Pensions: can you navigate the maze?

ANDREW LANG

As successive UK Governments seek to tighten the rules around pension reliefs and benefits for higher earners, many doctors could find themselves paying more tax than they expected on pension income. Andrew Lang describes the current pension landscape for doctors with NHS and private pensions.

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Over the past few years, pensions seem to be constantly creating headlines. Ironically, it began back in 2006 when 'pensions simplification' was introduced by the then Chancellor, Gordon Brown.

The intentions seemed sensible on the face of it. One goal was to try to bring together decades of different sets of pension rules under a new 'simpler' structure. At the same time, a lifetime and annual cap were set on the amount that could be saved while receiving tax relief. Anyone who had significant pension savings when the new rules were introduced could protect what they had so they were not unfairly punished by the new rules. So far, so simple.

Doctors traditionally had their NHS pension, which had been built up through years of service within the scheme, and may also have had private pensions if they received other earnings. The introduction of the new contract just three years earlier meant that pensionable pay had the opportunity to significantly increase before retirement.

While these pay rises took a few years to kick in, few realised that one major consequence of the increases was to bring many more doctors much closer to or even over the new pensions cap. This is where pensions became significantly more complicated.

THE LIFETIME ALLOWANCE

The lifetime allowance (LTA) is a limit on the amount of pension benefit that can be drawn from pension schemes – whether lump sums or retirement income – and can be paid without triggering an extra tax charge. Going over the allowance can trigger tax at up to 55%.

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When the LTA was introduced at a level of £1.5 million in 2006, the intention was that it would rise steadily to £1.8 million by 2010/11 and would then be increased in line with inflation each year. Up until 2010/11 the trajectory was as had been intended. However, the Treasury did not foresee the financial crash in 2008/09, which caused a huge strain on Government coffers. Pensions were seen as an area from which additional taxation could be raised and the LTA was set on a downward trajectory (Table 1).

This move may seem counterintuitive, as the Government generally prefers people to save for their retirement so they do not rely on the State. However, it is only when you dig a little deeper into the value of the NHS pension that you realise how many doctors may be affected by the series of LTA reductions we have seen since April 2012.

For LTA purposes, private pensions and the NHS pension are valued very differently. Private pensions are known as money purchase pensions, which means contributions are paid into a fund and that fund grows depending on the growth of the investments chosen.

Traditionally, at retirement an annuity would be purchased. However, following relaxation of the rules, there are now more options.

Tax year	LTA	AA
2006/07	£1.5m	£215 000
2007/08	£1.6m	£225 000
2008/09	£1.65m	£235 000
2009/10	£1.75m	£245 000
2010/11	£1.8m	£255 000
2011/12	£1.8m	£50 000
2012/13	£1.5m	£50 000
2013/14	£1.5m	£50 000
2014/15	£1.25m	£40 000
2015/16	£1.25m	£40 000
2016/17	£1m	£40 000

Table 1. The lifetime allowance (LTA) steadily increased until 2012/13, after which it started to be cut. The annual allowance (AA) has also been reduced sharply

THE NHS PENSION AND LTA

For LTA purposes, money purchase pensions are assessed at their actual valuation when benefits are taken. For example, a fund of £50 000 will be measured against the lifetime allowance when any benefits are drawn.

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The NHS pension, however, is a defined benefit pension scheme. These types of schemes are not reliant on investment returns, but instead are based upon length of service and salary. There are different versions of the NHS scheme, but let us look at the 1995 section, the largest group.

A doctor who joined the NHS pension scheme at age 25 when they graduated and worked through to age 60 may have accrued 32 years' membership within the scheme if they have always worked full-time but had a few years abroad. The top increment of the consultant contract has a basic salary of £102 465 from April 2016. If the doctor has some on-call responsibilities and has accrued some clinical excellence awards, the overall pensionable salary may be £110 000. This doctor will have accrued a pension of £44 000 gross per annum and a lump sum of £132 000.

For LTA purposes, the benefits are valued by multiplying the pension by 20 and adding the lump sum. This doctor therefore has an NHS pension valued at £1 012 000. This is higher than the current LTA of £1m, which came into effect in April 2016.

The two variables with the 1995 scheme are service and salary. With higher service and/or higher salary than in the example above, the figures for LTA purposes will also be higher. The same doctor with a national bronze award, for example, may have a pensionable salary of £140 000, which gives a nominal value of £1 288 000 for LTA purposes. If this doctor also has private pensions, these would be added on top.

The examples above are generic and each individual situation will be different. For GPs the 1995 scheme works slightly differently in terms of how the pension is calculated, as do the different NHS schemes (2008 and 2015). However, for LTA purposes, the calculation is always the same for a defined benefit scheme, *ie* 20 times the pension plus any lump sum.

Although the headline figure of £1m sounds high, it is easy to see the value of accumulating NHS benefits and that the limit can be breached without careful management.

TRANSITIONAL PROTECTION

Every time the Government has reduced the lifetime allowance, it has introduced a range of transitional protections to help those individuals affected.

There are currently three types of protection available and each one differs in terms of qualification rules and what can be protected. What is suitable for one person may not be for another, so it is important the correct protection is chosen. Doctors who think they may be impacted by the reduction of the lifetime allowance should take independent advice and consider their options.

THE ANNUAL ALLOWANCE

The annual allowance (AA) is a limit on the amount that can be contributed to a pension each year while still receiving tax relief. It is based on earnings for the year and is capped at £40 000.

The AA is a much more complex area than the LTA, with many more variables.

Table 1 shows that the allowance steadily increased up to a maximum of £255 000 in 2010/11 and was then reduced drastically to £50 000, albeit with a new 'carry forward' rule.

If the allowance is breached in any one year, it allows a carry forward of any unused allowances from the three previous tax years. If there is still a breach after utilising the carry forward, the excess is added to the income for the tax year and taxed at the marginal rate of income tax.

There is also a different set of rules that came into force this tax year for anyone who earns more than £150 000 gross from all sources. This group may see their annual allowance reduced to as low as £10 000, depending on the level of income they receive.

In terms of the calculations, again, there are differences in the way money purchase pensions are measured for AA purposes when compared to defined benefit schemes. Any contributions to money purchase schemes are taken at face value. If a contribution is £500 gross per month (after basic rate tax relief), that totals £6000 per annum; 'input' is therefore £6000 for the tax year.

For defined benefit schemes it is more difficult. The accrued benefits are measured at the start of the input period and again at the end of the period. An allowance for inflation is made and the difference between the start and end values are deemed the 'input' for the year.

Any increase in benefits, such as an extra year of service accrued or an increase in pensionable salary, will count towards the input. A pay rise given through a contractual obligation, a clinical excellence award, making management positions pensionable or a simple statutory rise could generate a tax charge. It is important for doctors to determine their own position as the onus is on the individual to inform HMRC if they have exceeded the allowance.

SEEK ADVICE

Despite potential concerns about the LTA and AA, the NHS pension scheme remains an excellent pension. There are also many other options within the scheme such as early/late retirement, retire and return, becoming a deferred member, but all of these should be considered carefully before proceeding.

In recent years we have seen products other than pensions being used to save for retirement. Over time we may see pensions reduce as a proportion of overall retirement income, with products like ISAs taking more of an active role.

With the ever-increasing complexity of pensions for doctors, it is essential that they seek advice for their own particular situation.

Declaration of interests

Andrew Lang is co-founder of Sandison Lang (sandisonlang.com), which provides specialist accountancy advice to the medical profession. He also works with Cavendish Medical (www.cavendishmedical.com), which provides financial advice to senior medical professionals in private practice and the NHS.