Housing briefing, January 2023
High inflation and the Annual Allowance

At first glance, pensions and tax appear to sit neatly together. Pension contributions are exempt from income tax, while pension income is taxed (save an initial 25% tax-free element).

However, limits on tax relief have upset the balance. The relationship between pension growth and the Annual Allowance feels particularly problematic.

A breach of the Annual Allowance can trigger distressing statements, leaving people unsure what to do next.

The ongoing impact of rising inflation on pension saving further complicates the situation.

In the past, individuals affected by Annual Allowance breaches tended to be senior leaders. But this time, the impact is much wider.

Overview of pensions tax

The current pensions tax system is known as:

'Exempt – Exempt – Taxed'

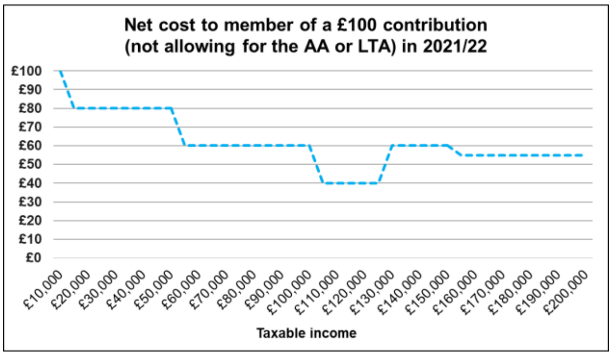
Exempt *
Contributions exempt from income tax

Exempt
No personal tax on investment growth

Taxed
Pensions taxed as income (25% tax-free)

One of the great incentives of pension saving is the immediate tax relief available on contributions paid.

The more a member pays into their scheme, the lower their taxable income and the less tax they pay. And tax relief is greater at higher levels of earnings, as shown in the following chart.



Whereas we would expect to see the 20% and 40% tax relief to the left and 45% tax relief to the right, a trench appears at the £100,000 income mark. This is the point where, for every £2 of taxable income earned over £100,000, the Personal Allowance reduces by £1. This can mean a marginal tax rate of 60%, or tax relief at 60%.

The Annual Allowance

You may have spotted the asterisk next to "exempt" earlier. This is due to the Annual Allowance (AA).

The AA is a limit on tax-relieved pension savings over a tax year. It's currently set at £40,000 but can be lower if taxable income is over £200,000 (often known as AA 'tapering').

When a member has assessed pension savings over £40,000, their scheme must issue them with a Pension Savings Statement by 6th October after the end of the tax year. This *might* mean that a tax charge has been triggered for that tax year and needs settling.

The assessed value of pension savings earned over a tax year is measured against the AA. Sounds simple?

For **Defined Contribution (DC)**, assessing the value of pension savings is fairly simple. The value of DC pension saving is the total gross pension contributions paid by both employee and employer.

However, the assessed value of **Defined Benefit (DB)** pension saving is not determined by contributions paid. Instead, it involves an intricate method which can feel like the Countdown numbers game combined with a riddle from Only Connect.

In theory, the calculation is simple: the difference between what are known as the opening and closing values. These values depend on the benefits earned at the start and end of a tax year.

For example, the opening and closing values for the 2022/23 tax year will be:

OPENING VALUE	CLOSING VALUE
Pension on 5 April 2022 *	Pension on 5 April 2023
Multiplied by 16	Multiplied by 16

** Uplifted by 3.1% CPI inflation from September 2021*

The main reasons for breaching the AA in a DB scheme have tended to be either:

- High pay
- Long pensionable service
- A jump in pay, perhaps due to a promotion
- Tapered annual allowance
- A combination of the above.

High and rapidly increasing inflation is now another factor affecting the Annual Allowance.

Social Housing Pension Scheme (SHPS)

Active SHPS members can still generate pension growth from their **final salary** benefits if one of these conditions applies:

- They are still active in a final salary section and building up more years of pensionable service
- They have retained a 'final salary link' to benefits from a previous period of service after their employer closed final salary to further pensionable service.

This is further complicated in the case of SHPS, where final salary does not mean *the* final salary.

SHPS 'final salary' is based on a three-year average of pensionable earnings, with some inflation built in, i.e. RPI from six months before the calculation date.

Here there are two mismatches in the AA calculation. Pension growth is triggered, not just by differences in the inflation measures used, but also by timing differences – with the opening and closing values influenced by inflation at different times.

Going back to our 2022/23 example, the opening value is linked to past **CPI inflation (3.1%),** while the closing value is partly linked to more recent **RPI inflation (14.2% from October 2022)**. In this case, RPI is bigger than CPI, resulting in pension growth regardless of other factors, such as salary increases.

Pension growth can be considerable for higher-pensioned SHPS members (not necessarily the highest earners), even where final salary has closed to further pensionable service. This issue can also apply in SHPS bulk transfer cases, where the final salary link has been retained in the employer's new scheme.

Local Government Pension Scheme (LGPS)

LGPS benefits differ from those of SHPS, with final salary benefits earned before April 2014 and career average benefits from that point.

Pre-2014 benefits retain a 'final salary link'. Post-2014 career average benefits are uplifted each 1st April, just before the end of the tax year.

We have often seen LGPS members use the 50/50 Section to control pension growth, but this doesn't always have the effect members wanted. While new career average pension growth is (broadly) halved, previously earned final salary benefits are still influenced by pay growth.

The inflationary impact on the Annual Allowance is likely to continue into 2022/23. And although pension growth is a good thing, an AA breach may feel like anything but.

First Actuarial can help

First Actuarial has pension tax specialists who are experts in providing education and guidance. We can help people make informed decisions – with group workshops or one-to-one sessions.

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