USS
UNIVERSITIES SUPERANNUATION SCHEME

Limits to tax relief and tax-free benefits

Introduction

Pension benefits accrued by individuals in the UK which qualify to receive tax relief are restricted to maximum allowances permitted by HM Revenue & Customs (HMRC).

The value of your pension benefits across all schemes in which you are accruing benefits is limited for taxation purposes in two ways:

1. The Lifetime Allowance (LTA) – this is a threshold for the tax favourable benefits you can receive on retirement (from all schemes) of a capital value of £1.8 million (the LTA will be reduced to £1.5 million with effect from 6 April 2012). You can accrue benefits that exceed this limit but the excess will be subject to a tax recovery charge (55% at the time of publication).
2. The Annual Allowance (AA) – this measures the increase in the value of your benefits over a 12 month period; this period is called the pensions input period (PIP). The PIP for a member of USS is 1 April to 31 March the following year. The AA is currently set at £50,000 a year and any excess accrued over the £50,000 limit will be subject to tax at your highest marginal rate.

Note: Deferred benefits held with previous schemes do not count towards the value of your benefits with regard to the AA.

It will be your responsibility to report to HMRC the value of your benefits via your tax return, however there are forthcoming information requirements – particularly in relation to the AA – that will be placed upon your employer and the Trustee Company which will help you gather this information for your tax return. There is more information about those requirements later in this factsheet.

Although both the LTA and the AA may be subject to increases, there is currently no commitment from the government to increase them above their current level.

The effect of the Lifetime Allowance on your retirement benefits

As mentioned above, you can accrue any amount of benefits you wish. However, any benefit in excess of the LTA is subject to a tax charge. The capital value of your USS benefit is simply the pension multiplied by 20, plus the amount of tax-free cash taken; this value, when measuring against the LTA figure in force at the relevant date, must include any other benefits you may be entitled to from other registered pension schemes (any pension scheme approved by HMRC), should they have already been taken or will be taken on the same day[1].

If the value of all of your retirement benefits exceeds the value of the LTA, a tax charge is applied to the excess. In some cases this excess can be returned to you as a lump sum refund, in which case a 55% tax charge applies; alternatively you may choose to take the excess as a monthly pension. In that case, the initial tax charge is 25% but the additional pension will be subject to PAYE. For a member who pays tax at 40%, this means that the total deduction will be at least 55%; for 50% tax payers, this will be even higher.

For example, if the total capital value of your benefits was £1.9 million in the 2011/12 tax year, assuming you could not/did not opt for one of the protection methods discussed in the next section, you would have an excess benefit value of £100,000.

If the option is open to you, you could choose simply to take a refund of this excess, less tax at 55%, therefore USS would pay a refund to you of £45,000 and would make a payment to HMRC of £55,000.

Alternatively you might decide to use the £100,000 excess to increase the value of your USS pension. However, before doing that, USS must deduct 25% for tax, leaving £75,000 to secure additional pension benefits. On the face of it you have saved a substantial amount of tax, however, if you are registered for tax in the UK, you would pay 40% PAYE (or 50% for those with earnings in excess of £150,000) on the additional pension, in addition to the original 25% deduction.

[1]Benefits already in payment before April 2006 are valued at 25 times the value of the annual pension in payment.

This might be an attractive option if you plan to live and become resident overseas in a country with lower tax rates than the UK.

It is important to note that the LTA will be reduced to £1.5 million with effect from 6 April 2012, and there will be some members who will have accrued benefits of more than £1.5 million but less than £1.8 million and will on 6 April 2012 be over the lower LTA limit. The government has introduced a transitional protection to ensure that those near to or over the £1.5 million limit do not suffer a greater tax charge than they would have done but for the change to the LTA.

The transitional protection is called fixed protection and will grant members who opt for it a fixed LTA of £1.8 million. Anyone can opt for this protection, irrespective of the capitalised value of their benefits, however there are conditions:

- you must make an election before 6 April 2012 or the opportunity to do so will be lost; and
- you cannot make any additional pension contributions to any scheme otherwise the election will be invalidated.

HMRC has produced some detailed advice as to how the transitional protection works in practice.

More information can be found at www.hmrc.gov.uk/pensionschemes/lifetime-allowance/savings.htm

The Annual Allowance

This is a measure of the amount of benefit you accrue or contributions you make in any one PIP. As mentioned overleaf, the AA is set at £50,000 a year and any excess over this allowance is taxed at your highest marginal rate. In a defined benefit scheme such as USS, it is the value of your accrual over the course of the year which is measured, not the contributions which have been paid by either you or your employer. In a money purchase arrangement, it will simply be the contributions which you have paid which are considered; investment returns are not included in the AA calculation for money purchase benefits.

So, to consider how this works for USS benefits, your accrual over the course of a year is calculated for the purposes of the AA in three stages:

1. **The opening value** – the pension is calculated at the beginning of the PIP (1 April) as if you were entitled to your benefits at that date but without applying any actuarial reductions for early payment. That pension is then rolled forward based upon the increases in the Consumer Prices Index (CPI) to ensure it takes some account of inflation. The revalued pension is then multiplied by 16 and the lump sum added to give a capitalised value.
2. **The closing value** – the pension is again calculated at the end of the PIP (31 March of the following year) without applying any actuarial reductions; this pension is then multiplied by 16 and the lump sum added to give a capitalised value. Note that the revaluation step in point 1 to account for inflation is not included here.
3. The opening value is subtracted from the closing value and the increase over the course of the PIP is then measured against the AA for that year. Any excess over £50,000 is subject to tax.

Should you be making any contributions to the USS money purchase scheme administered by Prudential, then the amount of those contributions will be added to the answer you get after following the three steps above. Importantly, deferred benefits do not count towards the value of your benefits.

With the AA now set at £50,000 (it was £255,000 in the tax year 2010/2011), there is a real possibility that more moderate income members of pension schemes may trigger an AA charge due to a one-off event such as a promotion. The government has put measures in place to try to mitigate the problem for those who have a one-off salary spike and those measures are called carry forward.

Under carry forward, any unused allowance for the three years prior to the one in which an AA charge is due can be used to offset an AA charge. If the total of the unused relief is greater than the accrual over the course of the PIP in question (or reduces the accrual to less than £50,000), then the amount payable will be reduced to zero.

So, if you trigger the AA charge in 2011/12, you can draw upon unused allowances for the tax years 2008/09, 2009/10 and 2010/11 to offset the charge. Importantly, it will be assumed that the AA for those prior years and the revaluation factor are £50,000 a year and 16:1 (plus the standard tax-free cash sum) respectively.

The AA is a personal taxation matter, however from April 2013 pension schemes will have a statutory responsibility to provide you with a savings statement within six months of 6 April each year if you have triggered an AA charge.

More information about the AA can be found at www.hmrc.gov.uk/pensionschemes/annual-allowance/guide.htm

I have exceeded the Annual Allowance – how can I pay the charge?

If you have exceeded the AA and you do not have any carry forward to utilise you will be facing a tax bill. There are circumstances where you can request USS to pay the tax charge, with a resulting reduction to your benefits. Of course you could choose to settle the charge yourself from savings, or if you're retiring and taking a tax-free lump sum, you could put aside some of the tax-free cash sum to settle the tax charge.

The Government has decided that a member of a registered pension scheme such as USS will be able to require the scheme to pay an AA tax charge on his/her behalf in return for an appropriate deduction to the member's benefits. This is called 'scheme pays'. Although this sounds simple in theory, in practice there is a lot to consider.

So when can you use scheme pays?

If your AA accrual in a USS pension input period (PIP) is greater than the AA (currently £50,000) and your overall AA tax charge is more than £2,000, then you can require the scheme to pay the charge for you with a corresponding deduction made to your benefits. Importantly you can pay part of the charge with the pension scheme covering the remainder or, if you wish, require the pension scheme to cover the whole charge.

If I decide to use scheme pays, what do I need to do and by when?

You will need to complete your self assessment tax return by no later than 31 January following the tax year in question and confirm to HMRC the amount of any AA charge which is to be met by the scheme administrator. You will then have until the following July – or retirement if earlier – to notify USS of the AA tax charge to be paid on your behalf[2].

It is your responsibility to ensure that the amount of the AA tax charge is correctly calculated, the scheme will not be in a position to calculate your tax for you. You should also bear in mind that a scheme pays notification is irrevocable, but it may be amended (see further details below).

Should you decide to only pay part of the AA tax charge, and the nominated amount of the scheme's liability is less than £2,000, then you will need to confirm in your notice to USS that your total AA charge is over £2,000.

To allow for the possibility that your liability to the AA charge can change, you can submit a further notice to the scheme, so long as the further notice is received no later than 31 July following the end of the period of four years beginning with the last day of the relevant tax year.

[2]For the 2011/12 tax year, you will not have to include the AA charge on your self assessment return until 31 January 2014 however you will have to notify the scheme by no later than 31 December 2013 should you wish to rely on scheme pays for a 2011/12 tax charge.

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Can I still use scheme pays if I am due to retire?

The answer to this is yes, however your notice must be given to the scheme before your benefits are drawn, rather than the July after your self assessment return was due.

In practice, your retirement quotation from USS – should you have requested a quote – will include your accrual for the PIP in which you retire and the previous year if this information has not already been issued. If based upon this information you calculate that your AA tax charge for the PIP in which you retire will exceed £2,000, then you can give notice to the scheme to pay the charge on your behalf.

As mentioned, you must submit your notice to USS prior to retirement so that the appropriate deduction can be applied before your USS benefits are brought into payment; the opportunity to rely on scheme pays will be lost if your notice is not given prior to your benefits crystallising. The notice of intention to elect for scheme pays will be included in the USS retirement forms.

It is possible that you will not know for certain what your AA tax liability will be for the PIP in which you retire until the end of the tax year – and therefore after your retirement date – as you will need to know what your taxable earnings were for the year. In that event, it seems that you could submit a scheme pays notice to USS shortly before your retirement on the basis of the information which is then known to you.

How will my benefits be affected under scheme pays?

In return for the scheme paying the AA tax charge, a corresponding deduction will be made to your pension benefits. The deduction will be expressed as an amount of pension which is equivalent to the cash value paid to HMRC. The amount of the deduction will be confirmed when you inform USS of the tax charge to be paid.

The pension debit will be rolled up each year by increases to official pensions[3] (this is currently based upon increases in the Consumer Prices Index and subject to the maximum pension increases payable under the scheme rules) until your benefits are drawn. The benefits payable to you will therefore be calculated after deducting the revalued scheme pays pension debit.

The following is a simple example of how the scheme pays pension debit is calculated:

Mr Smith, 59, is a member of USS and has, at 31 March 2011, 20 years of service and a pensionable salary of £130,000; he does not pay any AVCs. On 31 May, he is promoted and his pensionable salary as at 31 March 2012 has increased to £160,000 therefore his AA calculation (ignoring carry forward) is as follows:

Opening value

(20/80) x 130,000) + 3.1%[4] = £33,507.50

19[5] x £33,507.50 = £636,642.50

Closing Value

(21/80) x 160,000 = £42,000

19 x £42,000 = £798,000

Taxable accrual

(£798,000 - £636,642.50) - £50,000 = £111,357.50

AA Tax charge

£111,357.50 x 50 % = £55,678.75

[3]The deduction will reduce the amount of pension and cash available to you at retirement.
[4]CPI has been assumed to be 3.1%.
[5]The AA factor is 16, however, 19 is used to take account of the 3/80ths lump sum.

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Due to the size of the charge, Mr Smith requests that the Trustee Company pay the tax charge on his behalf under the scheme pays rules. Based upon Mr Smith's age, gender and salary, a pension of £2,000[6] per annum is equivalent to the tax charge of £55,678.75. The £2,000 per annum debit will be increased in line with official pensions[7] until the member's benefits fall due, at which point it will be treated as a deduction from those benefits.

How is my deduction calculated?

Exceptionally, if you ask USS to pay a tax charge at the point of retirement, you may choose to pay the tax charge from your tax-free lump sum or convert it to a pension debit, using the commutation factors applicable at retirement (the same factors that are used if you wish to commute pension to extra cash or vice versa). This amount would then be deducted from your pension.

Is it possible to have multiple scheme pays debits?

Yes. It is possible that a member could trigger the AA charge more than once and therefore he/she will have a scheme pays debit for each year in which the scheme is required to pay the charge.

How will a scheme pays debit affect any benefits which may be payable to beneficiaries?

Only the member's pension will suffer a reduction, any benefits which may become payable to a beneficiary (such as a spouse, civil partner, child or dependant) will be unaffected.

Enhanced and Primary Protection

When the simplification of pension taxation rules were introduced in April 2006, there were members who had accrued benefits under the old system of pension taxation which would not have been taxed under that system. To help facilitate the transition and ensure that individuals who had already accrued large pension benefits would not be unfairly taxed, the government allowed two forms of transitional protection: Enhanced Protection (EP) and Primary Protection (PP). These options were only available between April 2006 and April 2009 and you could have opted for either or both depending upon your circumstances. If you elected for EP or PP, this will still be valid even after the April 2011 changes come into force. If you have not applied for either of these forms of protection, you are no longer able to do so.

*Please refer to the HMRC website for full details on how these forms of protection work at **www.hmrc.gov.uk/pensionschemes/protection-of-existing-rights.pdf***

Maximum tax-free cash

A limit also applies to the amount of tax-free cash you can receive on retirement which is 25% of the value of your benefits (or 25% of the LTA if this is lower – £450,500 currently).

*Please see the 'Tax-free cash options' factsheet at **www.uss.co.uk***

[6]Hypothetical figure only.
[7]Scheme pays debits applied after the scheme changes are implemented, will be subject to the limits on increases applied to pensions in payment and deferment.

Statutory earnings cap

Members joining or re-joining USS on or after 1 June 1989 were subject to an earnings cap for pension purposes, set by HMRC. The contributions payable by the member and the institution were based on a maximum remuneration figure determined by the government. The published figure was usually reviewed annually to reflect changes in the Retail Prices Index and rounded to the next higher multiple of £600. Any remuneration in excess of the cap could not be taken into account when calculating pension benefits. The figure for the final year of the statutory earnings cap (2005/2006) was £105,600.

The statutory earnings cap was removed with effect from 6 April 2006 but for the purpose of calculating USS benefits its effect on past service accrued prior to that date remains. Members who were subject to the earnings cap as at April 2006 had the option to continue to have their future benefits subject to the cap. The continuation of the statutory earnings cap is written into the USS scheme rules and is known as the 'scheme specific cap'. It is increased on an annual basis using the same methodology as the statutory cap. The scheme specific cap will be revalued each year and any past service benefits, which were capped, will be based on the relevant figure at retirement; in addition it will be used as the basis for ongoing contributions for any members who decided to keep the cap for future accrual.

If you are unsure whether the cap applies to part of your USS benefits, please check with your employer.

Dealing with the earnings cap

If you were affected by the earnings cap for any service from 1 June 1989 (14 March 1989 in some cases) to 6 April 2006, your benefits accrued from 6 April 2006 will now be calculated by reference to your full pensionable salary, and your pension contributions will also be based on actual salary (unless of course you requested that your salary remained capped by the USS scheme specific cap).

If, after 6 April 2006, the earnings cap no longer affects you, your benefits will be calculated in at least two parts:

- The benefits from 1989 (or date you joined the scheme if later) to April 2006 will be calculated by reference to the scheme specific cap in the year in which you retire or leave;
- The benefits from April 2006 will be calculated by reference to your full pensionable salary.

Additionally, if you have transferred benefits to USS from another scheme and these may have been based on an uncapped salary, or you have earlier uncapped service, these will continue to be calculated by reference to your full pensionable salary.

You and your employer have the option of making a payment to remove the effect of the earnings cap in all or in part. There is only one opportunity to make a payment to remove the effect of the cap, however there is no time restriction on when this is made, so long as you remain an active member of the scheme.

If a payment is made to remove completely the effect of the earnings cap then all of your benefits will be calculated by reference to your full pensionable salary. If only part of the earnings cap is removed then your benefits will be calculated separately but with a reduced amount being subject to the cap. There are some restrictions on removing the cap; please speak to your employer regarding your options.

Calculating your pension

Below is an example where a member has service subject to the earnings/ USS scheme specific cap up to April 2006. In this example, the member also has service transferred-in to USS that was not originally subject to the earnings cap and is therefore not subject to the cap in USS.

How does this work?

Date joined USS:	1 September 1990
Date of birth:	14 July 1950
Anticipated retirement date:	30 September 2010
Service transferred-in from NHS:	15 years
Pensionable salary (full):	£150,000 a year
Scheme specific cap:	£112,800 a year

Firstly, we need to work out which elements of service are, and are not, subject to the earnings cap.

We know that the transfer-in is not subject to the cap and we also know that service from April 2006 is not subject to the cap, i.e. is unrestricted service:

6 April 2006 to 30 September 2010
= 4 years and 178 days (unrestricted)

Transfer-in = 15 years (unrestricted)

Total unrestricted service = 19 years and 178 days

Subject to the earnings cap

1 September 1990 to 5 April 2006
= 15 years and 217 days

Total restricted service = 15 years and 217 days

The member's pension calculation would be calculated as follows:

19y and 178d x 1/80th x £150,000 = £36,540

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15y and 217d x 1/80th x £112,800 = £21,988.10

Total pension = [£36,540 + £21,988]
= £58,528.10 a year

Additionally, the standard tax-free cash lump sum is simply three times the resulting pension.

In April 2006, members who we thought might be affected were issued with a benefit statement so they could undertake these calculations. Contact your employer if you require a copy.

Increasing your retirement benefits

With the AA and LTA in mind, you might have the ability to increase your retirement benefits by paying extra contributions to one of the USS Additional Voluntary Contribution (AVC) facilities.

You can contribute to either the USS Added Years or Revalued Benefits AVC facility (up to an extra 15% of your salary) or to the Money Purchase AVC run by Prudential (up to 100% of your available taxable pay after other deductions like national insurance and your standard pension contributions). With both options, you would receive tax relief at the appropriate rate and you can then take up to 25% of the capital value of all your USS benefits as a tax-free lump sum at retirement. Importantly, you can choose from where to take any tax-free cash.

The standard USS package includes a tax-free lump sum that is three times your annual pension, but you can take much more than this, up to the 25% maximum level. You may therefore be able to take the full value of any Prudential AVCs as a tax-free lump sum at retirement.

Remember, from April 2011 the value of any contributions paid to the Money Purchase AVC will increase the amount of the AA you have used up. Similarly, if you pay into the Added Years or Revalued Benefits AVC, any increase in the value of your pension over the pension input period will also increase the amount of the AA you have used up.

Please see the 'Additional Voluntary Contributions' factsheet at www.uss.co.uk

Recycling

Due to the increased scope to pay contributions to pension schemes and therefore to take tax-free cash, HMRC introduced rules in an attempt to limit any perceived abuse of the more generous rules with regard to tax-free cash. Recycling is generally thought to only occur where there has been a previous pension benefit brought into payment and the tax-free cash is used to fund a secondary scheme in order to increase the subsequent lump sum, however the rules are more far reaching.

The greater concern for USS members is with regard to large additional contributions paid shortly before retirement which will in turn increase a member's tax-free cash. There would seem to be less of an issue with USS Added Years AVCs as the 15% limit on contributions means that there is very little scope to boost tax-free cash via added years. However, there is more opportunity for recycling to be an issue with regard to the Prudential AVC.

Following legal advice from the scheme's solicitor and further guidance from HMRC, it was confirmed that increasing contributions prior to retirement can be considered as recycling, even if the additional funds have not been received from a prior retirement. It would seem however that HMRC would wish to determine your motive in paying that money in i.e. was it solely to increase the available amount of tax-free cash, before deciding whether you will be caught by recycling.

This could mean that should you receive a bonus, an inheritance or some other unexpected payment which is then paid to the scheme, then that payment may not be deemed as recycling as there was no pre-planning of the payment – essentially the guidance would deem that the payment has been made because of the windfall and not because of the potential lump sum. However, if you increase the amount of tax-free cash available by taking out a loan, receiving a pre-retirement payment from the employer or use savings and all of the above will be replenished/paid off following receipt of the increased lump sum, then this could be seen as recycling, causing the tax-free lump sum to potentially be subject to a 55% tax charge, with USS being subject to a scheme sanction charge of 35% of the lump sum.

The legislation does however set out a framework for the operation of the rule, and therefore it is only triggered if all of the following apply:

1. The member receives or will receive a tax-free lump sum from a pension scheme;
2. Due to the potential lump sum, the contributions paid are significantly higher than they would have otherwise been. Employee and employer payments are included;
3. The recycling was pre-planned. This is a similar point to the above but it means that contributions made several years in advance of retirement can be included;
4. The lump sum, taken together with any other lump sum in the previous 12 months, is more than 1% of the LTA in force in that year; and
5. The amount deemed to represent the additional contributions exceeds 30% of the lump sum.

The test to see whether recycling has or has not occurred is somewhat subjective which is of course an unsatisfactory situation for both members and institutions due to the uncertainty that surrounds it, however it is important that you are aware of the potential consequences of large payments made shortly before retirement.

It is worth noting that HMRC states that very few lump sum payments will be caught by the recycling rules and indeed none will be where contributions are just part of an individual's normal pattern of retirement saving.

A more detailed explanation of recycling can be found at www.hmrc.gov.uk/manuals/rpsmanual/rpsm04104920.htm

Financial Advice

The Trustee Company recognises that you may wish to seek financial advice on your options. If you visit the USS website **www.uss.co.uk** you can view a list of financial advisers. These advisers have been selected on the basis that they possess the highest level of qualification in retirement planning; they have also received training on the specific features of USS.