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Annual Allowance - Deferred Member Carve Out

19 August 2016: We have recently had several requests asking whether the ACA pensions tax committee have had any discussions with HMRC that can throw extra light on a particular area of the operation of the Annual Allowance.

The topic is the “deferred member carve out” (DMCO) and how it applies in the following relatively common situation:

A DB [or cash balance] arrangement exists in which it has been clear that if an individual leaves both pensionable employment and employment on Date X, the increase in the uncrystallised benefits from the start of the pension input period (PIP) following Date X would not cause any Pension Input Amount (PIA) because the arrangement qualifies for the DMCO (because the individual is a “deferred pensioner” and the increase is a “relevant increase” for the purposes of Finance Act 2004).

The special event that occurs is that

- **The arrangement is “closed to service accrual” at Date 1 (ie the benefit formula in the arrangement does not reflect any service after Date 1)**
- **but there continues to be some sort of link to salary in the benefit formula until the member leaves employment or opts out of the scheme, at Date 2;**
- **and there is an underpin that the benefit will not be less than the benefit had the member left both employment and pensionable service at Date 1 ie with the scheme’s leaver revaluation operating from that date.**

The question raised is: if there is a PIP before the one in which Date 2 falls, throughout which

- **the salary growth has been such that the pension at the end of the PIP is simply the underpin**
- **[or if the growth in relevant pension has solely been in line with the underpin revaluation – which is not quite the same thing]**

might the arrangement qualify for the DMCO during that PIP (so that PIA is automatically nil)?

1. HMRC’s PTM guidance deals with this in <https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm053910> , as per the extracts at the end of this note (which have appeared in HMRC for most of the time since the relevant legislation was introduced in 2010).
2. It has been suggested to us that HMRC’s reading is inconsistent with the reading given in <https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm053350> (particularly Scenario 3 in the worked example of “Emily” on that page). This deals with the situation when an individual has reached Normal Pension Age (NPA) but continues in pensionable service and their pension formula is the better of their benefit with continued accrual and their benefit at NPA increased with late retirement factors (ones that are in accordance with 14 October 2010 rules).

This is technically a different area and perhaps HMRC are having regard to various interplays of pieces of legislation. The operation of Finance Act 2004 is complex and difficult to read – and there are other areas where HMRC’s indication of their interpretation is difficult to track through legislation.

However, we note that a very large number of individuals - many of whom do not have large pensions - work beyond NPA, or have “Barber adjustments” to their benefits; and the HMRC’s reading means that Annual Allowance charges do not arise for these, and simplifies administration.

3. Where one cannot fully reconcile the rationale of HMRC’s guidance for two specific scenarios, this does make it difficult for trustees and their advisers to extrapolate how HMRC would interpret the law in variants of those

specific scenarios. However, we assume that parties will either approach HMRC for a reading via non-statutory Clearances processes; or will come to their own view on the legislation that they feel is appropriate.

At the current time the ACA pensions tax committee do not intend to approach HMRC to try to persuade it to change its interpretation, as expressed by the guidance, of the current legislation in the above areas.

4. We do note in relation to the DMCO as it currently stands:

(a) It is very difficult to read how the DMCO works for deferred pensioners (particularly since the The Finance Act 2004 (Registered Pension Schemes and Annual Allowance Charge) (Amendment) Order 2015 changed the structural framing of the DMCO and its interaction with statutorily-required revaluations). We would appreciate further discussions on the number work HMRC think applies following those changes.

(b) Where a member does not benefit from the DMCO, the PIA used up can be very unintuitive, particularly now that all PIPs end on 5 Aprils. For example, if the leaver underpin is solely the minimum required by statute (see *), in almost all cases the calculation of PIA will be such that the actual increase in pension in PIP ending 5 April X will reflect CPI in the year to September X - 1, whereas the CPI that is used to adjusted the opening value in calculating PIA will reflect the CPI to September X - 2 (see http://www.aca.org.uk/files/B_Letter_to_HMRC_dated_15_June_2012_re_relevant_percentage-24_July_2012-20120724114146.pdf . (Although this relates to FP12 and predates some law changes - but there is no reason why the core principle should apply differently for AA and be different).

(*currently, very broadly: the cumulative increase in CPI from leaving to NPA, with a collar and cap on that increase as a whole for the period, of, respectively, zero and of 2.5% compound per year in the period; with the required mechanical process reflecting CPI growth in years to Septembers.)

5. We also note the huge and growing number of deferred members [tax law definition]. We think that the government should review this part of the law to ensure it does not drift out of line with policy intent, and so as to preserve the DMCO in as wide a number of (reasonable) cases as possible. For example changes are made to leaver revaluation for all sorts of reasons (that currently lose the DMCO) which are clearly not avoidance inspired eg simplifications, readiness for buy-out, negotiation in connection with a scheme closure. Losing DMCO in such circumstances, and the long-tail impact this can have, seems out of line with policy intent and sensible taxation. We will take this point forward separately.

We are sending HMRC a copy of this note to members.

RELEVANT EXTRACT

In <https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm053910> it states the following:

Meaning of deferred member

*A deferred member is defined by elimination. Such an individual must not be an active member or a pensioner member. In particular, **an individual is an active member** of a registered pension scheme **if there are currently arrangements made under the pension scheme for the accrual of benefits** to or in respect of the person. This definition needs to be read in the context of a **per-arrangement** rather than per-scheme test for the annual allowance deferred member carve-out. The concept of 'benefit accrual' is therefore very important in this context. Note that the definition of deferred member is a definition under the tax rules. Even if the rules of a pension scheme refer to an individual as a deferred member or deferred pensioner this does not necessarily make them one for the purpose of the tax rules.*

Members with deferred benefits and continued employment link

*For a defined benefits arrangement an individual might have 'deferred benefits' to the effect that the amount of their pensionable service is no longer increasing. This might happen when an employer has given defined benefits for a period of time but has changed its pension provision for subsequent service to money purchase. **If the individual's pension rights are still based on their current salary and so they increase if they receive a pay rise (even though the length of service is not increasing for the purpose of the defined benefit) the individual is not a deferred member** and so the deferred member carve-out does not apply.*

There is also a similar section headed "Revaluation rate for deferred members linked to continuing service"

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