



SCOTTISH PUBLIC PENSIONS AGENCY

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Our ref: FIR/04/02/00

10 September 2009

Dear Colleague

SCOTTISH FIRE AND RESCUE SERVICE CIRCULAR No 10 /2009

FIREFIGHTERS PENSIONS SCHEME (FPS) Backdating Commutation Factors

1. Introduction

1.1 This Circular provides guidance on the implementation of new actuarial factors for the commutation of pension into a lump sum in the Firefighters' Pension Scheme 1992 (FPS), following the judgment in the High Court on the Judicial Review of the Home Office decision on the backdating of the equivalent factors in the Police Pension Scheme 1987.

1.2 This Circular is further to Scottish Fire and Rescue Service Circular 14/2008, issued on 9 September 2008.

2. Background

2.1 Circular 14/2008 announced the introduction of new factors for commutation of annual pension into a lump sum under regulation B7 of the FPS. The new factors were introduced with backdated effect to 1 October 2007. The factors themselves were included in guidance published by the Government Actuary's Department.

2.2 In July 2008 the Police Federation of England and Wales applied for Judicial Review of the decision by the Home Office to backdate no further than 1 October 2007. A hearing was held on 17 December 2008 and the Court's judgment was handed down on 17



March this year. The judgment decided that the commutation tables came into effect on the date when they were prepared by the Government Actuary and this date was 1 December 2006 in the case of the Police Pension Scheme. The Home Office decided not to appeal against the judgment. The outcome was therefore that the date on which the new factors under the Police Pension Scheme take effect is 1 December 2006.

2.3 SPPA are satisfied that the consequence of the judgment is that the equivalent factors for the FPS should take effect from 22 August 2006. The reason for the earlier date is that the Government Actuary's Department wrote to the Department of Communities and Local Government on 22 August 2006 informing the Department of the "assumptions which the Government Actuary would propose to adopt in recommending commutation factors in accordance with Regulation B7(3)."

2.4 This Circular provides guidance on what action Fire and Rescue Authorities (FRAs) must now take in order to arrange payment of the backdated lump sums.

3. Action to be taken

Identification of members entitled to backdated payments

3.1 The new factors apply to any member of the FPS who:

- retired between 22 August 2006 and 30 September 2007 inclusive (i.e. whose last day of service was 21 August 2006 or later) with immediate payment of pension; or
- whose deferred pension came into payment between 22 August 2006 and 30 September 2007 inclusive; and
- who commuted some of his/her annual pension for a lump sum.

3.2 In all such cases the lump sum to which the member is entitled must be recalculated using the new factors and guidance, based on the terms of the member's original notice of commutation.

3.3 Members who retired on or after 1 October 2007 will already have been covered by the previous backdating exercise following Circular 14/2008.

3.4 Members described in paragraph 3.1 will, given the higher new factors, be entitled to an additional payment. Authorities must write to the members concerned to explain the reason for the additional payment. The default position is that the member is given more lump sum, but he/she will be given an opportunity to return the money and request additional annual pension instead if he/she does so within one month of the date of the notification. This period may be extended at the authority's discretion in exceptional circumstances. A longer period should, for example, be allowed if the member is away and does not receive the notification directly after it is sent.



3.5 These additional commutation lump sum payments and interest on them, which are being made more than a year after the entitlement arose, are unauthorised payments for tax purposes and will incur an Unauthorised Payment Charge. It is not considered that it would be appropriate for authorities to incur tax charges in these circumstances and arrangements with HMRC will be made by the Scottish Government to account for and pay the total unauthorised payment liability. HMRC's view is that if a member returns the additional commutation lump sum payment and asks for additional pension instead this will not alter the nature of the payment – it will be an unauthorised payment if an actual additional lump sum is paid. The fact that it is returned and used to buy additional pension will not alter that position. So the Unauthorised Payment Charge will need to be calculated and notified to SPPA (see below for more information about the Unauthorised Payment Charge).

3.7 The additional amounts must be paid to members as soon as can be arranged. The following points should be borne in mind:

- interest must be paid on all additional amounts since they are being made more than three months after the entitlement arose;
- members who retired before age 55 with less than 30 years service and who commuted to give a maximum lump sum of 2¼ times the annual pension before commutation cannot receive any additional lump sum payment, but must instead receive the extra money to which they are entitled in the form of additional annual pension (as no commutation lump sum is provided in such cases scenario there is no unauthorised payment);
- some members who retired before age 55 with less than 30 years service who did not commute to give a maximum lump sum might nevertheless be taken over the maximum by the additional payment – in which case they will receive an additional lump sum payment up to the maximum and the balance will be used to provide additional annual pension (assuming only the residual lump sum up to the maximum is actually paid then the unauthorised payment will be limited to that amount);
- the tax treatment of payments made under these arrangements varies according to the type of payment;
- the additional lump sum is not covered by a Benefit Crystallisation Event (BCE) and therefore does not trigger a Lifetime Allowance test (LTA). See HMRC guidance note RPSM11102100. However any case where an additional pension is paid will require a revision to the LTA certificate.
- in cases of deferred pension payable from age 60, pensions increase is awarded as normal and then in the April following the pensioner's 60th birthday an additional amount of pensions increase is added to the lump sum (this is commonly referred to as an article 4 increase and is provided for in each year's Pensions Increase (Review) Order).

3.8 Further guidance on some of these complicating factors is given below.

Payment of interest

3.9 Interest should be paid on these backdated payments.

3.10 Scottish Fire and Rescue Service Circular 14/2008 advised that interest on backdated payments should be calculated at the fixed rate of 5% per year, compounded with yearly rests. We would propose the same arrangement for these payments.

3.11 Interest payable on additional lump sum payments is not subject to income tax at source. These payments are subject to the Unauthorised Payment Charge.

Members who received or would receive the maximum lump sum

3.12 Under regulation B7 of the FPS, the maximum commutation lump sum payable to a member who retired with an ordinary pension based on less than 30 years pensionable service before normal pension age (55) is $2\frac{1}{4}$ times the annual pension before commutation. This requirement is not changed by the new factors, so a member who received this maximum cannot receive any additional payment by way of a lump sum. The extra amount to which a member is entitled as a result of the new factors must, to the extent that it would cause the $2\frac{1}{4}$ maximum to be exceeded, be paid as additional annual pension instead. If the original commutation fell short of the maximum, an additional payment of lump sum could be made to the extent that the maximum is not exceeded.

3.13 Where a member has already received the maximum lump sum, the amount of annual pension which the member has to give up in order to receive the maximum should be recalculated using the new factors. This will be less than the amount he/she previously had to give up using the old factors, so the balance is paid as additional annual pension. A similar approach is adopted where the member receives part lump sum and part additional annual pension.

3.14 Interest must be paid on arrears of additional annual pension on the same basis as on lump sums.

3.15 All commutation lump sum payments (including interest) made under this exercise will attract an Unauthorised Payment Charge. Each payment will therefore require an accompanying calculation of the charge that would have been incurred. Authorities should maintain records of individual cases. In addition, SPPA will require information on the totals paid by each authority and of the Unauthorised Payment Charge that would be due. Details should be submitted to SPPA in the following format by 31 October 2009:

- A Total additional commutation lump payments following backdating to 1 December 2006
- B Total interest payable on additional commutation lump sum payments
- C Total liability for unauthorised payment charges on commutation lump sums and interest (i.e. 40% of the sum of the figures at rows A and B)
- D Total arrears of additional pension
- E Total interest payable on arrears of additional pension

Notes

1. The figure in row A should include only additional commutation lump sum payments.
2. The figure in row B should include only interest paid on commutation lump sum payments.
3. The figure row C is the unauthorised payment charge which would be payable on commutation lump sums and interest on commutation lump sums paid as a result of this exercise, calculated in accordance with paragraph 4.21 of this Circular.
4. The figure in row D should include only arrears of any additional pension payments, not additional pension going forward
5. The figure in row E should include only interest payable on arrears of additional pension, not interest on commutation lump sums.
6. The figures in rows D and E are not unauthorised payments and should not be included in the calculation of unauthorised payment charges in row C.

3.16 Interest payable on an unauthorised payment is itself an unauthorised payment and therefore subject to the Unauthorised Payment Charge. As mentioned in paragraph 3.11, interest is not subject to income tax at source. The legislation (section 208(8) of the Finance Act 2004) specifically provides that unauthorised payments are not income. Since all the unauthorised payment liabilities in this instance will be met at Central Government level, retired members do not have to include the payment of interest on the additional commutation lump sum payment on their tax return.

3.17 Arrears of additional pension paid under these arrangements are not unauthorised payments; nor is the interest payable on arrears of additional pension. They are authorised as Scheme Administration Member Payments and therefore do not attract an unauthorised payment charge. However, where additional pension and arrears of additional pension are paid, pensions administrators will need to:

- issue a revised certificate showing amount of LTA used up;
- deduct tax under PAYE from the lump sum representing arrears of pension, which is taxable as pension income;
- advise members that, although taxable, interest on arrears of pension is payable gross under the tax rules and the member is liable to account for the tax in the year of receipt.

3.18 Operating PAYE on the lump sum of arrears of pension may give rise to higher rate liability for a pensioner, who in most cases will be a basic rate taxpayer. If so, the pensioner should contact his/her tax office and supply a schedule showing the years to which



underpayments are attributable. HMRC will then be able to spread the payments back over the relevant years (as pensions are taxable on an accruals basis rather than the receipt basis) and recalculate the tax liability. Underpayments in the earlier years may be set-off against the resulting over-payment in the year of the lump-sum payment. Any balance of over-paid tax will be repaid to the pensioner.

3.19 Interest on arrears of pension is not taxable as pension income at source. It is the member's responsibility to declare interest on backdated additional pension on their tax return.

3.20 The tax position may be summarised as follows:

- additional commutation lump sum payments under this exercise are unauthorised payments;
- interest payable on additional commutation lump sum payments under this exercise are also unauthorised payments;
- both commutation lump sum payments and interest therefore attract an Unauthorised Payment Charge;
- unauthorised payment charges will be met at Central Government level and will not be payable by members or authorities;
- members do not have to pay tax on commutation lump sum payments or interest paid on commutation lump sum payments;
- backdated additional annual pension, and interest payable on it, are not unauthorised payments;
- arrears of additional annual pension are taxable at source under PAYE as pensions income;
- interest payable on arrears of additional annual pension is not taxable at source, but the member should declare it through the Self Assessment system; and
- members can ask HMRC for the tax payable on arrears of additional pension to be spread over the years in which it was originally payable.

3.22 The following example sets out the approach which FRAs must adopt in calculating the Unauthorised Payment Charge for notification to SPPA.

Example: a member is entitled to an additional commutation lump sum payment of £12,500, including interest: the unauthorised payment (UP) charge is 40% of £12,500 = £5,000. The authority is responsible for notifying the amount of the £5,000 UP charge to SPPA, so that the Scottish Government can make arrangements with HMRC in respect of UP charges.



Taxation rules: scheme sanction charge

3.23 HMRC has agreed that there will be no liability for a scheme sanction charge on account of the unauthorised payments.

Members who have died since 22 August 2006

3.24 There may be cases where a member has died after having retired or after having had a deferred pension come into payment on or after 22 August 2006. In such cases, the additional lump sum payment and interest should be calculated in the same way as in any other case, but the payment should be made to the former member's legal personal representative (i.e. his/her estate).

3.25 The guidance above, in relation to the maximum lump sum, applies equally to payments in respect of members who have died. Payments in respect of members who have died will take the form of additional pension only where and to the extent that the maximum lump sum would otherwise be exceeded. Payment of additional pension in respect of members who have died will take the form of a one-off payment to the member's legal personal representative (i.e. his/her estate).

3.26 Any additional payments under these arrangements in respect of member's who have died have no effect on the level of any adult or child survivor's pension.

Yours sincerely

