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Dear Colleague

POLICE PENSIONS CIRCULAR No 2009/5 FURTHER BACKDATING OF THE COMMUTATION FACTORS APPLICABLE TO THE POLICE PENSION SCHEME (PPS)

This circular should be brought to the immediate attention of force personnel officers, Finance Managers and the Pension Managers and administrators of the PPS.

1. Introduction

1.1 This circular provides further guidance on the implementation of the new actuarial factors confirmed in SPPA Police Circular 2008/3 for the commutation of pension into a lump sum in the Police Pension Scheme 1987. Scottish Ministers have considered the judgment in the High Court on the Judicial Review raised by the Police Federation for England and Wales and have decided that the new factors should be applied from 1 December 2006. Circular 2008/3 previously allowed backdating of the new factors to 1 October 2007.

2. Summary of main points

2.1 The main points of this Circular are as follows:

- the revised lump sum commutation factors issued under circular 2008/3 are now backdated to 1 December 2006 (Sections 3 and 4)
- police authorities must identify and write to any officer who is entitled to an additional payment as a result of this decision (paragraphs 4.1 – 4.6 and Annex A)

- payments, which will attract interest, must be made as soon as can be arranged, wherever possible by the end of June (paragraphs 4.7 – 4.14)
- neither retired officers nor police authorities will incur unauthorised payment tax charges on the extra lump sum payments or the interest payable on them, but these charges must be calculated by police authorities in order that appropriate arrangements can be made at centrally with Her Majesty's Revenue and Customs (HMRC) (paragraphs 4.15 – 4.16)
- arrears of additional pension (where this is paid instead of additional lump sum) and interest paid on additional pension are not unauthorised payments but are taxable as pension scheme payments in the normal way (paragraphs 4.17 – 4.19)
- there will be no scheme sanction charges (paragraph 4.22)
- police authorities must complete and return by 31 July confirming the number of cases involved the amounts payable both arrears and interest so that the resulting tax charges can be calculated. (paragraph 6)
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3. Background

3.1 SPPA Police Circular 2008/3 announced the introduction of new factors for commutation of annual pension into a lump sum under regulation B7 of the Police Pensions Regulations 1987. 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.

3.2 In July 2008 the Police Federation of England and Wales applied for Judicial Review of the decision to backdate no further than 1 October 2007. A hearing was held on 16 December 2008 and the Court's judgment was handed down on 17 March this year. The Home Office has decided not to appeal against the judgement. Scottish Ministers considered the impact of that ruling for Scotland and decided that its outcome should be applied to Scottish police pensioners.

3.3 The effect of the judgment is that the date on which the new factors take effect is 1 December 2006.

3.4 This means that the new factors apply to any officer who retired with an immediate pension on that date or later (i.e. whose last day of service was 30 November 2006 or later) or whose deferred pension came into payment on 1 December 2006 or later. This will require the payment of interest in all cases.

3.5 The full judgment should be available in due course on the [British and Irish Legal Information Institute \(BAILII\) website \(new window\)](#). The reference is [2009] EWHC 488 (Admin).

4. Action to be taken

Identification of officers entitled to backdated payments

4.1 In anticipation of this circular police pensions administrators may already have identified which retired officers are affected. The backdating to 1 December 2006 affects any officer:

- who retired between 1 December 2006 and 30 September 2007 inclusive (i.e. whose last day of service was between 30 November 2006 and 29 September 2007 inclusive), or
- whose deferred pension came into payment between 1 December 2006 and 30 September 2007 inclusive, and
- who commuted some of his or her annual pension for a lump sum under the Police Pensions Regulations 1987

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

4.3 Officers who retired on or after 1 October 2007 will already have been covered by the previous backdating exercise following SPPA Police Circular 2008/3.

4.4 Officers described in paragraph 4.1 will, given the higher new factors, be entitled to an additional payment. Forces must write to the officers concerned to explain the reason for the additional payment. The default position is that the officer is given more lump sum, but he or she will be given an opportunity to return the money and request additional annual pension instead if he or she does so within one month of the date of the notification. This period may be extended at the police authority's discretion in exceptional circumstances for example, allow a longer period if the officer is away and does not receive the notification directly after it is sent.

4.5 HMRC's view is that if an officer returns the lump and asks for additional pension instead this will not alter the nature of the payment – it will be an unauthorised payment if an actual 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 the SPPA (see paragraphs 4.15 – 4.21 for more information about unauthorised payment charges and paragraph 5 about information required by SPPA).

4.6 Model notification letters, depending on the officer's circumstances, are provided in the attached Annex A. The letters are generic and designed to meet various scenarios and should be checked carefully before use. They will need to be adapted further to meet an officer's individual circumstances and the police authority's payment arrangements.

4.7 The additional amounts must be paid to officers as soon as can be arranged both to ensure that the officers receives their payment as quickly as possible and to effectively manage the payment of interest. We would hope that in the majority of cases it should be possible to arrange payment by the end of June.

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
- officers who retired 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 this scenario there is no unauthorised payment)

- some officers who retired 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)
- 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
- the tax treatment of payments made under these arrangements varies according to the type of payment
- in all cases, whether additional pension or lump sum or combination of the two is awarded, revised Lifetime Allowance certificates will need to be issued
- 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)

4.8 Further guidance on some of these complicating factors is given in paragraphs 4.9 – 4.21.

Payment of interest

4.9 Interest will be paid on these backdated payments because they have not been paid within three months of the date of entitlement (i.e. the officer's date of retirement or the date a deferred pension came into payment).

4.10 SPPA Police Circular 2008/3 directed that interest on backdated payments should be calculated on a daily basis at 1% above the Bank of England base rate. The base rate has experienced significant variation recently. To simplify calculations, interest should be calculated at the rate of 5.3% a year as a standard compound interest calculation. The interest must be applied to each backdated payment, with each additional instalment of pension payment having interest applied separately. The following example illustrates the calculations that are required.

Interest example 1 – backdated lump sum

- Date pension commences: 22 April 2007
- Date of back-payment: 15 June 2009
- Period of backdating = 2 years 54 days
- Backdated lump sum due = £17,500
- Total backdated payment due = $£17,500 \times 1.053^{(2 + 54/365)} = £19,552.98$
- Interest due = $£19,552.98 - £17,500 = £2,052.98$

Notes to example

1. This is a standard compound interest calculation.
2. The expression in the 5th line is "1.053 to the power of (2 + 54/365)"

3. The calculation can be carried out using Excel or other available spreadsheets or software
4. Any pensions administrator who does not have access to easy ways of carrying out compound interest calculations should contact SPPA who can put them in touch with a police authority able to offer help

4.11 Interest payable on additional lump sum payments is not subject to income tax at source. These payments are subject to the unauthorised payment tax charge. The tax position is covered in paragraphs 4.15 – 5.20.

Officers who received or would receive the maximum lump sum

4.12 Under regulation B7 of the Police Pensions Regulations 1987, the maximum commutation lump sum payable to an officer who retired with an ordinary pension based on less than 30 years pensionable service before his or her pre-October 2006 compulsory retirement age is $2\frac{1}{4}$ times the annual pension before commutation. This requirement is not changed by the new factors, so an officer who received this maximum cannot receive any additional payment by way of a lump sum. The extra amount to which an officer 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.

4.13 Where an officer or former officer has already received the maximum lump sum, you should recalculate the amount of annual pension which the officer has to give up in order to receive the maximum, using the new factors. This will be less than the amount he or 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 officer or former officer receives part lump sum and part additional annual pension.

4.14 Interest must be paid on arrears of additional annual pension on the same basis as on lump sums. As with interest on additional lump sums, this must be paid out of the operating account. The following example illustrates the calculations that are required.

Interest example 2 – backdated pension

- Date of first pension payment: 1 February 2007
- Date of back-payment: 8 June 2009
- Backdated pension due: £50 per month
- Interest on backdated pension payments is calculated in the same way as interest on lump sums but account is taken of each backdated pension payment that is more than 3 months late. At 8 June 2009 the backdated pension payments in respect of pension instalments from 1 February 2007 and 1 March 2009 will be more than 3 months late, and so attract interest

The calculations required for first two pension payments are shown below. Similar calculations are required for all instalments that attract interest.

- Period from 1 February 2007 to 8 June 2009 = 2 years 127 days
- Period from 1 March 2007 to 8 June 2009 = 2 years 96 days
- Total backdated payment due for February = $£50 \times 1.053(2 + 127/365) = £56.45$

- Total backdated payment due for March = $£50 \times 1.053(2 + 96/365) = £56.20$
- Total interest due for the first two months = $£56.45 + £56.20 - £100 = £12.65$

Notes to example

1. This is a standard compound interest calculation.
2. The expression in the 7th and 8th bullet points are “1.053 to the power of (2 + 127/365)” and 1.053 to the power of (2 + 96/365)
3. The calculation can be carried out using Excel or other available spreadsheets or software.
4. Any pensions administrator who does not have access to easy ways of carrying out compound interest calculations should contact the SPPA, who can put them in touch with a police authority able to offer help.

Taxation rules and the unauthorised payment charge

4.15 All commutation lump sum payments (including interest) made under this exercise will be more than a year after entitlement arose and will therefore attract an unauthorised payment charge. We do not consider that it would be appropriate for police authorities to incur tax charges in these circumstances and arrangements with HMRC will be made by the Scottish Government regarding the total unauthorised payment liability. However, to enable this to be done we need to know how much each police authority would have paid in unauthorised payment charges had they been required to do so. Each payment will therefore require an accompanying calculation of the unauthorised payment charge that would have been incurred.

4.16 Interest payable on an unauthorised payment is itself an unauthorised payment and therefore subject to the unauthorised payments tax charge. As mentioned in paragraph 4.11, 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 centrally, retired officers do not have to include the payment of interest on the additional commutation lump sum or their additional lump sum payment on their tax return.

4.17 Arrears of additional pension paid under these arrangements are not unauthorised payments; nor is any 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 retired officers that, although taxable, interest on arrears of pension is payable gross under the tax rules and the retired officer is liable to account for the tax in the year of receipt

4.18 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 or 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.

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

4.20 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 tax charge
- unauthorised payment charges will be met at central Government level and will not be payable by retired officers or police authorities
- officers 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 retired officer should declare it through the Self Assessment system
- retired officers can ask HMRC for the tax payable on arrears of additional pension to be spread over the years in which it was originally payable

4.21 The following example sets out the approach which forces must adopt in calculating the unauthorised payment charge for notification to SPPA (see paragraphs 5).

Unauthorised payment charge example

An officer is entitled to an additional commutation lump sum payment of £12,500, including interest.

UP charge is 40% of £12,500 = £5,000.

The police authority is responsible for notifying the amount of the £5,000 UP charge to SPPA, so that SPPA can make arrangements with HMRC in respect of UP charges.

Taxation rules: scheme sanction charge

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

Officers who have died since 1 December 2006

4.23 There may be cases where a former officer has died after having retired or after having had a deferred pension come into payment on or after 1 December 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 officer's legal personal representative (i.e. his or her estate).

4.24 The instructions at paragraphs 4.1 - 4.21, in relation to the maximum lump sum, apply equally to payments in respect of former officers who have died. Payments in respect of former officers 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 officers who have died will take the form of a one-off payment to the former officer's legal personal representative (i.e. his or her estate).

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

4.26 Financing for the additional payments will be provided by the Scottish Government. Full details will be provided by the Police Division team of the Police and Community Safety Directorate.

5 Information required to provide the tax charge payments.

5.1 This return should be made to SPPA no later than 31 August 2009

5.2 Having identified all the pensioners concerned and paid the relevant arrears and interest police authorities will need to confirm to SPPA details of the following. If there are any difficulties in paying the arrears an estimated amount should be included. The list of individual cases should be maintained by each force in the event that HMRC wish to confirm any details of the final payments.

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.

Annex A: model letters to police officers

Letter 1: former officer entitled to an additional lump sum payment

I am writing to let you know about an increase in the amount of your police pension lump sum.

You chose to commute part of your annual pension for a lump sum payment and the amount of your lump sum was calculated according to factors prepared by Government Actuary's Department. As you may know, these factors were revised last year with backdated effect to 1 October 2007. Following a judgment by the High Court, the revised factors have now been further backdated to 1 December 2006. Scottish Ministers have decided that this decision should also be applied in Scotland. We have therefore recalculated the amount of your lump sum using the new factors and you are entitled to an additional tax-free lump sum payment of £ , plus tax-free interest of £ . This will be included in your next payment.

If you would prefer to receive additional annual pension instead of the additional lump sum, you may choose to do so provided you tell us and return the lump sum to us within one month of the date of this letter.

Please get in touch with us if you have any questions about this change.

Letter 2: former officer entitled to an additional lump sum payment but has already received the maximum 2¼ times annual pension

I am writing to let you know about an increase in the amount of your police pension.

You chose to commute part of your annual pension for a lump sum payment and the amount of your lump sum was calculated according to factors prepared by Government Actuary's Department. As you may know, these factors were revised last year with backdated effect to 1 October 2007. Following a judgment by the High Court, the revised factors have now been further backdated to 1 December 2006. Scottish Ministers have decided that this decision should also be applied in Scotland

Since you chose to commute to the maximum lump sum of 2¼ times annual pension allowed by the Police Pensions Regulations 1987, the additional amount can only be paid in the form of additional annual pension.

We have therefore recalculated the amount the amount of annual pension which you would have to give up in order to receive the maximum lump sum using the new factors. The amount of additional annual pension to which you are entitled is £ , which will be included in your next payment onwards. You are also entitled to payment of arrears of additional pension to the date you retired, of a total of £ . plus taxable interest of £ . This will also be included in your next payment. The lump sum payment of arrears of pension will be taxed as pensions income. Although it is taxable, the interest is payable gross under the tax rules. It is your responsibility to account for any tax due through the Self Assessment system. You should contact HM Revenue and Customs if you have any enquiries about tax.

Please get in touch with us if you have any questions about this change.

Letter 3: former officer entitled to an additional lump sum payment but it would take him or her over the maximum 2¼ times annual pension

I am writing to let you know about an increase in the amount of your police pension lump sum and annual pension.

You chose to commute part of your annual pension for a lump sum payment and the amount of your lump sum was calculated according to factors prepared by Government Actuary's Department (GAD). As you may know, these factors were revised last year with backdated effect to 1 October 2007. Following a judgment by the High Court, the revised factors have now been further backdated to 1 December 2006. Scottish Ministers have decided that this decision should also be applied in Scotland. We have therefore recalculated the amount of your lump sum using the new factors and you are entitled to an additional lump sum of £ .

However, if this amount were to be paid to you in full your total lump sum would exceed the maximum of 2¼ times annual pension allowed by the Police Pensions Regulations 1987. You will therefore receive an additional tax-free lump sum payment of £ , plus tax-free interest on that lump sum of £ , and the rest will be paid in the form of additional annual pension.

The amount of additional annual pension to which you are entitled is £ , which will be included in your next payment onwards. You are also entitled to payment of arrears of additional pension to the date you retired, of a total of £ . plus taxable interest of £ . The lump sum payment of arrears of pension will be taxed as pensions income. Although it is taxable, the interest is payable gross under the tax rules. It is your responsibility to account for any tax due through the Self Assessment system. You should contact HM Revenue and Customs if you have any enquiries about tax.

The additional lump sum and interest, plus the arrears of annual pension and interest, will be included in your next payment and your annual pension will be increased from that payment onwards.

If you would prefer to receive all the extra amount to which you are entitled in the form of additional annual pension, you may choose to do so provided you tell us and return the lump sum to us within one month of the date of this letter.