



Example 2.2

Julie has accrued 25 years' service in her defined benefit pension scheme. She recently left service and her final pensionable remuneration was £30,000 p.a.

Calculation of benefits for a pension plus cash lump sum scheme with an accrual rate of 1/80th:

- Pension is $25/80\text{ths} \times £30,000 = £9,375$ p.a.
- PCLS is $3 \times 25/80\text{ths} \times £30,000 = £28,125$.

Calculation for a pension with an accrual rate of 1/60th and a cash commutation rate of 16.2.

- Where no PCLS is taken, the pension is $25/60\text{ths} \times £30,000 = £12,500$ p.a.
- Alternatively, maximum PCLS is $(£12,500 \times 20) \times 25\% = £62,500$.
- Plus reduced pension is $£12,500 - (£62,500/16.2) = £8,642$ p.a.

It is important to note that no element of GMP can be commuted for cash, therefore any GMP element would have to be deducted from the total pension before calculating the maximum cash amount.

D3 Death benefits pre-retirement

Death benefits provided by the scheme will be confirmed in the scheme rules and generally the benefits provided will include:

- Spouse's pension.
- Dependant's pension.
- Children's pension.
- Lump sum death benefits.

It is important to obtain specific information regarding the description and definitions of the benefits provided by the scheme as there is wide variation between different schemes. All pension benefits paid by defined benefit schemes are taxable as the recipient's pension income under PAYE.



Consider this...

Many schemes provide different benefits pre- and post-retirement. It is important to establish not only the benefits provided but also the eligibility criteria.

Spouse's pension

A spouse's pension will generally be the main death benefit payable by a defined benefit pension scheme. This is usually expressed as a percentage of the member's benefit. Where the member has left service, the benefit will be calculated as at date of leaving and will be revalued to date of death.

- **Definition of spouse** – this most often means a husband or wife, and will usually include civil partners and same sex married partners. The scheme may, however, have its own definition and it is important to confirm what this is.
- **Same sex marriage and civil partnerships** – trustees do not have an obligation to change the scheme rules to accommodate changes in legislation, therefore there is a possibility that the scheme may not pay a pension even where there is a legally defined relationship. Where the rules have been changed, there are some schemes that will only pay benefits effective from the date of the change in legislation.
- **Percentage of benefits** – the percentage of benefits could be based on the pension before or after commutation. Based on the example above, if the scheme pays 50% of uncommuted pension this would be £6,250 per annum, regardless of whether a cash lump sum is taken at outset.
- **Reduction in benefits** – the scheme trustees may retain an option to reduce or stop paying spouse benefits in certain circumstances, e.g. when the spouse is significantly younger than the member (usually ten years or more), or where the surviving spouse remarries or is cohabiting.
- **Other issues** – some schemes may not pay a spouse's pension where the marriage occurred after the member left service, is recent (say, within six months) or where spouses are not living together, even if they remain legally married.



Critical reflection

Spouse's and dependant's benefits are provided at the discretion of the trustees and not as an absolute right.

Do you think the trustees of a scheme are under pressure to make sure the benefits follow current legislation? What are the wider implications of not doing so?

This formula gives the same answer as the alternative formula, but for the purposes of this study text the first formula as shown in the PTM has been used.

This formula looks rather complex, but the good news is that once you have learned it you can apply it to any scenario given to you in the exam, as shown in the following example.



Example 3.5

Chris has recently reached his normal pension age of 65 and will be taking benefits from his defined benefit scheme. His pre-commutation pension is £30,000 based on a salary of £90,000. The commutation factor is 15:1 after A-Day.

Chris' maximum PCLS is:

$$\frac{(20 \times £30,000 \times 15)}{(20 + (3 \times 15))} = \frac{£9,000,000}{65} = £138,462$$

Chris' residual pension will be:

$$£30,000 - (£138,462 \div 15) = £20,769$$

The 25% of fund value can be checked as follows:

$$((£20,769 \times 20) + £138,462) \times 25\% = £138,462.$$

(The answer above has been rounded to the nearest pound and HMRC are happy for such rounding to be applied.)

If the alternative version of the formula was used the answer would be exactly the same, i.e.:

$$\frac{£30,000 \times 15}{(1 + (0.15 \times 15))} = \frac{£450,000}{3.25} = £138,462$$

If a defined benefit scheme chooses to pay PCLS benefits in line with the maximum permitted under HMRC rules, it is likely that the PCLS figure will be higher than if it were calculated in line with the scheme's accrual rates.

If the maximum PCLS payable by the scheme is less than the HMRC maximum the trustees may, at their discretion, increase the amount of PCLS available to the member up to the HMRC maximum, and then adjust the residual pension accordingly.

Useful website

You can find more information about calculating PCLS under a defined benefit scheme here:

www.hmrc.gov.uk/manuals/ptmanual/ptm063240.htm

Then click on 'The applicable amount for an arising entitlement to a scheme pension under a defined benefits arrangement'.



C5 Bridging pensions

Some defined benefit schemes pay a bridging pension, usually where the scheme's normal pension age is lower than State pension age (SPA). When the member reaches their normal pension age a higher pension is paid until SPA is reached, at which time it reduces to reflect the commencement of the member's State Pension. This can also be referred to as a State pension deduction.

Be aware

Not all schemes will reduce the pension after SPA if a bridging pension is in place prior to the SPA.



This is permitted under the **Finance Act 2004** and the **Finance Act 2013**, which allow higher pensions to be reduced after SPA provided the reduction does not exceed a limit, which is designed to ensure that the reduction is based on the member's expected State Pension. This is one of the few circumstances where a scheme pension can be reduced.

C4 Pension commencement lump sum (PCLS)

As well as a pension, a defined benefit scheme also provides a PCLS at retirement. The rules of the scheme determine how much PCLS can be accrued for each year of service, e.g. they may have an accrual rate of 3/80ths of final pensionable remuneration for each year of service.

Some schemes accrue the pension and PCLS separately, e.g. the member may be entitled to 1/80th final pensionable remuneration for each year of service as a pension plus 3/80ths of final pensionable remuneration as a PCLS. However, this is more typical for public sector schemes and it is more usual in private sector defined benefit schemes for the pension to be commuted to provide the PCLS, as follows:

- the annual pension is reduced (commuted) on a pre-determined basis for every £1 of PCLS that is taken; and
- the rules of the scheme will specify the commutation factor that will be used to reduce the pension, e.g. a commutation factor of 12:1 means that for every £12 of PCLS the pension will be reduced by £1.



Example 3.4

In example 3.1, Amrit was entitled to a pension of £24,000 after 20 years in a 1/60ths defined benefit scheme. Under the scheme rules he is able to commute part of this pension for a PCLS of 3/80ths of final pensionable remuneration for each year of service. The commutation factor is 12:1 and Amrit's final remuneration was £72,000. We can calculate his PCLS and his reduced pension as follows.

- Amrit will be entitled to a PCLS of $20 \times 3/80\text{ths} \times £72,000 = £54,000$.
- For every £12 of PCLS his pension will be reduced by £1.
- The reduction in his pension is therefore $£54,000 \div 12 = £4,500$.
- His annual pension will be reduced to $£24,000 - £4,500 = £19,500$.

A scheme that was contracted out prior to 6 April 2016, cannot allow any part of any GMP to be exchanged for PCLS. This has the effect of restricting or even eliminating the lump sum when the non-GMP part of a pension is small. This can arise when:

- someone with low earnings retires from a scheme offering a pension build-up rate of 1/80th;
- someone has substantial non-pensionable earnings, e.g. overtime; or
- someone retires early on a substantially reduced pension.

The maximum PCLS that HMRC rules allow is 25% of the value of the benefits. Pension benefits are valued using a factor of 20:1 and PCLS benefits are taken at face value. When benefits are taken, a check takes place to make sure that the PCLS provided does not exceed the overall 25% maximum.

Where the PCLS and pension are provided separately, the pension figure is multiplied by the factor of 20 and the PCLS is added to this. The resulting total is the notional value of the member's benefits and the maximum PCLS cannot exceed 25% of this figure.

When the PCLS is provided by commutation it is more complicated. This is because the member's residual pension after PCLS will depend upon the amount of PCLS taken and the scheme's commutation factor.

Under the simplified regime, the maximum PCLS is calculated as follows:

- $\text{PCLS} = (\text{PCLS} + (20 \times \text{residual pension})) \times 25\%$.
- The residual pension = pre-commutation pension – (PCLS/C), where C is the commutation factor used by the scheme.

This leads to a complex scenario because it is not possible to calculate the member's residual pension until the PCLS has been calculated – and it is not possible to calculate the PCLS until the residual pension has been calculated.

The Pensions Tax Manual (PTM) lays out a formula that must be used to calculate the maximum PCLS payable by a DB scheme.

This formula is:

$$\text{PCLS} = \frac{20 \times \text{pre-commutation pension} \times C}{(20 + (3 \times C))}$$

You may also have seen the formula above expressed as:

$$\text{PCLS} = \frac{\text{Pre-commutation pension} \times C}{(1 + (0.15 \times C))}$$