

HMRC Guidance on Taxation

Introduction

HMRC have provided extensive guidance on the taxation of pensions in the Registered Pension Schemes Manual, which is accessed from the HMRC website and currently contains over 1,500 individual web pages. The Technical Pages give the most detailed guidance. The intention is that this document will be primarily web based and continuously updated, and in the case of any tax query NPPS administrators are strongly recommended to consult the live version of Manual to obtain the latest tax guidance.

At present, it is not apparent from viewing a web page whether it has been amended, or even when it was last amended. It is possible to download all of the web pages and then refer to these to avoid a need for online access in respect of every query, but unless the pages are re-downloaded very regularly there is the danger that they may not be up to date. HM Revenue have made part of the Manual available in pdf format but have not guaranteed that this will be kept up to date. So under the present circumstances there seems to be no real alternative to online access.

The following notes can only be for general information about tax issues that may affect NPPS.

An explicit decision was taken not to make any reference to tax limits in the NPPS regulations. This is unnecessary as these derive from other legislation and apply regardless.

Background to the tax regime

The tax treatment of pensions changed significantly on 6 April 2006. This has been described as a "simplification" - and indeed many of the previous complexities have been removed - but the new regime has in some cases produced new difficulties.

In a number of respects the legislation is permissive. For example:

- there is no limit to the amount that an individual may pay in pension contributions; but there is a limit to the amount that may be paid free of tax
- there is no limit to the amount of pension benefits which may be paid to an individual; but payments in excess of a limit will be subject to a tax charge.

However, in other areas the legislation is restrictive. In particular, the payments that a pension scheme is authorised to make are set out by statute, and anything that falls outside the precise definition will be an "unauthorised payment".

The main legislation which controls the taxation of pensions is the Finance Act 2004, which has been amended by the Finance Act 2005 and will be amended further by the Finance Act 2006. There are then numerous regulations relating to specific aspects; draft regulations are listed on the HMRC website.

New terminology introduced by the Finance Act 2004 includes:

The **annual allowance** – the amount by which the value of an individual's pension benefits may increase in a tax year without the individual incurring a tax charge, set initially at £215,000 for 2005/06 and increasing as follows:

2007/08 - £225,000
2008/09 - £235,000
2009/10 - £245,000
2010/11 - £255,000

The **lifetime allowance** – the amount within which an individual's total pension benefits will not be subject to an additional tax charge, set initially at £1.5m for 2006/07 and increasing as follows:

2007/08 - £1.6m
2008/09 - £1.65m
2009/10 - £1.75m
2010/11 - £1.8m

A **benefit crystallisation event** – broadly, something which triggers the payment of pension benefits. As the tax legislation permits an individual to receive a pension whilst continuing to work for the same employer, a term has to be invented as “retirement” is not necessarily applicable.

Many of the tax provisions affect the individual rather than the pension scheme. The following notes focus on the impact on pensions administrators.

The annual allowance

As mentioned above, this limits the amount of increase in pension benefits in a tax year which is free of tax, which is referred to as the ‘pension input amount’. This is not the same thing as a limit on pension contributions.

For a money purchase scheme, the pension input amount is the amount of pension contributions. For a defined benefit scheme such as NPPS, the situation is more complex; the pension input amount is:

- The increase in annual pension benefits in the year, multiplied by 10, plus
- The increase in the (uncommuted) lump sum in the year.

Example

An officer has 35 years' pensionable service in NPPS and his/her salary increases by £20,000 p.a. on 6 April. At the end of that tax year, the officer's pension rights will have increased by £10,000 p.a. and his/her lump sum entitlement by £40,000 (four times the increase in the pension).

Therefore the pension input amount for the tax year is (£10,000 x10) plus £40,000 = £140,000.

It is therefore possible if an officer receives a major promotion (possibly from Commander to Deputy Assistant Commissioner in the Metropolitan Police) then the pension input amount could exceed the annual allowance. Other than the transitional arrangements for “enhanced protection” (see below) there is currently no way of protecting the officer against this.

A problem could also arise if an officer was to make a large contribution to another pension scheme at the same time as contributing to NPPS, or made an exceptionally large NPPS contribution by lump sum.

If the annual allowance is exceeded, a tax charge is payable by the individual of 40% of the amount by which the pension input amount exceeds the annual allowance. So, if an officer’s pension input amount is £240,000 in 2005/06, he/she will incur a tax charge of £10,000 (£25,000 x 40%). HMRC state that: “The annual allowance charge is payable by the member concerned (not the scheme administrator). This will be done through the individual’s personal Self Assessment return. If the individual has not been issued with a personal tax return, but they have a liability to pay the charge, they should notify their tax office of the position.”

HMRC also state that “The annual allowance charge will not apply to an individual who has registered to have enhanced protection of pension rights under schedule 36, paragraph 49, Finance Act 2004. This is providing that the conditions of the enhanced protection apply throughout the tax year being considered for an annual allowance charge.”

The annual allowance does not apply to a pension scheme in the tax year that all pension benefits are paid from that scheme – so, for example, an increase in NPPS pension rights resulting from an enhanced top-up ill-health pension would not be subject to the annual allowance test.

Contribution limits

Tax relief on member contributions is a separate issue from the lifetime allowance.

Tax relief on pension contributions is given up to the individual’s total taxable earnings in a tax year. Thus there should not usually be any difficulty in allowing tax relief on regular contributions, even if these are higher than normal because of the payment by instalments of arrears or the purchase by instalments of added years. Circumstances to look out for include:

- Any large one-off payments of contributions for whatever reason – such as a lump sum payment for the purchase of added years or to repay a refund of contributions – in case these would exceed taxable earnings
- Officers on no pay, or on very low pay, who wish to make pension contributions to NPPS. Tax relief is only available up the total taxable earnings in the year. The publicised tax relief for contributions up to £3,600 p.a. applies where an individual receives tax relief at source, and NPPS operates a ‘net pay arrangement’ which does not qualify for this.

Payment of benefits in excess of the lifetime allowance

If pension benefits are paid above the lifetime allowance, arrangements must be made to pay any tax which is due. The tax charge is 25% on any excess pension payments and 55% on any excess lump sum.

NPPS retirement benefits are valued at 20 times the annual pension plus any lump sum (so if an officer's initial pension is £40,000 p.a. and he/she receives a lump sum of £160,000, the amount which counts against the lifetime allowance is £960,000). Individuals must certify how much of their lifetime allowance remains (as a percentage) when pension benefits are paid ["crystallise" in HM Revenue terminology]; it is possible (though unlikely) that an individual officer may have used a significant proportion of the allowance already and that his/her police pension will take him/her over the lifetime limit. Therefore officers must inform the police authority of the amount of lifetime allowance that has already been used when retiring from the police service (if they are already receiving other pension benefits, or have other pensions coming into payment on the date of retirement from the police).

It is to be expected that officers who are likely to be affected by the lifetime limit will be very senior in rank, will have consulted independent financial advisors and will have taken steps where possible to avoid breaching the lifetime allowance. If the unusual circumstance does arise where a tax charge becomes due, the recommended method of payment is to reduce the annual pension. Treasury and actuarial guidance is incomplete at present and any police authority which is in this position is advised to consult the Home Office before taking action.

Benefit crystallisation events

The importance of these is that each triggers a lifetime allowance test. There are eight benefit crystallisation events (BCEs) as follows:

BCE 1 [Money purchase schemes only, so does not apply to NPPS or PPS] Where funds are designated to provide a member with an unsecured pension or where the member reaches age 75 still holding uncrystallised funds.
BCE 2 Where a member becomes entitled to a scheme pension, whether from a defined benefits arrangement or a money purchase arrangement.
BCE 3 Where a scheme pension already in payment to a member is increased beyond a permitted margin (the permitted margin basically being the greater of 5% and RPI).
BCE 4 [Money purchase schemes only] Where a member becomes entitled to a lifetime annuity under a money purchase arrangement.
BCE 5 Where a member reaches their 75th birthday under a defined benefit arrangement without having drawn all or part of their entitlement to a

<p>scheme pension and/or lump sum</p>
<p>BCE 6 Where the member becomes entitled to a relevant lump sum (a pension commencement lump sum, a serious ill health lump sum, or a lifetime allowance excess lump sum).</p>
<p>BCE 7 Where a relevant lump sum death benefit is paid on the death of the member (this applies to all NPPS lump sum death benefits). [Where benefits are paid on the death of the member in the form of a dependant's pension a lifetime allowance test is not triggered]</p>
<p>BCE 8 Where a member's benefits or rights are transferred to a qualifying recognised overseas pension scheme.</p>

It will be noted that the payment of a retirement lump sum and the payment of a retirement pension are separate benefit crystallisation events.

At each of these events, the amount of the lifetime allowance used must be calculated. For NPPS:

- A pension is valued at 20 times the annual pension payable for the first 12 months
- A lump sum is valued at the amount of the lump sum
- A transfer to a qualifying recognised overseas pension scheme is valued at the amount of the transfer payment.

This amount is then compared to the amount of the individual's lifetime allowance remaining to see whether the lifetime allowance has been exceeded.

It will not necessarily be apparent whether an overseas pension scheme meets all the criteria of a "qualifying recognised overseas pension scheme" but HMRC have stated that they will be able to confirm whether a specific scheme does qualify.

Protecting members' rights on 5 April 2006 from tax charges

The legislation allows individuals some rights to protect pension rights accrued up to 5 April 2006. To do this, the appropriate form must reach HMRC on or before 5 April 2009.

There are three forms of protection:

- Primary protection, where an individual's pension rights are valued at more than £1.5m on 5 April 2006 – which acts to permanently augment the individual's lifetime allowance
- Enhanced protection, available to anyone but of limited use as it will be lost if "relevant benefit accrual" takes place after 5 April 2006 – "relevant benefit accrual" occurs if a contribution is paid into a money purchase pension scheme and will almost certainly occur if a police officer increases pensionable service

- Pension credit – where an individual has pension credit rights (arising from pension sharing on divorce) on 5 April 2006, he/she may claim an additional lifetime allowance.

In every case, registration for protection must be made by the individual.

Further explanation of the protection mechanisms was included in the Home Office model letter to superintendents and above, which was circulated to police authorities in December 2005.

Authorised payments

These are defined in the Finance Act 2004 as the only payments that a registered pension scheme is authorised to make to, or in respect of, a member of a pension scheme; they are listed at the end of this Annex with a comment on the relevance of each to NPPS.

Unauthorised payments

An unauthorised payment is anything which is not an authorised payment. An unauthorised member payment will attract a 40% tax charge payable by the individual. If unauthorised payments by a pension scheme exceed a threshold in a given time period, a tax surcharge of a further 15% is levied, bringing the total tax charge to 55%.

It is important that every police authority guards against the possibility of making an unauthorised payment. Unauthorised payments are not permitted under the regulations but particular care should be taken in the following circumstances:

- payment of pension benefits to unmarried partners: whilst a police authority is able to exercise discretion in the period of cohabitation, it is essential in every case that the authority is satisfied as to financial dependency or interdependency at the date of the officer's death (see Pension Death Benefit Rule 1)
- assignment: pension benefits must be paid to the person entitled to receive them and assignment to anyone else is not allowed. The only exceptions are (i) allocation (under **regulation 39**) and (ii) where the beneficiary is a minor or is incapable of managing his/her affairs (see **regulation 85**).
- refunds of contributions: refunds must be made from the pension fund and only if the officer's pensionable service has ended (e.g. he/she has opted out or ceased to serve). The HMRC view is also that refunds of pension contributions cannot be made through the payroll. Therefore, when contributions have been overdeducted and the officer is still in service, it may be necessary to suspend pension contributions until the overpayment is cleared, rather than risk making an unauthorised payment.

Recycling lump sums

In the Finance Act 2006, it is planned to introduce anti-avoidance provisions to prevent lump sum pension payments being used to fund further tax-relieved pension contributions. The proposal is that this will apply:

“in relation to a pension commencement lump sum if—

- (a) because of the lump sum, the amount of the contributions paid by or on behalf of, or in respect of, the member to the pension scheme, or to any other registered pension scheme, is significantly greater than it otherwise would be, and
- (b) the member envisaged at the relevant time that that would be so.”

Any such payment would become an unauthorised payment. It could cover not only pension contributions made after the lump sum is paid, but also contributions paid before receipt of the lump sum if the member intended to use the lump sum to fund them.

To be caught by this:

- The lump sum payment must exceed 1% of the standard lifetime allowance (i.e. £15,000 for 2006/07)
- The pension contributions are “significantly greater” if the increase is more than 30% of the lump sum and the contributions are more than 30% higher than “the contributions that might have been expected”
- The arrangement must be “pre-planned”.

The problem is that “pre-planning” is likely to be very difficult to establish. If legislation is enacted as anticipated, pension schemes may start to seek declarations from members that they will not use lump sums for recycling. It is suggested that NPPS pensions administrators take no action at this stage other than noting that it might become a potential problem area.

Authorised payments and relevance to NPPS

Authorised payment	Comment re NPPS
Pension rules (FA2004 s165)	
<p><i>Pension rule 1</i> No payment of pension may be made before the day on which the member reaches normal minimum pension age, unless the ill-health condition was met immediately before the member became entitled to a pension under the pension scheme.</p>	<p>The Pension Schemes (Prescribed Schemes and Occupations) Regulations 2005 [SI 2005/3451] specify the Police Pension Scheme as an exception.</p>
<p><i>Pension rule 2</i> If the member dies before the end of the period of ten years beginning with the day on which the member became entitled to a scheme pension, an annuity or alternatively secured pension, payment of the scheme pension, annuity or alternatively secured pension may continue to be made (to any person) until the end of that period. But no other payment of the member's pension may be made after the member's death.</p>	<p>Not relevant – NPPS does not have a “pension guarantee”.</p>
<p><i>Pension rule 3</i> No payment of pension other than a scheme pension may be made in respect of a defined benefits arrangement.</p>	<p>All NPPS member pensions are scheme pensions.</p>
<p><i>Pension rule 4</i> If the member has not reached the age of 75, no payment of pension other than— (a) a scheme pension, (b) a lifetime annuity, or (c) unsecured pension, may be made in respect of a money purchase arrangement; but a scheme pension may only be paid if the member had an opportunity to select a lifetime annuity instead.</p>	<p>Not relevant (money purchase arrangements only)</p>
<p><i>Pension rule 5</i> The total amount of unsecured pension paid in each unsecured pension year in respect of a money purchase arrangement must not exceed 120% of the basis amount for the unsecured pension year.</p>	<p>Not relevant (money purchase arrangements only)</p>

Authorised payment	Comment re NPPS
<p><i>Pension rule 6</i> If the member has reached the age of 75, no payment of pension other than— (a) a scheme pension, (b) a lifetime annuity, or (c) alternatively secured pension, may be made in respect of a money purchase arrangement; but a scheme pension may only be paid if the member had an opportunity to select a lifetime annuity instead.</p>	Not relevant (money purchase arrangements only)
<p><i>Pension rule 7</i> The total amount of alternatively secured pension paid in each alternatively secured pension year in respect of a money purchase arrangement must not exceed 70% of the basis amount for the alternatively secured pension year.</p>	Not relevant (money purchase arrangements only)
Lump sum rule (FA 2004 s166)	
No lump sum may be paid other than -	
(a) a pension commencement lump sum	This covers the standard lump sum on retirement.
(b) a serious ill-health lump sum	Only relevant to pension credit members (regulation 63).
(c) a short service refund lump sum	Relates to refunds of contributions under regulation 34 .
(d) a refund of excess contributions lump sum	Not relevant.
(e) a trivial commutation lump sum	Limits the circumstances in which a small pension may be commuted for a lump sum – see regulation 38 .
(f) a winding-up lump sum, or	Not relevant.
(g) a lifetime allowance excess lump sum.	Not relevant.
Pension death benefit rules (FA 2004 s167)	
<p><i>Pension death benefit rule 1</i> No payment of pension death benefit may be made otherwise than to a dependant of the member.</p>	NPPS survivor pensions can only be paid to dependants.
<p><i>Pension death benefit rule 2</i> No payment of pension death benefit other than a dependants' scheme pension may be made in respect of a defined benefits arrangement.</p>	All NPPS survivor pensions are dependants' scheme pensions.

Authorised payment	Comment re NPPS
<p><i>Pension death benefit rule 3</i> If a dependant has not reached the age of 75, no payment of pension death benefit to the dependant other than— (a) a dependants' scheme pension, (b) a dependants' annuity, or (c) dependants' unsecured pension, may be made to the dependant in respect of a money purchase arrangement; but a dependants' scheme pension may only be paid if the member or dependant had an opportunity to select a dependants' annuity instead.</p>	<p>Not relevant (money purchase arrangements only)</p>
<p><i>Pension death benefit rule 4</i> The total amount of dependants' unsecured pension paid to a dependant each unsecured pension year in respect of a money purchase arrangement must not exceed 120% of the basis amount for the unsecured pension year.</p>	<p>Not relevant (money purchase arrangements only)</p>
<p><i>Pension death benefit rule 5</i> If a dependant has reached the age of 75, no payment of pension other than— (a) a dependants' scheme pension, (b) a dependants' annuity, or (c) dependants' alternatively secured pension, may be made to the dependant in respect of a money purchase arrangement; but a dependants' scheme pension may only be paid if the member or dependant had an opportunity to select a dependants' annuity instead.</p>	<p>Not relevant (money purchase arrangements only)</p>
<p><i>Pension death benefit rule 6</i> The total amount of dependants' alternatively secured pension paid to a dependant in each alternatively secured pension year in respect of a money purchase arrangement must not exceed 70% of the basis amount for the alternatively secured pension year.</p>	<p>Not relevant (money purchase arrangements only)</p>

Authorised payment	Comment re NPPS
Lump sum death benefit rule (FA 2004 s168)	
No lump sum death benefit may be paid other than -	
(a) a defined benefits lump sum death benefit	Covers the NPPS lump sum death awards under regulations 45 - 47.
(b) a pension protection lump sum death benefit	Not relevant
(c) an uncrystallised funds lump sum death benefit	Not relevant (money purchase arrangements only)
(d) an annuity protection lump sum death benefit	Not relevant (money purchase arrangements only)
(e) an unsecured pension fund lump sum death benefit	Not relevant (money purchase arrangements only)
(f) a charity lump sum death benefit	Not relevant (money purchase arrangements only)
(g) a transfer lump sum death benefit	Not relevant (money purchase arrangements only)
(h) a trivial commutation lump sum death benefit, or	Limits the circumstances in which a small pension may be commuted for a lump sum – see regulation 38.
(i) a winding-up lump sum death benefit.	Not relevant