Taxing times for pension savers.

Firefighters pension schemes are widely regarded as among the most generous in the UK. That's great news! But HMRC restrictions on tax relief for pensions can restrict the amount of pension (and lump sum) that can be delivered by the Schemes and firefighters may be concerned about how these tax rules impact on their pension savings.

This article looks at the HMRC Pension Tax restrictions and how they may affect firefighters pensions.

Why are there restrictions on pension saving?

In 2017/18 the amount of income tax relief provided to pension savers by HMRC is estimated at around £40 billion[1]. That's a lot of money! And about 50% of that relief goes to just the top 10% of taxpayers[2].

Tax and pensions go hand-in-hand. Contributions to pensions are tax-free, most growth in your pension is tax free and when you take your benefits you can take up to 25% of the value of your pension tax free. That generally means that pension saving is a pretty tax-efficient way of saving.

But because the Government "gives" so much tax away there are restrictions on how much you can save into a pension. These restrictions limit your yearly growth in pension savings; the Annual Allowance, and your total pension value; the Lifetime Allowance.

These two allowances were introduced in April 2006. Initially they were set at £215,000 for the Annual Allowance and £1,500,000 for the Lifetime Allowance and they replaced a very complex set of tax rules. This was known as Tax Simplification – hold that phrase in your mind!

Initially very few people were affected by these levels. However, the allowance levels have been reduced regularly. HMRC are now "saving" about £6bn in relief because of the allowances and their reductions – a lot of which was going to "*subsidise wealthy people's pensions".[3]*

The Standard Annual Allowance for the 2019/20 tax year is £40,000 and the Lifetime Allowance is £1,055,000. Significant amounts, and you may dream about this level of pension saving, but many people are affected by one or the other, or sometimes both of these.

There's a sting in the tail for "higher earners" too. If someone has taxable income over £150,000 (which includes the amount saved into their pension) the Annual Allowance may be further reduced to as low as £10,000. This is known as the Tapered Annual Allowance.

Any pension savings that exceed the allowances are subject to tax charges. These can be eye-watering amounts! Your pension scheme can help here and a system called "Scheme Pays" can settle your tax bill and (effectively) loan you the money which they then recover from your pension when you retire.

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[1] Source. Combined amounts for savings made to registered pension schemes and employer contributions. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/675345/Dec_17_Main_Reliefs_Final.pdf

[2] Source. Treasury select committee report published 28 July 2018. Household finances: income, saving and debt Chart 5.1

[3] Source. Treasury select committee report published 28 July 2018. Household finances: income, saving and debt Para 116

What Firefighters are affected – and why?

It's usually, but not always, only the higher earners who are affected by the tax allowances. But due to the way that pension savings are calculated for pensions like the Firefighters' schemes the Annual Allowance may be exceeded by someone with long service getting an increase in pay through promotion, or starting to receive a new pensionable payment, like the 20% flex payments. So it can affect Watch Managers being promoted to Station Managers, or Station Managers starting to receive a flex allowance.

The increase in pensionable pay flows through to an increase in pension and as HMRC look at the growth in your pension each year for the Annual Allowance (and use a complicated formula to measure this – see below) it will depend on when you had the increase in pay as well as how much it was for. Unless your pay increases significantly each year it is unusual to be regularly above the Annual Allowance unless your pay is higher (above £70,000) and your service is long (above 20 years). Everyone is different though and how your pay has changed in recent years and whether you make any other pension savings can change this.

How pension savings are tested against the annual allowance.

It's not how much you have paid in! In a defined benefit pension scheme like the FPS and NFPS the way that HMRC measure the growth in your pension savings is by comparing your pension at the end of the tax year with the revalued pension from the beginning of the tax year. Then they multiply the difference by 16 to approximate the overall value of this extra pension.

Pension 5th April 2018 minus (Pension at 6th April 2017 + CPI) x 16 = Pension Input Amount

The result is tested against the Annual Allowance and if it is bigger a tax charge may be due.

For someone who's pension is now £35,000pa but last year it was £31,000 it would look like this;

£35,000 – (£31,000 +3%) which is £35,000 - £31,930 = £3,070

£3,070 x 16 = £49,120   This is the Pension Input Amount.

The Annual Allowance is £40,000 so there is currently £9,120 more than HMRC allow. If you haven't used all your annual Allowance in the three previous tax years you can use these unused allowances, starting with the oldest, against any excess amount this year.

For the last three tax years the Pension Input Amounts and Annual Allowances were

Year	Pension Input Amount	Annual Allowance	Unused amount
2016/17	£35,000	£40,000	£5,000
2015/16	£40,000	£40,000	NIL
2014/15	£22,000	£40,000	£18,000

The unused allowance of £18,000 from 2014/15 is more than the £9,120 excess so there is no tax charge to pay. For the next tax year any unused allowance from 2014/15 would not be available but the unused £5,000 from 2016/17 would be, if required.

Annual Allowance – it's all about YOU!

It's up to *you* to assess whether *you* have pension savings more than the Annual Allowance. If there is a tax charge this is declared through self-assessment and tax is payable at your marginal rate. The point about self-assessment is that this means it is up to *you* to tell HMRC if *you* have tax to pay. How do *you* know?

Your pension scheme may tell you if your pension savings exceed the Standard Annual Allowance (they should do this by 6th October each year) but if you have several pension schemes or are affected by the taper they don't have to do this – *you* will have to ask. They will send you a Pension Savings Statement that shows how much your pension savings are for the last tax year and the three previous tax years. It is up to *you* to work out if you have exceeded the Annual Allowance and/or if *you* are affected by the taper.

If you are it doesn't stop there. *You* have to work out how much tax is due, and *you* have to declare the tax charge to HMRC and *you* must also pay the tax. *You* can pay HMRC directly, or *you* can ask if your pension scheme may be able to pay your tax bill for you (known as Scheme Pays) and (if they will) in return, they will reduce your pension to pay for the tax – how they do this depends on which scheme you are in - and there are rules about when they can do this and deadlines that *you* have to meet.

The onus is on *you* to do a lot of the work – (nearly ALL the work!)

Lifetime Allowance – not a limit on living!

Lifetime Allowance values can be estimated at any time but are only tested when you take your pension. This used to be known as "retirement" but now HMRC call these "Benefit Crystallisation Events" (BCE). Catchy name! There are about 12 BCEs and each represents a different way of you taking some or all of your pension; like taking a lump sum or buying an annuity or moving funds into drawdown. Each time you take some of your benefits you will use up part of your Lifetime Allowance and when you have used up 100%, any pension savings left, and any further BCE's, are likely to mean a Tax Charge is due.

Your pension scheme or provider provide help here and they can work out the tax charge and can pay this to HMRC directly (on your behalf), again, reducing your benefits to recover the tax. There are two different tax charges depending on whether you take the amount above the Lifetime Allowance as a pension (tax charge of 25%) or as a single payment (55% tax charge). If you do take the excess amount as pension you will still pay income tax on the remaining 75%, so for higher rate tax payers this works out broadly the same as the 55% single payment rate. Ow!

Don't forget the good bits

We see people regularly who focus on the tax charge and forget that behind this are still significant amounts of money that do benefit from tax-relief. It's only the excess amounts that are taxed and that means that your pension can grow by £2,500pa before you are considered to have breached the £40,000 Annual Allowance. And if your pension hasn't grown by this much in the last few years you may be able to have a much larger increase in pension without a tax charge.

This is confusing! Is there any help available?

It is complicated and this article only touches on the main issues. There is lots of information to help you understand the tax rules and most pension administrators have factsheets and supporting materials on their websites. HMRC have a Pension Tax Savings Manual that describes all the detail you could possibly want – it's over 2,000 pages so have some moral support to hand before diving into this! HMRC also have a calculator that you can use to test your Annual Allowance values and work out how much tax is due (if any).

Guidance and training is also available from consultancy firms and this can go a long way to getting you up to speed and being able to "self-assess" whether you need more help.

Accountants and financial advisors can also help you get to grips with the rules and walk you through the processes. But they may be expensive and you are likely to still need to roll your sleeves up and do a lot of the work yourself.

It's a complex issue and you may question whether the term "tax simplification" was ever appropriate but many firefighters will never reach these allowance levels. For those that do I suggest "tax complification" is a better phrase – and some further reading will be necessary.

Mark Belchamber has over 25 years' experience helping people understand their pensions and is Director and founder of "Income for the Third Age Ltd", a company that specialises in guidance and education for employers and employees on pensions, pension tax issues and retirement options.