Blue Light Pensions Newsletter #3

In the last newsletter I promised this edition would look at pensions tax. As we saw in the Budget on Wednesday (8 July) the Government has not lost its appetite for taxing pensions, imposing ever reducing allowances and bringing more and more public servants into the tax 'net'. And it gets more and more complicated.

So what are the main elements of pensions tax that both employers and scheme members need to understand? And why do employers need to be concerned? After all, traditionally tax has been a private matter between the individuals and HMRC, so what's changed? I will try and shine some light on this complicated subject and hopefully answer your questions.

Summary

The Chancellor has announced a reduction to the Annual Allowance to £10,000 a year for higher earners. This is in addition to the cut in Lifetime Allowance to £1m from 2016 which had already been announced and will impact those earning around £75,000 or more. And the first tax year (2014/15) with the current Annual Allowance of £40,000 has now completed and will impact your staff earning around £50,000 in certain circumstances.

Those earning over £110,000 are very likely to be impacted by both the Lifetime Allowance and by the Annual Allowance *each year*, which means that they may not get value back for their own pension contributions and may decide to leave their scheme. The new rules will be effective from 6 April 2016 – but there is work to be done before then.

Here is our initial press release on the subject: KPMG Pensions Budget Press Release

And now for the detail...

Pensions Income Tax relief: Currently personal contributions by scheme members to their pension scheme are eligible for income tax relief. So each £1 an individual pays in contributions will only cost them 80p with HMRC providing the other 20p (if their marginal tax rate is 20%). For the highest rate taxpayers, the ratio is 55p to 45p. Pension accruals are not taxed during an individual's working lifetime and up to 25% of the benefits can be taken tax free.

Thus saving for a pension has been a very tax efficient savings vehicle, especially for higher earners. But this is before the Lifetime and Annual Allowances apply and these now change the picture.

Lifetime Allowance (LTA): This is the amount of pension an individual can save during their lifetime, which includes occupational and personal arrangements and which is not subject to tax. The current Lifetime Allowance is £1.25m, but it will reduce to £1m from 6 April 2016. In broad terms any pension over the LTA incurs a 25% charge to recoup the tax relief. For Defined Contribution (DC) schemes calculating what is in a pension pot is straightforward – it is the physical amount of cash in an individual's DC account. However, for public sector schemes you need to multiply the member's expected annual pension benefit on retirement (easy to define in the old schemes, hence the name) by a factor of 20 and add in any lump sum. This threshold is reached with a pension of £50,000 in a Final Salary Scheme where no lump sum is automatically provided and just over £42,000 for one with a 4 x pension lump sum (eg the 2006 police scheme).

Annual Allowance (AA): The amount an individual can add to their 'pension pot' in any one year without incurring tax charges is known as the Annual Allowance and is currently £40,000, having been reduced from a peak of £255,000 as recently as 2010/11. 2014/15 was the first tax year for the £40,000 level and by this Autumn those who are impacted will have received statements. It is likely to be significantly more people than in previous years.

The tax charge is designed to remove the tax relief up front, tax relief which otherwise would have been deemed to have applied to the excess pension.

Again for DC scheme members, determining how much has been added to a member's pension pot is straight forward – it is the total payments into the fund by both employee and employer during the year. For public sector schemes, it is calculated by multiplying the increase in the accrued pension during the year by a factor of 16. So someone expecting a pension of £30,000 who has been promoted and will now receive a pension of £35,000 has seen a growth in value of £5,000 x 16 = £80,000 i.e. £40,000 over the AA. This may not result in a tax charge as the individual can carry forward unused AA from previous years. And it is this £40,000 AA that the Chancellor altered (again) in his Budget. The principal behind the change is to limit the highest rate of pension tax relief, but the calculation is complicated.

Changes to Annual Allowance

The AA reduction will be tapered from the current £40,000 threshold down to £10,000 for those earning between £150,000 and £210,000. Earnings for this purpose is based on a new definition, 'adjusted income', which includes income from investments and property for example. Crucially, it also includes the value of the employer's contributions (see below). The reduction is applied by removing £1 of Annual Allowance for every £2 of adjusted income.

The value of the employer's contributions is easy to assess for Defined Contribution schemes. Not so for public sector schemes. So the value will have to be calculated in the same way as for the Annual Allowance calculation, by applying a factor of 16 to the increase in the benefit. This 'Pension Input Amount' will be adjusted to reflect employee contributions to determine a deemed employer contribution.

The Chancellor's detailed notes include reference to another new earnings definition called 'threshold income', which includes earnings sacrificed for pension provision and other income such as from investments and property. Those with threshold income of £110,000 or less will not be subject to any reduction in the AA (it will remain at £40,000). For those with threshold income above £110,000 the adjusted income figure will apply, and the inclusion of the employer contribution amount will count towards the £150,000 and may then lead to a tapering in the AA. This means these scheme members are very likely to see their AA reduce. So they will incur an additional AA charge (or a new charge if otherwise they would not have had one), as well as a Lifetime Allowance charge.

In your organisations only the very highest earners will be affected by these latest changes, but for those affected they will be in a position where they will incur AA charges every year on a pension which is expected to exceed the Lifetime Allowance. This leads to double charges and may reduce the net value of the extra pension accrual to be less than the amount of contributions paid by those individuals. (Please note that this analysis is generic, individual cases will require careful analysis and will depend on the views and circumstances of individuals – our comment here does not constitute advice.)

With your most senior officers better off out of the scheme rather than remaining in, this could have some major implications for you organisation.

LTA Protection: As the Lifetime Allowance has fallen, protections have been put in place to protect those already over the limits. We do not as yet have the details of the protection method for the reduction from £1.25m to £1m.

So what should employers do?

Previously pension taxation was considered a 'minority sport' and most of us knew very little about it. But the subject is now beginning to affect a growing number of public servants and as a good employer you may share the view that the provision of good, clear information on this issue to scheme members is a legitimate responsibility for scheme administrators. Employers need to understand who is, or could be affected, what options exist for employers and employees, and how best to engage with affected staff.

This can be summarised as **Analyse**, **Manage** and **Communicate** and we have an approach for dealing with this which takes you through these three steps in turn. Schemes are now faced with the real possibility of members of their senior management teams leaving prematurely and would be successors being less inclined to seek promotion because of the tax implications.

Hopefully that very brief description of the complicated world of pensions tax has been useful and if I can be of any help with any aspect of pension tax, do feel free to contact me.

Next time I will examine the administration of schemes and the new requirements being imposed by The Pensions Regulator for improved performance in this area.

Kind regards

Ian

Ian Pollitt CBE
Senior Manager Pensions
Tax and Pensions

KPMG LLP(UK)
One Snowhill
Snow Hill Queensway
Birmingham B4 6GH
ian.pollitt@kpmg.co.uk
Tel: 0121 232 3316
Mobile: 0782 521 8471

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