

To: Salaries and Wages Departments  
Human Resources  
Pension Contacts

Circular 03/2011  
15 February 2011

At: All employing authorities

Dear Colleagues,

## **Restricting Tax Relief – Tax Reforms**

### **1. Purpose of this Circular**

This circular has been issued to advise employing authorities of the pension taxation reforms due to be introduced with effect from 6 April 2011. The proposed reforms were described briefly in circular 12/2010 that was issued in October 2010.

The purpose of these reforms is to reduce tax relief on pension contributions for high earners. However, this circular highlights that the new restrictions on pension savings and the method of calculation for those in defined benefit schemes has the potential to include more moderate earners who may have sudden increases in their pension benefits. If annual pension savings are more than £50,000 then an individual may be affected. The rules for working out pension savings are described in detail in this circular. Sudden increases in pension benefits can arise from awards of additional membership or pension usually on redundancy or efficiency grounds, increased membership awarded due to ill-health retirement and pay increases due to promotions or job evaluations. The potential tax charges can arise both during membership and at leaving. However, it is expected that the new carry forward facility for annual allowance will mitigate the tax charge in the majority of cases.

The tax reforms are complicated and it is important that, although this is a specialist area, employers are aware of situations which may give rise to potential tax charges for employees.

The actions for employers are:

- To be aware that any event which increases pension benefits could potentially give rise to tax charges;

- To recommend that employees, who believe that they may be affected by the new legislation, seek specialist independent financial advice as the impact varies depending on individual circumstances;
- To provide NILGOSC with its annual return including details of pensionable pay by 6<sup>th</sup> July following the end of the tax year (timescales are now statutory).

NILGOSC will be:

- Writing to all active members before 31 March 2011 to advise them of the new tax reforms and remind AVC contributors to review their levels of contributions;
- Creating a section on its website that will provide more detail on the impact of the tax reforms by 31 March 2011;
- Notifying individuals who have deemed contributions of over £50,000 in any tax year within six months of the end of the tax year; and
- Providing information on pension savings to a member within three months of a request.

The actions for those affected members will be:

- To notify HM Revenue and Customs of pension savings above £50,000 on the self assessment form; and
- To elect the method for paying any tax charge.

## **2. Background to the restriction of tax relief**

The Chancellor of the Exchequer's Emergency Budget in June 2010 proposed various changes to pensions, including repealing the legislation which included the restriction of tax relief on pension contributions by high earners introduced in the Finance Act 2010 and announced further consultations on alternative ways of recouping £3 billion to HM Treasury. The Government issued a consultation document on an alternative approach to restricting pensions tax relief in July 2010 and then confirmed its intended approach on 14 October 2010. The October statement confirmed the following:

- From April 2011, the annual allowance for tax-privileged saving (i.e. pension contributions to a defined contribution scheme or 'deemed contributions' to a defined benefit scheme) will be reduced from £255,000 to £50,000.
- The lifetime allowance (LTA) will be reduced from £1.8 million to £1.5 million from April 2012. The lifetime allowance is the value of pension benefits which an individual can accrue over his/her lifetime without incurring a tax charge.
- The pension savings amount in a defined benefit (DB) scheme, such as the LGPS (NI), is the increase in value of a member's pension benefits and will

be calculated using a 'flat factor' of 16. This means that an increase in annual pension benefit of £1,000 would be deemed to be pension savings of £16,000.

- In recognition of one-off spikes in pension accruals under DB schemes, for example pension increases arising from pay increases due to promotion, it is proposed that unused annual allowance from up to three previous years can be carried forward to offset the excess. An allowance of £50,000 will apply to each of the previous years.
- A further consultation followed on a range of options for payment of any tax charges incurred. It suggested that, in some cases, the charges could be paid from the pension fund and the member's future benefits reduced accordingly.

The Finance Bill 2011 was issued on 9 December 2010 and it contained details of the lifetime allowance (LTA) protections and annual allowance (AA) serious ill-health exemptions.

Further consultations are due to be issued in early 2011.

### **3. Annual Allowance, Pension Input Period and Exemptions**

The annual allowance (AA) is the maximum amount of pension saving that can be made each year to benefit from tax relief. This includes pension savings made by individuals as well as pension savings made for them by their employers. If an individual's pension savings is more than the annual allowance then a tax charge is due on the amount in excess of the annual allowance.

The annual allowance for 2010/11 is £255,000.  
The annual allowance for 2011/12 is reduced to £50,000.

The Pension Input Period (PIP) is normally a year and in the LGPS (NI) is defined in regulations as the period from 1 April to 31 March<sup>1</sup>.

There will be exemptions from the annual allowance charge for members who die or who commute their full benefit in circumstances of serious ill-health. The latest draft (mid-December 2010) of the Finance Bill 2011 states that a member satisfies the severe ill-health condition if the individual is entitled to all his/her benefits as a consequence of evidence from a registered medical practitioner that the ill-health makes the individual unlikely to be able to undertake gainful work (in any capacity) at any time in the future (other than to an insignificant extent) or is entitled to a serious ill-health lump sum. It is likely that the Committee's Medical Panel will have to certify whether this condition is met for those members who are being awarded the top tier of ill-health benefits under the LGPS (NI). It is also likely that there will be no exemptions for the second tier of ill-health retirement benefits. At present serious ill-health commutation is not a Scheme option but I understand that consideration is being given in the LGPS in England and Wales to reintroduce this facility.

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<sup>1</sup> Local Government Pension Scheme (Administration) Regulations (Northern Ireland) 2009, regulation 29 (3)

There is no exemption in the year that benefits come into payment, as at present, **so individuals retiring early with enhanced benefits e.g. augmented membership could have large pension input amounts for the period in which they retire and this may make them liable for tax charges.**

Deferred members are exempt from the annual allowance regime.

More information is available on HMRC's website at [www.hmrc.gov.uk/pensionschemes/annual-allowance/reduced.htm](http://www.hmrc.gov.uk/pensionschemes/annual-allowance/reduced.htm)

#### **4. How to calculate total pension savings and check this value against the annual allowance**

The method of calculating pension savings depends on whether the pension arrangement is a defined benefit or defined contribution arrangement.

##### **Defined Contribution**

In a defined contribution arrangement the pension savings amount is the total of all contributions made or credited in a pension input period ending in the relevant tax year for all registered pension schemes of which the individual is a member.

##### **Defined Benefit**

In a defined benefit arrangement, such as the LGPS (NI), the method of calculating the pension savings amount is more complicated and the increase in value of the benefits is calculated. The amount of annual pension accrued by an individual in a pension input period is calculated by subtracting the annual pension value at the start of the period (plus a revaluation allowance based on the Consumer Price Index, CPI) from the value at the end of the period. The same calculation is also applied to any lump sum. The difference in value is multiplied by a factor of 16, previously 10, to produce a capital value representing the individual's pension savings amount over the pension input period.

##### **Calculation of pension savings amount for LGPS (NI) members**

[(Pension Value End – (Pension Value Start x Pensions Increase)] x 16  
Plus  
Lump sum end – (Lump sum Start x Pensions Increase)  
Plus  
Any AVC contributions made over the year

The pre-commutation figures are used to calculate the pension savings amount, i.e. the value of standard benefits is used in the calculation before any election is made to convert pension to additional lump sum.

If the pension savings amount is less than the annual allowance there is no tax charge. If it is higher, any unused allowance from the three previous years can be carried forward and if it is still exceeded, tax is charged on the excess at the member's marginal rate.

The up-rating of opening values can result in negative lump sums. HM Revenue and Customs (HMRC) has confirmed that negative lump sums are not treated as zero and are simply aggregated in with the pension accrual.

**Members whose pension savings grow by more than £3,125 over a year could be affected, i.e.  $16 \times £3,125 = £50,000$  but it is expected that the carry forward provisions will reduce the likelihood of a tax charge arising for the majority of LGPS (NI) members.**

## **5. Example of calculation of used annual allowance for LGPS (NI) member with AVCs**

Clare belongs to the LGPS (NI) and accrues pension of  $1/60^{\text{th}}$  pensionable pay for each year of Scheme membership. She joined in 2009 and does not have a separate lump sum. The pension input period (PIP) runs from 1 April to 31 March.

Clare also pays 9% of her pensionable pay (assumed £20,000) to AVCs with Prudential.

At the start of the PIP Clare has 2 years' membership. Her pensionable pay is £20,000. By the end of the period Clare's pensionable pay has risen to £22,000.

### **Opening value**

Annual pension =  $1/60 \times 2 \times £20,000 = £666.67$

Multiply annual pension by flat factor of 16 =  $£666.67 \times 16 = £10666.72$

Increase by CPI of 3.1% =  $£10666.72 \times 1.031 = £10997.39$

**Clare's opening value is £10997.39**

### **Closing value**

Annual pension =  $1/60 \times 3 \times £22,000 = £1100.00$

Multiply annual pension by flat factor of 16 =  $£1100 \times 16 = £17600$

**Clare's closing value is £17600**

**Clare's pension savings amount for the LGPS (NI) is the closing value less the opening value =  $£17600 - £10997.39 = £6602.61$**

### **Pension savings amount for AVC arrangement**

$9\% \times £20,000 = £1800$

**Pension savings amount for AVC is simply £1800**

### **Clare's total pension savings amount for 2011/12**

Add together the pension savings amounts from the LGPS (NI) and the AVC:  
 $£6602.61 + £1800 = £8402.61$

**Clare's total pension savings amount is £8402.61.** This is less than the £50,000 annual allowance so no charge arises.

## 6. Carry forward of unused annual allowance

As HM Revenue and Customs (HMRC) recognised that there could be large spikes in accrual which could cause the AA charge to affect individuals who are not high earners it has introduced a carry forward facility for annual allowance. This allows individuals to carry forward any unused AA from any of the three previous years. The carry forward allowance has been set at £50,000 for each of the three tax years before 2011/12 (2008/09, 2009/10, 2010/11).

The CPI up-rating factors for each of these years are:

September 2007 (for use in 2008/09)	1.8
September 2008 (for use in 2009/10)	5.2
September 2009 (for use in 2010/11)	1.1
September 2010 (for use in 2011/12)	3.1

## 7. Illustration of carry forward provisions

The following basic illustration illustrates how carry forward provisions work.

Year	Value of pension savings amount	Annual allowance	Unused annual allowance
2008/09	£30,000	£50,000	£20,000
2009/10	£35,000	£50,000	£15,000
2010/11	£40,000	£50,000	£10,000
Unused annual allowance			£45,000

The carry forward from earlier years can be cancelled if contributions in subsequent years exceed £50,000 as illustrated below:

Year	Value of pension savings amount	Annual allowance	Unused annual allowance
2008/09	£30,000	£50,000	£20,000
2009/10	£80,000	£50,000	£0
2010/11	£40,000	£50,000	£10,000
Unused annual allowance			£10,000

Negative unused allowance counts as zero.

## 8. Exceeding the annual allowance (AA) – payment of the tax charges

**The excess pension savings over the AA will be taxed at the income tax rates which would apply if they were additional earnings on top of the individual's taxable income i.e. the member's marginal tax rate.**

The Government published a consultation document on 'Options to meet high annual allowance charges from pension benefits' in November 2010 and this consultation closed on 7 January 2011. The discussion paper suggested that an amount of the charge, somewhere between £2,000 and £6,000, could be met from income but any higher charge could be paid from pension benefits. It was

also proposed that the individual could choose at self-assessment whether to pay the charge immediately from pension benefits or defer its payment with interest until the date the pension comes into payment.

NILGOSC awaits the outcome of this consultation with interest as it would be administratively difficult to account for an outstanding tax charge during the period from the date it arises to the date of retirement.

## **9. Anti-avoidance**

It should be noted that the anti-forestalling provisions put in place in the Budget on 22 April 2009 to prevent high earners making substantial new contributions to their pensions up until 5 April 2011 continue in force until the end of the 2010/11 tax year and will then be replaced by the restrictions outlined in this circular.

## **10. Information Requirements**

Where individuals have pension savings amounts over their AA in pension arrangements the Scheme must provide the member with a statement of his/her pension savings amount for the relevant year within six months of the end of the tax year (i.e. 6 October). If individuals request the information then the Scheme has to provide details within three months of the request and within six months of the end of the tax year. Members will be entitled to one free request per year.

Employers must provide NILGOSC with information on pensionable pay and membership by 6<sup>th</sup> July following the end of the tax year. For the first year only, Schemes have an additional twelve months to provide the required information (up to 6<sup>th</sup> July 2013 or 6 October 2013). This is now a statutory requirement.

This means that employers must provide NILGOSC with timely annual returns. At present, the deadline for submitting annual returns is 31 May each year. Providing this deadline is met, NILGOSC will be able to provide members with their pension savings amounts within six months of the end of the tax year. It is possible that this notification could form part of the annual benefit statements exercise.

## **11. Lifetime allowance and transitional protection**

The Lifetime Allowance (LTA) is the amount of tax-favoured pension savings which an individual can amass during his/her working life. In the LGPS (NI) the LTA allowance is normally calculated as the value of a member's pension times 20 plus the value of lump sum plus the value of the AVC fund.

From April 2012, the Lifetime Allowance (LTA) for tax-privileged saving will be £1.5m (reduced from £1.8m in 2010/11). The LTA valuation factor for defined benefits will remain as 20.

The maximum tax-free lump sum continues to be 25% of the standard LTA. However, as the LTA is reducing, this does mean that the maximum lump sum will reduce from £450,000 to £375,000 in April 2012.

There may be some form of transitional protection for those who already have benefits in excess of £1.5m. Enhanced and Primary Protections in place will continue to apply. Those who have, or anticipate having, benefits valued in excess of £1.5m will be able to obtain 'fixed protection'. This is a fixed LTA of £1.8m and HMRC must be notified by 5 April 2012. Fixed protection will be lost if contributions are made to a money purchase arrangement e.g. AVCs or if the value of pension benefits in the defined benefit scheme increase by more than inflation (CPI). It is not clear whether an individual opting for fixed protection will have to opt out of his/her pension scheme. If this is the case, those individuals subject to auto-enrolment will need to opt out within one month of being auto-enrolled to avoid losing fixed protection.

Tax due on excess lump sums over the LTA is 55% and on excess pension benefits is 25%.

## **12. Trivial Commutation**

The Scheme regulations allow NILGOSC to pay a lump sum representing the capital value of a small pension to a member or surviving dependant of a deceased member providing the payment qualifies as a trivial commutation lump sum under the Finance Act 2004. There are several HMRC requirements relating to payment of a trivial commutation lump sum. One of these requirements is that the value of the member's total pension rights could not exceed 1% of the LTA.

From April 2012 trivial commutation will no longer be limited to 1% of the LTA and instead will be restricted to a total value of less than £18,000.

## **13. Summary of the impact of tax reforms on members of the LGPS (NI) and actions for employers and NILGOSC**

These changes are most likely to affect:

- Members on very high pensionable salaries
- Members who get significant pay increases on promotion or job evaluation
- Members who are awarded additional membership or pension
- Members retiring on ill-health grounds who are not unfit for all work
- Members making significant contributions to the in-house AVC fund. The levels of contributions may need reviewed.

It is still unclear whether members electing to aggregate pension benefits e.g. an old period of membership with a new period of membership could take themselves over the annual allowance thresholds. However, the tax could be mitigated if they have unused allowance to carry forward.

In the majority of cases we expect that the carry forward provisions will be able to offset any tax charge which may arise.

### Actions for employers

- Employers should recommend that employees, who believe that they may be affected by the new legislation, seek specialist independent financial advice as the impact varies depending on individual circumstances.
- Employers will need to provide NILGOSC with their annuals return including details of pensionable pay by 6<sup>th</sup> July following the end of the tax year (timescales are now statutory).

### Actions for NILGOSC

- Write to all active members before 31 March 2011 to advise them of the new tax reforms and remind AVC contributors to review their levels of contributions.
- Create a section on its website that will provide more detail on the impact of the tax reforms by 31 March 2011.
- Notify individuals who have deemed contributions of over £50,000 in any tax year within six months of the end of the tax year. The pensions administration software will be developed to enable the annual allowance to be monitored and to produce estimates for members. This programming is at proposal stage at present.
- Provide information on pension savings to a member within three months of a request.

### Actions for affected members

- To notify HM Revenue and Customs of pension savings above £50,000 on the self assessment form; and
- To elect the method for paying any tax charge.

## **14. Prudential meetings and review of level of AVC contribution**

Any additional contributions which are made to AVCs are included in the annual allowance. Our AVC provider, Prudential, is happy to explain the tax changes in more detail and this can be arranged either on an individual basis or by invitation to deliver a short 25-30 minute presentation at future management team meetings.

In addition, Prudential will be writing to its AVC contributors to remind them that they should regularly review their AVC contributions and this review should take place before the new tax year begins.

If you are interested in either the individual or group presentations please contact Tim McEwan on 07833 235216 or by email to [timcp.mcewan@prudential.co.uk](mailto:timcp.mcewan@prudential.co.uk).

Tim will be pleased to arrange a meeting at a mutually convenient time.

Finally, if you have any queries regarding the content of this circular then please contact either myself or Christina Hanna.

Yours sincerely

A handwritten signature in black ink that reads "Zena Kee". The signature is written in a cursive, slightly slanted style.

Zena Kee  
Pensions Manager

*This circular is for information purposes only and should not be used as a basis for making any decisions which depend on individual circumstances. The information is based on our current understanding of legislation and government proposals and it may change in the future.*