



Addendum to 'Limits to tax relief and tax-free benefits' factsheet

Options for members affected by the Annual and/or Lifetime allowances

This addendum should be read in conjunction with the factsheet 'Limits to tax relief and tax-free benefits'. This addendum sets out the options open to members affected by the Annual and/or Lifetime allowances. The Annual Allowance (AA) reduced from £255,000 to £50,000 a year in April 2011 and the Lifetime Allowance (LTA) reduces from £1.8 million to £1.5 million from April 2012.

The government has encouraged pension schemes to introduce amendments to scheme benefits so that tax charges which may arise due to a breach of the LTA or AA do not fall due, or are reduced. The trustee company has introduced three options to help manage the impact of an LTA/AA tax charge.

The options are available to any member of the final salary section however they will only have any real value for those who are likely to suffer an annual allowance charge or a lifetime allowance charge. It is not the case that only the highest of earners with the longest of service may suffer an LTA/AA tax charge however the greater your pension benefits are, the more chance there is that you will incur such a tax charge. Which option is best for you will depend upon your personal circumstances, that is, your salary and how much service you have, and whether you are in danger of breaching the annual or lifetime allowance or indeed both.

It is important to note that many members may not need to elect for any of these options, even if they are or will be subject to an LTA/AA tax charge because even after the charge the amount of benefit secured may still outweigh the cost to you of being a member.

Details of these three options, and whom they are designed to help, are set out below.

Enhanced Opt-out

An enhanced opt-out election will be most useful for members with higher salaries and longer service. In particular it will be of assistance for those who may exceed or already have exceeded

the LTA and are perhaps likely to breach the AA often, and therefore face an LTA and AA tax charge¹.

If after carefully considering your personal circumstances you believe that there is no benefit to continuing to accrue service in the scheme, you can make an enhanced opt-out election and you will cease to accrue service in USS. In order for your death in service and incapacity cover to be maintained, you will be required to pay a mandatory contribution of 2.5% of your salary. Consequently should you elect for this option and then die in service or retire due to incapacity, benefits will be payable as if you had remained in USS active membership up to your date of death/incapacity retirement.

You may continue to make contributions to the money purchase AVC facility, up to the contribution limit of £50,000 (less the 2.5% contribution you are making), however should you have a valid fixed protection election in place and then make any contributions to the USS money purchase AVC after 5 April 2012 (or indeed any money purchase arrangement for that matter) then your protection will be lost. Please note however that payment of the 2.5% contribution under this option does not invalidate fixed protection as this is a contribution under a defined benefit arrangement and no benefit is accrued as a result of this contribution.

If, at any point after making this election, you leave your USS eligible employment or retire other than due to incapacity, then your benefits will be calculated based upon your service and pensionable salary prior to the date of your election. In the case of retirement before Normal Pension Age, any reductions applicable will be the same that would have applied had you not made this election.

This option is required to be made for the long term, but must at the very least remain in place for a minimum of 12 months. If at some point after these 12 months you recommence benefit accrual, you will re-join the scheme as a new member of the career revalued benefits section and your past benefits will remain deferred.

If you decide not to take the enhanced opt-out option, and instead simply opt-out of the scheme and become a normal deferred member, then the benefits which will be paid should you die or retire due to incapacity will be different. For more details on the benefits payable please see factsheets 'Options on leaving a USS institution', 'Benefits payable on death in service', 'Retirement on the grounds of partial or total incapacity' and 'How to apply for early payment of USS deferred benefits on the grounds of ill-health' for further details.

¹ This option may be particularly helpful if you have applied for fixed protection (as described earlier in this factsheet), but are concerned about leaving the scheme and the effect this will have on your potential death and incapacity retirement benefits. There is however only a short window of opportunity to apply for fixed protection (no further elections can be accepted by HMRC after 5 April 2012) and an enhanced opt-out election after 5 April 2012 is likely to invalidate your fixed protection election with HMRC.

Example of the enhanced opt-out option

Mr McNulty has a pensionable salary of £180,000, and from 1 October, at age 58, he will have 33 years of service. At 1 October the capital value of his benefits is already more than the LTA of £1.5 million:

$33 \text{ years}/80 \times £180,000 = £74,250 \text{ pension per annum}$

$£74,250 \times 3 = £222,750 \text{ lump sum}$

$(£74,250 \times 20) + £222,750 = £1,707,750 \text{ LTA used up}$

Amount liable for LTA tax charge

$£1,707,750 - £1,500,000^* \text{ (assuming no FP)} = £207,750$

At this point, Mr McNulty's pension exceeds the LTA by £207,750 and should his benefits be drawn then an LTA charge of 55% on the excess would fall due (assuming that the excess is taken as a lump sum). If he continues to accrue benefits the value of this pension will increase, meaning that at retirement he is likely to face an even bigger tax charge. He will, now that tax options have been made available, have a choice as to whether he should continue to accrue further benefits and increase his liability to a LTA charge at retirement, or make an enhanced opt-out election so that no further benefits accrue - but death-in-service and incapacity cover is maintained - or if the continuation of life and incapacity cover is not required, then withdraw from the scheme in full.

Mr McNulty decides to retire, 7 years after taking the enhanced opt-out option, now aged 65. His benefits are calculated based upon his service and pensionable salary prior to the effective date of the enhanced opt-out election, and increased from this date to the date of retirement by reference to standard USS pension increases. Here we have assumed that the increases were 3% for each year from the date of enhanced opt-out to the date of retirement:

$33 \text{ years}/80 \times £180,000 = £74,250$

Increased by 7 years at 3% = £91,318 pension per annum

$£91,318 \times 3 = £273,954 \text{ lump sum}$

But what if Mr McNulty had retired due to total incapacity 5 years after electing for the enhanced opt-out election, at the age of 63? He would be entitled to unreduced benefits based upon the benefits he had accrued up to the date of enhanced opt-out, plus a service addition based upon benefits accrued from the date of enhanced opt-out to the date of incapacity retirement, plus benefits he would have accrued from the date of incapacity retirement up to age 65. These benefits would be based upon his pensionable salary at the date of incapacity retirement, now £209,000, as follows:

Benefits accrued up to date of enhanced opt-out

$33 \text{ years}/80 \times £209,000 = £86,213 \text{ pension per annum}$

Benefits accrued from date of enhanced opt-out to date of incapacity retirement

$5\text{years}/80 \times \text{£}209,000 = \text{£}13,063$ pension per annum

Benefits which would have accrued from date of incapacity retirement to age 65

$2\text{years}/80 \times \text{£}209,000 = \text{£}5,225$

Total pension and lump sum

$\text{£}86,213 + \text{£}13,063 + \text{£}5,225 = \text{£}104,501$ pension per annum

$\text{£}104,501 \times 3 = \text{£}313,503$ lump sum

It is important to note that, in this example of incapacity retirement, the member would have invalidated any application for Fixed Protection, due to the fact that they have accrued benefits after 5 April 2012

If Mr McNulty had decided to simply withdraw from the scheme in full, and not take the enhanced opt-out option, his benefits at the date of incapacity retirement would have been based upon the benefits he had built up to the date of his opting out only and upon his pensionable salary at this date, as follows:

$33\text{years}/80 \times \text{£}180,000 = \text{£}74,250$ pension per annum

$\text{£}74,250 \times 3 = \text{£}222,750$ lump sum

Therefore had he withdrawn from the scheme, upon his incapacity retirement he would have received an annual pension of £74,250 and lump sum of £222,750 (subject to revaluation).

The choice is not a simple one as although the continuation of accrual may very well further increase exposure to a LTA charge, it may still be in your interests to remain in the scheme and accrue further service as the additional benefits, even if taxed, remain to be worthwhile. This will of course be a matter that you should take independent financial advice on to help determine what is the best option.

Temporary cessation of accrual (TCA)

TCA is designed for use by members who would not normally need to consider an AA charge, but experience a one-off increase in salary - say for example, due to promotion - which may mean that an AA tax charge is likely in the year of the one-off increase.

Under TCA, from the effective date of your election you will temporarily cease to accrue pensionable service in USS, whilst continuing to pay a contribution of 2.5% of salary in order to maintain death in service and incapacity cover. Therefore should you die or retire due to incapacity whilst on a period of TCA, your benefits will be calculated as if you had remained in USS active membership up to the date of your death/incapacity retirement.

However you should be aware that if you leave the scheme or retire (other than due to incapacity) whilst on a period of TCA, your benefits will be calculated as at the day before the date the election took effect, using your service and salary prior to this date only. In the case of retirement before Normal Pension Age, any reductions applicable will be the same that would have applied had you not made this election.

A TCA election can be made for a maximum of 6 months, and the election will expire on 31 March which follows on from the effective date of the election. Therefore, the earliest date on which you may cease accrual under this option in any given year is 1 October. For example, if you decide to use this option from 1 December 2012, you will not accrue any service for the period 1 December 2012 to 31 March 2013 – on 1 April 2013 you will recommence regular accrual.

The effect of a TCA election is that you will accrue less pension benefits within the PIP in which you temporarily cease accrual than you would have normally, because you will have built up less service. This means that you may avoid breaching the AA, or breach it by a lesser amount, than if you had remained in regular service, therefore either avoiding an AA tax charge, or facing a lesser AA tax charge. Once the following 1 April is reached you will continue to build up benefits as normal, as a member of the final salary section. There is no limit to the number of times you can use this option, though it can only be used once in a scheme year.

It will be difficult to determine when is the best time to take advantage of TCA, and it is your responsibility to make this decision. It cannot be used retrospectively, and so can't be relied upon to manage a tax charge which has already arisen in a previous PIP. If you know that you are due to receive a large pay increase then you may wish to ask us to provide you with a forecast of what your benefits accrual is likely to be for the current PIP, as this may be helpful when making your decision. You will need to give careful consideration to the effect that using the option will have on your benefits.

A TCA election is irrevocable, and so once it is in place you may not return to regular accrual any earlier than the following 1 April.

Example of TCA option

Miss Greggs received a salary of £37,600 from 1 April 2010, and on 1 September 2011 she is given a promotion, and so her salary increases to £60,000. On 1 October 2011 she is given a further salary increase to £61,800. As at 1 April 2011 she has 14 years of service. She realises that her large salary increase means that she is likely to face an AA tax charge, and so she decides to take the TCA option with effect from 1 October 2011. Her AA calculation for the PIP in which she takes TCA is:

Opening value

$$((14 \text{ years}/80 \times £37,600) + 3.1\% \text{ CPI}) \times 19 = £128,896$$

Closing value

$$(14 \text{ years} + 183 \text{ days}/80 \times £51,667^2) \times 19 = £177,945$$

Benefit accrual

$$£177,945 - £128,896 = £49,049$$

² Pensionable salary worked out using 5 months at £37,600, 1 month at £60,000, and 6 months at £61,800

Amount liable for tax charge
£49,049 - £50,000

Therefore with the TCA option Miss Greggs will not have to pay an AA tax charge. Had she not taken the TCA option, her closing value would have been higher as she would have had 182 days' extra service:

Closing value without TCA option
(15years/80 x £51,667) x 19 = £184,064

Benefit accrual
£184,064 - £128,896 = £55,168

Amount liable for tax charge
£55,168 - £50,000 = £5,168

Without the TCA option Miss Greggs would have faced an AA tax charge based upon £5,168. However with the TCA option she will instead face a much smaller AA tax charge, and from 1 April 2012 she will recommence regular accrual.

Salary capping and past service deferral

This option will be of use to those with higher salaries and shorter service, and so feel that the enhanced opt-out option is not necessary as they are not in danger of breaching the LTA at this stage, but who are likely to breach the AA on a regular basis.

From the effective date of the election, all your previous benefits will become deferred, and you will commence a new, separate period of accrual for future service. Your future service will still be in the final salary section, however your salary and pensionable salary will be capped at £150,000³ - that is, you will pay contributions on salary up to this figure and your benefits will be calculated based upon pensionable salary up to this figure. If your salary is already less than £150,000, or it drops below this figure, then your contributions and benefits will be based upon the actual salary you receive. If you are part time, your contributions will be based upon the actual salary you receive and your benefits will be based upon your full time equivalent salary.

It is important to consider under this option, that if your salary is subject to the cap, then all of your benefits will be calculated by reference to this cap, including benefits payable on your death in service. You may therefore wish to review your life cover requirements if you elect for this option.

Taking the salary capping and deferral of past service option will help to prevent an AA tax charge in any subsequent PIPs as your deferred benefits will be ignored for AA purposes, and

³ The trustee company can change this cap in relation to any future changes in the AA. It should also be noted that if you are part-time, or go part-time after the election, this cap applies to the full time equivalent salary. For example, if you have a part-time service fraction of 50%, the highest actual salary you could pay contributions on would be £75,000 (50% of £150,000). The full time equivalent of £150,000 would still be used for the calculation of your benefits.

salary capping may mean that your future benefits will not breach the AA limit (provided it is not lowered), as you will be accruing less benefits than if you had continued to use your actual salary for pension purposes.

For the PIP in which you take this option, the deferred benefits built up in that PIP will be tested against the AA and added to the benefits built up from the election date to the end of the PIP. This is likely to avoid, or at least reduce, an AA tax charge in this year as the overall benefits built up will be less than if you had not taken this option.

It should be noted that this option is irrevocable. Once it has been taken you cannot aggregate your benefits or return to using a salary higher than £150,000 for pension purposes.

Example of salary capping and past service accrual

Professor Daniels has 10 years of service and a pensionable salary of £325,000 as of 1 April 2012, and does not have any salary increases for the rest of the year. His high salary means that he will breach the AA, and so he opts to defer his past benefits and cap his future salary with effect from 1 October 2012. As a result of taking this option, his AA calculation is as follows:

Deferred benefits

Opening value

$$((10 \text{ years}/80 \times £325,000) + 3.1\% \text{ CPI}) \times 19 = £795,803$$

Closing value (as at 30 September 2012)

$$(10\text{years}183\text{days}/80 \times £325,000) \times 19 = £810,574$$

Benefit accrual for deferred benefits

$$£810,574 - £795,803 = £14,771$$

New capped salary benefits

Opening value (as at 1 October 2012)

Nil

Closing value

$$(182\text{days} \times £150,000) \times 19 = £17,764$$

Benefits accrual for new capped salary benefits

$$£17,764 - \text{Nil} = £17,764$$

Total accrual (benefits accrual for deferred benefits plus benefit accrual for new capped salary benefits)

$$£14,771 + £17,764 = £32,535$$

Professor Daniels' total benefit accrual of £32,535 is within the £50,000 AA limit, so he will not face an AA tax charge. However if he had not taken the option to defer his past benefits and cap his future salary he would have faced a charge, as his closing value would have been higher:

Closing value

$$(11\text{years}/80 \times £333,038) \times 19 = £862,224$$

Benefit accrual

$$£862,224 - £795,803 = £66,421$$

Amount liable for tax charge

$$£66,421 - £50,000 = £16,421$$

Professor Daniels would have faced an AA tax charge based upon £16,421 had he not taken this option.

How to apply

There are separate application forms available for each of these options. These are available on the USS website (Tax limits page) or from the pensions contact at your institution. To opt for temporary cessation of accrual, the trustee company requires at least 28 days' notice in writing before the date of the election. For the enhanced opt-out and salary capping with deferred past benefits options, the application must give the trustee company 28 days' notice, and the election will take effect from the first day of the month following the one in which the notice expires.

If you are thinking of taking any of these options, it is important to consider the effects carefully as they will have an impact upon the amount of pension you will receive when you retire. You should seek financial advice before making any decisions about your benefits.