HFMA How It works briefing
May 2019 (updated August 2019)

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Pensions lifetime and annual allowance

The impact on the NHS

Introduction

The tax implications of the lifetime and annual allowance on clinicians who are members of the NHS pension scheme has been in the press recently. It has also been raised in recent debates in the House of Lords and the House of Commons. As a result, on 21 May 2019, the Chancellor announced[1] that HM Treasury and the Department of Health and Social Care (DHSC) are considering how to provide additional pension flexibility for NHS doctors affected by the annual allowance tax charge. A proposal to change the NHS pension scheme for clinicians was announced[2] in August 2019.

This 'How it works' briefing sets out the background to the issue and points members at useful guidance. The briefing does not include any advice as the HFMA does not provide financial or pension advice.

While every care had been taken in the preparation of this briefing, the HFMA cannot in any circumstances accept responsibility for errors or omissions and are not responsible for any loss occasioned to any person or organisation acting or refraining from action as a result of any material in it.

[1] House of Commons, *Oral answers to questions*, 21 May 2019
[2] DHSC and HM Treasury, *NHS pensions for senior clinicians: new changes announced to improve care*, 7 August 2019

Overview

Recently there have been a number of articles in the press about the NHS pensions crisis and clinics being cut as a result of doctors leaving the NHS. The British Medical Association (BMA) is lobbying the government for changes to the NHS pension scheme or the current tax rules, arguing that the impact on NHS services is an unintended consequence of the recent changes to the tax legislation.

The issue at the heart of this debate is the limit to the contribution that individuals can make to their pension scheme each year and the size of the pension pot without being subject to tax – the annual allowance and the lifetime allowance. The annual allowance was significantly reduced in 2011, but in 2016 it was subject to a taper which means that more highly paid individuals are being impacted and are having to pay additional tax. The annual allowance and lifetime allowance are applicable to everyone paying tax in the UK – this is not an NHS specific issue or even a public sector specific issue. The press and social media coverage focuses on the impact on clinicians, but other long-serving senior managers in the NHS are equally affected.

The arrangements for calculating the contribution made by an individual to a defined benefit scheme, such as the NHS pension scheme, are complicated. It is possible to for individuals to forecast the impact of the annual allowance, but it is a difficult and technically challenging calculation. See Exhibit 1 for a definition of the different types of pension scheme.

The issue currently being debated is in relation to the annual allowance, so this briefing focuses on that specific aspect. It is possible that, once an individual goes over the annual allowance, the amount of tax that is due in the year can be more than the pay increase that caused that individual to breach the annual allowance – negating the pay increase. More often, it means that additional work or a pay rise is effectively being taxed at a much higher rate than the current highest rate of income tax.

As a result, some clinicians are refusing to take on additional clinics or managerial duties, taking early retirement, or are seeking a reduction in working hours. Other senior managers may be refusing promotions or pay rises.

This briefing sets out:

- the background to the issue
    - tax arrangements
    - the NHS pension scheme
- the impact that the issue is having on individuals and the NHS
- possible action that can be taken to resolve the issue.

The briefing does not include any worked examples or provide any advice – the HFMA cannot provide personal financial or tax advice - instead it signposts where worked examples and advice can be found.

Exhibit 1: What are the different types of pension schemes?

Defined contribution schemes

IAS 19 *Employee benefits* defines defined contribution schemes as:

> 'post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.'

Defined benefit schemes are any other post-employment benefit plans.

In practical terms, the amount of benefits paid on retirement from a defined contribution scheme (also called a money purchase scheme) will be based on the amount of money that has been paid into the scheme, how long it has been invested, what the investment returns are and the level of charges. Most private sector pensions are now defined contribution schemes – some will have legacy defined benefit schemes which are closed to new members.

Defined benefit schemes

There are lots of different types of defined benefit schemes but, in summary, the amount of benefit paid on retirement is linked to the amount of money the employee is earning on or around retirement and the length of membership in the scheme. In a final salary scheme, the amount of pension is a proportion based on the number of years membership in the scheme (typically 1/60th or 1/80th for each year of membership) of the final salary being earned at the date of retirement. The final salary will be defined on a scheme by scheme basis and may not necessarily be the actual salary being paid on the date of retirement. In an average earnings scheme, the pension is linked to an average of the salary being earned a number of years before retirement.

Hybrid schemes

To complicate matters further, there are also hybrid schemes which have characteristics of both types of scheme. These schemes tend to share the risk of paying higher costs or receiving reduced benefits between employees and employers whereas defined contribution schemes are a risk for the employee and defined benefit schemes for the employer.

Background to the issue

Tax relief on pension contributions

Payments into pension schemes are a tax efficient way to save. Contributions paid into pensions are subject to tax relief subject to the following limits:

- 100% of earnings in a year
- the annual allowance (currently, £40,000 a year)
- the lifetime allowance (currently, £1,055,000).

As is the case with all pensions, payments out of the NHS pension scheme are subject to tax.

Annual allowance on pension savings benefiting from tax relief

Since 2006, an individual's ability to make tax-free contributions to a pension scheme has been subject to the annual allowance[3]. Once that allowance has been reached, the individual is subject to an annual allowance charge which is calculated as part of their tax return. It is the individual's responsibility to submit a tax return if they are liable for the annual allowance charge and then to pay the tax due.

For defined contribution schemes, the allowance is a limit on the amount that can be paid into the pension scheme by the individual or their employer. For defined benefit pension schemes, like the NHS pension scheme, the limit is on the value of the increase in the pension built up over the pension input period[4]. This cannot be calculated by the individual without information provided by the pension scheme.

The annual allowance was originally £215,000 and rose to £255,000 in 2010[5]. In the 2010 budget the then government announced that the changes to the regime would be subject to informal

[3] *Finance Act 2004*, section 227
[4] From 2016/17, the pension input period is typically the tax year but can be less where the individual joins a scheme part way through a year. It will always end on 5 April as this is the last day in the tax year. In 2015/16 there were transitional arrangements to change pension input periods from being based on the date that the individual joined the scheme to being based on the tax year.
[5] HM Treasury, *Government announces further details about changes to pensions tax relief*, 3 March 2011

consultation. In 2010, it was announced that the annual allowance would be reduced to £50,000[6]. Since 2014 it has been reduced further to £40,000[7].

Taper on the annual allowance

In the Summer Budget 2015[8], the then government announced that a taper to the annual allowance for those with adjusted annual incomes, including their own and employer's pension contributions, of over £150,000 would be applied from April 2016:

> 'For every £2 of adjusted income over £150,000, an individual's annual allowance (the limit on the amount of tax relieved pension saving that can be made by an individual or their employer each year) will be reduced by £1, down to a minimum of £10,000.
>
> To ensure this measure is focused on the higher and additional rate tax payers who currently gain the most benefit from pensions tax relief, those with income, excluding pension contributions, below a £110,000 threshold will not be subject to a tapered annual allowance. Only 1% of taxpayers exceed this threshold and save into pensions, and even fewer will actually be affected by this measure.'

The impact assessment[9] stated that around 300,000 pension savers were expected to have net incomes of at least £110,000 and therefore could be affected by this measure. It was expected that there would be some change in behaviour in response to the changes:

- individuals and employers would reduce pension contributions which would be in excess of the annual allowance. This would increase the amount of income subject to income tax
- individuals in the taper region (between £150,000 and £210,000) would reduce their incomes in response to the taper.

It was also anticipated that there would be some impact for pension schemes and employers in terms of providing information and guidance and to update their systems to reflect the changes to pension arrangements.

The new arrangements came into force in 2015/16 under section 23 and schedule 4 of the *Finance (No.2) Act 2015*[10] which amended the *Finance Act 2004*. Exhibition 2 explains some of the key definitions included in the legislation.

Lifetime allowance

The lifetime allowance is a limit on the size of an individual's pension pot before tax is payable. In 2018/19, the lifetime allowance was £1,055,000[11].

For defined contribution pension schemes, the pension pot is the amount of money that goes towards paying out the pension. The size of the pot will depend on the amount of money paid into the scheme by the individual and their employer, the performance of the fund's investments (up or down) and the way that the individual decides to take their money out of the fund.

For defined contribution schemes, the pension pot is calculated as 20 times the pension in the first year, plus the lump sum.

Where an individual's pension pot exceeds the lifetime allowance then they will be liable to pay tax. The rate of tax is currently 55% if the pension is received as a lump sum, or 25% if it is received any

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[6] HM Treasury, *Financial Secretary to the Treasury announces changes to restricting pensions tax relief*, 14 October 2010
[7] HMRC, *Pension schemes rates*, 15 April 2019
[8] HM Treasury, *Policy paper: summer budget 2015*, 8 July 2015 (section 3.10)
[9] HMRC, *Policy paper: pensions tapered annual allowance*, 8 July 2015
[10] *Finance (No. 2) Act 2015* and *explanatory notes* (paragraphs 389 to 436)
[11] HMRC, *Tax on your private pension contributions – lifetime allowance*, accessed 22 May 2019

other way. The tax is paid by the NHS pension scheme and taken out of the individual's NHS pension benefits[12].

Exhibit 2: Definitions

There a number of key definitions that are all explained on the HMRC's website.

Taxable income – this is the income for the year that is subject to taxation. It will include money earned from employment, profits from self-employment, some state benefits, pensions, rental income, taxable benefits from employment, interest on savings. For different types of income, there are allowances which mean earnings up to that amount are not taxed. Some income, such as premium bond wins or interest on individual savings accounts (ISAs) are not taxable.

Net income – this is taxable income for the year less any tax reliefs that apply, such as payments made to your pension scheme that had tax relief but were paid before the relief was given.

Threshold income – this is the net income for the year less the gross amount of pensions savings from all schemes, less the amount of lump sum death benefits received, less any reduction of income from pension provision through salary sacrifice arrangements made after 8 July 2015, less any reduction of employment income for pension provision through any relevant flexible remuneration arrangements made after 8 July 2015.

Adjusted income – this is the net income plus amounts of claims made for tax relief on pension savings, plus pension savings made to pension schemes where tax relief was given, plus relief claimed on pension savings made to overseas pension schemes, plus the amount of pension savings your employer made for you, less any lump sum death benefits received from registered pension schemes.

Pension savings – for defined contribution schemes this is the amount of savings made by the individual or on their behalf during the pension input period. For defined benefit schemes, this is the difference between the opening value and the closing value where:

- the opening value is the annual pension built up so far at the end of the previous pension input period multiplied by 16 plus any separate lump sum built up at the end of the previous pension input period, all increased by the consumer price index (CPI) for the previous September
- the closing value is the annual pension built up so far at the end of the pension input period multiplied by 16 plus any separate lump sum built up at the end of the previous pension input period.

Where the difference is negative, the pension savings are nil for that period. Where the difference is positive, that is the amount of pensions savings for that period.

NHS pension scheme

The NHS pension scheme for:

- England and Wales is administered by the NHS Business Services Authority
- Scotland is administered by the Scottish Public Pensions Agency
- Northern Ireland is administered by the HSC Business Services Organisation.

In all cases, the NHS pension scheme is made up of two different schemes:

- 1995/2008 NHS pension scheme which closed with effect from 1 April 2015. There are two sections to this scheme - the 1995 section and the 2008 section
- 2015 NHS pension scheme which was introduced from 1 April 2015.

[12] NHS Business Services Authority, *Lifetime allowance*, accessed 22 May 2019

Membership of the different schemes is based on the date of joining the NHS pension scheme and whether or not the individual had protected rights or transferred between schemes. Exhibit 3 sets out the key differences for individuals between each of the three schemes.

Exhibit 3: NHS pension schemes

NHS pension schemes are open to staff employed by an NHS organisation, a GP surgery, a direction body (usually an organisation now employing staff TUPE'd from an NHS organisation[13]) or an independent provider. It is also open to GPs, dentists, ophthalmic practitioners or non-GP providers of General Medical Services, Primary Medical Services, Alternative Provider Medical Services contracts or Specialist Primary Medical Services contracts.

	1995 section[14]	2008 section	2015 scheme[15]
Employee contributions	All member contributions are 5 – 14.5% of pensionable pay depending on the rate of that pay		
Pension	An annual pension worth 1/80th of the best of the last 3 years' pensionable pay per year of membership An annual pension worth 1.4% of total uprated earnings for practitioners	An annual pension worth 1/60th of reckonable pay per year of membership An annual pension worth 1.87% of total uprated earnings for practitioners	Each year a pension pot of 1/54th of the pensionable pay is built up and then revalued using an agreed formula each year. The final pension is the sum of each year's pension pot.
Retirement lump sum	Retirement lump sum of 3x pension	Option to exchange part of pension for cash at retirement up to a limit. Some members have a compulsory amount of lump sum	Option to take a lump sum in exchange for pension. £12 of lump sum is available for every £1 of pension given up.
Normal pension age	Normal retirement age of 60 years	Normal retirement age of 65 years	Normal retirement age is the state pension age or 65 if that is later

The NHS pension schemes are unfunded, defined benefit schemes. The scheme rules are set out in statutory regulations. The contribution rates (both employer and employee) are set as a result of the scheme valuation and cannot be varied by employers or employees. This means that NHS employees are either in the scheme or not in the scheme.

According to NHS Employers[16] and the NHS Business Services Authority (NHSBSA)[17], NHS employees are more likely to exceed their annual allowance if:

- they have long service in the NHS pension scheme – the pension savings is calculated using the annual pension built up which is the salary at the end the period multiplied by the number of years' service divided by the scheme multiple – for the NHS schemes either 1/60 or 1/80. As well as annual income tending to increase year on year, the pension savings will go up as additional years are worked

[13] NHS Business Services Authority, *NHS pension direction factsheet*, 2014
[14] NHS Business Services Authority, *1995/2008 NHS pension scheme – guide for members*, 2019
[15] NHS Business Services Authority, *2015 NHS pension scheme – guide for members*, 2019
[16] NHS Employers, *Annual allowance briefing*, September 2018
[17] NHS Business Services Authority, *NHS Pensions – annual allowance does it affect me?*, 2017

- they have transferred pensions rights from a club scheme[18] on or after 28 January 2015
- they have purchased additional pension or added years
- they are members of the 1995/2008 scheme
- they receive a significant increase in pensionable pay
- they are in receipt of a clinical excellence award
- they are promoted several times within a brief period
- they have pension savings in other workplace pension schemes
- they receive taxable income from other sources (for example, income from other employment, pension income, self-employment and income from rental properties)
- they have annual taxable earnings of more than £110,000
- inflation is low.

It is the individual's responsibility to complete a self-assessment tax return if they are liable to pay the annual allowance charge[19]. The individual can either pay any tax due themselves or use the scheme pays facility to share responsibility with NHS pensions[20].

The NHS pension scheme is a defined benefit scheme, which makes the calculation of the value of benefits complicated. There are many variables that need to be taken into account and some of the information can only be provided by the NHS pension scheme.

The NHS pension scheme will provide an annual allowance statement to those members whose pension benefit is over the standard annual allowance, currently £40,000[21]. However, the introduction of the taper means that the NHS pension scheme will not have all the information necessary to assess whether the tapered allowance has been reached. This is because the pension administrators will not have information on non-pensionable income that an individual has earned or any other pension schemes they may be members of. Therefore, the advice is that members with higher salaries should seek independent financial advice and should request a pension savings statement from the NHS pension scheme where their calculated adjusted income is between £150,000 and £210,000[22].

Impact on individuals and the NHS

Putting it simply, individuals who have threshold income[23] of less than £110,000 will have an annual allowance of £40,000. They will have to pay tax (the annual allowance charge) on any amount that their pension saving for the year above that £40,000 limit. Tax will be payable at their marginal tax rate – currently for individuals earning over £110,000 this will be the higher rate of tax.

Where an individual's threshold income is greater than £110,000 and their 'adjusted income[24]' is greater than £150,000, the tapered allowance applies. The calculation of the amount of their allowance is based on their adjusted income. They will have to pay tax on the amount that their pension saving for the year is above the calculated adjusted allowance.

Where adjusted income is greater than £210,000, the annual allowance is £10,000.

There is anecdotal evidence that by working additional hours or being promoted, individuals working in the NHS have been presented with a tax bill for the year that is greater than the additional income

[18] These are transfers from specific salary related occupational pension schemes some of which are public sector schemes and some of which are not – examples include the Civil Service scheme, the Armed Forces scheme, local authority pension schemes

[19] HMRC, *Tax on your private pension contributions*, accessed 8 May 2019

[20] NHS Business Services Authority, *Scheme pays election guide (2017/18 onwards)*, 2017

[21] NHS Business Services Authority, *Annual allowance: pensions savings statement guide*, accessed 8 May 2019

[22] NHS Business Services Authority, *2016/17 tapered annual allowance (12.2015) v1*, 2015

[23] Threshold income is taxable income adjusted for tax reliefs, pension savings and pension contributions

[24] Adjusted income is the taxable income plus the gross amount of pension savings

that they received. This has been widely reported and reference to some of the articles can be found in the further reading section of this briefing. This may be a particular issue for clinicians working in the NHS as the pay model used means that they are paid additional amounts for carrying out additional hours or duties.

The HFMA has found[25] that this issue is of concern to NHS senior finance managers and that staff taking early retirement, reducing their hours, refusing additional hours and new responsibilities is affecting NHS bodies and their patients.

Examples and further guidance

The guidance issued by the Pensions Advisory Service[26] advises employees to ask their scheme administrator if they are likely to be affected. Which? has included an NHS pension scheme specific worked example in its briefing[27] on how the pensions annual allowance works.

The BMA has developed worked examples for members of the NHS pension scheme[28]. In example 1a, an individual is promoted from specialised registrar to consultant and his pensionable salary increased by £30,781. However, the total change in his pension benefit value is £160,228. Taking into account the annual allowance and assuming he is carrying forward an annual allowance of £50,000 for the past three years, he will have to pay tax on £70,228 – at 45% this will be £31,603.

The NHS Business Services Authority have also developed a worked example[29] where a doctor has pensionable pay of £131,343, threshold income of £117,298 and adjusted income of £178,387 which means that the tapered annual allowance applied. The amount of tax payable is £10,471.

Tilney, an investment and planning group, has produced a comparison[30] of two 58 year-old GPs – one working full time and the other drawing their pension and working half time as a locum. The full time GP's annual income is only £338 more than the part time GP.

Actions currently being taken to reduce the impact

As the NHS pension scheme is an unfunded defined benefit scheme, employee and employer contributions are determined centrally and are based on an actuarial review. There is no flexibility for members of the scheme to vary their contributions.

Individuals who are required to pay tax above the annual allowance in any year can:

- use any annual allowance that they have not used in the previous three years to reduce the amount of tax payable in the year
- enter into a 'scheme pays' arrangement where the tax will be paid to HMRC by the NHS pension scheme on the individual's behalf – this is recorded as a separate account on the individual's pension record. On retirement the total amount in this account, including interest, will be deducted from the NHS pension benefits when they are paid
- pay the tax due.

In the longer term, actions that NHS staff are currently either considering or taking include:

- reducing their working hours
- taking early retirement
- refusing pay rises/ promotions

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[25] HFMA, *The impact of the pension lifetime and annual allowance on the NHS - summary survey results*, July 2019
[26] The Pensions Advisory Service, *Pensions and tax: the annual allowance*, accessed 9 May 2019
[27] Which?, *How the pensions annual allowance works*, updated March 2019
[28] BMA, *Annual allowance examples*, 8 March 2019
[29] NHS Business Services Authority, *NHS Pensions – annual allowance – tapered annual allowance example*, 2018
[30] Tilney, *GP numbers fall as pension complexities add to looming NHS staff crisis*, 8 May 2019

- leaving the NHS pension scheme (the annual allowance applies to all pension schemes so joining another pension scheme may not resolve the issue).

Possible changes to the current arrangements

The BMA has published guidance[31] which outlines a possible alternative pension contribution in the form of a separate cash payment. This would allow NHS bodies to pay the amount of the contribution to the NHS pension scheme direct to the employee as a cash payment. There are implications of this in relation to ill health and death benefits, holiday pay and redundancy payment calculations. The employee would also have to opt out of the automatic enrolment arrangements.

The local government pension scheme has a 50/50 section[32] which allows members to pay half their normal contribution to build up half of their normal pension. The BMA and NHS England have asked the government to consider this option for GPs[33 and 34]. In July 2019, the Secretary of State for Health and Social Care announced a consultation on the 50:50 option. However, in August 2019, it was announced that this consultation would be replaced by an alternative proposal[35] and guidance to employers. The new proposal includes giving:

- senior clinicians full flexibility over the amount that they put into their pension pots and
- employers the option to recycle the unused contribution back into the clinician's salary.

HM Treasury will also review how the tapered annual allowance supports the delivery of public services.

Conclusion

This is an issue which many individuals and NHS bodies are currently working through. It is likely to have an impact on service delivery and patient care at a time when there are already workforce shortages and demand for services is rising.

HFMA members may be asked to advise colleagues on this issue – rather than providing advice on this extremely complex area, those colleagues should be advised to seek independent financial advice. This briefing is intended to highlight just how complex this issue is.

The HFMA will be responding to the revised consultation once it is issued and will continue to monitor this issue in order to further assess the likely impact.

[31] BMA, *Pension contribution alternative reward policy*, 2019
[32] Local Government Pension Scheme, *Contribution flexibility – the 50/50 section*, accessed 9 May 2019
[33] BMA and NHS England, *Investment and evolution: a five-year framework for GP contract reform to implement the NHS long term plan*, 31 January 2019
[34] The Observer, *Plan to end the tax trap on NHS senior doctors' pensions,* 12 May 2019
[35] DHSC and HM Treasury, *NHS pensions for senior clinicians: new changes announced to improve care*, 7 August 2019

Further information

Guidance

NHS BSA, *Tax information for employers*

NHS BSA, *Tax information for members*

SPPA, *Changes from 2016/17 and tapering*

HSC BSO, *Annual allowance factsheets*

HMRC, *Tax on your private pension contributions*

The Pensions Advisory Service, *End of tax year planning*

Articles

Financial Times, *The future for the pensions taper,* 9 August 2019

BBC, *NHS pensions row: ministers act amid waiting list rise,* 7 August 2019

The Guardian, *'Tax trap' pensions rules to change in effort to halt NHS crisis,* 7 August 2019

House of Commons, *Oral answers to questions (HM Treasury)*, 21 May 2019

FT Adviser, *Hammond dismisses £6bn pension tax reform*, 21 May 2019

House of Lords, *Shortage of GPs and Nurses – private notice question* (column 1224), 8 May 2019

Twitter – Dr Tony Goldstone, *Sky News interview on NHS pensions crisis*, 8 May 2019

Twitter - Josephine Cumbo, *Number of members of the NHS pension scheme over the annual allowance*, 7 May 2019

The Sunday Times, *Patients feel pain as doctors cut clinics over tax*, 5 May 2019

Twitter – Oliver Pratt, *Stopped doing additional work and reduced contracted hours*, 30 April 2019

British Medical Association (BMA), *BMA warns of effect of pensions storm on NHS workforce*, 25 April 2019

Telegraph, *Pension tax row risks 'absolute crisis' with one in 10 NHS doctors quitting*, 9 April 2019

The Times, *Doctors pay to work after change in pension tax rule*, 8 April 2019

Westminster Hall, *NHS pension scheme: tapered annual allowance*, 2 April 2019

Financial Times, *Cuts to UK pension tax breaks drive NHS doctors to retire early*, 2 April 2019

Financial Times, *Diagnosing the NHS pensions problem*, 29 March 2019