ASSOCIATION OF LOCAL AUTHORITY CHIEF EXECUTIVES AND SENIOR MANAGERS

PENSIONS — FREQUENTLY ASKED QUESTIONS

Tenth Edition – January 2017

ANNEX 2
THE ANNUAL ALLOWANCE (AA)

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1. What is the annual allowance (AA)?

The annual allowance (AA) is the amount by which your total pension pot (from all sources other than your national state pension) is allowed to increase during a "*pension input period or PIP"* roughly equivalent to a single financial year (see question 4 below) before the excess above it becomes subject to an income tax charge.

The AA is very different from the lifetime allowance and it is calculated differently. This has caused some confusion, not only for some ALACE members, but also for some pension funds which have been known to confuse the two calculations – so beware!

2. When was the AA first introduced?

It was first introduced on 6 April 2006, which is known as "A day".

3. How much is the AA?

In April 2006 the annual allowance was set at £215,000. Parliament increased it each year until 2010-11 when it was dramatically reduced to £50,000. It was further reduced from 6 April 2014 to £40,000. The table below gives the rate of AA for each tax year since it was introduced.

Tax Year	**Rate of AA**
2006-07	£215,000
2007-08	£225,000
2008-09	£235,000
2009-10	£245,000
2010-11	£255,000
2011-12	£50,000
2012-13	£50,000
2013-14	£50,000
2014-15	£40,000
2015-16	£80,000 (transitional rules apply see questions 7 and 8 below)
2016-17	£40,000 (unless tapering applied see questions 7 and 9 below)

4. How is my LGPS pension tested against the AA?

The tax charge is tailored, and intended to recover tax relief received on the contributions you have paid. It therefore will recoup the full marginal rate of tax from which you have benefited. The test is a measure of the growth in all your pensions (other than the state pension), including the growth in your LGPS lump sum, over a "*pension input period"* or PIP. From 6 April 2016 the PIP for the LGPS (and all other pension schemes) is aligned with the tax year – 6 April 2016 to 5 April 2017. Prior to 2016/17 the PIP for the LGPS was 1 April to 31 March, except for the year 2015/16 when special transitional rules applied (see questions 7 and 8 below).

When calculating pension growth, the benefits at the start of the PIP are increased by the CPI figure from the previous September. (For September 2015 the CPI figure was negative. The benefits at the start of the 2016-2017 tax year will not therefore be subject to any increase when calculating pension growth for 2016-2017.)

The difference between the value of the pension at the end of the PIP and the value at the beginning of the PIP (uprated by the relevant CPI increase – zero for 2016 - 2017) needs to be multiplied by a factor of 16 to calculate the pension growth. The difference between the lump sum at the end of the tax year and that at the beginning of the tax year (uprated by the relevant CPI increase) then needs to be added to the pension growth figure to give the benefit growth figure.

If the difference in the value of your total pension benefits at the end of the PIP less the value of your pension benefits immediately before the start of the PIP (adjusted by the relevant CPI increase), is more than the AA limit then you may be liable to pay a tax charge.

The AA then needs to be subtracted from the overall growth figure to calculate the amount on which tax will be charged.

5. What happens if my pension growth is greater than the AA?

If your pension growth exceeds the AA you will be taxed at your highest marginal income tax rate on the amount over the AA. Any growth is added to your taxable income, and will be subject to tax in line with the prevailing income tax thresholds. (For example if the *total net income* is currently above £150,000 a 45% tax charge will be levied; if below £150,000 but above £43,000 a 40% charge will be levied.) If you have unused allowances from the previous three years, you may be able to use these to offset the AA charge in whole or in part (see question 6 below).

6. What is carry forward?

If your pension growth in any one year exceeds the AA, you can use any unused AA from the previous three years to offset the tax charge. The maximum amount that can be carried forward is equivalent to the AA in each of the previous 3 financial years.

You may therefore find, if you have some carry forward, that – even if you exceed the AA in one year – the carry forward will reduce or even cancel out the AA tax charge. This is especially helpful if you have a large pay rise in any one year (perhaps following a promotion or taking on a new job).

Once an amount has been carried forward and used to offset a charge it cannot be used again so, if you are a consistently high earner, with many years of pensionable service, you may have little scope for carry forward.

7. How do I calculate the growth in my pension pot for AA purposes?

This is very complicated and **you may need help from your pension fund to do the calculations.**

Worked examples can be found in the Members' section of the ALACE website in the "*Pensions seminar (England) July 2015: Pensions tax relief changes*" presentation from Hymans Robertson. These examples do, however, largely relate to relatively straightforward situations where the new special transitional arrangements for the tax year 2015-2016 (see questions 7 and 8 below), and the new tapering arrangement introduced in April 2016 (see questions 7 and 9 below) do not apply.

Your pension fund has a statutory duty first to notify you if your LGPS benefits, plus the amount of any Additional Voluntary Contributions (AVCs) you may have paid, exceed the AA, and you consequently have an AA tax charge to pay in respect of those pension benefits; and, secondly, to ensure that the tax charge is paid to HMRC. Unfortunately the fund's duty is to notify you no later than the 6 October of the following tax year when it is too late to consider actions that may reduce the charge. If you want to know whether you are likely to incur a charge in the future then your pension fund may be willing to do the estimates for you. **If they are not, you can get the calculations done through ALACE's Pensions Calculations Service** (currently provided by Hymans Robertson) for a fee payable by you to them through ALACE. Hymans Robertson need to be contacted through our Consultants Cheryl Miller or Pete Morris and *not directly*. (If neither Consultant is available and the matter is urgent, please contact the Honorary Secretary.)

The Government also provides more information about the AA, including an AA checking tool, on its website at – https://www.gov.uk/tax-on-your-private-pension/annual-allowance

8. What are the special transitional arrangements for the 2015-2016 tax year?

The special transitional arrangements for 2015-2016 mean that 2 *pension input periods* or PIPs (see question 4 above) apply in that tax year.

The first PIP, for the ‘pre-alignment tax year’, relates to 1 April 2015 – 8 July 2015. The revised AA limit during this period is £80,000.

The second PIP, for the ‘post-alignment tax year’, relates to 9 July 2015 to 5 April 2016. The AA limit for this period is the amount of the £80,000 AA not used up from the pre-alignment tax year (subject to a maximum of £40,000) together with any carry forward from the three previous tax years.

(If you have flexibly accessed any benefits in a money purchase arrangement on or after 6 April 2015 you should contact your pension fund for information about how the pre and post alignment tax years will work as it will be different from above.)

9. How does the new tapering arrangement work for determining the AA?

From the tax year 2016/17 the AA is tapered for individuals who have a ‘Threshold Income’ in excess of £110,000, and an ‘Adjusted Income’ in excess of £150,000. For every £2 that your Adjusted Income exceeds £150,000, your AA is reduced (tapered down) by £1 (to a minimum of £10,000).

	Definition	**Limit**
Threshold Income	Broadly your taxable income after the deduction of your pension contributions (including AVCs deducted under the net pay arrangement)	£110,000
Adjusted Income	Broadly your threshold income plus pensions savings built up over the tax year	£150,000

Threshold income includes all sources of income that are taxable e.g. property income, savings income, dividend income, pension income, social security income (where taxable), state pension income etc.

Please note, you are not allowed to deduct from taxable income any amount of employment income given up for pension provision as a result of any salary sacrifice made on or after 9 July 2015.

The taper reduces the AA by £1 for £2 of adjusted income received over £150,000, until a minimum AA of £10,000 is reached. This means that from 6 April 2016 the AA for high earners is as follows:

Adjusted Income	**Annual Allowance**
£150,000 or below	£40,000
£160,000	£35,000
£170,000	£30,000
£180,000	£25,000
£190,000	£20,000
£200,000	£15,000
£210,000 or above	£10,000

Examples

William		
Gross Salary 2016/17	£120,000	
Less employee pension contributions	£13,680	11.4%
Threshold Income 2016/17	£106,320	Below £110,000 so the AA will not be tapered and remains at £40,000
Pensions saving in the year	£19,500	**Less than £40,000 so no tax charge**
George		
Gross salary 2016/17	£130,000	
Less employee pension contributions	£14,820	11.4%
Plus taxable income from property	£30,000	
Threshold Income 2016/17	£145,180	
Plus pensions saving in the year	£30,000	
Adjusted Income 2016/17	£175,180	Greater than £150,000 so AA will be tapered
Tapered AA	£27,410*	
In excess of AA	£2,590	Pension saving of £30,000 less tapered AA £2,590 x 40%)
AA tax charge at marginal rate (assumed to be 40%)	**£1,036**	
Katherine		
Gross salary 2016/17	£180,000	
Less employee pension contributions	£ 22,500	12.5%
Threshold Income 2016/17	£157,500	
Plus pensions saving in the year	£ 73,500	
Adjusted Income 2016/17	£231,000	Greater than £210,000 so AA will be minimum of £10,000
Tapered AA	£10,000	
In excess of AA	£ 63,500	Pension saving of £73,500 less tapered AA £63,500 x 45%
AA tax charge at marginal rate (assumed to be 45%)	**£28,575**	

*Taper = £175,180 - £150,000 = £25,180 / 2 = £12,590. Standard AA £40,000 less £12,590 = £27,410

Please note, the examples above make no allowance for any carry forward.

10. How do I pay the tax charge?

If you exceed the AA in any year <u>you</u> are responsible for informing HMRC on your self-assessment tax return. This applies irrespective of whether you pay or you opt for *Scheme Pays*.

If the tax charge is for less than £2,000 you will need to pay it through your self-assessment tax return which effectively gives a deadline of 31 January in the year following the tax year, i.e. for the 2015/16 tax year your tax return needs to be submitted by 31 January 2017. If you are going to opt for the *Scheme Pays* option, you need to tell HMRC in your tax return.

If the tax charge is greater than £2,000 then you may be able to opt to pay it through the "*Scheme Pays*" option. Under this option, a calculation will be made by your pension fund to see what tax is owed, and a payment will be made from your pension pot. This will have the effect of reducing the value of your pension pot. If you want your Fund to pay some or all of your AA charge you must notify your pension fund no later than 31 July in the year following the end of the tax year to which the annual allowance charge relates, i.e. for the tax year 2015/16, you must notify your Fund by 31 July 2017. If you are retiring, however, and become entitled to all of your benefits from the LGPS, and you want the LGPS to pay some or all of the tax charge on your behalf from your benefits, you must tell your pension fund before you become entitled to those benefits. Your pension fund should be able to tell you more about this and the time limits that apply. Given that you need to advise HMRC as part of your tax return that you are opting for *Scheme Pays*, it is advisable to discuss this matter with your Fund before you complete your tax return.

If you are retiring in the year when your AA charge is due you need to be aware that –

- the AA calculation is done in relation to your pension benefits prior to you deciding whether or not to commute some of your pension into lump sum;
- your pension pot will not be assessed in respect of the lifetime allowance tax charge (on which see Annex 1 to the main *Pensions: FAQs* document) until after the "scheme pays" reduction has been made;
- if you are retiring early, and your benefits are being actuarially reduced, the AA test will be applied to your actuarially reduced benefits;
- if you are retiring early on redundancy grounds, any redundancy payments will not be included in the AA test but, if you claim unreduced benefits as a result of giving up some or all of your redundancy payment, the AA test will be applied to your unreduced benefits;
- only those retiring on ill-health grounds who are retired on Tier 1 benefits – the most serious level of ill health retirement, on which see question 8 of the *FAQs* – will have their benefits exempt from the AA test.

11. How easy is it to breach the AA?

Given that a multiplier of 16 is included in the calculation, it is quite easy for the AA to be exceeded – especially if a high earner is also buying AVCs or the like, or receives added years as part of a retirement settlement, or receives any sort of pay rise (including pensionable Returning/Election Officer payments), and certainly if that pay rise is significant e.g as a result of a promotion or moving job or receiving a pensionable performance bonus. In the case of a large pay rise this will significantly increase the value of your pension and may result in a tax charge that can often exceed the pay rise by a number of times.

When inflation is low, and now that the accrual rate in the LGPS is $1/49^{th}$, it is very likely that a high earner with long service will exceed the AA – even without a pay rise. This is especially true, following the introduction of the new AA tapering arrangements from 6 April 2016 (see question 8 above), for anyone earning in excess of £110,000 pa.

It is therefore vital for everyone to monitor the growth in their pension pot each year to see whether they are likely to be subject to an AA charge. This is especially true for anyone who is offered a pay rise for whatever reason. In these circumstances you may want to check with your pension fund what the effect will be in relation to the AA. It may be that the phasing of a pay rise could affect the scale of your liability for a tax charge.

It is not only pay rises that can lead to tax charges in relation to the AA. If your pension pot increases by more than the AA for other reasons, e.g. because you have amalgamated past pension benefits into one pension, or been awarded added years for pension purposes, that too can lead to a very substantial tax charge.

12. How will any pay arrears I receive affect the AA tax charge calculation?

Any arrears of pay will be treated by HMRC as pension growth in the year that the payment is received.

13. Are there any exemptions from the AA tax charge?

The AA charge will not apply on death, or if someone is retired early on the most serious level of ill health retirement – Tier 1 benefits, on which see question 11 of the main *Pensions: FAQs* document.

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