Changes to the Tax Controls on Pension Savings

The Local Government Pension Scheme (LGPS) is fully approved by HM Revenue and Customs (HMRC), which means that you receive tax relief on your contributions as they are deducted from your pay. However, there are two HMRC controls on the amount of pension savings you can have before you become subject to a tax charge. This is over and above any tax due under the PAYE system on your pension once it is in payment.

The two controls on pension savings are known as the annual allowance and the lifetime allowance and in this leaflet we take a brief look at the recent changes made to those allowances.

Most people will be able to save as much as they wish with full tax relief as their pension savings will be less than the allowances.

Annual allowance

What is the annual allowance?

The annual allowance is the amount your pension savings can increase in any one year before you become liable to a tax charge.

From 6 April 2011 the annual allowance reduced from £255,000 to £50,000. Unlike the position prior to 6 April 2011 the new annual allowance also applies in the year you take your benefits, although there is an exemption in the case of serious ill health retirement or death.

Generally speaking, any pension benefits you have in all tax-registered pension arrangements where you have paid contributions during the tax year (or your employer has paid contributions on your behalf) are included in calculating your pension savings in a year. For the LGPS, the pension saving year runs from 1 April to 31 March and is called the pension input period.

You will only have an annual allowance tax charge if the value of your pension savings for a tax year increase by more than £50,000. However, you may be able to carry forward unused annual allowance from the last three tax years. This means that even if the value of your pension savings increase by more than £50,000 in a year you may not be liable to the annual allowance tax charge.

For example, if the value of your pension savings for a tax year increase by £60,000 (£10,000 more than the annual allowance) but in the three previous years had increased by £35,000, £38,000 and £42,000, then the total amount by which each of these previous years fell short of £50,000 (i.e. £15,000 + £12,000 + £8,000 = £35,000) would more than offset the £10,000 excess pension saving in the current year. There would be no annual allowance tax charge to pay in this case. To carry forward unused annual allowance from an earlier year you must have been a member of a tax registered pension scheme in that year.

Most people will not be affected by the annual allowance tax charge because the value of their pension saving will not increase in a tax year by more than £50,000 or, if it does, they are likely to have unused allowance from previous tax years that can be carried forward.

How can I work out if I may be affected by the reduced annual allowance?

Working out whether you are affected by the annual allowance is quite complex, but this should help you work out your general position.

In general terms, the increase in the value of your pension savings in the LGPS in a year is calculated by working out the value of your benefits immediately before the start of the input period (1 April), increasing them by inflation (as currently measured by the Consumer Prices Index), and comparing them with the value of your benefits at the end of the input period (i.e. the following 31 March). In a defined benefit scheme like the LGPS the value of your benefits is calculated by multiplying the amount of your pension by 16 and adding any lump sum you are automatically entitled to from the pension scheme. If the difference between:

a) the value of your benefits immediately before the start of the input period (the opening value) and
b) the value of your benefits at the end of the input period (the closing value) plus any contributions you have paid into the scheme's Additional Voluntary Contribution (AVC) arrangement in the year or that you and your employer have paid into the scheme's Shared Cost AVC arrangement in the year

is more than £50,000, you may be liable to a tax charge. The method of valuing benefits in other schemes may be different to the method used in the LGPS.

If you have elected to transfer pension rights from another scheme (i.e. a scheme other than the local government scheme) into the LGPS, the value of the benefits relating to the transfer does not count towards your pension savings in the LGPS in the year the transfer payment is received. We are still awaiting clarification from the tax authorities regarding what the position is where a person transfers pension rights within the LGPS e.g. transferring from Devon County Council to Northumberland County Council. The current advice we have from the LGA is that an increase in the value of your pension resulting from such a transfer will count for the purposes of calculating any liability to a tax charge under the annual allowance rules, in the same way that an increase in the value of your pension resulting from a promotion would.

If your pension benefits in the LGPS are reduced following a Pension Sharing Order (issued as a result of a divorce or dissolution of a civil partnership) then, for the purposes of calculating the value of your pension savings in the LGPS, the reduction in your benefits is ignored in the year that the Pension Sharing Order is applied to your benefits.

If you retire on grounds of permanent ill health and an independent registered medical practitioner certifies that you are suffering from ill health which makes it unlikely that you will be able (otherwise than to an insignificant extent) to undertake gainful work (in any capacity) before reaching State pension age, there is no annual allowance tax charge on the ill health retirement benefits. Where a person retires with an enhanced ill-health pension and the person is able to work more than to an insignificant extent a tax charge under the annual allowance rules is possible.

Members most likely to be affected by the annual allowance tax charge are those that have a lot of scheme membership and have had a significant pay increase, or who pay high levels of AVCs, or who have been awarded a lot of additional membership in the LGPS by their employer. It can also have an impact in some ill-health cases

We will inform you if your LGPS pension savings are more than the annual allowance of £50,000 in any year, ignoring any carried forward allowance from the previous three years, not later that 6 October following the end of the relevant tax year. For 2011/12, that date is extended from October 2012 to October 2013.

Here's an example showing the calculation of the increase in the value of pension savings for an employee who has been an active member of the LGPS throughout 2011/12

Working out the opening value of the member's benefits for 2011/12

At 31 March 2011

Pensionable pay for the year to 31 March 2011 = £60,000

Scheme membership = 13 years (10 in the old 80ths scheme and 3 in the new 60ths scheme).

The Consumer Prices Index (CPI) for September 2010 is 3.1%

			£
Annual pension	10 / 80 x £60,000	=	7,500.00
	3 / 60 x £60,000	=	3,000.00
Total annual pension			**10,500.00**
Multiply by 16			168,000.00
Add lump sum	10 x 3 / 80 x £60,000		22,500.00
			190,500.00
Increase by inflation as measured by CPI			x 1.031
To give an opening value of			**196,405.50**

Do not add into the opening value any AVCs paid

Working out the closing value of the member's benefits for 2011/12

At 31 March 2012

Pensionable pay for the year to 31 March 2012 = £63,000

Scheme membership = 14 years (10 in the old 80ths scheme and 4 in the new 60ths scheme).

			£
Annual pension	10 / 80 x £63,000	=	7,875.00
	4 / 60 x £63,000	=	4,200.00
Total annual pension			**12,075.00**
Multiply by 16			193,200.00
Add lump sum	10 x 3 / 80 x £63,000		23,625.00
Add AVCs paid in this year			1,000.00
To give a closing value of			**217,825.00**

Working out the increase in value during 2011/12

The increase in the member's benefits over the year to 31 March 2012 is £217,825.00 - £196,405.50 = **£21,419.50**

As this is less than the annual allowance for 2011/12 of £50,000 there is no annual allowance charge in this example. The member has £28,580.50 unused annual allowance from 2011/12 to carry forward to 2012/13.

What happens if my pension savings increase by more than the annual allowance?

You will be liable to a tax charge (at your marginal rate) on the amount that the increase in your pension savings for the tax year, less any unused allowance from the previous three years, is more than £50,000. If you exceed the annual allowance in any year you are responsible for reporting this to HMRC on your self-assessment tax return.

Where the tax due amounts to more than £2000 it may be possible for you to opt to have the pension fund pay the tax on your behalf. Where you opt to do this the pension benefits you receive when you retire will be reduced to take account of the tax paid by the scheme on your behalf.

From 6 April 2011 the exemption from the annual allowance for the relatively small number of scheme members who received an enhanced protection certificate from HMRC has ceased.

Lifetime Allowance

What is the lifetime allowance?

The lifetime allowance is the total value of all the pension benefits you can have without you having to pay a tax charge when you draw them. If the value of your pension benefits when you draw them is more than the lifetime allowance you will have to pay tax on the excess benefits.

The lifetime allowance covers any pension benefits you may have in all tax-registered pension arrangements – not just the LGPS. This doesn't include any state retirement pension, state pension credit or any survivor's/dependant's pension you may be entitled to.

The lifetime allowance for 2011/2012 is £1.8 million and is reducing to £1.5 million in 2012/13. Despite this reduction, most people will not be affected by the lifetime allowance charge as they will not have pension savings of more than £1.5 million.

How can I work out if I could be affected by the reduced lifetime allowance?

To work out the capital value of pension benefits that start to be drawn on or after 6 April 2006, you multiply your pension by 20 and add any lump sum you draw from the pension scheme. As an example, and to give you a general idea, an LGPS pension of £66,500 per year and a lump sum of £170,000 would be a pension saving of £1.5 million.

For pensions already in payment before 6 April 2006, the capital value of these is calculated by multiplying the current annual rate of the pension, including any pensions increase, by 25. Any lump sum already paid is ignored in the valuation.

When any LGPS benefit, or any other pension arrangement you have, is put into payment you use up some of your lifetime allowance – so even if your pensions are small you should keep a record of any pensions you receive.

What happens if the value of my pension benefits is more than the lifetime allowance?

If your LGPS benefits are more than your lifetime allowance you will have to pay tax on the excess. If excess benefits are paid as a pension the charge will be 25%, with income tax deducted on the ongoing pension payments; if the excess benefits are taken as a lump sum they will be taxed once only at 55%.

Are there any protections from the lifetime allowance tax charge?

There are protections called primary lifetime allowance or enhanced protection for benefits earned up to 5 April 2006. To have this protection you must have already registered with HMRC by 5 April 2009. If you already have primary or enhanced protection you will be unaffected by the reduction in the lifetime allowance.

Because the lifetime allowance is reducing to £1.5 million in 2012/13 there is a new form of protection called fixed protection. With fixed protection your lifetime allowance will be fixed at £1.8 million rather than the new standard lifetime allowance of £1.5 million. However, if in the future the standard lifetime allowance rises to be more than £1.8 million your lifetime allowance will then be the higher standard lifetime allowance.

You will lose fixed protection if you start a new pension arrangement, other than to accept a transfer of existing pension rights, or if your benefits increase by more than the cost of living increases, or if you pay contributions into a money purchase pension arrangement other than to a life assurance policy providing death benefits that started before 6 April 2006. You will also be subject to restrictions on where and how you can transfer benefits.

To get fixed protection, the value of your pension doesn't have to be £1.5 million or more at 6 April 2012, so you may want to consider applying if you expect the value of your pension savings to be more than £1.5 million when you come to take your benefits.

If you are thinking about applying for fixed protection, then you may wish to get independent financial advice. **Remember, it's a condition of fixed protection that the amount of benefits you can build up will be limited, so if you get and wish to keep fixed protection you will need to keep a check on any increases to your benefits and take appropriate action.** To apply for fixed protection you have to make an application to HM Revenue & Customs (HMRC) in their prescribed form on or before 5 April 2012.

Remember - most people will be able to save as much as they wish with full tax relief as their pension savings will be less than the allowances.

More information

We hope you find this information helpful. Further information is available from the Pension Section, Finance Directorate, Northumberland County Council, County Hall, Morpeth NE61 2EF and on HM Revenue and Customs website at http://www.hmrc.gov.uk/pensionschemes/annual-allowance/index.htm and http://www.hmrc.gov.uk/pensionschemes/lifetime-allowance/index.htm

General information on the Local Government Pension Scheme can be found at www.lgps.org.uk