Housing Bulletin – August 2019

Navigating the Annual Allowance

Annual Allowance issues have been in the news recently, particularly in relation to the problems faced by doctors in the NHS Pension Scheme. However, it is not just public service sector schemes where the Annual Allowance can have an impact.

In the coming weeks, all pension scheme members who have exceeded the *Standard Annual Allowance* will receive Pension Savings Statements for the 2018/19 tax year.

In our experience, these Pension Savings Statements are not well understood. This is hardly surprising. It is a complex area and for defined benefit schemes is notoriously difficult to predict ahead of time.

If a member has breached their Annual Allowance, they have a duty to calculate their tax charge (which might be zero because of "carry forward"). If a tax charge is due, this is paid by either the member or the pension scheme (but because of different "Scheme Pays" policies it is not always clear what is possible). In other words, it's difficult for an employee to work out if a tax charge is due and what to do about it!

Health warning! Pensions tax is an extremely complicated topic! This bulletin sets out an overview of the Annual Allowance regime and discusses how employers can identify and support their employees.

What is the Annual Allowance?

The Annual Allowance is the value of pension benefits which can build up in a given tax year and benefit from full tax relief at the individual's marginal rate. This is completely separate from the Lifetime Allowance which is the total value of pension savings that can be accrued over someone's lifetime without further tax charges being incurred. So, it is possible to be hit by a double whammy. Reduced tax relief on monies paid into the "pot" and higher tax charges on monies paid out! This note just considers the Annual Allowance.

The *Standard Annual Allowance* is currently £40,000.

However, anyone with a Threshold Income[1] above £110,000 might have a lower allowance. For every £2 of Adjusted Income[2] above £150,000, the Annual Allowance is reduced by £1 but with a minimum Annual Allowance of £10,000[3].

This reduced annual allowance is known as the *Tapered Annual Allowance*.

[1] Threshold Income is all taxable income excluding the value of pension savings
[2] Adjusted Income is all taxable income including the value of pension savings
[3] Or £4,000 if the Money Purchase Annual Allowance has been triggered

What is a Pension Savings Statement?

The purpose of a Pension Savings Statement is to notify those pension scheme members who have breached the standard £40,000 Annual Allowance in a given tax year and to help them calculate any Annual Allowance tax charge. We expect a 2018/19 Pension Savings Statement will include a table which looks something like this:

Pension Input Period(s) ending in tax year	Aggregated Pension Input Amount (£)	Standard Annual Allowance (£)
5 April 2019	This column will show an individual's pension savings in each period	£40,000
5 April 2018		£40,000
5 April 2017		£40,000
9 July 2015 to 5 April 2016		£40,000*
31 March 2015 to 8 July 2015		£80,000

* Lower limit applies where pension savings were more than £40,000 in previous pension input period.

Knowing your Pension Input Amounts (described below) is one half of calculating if a tax charge is due. However, your Pension Savings Statement will not tell you if you are affected by the *Tapered Annual Allowance*. You need to calculate this yourself, and understandably, most people don't know where to start – but we can help support your employees.

Why am I given all this history?

Because if the Annual Allowance is exceeded in any one year, any unused allowance from the previous 3 years can be "carried forward" with the oldest year's unused allowance being used first.

What does Pension Input Amount mean?

Your Pension Input Amount is the value of pension benefits you have built up in a given year. For a Defined Contribution ("DC") scheme, this is straightforward.

DC: Total pension contributions paid over the year by both the employee and employer. Note this is *not* the increase in the fund value over the year.

For a Defined Benefit ("DB") scheme, it's a little trickier and you have to use this formula:

DB: Factor of 16 × (Accrued pension at end of year
less accrued pension at start of year, increased by CPI inflation)

Why have some people breached the Annual Allowance in the first place?

In short, it's because the value of the individual's pension savings over the tax year was greater than £40,000 (or the *Tapered Annual Allowance* if lower). This can happen in a DB scheme for a number of reasons, for example:

- The pension scheme has generous accrual rates (e.g. LGPS 1/49th or SHPS 1/60th);
- A big increase in pay – perhaps due to a recent* promotion;
- Long pension scheme membership;
- But, perhaps most likely, a combination of all three.

** Be careful. In calculating the benefits many pension schemes average salaries over say 3 years. The promotion could have happened a few years ago, but the full impact is still to feed through in increased benefits.*

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“Be aware” (1) – It’s not just high earners who can breach the Annual Allowance

For example, let’s take an employee on a salary of £55,000 with 10 years’ past service in a 1/60th Final Salary scheme. If they are promoted to a position with a salary of £65,000, then they can breach the Annual Allowance (assuming CPI of 2.5%).

DB: Factor of 16 × (11 / 60 × £65,000 less 10 / 60 × £55,000 × 1.025) **> £40,000**

"Be aware” (2) – …And people with tax to pay might not receive a Pensions Savings Statement to help flag this!

For example, imagine someone with a *Tapered Annual Allowance* of £20,000 and a pension input amount of £30,000. As the *Tapered Annual Allowance* has been exceeded, there is tax to pay. However, as this person has not exceeded the *Standard Annual Allowance* of £40,000, they will not receive a Pensions Saving Statement, yet they still have a responsibility to calculate if any Annual Allowance tax charge is due. It’s a tough ask!

What is Scheme Pays and how can it help?

“Scheme Pays” is an option for members to offset any Annual Allowance tax charge from their pension, rather than paying it themselves. The scheme then pays HMRC your tax charge on your behalf.

Where someone has a Pension Input Amount larger than £40,000 and a tax charge larger than £2,000, pension schemes are required to offer Scheme Pays to some extent. However, Scheme Pays might only be available to settle part of a tax bill, depending on the policy of the relevant pension scheme. For example, SHPS’ current policy is that Scheme Pays cannot be used to settle any tax bill relating to a member’s *Tapered Annual Allowance*. The below example helps illustrate this.

Imagine an executive employee in SHPS who has a threshold income of £160,000 pa and a pension input amount of £50,000. They therefore have an adjusted income of £210,000 and a *Tapered Annual Allowance* of £10,000. They apply for Scheme Pays through SHPS.

Tax charge where Scheme Pays can be used: 45% x (£50,000 - £40,000) = £4,500

Tax charge where Scheme Pays can’t be used: 45% x (£40,000 - £10,000) = £13,500

In this example, only £4,500 of a SHPS’ member’s tax bill can be paid by Scheme Pays, but the remaining £13,500 is a personal tax liability of the member. Hardly change you can easily find down the back of the sofa!

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How can we help review your Annual Allowance position?

We can help in the following ways:

- Identify which of your staff are likely to be affected by the Annual Allowance;
- Provide assistance in the calculation of an employees' tax charge;
- Describe how Scheme Pays operates on your pension scheme (eg SHPS, LGPS);
- Provide bespoke "1-2-1" guidance sessions to affected individuals;
- Identify strategies to help mitigate the above tax risk

Although not covered in this bulletin, we can also assist with reviewing an individual's Lifetime Allowance position and how best to manage this alongside the Annual Allowance.

The Annual Allowance is a technical area that is not well understood – and dare we say it, even at HMRC. We have seen instances of employees who are not aware of (and therefore have not declared and paid) Annual Allowance tax charges. We have even seen instances where professional tax advisers have missed it because it is a new, complex and far from intuitive requirement.

However, HMRC are informed by pension schemes each time someone exceeds the *Standard Annual Allowance,* so it is reasonably likely HMRC will pursue affected individuals at some point in the future. Ignorance is unlikely to be seen as a reasonable excuse.

We can help you review your Annual Allowance position to avoid unwelcome surprises for your key employees. Please contact your usual First Actuarial consultant, or any one of our nationwide team of housing consultants, to discuss your situation.

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