FPC(05)04

FIREFIGHTERS' PENSION COMMITTEE

FIREFIGHTERS' PENSION SCHEME (FPS)

Tax Simplification - Lifetime Allowance Primary and Enhanced Protection

Purpose of Paper

We have been asked to provide guidance to members of the Firefighters' Pension Scheme (FPS) on the implications of the introduction of a "Lifetime Allowance" (LTA) as part of the Tax Simplification proposals due to be introduced by the HM Revenue and Customs from 6th April 2006 (A-day).

Background

The LTA is a control to limit an individual's total tax relief on contributions and fund build-up in registered pension schemes. From April 2006 the maximum amount payable which will be treated as tax-privileged will be £1.5 million and this amount will rise to £1.8 million by 2010. The value of the LTA is based on a valuation factor of 20:1, in other words, £20 for each £1 of pension.

If the lifetime allowance is exceeded a "recovery charge" by way of a tax deduction would apply on the excess. The recovery charge would be 25% on benefits paid as a pension and 55% on lump sums. For example, a firefighter's pension entitlement of £20,000 before commutation would be valued at £400,000 for LTA purposes. This is within the LTA limit and would not, therefore, incur the recovery charge. It can be seen, therefore, that comparitively few scheme members are likely to be affected by the LTA. For illustrative purposes it follows that to avoid the risk of exceeding the LTA and incurring a future recovery charge, pension entitlement (before commutation) should not exceed £75,000 at A-day for the year 2006/7.

The LTA and a new Annual Allowance (the maximum annual amount after which any increase in benefits will give rise to a tax charge) will replace the current "earnings cap". The cap applies to people who joined the pension scheme on or after 1 June 1989 (and also to those who joined earlier but who have had a break in membership after that date) and sets the maximum annual level of earnings that may count towards calculation of pension scheme benefits or limits, normally indexed by price movement. It is set at £105,600 for 2005/6. The removal of the cap may result in an increase in pension awards to higher earners which may, in turn, increase the likelihood of the LTA being exceeded.

Consideration is currently being given to whether the current scheme and the new pension scheme should retain a cap on benefits and ODPM will bring forward proposals on how to proceed.

Guidance

There will be two methods of protection against the recovery charge for those with existing pension funds at A-day. The first is called **"Primary Protection"**. Where the value of a person's pension rights at A-day is greater than £1.5 million the excess, expressed as a percentage, can be registered and will be carried forward to subsequent years and continue to be exempt from the recovery charge. For example, if the value of pension rights at A-day is £1.95 million then this will be 130% of the initial LTA. When the person then comes to retire, the recovery charge will only have to be paid on any excess over 130% of the LTA applying at the time. For example, if retirement is in tax year 2010/11 when the LTA is £1.8 million, the value of the pension rights will be tested against 130% of £1.8 million i.e., £2.34 million. If pension rights at A-day did not exceed £1.5 million or if primary protection was not registered, the recovery charge would apply to any excess over the £1.8 million.

The second method is **"Enhanced Protection"**. If the pension scheme rules allow it, a person can register for enhanced protection and their ultimate fund, however much it is, will not be subject to the recovery charge. However, they must cease active membership of their pension scheme and no further benefits can be accrued although it will be possible for benefits to remain linked to final salary. Enhanced protection is available even if the value of the fund is below the LTA at A-day and may be relevant if it is considered that salary increases will outpace increases in the LTA. However, those opting for enhanced protection and leaving the scheme will become deferred members and would not be able to draw benefits until deferred retirement age (currently age 60 in the FPS).

Scheme members have until 5 April 2009 to register for these protections but benefits accrual must stop by 6 April 2006 if a person wishes to have enhanced protection.

Conclusion

The Committee is invited to note.

ODPM
April 2005