

# Member Newsletter

## Tax Implications of Pensions Annual Allowance and Lifetime Allowance

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# 1. Context and Limitations

This paper aims to set out some high level information in relation to the tax implications of the pensions' lifetime and Annual Allowance which will affect mainly higher earners. As a rule of thumb, if your annual pension is likely to exceed around £50,000 the tax rules around pensions may affect you.

The main issue currently being debated is in relation to the Annual Allowance, so this paper focuses mainly on that specific aspect. This paper sets out the background to the issue, the impact on individuals and potential options available to staff who are faced with tax liabilities.

Please note that this paper is not aimed at providing financial or pension advice to individuals and whilst every care had been taken in its preparation, HSC Pension Service cannot in any circumstances accept responsibility for errors or omissions and is not responsible for any loss occasioned to any person or organisation acting or refraining from action as a result of any material in it.

We have taken great care to get the details right at the time of publication but it does not give a complete or legally binding statement of the law and regulations which govern Tax and Pension Legislation. Nothing in this paper can override the legislation. In the event of any conflicting information, the Regulations and Legislation will prevail.

## 2. Tax Implications of Pensions Annual and Lifetime Allowance

The issue at the heart of this is the limit to the growth in pension benefits that individuals can have each year and the capital value of their total pension pot without being subject to tax – the Annual Allowance and the Lifetime Allowance.

The Annual Allowance was significantly reduced in 2011. Moreover, in 2016 it became subject to a taper which means that more highly paid individuals are being impacted and potentially may have to pay additional tax. The Annual Allowance and lifetime allowance are applicable to everyone paying tax in the UK – this is not an HSC specific issue or even a public sector specific issue. The press and social media coverage focuses on the impact on clinicians, but other long-serving senior managers in the HSC are equally affected.

The arrangements for calculating the growth in benefits an individual may have in a defined benefit scheme, such as the HSC Pension Scheme, can be complicated. It is possible for individuals to forecast the impact of the Annual Allowance, but it can prove to be a difficult and technically challenging calculation.

This Newsletter focuses on the Annual Allowance since recent changes but also references the lifetime allowance on page 13.



### 3. Annual Allowance on Pension Savings Benefiting from Tax Relief

Payments into pension schemes are a tax efficient way to save. Contributions paid into pensions are subject to tax relief subject to the following limits:

- 100% of pensionable earnings in a year
- The Annual Allowance (currently, £40,000 a year)
- The Lifetime Allowance (currently, £1,055,000).

As is the case with all pensions, some payments out of the HSC Pension Scheme are subject to tax, (Lump Sums up to 25% of a member's Lifetime Allowance are Tax Free).

Since 2006, an individual's ability to make tax-free contributions to a pension scheme has been subject to the Annual Allowance; the Annual Allowance was £255,000 in 2010 but was reduced to its current level of £40,000 in 2014. Furthermore, this is subject to tapering for higher earnings as discussed below.

This Annual Allowance is the maximum amount of pension savings on which HM Revenue and Customs (HMRC) will allow tax relief during a tax year. Once that allowance has been reached, the individual is subject to an Annual Allowance charge which is calculated as part of their tax return. It is the individual's responsibility to submit a tax return if they are liable for the Annual Allowance charge and then to pay the tax due.

For defined benefit pension schemes, like the HSC Pension Scheme, the limit is measured on the value of the increase in the pension built up over the pension input period i.e. growth in a person's pension pot. This generally cannot be calculated by the individual without information provided by the pension scheme.

### 4. Tapering on the Annual Allowance

Currently, the standard Annual Allowance is £40,000. However, the Annual Allowance available to individuals may be lower if they had taxable income of more than £110,000.

In the Summer Budget 2015, the then government announced that a taper to the Annual Allowance for those with **adjusted annual incomes**, including their own and employer's pension contributions, of over £150,000 would be applied from April 2016:

- For every £2 of adjusted income over £150,000, an individual's Annual Allowance (the limit on the amount of tax relieved pension saving that can be made by an individual or their employer each year) will be reduced by £1, down to a minimum of £10,000.
- To ensure this measure is focused on the higher and additional rate tax payers who currently gain the most benefit from pension's tax relief, those with income, excluding pension contributions, below a £110,000 threshold will not be subject to a tapered Annual Allowance (see below for example).



## 4. Tapering on the Annual Allowance - cont

Members are responsible for calculating their Adjusted Income and assessing what their Annual Allowance limit is and whether they have exceeded the Annual Allowance.

A member must firstly work out their Threshold Income - if Threshold Income exceeds £110,000, Adjusted Income must be calculated.

Threshold income is calculated by adding:

- ◆ HSC Pensionable Pay
- ◆ HSC Non Pensionable Pay
- ◆ Other Taxable Income

and deducting HSC Pension Scheme Member Contributions and any other tax deductible reliefs.

Adjusted Income is the total of Threshold Income plus Pension Growth. Pension Growth is provided on a member's Annual Allowance Statement.

If a members Adjusted Income exceeds £150,000 their Annual Allowance is reduced. For every £2 in excess of £150k the Annual Allowance is reduced by £1. An example is shown below and a calculator to estimate tapered Annual Allowance is available on our [website](#)

### Example Calculation

Step 1	Pensionable Pay	£104,000
	HSC Non Pensionable Pay	£ 30,000
	Other Taxable Income	<u>£ 10,000</u>
	Total Taxable Income	£144,000
	Member Contributions Paid (13.5%)	(£14,040)
	Other Tax Deductible Reliefs	= <u>      </u> (£0)
	<b>Threshold Income</b>	<b>£129,960</b>
Step 2	Threshold Income	£129,960 +
	Pension Growth**	<u>£ 48,000</u>
	<b>Adjusted Income</b>	<b>£177,960</b>

\*\*Pension growth is explained below- in broad terms the £48k represents an annual pension growth of around £3k x 16



## 4. Tapering on the Annual Allowance - cont

Step 3	Adjusted Income	£177,960
	HMRC Threshold	<u>(£150,000)</u>
	Excess/2	£ 27,960/2 = £13,980
	Annual Allowance	£40,000 -
	Excess/2	<u>(£13,980)</u>
	<b>Revised Annual Allowance</b>	<b>£26,020</b>

The HSC Pension Scheme will provide an Annual Allowance statement to those members whose growth in pension benefits is over the standard Annual Allowance, currently £40,000. However, the introduction of the taper means that the HSC Pension Scheme will not have all the information necessary to assess whether a member is subject to, or has exceeded, the tapered allowance. This is because the pension administrators will not have information on non-pensionable income that an individual has earned (for example in the private sector) or growth in any other pension schemes they may be members of. Therefore, members with higher salaries should seek independent financial advice and should request a pension savings statement from the HSC Pension Scheme where their calculated adjusted income is over £150,000.

## 5. Impact on Individuals and the HSC

Putting it simply, individuals who have threshold income of less than £110,000 will have an Annual Allowance of £40,000. They will have to pay tax (the Annual Allowance charge) on any amount that their pension growth for the year exceeds that £40,000 limit. Tax will be payable at their marginal tax rate – currently for individuals earning over £110,000 this will be the higher rate of tax.

Where an individual's threshold income is greater than £110,000 and their 'adjusted income' is greater than £150,000, the tapered allowance applies. The calculation of the amount of their allowance is based on their adjusted income. They will have to pay tax on the amount that their pension growth for the year is above the calculated adjusted allowance.

Where adjusted income is greater than £210,000, the Annual Allowance is £10,000.



## 6. Pension growth/savings

For defined benefit schemes (such as the HSC Pension Scheme) this is the amount of savings made by the individual or on their behalf during the pension input period. This is the difference between the opening value and the closing value where:

- the opening value is the annual pension built up so far at the end of the previous pension input period multiplied by 16 plus any separate lump sum built up at the end of the previous pension input period, all increased by the consumer price index (CPI)
- the closing value is the annual pension built up so far at the end of the current pension input period multiplied by 16 plus any separate lump sum built up at the end of the current pension input period.

Where the difference is negative, the pension growth is nil for that period. Where the difference is positive, that is the amount of pension growth for that period (see examples on Pages 7 & 9).

## 7. Effect of Arrears of Pay or Backdated Pay Award

In the event of a backdated pay award where arrears of pay may be owed to a member, a member's Annual Allowance amount will be calculated in the standard way.

The member's pension benefits at the end of the current pension input period will be calculated using their new pensionable pay amount as determined by the pay increase. Any arrears of pensionable pay received in the current pension input period relevant to previous input periods will not be used to establish the growth in benefits for the current period.

For example in the year 2017/18 Judith's pensionable pay was £80,000. Salary Negotiations concluding in 2019/20 (February 2020) decreed that Judith is awarded pay increases of 2% for 2018/19 and 1% for 2019/20. Judith will receive all backdated arrears for both years in March 2020.

As a result of the increases Judith's pensionable pay for year 2019/20 is now £82,416. Judith is owed a total of £4,016 arrears in her March 2020 Pay (£1,600 for year 2018/19 & £2,416 for year 2019/20). Judith's total pensionable pay received in 2019/20 (including arrears is £84,016).

For the purposes of calculating Judith's Pension Benefits in the year 2019/20 the arrears of £1,600 received in 2019/20 but relevant to year 2018/19 are ignored and her closing balance of pension benefits in year 2019/20 is based on a pensionable pay figure of £82,416.

Further information on how backdated pay increases are used in the calculation of Annual Allowance can be found at <https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm053800>



## 7. Effect of Arrears of Pay or Backdated Pay Award - cont

### Example 1 (1995 Section of the Scheme)

A member with 30 years' service earns £100,000 per year and gets a £20,000 increase in salary. The member has no additional income and therefore is not subject to a tapered Annual Allowance amount.

#### Closing Balance of Previous Input Period

	<u>Annual Pension</u>	<u>Lump Sum</u>
£100,000 x 30 / 80	£37,500	£112,500

#### Opening Balance for Current Input Period

£100,000 x 30 / 80 plus 2% CPI uplift	£38,250	£114,750
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#### Closing Balance for Current Input Period

£120,000 x 31 / 80	£46,500	£139,500
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Difference between Opening and Closing Balance	£8,250	£24,750
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<b>Pension Growth (difference x 16)</b>	<b>£132,000</b>	
<b>plus Growth in Lump Sum</b>		<b>£24,750</b>

<b>Total Pension Input Amount for Year</b>		<b>£156,750</b>
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Total Pensions growth is £156,750 which exceeds the Annual Allowance by £116,750. If we assume unused Annual Allowance had been carried forward from the previous three years, this could be deducted from the £116,750.

If no carry forward Annual Allowance is available the tax charge (based on a marginal rate of 40%) would be £46,700

If tax is due,

- It can be paid in a one off payment to HMRC before 31<sup>st</sup> January in the year following the tax year in which the charge occurred.
- Utilise the 'scheme pays' process, described below, whereby the amount due will be deducted from future annual pension.



## 7. Effect of Arrears of Pay or Backdated Pay Award - cont

In the example above, the tax charge of £46,700 would be deducted from the employee's Annual Pension and Lump Sum through Scheme Pays if applicable. The amount of the deduction from benefits would be calculated in line with advice from the Scheme Actuary.

In effect, the growth in salary of £20,000 would be received every year by the employee until retirement. The employee's annual pension associated with this salary increase would rise by between £5,000 and £8,750 (the latter calculated as £20,000 x 35/80, assuming 35 years' service on retirement).

However, (through Scheme Pays) the pension payable to the employee would be reduced by the tax due (£46,700 in this case); this would be deducted from the total pension paid to the employee at an estimated rate of around £2,335 per year (plus interest) plus 3 times the annual deduction from the lump sum. The factors used to ascertain the actual initial deduction of annual pension will vary per member and are dependent on age the member retires and the section of the scheme from which the deduction is attributed.

### Summary

Annual pay increase associated with 2018/19 salary increase	£20,000
Future Increase in annual pension) (Based on 35 years' service in 1995 section of the scheme)	£8,750
Future Increase to Lump Sum	£26,250
Reduction in Pension (based on compound interest of 4.4% for 4 years) Assuming CPI to be 2%	£2,774
Reduction to Lump Sum	£8,322

### Gross Increase in Benefits following AA Charge & Scheme Pays

Balance of Increase to Annual Pension	£5,976
Balance of Increase to Lump Sum	£17,928

In this particular example, in a scheme pays' scenario, the salary increase therefore results in additional annual salary for the employee and a net increase in their Annual Pension and Lump Sum.



## 7. Effect of Arrears of Pay or Backdated Pay Award - cont

### Example 2 (1995/2015 Transitional Member of the Scheme)

A member with 15 years' service in the 1995 Section of the Scheme and who transitioned to the 2015 Scheme on 01/04/2015 age 40. The member earns £94,000 per year and gets a £10,000 increase in salary in 2018/19. The member has additional non-pensionable HSC income of £31,400 (3 PA's) plus £10,000 other taxable income and therefore, is subject to a Tapered Annual Allowance Amount.

#### Closing Balance of Previous Input Period

	<u>Annual Pension</u>	<u>Lump Sum</u>
<b>1995 Section</b>		
£94,000 x 15 / 80	£17,625	£52,875
<b>2015 CARE Scheme</b>		
£94,000 / 54 plus CPI + 1.5% (3 years 15/16 to 17/18)	£5,574	£0

#### Opening Balance for Current Input Period

<b>1995 Section</b>		
£94,000 x 15 / 80 plus 2% CPI uplift	£17,978	£53,934
<b>2015 CARE Scheme</b>		
£94,000 / 54 plus CPI + 1.5% (3 years 15/16 to 17/18) + 2% uplift	£5,685	£0

#### Closing Balance for Current Input Period

<b>1995 Section</b>		
£104,000 x 15 / 80	£19,500	£58,500
Difference between Opening and Closing Balance	<b>£1,522</b>	<b>£4,566</b>
<b>2015 CARE Scheme</b>		
((£104,000 / 54) + £5,574) plus CPI + 1.5%	£7,762	£0
Difference between Opening and Closing Balance	<b>£2,077</b>	£0
<b>Total Pension Growth in both Schemes (difference x 16) plus Growth in Lump Sum</b>	<b>£57,584</b>	<b>£4,566</b>
<b>Total Pension Input Amount for Year</b>		<b>£62,150</b>

## 7. Effect of Arrears of Pay or Backdated Pay Award - cont

Tapered Annual Allowance £21,517

Total Pensions growth is £60,806 which exceeds the Tapered Annual Allowance by £39,289. If unused Annual Allowance had been carried forward from the previous three years, this could be deducted from the £39,289.

If no carry forward Annual Allowance is available the tax charge (based on a marginal rate of 40%) would be £15,716

If tax is due,

- It can be paid in a one off payment to HMRC before 31<sup>st</sup> January in the year following the tax year in which the charge occurred.
- Utilise the 'scheme pays' process, described below, whereby the amount due will be deducted from future annual pension.

In the example above and if we assume the member's Tapered Annual Allowance calculation to be £26,020 there would be a tax charge of £14,452.

Total Growth in Pension	£62,150
Tapered Annual Allowance	- <u>£26,020</u>
Breach of Annual Allowance	£36,130
Tax Charge = £36,130 x 40% =	£14,452

This would be deducted from the employee's Annual Pension and Lump Sum if the member opts for Scheme Pays. The amount of the deduction from benefits would be calculated in line with advice from the Scheme Actuary.

In effect, the growth in salary of £10,000 would be received every year by the employee until retirement. The employee's annual pension associated with this salary increase would rise by between £4,624 and £9,417 (the former based on the member retiring at age 60 and VER reduction factors applied to the 2015 Scheme benefits and the latter based on a retirement age of 68 both using a revaluation CPI factor of 2%).

If we assume the member elects to have the Scheme Pays amount deducted from their 2015 Scheme benefits at age 60 the pension payable to the employee would be reduced by the tax due (£14,452 in this case); this would be deducted from the total pension paid to the employee at an estimated rate of approximately £885 per year (plus interest).

## 7. Effect of Arrears of Pay or Backdated Pay Award - cont

### Summary

Annual pay increase associated with 2018/19 salary increase	£10,000
Future Increase in 1995 Section annual pension as a result of Pay Increase (Based on 15 years' service in 1995 section of the scheme)	£1,522
Future Increase to 1995 Section Lump Sum	£4,566
Future Increase in 2015 Section annual pension as a result of Pay Increase at age 60	£3,102
Reduction in Pension (based on compound interest of 4.4% for 17yrs, assuming CPI to be 2%)	£1,840

### **Gross Increase in Benefits following AA Charge & Scheme Pays**

Balance of Increase to Annual Pension	£2,784
Balance of Increase to Lump Sum	£4,566

In this particular example, in a scheme pays' scenario, the salary increase of £10,000 therefore results in additional annual salary for the employee and a net increase in their Annual Pension and Lump Sum.

It must be noted, under current HMRC Annual Allowance legislation if this member maintains their current total earnings (no increases) of £145,400 made up as detailed below their potential tapered Annual Allowance amount would be £33,370.

HSC Pensionable Pay	£104,000
HSC Non Pensionable Pay	£31,400
Non HSC Non Pensionable Pay	<u>£10,000 +</u>
Pension Growth approx. $((£104k / 54) = 1.5\% + CPI) \times 16$	£31,900

You will note that the tapered Annual Allowance amount would cover the growth in pension in this scenario, however any increases in pensionable pay will impact these figures as growth in both the 1995 Section and 2015 Scheme will need to be taken into account.

## 8. Actions to Reduce the Impact

As the HSC Pension Scheme is an unfunded defined benefit scheme, employee and employer contributions are determined centrally and are based on an actuarial review. There is no flexibility at present for members of the scheme to vary their contributions.

Individuals who are required to pay tax above the Annual Allowance in any year can:

- use any Annual Allowance that they have not used in the previous three years to reduce the amount of tax payable in the year
- enter into a 'scheme pays' arrangement where the tax will be paid to HMRC by the HSC Pension Scheme on the individual's behalf – this is recorded as a separate account on the individual's pension record. On retirement the total amount in this account, including interest, will be deducted from the HSC Pension benefits when they are paid. This means that annual pension payments and lump sum (if applicable) will be reduced accordingly
- pay the tax due.

## 9. Who is affected

All HSC staff can be affected but employees are more likely to exceed their Annual Allowance if:

- they have long service in the HSC Pension Scheme – the pension savings is calculated using the annual pension built up which is the pensionable salary at the end of the period multiplied by the number of years' service divided by the scheme accrual – for the HSC schemes either 1/60 or 1/80. As well as annual income tending to increase year on year, the pension savings will go up as additional years are worked
- they have transferred pensions rights from a club scheme on or after 28 January 2015
- they have purchased additional pension or added years
- they are members of the 1995/2008 scheme
- they receive a significant increase in pensionable pay
- they are in receipt of a clinical excellence award
- they are promoted several times within a brief period
- they have pension savings in other workplace pension schemes
- they receive taxable income from other sources (for example, income from other employment, pension income, self-employment and income from rental properties)
- they have annual taxable earnings of more than £110,000
- they are awarded tier 2 ill health retirement
- inflation is low

It is the individual's responsibility to complete a self-assessment tax return if they are liable to pay the Annual Allowance charge.



## 10. Lifetime Allowance

The lifetime allowance is a limit on the size of an individual's pension pot before tax is payable. In 2019/20, the lifetime allowance was £1,055,000.

For defined contribution pension schemes, the pension pot is the amount of money that goes towards paying out the pension. The size of the pot will depend on the amount of money paid into the scheme by the individual and their employer, the performance of the fund's investments (up or down) and the way that the individual decides to take their money out of the fund. For defined benefit schemes, the pension pot is calculated as 20 times the pension at retirement, plus the lump sum.

Where an individual's pension pot exceeds the lifetime allowance then they will be liable to pay tax. The rate of tax is currently 55% if excess benefits are received as a lump sum, or 25% if received as an annual pension. The tax is paid by the HSC Pension Scheme and taken out of the individual's HSC pension benefits.

## 11. What can HSC Pension Service do to help?

HSC Pension Service as the scheme administrators has been working on developing some initiatives, within restrictions of tax regulations, to assist members and alleviate some pressures.

1. HSC Pension Service is in the process of establishing a dedicated Annual Allowance Team. This team will work on issuing Annual Allowance statements on request to Scheme members, in addition to those who have breached the £40,000 limit as well as deal with all Annual Allowance queries for current and previous years.
2. HMRC have deadlines for the submission of Scheme Pays elections for members who have an Annual Allowance tax charge. If you have exceeded the Annual Allowance amount and not received details of your pension input amount and are unable to meet this deadline HSC Pension Service will allow a 3 month grace period i.e. deadline will be extended to 3 months following the production of the Annual Allowance statement for the submission of Scheme Pays Elections.
3. HSC Pension Service is currently working on developing the Member Self Service portal to provide members with access to an Annual Allowance Data View. This will show growth year on year in one easy to read table rather than a statement. Growth for 1995/2008 Sections and CARE scheme will also be shown separately.
4. Annual Benefit Statements from year 2019/20 will include details of the relevant Pension Input Period and will display the pension growth in said year.
5. HSC Pension Service website has been updated with current literature and a calculator to assist members with determining tapered Annual Allowance amounts applicable based on earnings.

## 12. Contact Us

**By writing to us at:-**

HSC Pension Service

Waterside House

75 Duke Street

Londonderry

BT47 6FP

**Via e- mail at:-** [hscpensions@hscni.net](mailto:hscpensions@hscni.net)

**By Telephone:** 028 7131 9111 (9.00am to 4.00pm – Monday to Thursday; 9.00am to 12.00pm Friday)



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