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Dear Miss Goldschmidt

Annual Allowance charge: Issues relating to defined benefit arrangements

This letter has been sent to you as Chair of the ACA Pensions Taxation Committee in connection with Committee's role as secretariat of the Joint Working Group (comprising ABI, ACA, APL, NAPF and SPC).

Attached to this letter are examples showing how pension input amounts are calculated in certain circumstances. We are aware that pension scheme administrators, employers and individuals have an interest in these examples so we have no objection to the Joint Working Group releasing these examples to your members and elsewhere.

HMRC intend to incorporate these examples into the Registered Pension Schemes Manual (RPSM) at the next available opportunity. In the meantime the content of each example can be read as if it were already incorporated into the RPSM.

The examples cover two aspects. The first is where a member has a defined benefits arrangement with 'split normal pension ages'. The other is the more general aspect of a member with a defined benefit arrangement who does not draw benefits on reaching normal pension age and continues in service.

Please note the examples contain terms which are explained in the Glossary attached to the RPSM, in particular the terms 'pension input amount', 'pension input period', 'valuation assumptions', 'CPI' and 'BCE'. Also, some of the examples have cross references to current RPSM pages.

Yours sincerely

Trevor Smeath

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Example 1

Defined benefits: Circumstances where the member's benefits under a scheme have different 'normal pension ages': Before reaching first split normal pension age

The following example is based on a 'Barber' case but the same principles would apply in relation to other cases where some of a member's benefits under a registered pension scheme have one 'normal pension age' and some have another.

The following data is used for the purpose of this example.

The pension formula for the pension scheme on retiring at 'normal pension age' is:

1/60 x pensionable service x final pensionable salary

'Normal pension age' under the scheme is effectively 'split' according to service as follows:

6 April 1987 – 5 April 1991 (normal pension age 60)

6 April 1991 onwards (normal pension age 65)

meaning that if the member retires from service at any time before age 65, the 6 April 1991 onward part will be reduced by an age related factor; and if the member retires from service before age 60 the 1987-1991 part will be reduced by an age related factor (i.e. below these respective ages the member does not have right to an unreduced pension, and these are respectively the earliest age for which this is true). So these are the relevant assumed ages for the purposes of the valuation assumptions used for pension input amount calculations. This is the meaning of normal pension age throughout this example.

On retiring from active service between age 60 and 65, the 1987-1991 part may be salary-linked, or it may be uplifted by late retirement factors past age 60, or it might be set by which ever of these two would give the better higher pension. As shown in the example below, these differing approaches do not affect the pension input amount prior to the member reaching age 60.

Pension input period is: 6 April to 5 April

CPI is: 3.1% (The particular pension input period being considered in this example is that ending 5 April 2012 so the CPI figure for September 2010 is used.)

Member's pensionable service:

Joined on 6 April 1987 and has 4 years of service at 'normal pension age 60'

At 5 April 2011, the end of the previous pension input period, age = 54 (i.e. below age 60) and the member had 20 years service with 'normal pension age 65'.

At end of current pension input period, age = 55 (i.e. also below age 60)

Final pensionable salary:

5 April 2011 = £160,000

5 April 2012 = £168,000

Firstly suppose all benefits for the member are held under a single arrangement

No BCEs occurred under the arrangement in the pension input period

Pension input period - 6 April 2011 to 5 April 2012

Opening value (age 54)

[(4/60 x £160,000) + (20/60 x £160,000) = £64,000] x 16 x 1.031 = £1,055,744

Closing value (age 55)

[(4/60 x £168,000) + (21/60 x £168,000) = £70,000] x 16 = £1,120,000

Pension input amount is £1,120,000 - £1,055,744 = £64,256

Conclusion

Each part of the benefit with a different 'normal pension age' should be calculated by reference to that normal pension age for annual allowance purposes (i.e. just because this is all in one arrangement, this does not mean one must determine a single normal pension age to be applied for the whole arrangement for purpose of the pension input amount calculation.)

The calculations are done for each part of the benefit and then aggregated to find the pension input amount for the arrangement as a whole. (Note that negative values at intermediate stages are not set to zero. It is only if the aggregate value for the whole arrangement is negative that the overall pension input amount is then set to zero.)

The outcome is the same as if no 'split' normal pension age were in play.

Also, the outcome in many cases, including this particular case, would be the same if the 'normal pension age 60' part and the 'normal pension age 65' part of the benefit were in separate arrangements. (However, note that this will not always be true. For example, negative pension input amount values may arise where there are separate arrangements (and each have to be set to zero), that would be treated differently (see above) if the arrangement were a single one. This is not a special feature of split normal pension age cases, but is here for completeness.)

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Example 2

Defined benefits: Circumstances where the member's benefits under a scheme have different 'normal pension ages': Reaching first split normal pension age

The following example is based on a 'Barber' case but the same principles would apply in relation to other cases where some of a member's benefits under a registered pension scheme have one 'normal pension age' and some have another.

Scenarios 1, 2 and 3 show different ways in which each part of the benefit might be required to be treated under a scheme's rules, and how this, in turn, has a bearing on the calculation of the pension input amount; and how the outcome could depend on whether benefits are all within one arrangement or not. In particular this latter point reflects the fact that the 'deferred member carve out' is applied on an arrangement by arrangement basis (i.e. looks at each arrangement as though other arrangements do not exist for the member in the scheme).

The following data is used for the purpose of this example.

The pension formula for the pension scheme on retiring at 'normal pension age' is:

1/60 x pensionable service x final pensionable salary

This formula for all service to age 60 (and ongoing if relevant)

'Normal pension age' for benefits under the scheme is effectively 'split' according to service as follows:

Benefit - for 6 April 1988 – 5 April 1990 ('normal pension age 65')

- for 6 April 1990 – 5 April 1995 ('normal pension age 60')

- for 6 April 1995 onwards ('normal pension age 65')

meaning that if the member retires from service at any time before age 65 the 1988-1990 and 6 April 1995 onward parts will be reduced by an age related factor; and if the member retires from service before age 60 the 1990-1995 part will be reduced by an age related factor.

The following shows how the pension input amount might differ depending on whether, by continuing in active service between age 60 and 65, the 1990-1995 part is salary-linked, or is uplifted by a late retirement factor or is set by which ever of these two would give the better higher pension.

Pension input period is 6 April – 5 April

CPI is 3.1% (The particular pension input period being considered in this example is that ending 5 April 2012 so the CPI figure for September 2010 is used.)

Age at the end of the previous pension input period (5 April 2011) = 60

Final pensionable salary (where relevant):

5 April 2011 = £60,000

5 April 2012 = £70,000

No partial retirement happens (i.e. no BCEs occur) during the period.

Scenario 1

Benefit under the scheme rules as follows

- the pension for 'normal pension age 65' part is calculated as continued accrual in line with salary and service and no other adjustment

- the pension for 'normal pension age 60' part is a continued link with salary

(A) - position if all benefits held under a single arrangement

Opening value (age 60):

[(2/60 x £60,000) + (5/60 x £60,000) + (16/60 x £60,000) = £23,000] x 16 x 1.031 = £379,408

Closing value (age 61)

[(2/60 x £70,000) + (5/60 x £70,000) + (17/60 x £70,000) = £28,000] x 16 = £448,000

Pension input amount is £448,000 - £379,408 = £68,592

(B) - position if the 'normal pension age 60' part of the benefit held in a separate arrangement from the part with 'normal pension age 65'

For the arrangement with 'normal pension age 60':

Opening value (age 60):

[(5/60 x £60,000) = 5,000] x 16 x 1.031 = £82,480

Closing value (age 61)

[(5/60 x £70,000) = £5,833] x 16 = £93,328

Pension input amount is £93,328 - £82,480 = £10,848

For the arrangement with 'normal pension age 65':

Opening value (age 60):

[(2/60 x £60,000) + (16/60 x £60,000) = £18,000] x 16 x 1.031 = £296,928

Closing value (age 61)

[(2/60 x £70,000) + (17/60 x £70,000) = £22,167] x 16 = £354,672

Pension Input Amount £354,672 - £296,928 = £57,744

Total Pension Input Amount: £10,848 + £57,744 = £68,592

The outcome in this particular case is the same as if all the benefit had been in one arrangement. However, the calculation does have to be stepped through. This is because, in some cases like this, the result could be different. For example, negative pension input amount values may arise where there are separate arrangements (and have to be set to zero), that would not arise if the arrangement were a single one and in such cases (A) and (B) above would give different results – for example if the closing pensionable salary had been £61,200 (or vice versa). (This is not a special feature of split normal pension age cases, but is here for completeness.)

***Scenario 2**:*

Benefit under the scheme rules as follows

- the pension for 'normal pension age 65' part is calculated as continued accrual in line with salary and service and no other adjustment

- the pension for 'normal pension age 60' part: apply a late retirement factor of 10% to the pension that would have been payable if drawn at age 60

(A) - Position if all the benefits held under a single arrangement

Opening value (age 60):

[(2/60 x £60,000) + (5/60 x £60,000) + (16/60 x £60,000) = £23,000] x 16 x 1.031 = £379,408

Closing value (age 61)

[(2/60 x £70,000) + (5/60 x £60,000 x 1.10) + (17/60 x £70,000) = £27,667] x 16 = £442,672

Pension input amount is £442,672 - £379,408 = £63,264

The above applies without regards to the background of the late retirement factors (for example, in particular whether or not they are in accordance with a provision in the scheme rules on 14 October 2010).

(B) - position if the 'normal pension age 60' part of the benefit held in a separate arrangement from the part with 'normal pension age 65' and

> if the late retirement factor were such that the provisions of RPSM06107110 (section headed "Increases by reference to late retirement actuarial uplift factors") apply to the 'normal pension age 60' arrangement then the deferred member carve-out would apply to the 'normal pension age 60' arrangement. (RPSM06107250 has more details about how the deferred member carve-out applies in relation to late retirement factors and RPSM06107110 for active members.)

The calculation in (A) above would change to the following:

For the arrangement with 'normal pension age 60':

The pension input amount is nil - because the deferred member carve-out applies

For the arrangement with 'normal pension age 65':

Opening value (age 60):

[(2/60 x £60,000) + (16/60 x £60,000) = £18,000] x 16 x 1.031 = £296,928

Closing value (age 61)

[(2/60 x £70,000) + (17/60 x £70,000) = £22,167] x 16 = £354,672

Pension Input Amount £354,672 - £296,928 = £57,744

Total pension input amount: £57,744

(C) - position if the 'normal pension age 60' part of the benefit were held in a separate arrangement from the part with 'normal pension age 65' and

> if the late retirement factor were such that the provisions of RPSM06107110 (section headed "Increases by reference to late retirement actuarial uplift factors") do not apply to the 'normal pension age 60' arrangement**,** so that the deferred member carve-out would not apply to the 'normal pension age 60' arrangement.

For the arrangement with 'normal pension age' 60:

Opening value (age 60):

[(5/60 x £60,000) = £5,000] x 16 x 1.031 = £82,480

Closing value (age 61)

[5/60 x £60,000 x 1.10 = £5,500] x 16 = £88,000

Pension Input Amount £88,000 - £82,480 = £5,520

For the arrangement with 'normal pension age 65':

Opening value (age 60):

[(2/60 x £60,000) + (16/60 x £60,000) = £18,000] x 16 x 1.031 = £296,928

Closing value (age 61)

[(2/60 x £70,000) + (17/60 x £70,000) = £22,167] x 16 = £354,672

Pension Input Amount £354,672 - £296,928 = £57,744

Total pension input amount is £5,520 + £57,744 = £63,264

The outcome in this particular case is the same as for (A) in Scenario 2. However, the calculation does have to be stepped through. This is because, in some cases like this, the result could be different. For example, negative pension input amount values may arise where there are separate arrangements (and have to be set to zero), that would not arise if the arrangement were a single one and in such cases (A) and (C) would give different results. (This is not a special feature of split normal pension age cases, but is here for completeness.)

Scenario 3

Benefit under the scheme rules as follows

- the pension for 'normal pension age 65' part is calculated as continued accrual in line with salary and service and no other adjustment

- the pension for 'normal pension age 60' part: apply greater of continued link with salary or late retirement factor

For the 'normal pension age 60' pension part of the benefit:

If the amount of pension that would have been payable if drawn from age 61 would have reflected continued link with salary (because that resulted in the greater figure), then the outcome would be in line with Scenario 1 (one arrangement or separated arrangement as appropriate).

If the amount of pension that would have been payable if drawn at age 61 would have reflected the late retirement factor (because that resulted in the greater figure), then the outcome would be:

- in line with (A) in Scenario 2 if all the benefits were under one arrangement

- in line with (B) in Scenario 2 if the part of the pension with 'normal pension age 60' were in a separate arrangement from the part with 'normal pension age 65' and if the late retirement factors were such that the provisions of RPSM06107110 (section headed "Increases by reference to late retirement actuarial uplift factors") apply to the 'normal pension age' 60 arrangement

- in line with (C) in Scenario 2 if the late retirement factors were such that the provisions of RPSM06107110 (section headed "Increases by reference to late retirement actuarial uplift factors") do not apply to the 'normal pension age 60' arrangement.

Conclusion

For pension input periods before reaching age 60, the pension input amount is calculated on the basis that each part of the benefit with a different normal pension age is calculated by reference to that normal pension age (as explained in RPSM06107105). It does not matter whether each part of the benefits relating to the 'normal pension age 60' and 'normal pension age 65' are all in the same arrangements or different ones (unless there

are differences arising from negative values, as explained in Example 1. This means that the fact of 'split normal pension age' does not impact on the calculations.

Once the member exceeds age 60, then how the pension input amount is calculated depends on the way the benefits are set to grow under the scheme rules, and sometimes also the underlying nature of the benefits that would actually have emerged given the facts at the relevant opening and closing dates of the pension input period. But it also depends on whether the benefit is in one arrangement or split between arrangements.

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Example 3

Defined benefits: Active member does not draw benefits on reaching normal pension age and continues in service

Commonly, members who continue in pensionable service after the normal pension age in a defined benefits arrangement are offered (a) continued accrual or (b) to have their benefits at normal pension age increased with late retirement factors or (c) the better of the two scales - and either could be better. RPSM06107110 has more details on how this interacts with the 'deferred member carve-out'.

The following shows how the pension input amount position might differ depending on whether the benefit that grows after normal pension age is salary-linked or is uplifted by age related factors or is set as the better of the two.

Data used for the purpose of this example

Emily has normal pension age of 60 (i.e. if the member retires from service at any time before age 60 the pension will be reduced by an age related factor).

The pension formula for her in the scheme on retiring at normal pension age is

1/60 x pensionable service x final pensionable salary

In all the following,

- Emily remains in pensionable service after age 60 and throughout the pension input period in question;

- all of Emily's benefits in the pension scheme accrue in a single arrangement; and

- no other benefits arise in the arrangement and the member does not draw benefit (i.e. no BCEs arise) during the pension input periods in question.

Pension input period is 6 April – 5 April

- this example uses the pension input periods ending 5 April 2014 onward

CPI is 3%

- the CPI figure used in this example is for illustrative purposes only and is used for each of the pension input periods for 2013/14 to 2015/16.

Pensionable service is:

- At 5 April 2013 her age is 60, service 18 years and final pensionable salary is £80,000

- At 5 April 2014 her pensionable salary is £83,000

- At 5 April 2015 her pensionable salary is £90,000

- At 5 April 2016 her pensionable salary is £92,000

Scenario 1

at retirement from service after age 60, the pension is calculated based on final pensionable salary at, and service to, actual date of retirement (a similar formula to the pension on retirement at age 60)

This example would follow the same lines as the calculation if Emily had not yet reached age 60, starting off as follows:

Pension Input Amount for the pension input period ending 5 April 2014 would be calculated as follows

Opening value = [18/60 x £80,000 = £24,000] x 16 x 1.03 = £395,520

Closing value = [19/60 x £83,000 = £26,283] x 16 = £420,528

Pension input amount for the pension input period = £25,008 (£420,528 - £395,520)

And similarly for the next pension input periods when Emily is accruing benefits in this way

Summary table for Scenario 1

Age	Pension on accrual basis	Pension input period	Pension input amount for the pension input period
60	£24,000		
61	£26,283	1	£25,008 as above
62	£30,000	2	£30,000 x 16 - £26,283 x 16 x 1.03 = £46,856.16
63	£32,200	3	£32,200 x 16 – £30,000 x 16 x 1.03 = £20,800

Scenario 2

at retirement from service after age 60 the scheme provides the pension accrued at age 60, uplifted by a late retirement factor in circumstances in which the provisions of RPSM06107110 (section headed "Increases by reference to late retirement actuarial uplift factors") apply

The deferred member carve-out applies for all the pension input periods (RPSM06107110 has more details). So Emily's pension input amount from this scheme is nil during the pension input periods that the uplift applies.

Scenario 3

at retirement from service after age 60, the pension is calculated as better of:

1. the pension accrued at age 60, uplifted by a late retirement factor, in circumstances in which the provisions of RPSM06107110 (section headed "Increases by reference to late retirement actuarial uplift factors") apply,

and

2. the pension calculated based on final pensionable salary at, and service to, actual date of retirement

The examples below show the calculation of the pension input amount for the three pension input periods from when Emily is age 60 to age 63. Throughout the period under consideration, she remains an active member of the scheme.

First pension input period

Pension Input Amount:

At present, the scheme's late retirement factor is 10% per annum simple, meaning that, for example, benefits delayed and taken at age 65 rather than age 60 receive a 50% uplift where the late retirement factor is the 'better of' scale. These factors are set in accordance with the provisions in the scheme's rules as at 14 October 2010 (which set out the manner of setting them, not a hardcoded table), and the uplift factors are used for a deferred pensioner delaying drawing pension past age 60.

Calculation of the opening value:

At the start of the pension input period, the pension to which Emily would be entitled if she drew it

18 / 60 x £80,000 = £24,000

The opening value is therefore:

£24,000 x 16 x 1.03 = £395,520

Calculation of the closing value

At the end of the pension input period, the pension Emily would, if she started to draw pension, be entitled to, being the greater of:

1. – late retirement factor - £24,000 x 1.1 = £26,400; and

2. – based on continuing service and salary – 19/60 x £83,000 = £26,283

so Emily's pension entitlement would have been £26,400

The closing value at the end of the pension input period is:

£26,400 x 16 = £422,400

Calculation of the Pension Input Amount:

The pension input amount for the scheme is normally calculated by comparing the opening and closing values.

However, in this case, the pension at the end of the pension input period was the one calculated using the late retirement factor in respect of the delay since age 60. As there were no additional benefits accrued during this pension input period and, as set out in RPSM06107110 (section headed "Increases by reference to late retirement actuarial uplift factors"), the deferred member carve-out applies, so Emily's pension input amount from this scheme is nil.

Second pension input period:

Pension input amount

Calculation of the opening value:

Using the methodology set out above, at the start of the pension input period, Emily's accrued benefit in the scheme, and the value of those benefits, are £26,400 per annum and £435,072 (£422,400 x 1.03) respectively.

Calculation of the closing value:

At the end of the pension input period, Emily's final pensionable salary has increased to £90,000, and she now has 20 years pensionable service

The benefit she has accrued at the end of the pension input period is calculated using the methodology set out above, and equals £30,000 per annum, this being the greater of:

1. £24,000 x 1.2 = £28,800; and

2. 20/60 x £90,000 = £30,000

The closing value of the benefits, at the end of the pension input period is therefore:

£30,000 x 16 = £480,000

Calculation of the Pension Input Amount:

As the pension at the end of the pension input period is on the basis of additional benefit accrual (based on continuing service and salary) since age 60, the deferred member carve-out does not apply (unlike the position in the previous pension input period). The pension input amount for the scheme is therefore calculated as normal, namely by comparing the opening and closing values, the pension input amount is therefore:

£480,000 - £435,072 (£26,400 x 16 x 1.03) = £44,928

Third pension input period:

Suppose during this pension input period the scheme's late retirement factors are reviewed, and they are increased to 12% per annum simple. This is not a change from the

methodology set out in the scheme's rules as at 14 October 2010, but rather an updating of the factors based on a consistent methodology.

Calculation of the opening value:

Using the methodology set out above, at the start of the pension input period, Emily's accrued benefit in the scheme, and the value of those benefits are £30,000 per annum and £494,400 (£480,000 x 1.03) respectively.

Calculation of the closing value:

At the end of the pension input period, Emily's final pensionable salary has increased to £92,000, and she now has 21 years pensionable service.

The benefit she has accrued at the end of the pension input period is calculated using the methodology set out above, and equals £32,640 per annum, this being the greater of:

1. £24,000 x 1.36 = £32,640; and

2. 21/60 x £92,000 = £32,200

The value of the accrued benefits at the end of the pension input period is therefore:

£32,640 x 16 = £522,240

Calculation of the Pension Input Amount:

As in the first pension input period, the pension that would be due to Emily if she were to draw pension at the end of the pension input period is the one calculated using the late retirement factor, not the accrual based on continuing service and salary linking. Because the late retirement factor was still in accordance with the 14 October 2010 rules, this means the deferred member carve-out again applies so Emily is able to count her pension input amount for the third pension input period as nil. Emily's ability to use the deferred member carve-out is not affected by the change to the late retirement factors during the pension input period, as this was merely a change to the value of the factors, and not to the underlying methodology, which remains as set out in the scheme's rules as at 14 October 2010.

Summary table for scenario 3

Age	Pension on uplift basis	Pension on accrual basis	Pension input period	Pension input amount for the pension input period
60	£24,000	-		-
61	£26,400	£26,283	1	Nil as per guidance
62	£28,800	£30,000	2	£44,928
63	£32,640	£32,200	3	Nil as per guidance

Scenario 4:

is as for Scenario 2 (i.e. only late retirement factors are used, not salary linking) but the late retirement factors used are <u>not</u> ones to which the provisions of RPSM06107110 (section headed "Increases by reference to late retirement actuarial uplift factors") apply

The deferred member carve-out would not apply.

The late retirement factors used feed into the calculation of the closing value for each pension input period.

Suppose the data that applied were as for Scenario 3 (ignoring the calculations there relating to continued accrual based on final pensionable salary and continued service), this results in the following calculations (which are the same as for Scenario 3 but ignoring the

items relating to calculating pension on accrual based on continuing service and salary basis).

Summary table for Scenario 4

Age	Pension on uplift basis	Pension input period	Pension input amount for the pension input period
60	£24,000		
61	£26,400	1	£26,400 x 16 – £24,000 x 16 x 1.03 = £26,880
62	£28,800	2	£28,800 x 16 – £26,400 x 16 x 1.03 = £25,728
63	£32,640	3	£32,640 x 16 - £28,800 x 16 x 1.03 = £47,616

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