Meeting of the Board 1st March 2017

ITEM 8

Scheme Pays – Options paper on introducing a 'Voluntary Scheme Pays' arrangement to the Firefighters' Pension Schemes.

Introduction

1. The introduction of the new 2015 CARE Scheme ('2015 Scheme') for firefighters has created some unintended implications for certain transitional members who want to use the existing 'Mandatory Scheme Pays' (MSP) provision within the pension scheme rules to pay tax charges incurred where they breach HMRC limits on annual pensions growth. Additionally, there are implications for members who are subject to HMRC's new tapered annual allowance arrangements which affect their ability to use the existing MSP provision.

2. This paper sets out these implications in more detail and seeks a view from the Scheme Advisory Board on a number of proposals to introduce a Voluntary Scheme Pays (VSP) arrangement to the Firefighters' Pension Schemes to address the issue and ensure that the policy intention envisaged under the MSP arrangements continues to be achieved now we have members with service in more than one firefighters' pension scheme i.e. those transitional members who transfer into the 2015 Scheme but continue to benefit from growth in their pension benefits in their connected 1992 or 2006 Scheme memberships.

3. Please note that this is an initial exploratory paper. Further legal advice and clearances will need to be sought by the Home Office before an approach can be confirmed. Legislative amendments may be required to give effect to any new VSP arrangement.

Recommendation: It is the Home Office's view that a VSP arrangement should be introduced to the Firefighters' Pension Schemes to allow:

(i) transitional members with pension growth of over £40,000 across both schemes (HMRC AA limit) and a corresponding tax charge, to use the scheme to pay this cost initially, before it is repaid by a pension debit added to the member's pension when it comes into payment – see **Option B;**

(ii) members subject to a tapered AA, to use the scheme to pay their charge initially and then this be repaid via a pension debit (as per (i) above) – **see Option C.** For this option, it is also recommended that the member should be required to make an initial contribution of £2,000 from their own finances towards the resultant AA tax charge.

Does the SAB agree with the Home Office's recommendation? Any further comments or suggestions would be welcomed.

Background

4. Individuals whose annual growth in pension savings during the Scheme's 'Pension Input Period' exceeds **HMRC's Annual Allowance Limit ('HMRC AA Limit')**, currently set at £40,000, and who have no unused Annual Allowance to carry forward from the previous three tax years will be subject to an **Annual Allowance tax charge ('AA tax charge')**. The AA tax charge is based at the member's marginal tax rate. For example if a scheme member is a 40% rate tax payer and has pension growth of £45,000 then they will incur an AA tax charge of £2,000 (40% x £5,000).

5. The individual can pay the AA tax charge from their own personal finances, however, the Finance Act 2004 provides that a pension scheme must provide a 'Scheme Pays' facility[1] where all of the following qualifying conditions are met:

   i. the HMRC AA limit (currently set at £40,000) has been exceeded in the pension scheme that the Scheme Pays election is made; and
   ii. an AA tax charge exceeding £2,000 has been triggered; and
   iii. the relevant time limits for making an election have been met.

   This is known as **Mandatory Scheme Pays ('MSP')**.

6. The Registered Pension Schemes (Modification of Scheme Rules) Regulations 2011 (http://www.legislation.gov.uk/uksi/2011/1791/contents/made) provide for pension schemes to allow access to a **Voluntary Scheme Pays ('VSP')** arrangement where the conditions for MSP are not met. VSP is not currently offered by any of the Firefighters' Pension Schemes.

7. If a member elects to have their AA tax charge paid via MSP, or VSP where a pension scheme permits, the scheme will effectively pay the full value of the AA tax charge direct to HMRC on their behalf. A pension debit[2] is applied to the member's pension to cover the full cost of any scheme pays election made by the member. As the pension debit only applies to the member's pension payments, if the member dies prior to the pension coming into payment, the pension scheme will effectively have paid the cost of the AA tax charge with no option to recover this from any survivor benefits.

[1] *A scheme pays facility works by having the pension fund pay the member's tax charge initially. This is then repaid by the member as a debit is added to their pension once it comes into payment.*
[2] *A pension debit is calculated using actuarial guidance and is designed to be actuarially neutral so neither the scheme nor the member benefits in the long term.*

Discussion:
Implications for 1992 and 2006 Scheme members who transfer into the 2015 Scheme

8. With the introduction of the 2015 Scheme, any unprotected members of the 1992 Firefighters' Pension Scheme ('1992 Scheme') and 2006 Firefighters' Pensions Scheme ('2006 Scheme') will have transferred into the 2015 Scheme on 1 April 2015. 1992 and 2006 Scheme members who are subject to tapered protections will transfer to the 2015 Scheme during the period 1 April 2015 to 31 March 2022. Once transferred, these 'transitional members' will effectively be members of two pension schemes and will see pension benefit growth in both schemes until retirement:

- 2006 Scheme transitional members will accrue future pension benefit growth in respect of their 2015 Scheme benefits and in respect of their 2006 Scheme past service benefits by virtue of the protected link to their final pensionable pay.

- 1992 Scheme transitional members will accrue future pension benefit growth in respect of their 2015 Scheme benefits and in respect of their 1992 Scheme past service benefits by virtue of the protected link to their final pensionable pay and an increased accrual rate due to the ongoing link to double accrual provisions.

9. By virtue of accruing their pension growth across two rather than one pension scheme, there is an increased likelihood that a transitional member will fail to satisfy the first qualifying condition for using MSP to pay any resultant AA tax charge, as explained below:

Transitional members - Pension growth across each scheme to exceed the £40,000 HMRC AA limit

10. As explained in paragraph 2(i) above, the first qualifying condition for MSP to apply is that the member's annual pension growth in each scheme must exceed the HMRC AA limit, which is currently set at £40,000. As a transitional member's annual pension growth will be shared over two schemes (i.e. the 2015 and 1992 Schemes or the 2015 and 2006 Schemes), there is an increased likelihood that although the member's total annual pension growth may exceed £40,000, the pension growth in any one of the schemes may fall short of the HMRC AA limit. As such, they will not be eligible to use MSP to pay the AA tax charge. For example:

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(i) **A 1992 Scheme transitional member may have a combined pension growth of £50,000, that is £30,000 in respect of 1992 Scheme benefits and £20,000 in respect of 2015 Scheme benefits.** In these circumstances, the transitional member would incur a £10,000 breach (which would generate an AA tax charge of around £4,000 if the member had a marginal tax rate of 40%) of the £40,000 HMRC AA limit but as the growth in each scheme is less than £40,000, they would not be eligible to use MSP under either scheme to pay the resultant AA tax charges.

(ii) **A 2006 Scheme transitional member may have a combined pension growth of £60,000, that is £45,000 in respect of 2006 Scheme benefits and £15,000 in respect of 2015 Scheme benefits.** In these circumstances, the transitional member would incur a total £20,000 breach of the HMRC AA limit (which would generate an AA tax charge of around £8,000 if the member had a marginal tax rate of 40%). However, as the pension growth in the 2015 Scheme is less than the £40,000, they would not be eligible to use MSP under this scheme to pay the AA tax charge generated in respect of all of this increase. As the member's pension growth in the 2006 Scheme has exceeded the £40,000 HMRC AA limit, by £5,000, they can use MSP to pay the AA tax charge generated in respect of this increase (which would total £2,000 if they were a 40% tax rate payer).

However, the balance of the AA tax charge would have to be paid by the member from another source.

11. This is not expected to be a major issue for transitional members employed in regular and middle ranking firefighting roles, unless in exceptional circumstances where they receive a number of significant uplifts in pay in quick succession over a short period of time, for example from successive promotions. However, it is expected to have a greater impact on those transitional members employed in senior firefighter roles and earning in excess of £75,000 per year. For these cases, it may not be uncommon for members to be vulnerable to breaching the £40,000 HMRC AA limit and incur an AA tax charge each year.

Scheme members subject to a tapered AA – i.e. some Chief Fire Officers

12. Recent changes to the tax rules also now mean that some high earning members with income of more than £150,000 per annum are now subject to a **Tapered Annual Allowance ('tapered AA')** which reduces from £40,000 to £10,000 incrementally for those earning between £150,000 and £210,000 per annum. This issue is not limited to those members who transition to the 2015 Scheme and can also affect protected members of the 1992 or 2006 Schemes. Any members earning over £210,000 per annum will be subject to a tapered AA of £10,000. Members who are subject to a tapered AA will incur an AA tax charge where their pension growth exceeds their tapered AA. The tapered AA will be lower than the £40,000 HMRC AA limit and therefore is likely to lead to an increase in the instances of breach with these members

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being more likely to incur an AA tax charge than members not subject to the tapered limit.

13. There may be cases where the member's pension growth may exceed their tapered AA, and therefore incur an AA tax charge; however, it may not exceed the £40,000 HMRC AA limit. This will mean that they will not be able to use MSP to pay the resultant AA tax charge at all. There are two examples set out below giving examples of how Chief Fire Officers could be affected in this circumstance.

<u>Example A</u>
A member may have a tapered AA limit of £10,000 and have pension growth of £30,000. This is likely to generate an AA tax charge of around £9,000 on £20,000 growth. As the member's pension growth does not exceed the £40,000 HMRC AA limit, the member will not have the option of using MSP to pay any of the AA tax charge and under current rules will have to pay it from their own finances.

<u>Example B</u>
A member with a tapered AA of £10,000 has pension growth of £45,000. They will incur an AA tax charge on the £35,000 that their pension growth has exceeded their tapered AA. In this case, the member will only be able to use MSP to pay the AA tax charge on the pensions' growth that exceeds the £40,000 HMRC AA limit i.e. £5,000 (which, based on the member being a 45% marginal tax payer, would allow them to pay £2,250 of the AA tax charge). The tax charge incurred on the remaining £30,000 pension growth above their tapered AA (around £13,500 based on the member having a marginal tax rate of 45%) would have to be paid from their own finances.

Options for SAB to consider:

14. These options are not mutually exclusive. Accordingly, it is appropriate to consider more than one. Option A proposes to maintain the status quo, option B seeks to tackle the issue for transitional members, and option C proposes an option for Chief Fire Officers affected by the tapered AA issues. The initial Home Office view is that options B and C (or a variation of them) could be taken forward in tandem.

A. Retain the status quo whereby the Firefighters' Pension Schemes only offer members the ability to pay any AA tax charge by means of MSP.

Risks/Benefits – This will mean that transitional members and those members who are subject to a tapered AA limit are more likely to incur an AA tax charge due to their pension growth but will have to pay the charge from a personal finance source. There is a risk that transitional members who would have been able to use MSP had they stayed in their existing schemes (where all the pensions growth would have been under one scheme) may argue that moving to the 2015 Scheme is causing them an unintended and unfair

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detriment. It is possible that such members may seek to challenge the legality of such an approach.

B. Introduce VSP arrangements whereby transitional members can elect to pay an AA tax charge where the pension growth in each scheme does not exceed the £40,000 HMRC AA limit, but where the combined growth across both schemes does. Eligibility to use the VSP would be conditional on an overall AA tax charge exceeding £2,000 also being triggered.

Risks/Benefits – This would mean that transitional members should be able to use the VSP arrangement to pay an AA tax charge and the adverse effect of their having transitioned to two schemes, which has had the effect of disqualifying more members from MSP, would be mitigated. This would in turn decrease the risk of any legal challenge.

The introduction of additional VSP arrangements will carry additional financial risk to the Schemes in comparison to the current position. As the pension debit (which recovers the tax charge from the member) is only applied to the member's pension (and not survivor benefits) when it comes into payment, should the member die prior to retirement, or after retirement but before the full amount owed is recovered, the scheme will have effectively paid all or part of the cost of the member's AA tax charge/s. However should the member live beyond normal lifetime expectancy (used by GAD to calculate the corresponding pension debit) the scheme will ultimately benefit.

As part of this option, any proposed VSP arrangement would also need to consider how the pension debits would be levied against each of the member's scheme memberships. For example, should the pension debits be (i) levied against the 2015 Scheme only, (ii) done on a proportionate basis in accordance with the growth in each scheme, or (iii) should the member have the option to decide. The Home Office's initial view is that this should be done on a proportionate basis for simplicity. We would want views from FRAs/administrators as to how this would work in practice.

C. Introduce arrangements whereby high-earning members subject to a tapered AA can elect VSP to pay an AA tax charge where the pension growth in one of their schemes is less than the £40,000 HMRC AA limit, but more than their tapered AA limit. To mitigate the financial risks to the pension schemes of extending the current 'Scheme Pays' arrangements, and to reflect the fact that affected members will be very high earners, this option could also include a requirement for the member to pay the initial: (i) £2,000; (ii) £5,000, or (iii) £7,500 of their AA tax charge from their own finances.

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Risks/Benefits - For those members who are subject to a tapered AA limit, there is an increased risk that they will incur substantial AA tax charges as a consequence of the recent tapered reductions to AA limits. These AA tax charges may also be incurred on a regular basis and may cause short-term financial pressure for those members affected. In the absence of any VSP arrangement, these members may find it difficult to pay the resulting tax charge from other sources.

The financial risks will be similar to those outlined in Option B, but concentrated amongst a smaller number of members. As the option also lowers the pension growth threshold at which the member with a tapered allowance can pay an AA tax charge, the total charges may well be larger. This risk will be offset somewhat by the requirement for the member to pay an initial contribution to their AA tax charge from their own finances.

Marc Sherratt, Home Office
1st March 2017