ASSOCIATION OF LOCAL AUTHORITY CHIEF EXECUTIVES AND SENIOR MANAGERS

PENSIONS — FREQUENTLY ASKED QUESTIONS

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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 savings (from all sources excluding your national state pension) is allowed to increase tax free during a "*pension input period (PIP)"* normally a tax year. The excess above the AA is subject to a tax charge.

The AA calculations are undertaken annually whereas the Lifetime Allowance is assessed once at retirement . The methodology for determining pension growth in the year and the value of pension savings for LTA purposes are very different calculations.

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)
2016-17	£40,000 (unless tapering applies)
2017-18	£40,000 (unless tapering applies)
2018-19	£40,000 (unless tapering applies)
2019-20	£40,000 (unless tapering applies)

4. How do I find out what the growth is in my pension savings for AA purposes? What are my responsibilities?

Your Fund has a statutory duty to notify you if your LGPS benefits, plus the amount of any Additional Voluntary Contributions (AVCs) you may have paid, exceed the AA. They would also inform you if you had any unused allowances from previous years. This should be done by 6th October following the end of the tax year, i.e. 6th Oct 2019 for 2018/19.

If you have other pension savings, you will need to obtain from that Fund's administrator the value of pension growth in that Fund whether it is positive or negative.

It is your responsibility to gather this information and aggregate it.

It is also your responsibility to determine what your Annual Allowance is if it is subject to taper (see Q below). Your Fund administrator may try and help with this, but they will not know your net taxable income.

The AA taxable excess must be reported to HMRC by 31st January in the following calendar year, i.e. 2018/19 position must be reported by 31st January 2020.

For many members, this will be a challenging deadline particularly if the position was a "surprise".

Your Fund administrator may be willing to do estimates of Pension Input Amounts which would be useful if you are expecting a significant charge. This also gives an opportunity to check the PIA (pension growth) particularly if it was higher than you were expecting.

You can also get calculations done through ALACE's Pensions Calculations Service (provided by Hymans Robertson) for a fee payable by you to them through ALACE. ALACE cannot recommend this service but it is an option for ALACE members. Hymans Robertson will be contacted through the ALACE Pension Consultant, Pete Morris and *not directly*. (If the consultant is not 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

5. How is my LGPS pension growth calculated and tested against the AA?

The test is a measure of the growth on all your pension benefits (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) has been 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 question 8 below).

The value of pension benefits is: Value of pension earned*16 + Value of lump sum
A simplistic illustration below:

Say pension is £40k per annum and lump sum (earned on pension savings to 3/2008) is £60k

The value of benefits (40k*16)+£60k= £700k

When calculating pension growth, the value of benefits earned at the end of the preceding PIP are increased by inflation (CPI figure from the previous September) to give the Opening Value for the start of the new PIP.

Thus, say the value of Pension Benefits earned at 5/4/18 is £700k (i.e. the closing value for 2017/18 PIP.

The Opening Value for 2018 is 2017/18 closing value + 3% (inflation rate as at Sept 17)

£700k *1.03 = £721k

Say value of pension earned as at the end of the PIP is £43k and the lump sum was £61k

This would give a closing value of (16*£43k) + £61k = £749k

Pension Growth for the Year is determined by deducting the opening value of pension savings from the closing value at the end of the PIP. Thus, Pension Growth = £749k - £721k = £28k

With an AA of £40k , there is an used allowance of £12k that can be carried forward for up to 3 years to be offset against any future excess. There is no tax charge to pay.

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

If your pension growth exceeds the AA, the excess will be taxed at your highest marginal income tax rate on the amount over the AA. If you have unused allowances from any of the previous three years, you should be able to use these to reduce the excess and thus the AA charge in whole or in part.

The net excess is added to your total net taxable income.

It's likely that marginal tax rates will be either 40%, 45% or a mix of both

A rough calculation is illustrated in the table below.

2018/19	£k	£k
Pension Growth (Pension Input Amount)		80
Annual Allowance		40
Excess		**40**
Unused Allowances		
2017/18	6	
2016/17	4	
2015/16	10	
Unused Allowances applied		**20**
Excess		**20**
Tax – assume marginal rate of tax of 40%		**8**

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 special transitional arrangements for the tax year 2015-2016 (see question 8 below), and the tapering arrangement introduced in April 2016 (see question 9 below) do not apply.

7. What is carry forward?

If your pension growth in the tax 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 the unused AA in each of the previous 3 financial years.

Unused Allowances carried forward will either reduce or eliminate the excess and tax charge.

An unused allowance can only be used once, the oldest are used first.

If your pay is more than £125k, it is unlikely that you will have any unused allowances unless your pay increases are less than inflation.

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

The special transitional arrangements for 2015-2016 meant that 2 *pension input periods* or PIPs applied in that tax year.

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

The second PIP, for the 'post-alignment tax year', related to 9 July 2015 to 5 April 2016. The AA limit for this period was 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 work as it will be different from the explanation above).

9. How does the 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 all 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, 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 2017/18	£120,000	
Less employee pension contributions	£13,680	11.4%
Threshold Income 2017/18	£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 2017/18	£130,000	
Less employee pension contributions	£14,820	11.4%
Plus taxable income from property	£30,000	
Threshold Income 2017/18	£145,180	
Plus pensions saving in the year	£30,000	
Adjusted Income 2017/18	£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 2017/18	£180,000	
Less employee pension contributions	£ 22,500	12.5%
Threshold Income 2017/18	£157,500	
Plus pensions saving in the year	£ 73,500	
Adjusted Income 2017/18	£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? What is Scheme Pays?

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 the charge directly to HMRC or whether you opt for the *Scheme Pays* arrangement .

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 2018/19 tax year your tax return needs to be submitted by 31 January 2020. 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, your Fund pays the tax charge and offsets the cost by a reduction in your pension when it is brought into payment. The Scheme Pays calculation is undertaken by your Fund administrator using Government Actuaries Department factors that determines the reduction to pension.

If you opt to use the '*Scheme Pays'* option, then your Fund must pay your AA tax charge provided your charge is over £2,000 and provided the tax charge is based on the excess over the standard AA of £40,000. This part of the tax charge is known as the "*mandatory"* tax charge. If, however, part of the tax charge arises as a consequence of the tapering of your AA, then your Fund has the option not to pay this part of the tax charge, known as the "*voluntary"* tax charge, through the *"Scheme Pays"* option. Should you be the subject of a tapered AA you will therefore need to check with your pension fund whether they are prepared to use the *Scheme Pays* option to pay all of your tax charge or whether it is only prepared to pay the "*mandatory"* part of it – in which case you will be responsible for paying the *"voluntary"* part of it direct to HMRC.

If you want your pension 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 2018/19, you must notify your fund by 31 July 2020. However, this is <u>not</u> the case in relation to the *"voluntary"* part of any tax charge. The latest date at which the tax relating to a *"voluntary"* AA tax charge can be paid without you incurring an additional tax penalty for late payment is 31 January in the year following the end of the tax year in which the breach of the AA occurred (i.e. 31 January 2020 for a charge related to the 2018-19 tax year). This means that, if you have incurred an AA tax charge partly because you have a tapered AA, then you will need to ask your pension fund well ahead of 31 January deadline if they will let you use the *Scheme Pays* arrangement to pay the *"voluntary"* part of your AA tax charge, otherwise you will incur interest on that part of the tax charge. If they will not let you use the *Scheme Pays* arrangement to pay the *"voluntary"* part of your charge, then you must declare and pay that part of the charge direct to HMRC by 31 January otherwise you will incur an interest charge.

You should consult with your own Fund to check whether they have any local deadlines for Scheme Pays.

Your fund will give you an estimate of the pension offset that will be applied to recover the tax paid to HMRC and thus you can judge the value for money of the pension offset compared to you paying the charge directly. If you retire early, the pension offset will be reduced and, if you retire later than your normal pension age, it will be increased.

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 savings will not be assessed in respect of the lifetime allowance tax charge 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,– will have their benefit growth exempt from the AA test. If you are retiring on the grounds of ill health, you should check as early as possible with your Fund Administrator what any potential tax charge will be and the impact it has on the benefits to be brought into payment.

11. How easy is it to breach the AA?

Relatively easily

An AA of £40k equates to a real increase in pension for the year of £2,500.

A pay of £125k gives an increase in CARE pension of over £2.5k and assuming no other sources of additional taxable income or allowances (other than pension contributions), this would also result in income above Threshold Income for taper purposes and reductions to AA because of the taper will start to apply

Pension Growth will also include the increase in historical final salary benefits earned before April 2014 if there is a real increase in pensionable pay as roughly illustrated in the table below:

Pay £k	Value of Final Salary Benefits – SAY £k	Real Increase in Pay SAY %	Final Salary Pension Growth £k
100	600	20	120
150	1000	30	300
180	1000	5	50

If you have built up significant final salary benefits and you are promoted with a material pay increase, you will have a very significant AA tax charge as illustrated in the table above and for earners at the top of the LGPS range, a modest real pay increase will give significant pension growth reflecting the growth in CARE and Final Salary Benefits and an AA at the £10k minimum. It's unlikely that there will be any carry forward of unused allowances to partially offset the AA Excess and tax charge.

Any contributions to AVCs will add to pension growth, but in some cases, contributions may be useful in keeping a member below threshold income and thus maintaining an AA of £40k when taper would otherwise apply.

There are many other factors that could result in an increase in pension growth, such as:
- additional pension as part of a retirement settlement,
- additional income from pensionable other duties e.g. Returning Officer
- a pensionable performance bonus or allowance
- working beyond your normal retirement age
- a transfer of final salary benefits as a result of a new job

It is therefore vital for everyone to monitor the growth in their pension savings 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 and if your net pay is near threshold income, considering ways of keeping it below threshold income and thus maintain a £40k AA

12. 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.

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