HMRC - PTM093520 - Defined Benefits Arrangements - Aspects Of ‘Benefit Accrual’

Due to the similarities in the principles of these three types of protection this guidance covers them all unless otherwise specified and the three types of fixed protection are referred to collectively on this page as “the fixed protection(s)”.

Scheme with an earnings cap

Fixed Protection (FP 2012) - Paragraph 18 Finance Act 2011

Fixed Protection 2014 (FP 2014) - Paragraph 1(3) Schedule 22 Finance Act 2013

Fixed Protection (FP 2016) Paragraphs 3 and 4 Schedule 4 Finance Act 2016

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A pension scheme’s rules may include an earnings cap. This means that the pension scheme’s definition of final pensionable salary includes a cap on the amount of a member’s earnings that counts as pensionable salary. The cap may change with the tax year (for example the continued operation of the earnings cap under pre 6 April 2006 tax legislation).

Where a member has applied for one of the fixed protections and their pension scheme’s rules include an earnings cap, an increase in the cap will lead to the loss of the fixed protection where this results in benefit accrual.

Example

James is a member of a registered pension scheme. The scheme provides a pension benefit (before commutation for a pension commencement lump sum) of 1/60th of pensionable earnings for each year of service.

The scheme’s rules contain an earnings cap which increases every 6 April by an amount equal to the annual increase in the RPI for the year ending with the preceding month of September, rounded up to the nearest multiple of £600.

On 6 April 2013 the scheme’s cap is £150,000.

For tax year 2013-14, James has earnings of £200,000.

On 5 April 2014 James has completed exactly 30 years of pensionable service. James has therefore accrued a pension of £75,000 (£150,000 x 30/60). That is also the amount he has accrued immediately after midnight on 5 April 2014.

For FP 2014 purposes James’s pension rights are valued at £1.25 million (£75,000 x 20 = £1.5 million) and James has successfully applied for FP 2014.

The annual increase in the RPI between September 2012 and September 2013 is say 5.6%.

On 6 April 2014 the scheme’s earnings cap increases to £158,400 (£150,000 @ 105.6/100 = £158,400. There is no rounding up as £8400 is an exact multiple of £600).

James has remained in active membership of his scheme; under the scheme’s rules his benefits are increased by reference to his length of service and final salary (subject to the earnings cap) rather than by a percentage specified in the scheme’s rules.

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For the purposes of the benefit accrual test, the relevant percentage (see](https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm093600) for more detail) in James’s case is the higher of the appropriate CPI percentage increase and the relevant statutory increase percentage. The CPU percentage increase is the 5.2% increase (say) in the CPI between September 2012 and September 2013. This is higher than any relevant statutory increase percentage that may apply to James’s benefit. So, in James’s case, the relevant percentage for tax year 2014-15 is 5.2%.

This is less than the 5.6 % increase in James’s rights as a result of the increase in the earnings cap.

Benefit accrual has therefore occurred on 6 April 2014 and James loses his FP 2014 from that date.

The benefit accrual test for defined benefits in a tax year during which the member takes their benefits

When a member takes defined benefits in a tax year, whether or not there is benefit accrual at any time is calculated on the basis of their prospective benefits.

The test is carried out on any increase(s) in the value of the member’s prospective pension and lump sum rights occurring throughout the year, ending with the point in time immediately before the BCE(s) occur(s) in relation to the benefits taken.

In the case of an active member whose benefits accrue on the basis of final salary and years of service, since this does not involve increasing the rights of active members by a rate specified in the scheme’s rules, the ’relevant percentage’ (see [

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In the case of an active member whose benefits accrue on the basis of final salary and years of service, since this does not involve increasing the rights of active members by a rate specified in the scheme’s rules, the ’relevant percentage’ (see](https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm093600) for more detail) will be the appropriate annual increase in the CPI unless a higher relevant statutory increase percentage applies in which case that higher percentage is the relevant percentage.

If on this basis benefit accrual does occur at some time during the tax year before benefits are taken then the fixed protection is lost at the point the relevant percentage is exceeded.

If, later in the same tax year, those benefits are taken early and are subject to an actuarial reduction, then even though the value of the benefits taken may at that stage be less than the value of those benefits when they were calculated under the benefit accrual test, this does not alter the position and the fixed protection remains lost.

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Death-in-service benefit for members with fixed protection who ceases to accrue any further pension benefits in their employer’s defined benefits scheme

Under the tax rules it is possible for death-in-service benefits to be provided for individuals with deferred pension benefits. However a pension scheme may choose not to provide death in service benefits if a member stops being an active member. This will depend on the rules of the scheme.

Whether or not an individual can continue to have death benefits (life cover) and keep their fixed protection depends on the type of arrangement providing the death benefits. If the death benefit promised is a defined benefit (and this is often the case in occupational pension schemes) continuing to provide death cover should not cause loss of the fixed protection. This is because a death-in-service benefit is not considered to be part of a member’s defined benefit pension rights. So if a member continues to be provided with death-in-service defined benefits this is not benefit accrual and does not cause loss of the fixed protection.

If the death benefit promised is on the basis of an other (i.e. non-cash balance) money purchase benefit, cover may only continue with the member keeping their fixed protection if it is provided by a policy established before 6 April 2006. The conditions at PTM093100 must be met. Fixed protection is lost where contributions are made to a policy set up on or after 6 April 2006.

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The consequences where a scheme insures against lump sum death benefits and continues payment of premiums for a member with any of the fixed protections

If the death benefit promised is on the basis of an other (i.e. non-cash balance) money purchase benefit, cover may only continue with the member keeping their fixed protection if it is provided by a policy established before 6 April 2006. The conditions at PTM093100 must be met. Fixed protection is lost where contributions are made to a policy set up on or after 6 April 2006.

Where the only lump sum death benefit being provided under an arrangement under the scheme rules is an amount equivalent to the proceeds of an insurance policy, in other words, there is no provision for a defined benefits lump sum death benefit, then the arrangement is clearly an other money purchase arrangement.

Where the lump sum death benefit is expressed as being the greater or lesser of:

a defined benefit (an amount determined by reference to salary, service or some other factor) and

the policy proceeds,

then this is a hybrid arrangement. This is because, depending on the circumstances when the member dies, either a defined benefit or a money purchase benefit that is not cash balance will be payable.

Benefit accrual occurs in relation to both an other money purchase arrangement and a hybrid arrangement capable of paying such money purchase benefits where a relevant contribution is paid under the arrangement on or after:

6 April 2012 in the case of FP 2012)

6 April 2014 in the case of FP 2014, or

6 April 2016 in the case of FP 2016.

In each case, the payment of insurance premiums on or after the relevant dates result in benefit accrual and loss of fixed protection if the premium is a ‘relevant contribution’ as defined by paragraph 14 of Schedule 36 to Finance Act 2004 by virtue of paragraph 14(11) of Schedule 18 Finance Act 2011 for FP 2012, paragraph 1(10) of Schedule 22 to Finance Act 2013 for FP 2014 and paragraph 3(4) of Schedule 4 Finance Act 2016 for FP 2016.

However, there are a number of other scenarios in which insured lump sum death benefits may be paid. Where the death benefit being paid is not a money purchase benefit that is not cash balance, continuing payment of premiums after 5 April 2012, 5 April 2014 or 5 April 2016 as appropriate will not be benefit accrual and so the fixed protection is not lost. The following are examples of scenarios where there is no benefit accrual if insurance premiums continue to be paid.

Note: For the purpose of these examples, the defined benefits lump sum death benefit to be provided is assumed to be a lump sum of 4 times final salary. In practice, the defined benefit may be different (such as a specified sum or by reference to a different multiple of salary), and any increase in the value of defined benefit after 5 April 2012, 5 April 2014 or 5 April 2016 as appropriate is not benefit accrual.

Examples

A lump sum death benefit of 4 times final salary is paid out of scheme funds. This benefit is a defined benefits lump sum death benefit.

A lump sum death benefit is backed by an insurance policy where, if the policy proceeds exceed the promised lump sum death benefit, the excess is paid to the scheme for the provision of other benefits under the scheme.

A lump sum death benefit is backed by an insurance policy with the scheme liable to make good any shortfall where the proceeds of the policy are insufficient to fully fund the cost of the promised lump sum death benefit.

A lump sum death benefit is calculated as above and is backed by an insurance policy which will not pay out more than the promised lump sum death benefit but may contain restrictions. These restrictions, if applicable, will result in an amount payable to the scheme (or payable directly to the beneficiary(ies) which is less than the unrestricted promised defined benefits lump sum death benefit.

Many insurance policies contain such restrictions as terms of the policy. Examples include when there is a ‘catastrophe’ event resulting in multiple deaths of individuals covered by the policy or a reference to a particular individual who represents a greater insurance risk. If the lump sum death benefit paid to the beneficiaries after the restriction is applied can itself be expressed as a defined benefits lump sum death benefit then it will be treated as such. This can occur where the benefit

represents a percentage of the defined benefits lump sum death benefit that would have been provided in normal circumstances.

it is paid on a pro rata basis to the defined benefits lump sum death benefit that would have been provided in normal circumstances

it is expressed as a specified amount lower than 4 times final salary, or

the maximum paid under the policy is capped at a specified amount.

The exact position will depend upon the restrictions that apply under a particular policy. Provided the maximum lump sum death benefit that can be provided under the policy is the defined benefits lump sum death benefit of 4 times final salary and the restricted lump sum death benefit is defined in a manner which satisfies either the definition of defined benefits or, possibly, a benefit under a cash balance arrangement there will be no other money purchase element to the benefits to be provided. Where, under a group life policy, there are restrictions applying to one or more particular members covered by the policy but they do not apply to a member with fixed protection, then no account need be taken of those restrictions in deciding whether that member’s benefit is a defined benefits lump sum death benefit.

An individual has restricted benefits under one policy but a further policy is taken out by the scheme in respect of the individual to ensure that the maximum 4 times final salary lump sum death benefit is paid. The aggregated benefits under the two policies will be a defined benefits lump sum death benefit, subject to the top-up policy not itself being an other money purchase arrangement because the entire proceeds will be paid out as a lump sum death benefit.

The insurance policy might, for example, make provision for a maximum dependants’ pension equal to 30 per cent of the member’s salary, but with the pension restricted to the ‘free-cover’ divided by a specified multiple (say 30). So, if the free-cover is £500,000, the maximum dependant’s pension is £16,667. This is a defined benefit, as a specified benefit (a pension) will be provided and that pension is calculated by reference to a factor, rather than just the amount available for the provision of dependants’ benefits.

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People whose life cover ceased because they believed the continuing payment of premiums would lead to loss of their fixed protection

In such cases, re-instatement of the life cover is not regarded as involving a new arrangement for the member so long as:

the cover was re-instated as soon as possible whether with the same or a new insurer, and

the basis of the cover provided has not been increased in comparison to the cover previously provided.

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Refunds of contributions on death in service

Under scheme rules a lump sum death benefit may include an amount equal to a multiple of salary or a set monetary amount together with a refund of the contributions paid to the scheme by the deceased member.

HMRC’s view is that the payment of a refund of contributions on death is a defined benefit and that the aggregate lump sum is a defined benefits lump sum death benefit. Where the rules also provide for the refund to include an element of ‘interest’ or growth to be paid, then provided that the scheme rules provide for the payment and it is expressed or can be expressed in percentage terms then this will not affect the defined benefits nature of the lump sum. The scheme rules may specify an annual percentage rate of ‘interest’ or a rate in line with the average annual base rate of a bank etc. or a rate to be determined by the scheme trustees in accordance with actuarial advice. Such rules are accepted as providing a defined benefit.

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