Further changes to the annual and lifetime allowances

Will you be liable for a tax charge?

In this leaflet we look at some recent changes to the HM Revenue & Customs (HMRC) rules that govern pension savings and how they might affect you.

A bit of background

In addition to any tax you are to pay under PAYE there are limits on the total amount of tax free pension savings you can have. These limits were introduced from 6 April 2006. The limit on the contributions you can make each year into all pension arrangements is known as the annual allowance. The limit on the total amount of pension savings you are able to build up is known as the lifetime allowance. Any pension savings above these thresholds are subject to a tax charge.

Since April 2006 we have seen a number of reductions to the level at which tax charges might apply.

As a consequence this has increased the scope for people to be caught, bringing more moderate earners into the scope of these thresholds.

A little more detail

Lifetime allowance

The lifetime allowance restricts the amount of tax free benefits that you can have at retirement. Currently set at £1.5 million, the lifetime allowance will reduce to £1.25 million in April 2014.

What does this mean for you?

To find out if you might be affected by the reduction to the lifetime allowance you need to work out the capital value of your benefits, as it is this amount that is measured against the lifetime allowance. To calculate the capital value you must first calculate the value of your pension benefits in the LGPS. This calculation will vary depending on when you joined the scheme. Please see the example overleaf.

> “To find out if you are affected by this reduction you need to calculate your capital value.”

Calculating your capital value

Following changes made in 2008, Lindsay's service is split between two sections of the LGPS.

Pre-2008 section

A pension of 1/80 x pensionable salary for each year of service plus 3/80 x pensionable salary tax free lump sum.

Lindsay was in this section for 24 years.

Post-2008 Scheme

A pension of 1/60 x pensionable salary for each year of service. No automatic lump sum but an option to take a reduced pension in exchange for a tax free lump sum of 3/80 x pensionable salary for each year of service.

Lindsay joined the LGPS on 1 April 1984 and has 30 years membership in the scheme as at 31 March 2014. His pensionable pay as at 31 March 2014 is £150,000 and his pension benefits in the LGPS at that date are calculated as follows:

For membership to 31 March 2008	For membership from 1 April 2008
24/80 x £150,000 = £45,000 a year pension; plus 24 x 3/80 x £150,000 = £135,000 lump sum	6/60 x £150,000 = £15,000 a year pension

Total LGPS benefits - £60,000 pension plus £135,000 lump sum

The capital value of Lindsay's LGPS benefits is £1,335,000 which is calculated as follows:

Pension x 20 plus lump sum = £60,000 x 20 plus £135,000 = £1,335,000

In this example, the capital value of Lindsay's benefits is below the current lifetime allowance but is above the limit being introduced in April 2014.

What action can Lindsay take to prevent a tax charge?

Lindsay can choose to give up (commute) some of his pension in the Post-2008 section to increase his lump sum. If he does this, it will reduce the capital value of his benefits.

Example

If Lindsay decided to give up £12,500 of his annual pension he could provide a further lump sum of £150,000 (£1 pension to increase lump sum by £12). This will reduce his capital value to £1,235,000 which is calculated as follows:

Pension x 20 plus lump sum = £47,500 x 20 plus £285,000 = £1,235,000

This would bring his capital value below the new lifetime allowance but would reduce his annual pension. The financial implications of reducing annual pension should be considered before making any decision.

“You can reduce your capital value by giving up some of your pension in exchange for a tax free lump sum.”

What would happen if Lindsay was unable to reduce his capital value to below the lifetime allowance?

Where the capital value of LGPS benefits is above the lifetime allowance, the administering authority will deduct the tax charge directly from his benefits before they are paid. The amount of tax deducted will then be paid over to HMRC by the administering authority.

Protections

To help avoid penalising those individuals who may have pension rights over, or close to, the reduced lifetime allowance, HMRC has introduced a number of transitional protections, much as they have done in the past.

Fixed protection 2014 (FP2014)

This is similar to the previous fixed protection that was introduced in 2012 (now called fixed protection 2012). Members who are granted FP2014 will retain a lifetime allowance of £1.5 million but will have strict restrictions on future pension growth. The restrictions include no pension growth above the Consumer Price Index (CPI) in any one year and no pension savings in a new arrangement or new scheme, including additional voluntary contributions (AVCs).

FP2014 must be applied for by 5 April 2014.

Individual Protection (IP)

To be able to apply for IP the capital value of your benefits as at 31 March 2014 must be at least £1.25 million. Your individual protection is the capital value of your pension benefits up to a maximum of £1.5 million.

The real advantage of IP is that once granted, there is no restriction on future benefit growth. You will have until 5 April 2017 to apply for IP if you think it appropriate to your situation.

It is proposed that you can apply for both FP2014 and IP albeit that separate applications are required.

Members with enhanced protection

Historically, members of the LGPS with enhanced protection were able to keep this protection regardless of how much their benefits increased by. This is no longer the case. Anyone with enhanced protection should check their position with their pension team for clarification. If your enhanced protection has lapsed you may wish to apply for either FP2014 or IP.

What to do now!

- Check the capital value of your benefits. If the value is greater than £1.25 million you may need to apply for one of the protections described in this leaflet.
- If you have enhanced protection, check your position with your pension team.
- If necessary, take independent financial advice.

Not making the right decision may result in you paying additional tax.

Annual Allowance

The annual allowance restricts the amount that your pension savings can grow each year, without being subject to a tax charge. Originally set at £255,000 in 2006, it was reduced to £50,000 in 2011 and will reduce again from April 2014, this time to £40,000.

This means that any individual that earns in the region of £70,000 and receives above inflation pay rises could be liable for a tax charge.

Scheme Pays Option

Where any annual allowance tax charge exceeds £2,000 you can ask the pension scheme to pay the tax charge to HMRC for you and reduce your pension benefits to reflect this.

Remember that even after the reduction is applied you will still receive greater benefits than you would have been entitled to before your pay rise.

If you are liable for an annual allowance tax charge your pensions department must notify you by 6 October of the following year.

For more information on the topics covered by this newsletter you can visit the HMRC website at

www.hmrc.gov.uk/pensionschemes/lifetime-allowance.htm

Remember, the lifetime and annual allowances affect all your pension savings, so you will need to take into account your membership of any pension schemes outside the LGPS.

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