

The Chief Executives, Fife Council and Dumfries & Galloway Council
Chief Constables
Clerks to the Joint Boards

7 Tweedside Park
Tweedbank
Galashiels TD1 3TE
<http://www.sppa.gov.uk>
Telephone: 01896 893223
Fax: 01896 893230
James.preston@scotland.gsi.gov.uk

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Dear Colleague

POLICE PENSIONS CIRCULAR No 2006/3

POLICE PENSIONS: 'A-DAY' AND CHANGES TO POLICE PENSIONS REGULATIONS 1987

The purpose of this circular is:

- a) to explain the changes which are being made to the Police Pensions Regulations 1987 and the Police Pensions (AVC) Regulations 1991, including those consequential upon the A-day changes.
- b) to instruct police pensions administrators on the action they need to take before 6 April ('A-day') to comply with the changes to tax legislation which come into force on that day;
- c) to provide consolidated information about the effect of 'A-day' on high earners; and
- d) to notify you that we are in the process of moving the provisions for injury awards have been moved to a separate SSI, the Police (Injury Benefit) (Scotland) Regulations 2006, which will have with effect from 6 April 2006.

This circular does not cover the New Police Pension Scheme (NPPS), which will come into effect on the same date (6 April). This will be covered in a separate circular.

1. Changes to the Police Pensions Regulations 1987

- 1.1 A number of changes need to be made to the current Police Pension Scheme, by amendments to the Police Pensions Regulations 1987. These are consequential upon the new tax regime for pensions (the 'A-day' changes), to come into effect from 6 April.
- 1.2 The details of these changes are set out in **Annex A**.

- 1.3 The changes to the 1987 Regulations will be made by amending Regulations which will be circulated under cover of a separate circular in due course. In the meantime, the changes should be made administratively with effect from 6 April 2006.
- 1.4 We are taking this opportunity to give advance notice of a number of other minor corrections or changes that will be included in forthcoming SSIs. In a number of cases these involve bringing the relevant provision in the 1987 Regulations into line with the corresponding provision in the draft NPPS Regulations (i.e. what will become the Police Pensions (Scotland) Regulations 2006). This does not change the general principle that those officers who remain in the current scheme will be unaffected by the new scheme, but there are a number of points where both schemes are meant to operate in the same way and it would be inequitable not to make the corresponding improvement to the 1987 Regulations. These changes, which will not be implemented as from 6 April 2006, are set out in **Annex B**.

Commutation of pension for lump sum

- 1.5 One particular change which administrators should note is the change to the time limit for deciding whether to commute part of pension for a lump sum. We have been advised by HMRC that after 'A day', to avoid a tax charge, decisions to commute must be made before a pension comes into payment. We are making the necessary amendment to Regulation B7 (See Annex A, Paras A.5 to A.9). Details of this change were outlined in SPPA Police Circular 2006/1 but for information the impact is listed again below.
- 1.6 This change requires action in the following areas:
 1. HMRC's advice means that PPS administrators should have contacted urgently any former active and deferred members who are in receipt of a pension [after 5 October 2005] but who did not decide to take any lump sum at that time, to warn them that if they are planning to commute any pension they need to give formal notice by 5 April 2006.
 2. Administrators also needed to ensure that any active or deferred members retiring with a pension between now and 6 April are warned that they have only until 5 April to give formal notice of their commutation decision if they wish to avoid tax charges.
 3. From 6 April administrators should make it clear to members of either the current or the new pension schemes that decisions to commute pension to lump sum (or, in the case of the new scheme, to exchange lump sum for pension) have to be taken before the date of retirement.
 4. Particular care is needed to fix a date for retirement which allows the officer to commute in cases where an officer is ill-health retired, or is dismissed or required to resign with an entitlement to an ordinary pension.

2. 'A-Day'

- 2.1 Pensions administrators will be aware that, with effect from 6 April 2006, a new tax regime for pensions comes into effect. Pensions administrators have already been provided with some guidance on the effect of these changes and with the text of a letter to send to officers at Superintendent and above (who are most likely to be affected). However, for completeness, guidance on a number of issues in connection with A-day is reproduced here.

General information about A-day

2.2 **Annex C** gives information about the new allowances & limits and related changes that will come in from A-day. This is based on information from HM Revenue and Customs (HMRC). The HMRC on-line guide can be found at:

www.hmrc.gov.uk/manuals/rpsmmanual/index.htm

Duties on pensions administrators and police officers

2.3 Following A Day there is an obligation on you as pensions administrators to notify HMRC of the occurrence of certain events.

Pensions administrators need to make an Event Report to HMRC annually, they will need to notify HMRC if the following have occurred during the year:

- An unauthorised payment has been made
- A lump sum death grant has been paid to a survivor that is more than 50% of the deceased officers lifetime allowance
- An ill-health pension is withdrawn because the officer is fit to return to work
- An officer has crystallised their benefits and in doing so has exceeded the lifetime allowance
- An officer has relied on enhanced protection or an enhanced allowance to avoid exceeding the lifetime allowance
- A pension commencement lump sum is paid which is more than 7.5% but less than 25% of the lifetime allowance for that year
- A police officer transfers out and transfers their pension to a recognised overseas scheme that is not a registered pension scheme
- A lump sum is paid to the survivor of a retired officer who died when over the age of 75 as this would constitute an unauthorised pension.

Where an officer breaches the annual allowance the onus is on them to inform HMRC of the tax payable. They should do this via a self assessment form. Whilst this is their responsibility it would be helpful if you, as scheme administrators, could take the lead in ensuring they are aware of their obligations.

The scheme member must tell the scheme administrator if:

- They wish to rely on an enhanced lifetime allowance: they should provide their administrator with the HMRC reference number issued in connection with this
- They wish to rely on enhanced protection: they should provide the administrator with the HMRC reference number issued in connection with this

Administrators must notify the officer when:

- A benefit crystallisation event has occurred which resulted in a lifetime allowance charge being levied. They must be informed of:
 - the chargeable amount that has arisen as a result of the benefit crystallisation event
 - details of how the chargeable amount has been calculated

- the amount of tax due
- details of whether the scheme administrator has already accounted for the tax or intends to account for it.

Administrators must also provide retired officers with an annual statement of the percentage of their lifetime allowance that has crystallised since 6 April 2006 in relation to the Police Pension Scheme. Please see <http://www.hmrc.gov.uk/manuals/rpsmmanual/RPSM12200080.htm> for guidance on this.

Registration requirements

- 2.4 The PPS is currently classed as a “relevant statutory scheme” by HMRC and, as such, will automatically be registered by HMRC on 6 April. Registered pension schemes are required to appoint a scheme administrator to carry out tax obligations on behalf of the scheme.
- 2.5 In common with schemes such as the Local Government Pension Scheme and the Firefighters’ Pension Scheme, the PPS is administered by the relevant employers, namely Police Authorities. In response to concerns raised with them, HMRC have brought forward new legislation (The Registered Pensions (Splitting of Schemes) Regulations 2006) to permit scheme administrator responsibilities to be delegated from the Centre.
- 2.6 To meet the requirements of the new legislation, schemes that wish to be treated as “split schemes” had to register with HMRC by 17 February 2006. This Agency has registered the PPS as a “split scheme” and will be regarded by HMRC as the “split scheme administrator”. A further requirement is for the details of the administrators to whom responsibility is delegated, known as “sub scheme administrators” under the new legislation, to be provided to HMRC also by 17 February 2006. The information required is as follows:
 - Name of the Police Authority
 - Address
 - E-mail
 - Telephone number
- 2.7 This Agency has collated this information and passed it to HMRC.
- 2.8 In keeping with previous guidance on IDRP the Treasurer to the Police Authority is the official responsible to the Police Authority for the administration of the Police Pension Scheme. However, responses provided by police authorities for the above exercise provided contact names and telephone numbers to allow HMRC contact with those individuals who have day to day responsibility for tax matters.

Primary & Enhanced protection

- 2.9 **Annex D** provides technical notes for administrators on the valuation of PPS benefits at 5 April for primary protection purposes. **Annex E** describes the potential impact of the new tax regime on high earners in the PPS.

3. Benefits for death and injury attributable to police service

3.1 Under the new tax rules, attributable death and injury benefits cannot be part of the Police Pensions Regulations as you do not have to be a member of the Police Pension Scheme to receive them. They are therefore being removed and put in Police (Injury Benefit) (Scotland) Regulations. This is described in more detail in Annex F.

4. Authorised Payments – Arrears of Pension

4.1 As discussed previously, from A-Day a pension scheme needs to make payments that are Authorised payments as described in the Finance Act 2004, otherwise they will attract a tax charge for both the member and the scheme. This means that the Benefit Crystallisation Event (BCE) needs to occur before the officer in question retires so as to satisfy the requirement that an officer becomes entitled to his or her pension and lump sum at the date of retirement.

4.2 It is recognised that this may present problems in cases where the pension needs to be changed for reasons such as court order, a Pensions Ombudsman determination or awards where the "beginning date" for pensions increase is earlier than the date the pension starts to be paid. These are reasons that readily came to mind. If there are others that you think we should consider, please let us know.

4.3 HMRC have agreed that the provisions of the Finance Act 2004 and the regulations that were announced on 7 November 2005 would, for example, permit arrangements for paying arrears of pensions and lump sums and interest for delay such as are set out below. HMRC have therefore made regulations to cover the payment of arrears of pension so that they are authorised payments. It effectively allows for a second BCE. The main features are that:

- a) a backdated, higher rate of pension can be paid as a separate pension and the member will become entitled to this (in terms of the definition of entitlement under s165(3) FA04) once the amount has been determined (eg where a retrospective pay award has been applied). **However, schemes must ensure that the revised award is documented as a separate pension for tax purposes even if it is aggregated for the purposes of paying it;**
- b) in this case, because the member has become entitled to a scheme pension, it will come within Benefit Crystallisation Event 2 and the member will have an entitlement to a Pension Commencement Lump Sum in connection with that pension;
- c) a reasonable amount of interest can be paid in respect of the late payment of that pension lump sum (and for that matter the arrears of pension) as a scheme administration member payment (under s171 FA04); and
- d) the actual arrears of higher rate pension (that is from the date a member could have started to draw these higher rate benefits) to the date of entitlement (in terms of S165(3) FA04) come within the regulations that HMRC have made in order to make pension arrears "authorised member payments" (under s164 FA04).

4.4 The key adjustment in HMRC's advice is that the date of entitlement under tax law for the revised amount of entitlement is the date the revision was finalised by the scheme.

- 4.5 However, that is not the date of entitlement under scheme rules or for the purposes of the Pensions Increase Act 1971.
- 4.6 The scheme pension can be aggregated so there is no need for a separate scheme pension to cover arrears of pension and lump sum. Neither does anything in the HMRC provisions change the deemed date for pensions under the PIA.
- 4.7 Advice about separate pensions refers to there being a separate pension for tax purposes - the second BCE. HMRC policy colleagues have agreed that there is no requirement for separate pensions under scheme rules.
- 4.8 The above means that the 3-month pension lump sum rule for revised awards bites from the date the scheme determines the revised award. We assume that the scheme cannot determine that until it has the necessary information from the various sources. Assuming that you would be paying arrears of pension and lump sum together, we hope there should not be a problem with the 3-month rule.
- 4.9 On arrears, you can now pay arrears of revised award as well as of the original pension. And, of course, the concerns about awards of interest etc should have been dealt with by the recognition that these can be paid as scheme administration member payments (SAMPs). **NB: SAMPs are taxable.**
- 4.10 The first revised award under the new tax rules would be a BCE no earlier than 6 April 2006, assuming that the scheme determined the revised amount on that date. That would presumably give three months in which to pay the extra pension lump sum alongside arrears of pension.
- 4.11 More information is available in **Annex G**.

5. Civil Partners

- 5.1 This is to confirm that Regulations on Civil Partnerships have now been finalised with a view to being laid before Parliament shortly after the return from the Easter recess.
- 5.2 The 3 month time limit for women to buy back service from 6 April 1988 until May 1990 will run from the date the Regulations come into force.
- 5.3 Further details about this and a draft letter to contact officers concerned will be issued shortly.

Yours sincerely

J.Preston.

Jim Preston
Policy Manager

Annex A: Changes to the 1987 Regulations as a result of 'A-day'

Tax Simplification

A.1 Under the provisions of the Finance Acts 2004 and 2005, HM Revenue and Customs are introducing a simplified tax regime for pensions that will come into force on 6 April 2006. In order to meet its requirements a number of changes have to be made to the Police Pension Scheme (PPS). **These changes need to be made administratively in the meantime with effect from 6 April 2006.**

A.2 The main changes that will affect the PPS, and other public sector schemes, are new limitations on how and when lump sum awards or gratuities may be made, and new roles and responsibilities for administrators. There is also an important change to the time limits for commutation. In general, the penalty for not adhering to the new rules is a tax charge. The main areas for amendment are as follows.

Changes to 1987 Regulations

A.3 **Personal and survivor benefits.** The minimum period of service will be changed from two/three reckonable years to two qualifying years. The 1987 regulations provide that two years' pensionable service is needed for a short service pension (B2(3)) or ill-health pension (B3(3)(a)), and three years' pensionable service for a widow's ordinary pension (C1(1)) or a child's ordinary allowance (D1(1)(c)). These will be changed to depend on two years' qualifying service based on the definition in Pension Schemes Act 1993 s71(7) which is as follows:

(7) *In subsection (1) "2 years' qualifying service" means 2 years (whether a single period of that duration or two or more periods, continuous or discontinuous, totalling 2 years) in which the member was at all times employed either—*

(a) *in pensionable service under the scheme; or*

(b) *in service in employment which was contracted-out by reference to the scheme; or*

(c) *in linked qualifying service under another scheme.*

A.4 **Short service or ill-health gratuity.** Where a police officer retires with less than 2 years' qualifying service, the PPS provides for a short service or ill-health gratuity under regulation B2 or B3. This gratuity is calculated in accordance with Schedule B, Part IV and provides for the greater of a member's aggregate pension contributions or 1/12th of his average pensionable pay multiplied by the period in years of his pensionable service. Under the new tax regime, a short service gratuity will not be permitted to exceed the aggregate of a member's pension contributions and an amendment will be required so that the amount of short service gratuity will equal the aggregate of a member's pension contributions in all circumstances. Please note that Regulation F10 also allows an officer with at least 3 months' pensionable service to take a transfer value out instead of a refund.

A.5 It will also be necessary to offer an officer with less than 2 years' qualifying service but who is being ill-health retired because he or she is disabled as a result of an injury sustained in the execution of duty a refund of contributions as an alternative to an ill-health pension.

A.6 The 1987 regulations also provide that a deferred pension is payable based on a definition of two years qualifying service in regulation B5, which was made before PSA 1993 existed. For consistency, that definition will be changed to be based on the definition in PSA 1993. This brings the definition into line with the NPPS.

A.7 **Repayment of aggregate pension contributions:** We will also need to make clear in Regulation B6 that pension contributions can only be repaid where a member has accrued less than 2 years qualifying service.

A.8 **Transfer values.** Regulation F10(2)(b) currently provides that a transfer value can be paid after 3 months' pensionable service, but this is not quite the same as the statutory "three month condition" in the Pension Schemes Act 1993 s101AA [inserted by Pensions Act 2004 s264] **which we have used in NPPS.** The definition in PSA 1993 will be used instead and is as follows:

(2) *For the purposes of subsection (1), the three month condition is that the period of the member's pensionable service under the scheme, taken together with-*

(a) *any previous period of his pensionable service under the scheme, and*

(b) *any period throughout which he was employed in linked qualifying service under another scheme,*

amounts to at least three months.

(3) *A period counts for the purposes of paragraph (a) or (b) of subsection (2) only so far as it counts towards qualification for long service benefit within the meaning of Chapter 1.*

A.9 **Commutation:** The PPS allows members to commute up to a quarter of their pension into a lump sum payment, when they retire. This provision currently requires a member to notify the police authority of his/her intention to commute part of their pension no later than 6 months after retiring.

A.10 HMRC's interpretation of the relevant legislation (section 66 of the Finance Act 2004), is that commutation of a pension to provide a 'pension commencement lump sum', for the purposes of the 2004 Act, must be done at the time of entitlement to a pension first arises. The scheme then has a period of 3 months in which to pay the lump sum derived by the commutation of pension. The 3 month rule is intended to cater for possible administrative delays in paying a lump sum, not to permit commutation after retirement.

A.11 Accordingly, a lump sum paid by commutation of a pension already in payment cannot be a 'pension commencement lump sum' for the purposes of the Act. It would become an unauthorised payment and the tax charges for unauthorised payments would apply as appropriate. In addition, the scheme pension payable at 6 April 2006 would be reduced following commutation. This reduction would fall foul of the provision in the 2004 Act which provides that a reduced pension ceases to be a scheme pension. Since the reduction would not fall within any of the excluded categories set out in the Act, the unauthorised payment tax charges would also apply in respect of the reduced pension.

A.12 Under the new tax rules, from 6 April commutation will only be an authorised payment if notice is given before a member's intended date of retirement. Regulation B7 will therefore be amended so that any notice of commutation must be given before a member's intended date of retirement. Regulation B7 will also need to be

amended to include the new requirement for commuted lump sums to be paid within a period of 3 months beginning with the day on which the member becomes entitled to it.

A.13 HMRC has advised that a degree of protection is afforded by paragraph 2 of the Pipeline Lump Sums draft regulations (which are available on the HMRC website at www.hmrc.gov.uk/pensionschemes/draftregs.htm). Where a valid notice to commute part of a member's pension is received before 6 April 2006, an entitlement arises to a lump sum at that time. Provided the lump sum is paid before 6 July 2006, the lump sum will be a 'pension commencement lump sum' and the resulting reduction in the scheme pension will not fall foul of the relevant provision in the 2004 Act. Scheme members who retire before 6 April 2006 and have not already given notice of commutation will need to give notice before that date to avoid giving rise to unauthorised payments and consequent tax charges.

A.14 **Commutation of small pensions:** The PPS provides police authorities with the discretion to commute to a gratuity a member's pension that is below a certain level. The new tax rules place an upper limit on the amount of pension that may be commuted of 1% of the standard lifetime allowance (SLA). The SLA for 2006/07 is set at £1.5 million. Regulation B8 of the PPS will need to be amended accordingly.

A.15 Similar limitations apply to the Gratuity in lieu of surviving spouse's pension (E5) and the Gratuity in lieu of child's allowance (E6). As in Regulation B8, the amount of gratuity is limited to not more than 1% of the SLA. In addition, lump sum death benefits can only be paid where the member dies before their 75th birthday and payment must be made before the date the member would have reached their 75th birthday.

A.16 **Deduction of tax from certain awards** - Scheme Administrators will be required to pass on any tax charges on scheme members by payover to HM Revenue and Customs and subsequent recovery from payments. An appropriate amendment will be made to Regulation B11. We will insert a provision to allow recovery of tax charges where LTA is breached (either by lump sum payment or deduction from pension) depending on which the officer opts for.

A.17 **Payment of periodical contributions for increased benefits:** From 6 April 2006 there will no longer be the 15% cap on tax privileged pension contributions. The new tax rules will permit contributions equivalent to an individual's relevant taxable UK earnings for the year. As a consequence regulation G7(3) will be removed. However, a scheme limit will remain so that accrued service plus increased benefits cannot exceed 40/60^{ths} and increased benefits cannot be used to reduce one's retirement age below 55 (or the compulsory retirement age).

A.18 **Pension debit members - restriction on replacement of debited rights:** Under regulation G9, a pension debit member is prohibited from replacing any rights debited as a consequence of a pension sharing order with any rights that he would have been unable to accrue had the order not been made. After 6th April 2006 these restrictions will no longer apply on divorce and regulation G9 will be removed. A scheme limit will remain so that accrued service benefits can not exceed 40/60ths.

New Provisions

A.19 **Scheme Administrator:** Under the Finance Act 2004 pension schemes are required to appoint a Scheme Administrator whose responsibilities include filing the Event Reports, Pension Scheme Return and Accounting for Tax forms. The PPS is administered by Police Authorities and we have been seeking clarification from the HMRC as to how the role of Scheme Administrator will apply to the PPS (and other similar schemes). As explained in the paragraph above, the PPS will be treated as a "split scheme", that is a registered pension scheme that is treated as having been split in to two or more "sub schemes". A new provision under Regulation L will need to be inserted to specify the requirement.

A.20 **Dependent child's pension – new age limit:** In general new dependent children's pensions beginning on or after 6 April 2006 must stop at the latest by the beneficiary's 23rd birthday. The change has been reflected in the New Police Pension Scheme.

A.21 **New contribution limits:** From 6 April 2006 there will no longer be the 15% cap on tax privileged pension contributions (i.e. total contributions, this does not allow officers to contribute more than 11% or 9.5% to the police pension scheme). The new tax rules will permit members to contribute as much as they like up to 100% of their pensionable earnings and receive full tax relief, subject to the Annual Allowance. As a consequence Regulation G7(3) will be removed. However, a scheme limit will remain so that accrued service plus increased benefits cannot exceed 40/60^{ths}.

A.22 **Tax free lump sum from AVCS:** Members drawing their AVC benefits from 6 April 2006 will be allowed to take up to 25% of their fund as a tax-free lump sum (at present, there is no tax-free lump sum). There will be no limit imposed by the scheme on how much you can contribute to an AVC. The only limit that applies is the HMRC limit which states that you cannot contribute more than your salary.

Annex B: Other changes to the 1987 Regulations

B.1 This is for **advanced warning**. We aim to make these changes later in the year. They **do not** have to be implemented yet.

B.2 **Survivor Benefits.** The inequity between pre- and post-retirement marriage widowers (and latterly civil partners) will be removed. This means that all widower and surviving civil partners' awards will be based on the proportion of the officer's total service which counts for such an award and not just the actual service which counts. (This particularly affects Schedule C, both part I, paragraphs 2A, 2B & 2C, and part III paragraphs 1A, 1B & 1C. It may be useful to compare with part IV for reference.) It is intended to back date this provision to 5 December 2005.

B.3 **Salary Sacrifice.** Pensionable pay will be defined as the full salary (without salary sacrifice deducted). Pension arrangements will remain unchanged, so that officers who choose to take part in the flexible benefits scheme will continue to pay their contributions and receive benefits based on the substantive salary. The officer's final pensionable salary will also comprise the substantive salary (that is the salary without the sacrifice).

B.4 **Pensionability of adoption leave.** The Police Pensions Regualtions will be amended so that unpaid adoption leave will be able to be bought back on the same lines as parental leave; this is pending a firm definition being put into the Police Regulations 2003.

B.5 **Pensionable pay and average pensionable pay.** In regulation G1(1), the words "in a rank below that of superintendent" will be deleted, to make it clear that part-time service is applicable to any rank.

B.6 **Appeals on eligibility for pension awards payable on the ground of permanent disablement.** Regulation G8(3) will be amended to bring it into line with regulation 71 of the draft NPPS Regulations (Appeals against decisions on eligibility for pension awards payable on the ground of permanent disablement). This means changing the wording and the order of events so that they are in line with that in the NPPS regulations.

B.7 **Appeal by a member of a home police force.** Regulation H5 will be amended bring it into line with regulation 67 of the draft NPPS Regulations. This involves making a list of the issues that can be appealed.

B.8 **Purchase of Increased Benefits (Amendments to Police Pensions (Purchase of Increased Benefits) Regulations 1987).** These Regulations already provide that buy-back is only for service that has already been lost in that an officer can purchase benefits which cannot be built up by further service. We are considering whether to specify that the further years of service available to an officer before they reach the Compulsory Retirement Age must always be calculated on the basis of full-time service.

B.9 In regulation 7A, paragraph 5, the word "percentage" (in point (a)) will be replaced by the word "amount". The definitions of the letters in the formula used in regulation 7A, paragraph 6, are not quite right. They will be changed to read as follows:

P is "the added years he would be entitled to had there been no variation";

and

F is “the amount of contributions paid by periodical payment had there been no variation”

- B.10 Currently, due to the inclusion of the pensions increase as part of the underpin, a part-time officer can potentially be entitled to a higher pension (as a result of the increase) than his or her full-time counterpart. Essentially, this is because the part-time officer can use the underpin to go back further for average pensionable pay, which is revised in line with pensions increase.
- B.11 The underpin will be limited to the amount of pension the officer would have been entitled to had he not reduced his hours at the point in question.

Annex C: Tax simplification – New allowances & limits and related topics

- C.1 From 6 April 2006, the present range of tax and pensions legislation is replaced by a simplified system which permits schemes to relax many of the current limits but also introduces new controls - mostly for the higher-paid. The new tax regime introduces a 'Lifetime Allowance' and an 'Annual Allowance' to replace all the current limits on tax-free contributions and benefits from pensions. For most people, the tax changes will be beneficial as they will increase the amount that can be saved in pension schemes without paying income tax on their contributions.
- C.2 A number of the other new provisions are permissive, not mandatory. This means that although the law is changed, some of the provisions are optional and do not automatically over-ride pension scheme rules. Each pension scheme is able to make its own decisions as to whether it changes its rules to reflect these optional provisions of the legislation.

Lifetime Allowance

- C.3 The Lifetime Allowance (LTA) is the total value of all pension benefits (except the State pension) that can be taken by or in respect of an individual without paying extra tax. Pension benefits are tested against the LTA at the time that the member takes their pension benefits. The LTA for 2006-7 will be £1.5 million and will increase over the next 5 years to £1.8 million. If the capital value of a member's benefits from all their pension arrangements exceeds the LTA they will have to pay extra tax on the excess.
- C.4 Most police officers' pensions will be nowhere near the LTA. An indication of those likely to be affected is given in the letter to officers at Superintendent and above (reproduced at Annex E).
- C.5 Everyone who brings a pension into payment, whether it is an occupational pension or a personal pension, will use some of their LTA. Even if a pension is small and will not exceed the LTA, individuals must keep records of any pensions that are paid to them. When they come to draw their pension, it will be assessed against their remaining LTA to check whether extra tax is due (even though most people's pensions will not reach anywhere near the LTA).
Every pension drawn will use up part of the LTA (the only exception to this is the State Pension).

Pensions credit on divorce

- C.6 Members who became entitled to a pension credit before 6 April 2006 following a divorce can apply to HM Revenue and Customs (HMRC) to increase their LTA. This is because their pension credit will count against their LTA. Members who have a pension debit against them should note that this does not count towards their LTA.

Benefit Crystallisation Events

- C.7 The Finance Act 2004 defines what are known as "Benefit Crystallisation Events" (BCEs). These are points at which pensions come into payment or other significant changes occur. BCEs are listed in section 216 of the 2004 Act. The ones which are likely to be relevant to police pensions administrators are:

- Bringing a pension into payment (BCE2) (not a dependant's pension)
- Revising the amount of pension where it exceeds a permitted amount (BCE 3)
- A member becoming entitled to an annuity from his or her AVC fund (BCE4)
- A member reaching the age of 75 before bringing his or her pension and/or lump sum into payment (BCE5)
- Paying a lump sum to a member (BCE6)
- Paying a lump sum to someone on the death of a member (BCE7)
- Making a transfer payment to a "qualifying recognised overseas pension scheme" on behalf of a former member (BCE8)

C.8 When a BCE occurs, the member must have sufficient LTA to cover the event. If not, LTA tax will be payable.

Annual Allowance

C.9 In addition to the LTA, there will be an Annual Allowance. This defines the maximum amount by which the capital value of an individual's total pension rights can increase in any one year before they are liable to pay additional income tax at 40%. The Annual Allowance will be £215,000 in 2006-7. The amount of increase will be defined as:

- contributions paid into money purchase arrangements, plus
- the increase in any defined benefit pension, multiplied by 10, plus
- the increase in any defined benefit pension lump sum.

C.10 In practice, the Annual Allowance is most likely to bite in the following circumstances (individually or combined):

- a significant pay rise, particularly where someone has a lot of pensionable service
- an enhancement of service (other than on pension benefits coming into payment – e.g. on ill-health retirement or redundancy)
- a significant contribution into a pension scheme
- a credit of service more generous than that implied by the transfer value received
- aggregation of an earlier preserved pension

C.11 **Annual Allowance reporting is the responsibility of the individual** and will be included in HMRC self-assessment returns sent out from April 2007.

C.12 Individuals will be required to report details of the increase in value of defined benefit pensions and of contributions to all other pension arrangements on their income tax self-assessment. Individuals who breach the Annual Allowance will be liable to pay income tax at a rate of 40% on the excess over the Annual Allowance. The Annual Allowance will not affect the vast majority of police officers. PAs should be prepared to negotiate a phasing in of a pay rise to an officer who believes this will be beneficial to them if they would otherwise breach the annual allowance.

Pension Input Period

C.13 For the purpose of calculating the annual allowance the scheme will need to have a pension input period. This will be from the 1 April to 31 March or from the date of starting for new members.

New time limit for transfers in from non occupational (not sponsored by an employer) pensions

C.13 An application for a transfer from a scheme other than another occupational pension arrangement (a personal pension or a deferred annuity contract) will be permitted only during the first 12 months of the member becoming eligible to join the police pension scheme. The limit applies to all officers, not just new joiners from 6 April 2006.

New age limit for early payment of pensions for new entrants

C.14 From 6 April 2006 any new entrant will only be able to draw their pension from age 55. This is reflected in the New Police Pension Scheme. Officers who joined before 6 April 2006 and who remain members of the current scheme will not be affected. This change does not affect pensions paid on ill-health retirement (where age limits do not apply).

New age limit of 75 from 6 April 2006

C.15 The new tax regime is designed on the basis that members will draw benefits before their 75th birthday. Lump sum payments made after that time will be classed as an 'unauthorised payment' and the member will have to pay a 40% tax charge. The scheme will also have to pay a fine for making the unauthorised payment. This is highly unlikely to affect any police officers.

Annex D Valuation of Police Pension Scheme Benefits at 5 April 2006 for Primary Protection purposes: technical notes for administrators

D.1 The valuation at 5 April 2006 for the purposes of primary protection must take into account all pension rights held by the officer and so account must be taken not only of accrued benefits under the PPS but also pension rights held in any other pension arrangement, e.g. deferred benefits in some other occupational pension scheme, personal or stakeholder pensions, Additional Voluntary Contributions attached to a previous pension scheme, or Free Standing Additional Voluntary Contributions.

D.2 It will be the officer's responsibility to obtain this information and add it to the PPS valuation when seeking primary protection. These notes concentrate on how the benefits should be valued under the PPS. The notes are based on guidance provided by HMRC. The references in this Annex to sections and schedules are to those contained in the Finance Act 2004.

Valuation formula

D.3 When valuing a pension administrators should treat the officer's entitlement as if the pension were coming into payment that day. Therefore it should be calculated as:

Annual pension x 20 plus any other pension entitlements or a pension credit
plus any pension already in payment x25

Please note that the uncommuted pension should be valued and that the pension of an officer with less than 25 years service should be treated as a short-service award.

If an administrator is calculating the value of benefits at retirement to see if they are within the LTA the same formula should be used but where an officer elects to commute the lump sum should be added on to the total.

Annual rate of pension

D.4 Pensionable service and average pensionable pay are needed to assess the value of the pension pot. It should be treated as if the pension were coming into payment on the day of the calculation.

D.5 When working out the average pensionable pay to use in the assessment of pension as at 5 April 2006 you will average the pensionable pay received for the period 6 April 2005 to 5 April 2006, not the period 6 April 2003 to 5 April 2006. Or, if it would have been higher, the average pensionable pay for the period 6 April 2004 to 5 April 2005, or 6 April 2003 to 5 April 2004 could be substituted.

Lump sum

D.6 The definition says that this is the lump sum to which the member would be entitled "otherwise than by way of commutation of pension". The PPS offers a lump sum only by commutation and so "LS" in the formula will be "0".

D.7 In this respect the valuation of benefits at 5 April 2006 differs from the method used when benefits come into payment. Then, account must be taken of any election to commute and the pension to be multiplied against the relevant valuation factor will

be the portion left after commutation and the lump sum from commutation will be added on as "LS".

Example E1

An officer joined the PPS after 31 May 1989 and transferred pension rights from his previous occupational scheme. He has 30 years' service on 5 April 2006. His pay for the past three years has been £108,000, then £114,000, and finally £120,000.

Using fast accrual principles his service would give him a pension based on 40/60 x average pensionable pay. However, his pensionable pay has been limited to the earnings cap since he joined the PPS. Average pensionable pay for the period 6 April 2005 to 5 April 2006 would be £105,600. Consequently the valuation of PPS benefits for Primary Protection would be:

$$(40/60 \times £105,600) \times 20 + 0 = £1,408,000$$

To be able to claim Primary Protection the officer must have benefits valued in excess of £1,500,000 at 5 April 2006. His PPS benefits are below this level.

Example E2

An officer joined the PPS before 1 June 1989. She has 28 years' service. Her average pensionable pay for the period 6 April 2005 to 5 April 2006 is £130,000. This is higher than for the two previous years.

Using fast accrual principles, her service would give her a pension based on 36/60 x average pensionable pay. Consequently the valuation of PPS benefits for Primary Protection would be:

$$(36/60 \times £130,000) \times 20 + 0 = £1,560,000$$

Because this value is in excess of £1,500,000 she can seek Primary Protection.

Annex E Effect on higher earners in the Police Pension Scheme.

E.1 The new lifetime allowance will not affect the majority of police officers. However some high earners may face new pensions tax charges HMRC has devised two methods of protection for a high earning officer. They are **primary protection** and **enhanced protection**.

Primary protection for those who exceed the lifetime allowance

E.2 An individual with pension rights at 5 April 2006 which are in excess of £1.5m (calculated as indicated above) can register with HMRC for “**primary protection**” in order to have these rights protected in certain circumstances. It is in the interests of anyone with pension benefits exceeding £1.5m at 5 April 2006 to register for primary protection.

E.3 The effect of primary protection is to augment permanently the lifetime allowance for an individual. For example, if someone’s pension rights at 5 April 2006 were to be calculated at £1,875,000, then his or her lifetime allowance would always be the standard lifetime allowance multiplied by 1.25. So, for example, for 2010/11 the lifetime allowance would have increased to £2,250,000 (i.e. £1,800,000 x 1.25). The individual is free to make further pension contributions and to build up further pension benefits, but he may be subject to a tax charge when he draws a pension if, at that point, his pension exceeds his personally augmented lifetime allowance. In the Police Pension Scheme, the entitlement to pension benefits can increase through:

- an increase in pensionable service
- a pay award
- a promotion
- “added sixtieths”
- AVC contributions.

E.4 It is therefore in the interest of anyone who registers for primary protection to review their position regularly after A-Day. It is not possible to protect any excess over the augmented lifetime allowance, but you need to be aware of any possibility of a tax charge and might wish to discuss the possible options with a financial adviser. Note that primary protection can only apply to benefits which did not exceed HMRC limits under the pre-April 2006 regime.

E.5 Important points to note about “primary protection” are:

- registration for protection must be made by the individual
- the application to register (on a standard form) must reach HMRC by 5 April 2009
- it is only available to individuals whose pension rights are valued at more than £1.5m at 5 April 2006
- it protects pension rights at A-Day, but does not prevent the later application of a tax charge if the individual’s augmented lifetime allowance is exceeded for any reason.

Enhanced protection

E.6 There is a further mechanism to protect pension rights at A-Day, called “**enhanced protection**”. Anyone can apply for this – it is not necessary for the lifetime allowance to be exceeded at A-Day. It is a means to protect pension rights built up before 6 April 2006 from the lifetime allowance charge when they come into payment after that date, provided that these rights have risen in value only within the limits laid down by HMRC.

E.7 Enhanced protection will be lost if relevant benefit accrual occurs. Because the Police Pension Scheme is a defined benefit scheme relevant benefit accrual does not occur until “benefit crystallisation” which will generally mean retirement but it would also occur upon a transfer. **An individual can keep paying 11% into the pension scheme and not lose enhanced protection provided relevant benefit accrual does not occur.**

E.8 HMRC will test a pension in 2 ways to see if relevant benefit accrual has occurred, an individual need only fulfil the requirements of one of these tests to keep their enhanced protection.

- **Test 1** Calculate the value of the officer’s benefits at 5 April 2006. Relevant benefit accrual will only be deemed to have occurred if the value of their pension on retirement has increased by more than 5% compound per annum from the 5 April 2006. (If the officer intends to commute part of their pension for a lump sum when their benefits come into payment it is likely that their pension benefits can in fact have risen by more than 5% p.a. without invalidating their enhanced protection because the initial calculation was based on the assumption that he or she would not commute.) If the individual wishes to accrue a few more 60ths and feels that their pay will not increase by much in the years before retirement this may be an option for them. We are in discussions to ascertain whether there will be an option to avoid breaching enhanced protection either by waiving or allocating a portion of the pension benefits of an individual whose pension has grown by slightly more than 5% per annum. Individuals should consult their IFA before making this decision.
- **Test 2** In a defined benefit scheme relevant benefit accrual does not occur if the value of an individual’s pension is higher because their salary has risen but their years of service remain the same. In the PPS this is useful for officers with 30 years service who anticipate that their salary will rise between 6 April and their retirement. For this to work an individual must have 30 years service (or relevant benefit accrual will occur when they subsequently retire with benefits that have risen by more than 5% p.a) and they must keep paying the 11% contribution towards the pension scheme.

Exceeding the lifetime allowance

E.9 Some people – whether or not eligible for enhanced or primary protection - who will exceed the lifetime allowance when they come to draw benefits after 6 April 2006. These individuals will have to pay LTA tax. However they will have a choice as regards how to make this payment.

E.10 They could opt to pay the LTA tax as lump sum at the point of retirement. If this option is taken individuals would receive a reduced lump sum commutation but

would not incur any further taxation due to the size of their pension pot, (other than income tax, paid as now, on their annual pension).

E.11 The other option would be to spread the cost of the recovery charge by paying it at an actuarially calculated rate from their personal (and a dependents survivor) pension. This would mean that they would receive a reduced pension for the entire time it was payable to them.

E.12 Both these options have benefits but deciding which to opt for would depend heavily on personal circumstances. We would not be able to advice officers on which course to take and would strongly advise them to seek independent financial advice.

Enhanced Protection and the Annual Allowance

E.13 Enhanced protection also offers protection from the annual allowance.

Phasing in a pay rise

E.14 The annual allowance may affect an officer who takes a significant promotion. Although it may happen only rarely, the officer will be liable to pay tax if it he or she takes a pay rise of more than around £30,000 in any one year. If this is the case the officer should contact their PA so that they can agree a way of phasing in the pay rise if the officer feels that would be beneficial to them. Please see the example:

- Officer A has 28 years of service
- Her pay is increasing from £110,000 to £150,000
- Her accrued pension when pay rise awarded = $\text{£110,000} \times (20/60 + 8/30) = \text{£66,000}$
- Her accrued pension a year after pay rise awarded = $\text{£150,000} \times (20/60 + 9/30) = \text{£95,000}$
- Her “pension input amount” = $10 \times (95,000 - 66,000) = \text{£290,000}$
- She is liable for an annual allowance charge of $40\% \times (290,000 - 215,000)$
=£30,000 tax payable

E.15 If the officer receives the full pay rise then she will face an additional income tax charge of £30,000. The annual allowance charge would be reduced to nil if the new pay was restricted to £138,157 in the first year and only fully realised one year after first being awarded. By doing that the officer would forsake around £7,000 post-tax income but avoid a £30,000 charge.

E.16 However an officer who opts for this route **must** bear in mind that if they were to die in the first year the benefits paid to an adult survivor would be based on the lower pay. If an officer is considering this they should bear in mind the implications for their family or any dependents.

Opting out and the police pension

E.17 If an individual does decide to opt out of the pension scheme and they have 25 or more years of service their pension will come into payment when they retire or when they attain they age of 50 (if they retire at an earlier age). If they opt out with less than 25 years of service the pension will come into payment at age 60.

Annex F: Benefits for death and injury attributable to police service

- F.1 The new tax regime for pensions will recognise relevant statutory pension schemes such as the PPS automatically and will treat them as registered for tax privilege purposes. However, non-contributory compensatory provisions (i.e. benefits not derived from pension contributions) for duty related death and injury that are currently incorporated into the PPS will be regarded as unauthorised under the new regime. This would result in a tax liability for members (injury awards are currently non-taxable) and an additional administrative burden for police authorities. Injury benefits would also be added to the value of a member's pension for determining the Lifetime Allowance (LTA), with an adverse impact on members of the PPS.
- F.2 We have therefore removed all the regulations relating to injury awards from the main police pension scheme regulations. From 6 April, there will be a new set of injury awards regulations for both the existing police pension scheme and NPPS. These regulations do not represent anything new. They are being introduced solely because of the requirements of the tax legislation. The injury benefits arrangements will not be a registered pension scheme.
- F.3 There are plans to review the policy of injury awards provision later this year. No changes will be made to the regulations before a public consultation exercise has been completed.

New Regulations

- F.4 The Police (Injury Benefit) (Scotland) Regulations 2006 are planned to come into force before the start of Parliament's summer recess which begins on 1 July but the Regulations will have back-dated effect from 6 April 2006. HMRC have confirmed that injury benefits paid under the 1987 Regulations between 6 April 2006 and the new Injury Benefit regulations coming into force will not be subject to a tax charge on the assumption that the new regulations will have back-dated effect from 6 April 2006.
- F.5 The main changes to note are updated references to social security legislation, replacement of "widows' awards" with "adult survivors' awards" and an age limit of 23 on children's awards where the child is not disabled.
- F.6 The new injury awards regulations will be circulated later.

Annex G: Authorised Payments – Arrears of Pension

G.1 This section is about how the proposed arrangements for handling revised awards would operate in relation to pensions increases. In particular this concerns (a) situations where a pension is increased between the first BCE and the date of a revised award that generates a second BCE and (b) situations where a pension has an earlier beginning date for pension increase purposes than the date the pension starts to be paid and the pension lump sum then attracts pensions increase - or second-bite PI. This guidance has been cleared with HMRC.

Revised awards and pension increases

G.2 The rate of pension crystallised at the second BCE (when say a revised rate of pay is finalised) would take account of pension increases that have been implemented between the original beginning date of the pension award and the date the revised rate is paid. HMRC have agreed that only the increase in the value of the extra, revised pension needs to be included in the second BCE. The increases in the value of the original award can be treated as normal pension increases which do not involve a second BCE. Also, any resulting arrears of pension would be an authorised scheme payment under the The Registered Pension Schemes (Authorised Payments - Arrears of Pension) Regulations 2006 - SI 2006 No 614 - that HMRC made on 9 March.

G.3 The pension commencement lump sum that would be payable at the second BCE would reflect the revised rate of pension as payable at the date of the first BCE without any pension increases. S9(9) of the Pensions Increase Act 1971 does not permit such increases where the amount of a pension lump sum is recalculated. Any additional amounts payable, such as interest for delay under scheme rules, would therefore clearly fall to be treated as taxable scheme administration member payments (SAMPs), not as part of any tax-free pension lump sum. There are no specific provisions for the taxation of SAMPs so the normal tax rules will apply to each type of payment. Interest payments will be taxable under section 369 Income Tax (Trading and Other Income) Act 2005 . Section 349(2)(a) ICTA 1988 says that tax must be deducted from a payment of yearly interest made by a company (other than one acting in a fiduciary or representative capacity) but otherwise it can be paid gross - unless the recipient is a person who is non-resident in which case there is then an obligation to deduct tax from yearly interest, whoever is making the payment (section 349(2)(c)).

G.4 To illustrate this sort of case, assume a lump sum of £30,000 and pension of £10,000 payable in April 2006, pension uprated to £10,200 in April 2007 and a backdated revision in October 2007 of the original April 2006 rate which becomes £12,000. The rate of pension for the second BCE would be £2,040 (the £12,000 rate uprated by the 2% PI, ie £12,240, less the original £10,000 uprated by the 2% PI, ie £10,200). The PCLS would be £6,000 (£2,000 x 3). The BCE would therefore be £46,800 [(2,040 x 20) + 6,000].

G.5 The £3,120 arrears of pension (£2,000 for 2006-07 and £1,120 for 2007-08) would be a taxable scheme pension payment outside the second BCE. If interest for delay on the lump sum was payable (say a hypothetical 2% real - 4% nominal - at monthly stops producing around £370) this would be a taxable SAMP.

Awards where the "beginning date" for pensions increase is earlier than the date the pension starts to be paid

G.6 The cases above are those where an award has come into payment, the continuing pension has been increased and the original rate of pension is then revised. The position on benefits such as deferred pensions is somewhat different as a deferred pension lump sum could attract a subsequent pensions increase. Indeed this could apply to any pension where the "beginning date" for pension increase purposes is not the date the pension started to be paid.

G.7 In addition to deferred pension awards there will be the large number of cases each year where for example the end date of the pensionable pay period used to calculate the pension is not the date the pension started to be paid. Almost all pensionable pay formulae offer periods of more than just the last year and stepping down, temporary promotions etc often arise during that period. There are also some other types of case such as where a former spouse's pension credit "begins" from the date of divorce.

G.8 In such cases pension schemes pay a second bite tax free lump sum. This is a legal entitlement to an additional payment of lump sum, payable even if the member has already died, that is calculated by applying a proportion of the PI uprating at the uprating date that follows the date the pension started to be paid. This second-bite PI is therefore indexing the basic rate of the lump sum up to the date it and the pension were brought into payment and HMRC consider that this generates a second BCE.

G.9 The pension schemes of course also uprate the pension from the April following the date the pension and lump sum are paid. That pension uprating will always be at least as great as the uprating applied to the lump sum and will usually be considerably higher because the pension uprating will cover the whole of the previous year in such cases (because they are all cases where the "beginning date" was before the previous April's uprating date).

G.10 That first pension uprating is however unlike subsequent upratings and those for other awards. As with the second-bite lump sums, part of the uprating is increasing the pension calculation in respect of the period between the date the previous uprating order came into effect and the date the pension started to be paid. The rest reflects the normal uprating of the pension once it has come into payment.

G.11 HMRC has agreed that this part of the pension uprating relating to the period before the pension starts to be paid is another category of revised award. Therefore for both the pension and the lump sum there is a retrospective increase from the previous April's pensions increase date up to the date the pension started to be paid. However, there is no legal entitlement to these increases until the next PI date the following April, when the second BCE is generated.

G.12 Second-bite PI cases have to be distinguished from those where the PI "beginning date" is also the date the pension started to be paid. In the latter cases pensions increase is not applied to the pension at the date it starts to be paid and applies at the next uprating date only in respect of the period between the date the pension started to be paid and the uprating date.

G.13 As an illustration of second-bite PI, assume someone who left the PCSPS in 1995 and has a deferred PCSPS Classic pension of £3,000 and lump sum of £9,000 that began to be paid on 1 July 2005. When that pension and lump sum start to be paid they will reflect the pension increases from the 1995 beginning date until the April 2005 uprating. On 10 April 2006 a PI uprating of 0.68% will apply to the lump sum, so a second bite tax-free lump sum £61.20 will be payable. The pension would rise by the full 2.7% uprating to £3,081. Of that uprating, 0.68% or £20.40 would be regarded as equivalent to the retrospective recalculation of pension as for the lump sum. The other 2.02%, or £60.60, reflects the indexation period since the pension started to be paid.

G.14 The second BCE would therefore be for £469.20 [(£20.40 x 20) + £61.20]. There will always be enough pension to cover the lump sum in such cases as they would be increased by the same rate for the period up to the date the pension started to be paid. However, schemes will of course need to manage small second BCEs as a matter of routine for a high proportion of awards.

G.15 The assumption should be that a standard formula should be applied in all cases to get that element of the uprating that is increasing the pension calculation up to the date the pension started to be paid. The logic of that approach would need to be maintained against pressure from a few high earners who are very close to the LTA and have taken lump sums worth considerably less than 25% of the pension value, who might argue that they do not need to crystallise so much pension so the second BCE could be smaller.

G.16 As the second BCE follows quite soon after the first BCE and the amounts are likely to be small, it might be possible to keep administration costs to much less. There are no "de minimis" limits in the Information Power Regulations (SI 2006 No.567) so the scheme will need to provide information about the further BCEs (whatever their size) to the member in accordance with Regulation 14 and in a few instances to HMRC under event reports 6, 7 or 8. However, schemes would probably not need in most cases to do a further LTA test (including asking the member about any other BCEs between date of the first BCE for Events 2/6 and date of the second BCE for Events 2/6) where the test at the time of the first BCE showed that the member had no other rights and the amounts crystallised from the scheme were well below the LTA.

Death before second-bite PI becomes payable

G.17 In a few cases the person with a potential entitlement to second-bite PI will die before the date of the uprating at which the lump sum and continuing pension would be increased. In such cases the extra benefit will need to be treated as additional death grant, not as arrears of pension lump sum payable to the former member. The conditions for treatment as a defined benefits lump sum death benefit are set out at paragraph 13 of Schedule 29 to the Finance Act 2004. Given the way that second-bite PI arises, schemes should be able to satisfy the conditions that the member dies before age 75 and the benefit is paid within 2 years of the date of death.

G.18 Any survivors' benefit payable would continue to have the same beginning date and to be uprated, from that beginning date, at the uprating at which the extra death grant becomes payable.