House of Commons

Appendix: Summary of McCloud tax implications

1 Summary

HMRC intends to make regulations ("the Regulations") before the end of the current tax year which will clarify various tax matters relating to the McCloud exercise in the PCPF. While the Regulations are not yet finalised, we believe that we have a good understanding of how the main tax points will work in practice. This is based on engagement with HMRC, as well as HMRC's *Pension Schemes Newsletter 158* ("Newsletter 158"). The information provided in this Appendix, is based on that understanding, and is subject to the caveats in the covering letter.

At a very high level, the overall intention is that the net effect on members whose McCloud choice results in a change to their PCPF benefits is that they will pay the same amount of tax as they would have paid if they had accrued benefits on the revised basis in the first place (i.e. as if the PCPF McCloud exercise were fully retrospective). In practice, members will need to pay the tax owed and then apply to have an equivalent amount paid back to them.

The Regulations will make it possible for some elements of the McCloud remedy to be implemented in a way that is tax neutral. For example, where a member has "overpaid" contributions (i.e. where the rate of contributions they have actually paid is higher than the rate which would have been payable, based on their McCloud choice), it will normally be possible for the Trustees to pay the net amount of additional salary which the member would have received if it had been paid at the relevant time, and the payment of that net amount will not itself attract tax.

However, there are other aspects of the McCloud remedy which may not be tax neutral at the point of implementation (e.g. in relation to the annual allowance). Where this results in you paying more tax than you otherwise would have paid if your choice were fully retrospective, you will be able to make an application under the "Redress Scheme" which IPSA has introduced within the PCPF Rules. Payments under the Redress Scheme are discretionary, so it is not legally possible to guarantee any particular outcome, but the Redress Scheme is intended to put members into the position which they would have been in had they accrued benefits on the revised basis in the first place (i.e. as if the PCPF McCloud exercise were fully retrospective). In most cases, Payments under the Redress Scheme are determined by the Trustees, but there are circumstances in which IPSA's consent may be required.

The information in this Appendix should be sufficient to allow most members to make an informed decision, having taken such independent financial advice as they consider appropriate. However, if you have specific questions, you should raise these with the Members' Pensions team as soon as possible.

Section 2 of this appendix highlights a number of circumstances in which you should contact the Members' Pensions team as soon as possible, if they apply to you.

Section 3 of this appendix provides further detail on specific aspects of the tax implications of the PCPF McCloud exercise.

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2 Particular circumstances which may impact tax analysis

If any of the following circumstances apply to you, and you are considering exercising a McCloud option which would result in a change to your PCPF benefits, please contact the Members' Pensions team as soon as possible:

- If you were in receipt of a pension from the PCPF and you either have already, or are considering exercising a McCloud option which would reduce the amount of pension payable to you
- If you incurred a lifetime allowance charge as a result of starting to take benefits in another pension scheme at any point between 8 May 2015 and 31 March 2023
- If you have been paid a Lifetime Allowance Excess Lump Sum or a Guarantee Shortfall Lump Sum from the PCPF
- If you have triggered an annual allowance charge in relation to any tax year from 2015/16 to 2022/23 and you paid some or all of that tax charge using "scheme pays" from a different registered pension scheme (ie not through the PCPF).

3 Further detail on specific tax issues

The tax issues relating to McCloud and the benefit structure in the PCPF are both very complicated, and further complications may arise for the individual circumstances of particular members. The following sections are summaries only, and are based on our current understanding. They do not attempt to cover all possible scenarios.

3.1 Annual allowance (2024/25)

Where the exercise of a McCloud option results in a change to the member's benefit entitlement, it will impact the calculation of the member's "pension input amount" for annual allowance purposes for the tax year 2024/25. To avoid a tax windfall, HMRC have also extended the annual allowance regime to pensioner members (who are normally out of scope) for the year 2024/25 only.

HMRC explained how the additional pension input amount will be calculated in Newsletter 158, which contains more detail, but at a very high level the additional pension input amount will be calculated by assessing the change to the member's aggregate benefits, i.e. looking across both the CARE Section and the Final Salary Section.

Where a member's benefits increase as a result of their McCloud choice, this may result in the member becoming liable for an annual allowance charge which is greater than the aggregate annual allowance charge(s) which would have been payable if the relevant benefits had been accrued retrospectively. If so, the member would be able to apply for redress under the Redress Scheme.

We understand that a member will need to pay their annual allowance charge before the Trustees can reimburse them from the Redress Scheme, to avoid additional tax complications. However, it should be possible for members to ask the Trustees to pay the charge via "Scheme Pays", so that the Trustees pay the charge directly and adjust the member's benefits accordingly. The part of the adjustment which relates to an "overpaid" tax charge can then be "unwound" under the Redress Scheme (i.e. thereby seeking to restore the member to a tax neutral position).

If you transfer your benefits out of the PCPF, you should be aware that you will be unable to use Scheme Pays to help pay any applicable annual allowance tax charge.

3.2 Lifetime allowance (2024/25)

Although the lifetime allowance has now been abolished, the Regulations will include provisions for a special tax charge which is intended to avoid members receiving a windfall where they would have been subject to a lifetime allowance charge if they had been able to take their McCloud revised benefits at their retirement.

It is important to note that HMRC's proposals on this tax charge have evolved since Newsletter 158 was published in April, and members should therefore *not* rely on Newsletter 158 in relation to the lifetime allowance windfall charge.

HMRC is now proposing that, in summary, the amount of the charge will be equal to the total amount of additional lifetime allowance charge(s) for which the member would have become liable if the McCloud remedy had been fully retrospective for tax purposes. Members who pay this tax charge should therefore not incur any adverse tax consequences.

3.3 Annual allowance charges and lifetime allowance charges from previous tax years

If a member exercises a McCloud option which reduces the value of the benefits they accrued in the relevant period, any annual allowance charges and/or lifetime allowance charges which they triggered during that period may have been "too high". In this scenario, it is expected that the member would be able to recover the "excess" tax paid from the Redress Scheme.

If the relevant tax charge was paid by the Trustees (e.g. through "Scheme Pays"), and the members benefits were subsequently reduced, the Trustees will be able to unwind the part of the adjustment which relates to the "overpaid" annual allowance tax charge under the Redress Scheme (i.e. we will seek to put the member in a tax neutral position).

3.4 Payments from Trustees to member (refund of excess contributions / arrears of underpaid benefits)

Broadly speaking, it is expected that payments from the Trustees to the member will be made net of the tax which would have been deducted (or otherwise payable) by the member if the relevant payment had been made at the relevant time (i.e. retrospectively).

For example:

Where a refund of excess contributions is paid, it will be paid net of the income tax which would have been payable when the contributions should have originally been paid. This means that the amount members receive should be equal to the amount they would have received, had they not made the contributions in the relevant McCloud remedy tax years. In other words, the payment will reflect the fact that members received income tax relief on the contributions which they originally paid. In due course, you will be asked to confirm your marginal tax rate for each year of the McCloud period and may also be asked to provided supporting evidence. Once this is received, Gallagher will be able to confirm the total net payment due to be made to you.

A top up to a pension commencement lump sum will be paid free of tax (because it would also have been paid tax-free if paid at the relevant time) as long as you have sufficient lump sum allowance. If you have insufficient lump sum allowance available, you should contact the Members' Pensions team.

The Regulations will provide that relevant payments that have been calculated in this way will be treated as authorised payments (for pension tax purposes) and not subject to income tax.

However, arrears of underpaid pension will be subject to income tax in the year in which the payment is made. If you are owed arrears of pension payments as a result of your McCloud choice and your marginal rate of income tax is higher than the marginal rate which applied at any time during the period over which your pension has been in payment (including where the arrears payment puts you into a higher tax bracket), you may incur "too much" income tax. In this scenario, it is expected that the member would be able to recover the "excess" tax paid from the Redress Scheme.

3.5 Payments from member to Trustees (arrears of underpaid contributions / repayment of overpaid benefits)

It is expected that the amount payable to the Trustees will be net of the amount of tax actually paid by the member on the relevant amount they received.

For example, where a member owes the Trustee additional contributions as a result of their McCloud choice, the member will only have to pay the net amount of "extra" salary they received as a result of paying lower contributions. In order to calculate the net payment required, in due course you will be asked to provide confirmation of your marginal tax rate for the McCloud period, including whether you were a Scottish taxpayer for any of this period. You may also be asked to provide supporting evidence.

Similarly, the amount of overpaid benefits to be recovered will be calculated net of the income tax actually paid by the member on those benefits.

Arrangements for making these payments will be determined by the Trustees depending on the particular circumstances, and may involve offsetting the relevant amounts against future benefit payments. This is not expected to have any adverse tax consequences for members.

3.6 Members who have transferred out

Where a member has transferred out and exercises a McCloud option which results in an increase to the value of their benefits, it will generally be possible to effect the McCloud remedy by paying an additional transfer payment to the receiving scheme (provided that the receiving scheme is able to accept it). Such a payment will be a "recognised transfer" for pension tax purposes.

3.7 Deceased members

The implementation of a McCloud option may be more complex in some cases where the member is already deceased, particularly where death benefits are being (or have been) paid to multiple beneficiaries.

The Trustees will seek to engage with impacted beneficiaries to manage these issues as effectively as possible.

3.8 Redress Scheme payments

The Regulations will include provisions to ensure that payments made from the Redress Scheme will be treated as "authorised payments" for pension tax purposes and are not subject to income tax, provided that they fit within certain criteria.

Those criteria are intended to capture the principal circumstances in which it is anticipated that Redress Scheme payments may be needed in order to ensure that members do not suffer inequitable tax outcomes.

As noted above, the Regulations will also ensure that it is possible for the Trustees to effect tax redress under the Redress Scheme by unwinding the relevant part of a tax-related adjustment to benefits (e.g. following the exercise of a "Scheme Pays" option). This means if your benefits are actuarially reduced to take account of a tax charge the Trustees are required pay on your behalf, the actuarial reduction can be unwound, to the extent that you would not have incurred a tax charge if the PCPF McCloud remedy was considered retrospective for tax purposes.