

## **Issues for high earners and those with very large salary increases**

You will be aware from our previous Announcement posted on 8 June 2009 that various changes were introduced in the 2009 budget to reduce the tax relief available to high earners.

[Announcement 8 June 2009 -](http://www.teacherspensions.co.uk/bulletin/article16.htm)

<http://www.teacherspensions.co.uk/bulletin/article16.htm>

The following summarises the potential affects on:

- high earners and also
- those who have had a large increase in accrued pension benefits, perhaps as a result of a significant promotion.

For those who may be affected by the Lifetime Allowance excess charge and/or the Annual Allowance excess charge, there is a link to an HM Revenue and Customs (HMRC) Help sheet below:

<http://www.hmrc.gov.uk/helpsheets/hs345.pdf>

### **ISSUE 1 - The Annual Allowance and the potential impact on members who have a significant increase in pension benefits during a scheme year**

The Annual Allowance was introduced on 6 April 2006 and acts to limit the tax relief that may be obtained on pension contributions in each year. It affects any member with a large increase in their accrued pension benefits during a relevant "Pension Input Period" (PIP). The PIP for the Teachers' Pension Scheme (TPS) is 1 April to 31 March to coincide with the Scheme year.

The Annual Allowance for 2009/10 is £245,000 and for the tax years 2010/11 to 2015/16, the Annual Allowance is set to remain at the level of £255,000. The growth in a member's benefits in a PIP is assessed against these amounts.

The potential effect of the Annual Allowance is demonstrated in the examples of Mr B and Mr N below. You will see that the risk of being affected by the Annual Allowance increases where the member has already accrued a longer period of service (Mr B) compared with someone who has shorter service (Mr N), even though the salary increase is the same.

Please note that in both examples, neither Mr B nor Mr N are retiring or planning to retire and in any event, the "excessive salary" provision is not relevant to the Annual Allowance assessment and the potential tax liability:

You should also be aware that the Annual Allowance charge is not applicable in the tax year in which benefits from all your pension schemes are taken.

The section of the HMRC Manual relating to the Annual Allowance charge can be found on the following link:

<http://www.hmrc.gov.uk/manuals/rpsmmanual/RPSM06100000.htm>.

### EXAMPLE 1

Mr B is a lecturer on a salary of £30,000 per annum and is appointed to a senior position at a Higher Education establishment on a salary of £80,000 per annum. The change took effect from 1 April 2009. Mr B had already accrued 40 years service at this date and having continuous service before 1 January 2007 accrues benefits with an automatic lump sum of 3/80ths for each year of reckonable service and a pension of 1/80ths for each year.

The growth in benefits during the PIP from 1 April 2009 to 31 March 2010 can be calculated using the following formula:

Total pension accrued to 31/3/2010 <b>(A)</b> x 10  (less)  Total pension accrued to 1/4/2009 <b>(C)</b> x 10	+	Total lump sum accrued to 31/3/2010 <b>(B)</b>  (less)  Total lump sum accrued to 1/4/2009 <b>(D)</b>
---------------------------------------------------------------------------------------------------------------------------	---	-------------------------------------------------------------------------------------------------------------------

**(A)** Total pension accrued to 31 March 2010

$$\frac{41}{80} \times £80,000 = £41,000 \text{ per annum}$$

**(B)** Total lump sum accrued to 31 March 2010

$$3 \times \frac{41}{80} \times £80,000 = £123,000$$

**(C)** Total pension accrued to 1 April 2009

$$\frac{40}{80} \times £30,000 = £15,000 \text{ per annum}$$

**(D)** Total lump sum accrued to 1 April 2009

$$3 \times \frac{40}{80} \times £30,000 = £45,000$$

*Hence, the amount to be assessed against the Annual Allowance is therefore:*

$$[(A \times 10) \text{ less } (C \times 10)] + (B \text{ less } D)$$

$$[(£41,000 \text{ p.a.} \times 10) - (£15,000 \text{ p.a.} \times 10)] + (£123,000 - £45,000)$$

$$(£410,000 - £150,000) + £78,000$$

$$£260,000 + £78,000$$

### **Growth in benefits assessed against the Annual Allowance = £338,000**

This amount exceeds the Annual Allowance for 2009/10 of £245,000. Mr B will therefore have a significant additional tax liability for the 2009/10 tax year which will be notified and collected by HMRC via self assessment:

#### *Calculation of Mr B's Annual Allowance Charge*

$$\begin{array}{r} \text{(less)} \quad \text{£338,000} \\ \quad \quad \text{£245,000} \\ \hline \text{£93,000} \end{array} \times 40\% = \text{£37,200 tax}$$

Hence although Mr B has been promoted, he will incur a significant tax liability on account of the increase of his accrued benefits.

Please note that the tax liability would increase if Mr B had any other accrual of pension or paid contributions to another registered pension scheme e.g. Contributions paid in respect of Additional Voluntary Contributions (AVCs), other registered pension arrangements or Additional Pension purchased in the TPS during the tax year.

In these circumstances, the member must notify HMRC on their self assessment tax return (SATR). The section relating to the Annual Allowance can be found in the Supplementary pages of the SATR. The Supplementary page of the SATR and notes on the HMRC website for the tax year ending 5 April 2009 can be found on the following links:

<http://www.hmrc.gov.uk/forms/sa101.pdf>

<http://www.hmrc.gov.uk/worksheets/sa101-notes.pdf>

#### **EXAMPLE 2**

Mr N is also a lecturer on a salary of £30,000 per annum and is appointed to another senior position at a Higher Education establishment on a salary of £80,000 per annum. The change took effect from 1 April 2009. Unlike Mr B, Mr N has accrued 25 years service at this date. Mr N also has continuous service before 1 January 2007 and therefore like Mr B accrues benefits with an automatic lump sum of 3/80ths for each year of reckonable service and a pension of 1/80th for each year.

#### **(A) Total pension accrued to 31 March 2010**

$$\frac{26}{80} \times \text{£80,000} = \text{£26,000 per annum}$$

#### **(B) Total lump sum accrued to 31 March 2010**

$$3 \times \frac{26}{80} \times \text{£80,000} = \text{£78,000}$$

**(C) Total pension accrued to 1 April 2009**

$$\frac{25}{80} \times \text{£}30,000 = \text{£}9,375 \text{ per annum}$$

**(D) Total lump sum accrued to 1 April 2009**

$$3 \times \frac{25}{80} \times \text{£}30,000 = \text{£}28,125$$

*Hence, the amount to be assessed against the Annual Allowance is therefore:*

$$[(A \times 10) \text{ less } (C \times 10)] + (B \text{ less } D)$$

$$[(\text{£}26,000 \text{ p.a.} \times 10) - (\text{£}9,375 \text{ p.a.} \times 10)] + (\text{£}78,000 - \text{£}28,125)$$

$$(\text{£}260,000 - \text{£}93,750) + \text{£}49,875$$

$$\text{£}166,250 + \text{£}49,875$$

**Growth in benefits assessed against the Annual Allowance = £216,125**

This amount is within the Annual Allowance for 2009/10 of £245,000 and therefore Mr N will not have an additional tax liability for the 2009/10 tax year, provided that he has not made any additional pension provision which valued at more than £28,875. If this were the case, the balance would be taxed at 40%:

**ISSUE 2 - The Special Annual Allowance Charge**

The impact of the 2009 budget was covered in the Announcement dated 8 June 2009.

**[TECHNICAL ISSUES: Budget – The impact on High Earners](http://www.teacherspensions.co.uk/bulletin/article16.htm)**

**<http://www.teacherspensions.co.uk/bulletin/article16.htm>**

Amongst a raft of changes affecting high earners, the Chancellor announced that from 6 April 2010, a new 50% tax band (for taxable income over £150,000) will be introduced together with changes made to the personal allowance for high earners. Restrictions on tax relief will take effect from 6 April 2011, but in the interim period, the government has introduced “anti-forestalling” measures which are detailed below.

***A helpful Questions and Answers document in respect of the Anti-forestalling legislation can be found on the following HMRC webpage***

**<http://www.hmrc.gov.uk/budget2009/anti-forestalling-qa.pdf>**

**The position up to 5 April 2011 – The “Special Annual Allowance” charge**

In the run up to 6 April 2011, high earners may be subject to a “special annual allowance” (SAA) charge in respect of additional pension savings made.

Up to 21 April 2009, it was possible for all higher rate tax payers to obtain tax relief at their marginal rate of tax in respect of all benefits accrued. On 22 April 2009, the Chancellor introduced the SAA which restricts the amount of tax relief a high earner can obtain in respect of pension savings.

In the 2009 Budget, a high earner was defined as a person with income exceeding £150,000 per annum or over in any tax year from 6 April 2007 to 5 April 2011. This would incorporate all taxable income and the member's pension contributions. Redundancy payments over £30,000 will also count in a person's income. The pre-Budget Report (PBR) published on 9 December 2009 confirmed that the income level at which the SAA applies is reduced to £130,000 from that date onwards, so potentially affecting more members with this level of income.

A member will only be affected if their input to all registered pension schemes is valued at more than the SAA in either tax year 2009/10 or 2010/11. The SAA is £20,000 but there is the potential to be increased to £30,000 if the member has a history of contribution payments on a less than quarterly basis for the three tax years prior to 2009/10. Any pension savings prior to 22 April 2009 will not be affected. In defined benefit schemes such as the TPS, the value of benefits accrued in a tax year has to be assessed.

If a member is a high earner with pension savings in a tax year of more than the SAA then they will need to assess how much, if any, of these savings are protected from the SAA charge.

Broadly speaking, any regular pension savings pattern established prior to 22 April 2009 will be protected and even if they exceed the SAA will not result in a tax charge. Contributions made on a quarterly or more frequent basis will be regarded as regular for this purpose. Therefore, any one-off or annual payments will not be regarded as protected.

An individual's remaining SAA is calculated by deducting the amount of protected pension savings from the SAA (restricted to zero). The amount remaining is the amount of non-regular or new pension savings that can be accrued in a tax year without becoming subject to a tax charge.

### **EXAMPLE**

Mr Q has left his position as a director of a home products company where he received a salary over £150,000 per annum and returned to pensionable teaching employment. He is therefore potentially affected by the SAA. Although he has taken a drop in salary to £120,000, he also has annual rental income of £10,000 which would mean that he would be affected by the SAA in any case (see above).

Having started work with his new employer on 1 April 2009 on a salary of £120,000 he automatically accrues pension benefits at a rate of 1/80th pension and a tax free lump sum 3/80<sup>th</sup> for each year of reckonable service. Mr Q has no other pension savings and there has been no pattern of extra contributions by way of Additional Pension or AVCs.

The "protected pension input" in respect of pension accrual for 2009/10 is lower than the SAA. Hence there is only limited scope to accrue further benefits and

not be affected by the SAA. The “protected pension input” as a member of TPS is calculated as follows:

Value of pension:  $1/80 \times \text{£}120,000 = \text{£}1,500 \times 10 = \text{£}15,000$

Value of tax free cash:  $3/80 \times \text{£}120,000 = \text{£}4,500$

Total value:  $\text{£}19,500$

SAA applicable to Mr Q is  $\text{£}20,000$

**Mr Q’s remaining SAA =  $\text{£}20,000 - \text{£}19,500 = \text{£}500$**

Therefore, if Mr Q decided to invest in an AVC or other “defined contribution” (DC) arrangement, and paid a one off amount of  $\text{£}5,000$  on 1 May 2009,  $\text{£}4,500$  of this would be subject to the SAA charge because he only had a remaining allowance of  $\text{£}500$ .

Alternatively, if Mr Q had bought  $\text{£}500$  per annum of Additional Pension on 1 May 2009 in the 2009/10 tax year instead of AVCs, he would similarly be affected to an SAA charge. The Additional Pension purchased would also be valued at  $\text{£}5,000$  (i.e.  $\text{£}500$  per annum Additional Pension  $\times 10 = \text{£}5,000$ )

In both cases, the SAA charge would be as follows:

Extra Input during 2009/10:	= $\text{£}5,000$
(Less) Available SAA:	= <u><math>\text{£}500</math></u>
Amount subject to the SAA charge:	= $\text{£}4,500$

The SAA charge will be at a rate of 20% for 2009/10 but will be amended for 2010/11. The payment of this tax charge is the responsibility of the member and should be submitted through their Self Assessment Tax Return.

The SAA charge has the potential to affect high earners in the TPS who are looking to:

- Make payments on a less than quarterly basis into a registered pension scheme; or
- Increase contributions towards AVCs, other registered pension schemes or purchase Additional Pension; or
- Start accruing benefits in a new pension arrangement; or
- Receive a redundancy payment in excess of  $\text{£}30,000$ .

The details given above are only intended to provide a very broad description of the SAA charge. Therefore, high earners may wish to take independent financial advice on these matters to discuss the implications of the SAA in respect of their pension benefit arrangements.

You should also be aware that in a defined benefits schemes such as the TPS, the SAA charge is not applicable in the tax year in which benefits under that arrangement are taken.

### **The position from 6 April 2011 – The reduction in tax relief on pension contributions**

From 6 April 2011, there will be a restriction on tax relief available for pension contributions where an individual has income which includes the value of all pension savings of more than £150,000.

The value of pension savings will include the value of employee and employer contributions to a DC arrangement and the total value of defined benefit accrual including the element funded by the employer.

The tax relief on all pension savings (including the employer element) in relation to the individual will be tapered downwards for income above £150,000, so that for those earning over £180,000 relief will be worth 20%, the same as that for a basic rate taxpayer.

In the PBR, the Chancellor confirmed that if an individual's income is less than £130,000 without including the value of the employer's contribution, then the individual will not be subject to the tax relief restrictions.

A consultation is underway regarding the restrictions on tax relief for pension savings from 2011. Further details will be issued when the consultation has been finalised.

### **ISSUE 3: The Lifetime Allowance (LTA) Charge and the possible loss of "Enhanced Protection"**

This issue of the LTA and the protections available from the LTA charge has been covered in a previous Announcement dated 6 April 2006, the link to which is set out below:

#### **[LTA Announcement.....](http://www.teacherspensions.co.uk/bulletin/article8.htm)**

<http://www.teacherspensions.co.uk/bulletin/article8.htm>

For your information, the section of the HMRC Manual relating to the Lifetime Allowance charge can be found on the following link:

<http://www.hmrc.gov.uk/manuals/rpsmmanual/RPSM11100000.htm>

The LTA for the tax year 2009/10 is £1,750,000 increasing to £1,800,000 for the tax years 2010/11 to 2015/16.

An example of how the LTA can affect a member's benefits is set out below:

**Example 1: - Annual pension and lump sum for Mr Y**

Mr Y has no protection certificate in place from HMRC. Mr Y has decided that he does not wish to convert any of his pension to an extra retirement lump sum.

The pension coming into payment in the 2010/11 tax year is a pension of £85,000 per annum which, for valuation purposes against the LTA, is multiplied by 20. The automatic retirement lump sum is 3 times Mr Y's pension. The LTA for 2010/11 is £1,800,000.

**Valuation against the LTA as follows:**

Annual pension: £85,000 per annum x 20	=	£1,700,000
Plus retirement lump sum, which is 3 times the member's initial pension (£85,000 x 3) of	=	£255,000
		<hr/>
Value of benefits against the LTA	=	£1,955,000

This represents a value against the LTA of 108.61% of the LTA at retirement.

As the benefits exceed the LTA for the tax year, an LTA charge is applicable in respect of the "chargeable excess" of £155,000.

As the benefits in excess of the LTA are paid as pension, the additional tax rate payable is 25% of the excess. The tax rate is calculated as follows:

$$£155,000 \times 25\% = £38,750 \text{ which is paid to HMRC by the TPS.}$$

Mr Y's annual pension is reduced initially by the following amount and this reduction will remain in place for each subsequent year, adjusted for pensions increase, for the remainder of Mr Y's life:

$$\begin{aligned} \text{Amount of tax divided by 20} &= \text{initial annual reduction deducted for life} \\ \text{Initial annual reduction } \frac{£38,750}{20} &= £1,937 \text{ per annum} \end{aligned}$$

### **Example 2: - Annual pension and lump sum for Mr Z**

As with Mr Y, Mr Z also has no protection from the LTA charge. Mr Z's standard pension coming into payment in the 2010/11 tax year £85,000 per annum. Mr Z has decided to convert part of his pension into the maximum lump sum allowed by HMRC. The overall HMRC maximum lump sum is one quarter of the LTA and Mr Z is affected by this upper restriction on the lump sum payable. The maximum lump sum Mr Z can be paid is calculated as follows:

$$\frac{\pounds 1,800,000}{4} = \pounds 450,000$$

In order to obtain this higher lump sum, Mr Z would need to convert £16,250 of annual pension to obtain an extra retirement lump sum of £195,000 on top of the existing automatic lump sum of £255,000.

Mr Z's net pension after exercising the conversion option is £68,750 per annum.

#### **Valuation against the LTA as follows:**

Reduced annual pension: £68750 per annum x 20 = £1,375,000

Plus retirement lump sum, which  
after conversion of pension is the maximum allowable = £450,000

---

Value of benefits against the LTA = £1,825,000

This represents a value against the LTA of 101.39% of the LTA at retirement.

As the benefits exceed the LTA for the tax year, an LTA charge is applicable in respect of the "chargeable excess" of £25,000.

As the benefits in excess of the LTA are paid as pension, the additional tax rate payable is 25% of the excess. The tax rate is calculated as follows:

$$\pounds 25,000 \times 25\% = \pounds 6,250 \text{ which is paid to HMRC by the TPS.}$$

Mr Z's annual pension is reduced initially by the following amount. This reduction will remain in place for each subsequent year, adjusted for pensions increase, for the remainder of Mr Z's life:

Amount of tax divided by 20 = initial annual reduction deducted for life

$$\text{Initial annual reduction } \frac{\pounds 6,250}{20} = \pounds 312.50 \text{ per annum}$$

For those with large pensions accrued up to 5 April 2006 who applied for either “Primary” or “Enhanced” Protection (or both), by 5 April 2009 the effects of the LTA charge may be mitigated.

Members who applied for Enhanced Protection need to be aware of the possibility that Enhanced Protection can be lost in certain circumstances:

e.g. if a contribution is paid to a money purchase arrangement after 5 April 2006

or

the growth in the value of the member’s benefits exceeds the “Appropriate Limit” giving rise to “relevant benefit accrual.”

If such an eventuality occurs, the member must surrender their Enhanced Protection Certificate to HMRC.

**All high earners and those with a protection certificate are advised to take independent financial advice on these matters.**