

## **Compliance with HMRC Tax Regimes from April 2006**

**Letter of 1 February 2006**

This letter raises the following ***benefit issues*** for consideration:

1. Taxation of members' benefits above the life time allowance
2. Protections
3. Removal of the cap on pensionable pay from 6 April
4. Scope for buying added years
5. Extinguishing of pension rights relating to refunds
6. Limits on employee contributions for scheme members with more than one "arrangement"
7. Debit on divorce
8. Pension credit members
9. Normal retirement age for Councillors



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1 February 2006

Dear Colleague

**LGPS: Compliance with HMRC Tax Regime from April 2006**

You will be aware that ODPM is carrying out a consultation exercise, between 5 December 2005 and 28 February 2006 on a set of draft regulations to amend the LGPS. During this period, ODPM officials and other LGPS interests have been considering in more detail the amendments relating to tax simplification measures which need to be enacted in accordance with the Finance Act 2004 (Parts II and III of the draft SI). During these considerations, a number of issues have emerged that will require specific provisions in the final amending regulations. .

To assist LGPS institutions and members in focusing their responses I am therefore now writing to expand these issues in order that the views of LGPS interests can be considered alongside the responses to the statutory consultation ending 28 February. We would be grateful, where possible, if you could respond on these matters as soon as possible, preferably by 10 February so that we are able to more easily proceed. However, responses will be accepted until the close of the consultation exercise on 28 February.

It may be relevant for consultees to be aware that ODPM is also in communication with LGPS administering authorities and employers with regards a number of technical and administrative issues also associated with the tax simplification changes. You are invited to contact ODPM for more information should you wish to.

Yours faithfully

Brian Town

## Matters relating to compliance with HMRC Tax Regime from April 2006 requiring further consideration by LGPS interests:

### ***Benefit Issues***

#### **1. Taxation of members' benefits above the lifetime allowance (LTA)**

Where scheme members have benefits whose capital value (when aggregated with other crystallised pension benefits) exceeds the standard LTA (£1.5million in 2006/07), or a scheme member's Primary or Enhanced LTA, a recovery tax charge will apply. This charge will be calculated with regard to how the excess is taken by the scheme member – as a lump sum or as a pension. The scheme could limit the options available to scheme members in this case or allow some degree of choice. We could follow one of the following approaches:

**Option A:** The scheme could require members to take benefits in excess of the LTA as cash (i.e. as a lump sum calculated using a 12:1 conversion factor for any excess benefits that relate to pension) after deduction of the 55% tax recovery charge required by the Finance Act 2004. This lump sum is payable over and above the maximum LTA permissible value (25% of the LTA in 2006/7 = £375,000).

**Option B:** The scheme could require members to take any excess over LTA according to the existing scheme provisions of pension rights accruing at a rate of 1/80<sup>th</sup> per annum and a 3/80<sup>ths</sup> tax free lump sum on retirement. Tax would be recovered from the lump sum above the maximum permissible value at 55% and the tax payable by the Fund on the excess pension would be at the rate of 25% as required by the Finance Act 2004. The reduction in the pension necessary to recover the tax could be carried out over a fixed period or over the average length of pension in payment. Advice will be forthcoming from the Government Actuaries Department (GAD) on this matter.

**Option C:** The scheme requires members to take the excess over LTA as pension, based on a reverse commutation factor of 1:12, with a tax recovery charge of 25% as required by the Finance Act 2004 (calculated as mentioned in B).

**Option D:** Allow scheme members the flexibility to choose option A, B, C or anything in between, with taxation applying to benefits above LTA in accordance with the Finance Act 2004.

**Question 1:** The simplest solution would be to proceed according to Option A; however Option D would provide more flexibility for scheme members. Which of these preferred options would consultees support and for what reasons? Or indeed, would they favour Option B or C or some other alternative arrangement?

## 2. Protections

Under the new HMRC regime, scheme members who have already accrued benefits in excess of the LTA may choose to elect for primary and/or enhanced protection. Scheme members who are certain or believe they may accrue benefits in excess of the LTA in the future may choose to elect for enhanced protection only. HMRC intend these protections to go some way towards protecting benefits accrued to 5 April 2006 that might be affected by the new tax regime. The choice must be made by 5 April 2009 in both cases.

Enhanced protection permits growth in benefits beyond 5 April 2006 up to certain limits (generally speaking, the greater of 5%, RPI or increases in pensionable pay). If these limits are exceeded, enhanced protection is lost. Scheme members would then be subject to the same provisions for taxation as adopted by the Scheme for excess over the standard LTA or Primary LTA protection for those who have also opted for that (as per the outcome of Section 1 above). It will be necessary for us to consider how the LGPS should be amended to treat members who elect for enhanced LTA protection. We could follow one of the following approaches:

**Option A:** Scheme members who have applied for enhanced protection could be allowed to continue to accrue membership in the Scheme. This will inevitably mean that their benefits are more likely to exceed the enhanced allowance more quickly than if they did not continue to accrue membership after 5 April 2006. None-the-less, it is acknowledged that scheme members could of course end their enhanced protection, should they wish to, by taking certain steps that would produce this result (for example, by contributing to an AVC or allowing the value of their benefits to exceed the limits mentioned above).

Where a Scheme member's standard  $1/80^{\text{th}}$  pension and  $3/80^{\text{th}}$  lump sum benefits exceed their enhanced allowance at retirement, we could allow the member the option, before they retire, to elect for their LGPS benefits to be limited (reduced) to the value that would keep them within the enhanced protection limits mentioned above. This would mean that they would continue to benefit from enhanced protection and thereby avoid tax on any excess above the standard LTA or Primary LTA protection if they have opted for it. If they did not elect to limit their benefits, they would automatically become subject to taxation on the excess over, the standard LTA or Primary LTA protection for those who have opted for it, which may be more financially attractive for some Scheme members.

In this option, if a member did not want to continue in the Scheme, they would have the option to opt out but, in that scenario, their LGPS benefits would just increase in line with inflation and they would lose ill-health and death cover. No special provisions would be incorporated for them.

**Option B:** The Scheme could preclude members who have enhanced protection from accruing further membership in the LGPS beyond 5 April 2006. Benefits accrued to that date would be treated as a standard deferred benefit, increasing in line with RPI. This option would mean that members would have to opt for enhanced protection by 5 April 2006 and not 5 April 2009 unless the Scheme is able to permit a refund of

pension contributions paid beyond 5 April 2006 in respect of those who opt for enhanced protection between 6 April 2006 and 5 April 2009. We are checking with HMRC whether such a refund would be permissible under the Finance Act 2004.

**Option C:** The Scheme could preclude members who have enhanced protection from accruing further membership in the LGPS beyond 5 April 2006. In addition, we would permit benefits accrued to 5 April 2006 to be calculated on the actual final pay figure on retirement (subject to the lifetime limits discussed above)

If this option is chosen, the Scheme must also decide whether to permit insurance cover for death, ill-health and redundancy to continue, even though the member is no longer accruing further periods of membership, and how the cost of increasing the benefits in line with final pay and the cost of the ill-health/death/redundancy cover is to be met (e.g. should the employee still have to pay a contribution, of less than 6%, to pay for the insurance cover and the fact that the benefits at 5 April 2006 would be increasing in line with salary rather than by RPI).

**Question 2:** ODPM would like views on whether the simpler option A is the preferred way to proceed or whether option B, C or other alternatives should be considered.

### **3. Removal of the cap on pensionable pay from 6 April**

As outlined in Brian Town's addendum letter of 10 December to consultees, the capping limit on pay for the purpose of calculating contributions and benefits (£105,600 for 2005/06) will be removed from the 2006/07 tax year onwards. The favoured approach is to provide for capped active members in the Scheme on 6 April 2006 to have their accrued membership to 5 April 2006 calculated on a pro rata basis between capped and uncapped pensionable pay.

A number of concerns have been raised since the consultation on the draft changes began on 5 December. We are able to clarify a number of issues at this time:

- Any existing transferred in service that had not been previously subject to the cap will not be pro-rated.
- The final pay of members who leave within 12 months of 6 April 2006 will be calculated on uncapped pay (including the part prior to 6 April 2006), in order to reflect the fact that the service will have been adjusted.

Since the initial consultation, a number of other issues have emerged which will need further consideration before the final regulations are made and laid. Consultees views on the following approaches are invited:

**Consideration 1:** It has been suggested that the service adjustment calculation should be based on final pay in the year to 5 April 2006, rather than the rate of pay as at 5 April 2006. This would remove any complexities where fluctuating elements of pay are received in the year prior to 6 April 2006.

**Consideration 2:** There has been some comment that members should be given the facility to pay for what is perceived as a loss of years. It is firstly important to

recognise that the tax simplification measures of the Finance Act 2004 do not decrease the value of benefits. In addition, there are already methods for benefits to be increased by employees and/or employers – augmentation, purchase of additional membership and AVCs or SCAVCs. These could be used under such circumstances, subject to their being within the limits set by the new tax regime and as long as this can be shown as reasonable within the relevant policy on the use of augmentation or SCAVCs. Further comments are invited on this issue, with due regard to the recognition of increased liability which could fall to a fund or employer.

#### **4. Scope for buying added years**

The current LGPS consultation proposes the removal of both the current contribution limit of 15% of pensionable pay and the limitation of the provision to buy added years to six and two-thirds years. To prevent additional liabilities being placed on the Scheme we could adopt some or all of the following approaches:

**Option A:** Scheme members would only be permitted to purchase one year for every year they have left before retirement, which falls within the six and two-thirds limit. Therefore a Scheme member aged 60, who is planning on retiring aged 65 would only be able to buy 5 added years.

**Option B:** In the event of early departure, ill-health or death, Scheme members would only receive pro rata what they had paid for. Protection would remain in force for those in existing added years contracts at 5 April 2006.

**Option C:** The facility to buy-out the remaining balance of an added years contract with cash following early retirement on redundancy or efficiency grounds could be removed but this right would remain in force for those with existing added years contracts at 5 April 2006.

Do consultees support any or each of these options, and if so on what basis, or do they have other suggestions?

#### **5. Extinguishing of pension rights relating to refunds**

For the purposes of the Finance Act 2004, the LGPS is treated as one single scheme within which it will be possible for scheme members to hold more than one “arrangement” (e.g. separate pension rights connected to multiple employments within one pension fund or separate employments in Sussex CC and in LB Lewisham or pension rights connected to one employment and an AVC arrangement).

It will no longer be possible, under the terms of the Finance Act 2004, to pay refunds to Scheme members relating to one arrangement where they have another arrangement in the Scheme, due to the fact that the LGPS is considered to be one single Scheme and the Finance Act requires all rights under a pension scheme to be extinguished on the payment of refund. Furthermore, refunds will not be permitted where the member has previously had a ‘benefit crystallisation event’ (i.e. a pension coming into payment). Therefore, we could adopt the following approach:

It will not be possible to pay a refund to a scheme member who has more than one arrangement in the scheme (relating to active, deferred, pensioner or pension credits) unless all arrangements have ceased and the member has less than 3 months total membership. It will also not be possible to pay refunds to individuals who have previously had overseas transfers out. Although not required for the purposes of the Finance Act, the LGPS in England and Wales and the LGPS in Scotland could be considered to be one scheme only.

Do consultees have any views on this approach since it is necessary to comply with the tax regime?

## **6. Limits on employee contributions for scheme members with more than one “arrangement”**

The draft amending regulations of the 5 December consultation suggest that the contribution limit of 15% of taxable pay be removed in accordance with the Finance Act 2004, which specifies that Scheme members will be eligible for tax relief on pension contributions of the higher of £3,600 or 100% of their UK taxable earnings in the tax year.

It will be necessary to clarify how this removal will affect Scheme members with more than one arrangement. ODPM is currently minded to introduce a further limit so LGPS contributions in each separate LGPS arrangement are limited to 100% of taxable pay in relation to that LGPS arrangement. Individuals would not be able to pay additional contributions into the LGPS relating to taxable earnings elsewhere. This would, of course, not affect member's choice to take out alternative arrangements to maximise tax relief in relation to other employments.

This approach would allow plenty of flexibility but keep administration relatively straight forward. Consultees views on this approach are sought with explanation of support or otherwise.

## **7. Debit on divorce**

Where a Scheme member gets divorced and part of their pension is allocated to their former partner, the member's pension is reduced. This is known as a pension debit. Currently the Scheme member is not permitted to make good this reduction in benefit.

Consultees are therefore asked to consider whether the regulations should be amended so active members who are pension debit members can rebuild any lost benefit entitlement.

## **8. Pension Credit**

Consultees are asked to consider whether pension credit members who have an entitlement to a pension credit lump sum retirement grant, should be entitled to increase the value of it by giving up pension, based on a commutation factor of 12:1. Should those pension credit members without entitlement to a lump sum (i.e. those whose credit was derived from a scheme member's pension that was already in payment) be entitled to commute part of their pension into lump sum?

## **9. Normal retirement age of Councillors**

The normal retirement age for Councillor members is currently 70. In order to allow the same provisions for flexible retirement that are permissible under the Finance Act 2004 (drawing a pension from an employer while still employed by that employer) to apply to Councillors, and to deal with age discrimination issues relating to the setting of a pivotal Scheme retirement age, we could adopt the following approach:

The Scheme would operate a normal retirement age for Councillors of 65 from 6 April 2006. It would be possible to join the Scheme between 65 and 75, and a decision would be needed as to whether this membership would be subject to the actuarial increase applying to benefits accrued before age 65 when that pension is taken after 65. Do consultees agree?