The Rt Hon Michael Ellis QC MP
Minister for the Cabinet Office
Cabinet Office
70 Whitehall
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(via email)

30 August 2022

Dear Minister,

**Impact of high inflation on Annual Allowance tax charges**

We are writing to raise the issue of the impact of high inflation on the calculation of Annual Allowance tax charges, and the potential consequences for individual civil servants and the delivery of important public services.

The Annual Allowance restricts the value of growth in pension savings that can attract tax relief. Changes to the basis for calculating Annual Allowance tax charges over the years have resulted in many civil servants incurring significant bills. This is not because these civil servants are in senior grades or on higher salaries, but as middle-income earners with longer public service they face having to pay additional tax charges.

We are not writing now about the issue of Annual Allowance tax charges in general, but to raise specific concerns about how these calculations can be unfairly distorted, in a presumably unintended way, at a time of high inflation.

This issue has received a lot of press attention in the context of its impact on senior clinicians and therefore the ability of the NHS to tackle the current backlog of operations and meet other key targets.

In a leadership debate on Sky News on 4 August, Liz Truss responded to a question from an NHS consultant by saying she had “met a lot of doctors who have gone into retirement because of the specific issues around their pensions” and “I need to sort that out”.

NHS Employers, the organisation that negotiates NHS employees’ terms and conditions on behalf of the government, wrote to the Chancellor of the Exchequer on 3 August about the urgent need to address the impact of high inflation on the calculation of AA tax charges.

It is welcome that politicians and employers have recognised there is a serious problem. However, it does not just affect the NHS. I am writing to ensure you are aware of the impact on civil servants and to ask that any solution for the NHS is also applied in the civil service.

**The issues**

The Annual Allowance is the maximum value of the growth in pension savings each year that can benefit from tax relief. In the civil service, it generally applies to the amount of new

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pension savings built up in the relevant tax year plus any real increase in the accrued pension built up before the start of the tax year.

There are some practical issues with the calculation of the real increase in the accrued pension built up before the start of the tax year. In previous years, these issues could often be safely ignored because the impact of the calculation of the real increase in the accrued pension was a fairly marginal element of the calculation.

However, at a time of very high inflation these issues cease being marginal and can significantly distort the calculation of Annual Allowance tax charges, resulting in inappropriately high bills for those affected.

The issues with the impact of high inflation on the calculation of Annual Allowance tax charges are:

(1) Difference in inflation measures used by HMRC and civil service pension schemes

The Annual Allowance tax charge is only meant to be levied on the real increase in accrued pension. So that only the real increase is included, the accrued pension at the start of the year must be increased by a factor representing the level of inflation over the year when the charge is calculated.

Under the relevant legislation (Section 235 (3) of the Finance Act 2004), the calculation of the Annual Allowance tax charge must use the increase in the Consumer Prices Index (CPI) in the 12 months to the September before the start of the tax year to allow for inflation.

However, the career average schemes in the civil service (Nuvos and Alpha) use the increase in CPI in the 12 months to the September during the tax year when increasing the value of accrued pension in line with inflation to calculate the total value of benefits at the end of the tax year.

The discrepancy between these factors has not been a major issue before because inflation has generally been relatively low and within a relatively narrow range. This meant that the difference between the increase in CPI in the 12 months to the September before the start of the tax year and the 12 months to the September during the tax year has usually been small.

The situation is very different at a time of high and growing inflation. For tax year 2022-23, the calculation of the Annual Allowance tax charge will use the increase in CPI in the 12 months to September 2021 (3.1%) to increase accrued pension. However, Nuvos and Alpha will use the increase in CPI in the 12 months to September 2022. While we do not know what this increase will be for certain, it is likely to be 10% or more.

The impact of the difference in inflation measures will be treated as if it was a real increase in pension value. Nuvos (legacy) and Alpha members will see some of their Annual Allowance taken up by this discrepancy in the inflation factors. This cannot be right, and should be rectified.

(2) Separation of accrual between two pension schemes

The Annual Allowance is a personal tax issue. It takes account of all defined benefit pension savings growth in the relevant tax year.

Many civil servants will have accrued pension in two different types of defined benefit pension schemes: a legacy, final salary pension scheme (such as Classic or Premium) and a reformed, career average pension scheme (Alpha).

Given the government's approach to civil service pay at this time of high inflation, it is very likely that many civil servants will experience negative real growth in any accrued pension they had in Classic or Premium at the start of the tax year.

At the same time, some might build up enough pension in Alpha during the tax year to breach the standard Annual Allowance.

In these circumstances, the combined growth in pension across the final salary and career average schemes could be below the standard Annual Allowance. However, the rules do not allow the growth in value of Alpha to be offset by the decrease in the real value of Classic or Premium.

Consequently, someone whose overall pension growth was less than the standard Annual Allowance could still potentially be liable for a tax charge. This is unfair and seems to be contrary to the intention behind the original legislation.

**Solutions**

There are simple, effective and fair solutions to the above issues. These have been proposed by other organisations besides Prospect and the FDA. The key point is that any solutions to this problem must be applied across the public sector, including in the civil service, and not just in the NHS.

Potential solutions are outlined below, we would be happy to discuss these in more detail with you or your officials:

(1) Difference in inflation measures used by HMRC and pension schemes

Section 235 (3) of the Finance Act 2004 should be amended so that more appropriate measures of inflation can be used in the calculation of Annual Allowance tax charges. This will ensure that charges only apply to the real value of growth in pension savings.

We are not proposing that the inflation factor currently specified in the Finance Act 2004 be replaced with a different factor, as this could just resolve problems in public service pension schemes while creating new problems in other schemes.

The language of any amendment would have to recognise that the appropriate inflation factor for calculating Annual Allowance tax charges can depend on what the inflation factor specified in the scheme's rules is.

(2) Separation of accrual between two pension schemes

It is unfair to assess pension growth in the legacy, final salary and Alpha schemes separately against the Annual Allowance. This can result in tax charges being payable when the total growth in pension savings was well below the Annual Allowance. The simple solution is to aggregate growth across both schemes before testing against the Annual Allowance.

(3) Uplift the Annual Allowance rate

The current rate of £40,000 was introduced by the Coalition Government on 6 April 2014. If the rate had remained in step with CPI, fewer public sector workers would have chosen to become economically inactive by retiring to avoid excessive tax charges on pension accrual.

**Next steps**

I hope it is clear that this letter is not a general complaint about pension tax issues but instead is focussed on the unfair and, we presume, unintended way that high inflation distorts the calculation of Annual Allowance tax charges.

Many civil servants face significant tax bills as a result of these problems and this could have a knock-on impact on operations, as they potentially cut back on their hours and / or retire earlier than otherwise.

There has been a lot of attention on the impact these problems are having in the NHS and there are suggestions that politicians and employers are seeking to come up with a solution for senior clinicians.

It is vital that other groups of public sector workers, including civil servants, are not overlooked when solutions to these problems are discussed within government.

We are writing to request that you and your officials ensure that the interests of civil servants are fully considered in any discussions about these matters and that the Cabinet Office requires any solution to apply to civil servants before giving its approval.

Yours sincerely,

Garry Graham

Deputy General Secretary, Prospect

Lucille Thirlby

Assistant General Secretary, FDA