PENSION TAX CHANGES – OCTOBER 2010
BRIEFING FOR CIVIL SERVANTS

The Government has announced some major changes to the pensions and tax regime.

1. **From tax year 2011-12, the Annual Allowance (AA) for tax-privileged saving will be reduced from its current level of £255,000 to £50,000 (and the basis of calculation will change)**

2. **From 6 April 2012, the Lifetime Allowance (LTA) will be reduced from its current level of £1.8m to £1.5m**

3. **Individuals will be able to carry forward three years' of unused AA.**

The following Q&A seek to explain these changes and the impact that they may have. Please note however that the Government is still consulting on a number of elements of the changes and that definitive answers are not yet available to all questions.

ANNUAL ALLOWANCE

Q I am only a civil servant, not a high earner. Surely none of this means anything for me?

A The changes are most likely to affect those on higher salaries but could also affect members of **classic**, **classic plus** and **premium** who get significant pay rises which feed through into large increases in pension. The new AA could also be an issue for moderate earners who get a one-off increase in pension as a result of early retirement after 31 December 2010 under current CER or FER terms. This is particularly likely to be the case for people with long service. You should look at the examples below.

You will be affected if your "deemed contributions" exceed your AA in any tax year from 2011-12 onwards. If you don't use up all of your AA in a year you can carry forward up to three years' of unused AA.

Q What are "deemed contributions"?

A Deemed contributions are the total of:

- contributions you and your employer pay to a money purchase scheme such as the Civil Service AVC Scheme, the **partnership** pension account, a stakeholder pension or to a personal pension; plus

- the value of benefits you have built up in any defined benefit scheme such as **classic**, **classic plus**, **premium** or **nuvos.** This is calculated as:

    - 16 times the pension built up in the year, plus

    - the increase in any automatic lump sum over the year.

For the purpose of this calculation benefits earned in a defined benefit scheme in a year (known as the 'input period') are assumed to be total benefits less benefits at the end of the previous input period, revalued in some way (for example in line with inflation).

Q How does the Annual Allowance work?

A The Annual Allowance is the amount of deemed contributions you can make to tax-relieved pensions before incurring a tax charge. This includes deemed contributions to defined benefit schemes such as **classic**, **classic plus**, **premium** and **nuvos** and actual contributions by you and your employer to a defined contribution scheme (such as a **partnership** pension account or Civil Service AVCs with Scottish Widows or Standard Life). For defined benefit schemes, deemed contributions will be calculated by reference to benefits built up during the pension input period:

Deemed contributions = 16 x [P1 – P0 x (1 + r)] + L1 – L0 x (1 + r)
where:
P1 = amount of pension at the end of the pension input period
P0 = amount of pension at the start of the pension input period
r = revaluation factor (assumed to reflect inflation)
L1 = amount of any lump sum at the end of the pension input period (**classic** and **classic plus** only)
L0 = amount of any lump sum at the start of the pension input period (**classic** and **classic plus** only)

Q What happens if my deemed contributions exceed the Annual Allowance?

A Any excess (ie after offsetting the Annual Allowance and any eligible unused Allowance from previous years) will be added to your taxable income for the tax year in question and subject to income tax in the normal way.

Q What is the pension input period?

A For the Principal Civil Service Pension Scheme (PCSPS), the pension input period runs from 1 January to 31 December. The pension input period relevant for tax year 2011-12 (the first year for the new tax regime) is the calendar year 2011.

Q It seems very unfair to hit me with a tax charge just because I got a promotion

A If you don't use up all your Annual Allowance for any tax year you can carry the unused allowances forward for up to three tax years. This will help protect people who wouldn't normally breach the Annual Allowance. Notional amounts, based on an assumed AA of £50,000, will apply for tax years 2008-9, 2009-10 and 2010-11 for use in 2011-12.

Q I have a deferred pension in another pension scheme. What happens to that?

A Deferred pensions are exempt from the new AA regime.

Q I am a classic member with a deferred pension which I expect to aggregate when I retire. That will give me a big increase to my pension. What happens to me?

A We gave you the opportunity to aggregate back in 2006 to avoid any future problems with the Annual Allowance. If you decide to aggregate and this takes you over the AA in the relevant tax year you will be subject to tax but this may be mitigated if you have any unused AA from previous years to carry forward.

Q I registered for Enhanced Protection back in 2006 so as to avoid the Annual Allowance. So I'm OK, aren't I?

A The Treasury has announced that Enhanced Protection will no longer give protection against Annual Allowance tax.

Q Are there any exemptions to the AA?

A Unlike under the previous (current) arrangements the Annual Allowance test will also apply in the year of retirement. The AA will not apply in the year of death or in the case of pensions or lump sums paid where individuals are diagnosed with serious (terminal) ill-health. The Government has indicated that it will consider exempting other ill-health retirement benefits from the AA test.

Annual Allowance - Example 1:

Jane is a member of **classic**. On 31 December 2010 Jane has 30 years' reckonable service and her pensionable pay is £50,000. On 31 December 2011 she has 31 years' reckonable service and her pensionable pay has risen to £54,000 following a promotion. During the year Jane purchased £300 of Added Pension (she did not have any previously) and also contributed £5,000 to Additional Voluntary Contributions (AVCs).

In respect of Jane's **classic** membership:

P1 (pension at end) = 31/80 x £54,000 = £20,925
L1 (lump sum at end) = 3 x £20,925 = £62,775
P0 (pension at start) = 30/80 x £50,000 = £18,750
L0 (lump sum at start) = 3 x £18,750 = £56,250

Assume r = 2.5%

Jane's deemed contributions to **classic**

= 16 x [£20,925 – (£18,750 x 1.025)] + £62,775 – (£56,250 x 1.025)
= £32,419

Jane's deemed contributions to her Added Pension = 16 x £300 = £4,800
Jane's contributions to her AVCs = £5,000
Jane's total deemed contributions = £32,419+ £4,800 + £5,000 = £42,219
Jane's Annual Allowance for 2011-12 is £50,000. Jane has used up £42,219 of this, leaving her with £7,781 of unused allowances. Jane can carry forward these unused allowances for the next 3 tax years.

Annual Allowance - Example 2:

Debbie is a member of **premium**. On 1 January 2011 Debbie has 25 years' reckonable service and her pensionable pay is £130,000. On 31 December 2011 she has 26 years' reckonable service and, following a promotion, her pensionable pay has increased to £140,000

In respect of Debbie's **premium** membership:

P1 (pension at end) = 26/60 x £140,000 = £60,667
P0 (pension at start) = 25/60 x £130,000 = £54,167

Assume r = 2.5%

Debbie's deemed contributions to **premium**

= 16 x [£60,667 – (£54,167x 1.025)] = £82,333

Debbie has made no other contributions to pensions, so her total deemed contributions = £82,333

Debbie's Annual Allowance for 2011-12 is £50,000 and she uses this up in its entirety, leaving her with £32,333 potentially liable to tax. If Debbie has unused (notional) Annual Allowance for 2008-9, 2009-10 and/or 2010-11 she can offset those unused Allowances against the £32,333 excess. Assume however that Debbie has no unused Allowances. In that case Debbie will be charged tax (through Self Assessment) on £32,333. As Debbie's salary is £140,000 it is likely that she will pay at least some tax at 50% and this tax (potentially over £16,000 if all taxed at 50%) would be due by 31 January 2013. The Treasury is considering whether to allow people incurring an Annual Allowance tax charge to have their pension benefits reduced rather than having to pay tax upfront.

Annual Allowance – Example 3:
This example shows that actions already taken during 2010 may impact on the new Annual Allowance calculation. This particular example reflects the current pay freeze – in the "normal" environment, the tax position could be less benign.

James is a member of **classic**. On 30 June 2010, James is promoted and his salary goes up from £160,000pa to £180,000pa. On 31 December 2010, James has 30 years' reckonable service. James's last year is his best, so his pensionable pay applying at 31 December 2010 is £170,000 (6 months @ £160,000 and 6 months @ £180,000).

By 31 December 2011, James has built up 31 years of reckonable service. The pay freeze means that he has not had a pay rise, and his pensionable pay (again, his last year) is £180,000.

The pension input period for tax year 2011-12 is (for the PCSPS) the calendar year 2011.

P1 (pension at end) = 31/80 x £180,000 = £69,750
L1 (lump sum at end) = 3 x £69,750 = £209,250
P0 (pension at start) = 30/80 x £170,000 = £63,750
L0 (lump sum at start) = 3 x £63,750 = £191,250

If we assume that uprating takes place at 3%, then James's deemed contributions to **classic**

= 16 x [£69,750 – (£63,750 x 1.03)] + £209,250 – (£191,250 x 1.03)
= £77,662

James will be potentially liable to tax on £27,662 but he can offset against this any notional unused Annual Allowance from 2008-9, 2009-10 and 2010-11 (see Example 2 above)

LIFETIME ALLOWANCE

Q Remind me how the Lifetime Allowance works

A Everyone has a Lifetime Allowance (LTA). Whenever you draw a pension (on retirement) you use up some LTA. Once you have used up all of your LTA, LTA tax is payable. Pensions are generally valued using a factor of 20, but a factor of 25 applies to any pension which came into payment before 6 April 2006 (see example below). The LTA is currently £1.8m

Lifetime Allowance Example:
Steve retires on 31 December 2010 when the LTA is £1.8m. His **premium** pension is £20,000 and he does not want to take a lump sum. Before joining the Civil Service, Steve spent a full career in the Police and retired before April 2006. The current value of Steve's police pension is £60,000pa.

Steve's police pension is valued for LTA at £60,000 x 25 = £1.5m – leaving him with £300,000 LTA

Steve's **premium** pension is valued for LTA at £20,000 x 20 = £400,000 meaning that £100,000 (£400,000 less his remaining £300,000 LTA) is subject to LTA tax at 25% - ie £25,000. MyCSP gives Steve the choice of paying the £25,000 upfront or of having his pension reduced by 1/20th of the tax – in other words, his **premium** pension would be paid at an initial rate of £18,750pa rather than £20,000pa.

Q I am planning to retire in March 2014. While my pension is worth less than £1.5m now, I estimate it will be worth around £1.6m in 2014, so I had expected to be

clear of LTA tax. Does this mean I have to bring my retirement forward to March 2012 to avoid having to pay extra tax?

A The Treasury proposes to consult on transitional protection to protect people who have already built up pension pots between £1.5m and £1.8m. Details are not yet available but, as your benefits are currently less than £1.5m, you may not benefit from these measures. Decisions on retirement should be taken carefully; while tax is definitely one consideration, it is not the only one.