

2. Illustrations of contributions and charges

DB scheme contributions

C.10 The restriction of pensions tax relief applies to tax relievable pension contributions made during the tax year, but not to investment growth. In DC schemes (including personal pensions), individuals have their own pension pot, which is built up through contributions and investment growth. DC contributions made by both the individual and any other person on their behalf (most likely their employer) are generally easily identifiable, so the test to be made against the AA is straightforward to apply in this case.

C.11 In DB schemes, however, employers give individuals the promise of a future annual pension based on various factors. For a traditional final salary scheme, these factors are typically their salary, years of pensionable service and the scheme's accrual rate where, generally,

$$\text{Annual pension} = \text{final salary} * \text{years of service} / \text{accrual rate.}$$

Normally, an individual's final salary DB pension entitlement will increase each year, both as a result of working for the employer for an extra year and from any rise in earnings upon which the pension is based. Other types of DB scheme also exist, for example the pension might be determined by reference to average earnings over an entire career with an employer. Part of the accrued pension rights may be commuted for a lump sum on drawing benefits; in other cases, lump sum rights accrue separately each year alongside the pension. This section uses examples based on final salary DB schemes with a commutable lump sum.

C.12 Recognising that DB and DC schemes are not funded in the same way by employers, a notional DB equivalent of the DC scheme contribution – the 'deemed' contribution – is used to ensure fairness and consistency between DB and DC schemes.

C.13 The value of a DB pension can depend on many factors, including life expectancy, marital status, normal pension age (NPA) etc. On the basis of simplicity and to minimise administrative burdens, the Government has decided to use a variant of the current flat factor approach to value DB pension contributions. The valuation simply involves multiplying the increase in annual pension entitlement accrued over the current year by a flat factor, which has been set at 16 following advice from the Government Actuary.

C.14 The increase in annual pension entitlement is the difference between 1) the annual pension earned at the end of the year (the closing value of the entitlement) and 2) the annual pension earned at the beginning of the year (opening value), uprated or revalued to the amount it would assume if left to accrue till the end of the year.

C.15 To illustrate how DB contributions are deemed, we take an individual who has been a member of her employer's DB scheme with a 1/60th accrual rate for 34 years. In her 35th year, she receives a pay rise of 20 per cent from £60,000 to £72,000. The deemed contribution at the end of the 35th year is calculated as follows:

- Step 1 – calculate the opening annual pension entitlement. At the end of her 34th year, she was entitled to an annual pension of £34,000 (= 34/60 x £60,000) on retirement based on her salary, length of service and scheme accrual rate.
- Step 2 – revalue the opening annual pension entitlement. If the individual had stopped accruing pension after 34 years, then the pension would have been uprated by the CPI. If the CPI increase is assumed to be 2.5 per cent, then her pension earned after 34 years would have risen from £34,000 to £34,850.

- Step 3 – calculate the closing annual pension entitlement. If pension accrual instead continues, then her pension will rise to £42,000 ($= 35/60 \times £72,000$) as a result of the extra year's service and the pay rise in the 35th year.
- Step 4 – the increase in annual pension entitlement is £7,150 ($= £42,000 - £34,850$).
- Step 5 – multiply by the flat factor to get the deemed contribution: £114,400 ($= 16 \times £7,150$).

C.16 In schemes where the lump sum accrues separately to the annual pension, the increase in the value of the lump sum over the same period would be calculated and added to the annual pension contribution in step 5 to get the total deemed contribution.

C.17 The contribution is relatively large in this example due to the combination of long service and a large pay rise. Once deemed, the contribution can be tested against the individual's AA, taking account of unused allowance from the previous three years, and any charge due can be determined.

Carrying forward unused allowances

C.18 In the example discussed in the previous section, the deemed contribution was found to be £114,400, which is £64,400 in excess of the AA of £50,000. Before calculating the size of any charge, the individual would look to see how much unused allowance she had from the three previous years.

C.19 The individual had received increases in pay of 5 per cent per annum in her 32nd, 33rd and 34th years. Her allowance in each of these three earlier years was £50,000, but her contributions over those three years totalled only £80,600 ($= £25,200 + £26,800 + £28,600$). She therefore has unused allowance from these earlier years of around £69,400 ($= 3 \times £50,000 - £80,600$) available to carry forward.

C.20 The individual thus has an effective annual allowance in her 35th year of £119,400 ($= £50,000 + £69,400$), which is sufficient to cover the deemed contribution in that year of £114,400 and still leave £5,000 to carry-forward to future years. **Carry-forward of unused allowance therefore allows the tax charge in this example to be reduced to zero.**

Calculating the tax charge due from excess allowance

C.21 If, after taking account of unused allowances, there had still remained some part of the pensions contribution in excess of the allowance, then a tax charge would have been due. Any charge would be calculated at the individual's marginal rate of income tax. The chargeable amount counts as if income for this purpose.

C.22 If the individual in the current example had had a pay rise of 22 per cent, rather than 20 per cent, then the deemed contribution would have been £125,600. The excess above the allowance, after carrying forward available unused allowance, would have been around £6,200 ($= £125,600 - £119,400$).

C.23 To determine the rate of charge, the excess would be added to her salary, taking her taxable income to £79,400 ($= £73,200 + £6,200$) which, in this case, remains in the higher-rate tax band of 40 per cent. The excess contribution would therefore be charged at 40 per cent, and the tax charge due to exceeding the AA would be around £2,500 ($= 40\% \times £6,200$).