NOTTINGHAMSHIRE
Fire & Rescue Service
Creating Safer Communities

Nottinghamshire and City of Nottingham
Fire and Rescue Authority
Finance and Resources Committee

RESTRICTION OF TAX RELIEF ON PENSIONS

Report of the Chief Fire Officer

Agenda Item No:

Date: 08 July 2011

Purpose of Report:

To bring changes in the taxation regime in respect of pensions which may have a significant impact on the Authority and in respect of which Members may wish to consider referring the matter to the Human Resources Committee with a recommendation.

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1. BACKGROUND

1.1 HM Treasury issued a discussion document in the Autumn of 2010 setting out the government's plans to limit the amount of tax relief applied to employee pensions. Whilst the proposed changes affect all employees in principle the reality is that only higher paid uniformed employees will be significantly disadvantaged by these changes.

1.2 This report sets out the effect of these changes from a financial perspective, considers the potential impact on the Service and suggests a course of action which Members may wish to refer to the Human Resources Committee for a decision and for the details to be worked through.

2. REPORT

2.1 For a number of years tax relief on pensions has been limited in two ways, firstly by what is known as the lifetime allowance and secondly by the value that a pensions value can increase in a single year whilst still attracting tax relief.

2.2 In respect of lifetime allowances the Treasury have reduced these from £1.8m to £1.5m from April 2012. More importantly however, the annual pension growth figure of £255,000 has been reduced to £50,000 and its method of calculation changed.

2.3 Under normal circumstances the Authority would probably take the view that changes to the personal taxation regime are not a matter for the Authority but one for employees and their representatives. In this case however, the impacts of the annual allowance changes are so severe that there is a high likelihood that the Authority's ability to recruit and promote to higher roles may be significantly impaired unless some action is taken.

2.4 The HMT document talks about concerns with approach of the previous administration in the Finance Act 2010 and that there is a need to reform existing allowances, principally by reducing the annual allowance (AA). This currently stands at £255,000, with only the very highest earners being subject to restrictions on tax relief.

2.5 The decision to reduce the AA to £50,000 to 'deliver the necessary yield' and will inevitably draw many more people into having reduced pensions tax relief particularly as under the existing AA regime, in a Defined Benefits scheme, a flat factor of 10 is used, with the Government now suggesting that this factor may need to be increased to 16. The impact of this will be seen in the calculations illustrated later.

2.6 Such a combined approach of reducing the AA whilst increasing the valuation flat factor will bring many more members of the Fire-Fighters Pension Scheme and the Local Government Pension Scheme into restrictions on pension tax relief.

2.7 Employees in the Fire-fighters Pension Scheme are affected more significantly in the last 10 years of their service due to the fast accrual rates (x2) during these years.

2.8 Aside from the issue of which pension scheme an employee is in there appear to be two main circumstances where an additional charge to tax may arise:

i) Where one year's additional service will breach the limit simply because of the accrual rate of pension.
ii) Where there is a pay rise
iii) Where an employee is promoted during the year

2.9 In the case of the Fire-fighters Pension Scheme and using a conversion rate of 16 times and a limit of £50,000 any employee in their last ten years of service earning more than £60,000 p.a will get very close to the limit in every year of their service from 20 to 30 years. As an illustration:

An Area Manager earning £67,000 p.a. with 20 years service will have a pension value of:

22/60 x 67,000 x 16 = £392,995 at the beginning of year 21

By year 22 this will be 24/60 x 67,000 x 16 = £428,800

This represents an annual amount of £35,804 just by virtue of the accrual rate inherent within the FPS.

A Brigade Manager on say £100,000 would accrue £53,333 for the same reason.

2.10 Where a pay rise is granted in any year the problem become exponential in that the value of the pay rise itself become backdated for relief purposes thus:

Area Manager

Opening 22/60 x 67,000 x 16 = £392,995

Assume a 2% pay rise

Closing 24/60 x 68,340 x 16 = £437,376

A difference of £44,381

For a Brigade Manager this is £66,133 i.e. a tax liability of £16,133 @40%

2.11 Local Government Pension Scheme members earning over £120,000 would also fall into this position but in every year of their service not just the final ten years. There are no employees in this category.

2.12 Turning to the issue of promotion the effects become even more startling. For example an Area Manager (salary say £67,000) gets promoted to Brigade Manager (Assumed salary £100,000) in his/her 26th year of service:

Opening Value £67,000 x 32/60 = £35,733
Closing Value £100,000 x 34/60 = £56,667

Difference £20,794
Multiplier @ 16 = £314,010

Less Allowance £ 50,000
Tax liable on £264,010

Tax payable at higher rate (50%) £132,005

2.13 The tax therefore would exceed the actual salary by £32,005

2.14 There are some arrangements for carry forwards of previous year's unused allowances but the earlier figures show that this is unlikely to be significant. There have also been some proposals by HM Treasury to enable individuals to pay this tax from their overall pension "pots" but no details have emerged and it is difficult to see how this could work.

2.15 The result of this of course would be that it will become extremely difficult to recruit to senior managerial posts and particularly Principal Officer posts as no one will be prepared to work for a negative salary in their first year. HMRC and the Treasury have been informed of this anomaly but are unmoved saying informally that staff could always leave the scheme.

2.16 Whilst in principle this problem extends throughout the organisation the ability to carry forward unused allowances from previous years makes it less likely but it is clear that staff will think very carefully before applying for promotions, particularly if these involve being promoted by more than one rank.

2.17 Even in non-uniformed roles and staff in the Local Government Pension Scheme anyone who receives an increase in pay of over £5,000 as a result of a promotion will incur these liabilities. This could even affect relatively low paid administrative staff.

2.18 Similarly all staff will be affected "in year" by the effect of any pay rises that are negotiated nationally. The reaction of Trade Unions when they discover that whatever pay rise they negotiate may have marginal tax rates of over 100% in the first year can only be imagined.

2.19 The position regarding employees entering the Service from another Authority or making a transfer of benefits from a different pension scheme is also unclear. It is hard to determine whether this will attract or discourage transferring staff. The concerns of this Authority are therefore twofold; firstly for the individuals where tax liabilities will be incurred even though they have no control over events such as accrual rates and secondly for the impact on the provision of this vital emergency service if suitably experienced staff cannot be recruited into supervisory or managerial roles.

2.20 The Fire Authority then needs to find a way of being able to mitigate the effects of this change in legislation whilst obviously staying within both the law and the pension regulations.

2.21 It has been suggested that the Chief Fire Officer could be given some flexibility with regard to the structure of remuneration to enable non-pensionable allowances to be paid as additions to salary for certain roles. This would have the disadvantage to the individual that they would not then get the higher pension that their new role would normally attract but then neither would they get the huge tax bill for doing so. The attractiveness of this to an individual will depend entirely on their personal circumstances in relation to years of service etc. The service would of course benefit by reduced pension contributions as well as preserving the ability to recruit.

2.22 The Authority will need to take some care to avoid employees opting in and out of salary/allowances to both avoid tax and increase pensions. This might be possible in say the final year of service where someone wants to increase their salary for the purposes of pension but without actually paying any contributions. It is suggested than that once an option to take a non-pensionable allowance has been exercised it should not be able to be reversed. This however is clearly a human resources matter.

2.23 The Finance and Resources Committee may wish to consider whether a non pensionable allowance could be enhanced in some way to acknowledge the employers pension contribution which will not then be payable on the allowance. Currently employers' contributions are 21.3% in the old pre 2006 scheme and 11% in the post 2006 scheme. It would perhaps not be unreasonable to consider sharing this benefit with the employee however this would be a matter for the Human Resources Committee.

3. FINANCIAL IMPLICATIONS

The financial implications are set out within the body of the report.

4. HUMAN RESOURCES AND LEARNING AND DEVELOPMENT IMPLICATIONS

The human resources implications of this report are considered to be so far reaching that there is a specific recommendation to refer it to the Human Resource Committee for a decision.

5. EQUALITY IMPACT ASSESSMENT

There are undoubtedly equalities issues arising from any event which will stifle promotion prospects and make matters worse for older or longer serving employees. This is not something within the control of the Authority but nevertheless the recommendation to take this forward to the Human Resources Committee will seek to minimise these effects.

6. CRIME AND DISORDER IMPLICATIONS

There are no crime and disorder implications arising from this report.

7. LEGAL IMPLICATIONS

There are no legal implications arising from this report save compliance with those regulations and statutes relating to HMRC.

8. RISK MANAGEMENT IMPLICATIONS

There are clearly significant risks arising from the situation as outlined in the report. The prospect of not being able to attract senior managers into the organisation will undoubtedly place it at risk and some action will be required.

9. RECOMMENDATIONS

9.1 That Members note the position with regard to personal taxation and pension schemes.

9.2 That Members refer this report to the Human Resources Committee with a recommendation that the Human Resources Committee consider the issue of granting flexibility to the Chief Officer around the payment of non-pensionable allowances as suggested in this report.

10. BACKGROUND PAPERS FOR INSPECTION (OTHER THAN PUBLISHED DOCUMENTS)

None.

Frank Swann
CHIEF FIRE OFFICER