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22 August 2011
(replacing letter of 28 July 2011)

REF 2082459

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Dear Peter

Changes to lifetime allowance, and the fixed protection option

I wrote to Judy Goodall (copy to you) on 28 July with a range of questions on the changes to Lifetime Allowance (LTA) and the introduction of Fixed Protection (FP), as documented in Schedule 18 and some of Schedule 16 of Finance Act 2011. We have also mentioned other points in other HMRC forums. I am writing to bring together the points we have raised so far in one place for your convenience and with a view to us copying our questions and comments to our members for their information.

(For your convenience I am enclosing a copy of my letter of 28 July marked up to show in what ways this letter differs – but this will not be part of what is released elsewhere).

The issues are set out here in full technical detail, and can be summarised as:

1. How Primary Protection works past 6 April 2012 when an individual has drawn BCEs before that date

We think there is an unexpected discontinuity across 6 April 2012 where BCEs have arisen in the past – an example is set out in Appendix 1.

2 The underlying “standard Lifetime Allowance” that a member depends on the different forms of protection the member has

In Appendix 2, we have set out a table of different enhancement circumstances and how they call different standard Lifetime Allowances. The variations are complex. We would note that we have set out what we believe to be HMRC's intention – in some areas we do not believe that as drafted the legislation actually achieves that intention, and so we have highlighted where the differences arise.

We hope this is helpful in your framing how information should be exchanged under The Registered Pension Schemes (Provision of Information) Regulations 2006.

These regulations currently refer to information exchange based on percentages of the “relevant standard LTA”, and are crucial in terms of one scheme understanding the LTA charge due from a current BCE after s/he has crystallised benefits in the past from another scheme.

Our default reading is that individuals have a mixture of standard LTAs. For a member with Fixed Protection it appears that the standard LTA is £1.8m, dropping to £1.5m if/when the member loses Fixed Protection. As we have suggested to HMRC before, it may be necessary for the Information Regulations to include a statement of the SLTA being used for a case.

3. The test for LTA charge for a member who loses Fixed Protections

We set out in Appendix 3 an example of how we think a member's BCE would be tested against the LTA if they lose Fixed Protection, for your confirmation. The RPSM needs to have an example for what could be a common occurrence.

4. How does the revaluation test for Fixed Protection operate in the year in which BCEs are drawn

We set out in Appendix 4 two examples of how we think Fixed Protection tests of benefit accrual apply when the tax year includes a BCE – which is not at all clear in the legislation.

We think this also brings into question the reading HMRC have given in correspondence with us that the test has done "day by day" rather than tax year.

5 Fixed protection - interaction with the valuation assumptions

In HMRC's Newsletter 47 HMRC set out its interpretation of the valuation assumptions – which highlighted that the annual pension rate used for an active member in establishing the opening and closing value can be very different from say the pension that would apply had they left at that date. Our reading is that the valuation assumptions have the same effect in the Fixed Protection legislation – so specifically would result in P and LS as at 5 April 2012 say for FP purposes the same as the PE and LSE for the closing value for AA PIA for a PIP that ended on that date. Do you agree?¹

6. To note that care is needed in HMRC guidance to individuals – for example not to take an inappropriate strong line to encourage individuals who are considering Fixed Protection into opting-out of active membership under their scheme's rules by 5 April 2012

We note that Notes in the Fixed Protection form warn that "If you ... have benefit accrual on or after 6 April 2012 you will normally lose fixed protection." There is no indication here that "benefit accrual" is a very special term for Fixed Protection – and not for example the same as "benefit accrual" when considering who is an active or a

¹ In considering 4 and 5 above, we note that the legislation describes the "benefits amount" from time to time for the Fixed Protection test as " $(P \times RVF) + LS$ where-

LS is the annual rate of the lump sum to which the individual would, on the valuation assumptions, be entitled under the arrangement (otherwise than by commutation of pension);

P is the annual rate of the pension which would, on the valuation assumptions, be payable to the individual under the arrangement;

RVF is the relevant valuation factor [= 20]"

and differs from the structure in the AA legislation eg because the wording there refers to "the annual rate of the pension which would, on the valuation assumptions (see section 277), be payable to the individual under the arrangement if the individual became entitled to payment of it at [the relevant date]; and there is no reference to how the calculation applies if there is a BCE2 BCE3 or BCE6 during the tax year .

deferred pensioner under Finance Act definition (and indeed very different from “relevant benefit accrual” for Enhanced Protection. Most readers might assume it means “you must opt out of active membership of a scheme and become a deferred pensioner”. It should be made clear in all material issued that it is a defined term with a special meaning for this particular test.

We have seen in other proposed material from HMRC messages along the lines of the difficulties of managing FP if not becoming a deferred pensioner. We understand that HMRC wishes to warn individuals about the non-trivial obligations arising with registration for Fixed Protection. However we think that an unremitting message to “opt-out” is inappropriate. On the one hand an opting-out member may find themselves locking into deferred pension revaluation that is not “relevant revaluation” and so lose Fixed Protection immediately (for example if revaluation rules have been changed since December 2010). On the other hand, the workings of the “valuation assumptions” – on which we have had much discussion with HMRC and see above – mean that what schemes and members consider true accrual might be very different from what counts for benefit accrual for Fixed Protection purposes; if you disagree please let us know.

This is very complex legislation when looking its interaction with scheme rules – as I am sure became apparent during the course of our many discussions and in the light of the queries you have received. We have written with only core starter examples only a limited number of topics – we feel that there are many extensions to most of these topics that will need exploring once the basics are established. These need to be in the RPSM if HMRC are not to face a very large number of queries (many repeated by different enquirers) in future.

For LTA management, these will be urgent given the hard 6 April 2012 deadline for decisions.

Yours sincerely

Karen Goldschmidt FIA

Chairman of the Pensions Taxation Committee of the Association of Consulting Actuaries
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Appendix 1: How Primary Protection works past 6 April 2012 when an individual has drawn BCEs before that date

First we show a relatively simple case of a member solely with Primary Protection. The adjustments where there have been past BCEs are quite complex to follow so we have spelled them out step by step. In this example it seems to be that on 5 April 2012 this member could have a maximum BCE of £2.88m without triggering LTA charge; and on 6 April 2012 this has risen to £2.91m – from a previously unnoticed way that the new legislation has been structured. Please note that this example is based on our understanding of the policy intent and the legislation.

The results are not as we might have expected.

Example 1 – LTA uplift solely from Primary Protection

On 5 April 2006 Joel has £2.55 million of existing pension rights in several pension schemes. He applies for and is granted primary protection by HMRC. This gives a primary protection factor of 0.7 = (£2.55 million - £1.5million)/ £1.5 million.

First benefit crystallization event – May 2010

In May 2010, Joel decides to draw benefits from one of the schemes. Since he has primary protection, his lifetime allowance at this benefit crystallization event (BCE) is calculated by the following formula:

$$SLA + (SLA \times LAEF)$$

where

- SLA = standard lifetime allowance at the point of calculation (in this instance £1.8 million).
- LAEF = lifetime allowance enhancement factor. Here, since Joel has primary protection, LAEF is his primary enhancement factor i.e. 0.7. [see sch 36 para 7(4)]

In other words his lifetime allowance at that point is calculated by:

1. Multiplying the standard lifetime allowance for the 2010/11 tax year by his lifetime allowance enhancement factor (£1.8 million x 0.7 = £1.26 million)
2. Then adding this figure to the standard lifetime allowance

$$\text{i.e. } £1.8\text{million} + (£1.8\text{m} \times 0.7) = £3.06 \text{ million}$$

Joel crystallises benefits worth £180,000 or 10% of the standard lifetime allowance at that point. His lifetime allowance, before the BCE, is 170% of the standard lifetime allowance so, after the BCE, 160% of the standard lifetime allowance remains.

Second benefit crystallization event – May 2012

In May 2012 Joel draws benefits from another scheme. The standard lifetime allowance is now £1.5 million. As Joel has primary protection and the BCE is post 6 April 2012, to calculate his total lifetime allowance at that point (before allowing for his previous BCE) we use the same formula as above but with an adjustment to the definition of SLA.

Because the BCE is after 5 April 2012 and Joel has primary protection, the formula is revised so that SLA is now calculated as the higher of £1.8 million and the standard lifetime allowance at that point. In Joel's case the latter is £1.5 million so we set SLA as £1.8 million. [see s218 (5B) of FA 2004]

The adjusted formula for Joel's lifetime allowance (before considering previous BCEs) is therefore:

$$\text{Adjusted SLA} + (\text{Adjusted SLA} \times \text{LAEF})$$

where

- Adjusted SLA = the higher of the standard lifetime allowance at that point (in this instance £1.5 million) and £1.8 million.
- LAEF = lifetime allowance enhancement factor (as before)

In other words his lifetime allowance at that point (before allowing for historical BCEs) is calculated by:

1. Compare the standard lifetime allowance at that point with £1.8 million and take the higher. Since the standard lifetime allowance for the 2012/13 tax year is £1.5 million we take the higher as £1.8 million.
2. Multiplying this number (i.e. £1.8 million) by his lifetime allowance enhancement factor (£1.8 million x 0.7 = £1.26 million)

3. Then adding this figure to the number calculated at step 1

i.e. £1.8million + (£1.8m x 0.7) = £3.06 million

His lifetime allowance is therefore 204% of the standard lifetime allowance of £1.5M (before considering historical BCEs).

The benefits Joel took in 2010 amounted to 10% of the standard lifetime allowance, and so he has 194% of the standard lifetime allowance remaining for his latest benefit crystallization event to be tested against.

This example illustrates that the legislation as drafted could actually lead to an increase in available LTA for individuals with PP, as BCEs pre April 2012 are effectively rated down by 1.5 / 1.8.

More extreme examples could be shown.

Example 2 – transfer from recognised overseas pension scheme

Please note that this example is based on our understanding of the policy intent. It is not how we believe the legislation as drafted actually works. More details are given in Appendix 2.

First enhancement event – May 2006

Colin does not have primary protection. He transfers £1.05 million into a registered pension scheme from a recognised overseas pension scheme (ROPS) in May 2006 and HMRC confirm that he is entitled to a lifetime allowance enhancement factor of 0.7. This is based on the standard lifetime allowance at that time of £1.5 million and is calculated as £1.05 million / £1.5 million.

First benefit crystallization event – May 2010

In May 2010, Colin decides to draw benefits from one of the schemes. Since he has an enhanced lifetime allowance resulting from the transfer from the ROPS, his lifetime allowance at this BCE is calculated by the following formula:

$$SLA + (SLA \times LAEF)$$

Where

- SLA = standard lifetime allowance at the point of calculation (in this instance £1.8 million).
- LAEF = lifetime allowance enhancement factor. Here since Colin has had a transfer from a recognized overseas pension scheme, LAEF is his recognised overseas scheme transfer factor i.e. 0.7.

Colin crystallises benefits worth £180,000 or 10% of the standard lifetime allowance at that point. His lifetime allowance (before the BCE) is 170% of the standard lifetime allowance so in future, after the BCE, he has 160% of the standard lifetime allowance at that point available.

Second enhancement event – May 2012

On 31 May 2012, Colin transfers a further £0.60 million into a registered pension scheme from a recognised overseas pension scheme (ROPS). HMRC confirm that, in respect of this transfer, he is entitled to a lifetime allowance enhancement factor of 0.4. This is based on the standard lifetime allowance at that time of £1.5 million and is calculated as (£0.60 million / £1.5 million).

Second benefit crystallization event – September 2012

In September 2012 Colin draws benefits from another scheme. The standard lifetime allowance is now £1.5 million. As Colin has an enhanced lifetime allowance resulting from the two transfers from a ROPS and the BCE is post 6 April 2012, to calculate his total lifetime allowance at that point (before allowing for his previous BCE) we use the formula below:

$$\text{SLA} + (\text{Adjusted SLA} \times \text{LAEF}(\text{pre 2012})) + (\text{SLA} \times \text{LAEF}(\text{post 2012}))$$

where

- SLA = the standard lifetime allowance at that point (£1.5 million)
- Adjusted SLA = the higher of the standard lifetime allowance at that point (in this instance £1.5 million) and £1.8 million. So Colin's Adjusted SLA is £1.8 million
- LAEF(pre 2012) = lifetime allowance enhancement factor due to any events occurring before 6 April 2012
- LAEF(post 2012) = lifetime allowance enhancement factor due to any events occurring after 6 April 2012

In other words his lifetime allowance at that point (before allowing for historical BCEs) is calculated by:

1. Compare the standard lifetime allowance at that point with £1.8 million and take the higher. Since the standard lifetime allowance for the 2012/13 tax year is £1.5 million we take the higher as £1.8 million.
2. Multiplying this number (i.e. £1.8 million) by his lifetime allowance enhancement factor in respect of any events that happened before 6 April 2012 (£1.8 million $\times$ 0.7 = £1.26 million)
3. Multiplying the standard lifetime allowance (i.e. £1.5 million for the 2012/23 tax year) by his lifetime allowance enhancement factor in respect of any events that happened after 6 April 2012 (£1.5 million $\times$ 0.4 = £0.60 million)
4. Then adding the above two figures to the standard lifetime allowance:

$$£1.5\text{million} + (£1.8\text{m} \times 0.7) + (£1.5\text{m} \times 0.4) = £3.36\text{ million}$$

His lifetime allowance is therefore 224% of the standard lifetime allowance of £1.5M (before considering historical BCEs).

The benefits Colin took in 2010 amounted to 10% of the standard lifetime allowance, and so he has 214% of the standard lifetime allowance remaining for his latest benefit crystallization event to be tested against.

Appendix 2: Adjustments in relation to Enhancement Factors

This appendix summarises what we believe is the intended operation of Lifetime Allowance Enhancement Factors across 6 April 2012.

218(4) explicitly states that where there is more than one event leading to an enhancement factor, there is only a single LAEF which is the aggregation of the individual factors.

The legislation indicates what to do where there has been one non-PP event which was pre 6 April 2012 (i.e. underpin SLA by £1.8M in the second term of the formula). Equally, it is obvious that where there has been a single non-PP event that is post 5 April 2012 one makes no adjustments.

However the legislation does not adequately deal with the case where one has more than one non-PP event, one pre 2012 and one post. The strict interpretation of the legislation is to aggregate the LAEFs (because there is more than one of them) and then adjust the formula to underpin SLA by £1.8M (because there is a non-PP event that is pre 6 April 2012). This would effectively apply the £1.8M for all the events giving rise to an LAEF, including those that occurred after 5 April 2012. We do not believe that this is HMRC's intention.

Individuals may, in certain circumstances, be granted an uplift to their standard lifetime allowance (SLA), known as a lifetime allowance enhancement factor (LAEF). For such individuals their lifetime allowance is modified to:

$$\text{SLA} + (\text{SLA} \times \text{LAEF})$$

where:

- SLA is the standard lifetime allowance at the time of the relevant benefit crystallisation event, and
- LAEF is the lifetime allowance enhancement factor for the individual (or where more than one operates, the aggregate of them).

Depending on the reason for the granting of the LAEF and the timing of this event, "SLA" as used in the above formula may be modified so it refers to "the greater of the current standard lifetime allowance and £1.8M".

This adjustment may apply to whole formula, OR it may affect only the second term of the formula (i.e. only to (SLA x LAEF) and not to the preceding SLA).

Set out below is a table showing when and in what circumstances the above formula is amended. The formula assumes that the current standard lifetime allowance is £1.5M.

If uplift(s) due to	If uplift event before 6 April 2012?	Then formula to use
Cause other than PP (see below list) *	Yes	1.5M + (1.8M x LAEF)
Cause other than PP (see below list) *	No	1.5M + (1.5M x LAEF)
Two causes from below list, neither PP	One before 6 April 2012, one after LAEF1 = pre 6 April 2012 event LAEF2 = post 5 April 2012 event	1.5M + (1.8M x LAEF1) + (1.5M x LAEF2)
Primary protection (PP)	Yes (PP only possible wef 6 April 2006)	1.8M + (1.8M x LAEF)
PP + reason other than PP	Yes for both events	1.8M + (1.8M x PP LAEF) + (1.8M x non-PP LAEF)
PP + reason other than PP	Yes for PP event (by definition) No for non-PP event	1.8M + (1.8M x PP LAEF) + (1.5M x non-PP LAEF)

Apart from primary protection, uplifts can be granted to individuals where the following applies:

- Individuals who have pension credits from previously crystallised rights
- Individuals who are not always relevant UK individuals
- Transfers from recognised overseas pension scheme
- Pre-commencement pension credits

Appendix 3: the LTA charge due on a BCE after a member has lost Fixed Protection

Finance Act 2011 states that (schedule 19 para 14)

“(1) This paragraph applies on and after 6 April 2012 in the case of an individual-[who has validly applied for Fixed Protection]

..

(3) Part 4 of FA 2004 has effect in relation to the individual as if the standard lifetime allowance were the greater of the standard lifetime allowance and £1,800,000 (the standard lifetime allowance for the tax year 2011-12).

(4) But this paragraph ceases to apply if on or after 6 April 2012- etc etc.”

Our reading is that, from 6 April 2012, this means that the standard lifetime allowance for Fiona is £1.8 million for BCE tests whilst Fiona has fixed protection, but drops to £1.5m for future BCEs if fixed protection is lost.

Here is an example for a member who registers for protection by 5 April 2012

First benefit crystallisation event - August 2012

In August 2012, Fiona decides to draw some of her benefits from her pension scheme. Her standard lifetime allowance for the 2012/2013 tax year is £1.8 million and the value of the benefits Fiona decides to draw is £600,000. The benefits amount to 33.33% of her standard lifetime allowance at the time.

In May 2013, Fiona starts to contribute to a defined contribution scheme and loses her fixed protection. Her standard lifetime allowance reverts to £1.5 million for the future.

Second benefit crystallisation event - August 2014

Using section 219 of the Finance Act, when a BCE arises, it is necessary to multiply amount of benefits crystallised in the past by [standard lifetime allowance at the time of the current benefit crystallisation event (£1.5 million)/ standard lifetime allowance at the previous crystallisation date: so for the BCE in 2014, the BCE in August 2012 when FP still applied is multiplied by £1.5m/£1.8 million ie $£600,000 \times 1.5/1.8 = £500,000$.

This means that a BCE of up to £1 million at this date would not cause LTA charge.

The exchange of information under the Information Regulations uses the “relevant Standard Lifetime Allowance” as a denominator; so would show BCEs of 33.33% for the first BCE; and £66.66% for the second – but would make no sense and not be useful unless accompanied by the standard LTA that applies for the member at the BCE.

The above is our reading on balance, but we can see arguments for other readings – please confirm your interpretation.

Appendix 4: Testing of benefit accrual for Fixed Protection purposes

This section relates to the benefit accrual test when an individual has a BCE during the tax year; and what implication does this have for whether benefit accrual has to be tested instant by instant or by tax year?

The legislation defines the amount of the increase in the value of an individual's rights (under the arrangement (and its amount if there is) to be determined as ..

"6(b) in the case of a defined benefits arrangement .. by reference to whether there is an increase in the benefits amount.

(7) For the purposes of sub-paragraph (6)(b) "the benefits amount" is $(P \times RVF) + LS$

where-

LS is the annual rate of the lump sum to which the individual would, on the valuation assumptions, be entitled under the arrangement (otherwise than by commutation of pension);

P is the annual rate of the pension which would, on the valuation assumptions, be payable to the individual under the arrangement;

RVF is the relevant valuation factor.

This would seem to cross-refer back to the valuation assumptions in S277 and the valuation factor in S276 of Finance Act 2004

When we look at rights in the context of AA, P and LS relate solely to uncrystallised benefits, P and LS do not by default include actual benefits drawn: there has to be an explicit add back when there is a BCE2 etc to deal appropriately with the accrual in that year. No such adjustment is indicated here – but we assume there is intended to be a closing value when benefits are drawn.

The following is an example following a case of early retirement as a start point from which other questions may follow (eg BCE3, late retirement) which the RPSM needs to address.

It suggests a treatment, and also shows why it is not appropriate to say that the FP benefit accrual test is a day to day one (which day to day test is what you have indicated in correspondence with us). It is only at the end of the tax year that one can determine what the values were at the end of the tax year.

Example 1 - early retirement

Emily is a member of a defined benefits scheme. Emily's pension builds up at a rate of 1/80th of pensionable salary for each year of service.

Emily applies for fixed protection and continues to build up benefits after 5 April 2012.

From 2012-13 onwards Emily needs to check each tax year to see if she has lost fixed protection. She does this by testing whether or not the value of her pension rights have gone up by more than the "relevant percentage" in the tax year. The relevant percentage, is either

- an annual rate specified in the rules of the pension scheme that was specified there on 9 December 2010, or where there is no such rate
- the annual percentage increase in the consumer prices index (CPI) for the month of September in the previous tax year.

The rules of Emily's pension scheme do not set a percentage by which member's benefits are increased each year for the period while she is accruing benefits as an active member. So Emily needs to check that her pension rights have not gone up by more than the annual CPI increase.

On 5 April 2012 Emily has 10 years of service and a pensionable salary of £132,000. She has built up a pension of

$$10/80 \times £132,000 = £16,500 \text{ pa}$$

The value of Emily's pension rights from this scheme on 5 April 2012 is therefore

$$(£16,500 \times 20) = £330,000.$$

The annual increase in CPI to September 2011 is assumed to be 3%. This means that to keep fixed protection Emily's pension rights on 5 April 2013 cannot be more than

$$£330,000 \times 103/100 = £339,900.$$

Emily knows that her pensionable salary will be fixed over 2012/13. At 5 April 2013 Emily's pensionable salary is therefore still £132,000. Her annual pension on 5 April 2013 is

$$11/80 \times £132,000 = £18,150.$$

This means the value of Emily's pension rights at 5 April 2013 would be

$$(£18,150 \times 20) = £363,000.$$

However at 4 April 2013 Emily retires early (as she had planned to do at the beginning of the 2012/13 year) Her pension is reduced by an early retirement factor of 10%, to £16,335.

So the value of Emily's pension rights are

$$16,335 \times 20 = 326,700$$

This is lower than the value of the 6 April 2012 benefits increased by the CPI increase (£339,900). Emily has not lost fixed protection at 5 April 2013.

[Had her benefits been measured half way through the 2012/13 tax year, at 5 October 2012 Emily's annual pension would have been

$$10.5/80 \times £132,000 = £17,325.$$

This means the value of Emily's pension rights at 5 October 2012 would be

$$(£17,325 \times 20) = £346,500.$$

She may have thought that she had lost fixed protection – but she had not because by the end of the tax year the increase was not excessive.

Example 2 - commutation of pension for lump sum

*The legislative reference is to LS as “otherwise than by commutation of pension” and P as “the annual rate of the pension which would, on the valuation assumptions, be payable to the individual under the arrangement”. Without the details in AA legislation relating to BCE2 etc (and surrenders) we are not sure whether actual commutation is “unwound” or reflected. The following would be the case if it **is** to be reflected.*

Christie is a member of a defined benefits scheme. Christie's pension builds up at a rate of 1/80th of pensionable salary for each year of service.

Christie applies for fixed protection and continues to build up benefits after 5 April 2012.

From 2012-13 onwards Christie needs to check each tax year to see if she has lost fixed protection. She does this by testing whether or not the value of her pension rights have gone up by more than the “relevant percentage” in the tax year. The relevant percentage, is either

- an annual rate specified in the rules of the pension scheme that was specified there on 9 December 2010, or where there is no such rate
- the annual percentage increase in the consumer prices index (CPI) for the month of September in the previous tax year.

The rules of Christie's pension scheme do not set a percentage by which member's benefits are increased each year for period while she is accruing benefits as an active member. So Christie needs to check that her pension rights have not gone up by more than the annual CPI increase.

On 5 April 2012 Christie has 20 years of service and a pensionable salary of £132,000. She has built up a pension of

$$20/80 \times £132,000 = £33000 \text{ pa}$$

The value of Christie's pension rights from this scheme on 5 April 2012 is therefore

$$(£33000 \times 20) = £660,000.$$

The annual increase in CPI to September 2011 is 3%. This means that to keep fixed protection Christie's pension rights on 5 April 2013 cannot be more than

$$£660000 \times 103/100 = £679800.$$

Christie knows that her pensionable salary will be fixed over 2012/13. At 5 April 2013 Christie's pensionable salary is therefore still £132,000. Her annual pension on 5 April 2013 is

$$21/80 \times £132,500 = £34650.$$

This means the value of Christie's pension rights at 5 April 2013 would be

$$(£34650 \times 20) = £693000.$$

However at 5 April 2013 Christie retires at her normal retirement date. She chooses to commute 10000 of her pension at the scheme's rate of £10 cash for each £1 pension given up

Her pension is therefore reduced to £24650. Her pension commencement lump sum is 100000

So the value of Christie's pension rights is

$$24650 \times 20 + 100000 = £593000$$

This is lower than the value of the 6 April 2012 benefits increased by the CPI increase. Christie has not lost fixed protection at 5 April 2013.

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Peter Seedhouse

HM Revenue & Customs

Pensions Policy Team

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By email to pensions.policy@hmrc.gsi.gov.uk
and cc to Paul Cottis and Judy Goodall (given the implications for the RPSM)

7 July 2011

Dear Peter

Annual Allowance valuation assumptions: “Barber” and similar “split NPA” adjustments

We are writing regarding a common benefit feature in defined benefit schemes, to ask for your confirmation of how Pension Input Amount calculations should reflect this; and to provide examples that would be useful to demonstrate the point in the RPSM.

In our letter of 14 January 2011 to which you replied 16 March, in section 3.2 we described the issue which we labelled Barber NPA splits. Typically these mean a member may have accrued some past service benefits (with ongoing salary linking) effectively “due” from age 60 and are now accruing benefits “due” from age 65 – albeit in practice the scheme rules require the pension to be drawn in one go, and the “due” aspect is dealt with by adjustments to the basic calculation. The ages involved may not be 60 and 65, and there may be more than a two way split.

How benefits are actually calculated in a scheme (ie for “real” purposes, not for tax purposes) in relation to this issue depends very much on

- § the scheme's current rules
- § its history of rules in the past
- § how the powers were implemented over time
- § the exact wording and its impact for legal interpretation

All of this may lead to different courses of action now to calculate (real) benefits – and potentially with knock on effects for the calculation of “tax benefits”.

The Appendix sets out our thinking on the principles, by way of worked examples.

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We casually used the term “split NPA” in previous correspondence. This may take several forms, but we focus mostly on one form that demonstrates the key issues. In the last section in the Appendix, I explain a variation in the “real benefit” to bring out how different treatment for Annual Allowance may arise.

This is a complicated area but an important one that arises for most DB schemes in the country, and an area in which there is much confusion and varied reading. We have tried to highlight basic principles, taking heed of your guidance so far on 16 March 2011. We would be very happy to meet to discuss this further with you if that would be helpful.

Yours sincerely



Prepared as an attachment to an email
at 15:22 on 7 July 2011

Miss K Goldschmidt FIA
Partner

As Chair of the ACA pensions taxation committee

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Appendix

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Important simplification that should be noted throughout in these examples, except in the one case where otherwise stated: we have deliberately assumed that the scheme rules do not contain a provision that existed October 2010 regarding revaluation (ie as might be referred to in 234(5C)). Many schemes would have such a provision and therefore may be looking to use the guidance you gave in section 3 in the letter of 16 March 2011 "Miscellaneous issues particularly relating to defined benefit (DB) arrangements". The reason we have made the assumption is because for this letter we wish to draw out some principles which would be hidden if the easement applied.

Core example: We do our analysis in the context of an example member:

the PIP is tax years;

he had four years of service that counted as "age 60 tranche" (see below);

but then, following changes to the scheme in April 1991 has subsequent and current accrual counted as "age 65 tranche".

At 5.4.2011 he is now age 54 (ie below age 60), and the calculation would look as follows if no "split NPA" issue were in play (if say his scheme pensionable salary were £160,000 and £168,000 at the opening and closing of the PIP). Our starting point is that all benefits in the scheme accrue in the same arrangement.

Scheme rules formula pension at 5.4.2011: $160,000 \times (4/60 + 20/60)$
 $= 10,667 + 53,333 = 64,000$

Scheme rules formula pension at 5.4.2012: $168,000 \times (4/60 + 21/60)$
 $= 11,200 + 58,800 = 70,000$

So if no "split NPA" age adjustments were in play, the PIA for 2011/12 would be

$$70,000 \times 16 - 1.031 \times 64,000 \times 16 = 64,256$$

1. Scheme A—Age adjustment if the individual leaves or stays active past age 60

In this scheme

- § If the member stays in service accruing benefit up to (or beyond) age 60 and then retires,
 - § If he draws his pension at age 60, the "age 60 tranche" is granted with no age adjustment, but the age 65 part has a "5 years early" age reduction.
 - § If he draws his benefits at age 65, then the "age 60 tranche" gets a "five years late" age adjustment applied - or might get the better of this and salary linking; but the age 65 part has no adjustment.
 - § If he draws his pension between age 60 and 65 the obvious intermediate approach applies to each tranche
 - § If he draws his benefits at an age below 60, age reduction applies to both tranches, reflecting the period relative to either 60 or 65, as appropriate.

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§ If the individual leaves service below age 60, then because of preservation legislation

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- § if he draws his benefits at age 60, the “age 60 tranche” has no age adjustment applied, but the age 65 part has a “5 years early” age reduction.
- § If he draws his benefits at age 65, then the “age 60 tranche” has a “five years late” age adjustment applied, but the age 65 part has no adjustment
- § If he draws his pension between age 60 and 65 the obvious intermediate approach applies to each tranche
- § If he draws his benefits at an age below 60, age reduction applies relative to 60 or 65.

1.1. Our reading of the correct approach to Annual Allowance PIA calculations

We need to consider how the valuation assumptions apply and hence how PB and PE are calculated. These are *“the annual rate of the pension which would, on the valuation assumptions ... be payable to the individual under the arrangement if the individual became entitled to payment of it at [the relevant date]”* and the valuation assumptions are that *“... if the person has not reached such age (if any) as must have been reached to avoid any reduction in the benefits on account of age, that the person reached that age on the date..”*

Our reading is that the age for the “age 60 tranche” is 60; and for the “age 65 tranche” is 65.

So while the member is below age 60 the calculation of PIA can simply use the face values described above and the PIA is indeed £64,256.

If by the closing position the member has left service, there is no change in principle in the calculation (just to the detail because of leaving).

We then consider the member reaching the first of the NPAs (60 here) if still in service. We note that the valuation assumptions do not specifically mention what age to assume if the member is above NPA, but do imply that we read into the start of it “or actual age if higher. Suppose we were looking at the PIA in the year in which the member reaches age 61 and is still in service. We assume that P for the closing value would duly reflect, for the age 60 tranche, the benefit that would be due if the member retired immediately then (ie one year’s late retirement uplift, or the salary linkage if that is what the rules provide for and it is the higher) with no adjustment to the age 65 tranche.

We did consider whether a different approach needed to be used, but the alternatives (see below) resulted in very artificial results and did not seem forced by the legislation. For completeness I set the different approach out below but strongly note that it seems inappropriate. We then look at a variation that schemes may wish to apply.

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1.2. Possible approach that HMRC might read into the legislation

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It may be that HMRC read into the legislation that only one notional age can be set in the calculation of PB or PE for the PIP and the arrangement. For the member concerned this would appear to be 65 because at ages below 65, part of the benefit is age-reduced (albeit that the other part is not). If the legislation assumes that the member has reached age 65 does this also mean that he has “passed through” age 60 and accrued late retirement increases? We would argue not, so the outcome is the same as above. This is particularly confirmed if the scheme’s adjustment between age 60 and 65 for the age 60 tranche is “the better of salary growth from age 60 and late retirement uplift” – there is no sensible way to interpret this.

But it may be that you feel the law has to be read that -although this assumption is not stated as required in the legislation - one assumes that the age 60 tranche was accrued below age 60 and so will accrue five years’ age uplift as the member “moves” up to age 60 and on to age 65 under the valuation assumptions if one pretends the member is now 65; and one brushes off the salary aspect. Clearly we do not know what that five year uplift will be in fact for the current member, but we look to a member who is already 65 at the relevant date ie the current “5 years late” factors

If there is no change in the late retirement factors used in the year, this might result in a calculation that looks like the following:

$$£160,000 \times (1.37^* \times 4/60 + 20/60) = £67,947 \text{ pa}$$

$$£168,000 \times (1.37^* \times 4/60 + 21/60) = £74,144 \text{ pa}$$

$$\text{PIA} = 74,144 \times 16 - 1.031 \times 67,947 \times 16 = 65,456$$

We would be concerned that if the late retirement factors are reviewed during the year, the change would come through weighted in at five years. Here is an example

$$£160,000 \times (1.37^* \times 4/60 + 20/60) = £67,947 \text{ pa}$$

$$£168,000 \times (1.47^* \times 4/60 + 21/60) = £75,264 \text{ pa}$$

$$\text{PIA} = 74,144 \times 16 - 1.031 \times 67,947 \times 16 = 83,376.$$

This creates an artificial extra £18,000 of PIA in the short term which may have no meaning ultimately. As we have mentioned elsewhere, and consistent with various other explicit normalising adjustments that appear in the closing adjustments for DB and CB arrangements, we think that when calculations are done for a PIP, these sort of factor reviews during the year – which will be

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known by the time the PIP calculation is done – should come into the start and end calculation equally.

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1.3. Possible alternative approach scheme administrators may wish to take if HMRC read the above into the legislation (or indeed anyway)

The numbers in 1.2 are confusing information to members, and show an adjustment that has no meaning for their retirement, since it matches accrued benefits with an implication that they stay in service past age 60 in an illogical way. It creates an extra calculation burden for AA and appears susceptible to anomalous results if HMRC cannot read the law to allow a factor review to be normalised out for consistency (in the way that say transfers out and in are).

So if that is deemed to be the core requirement, administrators may wish to consider an alternative that is available to them

In your 16 March 2011 letter to JWG, you indicated that schemes could set up separate arrangements with backdated effect. For this case, the Trustees would therefore deem that the member has two arrangements.

Arrangement (a) consists of the age 60 tranche benefit - so based on the closed 4 years of service and the impact of salary growth on it since the service was completed; and

Arrangement (b) consists of the age 65 tranche benefit – so reflects the service as it accrued and accrues and the impact of salary growth on it since the service was completed. The calculation of PIA would then be:

In arrangement (a) $£11,200 \times 16 - 1.031 \times 10,667 \times 16 = 3,243$

In arrangement (b) $58,800 \times 16 - 1.031 \times 53,333 \times 16 = 61,013$ Total £64,256

You will see that this creates no artificial uplifts and results in the same numbers as our preferred reading. However

- § It relies on HMRC agreeing in principle to the creation of such split arrangements (potentially retrospectively so that PIAs from one year to the next in carry-forward match up); and
- § it creates an artificial need to set up separate arrangements which changes the position of some members, and possibly not others (eg in the impact if negative values arise and are zeroed in an arrangement) and may cause problems for Trustee decisions

The Trustees would have to grapple with these issues in making their decision.

In the opening paragraph of this Appendix we noted the guidance in your 16 March 2011 letter and how “late retirement uplifts” might not count towards PIA calculations. Our reading is that (subject to the right conditions applying)

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this could be used under the approach for 1.3 in relation to the arrangement with “age 60 tranche” NPA 60; but could not be used under 1.1 or 1.2 because the one arrangement applying includes accrual of benefit. Do you agree? For this reason trustees may choose approach 1.3 rather than approach 1.1 or 1.2.

2. Scheme B - Age adjustment solely if the individual leaves service before retirement

The above reflects the fact that on continuing in service after age 60 the age 60 tranche attracts a late retirement uplift. In some schemes this would not apply – the benefit simply gets a salary link. It is only on leaving before age 65 (when DWP preservation law applies) that the age 60 tranche qualifies for late retirement uplift. So compared to the above:

In this scheme

- § If the individual leaves service below age 60, then because of preservation legislation
 - § if he draws his benefits at age 60, the “age 60 tranche” has no age adjustment applied, but the age 65 part has a “5 years early” age reduction.
 - § If he draws his benefits at age 65, then the “age 60 tranche” has a “5 years late” age adjustment applied, but the age 65 part has no adjustment
 - § If he draws his pension between age 60 and 65 the obvious intermediate approach applies to each tranche
 - § If he draws his benefits at an age below 60, age reduction applies relative to 60 or 65.
- § BUT if instead the member does not become a deferred pensioner but stays in service accruing benefit past age 60 up to age 65, there is no age adjustment: the “age 60 tranche” simply carries on having salary-linking if drawn any time up to age 65, the “age 65 tranche” has salary-linking and additional service accrual; and both parts have late retirement uplift only on deferment past age 65.

Annual Allowance PIA calculations

It seems clear that while the member is still in active status, one should ignore the fact that the benefits for the “tranches” operate differently on leaving. The age to consider is age 65, and the calculation is as in 1.1 above. On leaving the closing position will depend on HMRC’s ruling in the main case.

2078501

Judy Goodall

HM Revenue & Customs

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by email

And by email to pensions.policy@hmrc.gsi.gov.uk

8 July 2011

Dear Judy

Annual Allowance RPSM

I am writing further to our various email correspondence, to set out some points that would be very helpful to see covered in the RPSM pages on Annual Allowance.

16 March 2011 correspondence

Firstly, clearly, the material in the 16 March 2011 correspondence with Peter Seedhouse should appear as fully as possible in the RPSM pages: these all relate to areas that JWG/ACA had identified as common issues for schemes and have already proved to be very useful.

BCE2 and 6

We exchanged correspondence with Claire and Anne on 24/26 May with an example to clarify how to apply the new Bill provisions on dealing with BCE2 and BCE6 in a PIP in calculating PIA. The correspondence can be found here:

http://www.aca.org.uk/files/Annual_Allowance_Bill_Changes_-_document-26_May_2011-20110526130327.pdf

The example (or something similar) should appear in RPSM as it was very helpful in clarifying that the closing calculation should involve pension after any early retirement reduction but with commutation unwound – this is very difficult to read in the legislation. Ideally, please could you also explain how you got to that reading (I have seen one lawyer summarise it as briefly as follows: *“treat commutation for PCLS as surrender under member option (add back under Section 236(8)); but ignore BCE6 for PCLS because this only applies to “as of right” lump sums”*)

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Having clarified that one uses the actual pension, we think it important to highlight one exception where one does not. So Appendix 1 of this letter sets out an **extension** to that example, to show that if the case were a late retirement one then whether a late retirement uplift was also reflected depends on how the “deferred pensioner carve out” might apply bearing in mind guidance in HMRC’s letter of 16 March.

Split NPAs – treatment before reaching the NPA

We have written separately on the principles to follow for schemes with “split NPAs”.

Valuation assumptions

Newsletter 47 notes that the valuation assumptions need to be considered in conjunction with the whole of a scheme’s current provisions, including (old) Inland Revenue limits if the scheme so provides for them. This can make such a massive difference that we think it is important to give an example, and we duly enclose such an example in Appendix 2.

We will continue to send in material as we have time to develop it.

Yours sincerely



Prepared as an attachment to an email
at 15:08 on 8 July 2011

Miss K Goldschmidt FIA

Partner

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As Chair of the ACA Pensions Taxation committee

2078501

Appendix 1: Example of how BCE2 impacts on Pension Input Amount for member taking late retirement from active status from a DB arrangement

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John is in a defined benefit scheme where he accrues a 60th benefit for each year of service and has a Normal Pension Age of 60.

At the start of the Pension Input Period, he reaches age 60 when he has accrued a pension based on 20 years service and final pensionable salary of £80,000 as follows

Pension due at age 60 (the scheme NPA) if he were to retire immediately:

$$\text{§ } 20 / 60 \times \text{£}84,000 = \text{£}28,000 \text{ pa}$$

and so the opening value for PIA is calculated as $16 \times \text{£}28,000 = \text{£}448,000$.

If the PIP were the year ending 31 March 2012, the opening value would be uprated by 3.1% to **£461,888**.

Under the scheme rules if an individual stays in service beyond NPA, accrual ceases and the pension due on ultimate retirement is the pension that would have been paid at NPA, uplifted for delayed payment.

John reaches age 61 and decides to retire and the scheme duly grants him a pension.

§ The pension paid is calculated as £28,000 uplifted by 8%, the late retirement factor for one year's delay as is then in force in the scheme = £30,240 pa.

Without the closing value adjustment that is in (8) (8A) and (8B) of the Act his closing value would be nil (no uncrystallised benefit). But, because there has been a BCE2, there is a closing adjustment.

In principle the adjustment is based on the actual rate of annual pension that was crystallised (ie recognised in the BCE2) (here there has been no commutation so there is no further adjustment on that account). But we need to consider the clarification given in HMRC's letter to ACA of 16 March 2011 (section 3.2).

(A) if the LRF arises from a provision introduced into the scheme rules in 2011

No easement:

$$\text{The closing value is } = \text{£}30,240 \times 16 = \text{£}483,840$$

The PIA for this PIP from this arrangement is £483,840 – £ to **£461,888**. = £21,952.

(B) if LRF is in accordance with provisions in the scheme rules on 14 October 2011 (set by the Trustees having in accordance with the scheme rules considered advice from an actuary) albeit the factors having been reviewed since then

The only increase has been due to a late retirement uplift that counts as falling into the "deferred pensioner carve out", so no PIA arises for 2011/12.

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Appendix 2: valuation assumptions, and impact of IR limit being maintained

EXAMPLE 1: accrual "without contingencies"

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A scheme's rules promise a pension expressed at NRA as Service x (2/3rds /NS) where NS is the period (ignoring the valuation assumptions) from joining to NRA

On early leaving this is the formula for the deferred pension before revaluation; on early retirement the leaver pension is granted but with reduction for early payment.

	Member in year 19 in 2011/12, of potential NS 40	
Start	$19 \times (2/3 \times 1/40) \times 115,000 = 36,417$	
End	$20 \times (2/3 \times 1/40) \times 120,000 = 40,000$	
PIA	$(40,000 - 1.031 \times 36,417) \times 16$	= £39,265

EXAMPLE 2: accrual at NPA, earlier accrual deemed as dependent on contingencies

The scheme rules promise a pension on retiring from service at NRA of 2/3rds. On early leaving the formula is N/NS x 2/3 as deferred pension (before revaluation), and on early retirement from service this leaver pension is granted, reduced for early payment.

	Member in year 19 in 2011/12, of potential NS 40	
Start	$2/3 \times 115,000$	= 76,667
End	$2/3 \times 120,000$	= 80,000
		PIA £15,301
	Joiner in 11/12 with NS 40	
Start	$0 \times 115,000$	= £0
End	$2/3 \times 120,000$	= £80,000
		PIA £1,280,000 (few cases..)

Examples 1 and 2 are schemes that always provide the same actual, but have different AA PIAs because of the wording giving rise to the benefit.

EXAMPLE 3: as Example 2 but IR limits still are embedded in scheme rules

(Example assumes no retained benefits!)

	Member in year 19 in 2011/12, of potential NS 40	
Start	$2/3 \times 115,000$	= 76,667
	<i>or "IR limit at NPA" if less, say (if post 89): $19/30 \times [FR, \text{say } 115,000] = \underline{\underline{£72,833}}$</i>	
End	$2/3 \times 120,000$	= 80,000
	<i>or "IR limit at NPA" if less: $20/30 \times [FR, \text{say } 120,000] = \underline{\underline{£80,000}}$</i>	
	PIA	£78,547
	Joiner in 11/12 with NS 40	
Start	$0 \times 115,000$	= £0
End	$2/3 \times 120,000$	= £80,000
	<i>or "IR limit at NPA" if less: $1/30 \times [FR, \text{say } 120,000] = \underline{\underline{£4,000}}$</i>	
	PIA	£64,000



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20 July 2011

REF 2081077

TO: Peter Seedhouse
HM Revenue & Customs
Pensions Policy Team
By email

Copies by email to:
pensions.policy@hmrc.gsi.gov.uk

Judy Goodhall
(relevant for RPSM)

Please reply to:
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Dear Peter

Annual Allowance calculations: bridge pensions

This letter sets out our reading of the calculation for Pension Input Amount (PIA) for a common benefit structure specifically mentioned in the Treasury policy document [HMT response to consultation on draft Bill from 9 Dec 2011 - 31 Mar 2011](#): the temporary or bridge pension.

We have considered three different ways that bridges can arise in pension schemes:

- arising as an automatic part of basic accrual,
- created as an option exercised by the member at retirement in exchange for some whole-life pension; and
- arising automatically when an option such as early retirement is exercised.

We have shown our thinking with basic examples. If you can agree these, we will know that our starting point is correct and can then - if necessary - explore variations with you. In particular the example relating to the bridge being created as an option exercised at retirement is a template to understand how other options are treated.

We have set out the full details of our approach, and would be grateful if you could confirm our conclusions but also tell us that you agree the steps and logic along the way – or whether you consider any step to be incorrect. For the third version above, we have shown a case that arises where scheme design predates thoughts about AA and might appear difficult to move away from without triggering AA unreasonably – but we have deliberately provided a possible solution subject to your confirming it works as shown.

We hope these are all useful examples for the RPSM, but we realise that it may take some time to complete and publish. If you are able to confirm our examples earlier we would be happy to publish these on the ACA website (and via JWG bodies) with your confirmation.

Yours sincerely

Karen Goldschmidt FIA

Chairman of the Pensions Taxation Committee of the Association of Consulting Actuaries
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Appendix - Bridge pensions

In all these cases assume that there is a single arrangement involved, and it is “defined benefit”.

Example 1 - regular accrual

Member has Normal Pension Age of 60. Part of the basic provision of the scheme at retirement is a bridge pension payable from NPA to Age 65. The NPA rule specifies that the member's benefit on retirement at NPA is

- a whole-life pension of service at NPA x 1/60ths of Final Pensionable Salary (FPS) at NPA and
- a bridge pension of service x 1/80ths x the Basic State Pension (BSP) at NPA,

At the close of the previous pension input period (PIP), the member had service of 30 years, FPS of £60,000 and the BSP is £5,000. The member stays in service and a member throughout the PIP and at end of the PIP FPS is £62,000 and BSP is £5,100.

Opening Value

Step 1 – Find annual rate of pension entitlement at start of the input period for AA purposes

$$PB = 30/60 * £60,000 + 30/80 * £5,000 = £30,000 + £1,875 = £31,875$$

Step 2 – Multiply result by 16 (no special treatment arises from part of the pension being paid for a limited term)

$$£31,875 * 16 = £510,000$$

Step 3 – Add on any separate lump sum entitlement

None so running total is £510,000

Step 4 – Increase amount for CPI (here lets assume relevant CPI increase for the tax year this PIP ends in is 3%)

$$£510,000 * 1.03 = £525,300$$

Closing Value

Step 1 – Find annual rate of pension entitlement at end of the PIP for AA purposes

$$PE = 31/60 * £62,000 + 31/80 * £5,100 = 32,033.33 + 1,976.25 = £34,009.58$$

Step 2 – Multiply result by 16

$$£34,009.58 * 16 = £544,153.28$$

Step 3 – Add on any separate lump sum

None so running total is £544,153.28

If there are no other adjustments to the closing value, the PIA is £18,853.28 (£544,153.28 - £525,300).

The part of this arising from the increased entitlement to the temporary pension is £720.

This calculation could apply both before the member retires and also in the year in which the member takes his benefits (at NPA).

Example 2 – arising from a bridge exchange option at NPA

Member has Normal Pension Age of 60. However on retirement the member can exchange some of his whole-life pension due for a temporary pension which is paid from NPA to Age 65.

The NPA rule specifies that the member's benefit on retirement at NPA is a wholelife pension of service at NPA x 1/60ths of Final Pensionable Salary (FPS) at NPA

At the end of the previous pension input period, he has service of 30 years, FPS of £60,000. At end of period FPS is £62,000 and member retires at age 60 drawing pension. He exchanges £2,000 of whole-life pension for a temporary pension of £5,000 payable to age 65.

Opening Value

Step 1 – Find annual rate of pension entitlement just before the start of the PIP.

The member is still in service and has not exercised any option so the pension rate to reflect is the default whole-life pension:

$$PB = 30/60 * £60,000 = £30,000$$

Step 2 – Multiply result by 16

$$£30,000 * 16 = £480,000$$

Step 3 – Add on any separate lump sum

None so running total is £480,000

Step 4 – Increase amount for CPI (assume relevant CPI increase is 3%)

$$£480,000 * 1.03 = £494,400$$

Closing Value

Step 1 – Find annual amount of rate entitlement at end of the PIP:

“PE” under the valuation assumptions is zero initially because the member has started to draw all benefits and no benefits are uncrystallised in the arrangement. But during the PIP the member started “scheme pension” so had a BCE2, for which the starting pension rate was as follows:

$$\begin{aligned} [31/60 * £62,000 * &= £32,033.33] \\ - £2,000 + £5,000 &= £35,033.33 \end{aligned}$$

During the PIP, the “*annual rate of the pension .. to which the individual would be entitled under the arrangement*” has been changed by a “*surrender made in return for any other entitlement, any allocation made, or any similar action taken, pursuant to an option available to the individual under the arrangement*”. One therefore has to consider whether there is to be an adjustment under 236(8). The answer is no because the change is a rise in starting pension rate, and the adjustment arises only if there is a reduction.

Step 2 – Multiply result by 16

$$£35,033.33 * 16 = £560,533.28$$

Step 3 – Add on any separate lump sum

None so running total is £560,533.28

If there are no further adjustments to the closing value, the PIA is £66,133.28 (£560,533.28 - £494,400). Choosing to exchange whole-life pension for some temporary pension has added £48,000 to the PIA.

As the option to select a temporary pension only happens as retirement options are being finalised, there is no allowance for the temporary pension for PIPs prior to retirement. Whether the member triggers AA charge will depend on the availability of unused AA to carry-forward.

Example 2a

This example is exactly as for Example 2 but this time the member has NPA 65, and the option to exchange whole-life pension for bridge pension (payable solely until NPA) arises only on drawing benefits before NPA.

Data is as for Example 2 but at the end of the PIP the member reaches age 60 and is allowed to draw whole-life pension early but with a reduction for the early payment.

Again, just before the beginning of the pension input period, he has service of 30 years, FPS of £60,000. At end of period FPS is £62,000 but the member immediately retires early at age 60 with an early retirement reduction of 20% (4% for each year of drawing pension early). Again he exchanges £2,000 of scheme pension for a temporary pension of £5,000.

Opening Value

As above: £494,400

Closing Value

Step 1 – Find the annual rate of pension entitlement at end of the input period

The logic and arithmetic is as above but starting with the lower whole-life pension

$$\begin{aligned} [31/60 * £62,000 * 0.8 \text{ (early retirement reduction)}] &= 25,626.67 \\ - £2,000 + £5,000 &= £28,626.67 \end{aligned}$$

Step 2 – Multiply result by 16

$$£28,626.67 * 16 = £458,026.72$$

Step 3 – Add on any separate lump sum

None so running total is £458,026.72

The closing value is less than the opening value and there is no pension input amount in the final year.

As the option to select a temporary pension only happens at retirement, only the PIP in which the temporary pension is selected has any allowance for the temporary pension option.

Example 3 - bridge pension arises automatically on exercising an option to draw pension early

Member has Normal Pension Age of 65. The main provision of the scheme is whole-life pension. But when a member retires from service before age 65, a bridge automatically is paid until age 65.

The NPA rule specifies that the member's benefit on retirement at NPA is

- a whole-life pension of service at NPA x 1/60ths of Final Pensionable Salary (FPS) at NPA

Under the rule for **earlier** retirement the formula is similar but with a reduction for early payment and also an automatic bridge pension:

- bridge pension of service x 1/80ths x the Basic State Pension (BSP) at NPA.

Again, just before the beginning of the pension input period, the member has service of 30 years, FPS of £60,000 and BSP is £5,000. At end of period FPS is £64,000 and the BSP is £5,100 but the member immediately retires early at age 64 with an early retirement reduction of just 4%.

Opening Value

Step 1 – Find annual rate of pension entitlement at start of the input period for AA purposes

The member is still in service and has not exercised any option to retire early so the pension rate to reflect is the default whole-life pension:

$$PB = 30/60 * £60,000 = £30,000$$

Step 2 – Multiply result by 16

$$£30,000 * 16 = £480,000$$

Step 3 – Add on any separate lump sum entitlement

None so running total is £480,000

Step 4 – Increase amount for CPI (assume relevant CPI increase for the tax year this PIP ends in is 3%)

$$£480,000 * 1.03 = £494,400$$

Closing Value

Step 1 – Find annual rate of pension entitlement at end of the PIP for AA purposes

“PE” under the valuation assumptions is zero initially because the member has started to draw all benefits and no benefits are uncrystallised in the arrangement. But during the PIP the member started “scheme pension” so had a BCE2, for which the starting pension rate was as follows:

$$\begin{aligned} [31/60 * £64,000 * 0.96(\text{early retirement reduction})] &= 31,744.00 \\ \text{plus } [31/80 * 5,100] &= £1,976.25 \end{aligned} \quad = £33,720.25$$

There has been no surrender (choosing an early retirement pension instead of a deferred pension on leaving is not a “surrender”) so even though the pension reduced because of retiring early this does not trigger any adjustment under 236(8).

Step 2 – Multiply result by 16

$$£33,720.25 * 16 = £539,524.00$$

Step 3 – Add on any separate lump sum

None so running total is £539,524.00

If there are no other adjustments to the closing value, the PIA is £45,124 (=£539,524.00 - £494,400).

The part of this arising from the increased start level of pension due to the temporary pension is £31,620.00. Note that the bridge pension causing this extra PIA was a pension of £1,976.25 payable for just one year.

As the option to retire before NPA (and the automatic bridge that comes with it) only happens at retirement, only the PIP in which early retirement is selected has any allowance for the temporary pension option.

In this example 3, bearing in mind the disproportionate impact on PIA and hence on tax, it may be that the member does not want the bridge pension and asks the Trustees to exchange it for a lower whole-life pension – and the Trustees offer, instead of paying a bridge for just one year of £1,976.25, to pay whole-life pension of £90.00 pa.

For AA purposes, in the PIP “the annual rate of the pension .. to which the individual would be entitled under the arrangement has been reduced by any surrender made in return for any other entitlement, any allocation made, or any similar action taken, pursuant to an option available to the individual under the arrangement”, so the amount of the reduction (to the extent that it is not reflected in an amount added under subsection (8A)) is to be added to PE or LSE. Here that would mean adding back £1976.25 – £90, and the PIA outcome would be unchanged ie PIA of £31,620 arising solely because of the bridge pension.

But if the conversion were made unilaterally by the Trustees, and not “pursuant to an option available to the member”, then (8) would not be triggered and the closing value calculation above would be:

Step 1 – Find annual rate of pension entitlement at end of the PIP for AA purposes

“PE” under the valuation assumptions is zero initially because the member has started to draw all benefits and no benefits are uncrystallised in the arrangement. But during the PIP the member started “scheme pension” so had a BCE2, for which the starting pension rate was as follows:

$$\begin{aligned}
 & [31/60 * £64,000 * 0.96(\text{early retirement reduction}) = 31,744.00] \\
 & \text{plus } [31/80 * 5,100 = £1,976.25] \\
 & \text{Minus } £1,976.25 \text{ plus } £90 = £31,834.00
 \end{aligned}$$

Step 2 – Multiply result by 16

$$£31,834 * 16 = £509,344$$

Step 3 – Add on any separate lump sum

None so running total is £509,344

If there are no other adjustments to the closing value, the PIA is £14,944.00 (= £509,344- £494,400).

The Trustees consider (subject to the provision for change in the scheme's rules) changing the scheme rules before the PIP in which member retires early, which rule change is made with the members' consents (or individual request). The rule change has no impact to calculations for the PIP (because it does not change the NPA rule); but if and when in future PIPs the member chooses to draw pension before NPA with age reduction, the BCE2 reflects the actual pension underlying the BCE2 (ie not the bridge but the replacement whole-life pension instead of bridge).



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20 July 2011

REF 2081137

TO: Peter Seedhouse
HM Revenue & Customs
Pensions Policy Team
By email

Sent by email to:

pensions.policy@hmrc.gsi.gov.uk

Copy to Judy Goodhall
(relevant for RPSM)

Please reply to:

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Dear Peter

Annual Allowance (AA): “deferred pensioner carve” out and options at retirement

I am writing to check the position for AA Pension Input Amount calculations for a common issue that arises for defined benefit arrangements: options at retirement for deferred pensioners

In the correspondence with HMRC concluding with your letter of 16 March 2011, including http://www.aca.org.uk/files/B._Annual_allowance_Deferred_pensioners-16_March_2011-20110317103355.pdf the JWG committee wrote about the “deferred pensioner” carve out for DB pension arrangements and highlighted that it is very important for members and for scheme management because:

- § no AA is used up by the deferred benefit involved (often accrued many years ago) so the benefits do not potentially - and unexpectedly - push an individual into AA excess either on the benefits or on savings being made elsewhere; and
- § there is no scheme administration – no AA calculation and no AA information to be provided – in relation to such members: this is very important given the potential number of individuals involved for each scheme.

You have helpfully clarified in the letter referred to above that *‘It is the policy intention that where a deferred member becomes entitled to their benefits during the pension input period (PIP), and is a pensioner member for the rest of the PIP, then the ‘carve out’ will apply throughout that PIP.* We would hope you can be equally reassuring on a connected point that could be very material.

A member may have an entitlement to pension under scheme rules on reaching Normal Retirement Age (NRA), but schemes offer a variety of options at retirement to reshape benefits. Often the options offered to deferred pensioners will be similar to those offered to in-service members; and almost without exception the option offered to deferred pensioners will be designed to be “fair value” but no more.

A key example is the option to give up some whole-life pension for bridge pension ie instead to receive a (higher) temporary pension typically stopping at age 60 or 65 (or SPA); but there are all sorts of other options which result in a higher starting pension but no increase in “actuarial value”.

HMRC clarified that in the normal course of events, such an option would result in the member having more PIA (ie using up more AA) – because the starting pension underlying the BCE2 is higher than it would otherwise be, and because under (8) “surrender for other benefit” is unwound only where it causes the start pension to drop. And HMT have confirmed that there is no intention to change legislation for this, in their policy statement accompanying the Finance Bill of 29 March 2011.

We are writing to make sure that the so-called deferred pensioner carve-out can accommodate this sort of option when it is offered to a deferred pensioner. If it does not, then individual may unwittingly find that a large amount of PIA is used up by a benefit that accrued many years ago and solely by a “no gain” option. The confusion, additional information exchange and errors that could arise would be unthinkable. The point would certainly need highlighting in the RPSM.

So why should the carve out apply?

It is clear that the sort of option under discussion does not change the individual's status as being a “deferred pensioner”. So the issue at stake is whether the increase in pension counts at all as an “increase in the relevant rights of the individual” during the PIP – which we would argue it does not. If it does count as an increase of the rights, can it be counted as not more than the “relevant percentage”?

Ideally, we hope that there can be a general reading that if the pension would qualify for the carve-out without the option being exercised, then it also so qualifies if the option is exercised.

If this reading is not possible, then we would hope for at least a (much) more limited solution: that the carve-out could be said to apply to the “increase” in starting pension arising from the option so long as the option was already a provision of the scheme rules in October 2010 etc as an option for the member but on terms set by the Trustees (ie not involving a discretion of the Trustees, simply involving an obligation to set terms).

An example of what would arise if the carve-out does not apply may be worthwhile to emphasis the point:

Mr X is currently an active member of a scheme in his last year of service, and accrues PIA in the PIP of £4,000 (say because his accrued pension at opening and closing of the PIP were £24,000 and £25,000 respectively and taking account of the CPI allowance in the normal calculation). His scheme does not send him a pensions savings statement and he does not request one as it does not occur to him that he may have AA charge.

But he also has a deferred pension, accrued for service up to 1990, which he is claiming in the same tax year, of £10,000 pa; and the deferred pension has revalued in deferment according to rules in force at leaving and therefore benefits from the carve out. Under an option in the scheme, he converts £2,000 pa of this deferred pension into a five year bridge pension of £7,000 pa. If this counts, in your reading, as breaching the carve-out, then it causes PIA of at least £80,000 (16 x (15,000-10,000)). The same could apply to other options on offer.

At best it may be that at the end of the day no AA charge arises because of carry-forward of unused AA from the previous 3 tax years - but it takes a lot of correspondence and calculation to show this. At worst case, AA charge does arise.

So the workings of the AA as they apply for benefits accrued many years ago prevent the individual taking up a reasonable option; or require the scheme involved to make changes to its process when accrual ceased many years ago.

I look forward to your guidance on this matter, as it could be important in the way schemes offer options and whether members take them up.

Yours sincerely

Karen Goldschmidt FIA

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