We hear many comments from our clients regarding thoughts of opting out of the pension scheme because they will be exposed to annual allowance (AA) or lifetime allowance (LTA) charges. However, once we actually work through the operation and likely impacts of these charges, our clients tend to re-focus on the excellent overall value for money the scheme provides.

The following are simple worked examples of AA and LTA charges.

**AA Charge**

We are assuming in this example that the ‘scheme pays’ election is available and is used.

If we have a client with, say, a £5,000 AA tax liability for the year who uses scheme pays, interest at CPI plus 3% will begin to accrue from the January following the July scheme pays election deadline. So, if we have a scheme member, whose date of birth is 1 January 1958, in the 1995 scheme and who is planning to take their pension at age 60, then for the 2015/16 scheme year interest will start to accrue from 1 January 2018 – i.e. their 60th birthday.

The charge is recovered using prescribed factors for the scheme, for this member retiring at 60 who is currently age 58, the relevant factor is 17.1. The £5,000 liability is divided by this factor to give an estimated reduction in pension of approximately £292 per annum (plus 3 times this as a reduction in the lump sum for 1995 members only).

The reduction is calculated in current day terms and will be increased up to the point of retirement.

The charge is taken off the gross pension before income tax, so the client effectively gets higher rate tax relief on the charge, assuming they are a 40% taxpayer. The £292 per annum reduction in starting pension would net down to around £175 per annum – i.e. less than £15 per month. When you equate the liability to this level of lost income in retirement, most people no longer view AA charges, especially when scheme pays is available and CPI is low, as a salient factor in deciding on ongoing membership of the scheme.

**LTA Charge**

If our client has now reached age 60 and ends up with an LTA excess of £100,000, the standard liability on excess pension at 25% would be £25,000. This charge is effectively applied immediately after benefits are crystallised, so will not affect the lump sum for our 1995 member. The new lifetime allowance factors published in September 2015 tell us that a factor of 20.6 is applied, leading to a permanent reduction of £1,213 per annum in gross pension. Assuming 40% income tax, the net loss of pension is £728 per annum / £61 per month approximately. Again, when we break the charge down from a starting excess of £100,000 over LTA, to a net loss of income in retirement of around £15 per week, this tends to apply some perspective to the decision-making on ongoing scheme membership.

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Interaction of AA and LTA Charge Recovery

The capital value of any AA scheme pays charges due at retirement will be deducted from any LTA charge due, so where the client is exposed to both charges, they will effectively receive double tax-relief on the AA scheme pays charge – once by having its capital value deducted from the LTA value and then also by having it deducted from gross pension rather than net pension.

This is a necessarily simple example and there are other aspects to consider, but the point is to provide a context in which to consider potential tax charges. The simple message is the old adage “don’t let the tax tail wag the investment dog”.

We will of course be happy to review your personal position in detail.

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