WHY PAYING A TAX CHARGE ISN'T ALWAYS **A BAD THING**

A Royal London adviser policy paper
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INTRODUCTION

In 1981, Mick Jones of The Clash penned the song "Should I stay or should I go?" which became the group's **only number one** single in the UK.

More than 30 years on, that rock classic could be the soundtrack to many advisers' workloads as the tax year end approaches. Clients facing tax charges are anxious to know if it's worth their while staying in their pension scheme. The pensions tax situation may seem bleak to many individuals for a number of reasons. The reduction in the annual (AA) and lifetime allowances (LTA), the introduction of the tapered annual allowance, and the fact that many will have exhausted all available carry forward are all beginning to bite. The upshot is that the number of individuals who are now facing AA/LTA tax charges has grown exponentially. And understandably enough clients instinctively want to avoid a tax charge by taking mitigating actions – even if that involves leaving the scheme. But the instinctive reaction isn't always the right one. Clients need sound professional advice to help them come to the decision that's right for their circumstances.

Helping clients in this space involves a lot of time, effort and no small measure of risk – particularly if the client has DB benefits – with potentially little prospect of being able to make a product recommendation at the end of it. We take our collective hats off to all advisers who are prepared to do the necessary legwork to ensure the best outcome for their clients.

This policy paper sets out Royal London's thoughts on how advisers can set about giving sound advice to clients in this space. In addition to providing a brief reminder on how the annual and lifetime allowances work, we examine the options for paying the charges, set out suggested processes for working out whether an individual is better off financially by being in or out of their scheme and explain the other relevant considerations and regulatory issues. The paper is set out in digestible chunks for dipping in and out of as required. And we've included a number of case studies so advisers can select further reading according to their clients' circumstances.

As such our aim is to provide advisers with a reliable backing track to play when approached by clients singing that number 1 classic, "Should I stay or should I go?"

WHAT'S INSIDE

CASE STUDIES

HOW ANNUAL ALLOWANCE AND LIFETIME ALLOWANCE WORK

1. Annual allowance

The **limit on tax relief**[1] for an individual's gross contributions is restricted to the higher of £3,600 or 100% of relevant UK earnings. Employer contributions to employees' plans are not restricted in this way but the contributions need to meet certain conditions in order for the firm to be entitled to tax relief.

But an annual allowance (AA) for pension savings applies each year, which is based on a pension input period. If the AA is exceeded it is subject to a freestanding tax charge and it is charged at the appropriate marginal rate.

The standard AA has changed several times since it was introduced in 2006 and it is currently £40,000.

Under a money purchase scheme the AA used up is simply the value of all contributions paid during the pension input period. However, under a defined benefit (DB) or cash balance (CB) scheme it is the increase in the value of a member's rights during the pension input period. Contributions are irrelevant.

More information on AA can be found **here**[2].

Carry forward

Where the current year's AA has been exhausted, it may be possible to reduce or completely avoid the annual allowance charge using carry forward. Carry forward allows unused annual allowance from pension input periods ending in the previous three tax years to be carried forward and added to the annual allowance for the current pension input period. An individual must have been a member of a registered pension scheme at some point during the tax year from which they intend carrying forward the unused AA although they do not need to have had relevant earnings or made any contributions.

More information can be found **here**[3].

2. Money purchase annual allowance

This applies when someone has flexibly accessed their pension savings. If the MPAA has been triggered, only £4,000 can be paid to all defined contribution (DC) plans in any pension input period from that point on before a tax charge is applied. The individual's total pension input will also be tested against the annual allowance.

The MPAA is most commonly triggered by taking income from a flexi-access drawdown plan or taking an uncrystallised funds pension lump sum. However, other actions can also trigger it.

If it is triggered part-way through a pension input period only the contributions made after the trigger are tested against the MPAA. However the total contributions/accrual in that tax year is also tested against the annual allowance.

3. The tapered annual allowance

This impacts people with an adjusted income over £150,000 AND a threshold income over £110,000. For every £2 of income they have over £150,000, their annual allowance is reduced by £1. Their reduced annual allowance is rounded down to the nearest whole pound. The maximum reduction

1. adviser.royallondon.com/technical-central/pensions/contributions-and-tax-relief/pension-contributions-the-basics/
2. adviser.royallondon.com/technical-central/pensions/contributions-and-tax-relief/annual-allowance/
3. adviser.royallondon.com/technical-central/pensions/contributions-and-tax-relief/carry-forward/

is £30,000. So anyone with adjusted income of £210,000 or more will have an annual allowance of £10,000. People in a DC scheme with high income caught by the restriction might have to reduce the contributions paid by them and/or their employer or an annual allowance charge will apply.

However, the tapered reduction doesn't apply to anyone with 'threshold income' of no more than £110,000.

Adjusted income v threshold income

Definitions of adjusted income and threshold income are crucial to understanding whether or not someone's affected by the tapered reduction. The diagram below sets out in simplified terms how they can be worked out for any particular client. As "taxable income" is the starting point for these calculations, please ensure you read the section entitled "What do we mean by taxable income?" below.

TAXABLE INCOME

(INCLUDE ALL EARNINGS AND INVESTMENT INCOME)

Add + any employer contributions*

Deduct − any taxed lump sum death benefits received

Adjusted income =

Deduct − gross member contributions paid (whether under the relief at source method or net pay arrangement)

Add + an employment income given through a salary exchange agreement set up after 08 July 15

Deduct − any taxed lump sum death benefits received

Threshold income =

**for a DB scheme, this would be the pension input amount minus any employee contributions*

WHAT DO WE MEAN BY "TAXABLE INCOME"?

Both definitions include all taxable income - so it's essential that the right earnings figure is used depending on the type of pension scheme the individual is a member of.

- For relief at source schemes start with the individual's gross earnings
- For net pay schemes (this method of tax relief is commonly used in occupational and public service pension schemes) start with the individual's gross earnings before deduction of pension contributions
- For salary sacrifice/salary exchange schemes start with the individual's salary after the exchange. Remember that the pension contributions the individual exchanges for salary are employer contributions from a legal perspective and should be treated as employer contributions for this purpose.

"Taxable income" this isn't restricted to earnings. In all cases, investment income of all types and benefits in kind, such as medical insurance premiums paid by the employer, must also be included. Various deductions are made - typically trading losses, share loss relief and gifts to charities. A full list of the deductions can be found at s.24 of the Income Tax Act 2007.

A key point is that adjusted income includes all pension contributions (including the value of any employer contributions), while threshold income excludes pension contributions. So although the amount of an individual's adjusted income can't be manipulated, the amount of their threshold income can be by making pension contributions. This can mean that some or all of the annual allowance can sometimes be restored.

Salary exchanged income

Anti-avoidance rules were put in place to stop people entering into a salary exchange or flexible remuneration arrangement after 8 July 2015 so they could receive additional pension contributions, but reduce their threshold income. So if the arrangement was entered into after that date, the amount sacrificed must be included in threshold income.

Carry forward

It's still possible to carry forward unused annual allowance from previous years to a year where the taper applies.

However, the amount of unused annual allowance available when carrying forward from a year where the taper has applied will be the balance of the tapered amount.

4. Lifetime allowance

There is no limit on the value of pension savings that can be built up by a member. However, if the value of pension savings taken exceeds the lifetime allowance at a benefit crystallisation event (BCE), the amount in excess of the lifetime allowance will be subject to a tax charge known as the lifetime allowance charge. Each BCE uses up a percentage of the LTA. How this is calculated for each type of event is shown in the table below.

There are 13 BCEs. The most common of these are

Benefit Crystallisation Event	LTA valuation
BCE1: member moves into a drawdown pension	Value of fund designated for drawdown payments
BCE2: member takes a scheme pension	20 x pension amount
BCE4: member uses pension funds to buy an annuity	Value of fund used for annuity purchase
BCE5 a and b: member reaches age 75	**DC**: Value of fund **DB**: 20 x pension plus any cash by addition
BCE5 c and d: pension death benefits paid from uncrystallised funds	Value of fund designated to drawdown or used for annuity purchase
BCE6: member becomes entitled to a lump sum e.g., UFPLS or PCLS	Amount of lump sum paid
BCE7: lump sum death benefits are paid	Amount of lump sum paid

The lifetime allowance was introduced on 6 April 2006 (A-Day) but has not remained at the same level. For tax year 2019/20 this is £1,055,000. It will increase approximately in line with annual CPI as at the previous September.

Taking benefits usually involves two BCEs – one for the tax-free cash payment and one for the attached pension provision.

Different rules apply for benefits that were in payment before 6 April 2006. More information can be found **here**[4].

Protection from the lifetime allowance charge

Benefits may have protection from a lifetime allowance charge. This protection has the effect of locking the lifetime allowance at a certain rate. However, there are conditions which, if broken, can result in protection being lost. More information on the types of protection can be found **here**[5].

Two forms of protection, fixed protection 2016 and individual protection 2016 were introduced on 6 April 2016 when the lifetime allowance reduced to £1 million and there is no deadline for applying for them. More information can be found in our articles **here**[6].

4. *adviser.royallondon.com/technical-central/pensions/benefit-options/lifetime-allowance/*
5. *adviser.royallondon.com/technical-central/pensions/Pension-protection/*
6. *adviser.royallondon.com/technical-central/pensions/benefit-options/individual-protection/*

PAYING THE CHARGES

The Annual Allowance Charge and Lifetime Allowance charge are not HMRC fines or penalties for having contravened tax law, for tax evasion/avoidance or for other supposed "bad" behaviour. Both charges are simply mechanisms by which HMRC can claw back any tax relief the member has enjoyed which exceeds the Annual and Lifetime limits. There's **nothing inherently wrong** in paying one of these charges.

THE KEY QUESTIONS ARE:

- Are the prospective benefits the member receives over their retirement likely to have a greater value than the cost to the member of remaining in the scheme?
- Does payment of one or more of these charges alter this?

Section C considers ways advisers can make an assessment of this type. The operation of these charges and options for payment are considered below. Whether or not the client has to find the money to settle the charge from their own pocket could impact the advice given and is a significant consideration.

1. Annual Allowance and Paying the Charge

If, having exhausted all available carry forward, the value of pension savings in any particular tax year exceeds the AA the individual will be liable to pay a tax charge on the value of the excess saving. This is a freestanding tax charge and it is charged at the appropriate marginal rate.

Liability for a tax charge will also arise if the MPAA has been triggered and is exceeded in a tax year.

Individuals will need to account to HMRC for the charge through completion of the section "Pension Savings tax charges" (Additional Information pages SA101 for those completing paper returns) of their self-assessment tax return. This requirement applies even where accurate information is not available from the individual's scheme. Even if an individual's scheme is paying the tax charge, they still need to fill in their tax return. An amendment can always be submitted as long as this is within 12 months of the statutory filing date e.g. an amendment to a return for tax year 2019/20 would need to be submitted by 31st January 2022. The individual will need to pay the tax due in line with the normal deadline e.g. for tax year 2019/20 by 31st January 2021.

Liability to pay a tax charge may be unforeseen. This is particularly true for members of defined benefit schemes where calculation of pension input is complex. For this reason, realistically members of DB schemes are unlikely to be able to forward plan for payment of a tax charge. In many cases affected individuals are unlikely to be aware of their liability to a charge until a pension savings statement (PSS) is received from the scheme administrator. As the deadline for PSS is 6th October following the end of the relevant tax year, a PSS received close to the regulatory deadline will leave the individual less than 4 months to work out if a charge is due and if so, to pay it.

So there's not much time to find the money and the charge could be of an amount which can't easily be funded from the individual's own pocket. In particular, larger pay rises and some actuarial adjustments to benefits can cause significant pension input resulting in potentially escalating charges without the individual concerned knowing.

In order to prevent financial hardship in such cases, a facility has been introduced which allows individuals meeting certain conditions to ask their scheme to pay some or all of the charge on their behalf in return for a corresponding reduction to their benefits. The pension scheme is only obliged to facilitate the payment of the charge if certain conditions apply.

2. Scheme Pays Conditions

BOTH of the following conditions must apply before the pension scheme is required to pay the charge at the request of the member:

- The AA tax charge for the member for the tax year across all pension schemes is greater than £2,000

AND

- The pension input amount to the scheme the charge is to be taken from is greater than £40,000 (i.e. the amount of the standard Annual Allowance in force in the tax year in question)

If both of these conditions are met, then the individual and the scheme become jointly and severally liable for the AA charge.

Importantly, the conditions above continue to apply if the individual is subject to the MPAA or if their AA is tapered due to higher earnings. The requirement that pension input amount exceeds an amount equal to the amount of the standard AA (currently £40,000) persists. This means that an individual might have a tax charge as they have exceeded their tapered annual allowance but the scheme can't be made to pay.

3. Voluntary Scheme Pays

If the conditions set out above don't apply, the pension scheme doesn't have to offer scheme pays but may nevertheless choose to do so. The individual scheme decides the additional circumstances, if any, in which it will facilitate paying the charge. For example, a scheme might choose to pay an amount of a member's AA charge where the overall tax charge is greater than £2,000 and pension input to the scheme exceeds the individual's tapered AA.

4. The reduction in pension benefits

Under a DC scheme, the individual's fund value is reduced by an amount equal to the amount of the tax charge including any early withdrawal charges which may apply. Under a DB or cash balance scheme, an actuarially calculated adjustment will be made to the member's prospective benefit rights or to both the member and contingent beneficiaries' pension rights. However, adjustments solely to contingent beneficiary or other death benefits aren't allowed.

In either case, the law requires that the adjustment is "just and reasonable". In practice, what this test means is that regardless of whether the scheme pays the charge on a mandatory or voluntary basis, it can't charge the member for operating the facility. The adjustment must meet the just and reasonable test in accordance with normal actuarial practice.

5. Applying for Scheme Pays

The pension scheme must receive the request to pay the charge no later than 31st July in the year following the tax year in which the AA tax charge was incurred. For example, a request in respect of 18/19 would need to be submitted by 31st July 2020. In order to apply, an individual needs to submit an irrevocable written notice to their scheme administrator. Because specific information is required in order for the request to be valid, many schemes have template election forms.

Importantly, it's worth noting that schemes may operate different deadlines in relation to any scheme pays facility operated on a voluntary basis. Advisers should check with the scheme concerned.

INTRO
INDEX
SEC A
SEC B
SEC C
SEC D
SEC E
SUM
PAYING THE CHARGES

6. Giving Advice in relation to scheme pays

The priority for clients facing AA charges is understandably likely to be whether they should remain in or leave the scheme. We consider how advisers can tackle providing sound advice in this space and the regulatory considerations associated with it at sections C and E.

But the options available to the client for paying the charge under mandatory or voluntary scheme pays shouldn't be overlooked during the advice process.

In circumstances where the individual might otherwise be forced to opt out due to the tax charge affordability issue, availability of these options could open up the option of staying in the scheme. Even where the client does have sufficient available funds to pay the charge from their own pocket, advisers might still wish to consider whether scheme pays might be appropriate/advantageous:

Advantage	Detail
Tax Relief	Paying the charge from own funds means the charge is paid from post-tax income. This has the effect of compounding the reduction in tax-efficiency brought about by the tax charge itself. Scheme pays has the benefit of allowing the charge to be settled using monies on which tax relief has been granted.
LTA utilisation	Paying the charge from own funds will reduce the amount of benefits tested against the lifetime allowance (LTA). Scheme pays may therefore be advantageous for individuals with an actual or potential LTA issue.
Impact of actuarial adjustments	In the case of DB benefits the manner of the actuarial adjustments made to benefits may be favourable to the member depending on circumstances i.e. will the adjustment affect just the member's own benefits or will they also impact contingent beneficiary benefits? Does the approach suit the client? N.B. In the Public Sector, the approach taken by each scheme and the adjustment factors are typically set out in statutory guidance which is in the public domain. Worth asking for a copy or visiting the scheme's website.

CASE STUDY
SCHEME PAYS

Piotr is a hospital doctor in Swansea and a member of the NHS pension scheme. Piotr's wife has very little pension provision in her own right having left work as a dental hygienist to become a full-time carer to their two children. Piotr had a promotion and hefty pay rise in 2018/19 causing his NHS pension input to exceed £40,000 for the year. The PSS he's received from NHS Pensions show that his pension input in the 2008 section of the NHS final salary scheme was £11,500 and pension input in the 2015 (career average) NHS scheme was £37,800. Piotr doesn't have any carry forward available as he has also been paying contributions to a personal pension scheme for a number of years. Piotr seeks advice because he is facing a tax charge across all the schemes he contributed to during 2018/19 of £5,320.

Piotr's adviser analyses the potential benefits likely to be paid to Piotr using reasonable assumptions versus the cost to Piotr of remaining in the scheme. (See section C for information an examples on how to carry out such analysis). He advises that based on the assumptions made, Piotr will derive greater value by remaining in the scheme and paying the AA charge. Piotr will however need to reduce or cease contributions to his personal pension going forward. The adviser goes on to consider the most effective way for Piotr to pay the AA charge.

NHS Pensions doesn't have to pay any amount of Piotr's tax charge should Piotr make a scheme pays election. This is because the NHS final salary scheme and the NHS career average scheme are legally separate schemes so the conditions (see section B2 above) apply to each scheme separately and the value of Piotr's pension saving does not exceed £40,000 in either scheme.

However, NHS Pensions tells the adviser that where pension saving by any individual across NHS schemes exceeds £40,000 in aggregate, they will pay the amount of the charge relating to the excess saving in NHS pensions on a voluntary basis. Piotr can therefore ask NHS pensions to pay £3,720 of the charge (£37,800 + £11,500 - £40,000 x 40%) in return for a corresponding reduction to his benefits. Piotr is concerned that this will impact any pension paid to his wife and children in the event of his death. Piotr's adviser reassures him that NHS contingent dependents' pensions are not affected by scheme pays elections. So if Piotr died his wife would still receive her full pension entitlement as would the children if they are still dependants. This would be based on Piotr's pension before the reduction to his benefits. Piotr's adviser recommends Piotr takes advantage of the voluntary scheme pays option in order that he's not paying the charge from taxed income.

7. Lifetime Allowance and Paying the Charge

If the value of the benefits when they are taken exceeds the individual's LTA the excess is subject to the LTA charge. This charge can be applied in either of two ways or a combination of both depending on how the excess is taken. The charge is:

- 55% if taken as a lump sum, or
- 25% if taken as income

Liability for paying any LTA charge falls jointly on the scheme administrator and the member. The former calculates the capital value of the benefits at the BCE and normally must deduct any tax charge due before a benefit payment is made to the member. If the tax charge arises on the death of the member then it is the recipient of the payment who is liable to pay any LTA charge.

The way in which BCEs are determined is as explained in section A.

When income payments are being taken, the scheme will make a reduction to the individual's benefits being put into payment reflecting the amount of the charge. If the individual is in drawdown or the funds are still uncrystallised then the fund will be reduced. Where the benefit coming into payment is a scheme pension from a defined benefit scheme, this reduction will be calculated on an actuarial basis and may reflect the age and gender of the individual.

Scheme rules may dictate whether any lifetime allowance excess must be taken as a lump sum or income or a combination. For public service pension schemes, the options available to members and the pension debit factors which apply are typically set out in statutory guidance and should be available on the scheme's website or on request. It should also be noted that the factors to be used may change from time to time, for example following the scheme valuation.

A more detailed explanation of the lifetime allowance charge is outside the scope of this paper, but further information is available from the **HMRC Pensions Tax Manual**[7].

The key point here is that the individual does not have to find the amount of any LTA charge from their own pocket so there will not be any affordability issues in the event the LTA is exceeded. Payment of the charge from pension benefits has the advantage of allowing it to be settled using the realisable value of monies on which tax relief has been granted.

7. www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm080000

CASE STUDY
LTA CHARGE ANNUITY INCOME

Frank reached his normal retirement date on the 6th April 2019 and had benefits in a personal pension arrangement of £2,000,000. Frank does not have any LTA protection. The standard LTA at 6th April 2019 was £1,055,000.

Frank's excess benefits value is £945,000 (£2million - £945,000). Frank is taking the excess benefits value as income so the scheme administrator deducts a tax charge of 25% of the excess (£236,250). This leaves a net excess value of £708,750.

The benefits Frank takes from his personal pension scheme are as follows:

Tax-free cash (25% of standard LTA)	£263,750
Net of charge excess benefits value	£708,750
Residual benefits value (£1,055,000 - £263,750)	£791,250

The scheme administrator pays HMRC the tax charge of £236,250 and pays tax-free cash to Frank of £263,750. Frank uses the remaining benefits value of £1,500,000 to purchase a lifetime annuity.

Frank may have been eligible for IP16 which would have reduced his LTA excess.

CASE STUDY
LTA CHARGE SCHEME PENSION (DB)

Ruth is a member of her employer's defined benefit pension scheme. On retirement at age 65 she has a scheme pension entitlement of £47,600 and an additional lump sum entitlement of £142,800 making the capital value of her benefits £1,094,800. Ruth's lifetime allowance is £1,055,000. Her pension scheme's rules permit her to take any LTA excess as additional scheme pension, additional lump sum or a combination. Ruth prefers the security of additional scheme pension meaning that a tax charge of 25% of the value of the excess benefits must be paid. For retirements at age 65 (females), the scheme uses a debit factor of 17.79. Her scheme will divide the amount of her tax charge by this factor to calculate the amount to deduct from her pension. This actuarial factor used reflects that under Ruth's pension scheme rules contingent dependents' pensions will be continue to be calculated on Ruth's pension before the reduction.

Pension entitlement	£47,600
Capital value of pension entitlement (£47,600 x 20)	£952,000
Lump sum entitlement	£142,800
Capital Value of Benefits	£1,094,800
Excess over LTA (£1,094,800 - £1,055,000)	£39,800
Tax charge (£39,800 x 25%)	£9,950
LTA excess debit (£9,950 / 17.79)	£559.30
Ruth's reduced pension (£47,600 - £559.30)	£47,040.70

Ruth's scheme therefore pays the LTA excess charge of £9,950 to HMRC and it pays a lump sum of £142,800 and pension of £47,040.70 to Ruth.

CASE STUDY
LTA CHARGE DESIGNATED MONEY IN DRAWDOWN AT AGE 75

Celia retires at age 65 with DC savings of £1,000,000. She designates £750,000 for drawdown and takes £250,000 tax-free cash. Celia and her partner are able to live comfortably off the income from his business so Celia doesn't take any income from her drawdown plan. On reaching age 75, Celia's scheme administrator must carry out a BCE 5 check to see if an LTA charge is due on the net growth in Celia's funds. If the LTA is assumed to increase by 2% each year and Celia's funds in drawdown enjoy net growth of 5.5% each year, the situation will be as follows:

Total DC savings at age 65	£1,000,000.00
Amount designated for DD at age 65	£750,000.00
% of LTA used at age 65	94.78% (£1,000,000 / £1,055,000 x 100)
LTA at age 75	£1,286,039
Value of DD funds at age 75	£1,281,108
Net growth in funds at age 75	£531,108
LTA remaining at age 75	£67,131 (£1,286,039 x 5.22%)
Excess over LTA at age 75	£463,977 (£531,108 - £67,131)
LTA charge	£115,994 (£463,977 x 25%)

IN OR OUT? THE CALCULATIONS & CONSIDERATIONS

Where an individual facing tax charges and leaving the scheme/stopping contributions is a possibility, the adviser **will need to demonstrate** whether the individual will derive greater benefit from remaining in the scheme and paying the charge(s) or greater benefit from opting out of the scheme thereby avoiding future or escalating charges.

It is therefore crucial that calculations are done to ensure that any advice given in this space is sound and to ensure that the client knows what to expect and agrees a course of action on a fully informed basis.

Where specific regulatory requirements apply to any opt-out, the adviser will additionally need to ensure that the calculations done and other factors considered collectively meet the FCA test that the opt-out is demonstrably "in the client's best interests on contemporary evidence". It goes without saying that all factors considered should be carefully documented.

This paper takes a closer look at the tax charges and methods for payment in section B and at the regulatory considerations in section E.

In this section we look at:

- how an adviser can set about determining whether the client will be better off financially by staying in or opting out of the scheme; and
- other factors which need to be considered.

1. In or out? The process

No two clients are the same. They will have different circumstances, have different pension rights from different schemes and have different objectives. So planning will vary reflective of these different circumstances. But at high level the calculation process for working out whether the client is better off in or out of the scheme is the same. In particular the value of employer contributions should not be overlooked. It's free money! The factors relevant to the calculations will however vary depending on whether the issue is with the annual allowance, the lifetime allowance or both.

ANNUAL ALLOWANCE PROCESS

The process below shows how advisers can set about determing whether the numbers stack up for leaving the scheme. However, the numbers are only one aspect to be explored. See point 2 below for other factors which should be considered.

1 **Calculate the projected value of the individual's benefits at the date they expect to retire**

DC	Employer, employee and third party contributions. Investment returns.
DB	Accrual rate and structure and assumptions on payrises (and earnings/inflation rate for career average schemes).

2 **Calculate the overall cost of maintaining existing arrangements to expected retirement**

DB / DC	To ensure fair comparison, net of tax relief costs should be used if the individual contributes.

3 **Calculate the benefits payable net of any tax charge**

DC	For "scheme pays" (see section B) arrangements for reduction in benefits including any early withdrawal charges.
DB	For "scheme pays" arrangements for reduction in benefits including early withdrawal charges and actuarial factors.

4 **Calculate the value of deferred/paid up benefits at retirement (client opts out of scheme/ceases contributions)**

DB / DC	Carry forward will build up throughout deferred/paid up period allowing potential restart
DB	Deferred pension revaluation rate

5 **Identify the value of alternate arrangements**

Net cost to the individual of contributions/investment elsewhere
Any alternative remuneration/pension offered by the employer

6 **Add the value of deferred/paid up benefits to the value of any alternative arrangements at the individual's expected retirement**

DB / DC	Impact of any different tax wrapper on alternate benefits There will still be minimum £10,000 AA so no need to stop pension saving altogether

7 **Compare outcome of step 6 with outcome of step 3**

Does the individual believe net benefits (step 3) represent value for money?
Wider considerations (see page 27) should be highlighted

LIFETIME ALLOWANCE PROCESS

1

Calculate the projected value of the individual's benefits & LTA at the date they expect to retire

DC	Employer, employee and third party contributions. Investment returns.
DB	Accrual rate and structure and assumptions on payrises (and earnings/inflation rate for career average schemes). Maximisation of PCLS and commutation rate. Early/late retirement factors.
DB / DC	Value of existing arrangements

2

Calculate the overall cost of maintaining existing arrangements to expected retirement

DB / DC	To ensure fair comparison, net of tax relief costs should be used if the individual contributes.

3

Calculate the benefits payable net of any tax charge

DB	Arrangements for reduction in benefits including actuarial factors.
DB / DC	Do scheme rules dictate how LTA excess must be taken? Value of net lump sum versus net income on overall income / marginal tax rate. Factor in any protections held. Factor in change to level of LTA.

4

Calculate the value of deferred/paid up benefits at retirement (client opts out of scheme/ceases contributions)

DB	Deferred pension revaluation rate. Early/late retirement factors.
DC	Anticipated investment return.
DB / DC	There might still be an LTA charge. Factor in any protection. Factor in change to level of LTA.

5

Identify the value of alternate arrangements

Net cost to the individual of contributions/investment elsewhere.
Any alternative remuneration/pension offered by the employer.

6

Add the value of deferred/paid up benefits to the value of any alternative arrangements at the individual's expected retirement

DB / DC	Impact of any different tax wrapper on alternate benefits.

7

Compare outcome of step 6 with outcome of step 3

Does the individual believe net benefits (step 3) represent value for money?
Wider considerations (see page 27) should be highlighted.

CASE STUDY
LIFETIME ALLOWANCE (DC)

Linda lives in England is a 40% taxpayer aged 55, with pensionable salary of £80,000. Over and above salary Linda receives a performance related bonus each year, the first 50% of which is also pensionable. These bonuses have averaged £20,000 over the last 5 years. Linda plans to retire when she is 60 and is considering whether to opt out of her employer's scheme. Her employer currently pays 6% contributions as standard and employee contributions are matched 1 for 1 to a maximum of a further 6% of contributions. Her fund has a current value of £920,000.

	Linda opts out	**Linda stays in scheme** *Employer contributions only*	**Linda stays in scheme** *Employer + employee contribution of 6%*
Option	A	B	C
LTA in 5 years' time	£1,164,805	£1,164,805	£1,164,805
Starting fund at 6/4/18	£920,000	£920,000	£920,000
Net Cost to Linda	£0	£0	£16,938
Fund at retirement	£1,123,317	£1,154,449	£1,216,734
LTA Excess	£0	£0	£51,929
LTA charge (excess taken as lump sum)	£0	£0	£28,561
LTA excess lump sum	£0	£0	£23,368
Pension fund after charge	£1,123,317	£1,154,449	£1,188,173

Assumption 1: LTA increases by 2% each year

Assumption 2: Linda's pensionable salary increases by 2.5% each year, bonuses remain unchanged

Assumption 3: Investment growth net of charges is 4% p.a.

Linda's adviser explains the situation to her as follows:

- If Linda remains in her scheme with employer contributions only (Option B), based on the assumptions the adviser has agreed with Linda, she will face no tax charge on retirement at age 60.
- The adviser emphasises the value of the employer contributions and explains that opting out altogether would therefore be disadvantageous to Linda.
- Option C produces a higher pension fund net of the LTA charge, but this comes at a cost to Linda. When compared to option B, Linda will accrue additional net funds of £43,209 for a net cost to her after tax relief of £16,938.
- The adviser explains that based on the assumptions they've agreed about Linda's likely future pay rises and the investment funds chosen, the potential benefits from remaining in the scheme and continuing to benefit from employer, employer matching and personal contributions outweigh Linda's costs including the LTA charge. He ensures Linda understands that if reality differs from the assumptions used, the position could change, and that they should therefore regularly review the position.
- He goes on to explain that Linda's employer does not offer any alternative benefits/payments if an individual opts out of the pension scheme so there are no other options to be considered.

Recommendation

Linda remains in her scheme and continues to pay personal contributions of 6%.

CASE STUDY
LIFETIME ALLOWANCE (DB)

Duncan is a member of the 2008 section of the NHS pension scheme in England & Wales which offers defined accrual at a rate of 1/60th of pensionable pay each year. In 2019/20 he has pensionable pay of £90,000 and 35 years' service. He wants to retire in 5 years' time at age 66 when his wife will also be retiring. This is one year later than his scheme normal retirement age (NRA). NHS Pensions will apply an actuarial factor of 1.031 to his benefits accrued up to age 65 paid out one year later than NRA. Duncan is not eligible for any LTA protection. Although the scheme allows any LTA excess to be taken as either income or lump sum, Duncan prefers the additional income for life. The actuarial factor used to reduce NHS pensions for 2008 section members at age 66 reflecting the charge[i] is currently 17.82. This means that NHS Pensions will divide the excess amount by this factor to determine the reduction to Duncan's pension. Duncan's scheme contributions are 13.5% of pensionable pay. Advisers should read the statutory guidance available on the NHS Pensions website to ensure the correct factors are used for the client's circumstances.

	Duncan opts out and defers	**Duncan remains in scheme to 66**
Option	A	B
NHS pension rights at April 2019	£52,500	£52,500
Current LTA usage	£1,050,000	£1,050,000
Protection	None	None
Pension rights at age 66	£57,964	£68,272
LTA usage in 5 years' time	£1,159,280	£1,365,440
LTA in 5 years	£1,164,805	£1,164,805
LTA Excess	£0	£200,635
LTA charge (excess taken as income)	£0	£50,159
Reduction in pension	£0	£2,814.76
Gross pension after charge	£57,964	£65,457
Net Cost to Duncan	£0	£38,319

Assumption 1: LTA increases by 2% each year
Assumption 2: Duncan enjoys pay rises of 2.5% each year until retirement
Assumption 3: Deferred benefits are revalued each year by 2%
Assumption 4: NHS pensions in payment increase 2% each year
Assumption 5: The rate at which Duncan pays his NHS contributions does not change

i. www.nhsbsa.nhs.uk/sites/default/files/2017-04/Lifetime%20Allowance%20Charge%20examples%20V1%20%2804.2017%29.pdf

CASE STUDY
LIFETIME ALLOWANCE (DB) *Continues*

Duncan's adviser explains the situation to him as follows:

- Duncan's pensions rights are close to, but do not exceed the current LTA of £1,055,000. Based on the assumptions the adviser has agreed with Duncan, if he opts out now, his benefits will also not exceed the LTA when he takes his benefits in 5 years' time. So the adviser acknowledges that at first sight opting out may appear an attractive option.
- If Duncan remains in the scheme to age 66 (option B) and assuming he enjoys pay rises of 2.5% each year until retirement, continuing membership will cost him £38,319 after tax relief.
- In return for this cost, Duncan will receive extra annual pension of £7,493 after deduction of the LTA charge.
- This pension will of course be paid each year, will be revalued by CPI each year. If Duncan has a normal life expectancy, this escalating pension could give Duncan total additional gross pension of £182,060 over 20 years. The adviser goes on to point out that Duncan will pay higher rate tax on this pension income meaning that the net benefit to Duncan of the additional £38,319 cost is £109,236 assuming he lives for 20 years after retirement.
- Additionally, the adviser points out that the increase in Duncan's pension rights from remaining in the scheme will mean that in the event of his death, the pension paid to his wife will also be higher.
- Based on the assumptions the adviser has agreed with Duncan, the value of the additional benefits are therefore greater than the additional cost to Duncan of remaining in the scheme after the LTA charge is taken into account.
- The adviser has considered whether a potentially better result could be generated by an alternative strategy but has discounted this possibility because Duncan will not get tax relief on payments to any other vehicle within his risk appetite and has a normal life expectancy.
- Finally, the adviser ensures Duncan understands that if reality differs from the assumptions used, the position could change, and that they should therefore regularly review the position.

Any personal recommendation to opt out in favour of contributions to a personal pension would fall within the definition of a pension opt out for the purposes of COBs 19. For regulatory purposes the adviser would therefore need to be able to clearly show that such an opt-out was demonstrably in Duncan's best interests on contemporary evidence. See section E for further information on regulatory considerations.

Recommendation

The adviser recommends that Duncan remains in the NHS pension scheme.

He also ensures regular reviews are scheduled.

CASE STUDY

ANNUAL ALLOWANCE (DC)

Karl lives in England and is a company director aged 50 with a salary of £215,000. He is therefore a 45% taxpayer and his AA is tapered to the minimum of £10,000. Karl has no carry forward available. His employer pays 8% as standard and contributions are matched 1 for 1 up to a further 6%. Karl expects to retire in 10 years' time.

	Employer contributions only	**Employer + employee contribution of 20%**
Option	A	B
Pension input amount	£17,200	£43,000
AA excess	£7,200	£33,000
AA Charge	£3,240	£14,850
Post charge benefit	£13,960	£28,150
Value of additional funds in 10 yrs[i]	£20,664	£41,669
Net cost to Karl	£0	£7,095

Karl's adviser explains the situation to him as follows:

- Under option 1 after payment of the AA charge he will generate additional funds of £13,960 at nil personal contribution cost. The adviser emphasises that this underlines the value of the contribution Karl's employer makes to his pension.
- Under option 2, if Karl continues to make personal contributions, he will generate additional funds of £28,150. After taking tax relief into account, this will cost him £7095.
- Karl's adviser explains that money invested in a pension wrapper is tax privileged and will therefore grow free of income tax and capital gains tax. Using the assumptions agreed with Karl which take into account his appetite for risk, the employer and employee contributions paid under Option 2 can reasonably be expected to have grown to £41,669 by the time Karl retires in 10 years from now.
- The adviser explains his opinion that there is no other strategy within Karl's risk appetite under which an amount equivalent to his £7095 contributions could be expected to grow to £41,669 over 10 years. This is because Karl's employer is paying a further matching contribution of 6% which is like "free money" and because his personal contributions benefit from tax relief.
- The adviser informs Karl that he is eligible to make a scheme pays election as his pension input exceeds the annual allowance and his tax charge exceeds £2,000.00
- Finally the adviser ensures Karl understands that if reality differs from the assumptions used, the position could change, and that they should therefore regularly review the position.

Recommendation

Stay in pension scheme. Continue to pay maximum personal contributions. Make scheme pays election. Regular reviews to be scheduled.

i. Assumes 4 % growth after charges

CASE STUDY
ANNUAL ALLOWANCE (DB)

Madhuri has 15 years' service in her company's final salary DB scheme to which employees contribute 8%. Benefits accrue at a rate of 1/60th of pay each year. As at 5th April 2019, Madhuri's pensionable pay was £65,000 and she had 15 years' service. In 2019/20, Madhuri enjoys a pay rise of £3,500 plus a pay award of a further £4,500 backdated to 1st July 2018 in respect of a promotion. Madhuri has no carry forward available having paid maximum single premium contributions within the AA to a personal pension at the end of each of the last 4 tax years.

Uprated value of benefits at 6/4/18 (CPI = 3.0%)	£267,800
Closing value of benefits at 5/4/19 (£73,000 x 16/60 x 16)	£311,467
Pension input amount	£43,667
Madhuri's personal contribution (net of 40% tax relief)	£3,666
AA excess	£3,667
AA charge	£1,467
Pension rights at 5/4/18	£16,250
Pension rights at 5/4/19	£19,467
Increase in pension rights	£3,217
Total net cost to Madhuri (£3,666 + £1,467)	£5,133

Madhuri's adviser explains the position to her as follows:

- Madhuri will have to pay a tax charge of £1,467 which she needs to declare on her self-assessment tax form. She is not eligible to make a scheme pays election as her tax charge does not exceed £2,000 and her scheme does not offer voluntary scheme pays. She will therefore need to pay the money from her own funds by 31st January 2021.
- If Madhuri continues scheme membership she will generate additional annual pension of £3,217 in return for a total cost to her net of the AA charge and tax relief of £5,133. He points out that this pension will be paid for the rest of her life and will increase each year to help protect Madhuri against the impacts of inflation.
- Madhuri doesn't have reduced life expectancy. If Madhuri lives 20 years following retirement and her pension benefits increase 2% each year, she will have generated £78,165 total gross income for her net cost of £5,133. Although Madhuri is currently a 40% taxpayer, her projected pension & other income indicate that she will be a basic rate taxpayer after retirement. After income tax at 20% the extra pension accrued by staying in the scheme will be worth £62,532 over 20 years.
- He explains that he has considered alternate investment strategies but these will be unlikely to achieve a fund value of £78,165 from an investment by Madhuri of £5,133. Additionally, he points out that under Madhuri's pension scheme rules, the extra pension she accrues by staying in the scheme will mean that her husband's survivor benefits will be higher in the event of her death and she will lose her death in service cover if she opts out.
- The fact find carried out revealed that the backdated pay award was a one-off and Madhuri expects any pay rises in future to be much more modest. The adviser therefore points out that if Madhuri does decide to opt out of her scheme now despite his advice, it may be appropriate for her to consider opting back in in 2020/21 and review her circumstances on a regular basis.
- Finally the adviser ensures Madhuri understands that if reality differs from the assumptions used, the position could change, and that they should therefore regularly review the position.

Any personal recommendation to opt out in favour of contributions to a personal pension would fall within the definition of a pension opt out for the purposes of COBs 19. For regulatory purposes the adviser would therefore need to be able to clearly show that such an opt-out was demonstrably in Madhuri's best interests on contemporary evidence. See section E for further information on regulatory considerations.

Recommendation

Remain in the scheme. Regular reviews to be scheduled.

CASE STUDY
ANNUAL ALLOWANCE & LIFETIME ALLOWANCE (DB)

In this case study we revisit Duncan whose benefits fell below the LTA in 19/20 but are expected to exceed it at age 66 (Duncan's NRA). In March 2020 Duncan asks his adviser to re-review the position in light of a pensionable pay award of £9,000 he is expecting to receive from April 2020. He has only £20,000 carry forward available and is concerned that (potentially) breaching the AA as well as the LTA means it won't be worth staying in the NHS pension scheme. He expects to retire in 4 years time at age 66.

At 5/4/20 Duncan's pensionable pay is £90,000 and he will have 36 years' service. His NHS contribution rate is currently 13.5%. If a scheme pays request is made, **a recovery factor of 17.15 + compound interest**[i] will be used to calculate the adjustment to Duncan's benefits. In other words, NHS pensions will add interest to the AA charge amount that they pay and will divide the total amount by 17.15 when Duncan retires in 4 years' time at age 66. A factor of 17.82 will be used in respect of any LTA charge taken as income to adjust Duncan's NHS pension coming into payment at age 66.

Uprated value of benefits at 6/4/20 (CPI = 2.2%)	£883,008
Closing value of benefits at 5/4/21 (£99,000 *37/60) *16	£976,800
Pension input amount	£93,792
Excess pension saving after carry forward	£33,792
Duncan's personal scheme contribution (net of 40% tax relief)	£8,019
AA charge	£13,517
Pension rights at 5/4/20	£54,000
Pension rights at 5/4/21	£61,050
Debit equivalent amount at age 66 (includes 4% p.a. interest)	£15,813
Reduction in benefit (£15,813/17.15)	£922
Post AA charge benefit from staying in the scheme ((£61,050 - £922) - £54,000)	£6,128
Assumed LTA 2020/21	£1,076,100
LTA use at 5th April 2020 (£61,050-922)*20	£1,202,560
LTA excess (£1,202,560 - £1,076,100)	£126,400
LTA charge – excess taken as income	£31,600
Reduction in pension £31,600/17.82	£1,773
Post AA and LTA charge pension accrued(£6,128 - £1,773)	£4,355

Assumption 1: The interest rate applied by NHS Pensions to the scheme pays debit is 4%

i. www.nhsbsa.nhs.uk/sites/default/files/2017-04/Annual%20Allowance%20-%20Scheme%20Pays%20recovery%20factors%20%2809.2016%29%20V1.pdf

CASE STUDY

ANNUAL ALLOWANCE & LIFETIME ALLOWANCE (DB) *Continues*

Duncan's adviser explains the situation to him as follows:

- After carry forward is taken into account, an annual allowance charge at Duncan's marginal rate of tax (40%) will be due on the value of excess pension input of £33,792.
- Duncan can make a "scheme pays" election to cover this charge. NHS pension will adjust Duncan's benefits at retirement to reflect the charge they pay on his behalf. They will do this by adding compound interest to the amount of the charge they pay on Duncan's behalf and will divide the total by a recovery factor set by the scheme actuary.
- Duncan's payrise for 2020/21 will cause his total benefits to exceed the LTA at 5th April 2021, so an LTA charge will also be due. As Duncan has said he'd like to take any LTA excess as pension income, NHS pensions will make a further adjustment to Duncan's benefits when they are put into payment to reflect the LTA charge they pay on his behalf. This will be calculated after the reduction in Duncan's benefits for his scheme pays election.
- Net of both charges and assuming Duncan retires at age 66, remaining in the scheme during 2019/20 will generate additional pension rights of £4,355. After tax relief, the cost to Duncan of accruing these additional rights is £8,019
- The adviser emphasises to Duncan that the starting pension of £4,355 will be paid for the rest of Duncan's life and will increase by CPI (assumed to be 2%) each year. If Duncan lives for 15 years following retirement, this will mean he receives £75,313 in taxable income or £105,815 in taxable income if he lives for 20 years.
- After income tax at 40% and AA/LTA charges the total benefit to Duncan in return for his £8,019 net scheme contribution is £45,188 if he lives 15 years or £63,489 if he lives for 20 years.
- As Duncan is willing to accept some investment risk, the adviser has looked at alternative strategies if an amount equal to Duncan's personal contribution were invested elsewhere. Assuming an investment return after charges of 7% a fund value of £22,125 could be generated after 15 years or £31,031 after 20 years. If an investment return of 9% after charges were achieved, this would generate a fund value of £29,209 after 15 years or £44,942 after 20 years.
- In view of this and having discussed Duncan's views on his life expectancy and his understanding of/appetite for investment risk with him, the adviser informs Duncan that he doesn't believe an alternate strategy will generate a better financial return than staying in the scheme.
- The adviser also asks Duncan to consider that if he opts out of the NHS pension scheme this will also impact any benefits under the scheme which would be paid to Duncan's wife on his death as they would then be calculated on a different basis. Duncan's wife has very limited pension provision in her own right:
    - The lump sum payment would reduce from 2x reckonable pay (£198,000) to 2.25 x annual pension rights at date of death and would therefore be a minimum of £121,500 if Duncan were to die with pension rights accrued at April 20 (£90,000 x 36/60)
    - Duncan's wife would no longer be entitled to a short term survivor pension
    - The long term pension payable to Duncan's wife would be calculated on a less generous basis if Duncan dies more than 1 year after leaving the scheme.
- Finally the adviser ensures Duncan understands that if reality differs from the assumptions used, the position could change, and that they should therefore regularly review the position.

Recommendation

Stay in scheme for 2020/21. Make scheme pays election in relation to AA charge.
Regular reviews to be scheduled.

CASE STUDY
ANNUAL ALLOWANCE & LIFETIME ALLOWANCE (DC)

John aged 55, is a marketing director and has been a member of his employer's DC scheme for 26 years. His employer pays 16% contributions and John's required personal contributions are 6%. John's pensionable pay is £120,000. Up to now, John has not been subject to the tapered annual allowance, but in 2019/20, John's mother passes away, leaving him a portfolio of properties. The additional income from these investments means his adjusted income in 2019/20 will be £220,000 with the result that he will be subject to the minimum tapered annual allowance of £10,000. John's employer offers a discretionary pay supplement of 12% to employees who can demonstrate they are impacted by pension tax charges. John sees his adviser to discuss whether he should stay in his pension scheme or opt out. John isn't sure when he will retire and wants to consider one year at a time. As at 6th April John's workplace pension scheme has a value of £1,002,000. John also has a section 32 buyout plan from a previous employment with a value of 46,000.

	John opts out *12% employer supplement*	**John remains in scheme**
Option	A	B
LTA 19/2	£883,008	£1,055,000
Current LTA utilisation	£976,800	£1,048,000
E'er + E'ee contributions 19/20	£93,792	£26,400
Excess pension input	£33,792	£16,400
AA charge at 45%	£8,019	£7,380
Net of charge additional funds	£13,517	£9,020
John's net contribution cost	£54,000	£3,960
Estimated LTA utilisation at 6/4/20	£61,050	£1,126,800
LTA at 6/40/20	£15,813	£1,076,100
Excess lifetime pension saving	£922	£50,700
LTA charge (excess benefits taken as lump sum) at 55%	£6,128	£27,885
Gross employer funded income supplement	£1,076,100	£0

Assumption 1: Growth on John's fund value is 5% after charges
Assumption 2: LTA increases by 2%

John's adviser explains the position as follows:

- If John stays in his pension scheme the benefits he accrues over 19/20 will cause both his tapered annual allowance and the lifetime allowance to be exceeded. Net of his annual allowance charge he'll gain additional funds of £9,020, but this will cost John his £3,960 net personal contribution plus a lifetime allowance charge of £27,885.
- If John opts out of his pension scheme and elects to receive the 12% discretionary supplement in lieu of an employer pension contribution, he will not face any annual allowance charge. There will still be a lifetime allowance charge of £13,365. This is because John's fund value is increasing faster than the LTA. The 12% employer supplement will give John additional gross income of £14,400 (£7,920 after tax at 45%).

Recommendation

Opt out of scheme and elect to receive 12% employer discretionary supplement

2. In or out – Wider considerations

Up to this point, this paper has considered the direct financial implications to the member of opting out/becoming paid up or staying in their scheme and paying the tax charge. But there are potentially wider implications of deferral to be considered which should also be discussed with the client in order that any adviser recommendation and subsequent decision by the individual is fully informed.

Where the pension opt out advice falls within the definition of COBs 19.1 (see section E), there's a requirement that the suitability report contains not only analysis of the financial implications of opting out, but also a summary of other material information.

Some areas for advisers to consider are noted below. This list is not exhaustive – the relevant factors will depend on individual scheme rules.

- Dependants' benefits. On what basis will any dependants' pensions/lump sum benefit be calculated if the individual leaves the scheme? The calculation basis may be less generous if the individual has preserved benefits potentially requiring mitigating actions.
- Beneficiary nominations/expression of wishes. Do scheme arrangements for distribution of death benefits change on deferral? Some employer schemes may allow scheme discretion where the individual dies in active service, but benefits may be paid under direction where the individual has left the scheme. This can have an impact on the IHT treatment of the benefits.
- Ill-health benefits. On what basis will these be calculated if the individual leaves the scheme? The calculation basis may be less generous and/or there may be no option for serious ill-health commutation.
- For public sector clients, will the opt-out potentially impact any protections the individual has e.g. right to statutory underpin protection in the LGPS, right to maintain the final salary link, right to continuing final salary scheme membership etc. These protections are outside the scope of this paper but Royal London recommends advisers visit relevant public sector scheme websites for further details.
- What about the wider tax implications? The in or out question should be considered as part of overall planning and tax strategy.
    - Stopping pension contributions could also mean losing benefits or being subject to other tax charges. For example, if a client currently pays contributions which mean that their adjusted net income is just below £100,000 then stopping contributions will mean that their adjusted net income will increase and they will start to lose **personal allowance**[8].
    - The same theory applies in relation to high income **child benefit tax charge**[9] (applies when adjusted net income is over £50,000) and tax-free childcare which is lost when adjusted net income is over £100,000.
    - It is also worth reminding clients that if they opt out and therefore have more cash in their bank account – leaving it there could cause IHT problems so effective planning is needed.

8. *adviser.royallondon.com/technical-central/pensions/contributions-and-tax-relief/60-tax-relief-on-pension-contributions/*
9. *adviser.royallondon.com/technical-central/pensions/general/child-benefit-avoiding-the-tax-charge/*

A WORD ON THE NHS

The first half of 2019 has seen a good deal of press coverage about **the impact the tapered annual allowance** is having on doctors.

Views on whether doctors should receive special tax treatment continue to vary. We're of the opinion that the taper should be abandoned altogether. There are cleaner and clearer ways of restricting pensions tax relief for higher earners than this complex piece of legislation. But calls to do away with this unpopular and confusing limit have so far fallen on deaf ears.

Instead, on 3rd June 2019, the government announced that it intends to consult on a "pay half to get half" option for doctors known as a 50:50 plan. Members who choose this option will pay half the standard contribution rate and in exchange will accrue benefits at half the rate. Whilst any flexibility which will help ease the unwanted consequences of the current situation is welcome, 50:50 is no cure-all. Firstly, it will require doctors to be able to proactively model impacts of both full and 50:50 membership in advance – something which may not always be realistically possible. Secondly, because pension contributions are excluded from the definition of threshold income (TI), a 50% contribution may have the perverse effect of increasing TI with the result that the outcome of this option may not always be as compelling as doctors think.

And as is usually the case with new proposals, there are a range of issues which aren't yet clear. Firstly it's not clear whether the 50:50 plan option will be available solely to senior clinicians impacted by the taper, or whether it will be available across the membership. Access to a reduced contribution option might be attractive to the large numbers of much more modestly paid NHS workers who are leaving the scheme due to affordability issues. Secondly it's not clear whether the option will only be available under the career average scheme or whether it will also be available to older members who've remained in the 1995 or 2008 final salary scheme under transitional protections. Lastly, it remains to be seen whether members opting for a 50:50 plan would retain the right to death in service or ill-health benefits calculated as for full members.

The government will need to consult on proposals before they are written into regulations so stakeholders, including any clients who are members of the scheme, will have the opportunity to comment or potentially even to suggest alternative or additional measures. We have considered the merits and demerits of various potential options in a **piece written for the trade press**[10].

Theory is one thing and practice is of course another. So we've gone one step further here to see how the numbers might stack up for a typical hospital specialist under both existing and hypothetical scheme options including a 50:50 plan.

10. www.professionalpensions.com/professional-pensions/opinion/3075139/nhs-pensions-diagnosis-and-treatment

CASE STUDY
TITLE

Ursula is a 50 year old anaesthetist in Leeds with pensionable pay of £127,000 as at 31st March 2019. She has been accruing benefits under the NHS career average scheme since 1st April 2015, but she also has 15 years' final salary benefits in the NHS 1995 section which (as long as there's been no break in service of more than 5 years), remain linked to her final salary when she comes to retire. Her contributions to the scheme are **14.5% of pensionable pay**[i]. In 2019/20 she expects to earn additional pay of £8,000 in additional non-pensionable[ii] overtime pay of £8,000. She receives a pay award of £3810 on 1st April 2019 and as she has no carry forward available is concerned that the impact of the tapered annual allowance means she should leave the NHS scheme. Her plan is to retire in 10 years' at age 60 when she will be able to take her 1995 section benefits without actuarial reduction. She is not yet certain whether she'll take her career average benefits at the same time (in which case they will be actuarially reduced for early payment) or at a later date.

We've taken a look at 2 options currently available to Ursula:

- Stay in the NHS DB scheme (*option 2*)
- Stay in the NHS DB scheme but decline to work overtime (*option 3*)

We've also looked at how the numbers would stack up under 2 hypothetical options:

- Stay in the NHS DB scheme under a 50:50 option (*option 1*)
- Leave the NHS DB scheme but enter a new DC section where employer contributions can be capped at the individual's tapered annual allowance subject to a maximum of 16% of pensionable pay (*option 4*)

The table below summarises the outcome of our analysis shown as the overall benefit to Ursula against her costs.

	Option 1	**Option 2**	**Option 3**	**Option 4**
	Hypothetical 50/50 option	**Full contribution**	**Stay in scheme on full contribution but decline overtime**	**Hypothetical DC - maximum employer contributions within taper AA capped at 16%**
Ursula's costs *(tax charge + gross contribution)*	£9,484	£24,140	£22,540	£11,501
Additional Benefit Accrued				
Pension	£2,356	£3,615	£3,615	£950 (DB)
Lump sum	£2,143	£2,143	£2,143 *but* £8000 less taxable income	£2,143 (DB)
DC	-	-	-	£32,430
Estimated Value of additional pension over 20 year retirement	£89,445	£137,249	£137,249	£52,825[iii] (DC) £35,228 (DB)

i. www.nhsbsa.nhs.uk/member-hub/cost-being-scheme
ii. overtime is non-pensionable – reg 27 of the NHS 2015 regulations
iii. Value of pot on retirement at age 60 assuming 5% growth net of charges. Total estimated value will vary if Ursula leaves some or all of the value of her DC pot invested over her retirement.

INTRO
INDEX
SEC A
SEC B
SEC C
SEC D
SEC E
SUM
A WORD ON THE NHS

CASE STUDY
TITLE

Option 1

Under this hypothetical option, Ursula pays 50% of the full contribution to receive 50% of the pension build-up in the career average scheme. We've assumed that any growth in the deferred final salary benefits will not be impacted by this election.

In the event of death or ill-health, benefits are calculated as if Ursula had remained in the main section of the scheme.

Her final salary benefits remain linked to the salaries she earns in the career average scheme.

- If Ursula were to stay in the scheme under this option, she'd accrue additional pension rights of £2,356 in return for gross costs to her of £9,484. There is no annual allowance tax charge.
- If she were to live 20 years following retirement, using the assumptions noted below, these rights could amount to additional total taxable income over her retirement of £89,445. In addition to this she'll have an automatic tax-free lump sum of £2,143. This lump will increase if her salaries in the career average scheme continue to rise between April 2020 and Ursula's retirement.
- This means that her gross costs of staying in the scheme under a hypothetical 50/50 option are 10.6% of the estimated overall value of the benefits paid over her retirement.

Option 2

Under this option, Ursula continues to pay into the NHS scheme on the standard basis.

- This option results in additional accrued pension of £3,615 and an automatic tax-free lump sum of £2,143. This lump will increase if her salaries in the career average scheme continue to rise between April 2020 and Ursula's retirement.
- The gross cost to Ursula of this accrual are £24,140, calculated as her employee contribution of £18,967 plus a tax charge of £5,173
- As with the 50/50 option, the additional pension accrued of £3,615, will revalue between April 2020 and Ursula's retirement and will be paid each year thereafter on an escalating basis. Using the same assumptions as for option 1, it could be worth an estimated £137,249 over Ursula's retirement.
- This means that Ursula's costs of staying in the scheme under this option are 17. 6% of the estimated overall value of the extra benefits accrued.
- Under this option Ursula's costs as a proportion of her estimated expected benefits have increased because her pay award of £3810 and overtime payment of £8,000 have caused her to become subject to the tapered annual allowance (Ursula's threshold income in 18/19 was £108,585 calculated as her salary of £127,000 less her gross pension contribution of £18,415)

Option 3

Under this option, Ursula remains as a full member of the NHS pension but declines to do the overtime work.

- The pension benefits Ursula builds up in 2019/20 are unaffected as the overtime declined is non-pensionable. So as with option 2, by staying in the scheme Ursula accrues additional pension rights of £3,615 and additional lump sum rights of £2,143. Also, as with option 2, these additional pension rights could be worth an estimated £137,249 over her retirement.
- But this option changes Ursula's costs. She's declined £8000 worth of overtime making her adjusted income £8000 lower. This in turn results in a higher tapered annual allowance and lower tax charge.
- Her total gross costs are therefore £22,540 calculated as her £18,967 personal contribution plus an annual allowance charge of £3,573.
- This means that Ursula's gross costs of staying in the scheme under this option are 16.4 % of the estimated overall value of the extra benefits accrued, BUT ,Ursula will have £8000 less taxable income.
- Factoring this "hidden" cost, the gross cost to Ursula of staying in the scheme are 21.2 % of the overall estimated value of extra accrued benefits.

CASE STUDY
TITLE

Option 4

Under our final option, Ursula leaves the NHS DB scheme at the start of 19/20 and joins a (hypothetical) DC alternative offering NHS employer contributions of a maximum 16%. The employee may also contribute. Her career average benefits become deferred and revalue at the deferred rate of CPI.

In order to stay within her tapered annual allowance, Ursula's total contributions to the DC scheme must be lower than her allowance if she has pay growth over the period. This is because her final salary benefits will continue to generate pension input due to the "final salary link" whereby salaries earned in the career average scheme are used to calculate final salary benefits as long as there has been no break in service exceeding 5 years.

- In Ursula's case the maximum employer contribution of 16% (£20,929 - £130,810 of her pay is pensionable), means that she can make personal contributions of £11,501 without exceeding her tapered annual allowance of £35,130.
- For a gross cost to Ursula of £11,501 she has accrued additional DB pension rights of £950, additional DB lump sum rights of £2,143 plus a DC pension pot of £32,430 before investment growth and charges.
- Using the same assumptions as for options 1-3, the additional DB rights could be worth an estimated £35,228 over a 20 year retirement.
- This means that under this option, the gross cost to Ursula of opting for a DC arrangement would be 13.06%% of the expected overall value of the additional accrued benefits.

Advice

- Ursula's adviser explains that based on the reasonable assumptions they've agreed, all the options result in estimated expected benefits which exceed the cost to Ursula
- He explains he sees no merit in option 3 (Ursula declines overtime work). Compared to staying as a full NHS scheme member her tax charge will be £1600 less, but this saving will be more than offset by her earning £8000 less.
- Of the 3 remaining options, Option 1 produces the outcome with the lowest cost to benefit value, however this will reduce the rate at which Ursula accrues benefits.
- Using the assumptions noted, the adviser calculates that Ursula's benefits will have an estimated LTA valuation of £1,729,368 on retirement in 10 years if she remains a full member of the scheme. If she enters the 50/50 section, the adviser calculates that the value of her benefits at retirement will be an estimated £1,358,614. Assuming CPI of 2.4%, the LTA at that point will be £1,337,371.
- The adviser points out that these projections are sensitive to the rate of inflation and Ursula's pay awards and discusses the implications with her. He explains that under the 50/50 option, if the worst were to happen any survivor benefits due to her loved ones or any ill health benefits would be calculated as if she were still a full member of the scheme.
- Ursula is attracted to option 4 as this will provide her with a money purchase pot which she can take as cash or drawdown. Whilst this is true, the adviser explains that under options 1 and 2, Ursula is able to exchange pension for life for additional tax-free cash which she can use as she wishes. He also explains that her right to ill-health benefits and survivor benefits calculated for a full, active member of NHS pensions will cease if she opts for option 4. This is an important factor as Ursula's husband is self-employed with little pension provision of his own.
- Having regard to all the relevant factors including the analysis showing Ursula's benefits are likely to exceed the LTA as a full NHS DB member, he recommends that she elects to join the 50/50 section in 2019/20 but that the situation should be regularly reviewed.

CASE STUDY
TITLE

Further details on all the numbers is provided below.

	Option 1	Option 2	Option 3	Option 4
Pension entitlement at 6/4/19				
Final Salary	£23,813	£23,813	£23,813	£23,813
Career Average	£9,855	£9,855	£9,855	£9,855
Total Pension	£33,668	£33,668	£33,668	£33,668
Final Salary Lump sum	£71,438	£71,438	£71,438	£71,438
Pension entitlement at 5/4/20				
Final Salary	£24,527	£24,527	£24,527	£24,527
Career Average	£11,497	£12,756	£12,756	£10,091
Total Pension	£36,024	£37,283	£37,283	£34,618 (DB)
Final Salary Lump sum	£73,581	£73,581	£73,581	£73,581
DC (employer)	-	-	-	£20,929
DC (employee)	-	-	-	£11,501
Additional rights accrued over PIP				
Pension	£2,356	£3,615	£3,615	£950 (DB)
Lump sum	£2,143	£2,143	£2,143	£2,143 (DB)
DC	-	-	-	£32,430
Uprated value of benefits at 6/4/19				
Final Salary	£463,305 (CPI 2.4%)	£463,305 (CPI 2.4%)	£463,305 (CPI 2.4%)	£463,305 (CPI 2.4%)
Career Average	£161,464	£161,464	£161,464	£161,464
Total	£624,769	£624,769	£624,769	£624,769
Closing value of benefits at 5/4/20				
Final Salary	£466,013	£466,013	£466,013	£466,013
Career Average	£183,952	£204,096	£204,096	£161,456
DC	-	-	-	£32,430
Total	£649,965	£670,109	£670,109	£659,899
Pension Input amount	£25,196	£45,340	£45,340	£35,130

CASE STUDY
TITLE

	Option 1	Option 2	Option 3	Option 4
Ursula's gross contribution	£9,484	£18,967	£18,967	£11,501
Ursula's contribution net of tax relief at 40%	£5,690	£11,380	£11,380	£6,901
Threshold Income	£129,326	£119,843	£111,843	£127,309
Adjusted income	£154,522	£165,183	£157,183	£159,739
Tapered annual allowance	£37,739	£32,408	£36,408	£35,130
Excess pension saving	£0	£12,932	£8,932	£0.00
AA charge at40%	£0	£5,173	£3,573	£0.00
Gross cost to Ursula of staying in scheme	£9,484	£24,140 (£18,967 + £5,173)	£22,540 (£18,967 + £3,573)	£11,501

Assumption 1: Ursula's pensionable pay as at April 2015 was £119,675 and she has had 2% pay increases until April 2019 when she is awarded 3%

Assumption 2: CPI between April 2019 and Ursula's retirement is assumed to remain at 2.4%

Assumption 3: CPI following Ursula's retirement remains at 2.4%

Assumption 4: Ursula's pay awards from April 2020 onwards are 2%

REGULATORY ISSUES

1. Regulatory Background

Amidst all the debate relating to the evolving regulatory requirements which apply to DB transfers, it would be easy to forget that much of COBs 19 which sets out FCA's rules and guidance on these transfers also applies to pension opt-outs.

COBs 19.1.1 provides that the rules relating to the provision of advice of pension transfers also apply to the provision of advice on pension opt-outs. A pension opt-out is defined as:

"a transaction, resulting from the decision of a retail client who is an individual, to:

(a) Opt out of an occupational pension scheme, group personal pension scheme or group stakeholder scheme to which his employer contributes and of which he is a member; or

(b) Decline to become a member of an occupational pension scheme, group personal pension scheme, or group stakeholder pension scheme to which his employer contributes and of which he is eligible to join, or will be eligible to join at the end of a waiting period

in favour of a stakeholder pension scheme or personal pension scheme."

Importantly, the rules only apply (COBs 19.1.1(3)) where the opt-out advice is given in relation to "a pension opt-out from a scheme with safeguarded benefits or potential safeguarded benefits".

Thus, without triggering the rules, an adviser can recommend that an individual:

- opt out of an occupational money purchase scheme, GPP or GSHP, or
- opt out of a scheme with safeguarded benefits as long as contributions are not then paid to a stakeholder scheme or personal pension scheme instead.

Although logically an opt out from a scheme with safeguarded benefits in favour of paying contributions to the pension arrangements of a third party should not fall in scope of the specific requirements noted here (they fall outside the individual's own retirement planning and count towards the recipient's AA/LTA), regulation wording isn't completely clear, so caution is suggested.

The statements contained in COBs 19.1 are, of course, essential reading for advisers, but the table below notes the paragraphs which should be taken into consideration where applicable.

COBs 19.1.1A	Requirement for pension transfer specialist(1)
COBs 19.1.1B	Role of the pension transfer specialist when checking
COBs 19.1.6	Guidance on assessing suitability
COBs 19.1.6A	Working with another adviser
COBs 19.1.7C - 19.1.9	Record-keeping and suitability reports

2. Summary of Requirements

- The starting assumption should be that the opt-out will not be suitable.
- The opt-out should only be considered suitable if the adviser can clearly demonstrate that the opt-out is in the client's best interests.
- Prescribed factors should be taken into account when deciding whether the opt-out is in the client's best interests.
- Advice on the pension opt-out must be given or checked by a pension transfer specialist (PTS).
- Where a PTS is used to check the proposed advice, the firm should check that he/she completed certain specified steps. These include checking the completeness of the advice, confirming suitability of any personal recommendation and confirming that they agree with the proposed advice before it is provided to the client.
- Where two advisers (whether from the same firm or not) are working together in connection with a pension opt-out and investment in relation to the same transaction, certain requirements relating to the gathering of information about the client's appetite for risk should be met.
- Where a pension opt-out is arranged without the adviser making a personal recommendation, the adviser must record that no personal recommendation was made and retain that record indefinitely.
- If a personal recommendation is made to opt-out, the suitability report should include a summary of the advantages and disadvantages of opting out, an analysis of the financial implications (if the recommendation is to opt out) and a summary of any other material information.
- Where the advice is to stay in the scheme, this advice should be provided in writing.

As a matter of professional good practice, and in order to comply with the more general FCA "client's best interests rule" under COBs 2.1.1R, some analysis should always be done to ensure that opting out is in the client's best interests. Section C considers the calculations which can be performed to demonstrate whether remaining in the scheme or opting out meets that test from a financial perspective. We also consider the wider (potentially) relevant factors which clients should be made aware of in order that any recommendation is balanced.

Where the specific regulatory requirements apply, analysis of this type is absolutely crucial in order to avoid a breach of the rules. Advisers/firms will need to decide the extent and nature of calculations which need to be undertaken and other factors which need to be taken into consideration in order to feel comfortable that any opt-out recommendation meets the test to "clearly demonstrate on contemporary evidence" that the opt-out is "in the retail client's best interests".

CASE STUDY
REGULATORY ISSUES 1

Ravi, aged 57 is the Finance Director of a FTSE 350 company. He is currently a member of the executive section of his employer's final salary pension scheme which offers benefit accrual at a rate of 1/55th of pensionable pay. He has sought advice because he has faced an annual allowance charge for each of the last 2 years. Ravi's employer offers a 15% cash alternative to scheme membership for individuals with demonstrable AA/LTA tax charge issues. Ravi's adviser analyses the net value to Ravi of remaining in the scheme (see section C) and recommends that Ravi opts out in favour of taking the cash alternative. This does not trigger the requirements because although Ravi is opting out of a scheme providing safeguarded benefits, he is not opting out in favour of contributions to a personal pension or stakeholder pension. Although the specific requirements of COBs 19.1 did not apply, Ravi's adviser nevertheless analysed the situation using reasonable agreed assumptions in order to ensure that the advice was sound.

CASE STUDY
REGULATORY ISSUES 2

Julia, aged 52 is a senior local government officer accruing career average benefits at a rate of 1/49th of pensionable pay each year. Since being promoted to the position of Head of Education Services within her Council in 2015 she has routinely faced annual allowance charges. She has sought advice because she is thinking of opting out of the LGPS in favour of paying contributions to a personal pension scheme. She still has some headroom to accrue further benefits within the LTA, recognises the value of tax relief on pension contributions and considers that paying the AA charge each year "isn't worth it". In this case any personal recommendation made by the adviser to opt out will trigger the rules as the course of action being considered is a pension opt out of safeguarded benefits in favour of contributions to a personal pension scheme. The adviser will need to clearly demonstrate on contemporary evidence that the opt out is in Julia's best interests and he/his firm will need to have a clear view on the analysis which must be undertaken in order to satisfy this regulatory requirement. The adviser must however start with the assumption that the opt out will not be suitable for Julia. The advice must be checked by a pension transfer specialist and the suitability report should include:

- a summary of the advantages and disadvantages of the recommendation
- an analysis of the financial implications of opting out
- a summary of any other material information.

If, having done the analysis, Julia's adviser recommends that Julia remains in the LGPS, this advice should be given in writing.

SUMMARY

Regardless of whether the client's issue is with the LTA or AA or both, and regardless of whether they're in a DB or DC scheme **there's no easy route** to deciding whether opting out/ceasing contributions will be the best course of action.

This will often need to be considered on an annual basis. Calculations will need to be completed to work out the relative value of being in or out and evidenced on file. In addition, no recommendation will be sound unless the member has been alerted to key wider impacts of leaving the scheme. The stakes are higher where the potential opt-out falls within the definition of pension opt out for the purposes of COBs 19.1. In this case an adviser will need to start from the assumption that the opt out is not in the member's best interests and then proceed to demonstrate that it is based on contemporary evidence.

Alternative suitable strategies could include paying into alternative pensions, paying into the pensions of others, VCTs, EIS and variations on these themes. What doesn't vary is that the alternative strategy will need to reasonably project a better member (or beneficiary, if that is important to the member) outcome than continuing scheme membership/continuing contributions. Part of giving advice in this space will be to ensure the client understands that payment of a tax charge isn't a bad thing if the likely eventual benefits outweigh the member's costs including the charge.

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