RULE B8
Commutation – small pensions

Rule B8 explains how a small pension can be changed into a lump sum.

The meaning of "commutation"

In Rule B8, "commutation" means turning all or part of a pension which would be paid (normally) over the pensioner's life-time to a single, one-off lump sum payment. When the amount of annual pension is small it is usually in the best interests of the pensioner and the pension scheme administrator to capitalise it in this way, rather than for the pension to be paid in tiny instalments over a period of years.

The meaning of "small pension"

The lump sum derived from this form of commutation is referred to as a "trivial commutation lump sum" in the Finance Act 2004 which sets out the limits, terms of payment, and the tax due.

Eligibility and limitation

Since 5 April 2006, the limits on commutation of this type have been set out in paragraph 7 of Part 1 of Schedule 29 to the Finance Act 2004.

A person must have reached age 60 but not age 75 for "trivial commutation" to be allowed.

Also, the value of all benefits (under the FPS and any other pension arrangement) to which a person is entitled must not exceed 1% of the Standard Lifetime Allowance ("SLA") at a date nominated by the Scheme member. (Benefits you receive as the dependant of a pension scheme member do not have to be included for this purpose.) The SLA for tax year 2006/07 is £1,500,000 and so the 1% limit for this tax year is £15,000. (Your pensions administrator will be able to tell you how much the SLA is in subsequent tax years.)

The formula for valuing benefits which became payable on or after 6 April 2006 is –

$$(\text{Pension + any Pensions Increase} \times 20) + \text{lump sum}$$

and the formula for valuing benefits which became payable before 6 April 2006 is –

$$\text{Pension + any Pensions Increase} \times 25 \times \frac{\text{SLA at nominated date}}{\text{SLA at 6 April 2006 (£1,500,000)}}$$

If the total of all benefits valued in this way is less than 1% of SLA then you would be eligible for trivial commutation of those benefits. All benefits under the FPS would have to be commuted, but not all benefits in total. So you could continue to receive payment of benefits under some other pension scheme even if your FPS benefits are commuted. Those benefits which are to be commuted must be converted to trivial commutation lump sums within a single 12-month period in which the nominated date falls.

Trivial commutation of a set of benefits under the FPS would extinguish entitlement to all other benefits under the FPS including dependants' benefits. It would also extinguish entitlement to any Guaranteed Minimum Pension (see Annexe 8).

Rule B8 (continued)

Method of calculation

Rule B8(2) instructs that the amount of lump sum payable must be calculated from tables prepared by the Government Actuary. The Government Actuary has not published such tables for general use and so your fire and rescue authority would have to write to the Government Actuary asking for the relevant information. The fire and rescue authority must give the Government Actuary details of your basic pension, any Pensions Increase added to date and your date of birth.

Tax

A trivial commutation lump sum is subject to income tax.

If you have not taken, or were not entitled to, any payment of benefits from the FPS before payment of the trivial commutation lump sum , the taxable amount is 75% of the amount of the trivial commutation lump sum payment.

If the benefits were already in payment at the time of the payment of the trivial commutation lump sum, the taxable amount is the total amount of the trivial commutation lump sum payment.

If some benefits were in payment, and others not, the taxable amount is the amount of the trivial commutation lump sum less 25% of the value of the benefits not yet in payment.

Payment

Payment will be made in accordance with Rules L3 and L5.

If the FPS benefit is the first or only benefit to be commuted in this way, the payment must be made within 3 months of the nominated date. If other benefits are due under other pension schemes and these are to be commuted too, they must be commuted within the same 12 month period as the FPS benefits.

Useful reference source

- FSC 39/1978: introduction of commutation of small pensions into the FPS
- Paragraphs 8.12 to 8.16 of Inland Revenue Practice Notes on Approval of Occupational Pension Schemes (IR12(2001)): tax rules for commutation of trivial pensions
- Section 12C(1)(c) of the Pension Schemes Act 1993
- Regulation 20 of the Occupational Pension Schemes (Contracting-out) Regulations 1996: trivial commutation of benefits derived from section 9(2B) rights
- Regulation 60 of the Occupational Pension Schemes (Contracting-out) Regulations 1996: trivial commutation of guaranteed minimum pension
- FPSC 9/2006: amendment to Rule B8 required with effect from 6.4.2006 because of new tax regime

Rule B8 (continued)

Points To Note

1. It is very rare for a pension under the FPS to be small enough to commute. The only circumstances where it is likely to happen is in the case of a very small deferred pension. Rather than commuting your FPS pension, your fire and rescue authority may decide instead to increase the intervals at which they pay the instalments of pension.

2. Before commuting benefits under this rule your fire and rescue authority would have to collect information about any other pension rights to which you are entitled to ensure the Finance Act 2004 requirements are met.

3. If a pension sharing order has been issued, when testing the limit for trivial commutation by valuing the aggregate total of benefits, the value should not include a pension debit. So you would compare the pension to which you are entitled <u>after</u> any reduction has been made to provide your former spouse or civil partner with benefits. On the other hand, if you became the recipient of a pension credit under a pension sharing order, this <u>must</u> be taken into account.

4. Before 6 April 2006, the provisions for "trivial commutation" as set out in Rule B8 were based on the tax rules and social security legislation in force at that time.

   A small pension was defined as being no greater than £260 a year or any greater amount prescribed by regulations “for the time being in force under paragraph 15(4) of Schedule 16 to the Social Security Act 1973”. Subsequently section 12C(1) of the Pension Schemes Act 1993 replaced this reference. However the limit remained at £260. Commutation could not take place before State pensionable age and any Guaranteed Minimum Pension (see Annexe 8) could not be commuted.

   The tax requirements were set out in HMRC (Inland Revenue) Practice Notes IR12 (2001), paragraph 8.12 to 8.16 – “Commutation of trivial pensions”. Section 599 of the Income and Corporation Taxes Act 1988 imposed tax at the rate of 20% on the administrator of the pension scheme (in the case of the FPS the scheme administrator is the fire and rescue authority). Tax under section 599 was charged on the excess of the commutation payment over the greater of:

   (a) 3/80ths of average pensionable pay for each year of service, and
   (b) the maximum lump sum payable on commutation of pension under the FPS rules.