Government Actuary's Department

Local Government Pension Scheme (England and Wales)

Limit on additional cash commutation

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Contents

1 Introduction

1.1 The Secretary of State for Communities and Local Government is required to issue guidance in respect of the Local Government Pension Scheme on calculating the capital value of a member's accrued rights, for the purposes of determining the maximum lump sum the member may take at retirement.

1.2 In the remainder of this note:

> The second section provides background information and describes the calculation for the capital value of the member's accrued rights along with providing relevant links to HMRC guidance

> The third section contains examples

> Appendices A and B set out the relevant statutory references

> Appendix C sets out some important limitations.

Implementation and Review

1.3 The Secretary of State is required to consult with GAD before issuing actuarial guidance under the Local Government Pension Scheme Regulations 2013 ('the 2013 Regulations') [Regulation 2(3) of the 2013 Regulations].

1.4 As part of this consultation the Department for Communities and Local Government (DCLG) has asked GAD to recommend actuarial guidance in respect of the regulations detailed below. This document forms GAD's recommendation for the actuarial guidance required by these regulations.

1.5 This note has effect only when this guidance is issued by the Secretary of State in accordance with Regulation 2(3) of the 2013 Regulations, and is subject to the implementation instructions provided at that time.

1.6 This guidance relates to commutation of a member's pension benefits at retirement for a pension commencement lump sum, regardless of whether the member has been an active member of the 2014 scheme, or whether the pension benefits were earned before or after 1 April 2014. It also applies in relation to councillors. It replaces the previous guidance dated 1 March 2013.

1.7 This guidance has been written for pension administrators and assumes some knowledge of general pensions terminology, and some familiarity with retirement calculations for the Local Government Pension Scheme. Any questions concerning the application of the guidance should, in the first instance, be referred to DCLG.

Use of this note

1.8 This note has been prepared for DCLG and can be relied upon by them. We are content for this note to be released to third parties, provided that:

- it is released in full
- the advice is not quoted selectively or partially, and
- GAD is identified as the source of the note.

1.9 Third parties may wish to seek their own actuarial advice where appropriate. GAD has no liability to any person or third party for any act or omission taken, either in whole or in part, on the basis of this note.

Third party reliance

1.10 When issued by the Secretary of State in accordance with paragraph 1.5 above, this note should be used as the actuarial guidance required under the regulations cited. Other than for this purpose, no person or third party is entitled to place any reliance on the contents of this note, except to any extent explicitly stated herein.

2 Background and guidance

2.1 For the purposes of Regulation 33(3) of the 2013 Regulations the capital value of the member's accrued rights should be calculated in accordance with guidance issued by the Secretary of State. However, such guidance must itself recognise the requirements of the Finance Act 2004, associated regulations, and guidance from HM Revenue & Customs (HMRC).

2.2 This guidance also applies where benefits for Councillor members are valued under Regulation 33(3) of the 2013 Regulations.

2.3 This guidance has been simplified to refer to HMRC guidance where applicable.

2.4 The following paragraphs provide brief comments on the calculation of the capital value. Nothing in these paragraphs or elsewhere in this guidance can override any prevailing HMRC restrictions.

2.5 For members who have taken flexible retirement or early retirement under regulation 30 of the 2013 Regulations, commutation takes place after any reduction to the member's pension pursuant to regulation 30 of the 2013 Regulations.

2.6 Under Regulation 17(7) of the 2013 Regulations, a member may use the accumulated value of his or her AVCs to provide additional benefits under the Scheme (see the guidance document 'Use of accumulated AVCs to provide additional pension under the Scheme'). These can be in the form of a lump sum or a pension, or a combination of the two.

2.7 Regulation 15(4) of The Local Government Pension Scheme (Transitional Provisions, Savings and Amendment) Regulations 2014 ('the 2014 Scheme Transitional Regulations') (SI 2014/525) provides that, if additional benefits are provided through the scheme, any lump sum taken from the AVC fund should be included in the capital value of the member's accrued rights where the AVC arrangements were entered into by the member before 1st April 2014 (but otherwise it is excluded, by regulation 33(2) of the 2013 Regulations).

2.8 Alternatively, the member can take their AVC benefits outside the fund. In this case AVCs are not included in the assessment, and AVCLS and AVCP are zero in the calculation shown in paragraph 2.9 below.

2.9 A factor of 20 is used to value a member's pension in determining whether the total lump sum, including any retirement grant, does not exceed 25% of the capital value of a member's accrued rights. The capital value (CV) of the member's accrued rights is therefore as follows:

(a) where a cash sum is taken on retirement through the scheme from the member's AVC fund and the AVC arrangements were entered into prior to 1 April 2014:

$$CV = LS + AVCLS + (20 \times (P + AVCP))$$

(b) where a cash sum is taken on retirement through the scheme from the member's AVC fund, and the AVC arrangements were entered into after 1 April 2014, two separate checks need to be done. The first is to ensure the total scheme lump sum, including any retirement grant, does not exceed 25% of the capital value of a member's accrued rights (CVAR) ie excluding AVCs; and the second, specified by DCLG, is to ensure that any cash sum taken on retirement from the member's AVC fund does not exceed 25% of the capital value (CVAVC) of the benefits arising from the member's AVC fund that are payable through the scheme:

$CVAR = LS + (20 \times P)$
$CVAVC = AVCLS + (20 \times AVCP)$

As a result of separating the AVC and non-AVC elements, it should be clear that at no point could the total cash sum taken exceed 25% of the total capital value of the member's benefits (CVAR + CVAVC).

(c) in any other case:

$CV = LS + (20 \times P)$

Where:

LS = Retirement Grant + Additional lump sum by commutation of pension (excluding cash taken from AVCs)

P = Pension after commutation (excluding pension from AVCs)

AVCLS = Cash sum taken from the member's AVC fund

AVCP = Pension provided through the scheme from the AVC fund

See:
http://www.hmrc.gov.uk/manuals/rpsmmanual/rpsm11104220.htm

2.10 HMRC provides further guidance setting out how the capital value of a member's benefits should be calculated – see http://www.hmrc.gov.uk/manuals/rpsmmanual/rpsm09104400.htm.

2.11 HMRC also provides guidance on the maximum amount of lump sum that can be taken where the member has no automatic retirement grant and so is only entitled to a lump sum by commutation – see: http://www.hmrc.gov.uk/manuals/rpsmmanual/rpsm09104430.htm.

2.12 If a member also has AVCs, that are not taken outside the Scheme but are applied to provide additional pension through the Scheme, then HMRC also provides a flowchart that should be followed – see: http://www.hmrc.gov.uk/manuals/rpsmmanual/rpsm09104490.htm. However, the flowchart should not be used in a case where a member has entitlement to a lump sum that is not derived from the commutation of pension.

2.13 DCLG have instructed that the capital value of the member's accrued rights for the purpose of regulation 33(3) should not exceed the standard lifetime allowance, consistent with the permitted maximum level of pension commencement lump sum payable under Finance Act 2004, see: http://www.hmrc.gov.uk/manuals/rpsmmanual/RPSM09104220.htm

2.14 Section 3 includes three examples to show how this is calculated, and to illustrate the calculation of the maximum allowable lump sum.

Pension credit members

2.15 In some circumstances Regulation 33(4) of the 2013 Regulations prevents a pension credit member from commuting pension for a cash sum when the pension credit comes into payment. The Finance Act 2004 may also restrict a pension credit member's ability to commute pension for a cash sum.

3 Examples of commutation calculations

3.1 Example 1

Pension (before commutation) = £5,000 pa

Retirement Grant = £15,000

In addition the member has an AVC fund which he uses by taking a lump sum of £5,000 and a pension through the Scheme of £1,000 pa

The AVC arrangement commenced prior to 1 April 2014

Commutation factor = 12

Lifetime Allowance = £1.25 million (assumed)

The member chooses to commute £500 pa of pension, to obtain an additional lump sum of £6,000 (= 500 x 12)

Pension after commutation = 5,000 + 1,000 – 500 (including AVC pension)
= £5,500

Lump sum after commutation = 15,000 + 5,000 + 6,000 (including AVC cash)
= £26,000

Capital value of benefits = (20 x Pension) + total lump sum including AVC lump sum
= (20 x 5,500) + 26,000
= £136,000

Proportion of benefits taken as lump sum = Total lump sum after commutation / Capital value of benefits
= 26,000 / 136,000
= 19.1%

This is less than the limit of 25% (and the lump sum is less than 25% of the lifetime allowance) so the member is able to take this level of lump sum.

3.2 Example 2

Pension = £5,000 pa
No automatic retirement grant
The member has no AVCs
Commutation factor = 12
Lifetime Allowance = £1.25 million (assumed)

The member wishes to commute part of their pension in order to receive the maximum allowable lump sum

Maximum lump sum is the lower of:-

a) P x CF / (1+ (0.15 x CF)); and
b) 25% x lifetime allowance

P is the pension before commutation

Maximum lump sum = 5,000 x 12 / (1+ (0.15 x 12)) = £21,428.57
(this is less than 25% of the lifetime allowance)

Pension after commutation = 5,000 – 21,428.57 / 12 = £3,214.29

[Check that the lump sum does not exceed the permitted maximum of: 0.25 x [(3,214.29 x 20) + 21,428.57] = 21,428.59 – so the lump sum of £21,428.57 is permitted.]

3.3 Example 3

Pension = £55,000 pa
Retirement Grant = £198,500
The member has no AVCs
Commutation factor = 12
LTA = £1.25 million (assumed)

If no pension is commuted:
Capital value of member's benefits = (20 x P) + RG
= (20 x 55,000) + 198,500
= £1,298,500
This is in excess of the LTA.

However the member wishes to commute further pension in order to receive the maximum allowable lump sum.

In this example, the maximum additional lump sum is the lower of:-

a) (P – 0.15 x RG) x CF / (1+ (0.15 x CF)); and
b) (25% x lifetime allowance) – retirement grant

P is the pension before commutation
RG is the automatic retirement grant
CF is the commutation factor (ie 12)

Maximum additional lump sum is the lower of:-

a) (55,000 – 0.15 x 198,500) x 12 / (1+ (0.15 x 12)) = £108,107.14; and
b) (25% x 1,250,000) - £198,500 = £114,000

So maximum additional lump sum is £108,107.14

Pension after commutation = 55,000 – 108,107.14 / 12 = £45,991.07

Total lump sum = 108,107.14 + 198,500 = £306,607.14

Capital value of member's benefits after commutation
= (20 x pension after commutation) + total lump sum
= (20 x 45,991.07) + 306,607.14
= £1,226,428.54

In this example, by commuting part of the pension to receive the maximum lump sum, the capital value of the member's benefits is reduced to below the LTA.

If the resulting lump sum is in excess of one quarter of the LTA and/or the capital value of the member's benefits after commutation is above the LTA, the guidance 'Limit on Total Amount of Benefits – Lifetime Allowance' should be referred to.

Appendix A: Cited regulations

A.1 Excerpts from the 2013 Regulations

Introductory

2.—

…

(3) The Secretary of State may, after consultation with the Government Actuary's Department, issue actuarial guidance to administering authorities.

Additional voluntary contributions

17.—

…

(7) If a member draws benefits under regulation 30(1), (2), (4), (5), (7), (10) to (12) (retirement benefits) or regulation 35(1) (early payment of retirement pension on ill-health grounds: active members) or, if a member who draws benefits under regulation 30(6) (flexible retirement) makes an election to draw the realisable value in the AVC arrangement at the same time, that member must notify the appropriate administering authority that the realisable value under arrangements made under this regulation—

(a) is to be taken in full or in part by the member as a lump sum, and where only part is taken as a lump sum, the member must specify the amount to be so taken; and

(b) to the extent that the realisable value has not been taken as a lump sum, it is to be used—

(i) to purchase additional pension under the Scheme, the amount of which is to be determined by the administering authority in accordance with actuarial guidance issued by the Secretary of State, or

(ii) to the extent that it has not been used to purchase additional pension under the Scheme, to purchase an annuity from one or more insurance companies (within the meaning of section 275 of the Finance Act 2004).

(8) Where a member chooses to take some or all of the benefits referred to in paragraph (7) in the form of a lump sum, that sum does not form part of the total amount referred to in regulation 33(2) (election for lump sum instead of a pension).

…

Election for lump sum instead of pension

33.—

(1) Subject to paragraph (4), a member entitled to a retirement pension under the Scheme may by written notice given to the appropriate administering authority before any benefits in relation to the benefit crystallisation event become payable, commute the retirement pension payable, or part thereof, at a rate of £12 for every £1 of annual pension commuted.

(2) But the total amount of the member's commuted sum shall not exceed 25% of the capital value of the member's accrued rights under all local government pension provision in relation to that benefit crystallisation event excluding those under regulation 17(7)(a) (additional voluntary contributions).

(3) The capital value of a member's accrued rights shall be calculated in accordance with actuarial guidance issued by the Secretary of State.

(4) Paragraph (1) does not apply to-

- (a) a pension credit member where the member of the Scheme to whom the Pension Sharing Order applied has made an election under this regulation before the valuation date used when implementing the Pension Sharing Order;
- (b) a deferred pensioner member; or
- (c) any additional pension purchased by the member under regulation 17(7)(b)(i) (additional voluntary contributions).

A.2 Excerpts from the 2014 Scheme Transitional Regulations

Lump sum commutation

13.—

(1) Where a member elects to commute pension under regulation 33 of the 2013 Regulations (election for lump sum instead of pension) the member's benefits under the Earlier Schemes which are aggregated with the member's benefits under the 2014 Scheme are taken into account for the purposes of regulation 33(1) and (2) of the 2013 Regulations.

…

Additional contributions

15.—

…

(4) Regulation 33(2) of the 2013 Regulations (election for lump sum instead of pension) is modified as regards any AVC arrangement entered into by a member before 1st April 2014 by the substitution of the words 'including those under regulation 17(7)(a)' for the words 'excluding those under regulation 17(7)(a)'.

…

Appendix B: Legislative references

B.1 The Secretary of State is required under the 2013 Regulations to issue actuarial guidance in respect of the Local Government Pension Scheme on calculating the capital value of a member's accrued rights, for the purposes of determining the maximum lump sum the member may take at retirement. [Regulation 33 (3) of the 2013 Regulations].

B.2 On a benefit crystallisation event (BCE), before any benefits in relation to that event become payable, a member may elect to commute some of their own pension as a lump sum in addition to any retirement grant to which they are entitled. [Regulation 33(1) of the 2013 Regulations].

B.3 The total of the additional lump sum derived from commutation, any retirement grant received, and any lump sum taken from the member's AVC funds, should not exceed 25% of the capital value of the member's accrued rights. For this purpose, the accrued rights to be valued are restricted in terms of the Finance Act 2004 to those rights which are actually being crystallised at the point of retirement from Local Government employment. [Regulations 33 (2) and 33 (3) of the 2013 Regulations, together with Regulation 13(1) of the 2014 Scheme Transitional Regulations].

Appendix C: Limitations

C.1 This note should not be used for any purpose other than to ensure that a member's total lump sum at retirement, including any retirement grant, does not exceed 25% of the capital value of the member's accrued rights.

C.2 The guidance is based on GAD's understanding of the Finance Act 2004. Nothing in this guidance can override any prevailing HM Revenue & Customs (HMRC) restrictions.

C.3 This note should be considered in its entirety as individual sections, if considered in isolation, may be misleading, and conclusions reached by a review of some sections on their own may be incorrect.

C.4 This note only covers the actuarial principles around the calculation to determine whether a member's total lump sum at retirement, including any retirement grant, exceeds 25% of the capital value of the member's accrued rights. Any legal advice in this area should be sought from an appropriately qualified person or source.

C.5 Administrators should satisfy themselves that any additional lump sum taken complies with all legislative requirements including, but not limited to, taxation requirements.

C.6 This guidance is based on the Regulations in force at the time of writing. It is possible that future changes to the Regulations might create inconsistencies between this guidance and the Regulations. If users of this guidance believe there to be any such inconsistencies, they should bring this to the attention of DCLG. In no circumstances should this guidance take precedence over the Regulations. Administrators should ensure that they comply with all relevant Regulations.