimental effect upon your State Benefits. There is more information on this topic on the Council's Intranet site – See Smart Benefits.

Will SMART AVCs impact on my State pension entitlement?

It can do and you should satisfy yourself that you will be better off by taking part in SMART AVCs. Please see the Intranet for more details.

What happens if I die before I retire?

The invested AVC lump sum fund would be paid to your estate.

What is the minimum period I can be in the Smart AVC scheme?

Smart Benefits is a change to your contractual terms and conditions of employment. It is therefore not possible to revert to your original terms and conditions at will. The Council will allow you to review your participation in SMART AVCs on an annual basis at which point you can decide not to take part in SMART AVCs anymore.

Combining Tax and National Insurance into one deduction.

The Government are looking at the possibility combining the tax and NI into one single deduction . Any such change may be years away, if it happens at all. However if it does happen at some point in the future it could have implications for salary sacrifice benefits including smart AVC. At this stage it is impossible to say what the implications of such a change would be. We will however monitor the situation and keep scheme members informed of any developments in this area.

How can I find out more?

Call the Prudential on 0845 607 0077, or

Contact them online at www.pru.co.uk/localgov or

Northumberland County Council Pension Team can be contracted at

pensions@northumberland.gov.uk

phone 01670 623569

The Pension Manager, Finance Directorate, County Hall, Morpeth, Northumberland NE61 2EF