YOUR GUIDE TO DEFINED BENEFITS

FROM THE EXPERTS OF TECHTALK

SCOTTISH WIDOWS

AN INTRODUCTION TO DEFINED BENEFIT SCHEMES

Chris Jones

The 2015 pension freedom and choice reforms have led to an increase in transfers from defined benefit to defined contribution schemes to access those freedoms. Here we provide a reminder of the basics of defined benefit schemes and how they differ from defined contributions schemes.

Outside of the public sector the option to join a defined benefit scheme is now very rare. However, there are of course many members in existing schemes either continuing to accrue benefits or with deferred benefits. For many clients with accrued defined benefits, this will be one of their most valuable assets, however, due to their opaque nature, few will have an understanding of their true value.

WHAT ARE THEY?

Defined benefit schemes were the traditional form of employer pension scheme. Essentially they are a promise to pay the member a pension for life, the level of which will be determined by an employee's length of service and level of earnings. The amount was often based on the earnings at the end of employment, hence the name final salary.

Each scheme will have its own rules which will set out the basis of accrual and benefits.

A typical scheme would aim to offer a pension of 2/3rds of their final remuneration based on working for the same company for the whole of their working lives, usually assumed to be 40 years.

For example they would accrue 1/60th of their final salary for each year of work. Therefore with 40 years of service this would accrue 40/60ths of their final salary ie 2/3rds.

The benefit for the member is therefore a level of certainty. The other key aspect and key benefit is that the initial pension payable will be indexed and paid out for the rest of the member's life. With defined benefit schemes the employer takes all of the investment risk.

There are wide variations in the level of accrual and therefore the value of defined benefit schemes. Some schemes have less generous accrual, for example 1/120th for each year of service, and some schemes often offered executives more generous accrual for example 1/30th for each year of service.

Example

Bob worked for Steel is Real Cycles for 36 years. When he retired his salary was £28,000. He was in a 1/60th scheme.

When Bob retires his initial scheme pension will be

36/60 X £28,000 = £16,800.

Barbara retired as an executive from Titanium Rules Cycles. Her scheme offered a generous 1/30th accrual rate.

She worked for 15 years with a final salary of £60,000.

Barbara's initial scheme pension will be

15/30 X £60,000 = £30,000.

The definition of 'final salary' or final remuneration will also make a significant difference to the value of benefits with some schemes offering career averages and some basing it on the highest salary paid. Some will only be based on basic salary, others may include other benefits such as an average of recent bonuses.

There are also wide variations in the level of member contributions required - some schemes are still entirely non-contributory whereas some of the public sector schemes require member contributions of up to 14.5% of salary a year.

This all means that whilst a defined benefit scheme can be an extremely valuable benefit there are huge variations in the value of these benefits for individuals. In addition, as the benefits are essentially a promise, clients need to consider the scheme's ability to be able to fulfil that promise, particularly with many schemes currently in deficit.

The 'promise' aspect and the certainty of benefits assuming the promise is kept, contrasts significantly with a defined contribution scheme. Defined contributions are used to buy units in funds and create a transparent and direct relationship between pension contributions and fund performance and the monetary value of benefits. The significant downside is of course that with these schemes the individual member takes all the investment risk.

TAX FREE CASH

Under defined benefit schemes the calculation and accrual of tax free cash also differs considerably from defined contribution schemes. In most cases defined contribution tax free cash calculations are straightforward - it is simply 25% of the accumulated fund, though there are of course exceptions such as where clients have tax free cash protection.

With defined benefit schemes the member's tax free cash entitlement is calculated based on the scheme's own rules. An added complication is that whilst some schemes, mainly public sector schemes give members separate entitlements to tax free cash, most offer tax free cash by commutation. Commutation involves giving up an amount of accrued pension income in exchange for tax free cash.

SCHEME PENSION AND SEPARATE LUMP SUM

Example

Brian is a member of a public sector scheme. He is entitled to an index linked pension of 1/80th x final remuneration for each year of service plus a tax free lump sum of 3/80ths of final remuneration for each year of service.

He retires after 20 years of service with a final remuneration of £60,000.

He is entitled to an annual indexed linked scheme pension of 20/80 X £60,000 = £15,000 +

A lump sum of 60/80 X £60,000 = £45,000.

LUMP SUM BY COMMUTATION

This option is far more common in private sector schemes. The pension benefit builds up in the normal way but members have the option to commute part of their pension fund for a tax free lump sum. As with pension benefits, the commutation factor will vary from scheme to scheme. For example, a 15:1 commutation factor will mean a £1 reduction in pension for every £15 of tax free cash.

Example

Brenda has built up a scheme pension entitlement of 25/60ths of her final remuneration of £36,000. This could provide her with an indexed linked pension of £15,000 a year. Her scheme has a 12:1 commutation factor. She takes the option of receiving £36,000 tax free lump sum in exchange for a £3,000 a year reduction in pension (12 X £3,000 = £36,000).

In both cases the scheme must check the member's entitlement against HMRC maximums. The basic formula for checking the maximum tax free lump sum amount is (lump sum + 20 X the scheme pension in the first 12 months)/4.

Example

So for Brian above this would be

(£45,000 + £300,000)/4 = £86,250. As this is greater than the £45,000 it is well within the limits.

For Brenda this would be

£36,000 + £240,000/4 = £69,000. Again well within the limits.

This formula acts as a check after the tax free cash is known. There is an alternative formula that can be used where the client wants to determine the maximum tax free cash available based on the scheme's commutation factor.

ANNUAL ALLOWANCE

For annual allowance purposes the amount of pension savings in the tax year will be the increase in the value of the promised benefits over the pension input period. Now that pension input periods are all aligned to tax years this is relatively easier, however the calculation is still fairly complex and must follow the prescribed HMRC formula.

In simple terms it is the increase in value of the benefits over inflation multiplied by a fixed factor of 16 which is set by HMRC. This means the current rate of inflation will have a big influence on how much accrual there is in the scheme from year to year. It also means that a sudden spike in earnings, for example due to a promotion can lead to an extremely large pension input in that year. This was one of the key reasons for the introduction of carry forward when the annual allowance reduced significantly in 2011/2012.

Full details of the calculation are beyond the scope of this introductory article but some simple examples can help explain how the input works.

Example

Douglas is in a 1/60th scheme. At the start of the input period he has 10 years accrual and his remuneration is £24,000. At the end of the input period he has 11 years accrual and his earnings are £25,000. CPI is 2%.

Opening value
10/60 X £24,000 = £4,000
Multiplied by 16 = £64,000
Increased by CPI = £65,280

Closing value
11/60 X £25,000 = £4,583.33
Multiplied by 16 = £73,333.33

Input for annual allowance purposes is closing value minus opening value = £73,333.33 – £65,280 = £8,053.33

Deborah is also in a 1/60th scheme. At the start of the year she has 28 years service and earned £40,000. Shortly after she receives a promotion. At the end of the year she has 29 years service and her pensionable pay for the period is £45,000.

Opening value
28/60 X £40,000 = £18,666.67
Multiplied by 16 = £298,666.67
increase by CPI = £304,640

Closing value
29/60 x £45,000 = £21,750
Multiplied by 16 = £348,000

Opening value minus closing value = £348,000 - £304,640 = £43,360. As this exceeds the annual allowance if Deborah has no carry forward allowance from the three previous years she would face an annual allowance charge.

As the example demonstrates, an annual allowance charge can occur even with a relatively modest increase in salary. It also means that members have little control over their pension inputs

This contrasts with defined contributions where the pension input is simply the total of the contributions paid into the scheme during the input period, making it far easier to control. The tapered annual allowance makes it more complex for high earners in all schemes but more so for defined benefit members where they often won't know the full value of their input until after the end of the input period.

LIFETIME ALLOWANCE

Whenever benefits are taken they are subject to the Lifetime Allowance (LTA) test. The value for LTA purposes is based on the benefits actually received ie after any commutation for tax free cash or any early retirement factors. The value for LTA purposes is then calculated as 20 times (unless the scheme has agreed with HMRC to use a higher figure) the first year's annual pension plus any tax free cash.

> Example
>
> Albert retires at age 65. He will receive a pension income in the first year of £18,000 plus a lump sum of £75,000. For LTA purposes the value is
>
> £18,000 x 20 + £75,000 = £435,000

As the calculation is only based on the first year's pension any future increases in the pension payment through annual increments are not tested.

The relatively generous valuation factor of 20 means that the value for LTA purposes is often currently considerably less than the cash equivalent transfer value for many members where valuations can be around 30 times the accrued benefits for good quality schemes.

DEATH BENEFITS

Death benefits under a defined benefit scheme are usually offered as a death in service lump sum payment and a dependant's scheme pension. The lump sum is usually expressed as a multiple of salary, typically four times salary but as with other benefits there will be wide variations from scheme to scheme. As the name implies this benefit is usually only payable while the member is still working.

The dependant's scheme pension is only payable to a specific set of dependants. These will be limited by the legislative definition of dependants but the scheme's rules will often have much narrower limits for example only making payments to a spouse or civil partner.

As with member's pension benefits the level of dependant's scheme pension will vary from scheme to scheme. A typical scheme may offer half the benefits that would have been payable to the member. More generous schemes may offer 2/3rds.

A dependant's scheme pension will end on the death of the dependant at the latest but can sometimes end earlier than this, for example if the recipient remarries.

The inflexible nature of death benefits under a defined benefit scheme contrasts significantly with the new pension freedoms available to defined contribution schemes. Defined contributions members can nominate anyone to receive benefits. The benefit will be equivalent to the full value of the accumulated fund and where benefits are kept in beneficiary's drawdown any remaining benefit can be passed down through the generations. This flexibility means that defined contribution schemes provide the option to use pension funds as a useful estate planning tool.

REVIEWING BENEFITS

As I have highlighted above, not all defined benefit schemes are equal. Their value varies widely depending on the accrual rates, the definition of salary, the tax free cash commutation factors and the level of member contribution. When reviewing the value, the starting point will always be to check exactly what benefits are provided.

The cash equivalent transfer value of the benefits will provide the current monetary value of benefits. However, this is only one aspect that needs to be considered. The importance to the client of the certainty of benefits and the value of any beneficiary's pension will also be relevant.

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DEFINED BENEFIT TRANSFERS AND THE LIFETIME ALLOWANCE

Chris Jones

Current cash equivalent transfer values, coupled with lifetime allowance restrictions, mean the lifetime allowance charge adds a further complication to many defined benefit transfer decisions. Can pension freedoms help?

Cash equivalent transfer values for many defined benefit (DB) scheme members are historically high. This adds to the temptation to consider a transfer to access the pension freedoms available within defined contribution (DC) schemes since April 2015. However, the way the different types of schemes are treated for lifetime allowance (LTA) purposes varies significantly and can lead to unexpected tax charges.

With DB schemes, benefits are normally valued at a fixed factor of 20 times the first year's annual pension at the time the benefits are taken, plus any tax free cash. (It's technically possible for the scheme administrators to agree a higher figure than 20 with HMRC.) There is only one LTA test and usually no further test for any annual increases in payments.

Example

Alex takes benefits from his DB scheme. His annual pension in year one will be £25,000 and he'll receive a tax free lump sum of £100,000. The value of the benefits for LTA purposes is:

£25,000 X 20 + £100,000 = £600,000.

This uses up 58.25% of the £1.03m LTA (2018/2019)

For LTA purposes, DC schemes are tested at the monetary value of the fund crystallised. Where benefits are moved into drawdown they also face a second test on annuity purchase or at age 75, whichever is sooner. This tests any growth since the first crystallisation.

CASE STUDY

In January 2018 Denise is aged 55 with 30 years' service in a 60th DB scheme. Her salary is £80,000. She hopes to retire in five years' time. She is considering transferring her benefits to a DC scheme and has been offered a transfer value of £1,200,000.

Currently within the DB scheme her accrued pension is 30/60 X £80,000 = £40,000.

So the value for LTA purposes is £40,000 X 20 = £800,000.

This is well within the 2018/19 LTA. Even if Denise remains in the scheme until her planned retirement date she should still be within the LTA. She may also have scope to reduce this amount if she commutes some of her pension for tax free cash.

If she transfers to a DC scheme Denise may have an immediate LTA problem. The transfer value of £1,200,000 exceeds the 2018/19 LTA by £170,000. If she were to take all her benefits immediately, the excess would be subject to a LTA charge of 55% if taken as a lump sum or 25% if used to provide an income.

In addition, further funding will also be subject to a LTA charge. So further personal contributions are unlikely to be beneficial. Employers may be willing to offer an alternative to pension contributions but many will not. Employer contributions may also be conditional on her making personal contributions. All these factors need to be weighed up in the transfer decision.

CAN TRANSITIONAL PROTECTION HELP?

Unfortunately in this situation neither Individual Protection or Fixed Protection will be able to help Denise. As she's currently still an active member of the DB scheme she will have received benefit accrual since April 2016. This means she is not eligible to apply for Fixed Protection 2016. For Individual Protection 2016 purposes her benefits must be valued as at 5th April 2016 and this must be on the DB valuation basis. This means although the value of benefits post transfer is well in excess of £1m, it will be less than £1m as at 5th April 2016 and she won't be eligible to apply for Individual Protection 2016.

CAN PENSION FREEDOMS HELP?

One of the key reasons for considering a DB to DC transfer will be to access the fully flexible retirement options the DC regime offers. The full flexibility of the DC regime provides some scope to limit or delay the amount of LTA charge in addition to other planning opportunities.

Denise could, for example, crystallise some of the funds immediately and move into drawdown. This can limit the growth of the fund for LTA purposes as long as enough income is withdrawn to avoid a further charge at age 75 or earlier annuity purchase. As there are no limits on the amount of income that can be withdrawn it is possible to fully control the value at the point of the second LTA test. Of course any income taken will be subject to income tax. However, if she plans to take the funds at some point, income tax on withdrawals will normally be favourable compared to income tax plus the 25% LTA charge or the flat 55% charge.

Another possible option is that she could crystallise up to the LTA at age 60. This would avoid an LTA charge until age 75 on the excess.

Yet another possible alternative would be to just take what she needs at age 60 each year in the hope that the LTA will increase faster than the funds grow or possibly even be removed altogether.

If Denise has no need for the funds in excess of the LTA then she can consider leaving this inside the pension regime. Although she will have to pay the LTA charge of 25% at age 75, the funds will remain outside of her estate. If she dies post age 75 the ultimate beneficiaries will have to pay income tax on the benefits but this may be preferable to her paying income tax on the income and inheritance tax on any funds that remain in her estate.

Denise could also make use of the small pots regime to take up to £30,000 without these being tested for LTA purposes.

The flexibility of the DC regime offers many options but the markedly different valuations of pension benefits for LTA purposes adds yet another layer of complexity to the transfer decision.

TAX FREE CASH DIFFERENCES: DEFINED CONTRIBUTION VS DEFINED BENEFIT SCHEMES

Bernadette Lewis

The tax free cash lump sum survives, despite continuing rumours of its demise. Some aspects of this much loved benefit cause ongoing confusion, such as the differences in tax free cash entitlements in defined contribution and defined benefit schemes.

There's ongoing interest in transferring benefits out of defined benefit (DB) schemes and into defined contribution (DC) schemes to take advantage of the Pension Freedom reforms. This leads to a greater focus on understanding the practical differences between these types of pension provision.

As tax free cash is a key benefit in both types, we provide a reminder of the key differences when calculating member's entitlements in DC and DB schemes. This article clarifies the essentials and doesn't cover more complex situations.

DEFINED CONTRIBUTION SCHEMES

While the rule of thumb is that tax free cash (strictly speaking, a pension commencement lump sum) is 25% of a member's money purchase pension pot, it's actually the lower of the applicable amount and the available portion.

- The applicable amount is 25% of the total amount being crystallised, taking into account the tax free cash plus the amount designated for drawdown or used to buy an annuity / scheme pension.
- The available portion is 25% of the member's remaining available lifetime allowance (LTA).
- In 2017/2018, tax free cash is therefore normally capped at the lower of 25% of the crystallised money purchase pot and £257,500 (25% of the standard £1.03 million LTA).

This usually makes calculating tax free cash for a DC arrangement straightforward. The same approach applies whether the member is designating their remaining funds for flexi-access drawdown (FAD), or any type of annuity or scheme pension. It doesn't matter whether they have any type of personal pension, or a DC occupational pension scheme (OPS).

Example: personal pension

Sami has a personal pension valued at £190,000 which he designates for FAD in May 2016, when the LTA is £1 million. He had previously crystallised a £45,000 personal pension when the LTA was £1.5 million, using up 3% of the LTA. He has no LTA protection. Sami can:

- take maximum tax free cash of £47,500
- designate the balance of £142,500 for flexi-access drawdown.

His tax free cash is within both HMRC limits. The applicable amount is 25% of £190,000 = £47,500. As his remaining available LTA is 97% of £1 million, the available portion is 25% x £970,000 = £242,500.

However, if Sami had previously used up 83% of the LTA, his remaining available LTA would be 17% of £1 million, or £170,000. If he crystallised the whole fund, £20,000 would be subject to the LTA charge which is 55% on lump sums and 25% on amounts designated for income. In addition, he'd only be able to take 25% of £170,000 or £42,500 as tax free cash. So he'd be caught by the available portion cap. Therefore, if he still wanted net cash of £47,500, he'd have to:

- take maximum tax free cash of £42,500
- take a taxable lump sum of £11,111 less a 55% LTA charge of £6,111 giving £5,000 net
- designate the £136,389 balance of his fund for FAD less a 25% LTA charge on £8,889 of £2,222, leaving a balance in FAD of £134,167
- so that the total excess of £11,111 + £8,889 = £20,000 has been subject to the LTA charge.

Even in DC schemes, there can be complications when calculating some members' maximum tax free cash. Most of the underlying issues are beyond the scope of this article, but there's a brief look at GMP later. The main complicating factors are as follows:

- Fixed and individual protection. The available portion is based on the greater of the protected and standard LTAs.
- A disqualifying pension credit. That is, a pension credit received as part of a divorce settlement from the pension debit member's previously crystallised funds. The pension credit member cannot take any tax free cash when they crystallise this part of their pension provision.
- Scheme level protected tax free cash, where a member was entitled to tax free cash of more than 25% as at A-day (6 April 2006) and still retains that right, possibly after one or more transfers.
- Enhanced or primary protection, with or without lump sum protection.
- A guaranteed minimum pension (GMP) entitlement in a section 32 plan or a DC OPS with a GMP underpin.

DEFINED BENEFIT SCHEMES

A DB scheme calculates a member's tax free cash entitlement according to its own rules, taking account of any GMP if calculating tax free cash payable by commutation. The scheme then checks the entitlement against HMRC's applicable amount and available portion limits. To do so, the scheme has to convert the annual pension into a lump sum equivalent. So for DB schemes, the 25% applicable amount is normally calculated using the formula:

- (LS + AC) / 4
- LS = the amount of the lump sum actually being paid
- AC = 20 x the scheme pension payable in the first 12 months (although HMRC may exceptionally agree to schemes using a factor higher than 20)
- HMRC also permits schemes to use an alternative formula where relevant, as shown in the examples below.

As in DC schemes, there can be complications for members with:

- fixed or individual protection
- disqualifying pension credits
- scheme level protected tax free cash
- enhanced or primary protection with or without lump sum protection
- a GMP entitlement.

There's no simple rule of thumb method and it's always necessary to check with the scheme to establish a member's tax free cash entitlement. To aid understanding, the following simplified examples indicate the effects of some possible DB scheme approaches, ignoring any GMP.

ENTITLEMENT TO SCHEME PENSION PLUS LUMP SUM

Some pension schemes, typically in the public sector, give members separate entitlements to a scheme pension and tax free cash.

Example: separate lump sum

Yotam retires in May 2016 at his DB scheme's normal retirement age of 60 with exactly 24 years service. His final remuneration as defined in the scheme rules is £32,000. The standard LTA is £1 million and he has no LTA protection. Yotam had previously crystallised a personal pension with a value of £45,000 when the LTA was £1.5 million, using up 3% of the LTA.

Under the scheme rules, Yotam is entitled to:

- an index-linked pension calculated as N / 80 x final remuneration (with dependant's provision) plus
- a separate tax free lump sum calculated as (3N / 80) x final remuneration
- where N = length of pensionable service, capped at 40 years.

Therefore:

- lump sum of (3 x 24 / 80) x £32,000 = £28,800 plus
- initial scheme pension of (24 / 80) x £32,000 = £9,600.

LS = £28,800 and AC = 20 x £9,600 = £192,000. (LS + AC) / 4 = (£28,800 + £192,000) / 4 = £55,200. Therefore, his £28,800 lump sum entitlement is within the 25% of crystallised benefits applicable amount of £55,200. As his remaining available LTA is 97% of £1 million, the available portion is 25% x £970,000 = £242,500. Therefore his £28,800 lump sum is within the available portion.

Yotam's tax free cash is actually well within both HMRC limits, but remains £28,800 as this is the maximum amount calculated in accordance with the scheme rules.

ENTITLEMENT TO SCHEME PENSION WITH LUMP SUM BY COMMUTATION

Outside the public sector, it's more common for tax free cash to be available by commutation. A member primarily builds up an entitlement to a scheme pension, but can commute part of it for tax free cash. The extent to which taking tax free cash reduces their pension depends on the scheme's commutation factor. For example, a 12:1 commutation factor reduces the initial scheme pension by £1 for every £12 of tax free cash, while a more generous 15:1 basis reduces the initial pension by £1 for every £15 of tax free cash.

In some cases, the scheme rules for calculating the member's pension and tax free cash entitlements will be similar to those for schemes where members build up separate benefits. If so, checking whether the amount of tax free cash allowed by the scheme rules falls within the (LS + AC) / 4 test for the applicable amount is still straightforward.

Example: tax free cash on a 3N / 80 basis, 12:1 commutation

Nigel's personal circumstances are the same as Yotam's. However, under his DB scheme's rules, Nigel is entitled to:

- an LPI linked pension plus dependants' provision calculated initially as N / 60 x final remuneration
- a tax free lump sum calculated as (3N / 80) x final remuneration, available by commutation on a 12:1 basis.

Therefore:

- either an initial scheme pension of 24 / 60 x £32,000 = £12,800
- or a lump sum of (3 x 24 / 80) x £32,000 = £28,800 with an initial pension reduced by £28,800 / 12 = £2,400 to £10,400.

If Nigel takes the lump sum, LS = £28,800 and AC = £10,400 x 20 = £208,000. (LS + AC) / 4 = (£28,800 + £208,000) / 4 = £59,200. Therefore, his maximum £28,800 lump sum entitlement under the scheme rules is within the 25% of crystallised benefits applicable amount. It's also within the available portion of the LTA: as before 25% x £970,000 = £242,500, given that his personal circumstances are the same as Yotam's.

Example: tax free cash on a 3N / 80 basis, 15:1 commutation

Claudia's personal circumstances are the same as in the previous examples. Commutation is more generous under her DB scheme's rules, and she's entitled to:

- an LPI linked pension plus dependants' provision calculated initially as N / 60 x final remuneration
- a tax free lump sum calculated as (3N / 80) x final remuneration, available by commutation on a 15:1 basis.

Therefore:

- either an initial scheme pension of 24 / 60 x £32,000 = £12,800
- or a lump sum of (3 x 24 / 80) x £32,000 = £28,800 with an initial pension reduced by £28,800 / 15 = £1,920 to £10,880.

If Claudia takes the lump sum, LS = £28,800 and AC = £10,880 x 20 = £217,600. (LS + AC) / 4 = (£28,800 + £217,600) / 4 = £61,600. Again her £28,800 maximum lump sum entitlement is within the 25% of crystallised benefits applicable amount. It's also within the available portion of the LTA: as before 25% x £970,000 = £242,500.

However, it's also common for scheme rules to state that the tax free lump sum entitlement available by commutation is the maximum permitted by HMRC rules. In this case, HMRC allows schemes to use the following formula to calculate the maximum tax free cash, even if with rounding it gives a slightly different result to (LS + AC) / 4:

- (20 x F x G) / (20 + [3 x F])
- F = commutation factor
- G = gross scheme pension before commutation.

Example: tax free cash on HMRC maximum basis, 12:1 commutation

Sarit's personal circumstances are the same as in the previous examples. But under her DB scheme's rules she's entitled to:

- an LPI linked pension plus dependants' provision calculated initially as N / 60 x final remuneration
- tax free cash up to the HMRC permitted maximum, available by commutation on a 12:1 basis.

Under HMRC's alternative formula, F= 12 and G = £12,800 so the maximum tax free cash is calculated as: (20 x 12 x £12,800) / (20 + [3 x 12]) = £3,072,000 / 56 = £54,857

Therefore:

- either an initial scheme pension of 24 / 60 x £32,000 = £12,800 (G in the above formula)
- or a lump sum of £54,857 plus an initial pension reduced by £54,857 / 12 = £4,571 to £8,229.

If Sarit takes the lump sum, LS = £54,857 and AC = £8,229 x 20 = £164,580. (LS + AC) / 4 = (£54,857 + £164,580) / 4 = £54,859. So her tax free cash is within the applicable amount as calculated in the normal way. The sum is within the available portion of the LTA: as before 25% x £970,000 = £242,500.

Example: tax free cash on HMRC maximum basis, 15:1 commutation

Itamar's personal circumstances are the same. But under his DB scheme's rules there's a more generous commutation factor, so he's entitled to:

- an LPI linked pension plus dependants' provision calculated initially as N / 60 x final remuneration
- tax free cash up to the HMRC permitted maximum, available by commutation on a 15:1 basis.

Under HMRC's alternative formula, F= 15 and G = £12,800 so the maximum tax free cash is calculated as: (20 x 15 x £12,800) / (20 + [3 x 15]) = £3,840,000 / 65 = £59,077.

Therefore:

- either an initial scheme pension of 24 / 60 x £32,000 = £12,800 (G in the above formula)
- or a lump sum of £59,077 plus an initial pension reduced by £59,077 / 15 = £3,938 to £8,862.

If Itamar takes the lump sum, LS = £59,077 and AC = £8,862 x 20 = £177,240. (LS + AC) / 4 = (£59,077 + £177,240) / 4 = £59,079. So his tax free cash is also within the applicable amount as calculated in the normal way. The sum is within the available portion of the LTA: as before 25% x £970,000 = £242,500.

GMP RESTRICTIONS

A member's GMP benefits relate to contracting out of the state earnings related pension scheme (SERPS) in an OPS on a salary related (COSR) basis between 6 April 1978 and 5 April 1997. SERPS tops up the basic state pension for contracted in individuals who reached state pension age before the new state pension was introduced on 6 April 2016.

In simplified terms, ignoring GMP equalisation issues:

- Under contracting out, employers and employees paid lower rates of national insurance contributions.
- The contracted out members gave up SERPS entitlement.
- The scheme became liable for providing them with GMP benefits from age 60 for women and 65 for men including specified dependant's benefits on the member's death.

Which types of pension are affected?

- DB OPSs usually include GMP benefits.
- Many section 32 plans include transferred-in GMPs.
- Some DC OPSs were contracted out on a COSR basis, giving their members a GMP underpin to their money purchase benefits.

The GMP entitlement is paid as part of the normal pension benefits from a DB OPS, not as an additional amount. The GMP entitlement is usually much less than the actual pension entitlement built up in the ordinary way under the scheme rules. However, members are not permitted to commute any GMP for tax free cash. Complex rules on GMP increases can also cause tax free cash and other restrictions for members taking benefits before age 60 for women and 65 for men. The following example aims to demonstrate in simplified terms how GMP might restrict tax free cash.

Example: tax free cash restricted by GMP

Diana's personal circumstances are the same as in the earlier examples, so she's taking benefits at age 60. Her DB scheme's rules are the same as Sarit's so she's potentially entitled to:

- an LPI linked pension plus dependants' provision calculated initially as N / 60 x final remuneration
- tax free cash up to the HMRC permitted maximum, available by commutation on a 12:1 basis
- but she also has a GMP entitlement at age 60 of £9,500 a year.

The scheme rules and HMRC's alternative formula appear to give Diana the same options as Sarit, who can take tax free cash of £54,857 plus a reduced pension of £8,229. However, Diana isn't permitted to commute her initial pension below her £9,500 GMP entitlement to provide tax free cash. So her options are:

- either an initial scheme pension of 24 / 60 x £32,000 = £12,800
- or a lump sum of £39,600 plus an initial pension reduced by £39,600 / 12 = £3,300 to £9,500.

If Diana takes the lump sum, LS = £39,600 and AC = £9,500 x 20 = £190,000. (LS + AC) / 4 = (£39,600 + £190,000) / 4 = £57,400. So her restricted £39,600 lump sum entitlement is within the 25% of crystallised benefits applicable amount. It's also within the available portion of the LTA: as before 25% x £970,000 = £242,500.

TAKING TAX FREE CASH FROM AN AVC ARRANGEMENT

There may be planning opportunities for DB scheme members who've made additional voluntary contributions (AVCs) on a DC basis. Where an OPS is made up of a main DB arrangement alongside a DC AVC arrangement, HMRC permits the scheme to calculate the member's overall tax free cash entitlement at scheme level. If so, the member may be able to use their AVC pot to fund part or all of their tax free cash, reducing the extent to which they need to commute their scheme pension entitlement. This can be financially advantageous if the commutation factor isn't generous. Be aware that schemes aren't required to offer this option.

DEATH BENEFIT DIFFERENCES: DEFINED BENEFITS VS MONEY PURCHASE SCHEMES

Bernadette Lewis

This article summarises the key differences in death benefits between defined benefits and money purchase pensions following the Pension Freedom reforms.

The death benefit differences may prompt some individuals to consider transferring out of a defined benefits (DB) scheme into a money purchase (MP) scheme. However, this is only one factor to be considered. Importantly, it remains the view of the Financial Conduct Authority that the starting point when assessing the suitability of a pension transfer is that it will not be suitable, unless it can be shown to be in the client's best interests.

SUMMARY OF KEY DIFFERENCES	
DEFINED BENEFIT SCHEMES	MONEY PURCHASE SCHEMES
Permissible benefits on member's death	
• Lump sum (includes refund of contributions on death where relevant). • Dependant's scheme pension.	• Lump sum. • Dependant or nominee flexi access drawdown (FAD). • Annuity.
Passing pension funds down the generations	
• Not possible. Any dependant's scheme pension must end on dependant's death at the latest.	• Can use any funds still in FAD on dependant/nominee's death for successor FAD or pay out as lump sum. • Same applies if any funds remain in FAD on a successor's death. • Beneficiary FAD is ignored for the purposes of the recipient's lifetime allowance (LTA) and pension funding.
Income tax treatment for recipient of death benefits	
• If member dies below age 75: lump sum income tax free. • If member dies age 75+: lump sum taxed at recipient's own rate of income tax. (For 2015/2016 only, taxed at 45%.) • Dependant's scheme pension: recipient always pays income tax at own rate.	• If member/beneficiary dies before age 75: all forms of death benefit income tax free. • If member/beneficiary dies age 75+: recipient pays income tax at own rate on all forms of death benefit. (For 2015/2016 only, lump sums taxed at 45%.)
IHT treatment of death benefits	
• Lump sum death benefits normally outside member's inheritance tax (IHT) estate, provided scheme trustees/ administrators have discretion over payment. • Dependant's scheme pensions normally outside member's IHT estate.	• Death benefits normally outside members' IHT estate, provided scheme trustees/administrators have discretion over payment. • Potentially in member's IHT estate if dies within two years of transferring benefits and in ill health at time of transfer.
LTA test when member takes own benefits	
• Based on 20 x member's initial scheme pension after commutation (if relevant) plus any tax free cash. (Effectively ignores the value of any death benefit provision.)	• Based on value of crystallised funds, whether designated for tax free cash, FAD, annuity.
LTA test on death benefits	
• LTA test on lump sum if member dies under age 75. • No LTA test on lump sum if member dies age 75+. • No LTA test for dependant's scheme pension.	• LTA test on any uncrystallised funds if member dies under age 75. • No LTA test on any crystallised funds if member dies under age 75 or on any remaining funds if member dies age 75+.
LTA charge where applicable	
• 55% LTA charge on part of lump sum in excess of available LTA.	• 55% LTA charge on excess over available LTA if paid as lump sum. • 25% LTA charge on excess over LTA if designated for FAD. (Beneficiary FAD income paid tax free.)

DEFINED BENEFIT OPS DEATH BENEFITS IN MORE DETAIL

Each scheme's rules will specify who's treated as a dependant, within the following permissible categories (this also applies to who can receive dependant's FAD):

- the member's spouse or civil partner
- the member's child while under age 23
- the member's child over age 23 provided they are dependant on the member because of physical or mental impairment
- anyone else who was financially dependant on the member
- anyone else who was financially interdependent with the member (eg cohabitees)
- anyone else who was dependant on the member because of physical or mental impairment.

A dependant's scheme pension must cease on the dependant's death at the latest. If the scheme rules allow, it could stop or reduce sooner than this. For example, some schemes stop paying a dependant's pension if the recipient remarries or starts cohabitating

Since the July 2017 Supreme Court ruling in the case of Walker v Innospec, all schemes must offer fully equalised provision for same sex couples. Previously, some schemes restricted dependant's pensions for same sex couples to a percentage of the member's accrual from 5 December 2005.

Death benefits under each scheme will depend on the scheme rules. The rules often limit the payment of dependant's benefits to narrower groups than permitted by the legislation. So, for example, the scheme rules might mean that no dependant's pension is payable to a surviving cohabitee on the member's death, even though the legislation permits this.

MONEY PURCHASE SCHEMES AND PASSING MONEY DOWN THE GENERATIONS

Uncrystallised funds and any remaining drawdown/FAD funds on the member's death can be used to provide lump sum death benefits and beneficiary FAD. Remaining funds can also be used to provide beneficiary annuities if wanted.

Beneficiary FAD can be established on the member's death:

- for any dependant of the member
- for anyone nominated by the member even if they are not a dependant
- for anyone nominated by the scheme, but only if there are no dependants and no-one nominated by the member.

If the member dies before age 75, the recipients don't pay income tax on any form of death benefits, including lump sums, beneficiary FAD or beneficiary annuities. This is why an LTA test applies to uncrystallised funds on the member's death under age 75.

If the member dies age 75+, the recipient pays income tax at their own marginal rate on any death benefits. From 2016/2017, this applies to all forms of benefit. For 2015/2016 only, lump sums were taxed at 45%.

If the provider establishes beneficiary FAD on the member's death, any remaining funds following this initial recipient's death can be paid as a lump sum. Or the original beneficiary can nominate a successor to receive successor FAD so the funds stay invested in a pension environment. This can happen any number of times. The tax treatment for the new recipient depends on the age at death of the previous recipient. If they died under age 75, the next in line receives the benefits tax free, but the benefits are taxable if the previous recipient died age 75+.

Any funds held in beneficiary FAD are ignored when it comes to the recipient's own LTA testing. And withdrawals from beneficiary FAD don't affect the recipient's annual allowance.

IHT WARNING – TRANSFERS FOR MEMBERS IN ILL HEALTH

There's a potential IHT trap for members who are considering transferring their death benefits out of a DB scheme because they're in ill health, particularly if they have a terminal illness.

Pension scheme death benefits are normally outside the member's IHT estate, provided the scheme trustees/administrators have discretion over who it's paid to or the form of payment. This means that normally no IHT is payable in respect of the death benefits, no matter how large the amount.

However, HMRC argues in its inheritance tax manual section IHTM17072 that if a member transfers their benefits, the value of the death benefits is in their IHT estate if they die within two years. If they were in good health at the time of the transfer, the value of the death benefits is normally negligible so this has no real effect. However, if they were in ill health at the time of the transfer, HMRC determines the value of the resulting loss to their estate. This could cause a substantial death benefits lump sum to be subject to IHT.

The October 2018 Appeal Court ruling in the Staveley case, relating to the IHT treatment of death benefits following a pension transfer, went in HMRC's favour. This overturned previous tax tribunal rulings in this case. It's now more likely that HMRC will seek to charge IHT when terminally ill members transfer their pension benefits and die within two years.

HMRC form IHT 400 is used to calculate IHT on death. The IHT 400 notes confirm that HMRC will ask the deceased member's legal personal representatives to provide evidence of the member's state of health and life expectancy at the time of the transfer if they die within two years.

THE INSURANCE OPTION

In some cases, a client's primary motivation for considering a DB to DC transfer is to improve their death benefits. Transfer values of 30 times the annual pension are not uncommon. And as indicated earlier, the Pension Freedom reforms offer the opportunity to pass these substantial funds down the generations in a very tax efficient manner.

However, it's generally recommended that advisers weigh up the advantages and disadvantages of using a whole of life policy written in a flexible or discretionary trust instead. This might enable the member to take advantage of the fixed pension income stream from the DB scheme, while providing a lump sum equivalent to the transfer value to their family following their death that will be outside their IHT estate. Potential disadvantages of this route include the long term affordability of the premiums, although the cost might be covered by excess income from the DB scheme. In addition, the discretionary trust regime for IHT, income tax and capital gains tax applies to whole of life policies written in flexible and discretionary trusts.

Be aware that an HMRC form IHT 400 is used to calculate IHT on death. The IHT 400 notes confirm that HMRC will ask the deceased member's legal personal representatives to provide evidence of the member's state of health and life expectancy at the time of the transfer if they die within two years.

Every care has been taken to ensure that this information is correct and in accordance with our understanding of the law and HM Revenue & Customs practice, which may change. However, independent confirmation should be obtained before acting or refraining from acting in reliance upon the information given.

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