Annual Allowance and the LGPS

The annual allowance is the amount by which the value of the pension benefits can increase in one year without there being a tax charge payable. In the Local Government Pension Scheme (LGPS), the period is from 1st April to 31st March, and is referred to as the 'Pension Input Period' (PIP).

From 6th April 2014, the amount of annual allowance reduced from £50,000 to £40,000.

The majority of scheme members will not be affected by the change but the reduced threshold has potential to affect members who receive a substantial pay increase coupled with significant membership of the Scheme.

Where the annual allowance is exceeded the tax liability can be substantial. However there is a mechanism within the Scheme in certain cases (explained below) for the tax liability to be paid by the pension fund in return for a permanent reduction in benefits and it is worth noting that in most cases the benefits with reduction still outweigh the value the benefits would have been had the member not taken the pay rise that caused the annual allowance to be exceeded.

Basic Formula

The formula used to calculate the annual allowance is as follows:

Value of Benefits at End of the PIP minus Value of Benefits at the Beginning of the PIP

Value of benefits is calculated by multiplying the amount of annual pension by 16 and adding any lump sum and Additional Voluntary Contributions (AVCs).

Rises in the cost of living during the PIP are taken into account to ensure a reasonable comparison of benefits is made.

Details of your pensions input amount will be supplied on your annual pension forecast; however we would contact you separately with further information if you exceeded the annual allowance.

Exceeding the Annual Allowance

Where the increase in the value of the benefits exceeds £40,000, the excess will be subject to tax at the rate applicable for the amount of income received in the relevant tax year.

The tax rate that's charged depends on any other taxable income you have. The amount of your pension savings that exceeds your annual allowance is added to any other taxable income for that tax year, meaning the excess will be taxed at your marginal tax rate.

However, it is possible to carry forward any unused annual allowance from the previous three tax years; therefore, someone who exceeds the allowance in 2014/15 will be able to use any unused allowance from 2013/14, 2012/13 and 2011/12.

The Scheme member is responsible for paying the annual allowance tax charge; however in certain circumstances you can ask the Pensions Authority to pay the tax for you in exchange for a reduction in your pension pot. This is known as Scheme Pays.

Where any annual allowance tax charge exceeds £2,000 a member can ask South Yorkshire Pensions Authority to pay the tax charge to HMRC and reduce pension benefits to reflect this.

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Example 1

At the 1st April 2014, a member has 25 years' membership, some of which is pre-31st March 2008 where it accrued a lump-sum, and their pensionable pay was £42,000

A year later at 31st March 2015, the member has another year's membership making 26 years, and their pensionable pay has risen to £49,000

Opening Balance

At the start of the PIP, the annual pension was **£14,175** and the lump-sum was **£29,925**.

The value of the benefits at the start of the PIP, 1st April 2014 are:

Factor of **16** x **£14,175** =

Annual pension	**£226,800.00**
Lump-sum	+ **£29,925.00**
	= **£256,725.00**
Assume benefits are increased by 2.7% inflation =	+ **£6,931.58**
Value of the benefits =	**£263,656.58**

Closing Balance

The annual pension is now **£17,537.50** and the lump-sum is **£34,912.50**.

The value of the benefits at the end of the PIP, 31st March 2015 are:

Factor of **16** x **£17,537.50** =

Annual pension	**£280,600.00**
Lump-sum	+ **£34,912.50**
	= **£315,512.50**

Annual allowance increase for the year

£315,512.50 - £263,656.58 = **£51,855.92**

Excess above £40,000 subject to tax = **£11,855.92**

AA tax charge at marginal rate (assumed to be 40%)

£11,855.92 x **40%** = **£4,742.37**

Whilst this member would most likely have tax relief from previous years, for the purpose of this example we will assume that the tax is due and that the member has elected for Scheme Pays instead of simply paying the tax.

Example 2

Scheme Pays Option

The Scheme Pays option is available where:

- The annual allowance with the Scheme exceeds £40,000; and
- The annual allowance tax charge you need to pay exceeds £2,000

As this member's annual allowance tax charge exceeds £2,000 the pension scheme can pay the tax charge to HMRC and reduce the member's pension benefits to reflect this.

The formula for calculating the pension offset is:

Annual Allowance TAX/Annual Allowance Factor

AA Tax =	**£4,742.37**
AA Factor = (which is the Scheme Pays factor for a male member aged 45 based on a retirement age of 65).	**9.45**
4,742.37/9.45 =	**£501.84**

Annual Pension - reduction = New Annual Pension

£17,537.50 - £501.84 = £17,035.66

The reduction in pension applies only to the member's pension. Dependants' benefits are not affected.

The debit will increase every year in line with CPI and will be adjusted if this member's pension is paid early or late.

What if the member didn't accept the pay rise?

If the above member had chosen not to accept the pay rise in order to avoid the annual allowance tax charge then they would have an annual pension of **£15,032.14** compared to an annual pension of **£17,035.66** (which includes the reduction in pension). *See example below.*

At 31st March 2015 the member has 26 years membership, if they choose not to accept the pay rise this member's pensionable pay will remain at £42,000

19 Years x 1/80 x **£42,000** =	**£9975.00**
6 Years x 1/60 x **£42,000** =	**£4,200.00**
1 Year x 1/49 x **£42,000** =	**£857.14**
Total Pension	**£15,032.14**

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Find out more

Irrespective of what you decide to do, if you exceed the annual allowance you need to tell HMRC about your tax charge (usually through the completion of a Self-Assessment tax return). South Yorkshire Pensions Authority cannot do this for you. For more information about telling HMRC of your annual allowance tax charge & how to pay it visit:
http://www.hmrc.gov.uk/pensionschemes/calc-aa.htm#5

You may also wish to seek specialist financial advice. If you need help dealing with any tax issues you should contact an independent tax specialist or HMRC. There are all kinds of information on the HMRC website, and we've found a particularly useful guide at:
http://www.hmrc.gov.uk/pensionschemes/aa-ps.htm

Next Steps

If you think you will be affected by this measure you may wish to seek specialist financial advice.
https://www.unbiased.co.uk/

For more information please contact us at;

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