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Pension tax rules - impact on NHS consultants and GPs

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This short note focuses on the current debate about the impact of pension tax rules on some senior NHS staff. The broader issues are discussed in Library Briefing Paper CBP 5901 Restricting pension tax relief.

What are the pension tax rules?

Pension tax relief works on the principle that contributions to pensions are exempt from tax when they are made, but taxed when they are paid out. Pension contributions made by individual employees are usually paid out of pre-tax salary, so tax relief is received at the individual's marginal tax rate. The main limits that apply are:

- The annual allowance. (AA) - which limits the amount of annual pension savings that benefit from tax relief. There is a tax charge if contributions, or the value of benefits accrued in a year, exceed the AA.[1] This is broadly intended to recoup the tax relief they would have received on the excess contributions.[2]
- The lifetime allowance (LTA) - which limits the amount of pension saving over an individual's lifetime that can benefit from tax relief. Pension savings are tested against the LTA at 'benefit crystallisation events', for example, when an individual becomes entitled to a lifetime annuity. A breach of the LTA leads to a charge (25%, if the excess is a pension, or 55% if it is a lump sum). [3]

At introduction in 2006, the AA was set at £215,000 and the LTA at £1.5 million.[4] Both were set to increase in stages, with the LTA reaching £1.8 m and the AA £255,000 by 2010.[5] Since 2010, both allowances have been reduced:

- The LTA is now £1,055,000.
- The standard AA was reduced from £255,000 to £50,000 in 2011 and then to £40,000 in 2014. From April 2016, there has been a tapered AA, applying to higher income individuals.

The legislation is in the *Finance Act 2004* (part 4, chapter 5). Detailed guidance is in HMRC's Pension Tax Manual – Lifetime Allowance and Annual Allowance.

1 *Finance Act 2004*, Pt 4; HMRC Pension Tax Manual – annual allowance
2 HMRC, Pension Tax Manual - Annual Allowance: tax charge/rate of tax charge/general
3 Pension Tax Manual – Pension Tax Manual – The Lifetime Allowance charge
4 Ibid
5 Budget 2004, para 5.45

How pensions in defined benefit (DB) schemes measured against these limits?

The NHS Pension Scheme – like the other main public sector schemes – is a defined benefit (DB) scheme i.e. one which provides pension benefits based on salary and length of service.

Rights in DB schemes are measured against the tax limits not by looking at the contributions made, but at the value of annual pension benefits that have been built up and multiplying it by a set figure. In the case of the AA, you look at the increase in the value of pension rights over the year and multiply it by 16.[6]

What did the Government do to mitigate the impact of reductions in the AA?

When bringing forward its proposals to reduce the annual allowance (AA) in October 2010, the Coalition Government said it expected this to affect the highest pension savers, with those who could "save more than an AA in the range of £30,000 to £45,000 in a year are concentrated among the highest earners."[7] However, it recognised that the nature of defined benefit (particularly final salary) schemes could lead to some individuals on low to moderate incomes exceeding the AA – for example, on promotion.[8] It noted that:

> 1.5 It is relatively simple for individuals who are members of defined contribution (DC) schemes to identify and control contributions into their pension pot. However, the Government recognises that this is more difficult for members of defined benefit (DB) schemes, particularly traditional final salary schemes. This is because DB pension-holders receive a future pension promise determined by various factors including length of service, scheme accrual rate, level of salary, and rate of salary increase. In particular circumstances, the combination of these factors could create uneven, and potentially sizeable, annual increases in pension in certain years.[9]

It whether increases in pension rights relating to past service should be ignored for these purposes but decided against.[10] Instead, it decided to allow individuals to "offset excess contributions against unused allowance from up to the previous three years."[11]

It recognised that there would still be cases where a tax charge would arise that would be difficult to meet out of current income.[12] Following consultation it legislated to require schemes to provide a facility for members to elect for a charge to be met from their pension benefits, where:[13]

- They have exceeded the standard AA (£40,000); and
- The tax charge is more than £2,000.[14]

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6 *Finance Act 2004*, s234; Gov.UK, Work out your reduced (tapered) annual allowance/work out your pension savings. In the case of the LTA, a multiplier of 20 applies (*Finance Act 2004*, s212 and 276)

7 HM Treasury, Restriction of pension tax relief: a discussion document on the alternative approach, July 2010, para 3.1

8 Ibid, para 3.4

9 HM Treasury, Options to meet high annual allowance charges from pension benefits: a discussion document, November 2010

10 HM Treasury, Restriction of pension tax relief: a discussion document on the alternative approach, July 2010, para 3.4

11 HM Treasury, Restricting pensions tax relief through existing allowances: a summary of the discussion document responses, October 2010, summary and para 3.6

12 HM Treasury, Options to meet high annual allowance charges from pension benefits: a discussion document, November 2010, para 1.7

13 HC Deb, 3 March 2011, c31-2WS

14 HMRC's Pensions Tax Manual – Annual allowance: tax charge: scheme pays: general

This involves the scheme effectively making a loan to the individual to pay the charge, which they must later repay with interest.[15] Pension schemes have the discretion to offer this facility in wider circumstances (sometimes referred to as 'voluntary scheme pays', compared to 'mandatory scheme pays', when the conditions above are met).[16]

How does the tapered annual allowance work?

The tapered AA which applies if:

- Their 'threshold income' (essentially total taxable income, net of employer pension contributions) is over £110,000; and
- Their 'adjusted income' (essentially total taxable income, net of the value of any employee pension contributions) is over £150,000.

For individuals who tick both these boxes, every £2 of adjusted income over £150,000 reduces the amount they can contribute tax free to their pension (their AA) by £1, down to a minimum of £10,000:[17]

Adjusted income	AA
£150,000	£40,000
£160,000	£50,000
£170,000	£30,000
£180,000	£25,000
£190,000	£20,000
£200,000	£15,000
£210,000	£10,000

HMRC guidance explains how to work out your (reduced) tapered annual allowance.

Why was it introduced?

In 2015, the Government said that reductions in the AA and LTA meant that "sustainability of the system has been improved, with restrictions made since 2010 contributing over £6 billion a year to repairing the public finances" and "significantly reduced the share of pensions tax relief that goes to additional rate taxpayers." The introduction of the tapered AA was expected to continue these trends.[18] When the legislation to introduce it was before Parliament, the then Treasury Minister David Gauke explained that it was "focused on the wealthiest pension savers, to ensure that the benefit they receive is not disproportionate to that of other pension savers."[19]

The Government estimated that the tapered AA measure would save some £4bn over the six years to 2020-21, with the annual saving rising to £1.28 billion in 2020-21:[20] The OBR assigned this a very high uncertainty rating, partly to reflect the difficulty of estimating the extent to which individuals would deploy tax planning to avoid its effects.[21]

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15 HL 17506, PQ 6 August 2019; NHSBA/Member Hub/Annual Alllowance/Scheme Pays FAQs. See also NHSBA 'Scheme Pays Election Guide'

16 Ibid; NHS Pension Scheme, Annual Allowance – scheme pays election

17 BMA Annual allowance examples; See also, Gov.UK tapered annual allowance policy paper; Royal London, Finding the right medicine, May 2019.

18 HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July 2015, para1.5 and 2.6

19 PBC Deb 13 October 2015 c83

20 HM Treasury, Overview of tax legislation and rates, July 2015, p62

21 OBR, Fiscal sustainability analytical paper. Private pensions and savings: the long-term effect of recent decisions, October 2016, para 2.13; HM Treasury, Overview of tax legislation and rates, July 2015, p62

Why is this issue affecting NHS consultants and GPs now?

In its consultation published on 22 July, the Department of Health & Social Care (DHSC) pointed to the nature of work in the NHS and the fact that the passage of time meant many affected had now used up allowances from previous years

> 2019/20 is the 4th year since tapering was introduced and therefore the potential for carry forward of allowances has been greatly reduced. Critically, the tapered annual allowance calculation includes non-pensionable pay, including pay for additional sessions above full-time hours worked by many consultants and therefore has brought increasing numbers of high earners in the NHS within the scope of pension tax […]
>
> NHS consultants and GPs have the opportunity to take on additional work each year and can flex their income up or down. Consultants typically volunteer for additional non-pensionable sessions of work, often at short notice, to cover service pressures. As payment for this work counts towards the tapered annual allowance, many more senior clinicians are being caught by pension tax. The design of the taper also creates cliff edges. It has been argued by some that the operation of the taper is difficult to predict, particularly when a senior clinician is unsure what level of income that they will earn within a tax year. Around a third of NHS consultants and GP practice partners have earnings from the NHS that could potentially lead to them being affected by the tapering annual allowance.[22]

What was the effect on individuals?

The BMA says it has been raising concerns about this for the last 12 months. In March 2019, it wrote to the then Chancellor Exchequer Philip Hammond saying that the rules were "forcing some of our most experience doctors to retire, reduce their workload, abandon leadership positions and stop covering vacancies":

> The causes of this problem are complex and are explained more fully in the appendix to this letter. However, in essence the nature of the calculation of pension growth in defined benefit schemes such as the NHS pension scheme, the introduction of tapering to Annual Allowance coupled with the way pension growth is calculated for members who are members of two NHS pension schemes, means that significant – four, five and six figure charges in addition to PAYE and other tax charges - and regular Annual Allowance charges have now become a problem that will affect all full time consultants. In order to avoid these Annual Allowance charges, consultants must limit their income, and in most cases, this means stopping doing regular overtime in the form of additional programmed activities. The majority of NHS services rely, at least in part, on these additional programmed activities to deliver routine patient care. Astonishingly, as a result of these Annual Allowance tax charges, it may also make financial sense for consultants to consider working part-time. This is because the majority of consultants cannot afford to pay these bills from their 'net' take-home pay, since they are such substantial sums, and have no choice but to pay these tax bills from their pension using the 'scheme pays' option. Consequently, as a result of paying this tax and the interest rate charged on this loan, they may paradoxically receive a significantly higher pension by working part-time once the 'scheme pays' loan is deducted.
>
> A further problem is that large numbers of doctors have incomes close to the 'threshold income'. Again, because of the way that pension growth is calculated and then included in the calculation of 'adjusted income', very small increases in taxable income can push doctors over a 'tax cliff' resulting in tax rates in excess of several hundred percent where this coincides with a pensionable pay rise. At a time when the NHS is reliant on its staff doing additional sessions and waiting list initiatives to prop up front line clinical services, this provides a powerful disincentive as doctors may find that they not only derive no financial benefit from the extra work but are in effect themselves paying significant sums in order to take on this extra work. Alternatively, and equally unattractive than paying to go to work, consultants using 'scheme pays'

[22] DHSC, NHS Pension Scheme: proposed flexibility, 22 July 2019, Para 1.11-12

> may find this work significantly reduces their pension, for work that is non-pensionable and would have given them no gain to their pension.[23]

The DHSC consultation explains that, for some higher earners, the effect had been to reduce their total reward package compared with members at lower earnings:

> The NHS Pension Schemes are a valuable part of the total reward package for NHS staff and are among the most generous pension schemes available. However, for a relatively small but important group of staff, the interaction of the Schemes with the pension tax regime has created significant challenges. The evidence the Department has demonstrates that the largest groups affected are high earning consultants and GPs. Stakeholders have suggested that the effect of this is that for some high earners, the value of the total reward package that they receive with employer pension contributions of 20.6% is diminished compared with members at lower earnings levels.[24]

There was evidence that some senior clinicians were reducing their workload to manage their tax charge liability:

> 1.23 The NHS Pension Schemes are a valuable element of the total reward package offered by the NHS to staff. The NHS Pension Schemes provide generous benefit accrual for members and the Department understands this means many senior clinicians are exceeding their annual allowance for tax-free pension saving, producing a tax charge. In response, there is evidence that senior clinicians are managing their annual allowance tax charge liability by reducing their workload, turning down extra responsibilities or opportunities and/or retiring early. Consequently, there is a reduction in NHS service capacity and patient care is adversely affected.[25]

Is this just an issue for the NHS?

No. The pension tax rules apply in the same way across registered pension schemes in the public and private sector.

The nature of work in the NHS - with consultants having the opportunity to volunteer for additional sessions of work, often at short notice, to cover service pressures – may mean there is more of an impact in this area. The BMA has also raised concerns about the impact on doctors in the Defence Medical Services.[26] The impact on other public servants – including the senior military, the judiciary, and senior civil servants – has featured in reports of the pay review bodies.[27] The impact on judges is discussed in Library Briefing Paper CBP 8540, section 2.2.

The fact that there is often more flexibility in remuneration packages in the private sector may mean there is less of an impact there. In April 2019, the then Chancellor of the Exchequer, Philip Hammond said to the Treasury Select Committee that someone in the private sector who found they were likely to face a tapered annual allowance charge would "often be able to arrange to change to their remuneration package, so they get more pay and less pension contribution."[28]

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23 BMA letter to Chancellor to the Exchequer, Philip Hamond, March 2019
24 DHSC, NHS Pension Scheme: proposed flexibility, 22 July 2019
25 Ibid para 1.23
26 https://www.bma.org.uk/news/media-centre/press-releases/2019/may/bma-calls-on-government-to-address-pension-crisis-facing-armed-forces-medical-workforce
27 E.g, Review Body on Senior Salaries, Cm 9694, Sept 2018, para 3.89-90; Doctors' and Dentists Pay Review Body, Cm 9670, July 2018 – see also table 11.1
28 HC2506 24 April 2019

How does the Government intend to respond?

On 10 April 2019, the then Health Minister Stephen Hammond said scope of the 'voluntary scheme pays' facility in the NHS scheme would be extended to cover the payment of tax charges from breaches of the tapered AA (i.e. individuals could apply to have a charge arising from the tapered annual allowance to be paid from their pension benefits).[29]

On 22 July 2019, the DHSC launched a consultation on introducing more flexibility into the NHS Pension Scheme – in the force of a "50:50 option whereby senior clinicians who expect to be affected by the annual allowance can elect at the beginning of the year to reduce their contributions and their pension accrual by 50%."[30]

On 6 August 2019, the Government said that the Department for Health and Social Care would launch a further consultation, replacing that launched on 22 July, on a proposal to allow senior clinicians in the NHS in England and Wales to set the exact level of pension accrual at the start of each year and allowing employers the option to recycle their unused pension contribution back into the clinician's salary:

> The Department of Health and Social Care (DHSC) will shortly open a new consultation asking people what they think about the set of proposals, which includes giving senior clinicians full flexibility over the amount they put into their pension pots. This replaces the 50:50 proposal put forward for consultation in July. Starting from next financial year, the new rules would allow senior clinicians to set the exact level of pension accrual at the start of each year. For example 30% contributions for a 30% accrual rate, or any other percentage in 10% increments depending on their financial situation. This would give them room to take on additional work without breaching their annual allowance and facing tax charges. Employers would then have the option to recycle their unused contribution back into the clinician's salary.[31]

Will it change the pension tax rules?

Some commentators have argued strongly that more flexibility in pension arrangements will not go far enough. The BMA has said that the 50:50 proposal would "categorically not solve the problem." It would "not only result in doctors receiving a lower pension, but also does not remove the perverse incentive for doctors to reduce the work they do for the NHS."[32] Royal London agreed, saying:

> **The best solution would be to remove a complex and unpredictable feature of the tax system**– the tapered annual allowance – even if this required a reduction in the overall annual allowance.[33]

In April 2019, Philip Hammond said it would be difficult to change the rules for one particular group:

> The pension tax reliefs we give are extraordinarily generous and among the most expensive elements of tax relief in the system. They are also heavily skewed to the better off in society. This is a legacy relief system, but it would be difficult to make a case to put in more relief to overcome an anomaly, because it is already extraordinarily generous, particularly to those on the highest incomes. Clearly, we cannot say that we will treat NHS staff differently from everybody else, just because we are the employer in that case.

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[29] PQ 239952, 10 April 2019; NHS Pensions, Scheme pays - FAQs, Feb 2019; PQ 261238, 11 June 2019; *Finance Act 2011*, Sch 17

[30] Ibid, para 1.21

[31] HM Treasury, NHS pensions for senior clinicians: new changes announced to improve care, 7 August 2019

[32] Letter to the Prime Minister on 8 June 2019, the BMA

[33] Royal London, Finding the right medicine, May 2019.

However, on 6 August 2019, the new Chancellor of the Exchequer, Sajid Javid, said HM Treasury would "review how the tapered annual allowance supports the delivery of public services such as the NHS".[34] The BMA welcomed this as a step forward.[35]

The *FT* reported that unions representing dentists and firefighters had warned the government it could face a legal challenge if it failed to extend pension flexibility to other public sector workers.[36]

Does the Scottish Government have a role to play?

The Scottish Government has the power to make regulations for the NHS Pension Scheme in Scotland.[37]

BMA Scotland called on the Scottish Government "respond rapidly to ensure Scottish doctors are in no way disadvantaged compared to UK counterparts."[38]

Pension tax legislation is UK-wide.[39] Power to change it is reserved to the UK Government.[40]

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34 Ibid
35 BMA press release, 7 August 2019v
36 'Unions threaten legal challenge over pension measures', *Financial Times*, 7 August 2019 (£)
37 *Public Service Pensions Act 2013*, s2 AND Sch 2
38 BMA Scotland respond to Westminster Pension Tax Announcement, 7 August 2019
39 *Finance Act 2004*, Part 4
40 *Scotland Act 1998*, (as amended), Sch 5 (II) (A1); Library Briefing Paper CBP 8544v