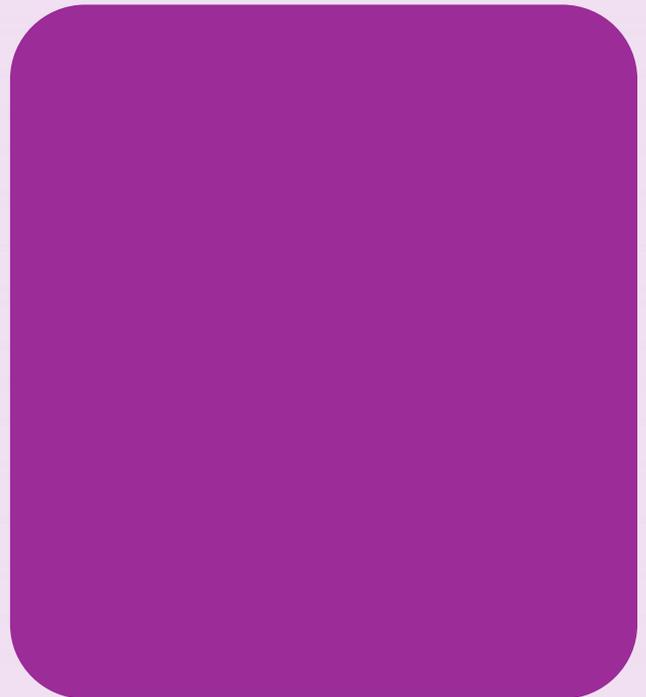


Informal view on Income Tax and National Insurance implications

The Firefighters' Pension Scheme 2006 as modified
for 'special' retained firefighters



Foreword

These Notes offer an informal consideration of the tax¹ and National Insurance implications in respect of backdated contributions into the special modified scheme. They cover the following –

1. Tax relief on pension contributions
2. Annual allowance (the ceiling for annual income tax relief)
3. What action can be taken if a person cannot claim full tax relief entitlement or where they incur a personal income tax liability
4. National Insurance refunds (reflecting a move to contracted out status)

Important Disclaimer

This discussion document has been commissioned by DCLG (now Home Office) on behalf of Fire and Rescue Authorities to provide informal advice on paying benefits from the Modified 2006 Pension Scheme.

The document has been approved for release to employers by HMRC.

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¹ **Note:** The figures used in the explanation of tax limits are those relevant to tax year 2014/15.

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Background

Following the introduction of the Part-Time Workers (Prevention of Less Favourable Treatment) Regulations 2000, a claim was made by a number of retained firefighters that they should receive equal treatment with full-time regular firefighters and thereby be able to access pension benefits under the 1992 Firefighters' Pension Scheme. The claim proceeded through the Employment Tribunal and Court of Appeal before judgement was given in the House of Lords in favour of the retained firefighters.

Although, since 6 April 2006, retained firefighters have been eligible to join the Firefighters' Pension Scheme 2006 ("FPS 2006") the House of Lords judgement allowed those who were serving during the period 1 July 2000 to the date on which they elected to join the 2006 Scheme, to have special provisions which generally reflect the rules of the Firefighters' Pension Scheme 1992 ("FPS 1992"). They could not be given backdated membership of FPS 1992 because that Scheme is now closed. Consequently FPS 2006 was amended for these "special" retained firefighters; they have their own modified version of the Scheme within the main Scheme rules.

Those who qualify for membership of the modified Scheme and make an election to join (which as extended by SI 2015/590 must be no later than 30 September 2015) will be required to pay pension contributions in respect of the earlier service which they wish to count. This has implications for tax and National Insurance.

Tax relief on pension contributions

1. Tax relief for pension contributions paid in tax year 2014/2015

Tax relief is available for pension contributions paid by a UK resident to a registered pension scheme within a tax year (i.e. the period from 6 April to the following 5 April).

In any tax year, tax relief is given on the higher of:

- gross pension contributions up to 100% of "relevant earnings", or
- gross pension contributions up to £3,600 if there are no "relevant earnings" or if the pension scheme member is not liable to income tax.

For example, a person with no "relevant earnings" can get tax relief on contributions of up to £3,600 whereas a member with "relevant earnings" of £30,000 can get tax relief up to £30,000. It does not matter that the member's payment may be in respect of pension benefits accruing from periods of service before the current tax year because tax relief is given against contributions made out of "relevant earnings" in that tax year of payment.

"Relevant earnings" means income from employment or self-employment, including:

- self-employed trade or vocational profits
- the taxable part of redundancy payments
- earnings from Crown employment overseas (this applies particularly to non-UK resident members).

It does not include:

- tax exempt redundancy/leaving payments
- State basic and additional pensions
- other occupational or personal pensions
- investment income, such as bank interest, dividends and rents received
- capital gains – profits on sales of assets.

2. Means of providing tax relief where there are insufficient earnings or where tax relief cannot be given for pension contributions through normal payroll processes

There are two existing mechanisms whereby an individual can claim tax relief on contributions paid. These are:

- (a) Net Pay Scheme
- (b) Direct Claim

Net Pay Scheme

Under this arrangement the employer deducts contributions from the pension scheme member's gross salary before applying income tax. National insurance contributions are still calculated on the gross salary. Tax relief to taxpayers is given at all the relevant rates of income tax. These are currently: basic rate at 20%, higher rate at 40%, and top rate at 45%.

The "Net Pay Scheme" does not provide tax relief where there are no, or insufficient, "relevant earnings" or where the pension scheme member is not a taxpayer. Otherwise, relief is given at the person's highest marginal rate by the deduction of the pension contributions from salary by payroll and applying PAYE to the balance.

Direct Claim

This can operate when it is not possible to secure full tax relief through the "Net Pay Scheme". The member would need to submit a Self-Assessment Tax Return where, otherwise, there might be no requirement to submit one because, for example, the person has low earnings or income covered by a personal tax allowance of £10,000. <https://www.gov.uk/tax-on-your-private-pension/pension-tax-relief>

How to calculate the amount of tax relief to which an individual should be entitled in respect of their pension contributions for past service

By way of example, an employee who

- is earning £5,000 a year from July 2000 to July 2010,
- subject to basic rate tax of 20%, and
- paying pension contributions of 12%

would be entitled to annual tax relief of £120 on total pension contributions of £600 per annum
(i.e. $12\% * £5,000 = £600.00$
 $£600 * 20\% = £120$).

It may well be that current "relevant earnings" as paid through the employer's payroll are sufficient to cover a taxpaying employee's pension contributions for both current and past service. In which case, loss of tax relief would not be an issue.

It follows that, based on the above example, present or future member contributions in respect of past service must be capable of replicating the previous total tax relief "lost" for ten years – £1,200 in aggregate – whether the person pays the contributions as a single, one-off, lump sum, or has them deducted from pay in instalments.

3. How to calculate the amount of tax relief entitlement that an individual is unable to claim through existing HMRC processes

There needs to be a simple calculation of the member's normal current pension contributions in order to establish the current year's pension accrual (based on the assumption that there is no "purchase" of earlier years). This approach produces a contribution figure that may attract tax relief depending upon whether the person is – or is not – a taxpayer. The "Net Pay Scheme" would not in those circumstances produce tax relief, but an alternative would be for the employee to instigate a "Direct Claim" through the self-assessment process.

The issue of employer compensation for any lost tax relief (see below) should not arise as any unavailable relief is unaffected by the instatement of earlier years' membership.

In respect of the balance of present contributions relating to earlier tax years, one would have to evaluate what tax relief was potentially available for tax years 2000/01 to 2010/11, assuming pension contributions for the relevant service being "purchased" in respect of those years had been paid at the appropriate time.

There would be a basis for HMRC's tax treatment of compensation if tax relief would have been available in any of those earlier years but neither presently nor prospectively, or in a reduced sum.

If, as in the example, tax savings of £1,200 were lost – an evaluation must be made as to whether the tax relief lost can be recovered by current or future tax saved on the past-service contributions to be paid by the person in the current or future tax years. The recovery of lost tax relief is dependent upon the type of relief available – "Net Pay Scheme" or "Direct Claim" – and the person's status and marginal tax rate.

When contacting HMRC to make a 'direct claim' through the self-assessment process it is recommended that the Firefighter is clear about what they are claiming for and what contributions they have paid.

The following wording is suggested for consistency

When paid by lump sum

"I have joined the Modified 2006 Firefighters Pension Scheme as a special firefighter member, and on dd/mm/yyyy paid £x by [insert how the contributions were paid, ie cheque/deducted from my lump sum/offset against payment of pension arrears/other] in historical contributions as a lump sum to count service from dd/mm/yyyy. My employer can't provide me tax relief by PAYE because [insert reason, ie earnings to low, not on payroll etc]. I would now like to claim tax relief on this amount."

When paid by periodical contributions

"I have joined the Modified 2006 Firefighters Pension Scheme as a special firefighter member, and commencing from dd/mm/yyyy will pay £x per month until dd/mm/yyyy in historical contributions to count service from dd/mm/yyyy. My employer can't provide me tax relief by PAYE because [insert reason, ie earnings to low, not on payroll etc]. I would now like to claim tax relief on this amount annually until dd/mm/yyyy."

Annual Allowance (the ceiling for annual income tax relief)

The Government's policy is to control the total amount of tax relief available to individuals in any tax year whether as members of a defined benefit pension scheme or of a defined contribution scheme sponsored by the employer, employee, or a combination of both. The annual allowance is a cap on a person's "pension savings" from all registered pension schemes and is set at £40,000 for the tax year 2014/15.

1. "Pension Input Periods" and "Pension Savings"

In these Notes it is assumed that the "pension input period" is 1 April 2014 to 31 March 2015. In calculating the "pension savings", that input period will be considered as conterminous with the tax year ending 5 April 2015.

It is not mandatory for other pension schemes in which the member may participate to have the same pension input period. For example, a private pension plan may have a pension input period which ends on 30 November 2014. Again, this would normally be considered as conterminous with the tax year ending on 5 April 2015 as the period ends within the tax year.

"Pension savings" are evaluated for each pension scheme (or plan) and then allocated to each scheme's input period before subsequent aggregation to ascertain whether the pension savings cap of £40,000 for tax year 2014/15 has been exceeded. If it has, the excess is charged to income tax at the person's income tax marginal rate and is collected after he/she has completed a Self-Assessment Tax Return (Form SA100).

2. "Pension Savings" and calculation of excess amount

The "pension savings" in respect of a defined benefit pension scheme are assessed as the increase in the value of accrued pension during the pension input period. The formula is:

$$(\text{value of pension at end of period} \times 16) - (\text{value of pension at beginning of period} \times 16 + \text{CPI})$$

Assuming that the pension assessed at the end of the period is £3,800, that at the beginning it was £1,100, and that the CPI increase is 2%, the pension savings for the input period would be:

$$(\text{£3,800} \times 16) - (\text{£1,100} \times 16 + 2\%) = \text{£60,800} - (\text{£17,600} + \text{£352}) = \text{£42,848}$$

The annual allowance for the tax year is £40,000. The pension savings are £2,848 over this limit.

To this would have to be added the value of any pension savings from other pension schemes in the same tax year.

3. Potential to reduce taxable excess on "pension savings" by bringing forward unused allowance from previous years

There is the potential to reduce the taxable excess in the tax year 2014/15 by bringing forward and using the unused annual allowance for each of the three earlier tax years – 2011/12, 2012/13, 2013/14 – using the earliest tax year (2011/12) first. Care needs to be taken here as the ability to bring forward unused annual allowance and use it against "pension savings" excess has its conditions.

For the bring-forward facility to apply, the person must be a member of a registered pension scheme at some time in the selected earlier tax year. For example, if a person joined a personal pension plan twenty years ago with an initial contribution of only £100 and had added nothing since, the continued existence of that plan would still entitle the member to have unused annual allowance of up to £50,000 brought forward from 2011/12, 2012/13 or 2013/14, less any pension savings from any other pension scheme relevant to those years.

For retained firefighters, the retrospective effect of joining the modified Firefighters' Pension Scheme would be expected to generate substantial unused allowances in any or all of the three tax years 2011/12 to 2013/14 inclusive which could be used in respect of the abnormal uplift in pension savings within the year 2014/15 resulting from the "purchase" of earlier service.

4. Summary

- (a) There is no financial limit that an individual can pay to a UK registered pension scheme although tax relief is limited to the higher of 100% of "relevant earnings", or £3,600.
- (b) A separate, unrelated calculation has to be made to check whether the "pension savings" accrued during a "pension input period" exceed the current annual allowance of £40,000 or the current annual allowance plus unused annual allowance from the previous three tax years.
- (c) "Pension savings" in excess of the annual allowance are taxed as income, and are the liability of the member who should declare them to HMRC on Self-Assessment Tax Return SA100.
- (d) The annual "pension savings" and the question as to whether the combined current and brought forward annual allowances are exceeded, are not limited to a single scheme but must also take account of all the registered pension schemes in which the person participates.

Individuals who are unable to claim full tax relief or who incur a personal income tax liability

1. Unrelieved contributions

There may be a variety of reasons, unrelated to joining the modified Scheme, why full tax relief entitlement for contributions cannot be given to individuals. For example, total income could be less than the £10,000 personal tax allowance or the contributions allowance of £3,600 may already have been used. In these circumstances, the inability to obtain any – or further – tax relief would occur anyway.

2. Spreading contributions to obtain tax relief

The ability (as allowed by the modified Scheme) to spread the past service contributions over a period of up to ten years should assist special deferred and special firefighter members in using a tax-relievable amount of up to £3,600 in each of those years. Special pensioner members will have the option to pay the past service contributions from the commuted lump sum. These actions could help reduce the circumstances in which an individual is unable to claim their full tax relief entitlement and, therefore, reduce the need for employer compensation.

3. HMRC's tax treatment of compensation

Compensation paid to an individual by their employer in order to cover the person's tax liability on excess "pension savings" does not represent "earnings from employment" or "by reason of employment". Consequently HMRC considers the compensation to be non-taxable.

Similarly, compensation paid to an individual by his/her employer where tax relief is unavailable on pension contributions in respect of past service is also not taxable.

National Insurance Refunds

This section looks at:

- (a) The process whereby a fire and rescue authority can reclaim the difference between the non-contracted-out rate National Insurance contributions which will have been paid in respect of those retained firefighters who choose to join the modified Scheme, and the contracted-out rate contributions which would have been paid had they been Scheme members during the period of back service. Similarly, the retained firefighters would be entitled to a rebate equivalent to the difference between the contracted rate paid by them and the non-contracted-out rate which they would have paid as Scheme members.
- (b) The effect on the additional earnings-related State Pension of a modified Scheme member. Where there is a rebate of the difference between contracted-out and non-contracted out National Insurance contributions, there will be a reduction in any earnings-related State Pension which has accrued. (The present basic State Pension is unaffected but the introduction of a universal State Pension, to be introduced in April 2016, would combine the present basic and earnings-related components going forward from that date.)

1. Rebates of National Insurance contributions and effect on additional State Pensions

Firefighters' Pension Schemes are contracted-out of the additional State Pension arrangements, i.e. the State Earnings Related Pension Scheme ("SERPS") and the State Second Pension ("S2P"). S2P accrual replaced SERPS accrual on 6 April 2002.

Those who elect to join the modified Scheme would have paid the lower contracted-out rate National Insurance contributions for the period they select as back-dated service. Similarly, the employer would have paid a lower rate. By backdating membership in the contracted-out modified Scheme (and receiving a rebate on contributions) the Scheme member will be surrendering entitlement to the additional SERPS and S2P element of their State Pension. (The basic State Pension would not be affected.)

It is difficult to estimate the potential loss of SERPS and S2P although the average weekly addition is estimated as £1.40 for each year of SERPS and S2P membership. However, if earnings are very low and National Insurance thresholds for the payments of contributions had not been reached in any period, there may be no accrual of SERPS or S2P in respect of that period.

The rate of National Insurance rebates will vary according to the tax year to which the refund relates. For example, the 2005/06 rebate for an employee is calculated as 1.6% of weekly earnings which fall

in the pay band £94 to £630. For an employer it would be 3.5% on the corresponding amounts.

2. Claiming National Insurance contribution rebates

To claim a National Insurance contribution rebate from the HMRC Contributions Agency, an operating payroll would have to supply, in respect of each individual member,

- name, address, National Insurance number and date of birth
- dates of membership of the modified Scheme
- gross pay for each tax year
- the amount of National Insurance contributions paid separately by the employer and employee, each week or each month dependent upon the pay interval, within the relevant period of backdated membership.

The Contributions Agency will then perform the rebate calculations and issue a formal claim form for employers to complete for the refunds in respect of both the employer and the Scheme member.

3. Those who contribute to an "Approved Personal Pension Plan"

Where an individual was not in a contracted-out occupational pension scheme during the period that they were employed as a retained firefighter, but chose to pay the full rate ("Rate A") of National Insurance in the year, HMRC allowed for the amount capable of rebate to be invested (by election in the year by the individual) into an Approved Personal Pension Plan ("APP").

The contracted-out amounts are invested into a "money pot" and grow as an investment product. Currently the "money pot" can be accessed at age 55 or later and constitute "protected rights" which can be used to purchase an annuity at the prevailing rates. One condition is that accessing the pot must provide a surviving spouse or civil partner with an annuity equivalent to 50% of the APP member's annuity, unless the spouse or civil partner waives the entitlement.

If a person with an APP chooses to join the modified Scheme, this facility would be withdrawn by HMRC with retrospective effect for the period of his/her membership of the modified Scheme. This means that HMRC will then reclaim the National Insurance rebates made into the APP.

4. Financial Advice

An election for backdated membership of the modified Scheme will affect a person's future entitlement to SERPS and S2P, and the maintenance of any APP product. It must be the person's own decision as to whether or not they should join the modified Scheme. Individual circumstances will differ and so it is suggested that personal advice should be sought from a suitably qualified Independent Financial Adviser (who may charge for this service).

The new State Pension will be a regular payment from the government that can be claimed from an individual's State Pension age on or after 6 April 2016. The amount has not been formally announced but is likely to be in the region of £140 per week. The new State Pension applies to a man born on or after 6 April 1951 or a woman born on or after 6 April 1953. It replaces the current State Pension scheme and there will be no further entitlement to additional State Pension accrual beyond 2016. State Pension is payable under the current scheme if a person reaches their State Pension age before 6 April 2016. The starting amount of the new State Pension may include a deduction if a person was in certain earnings-related pension schemes at work (eg a final salary or career average pension) before 6 April 2016 or a workplace, personal or stakeholder pension before 6 April 2012. This includes the Firefighters' Pension Scheme.

A member of the Firefighters' Pension Scheme will have paid lower national insurance contributions because the scheme is 'contracted out' of the additional State Pension and this will affect most people who have been in work and their State Pension and any additional components.

On 6 April 2016 these rules will change so that if a person is currently contracted out, they will no longer be contracted out and will pay the standard amount of national insurance. Any forecasts currently provided by DWP may not anticipate future changes in qualification for the State Pension.

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