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PRACTICE NOTE

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ISLE OF MAN APPROVED PENSION SCHEMES

TRIVIALITY

What is Triviality?

Approved pension schemes are set up with the sole purpose of providing the member with a pension for life. To fund the pension, the member, the member's employer and, in some cases the DHSS, will make contributions to the scheme. Triviality occurs when the total amount of those contributions and associated investment returns is small. There are many reasons for this, including low contribution rates or short periods of employment/membership of an employer's pension scheme.

When triviality occurs, the member can opt to convert the small pension fund into a single lump sum (known as a trivial commutation lump sum). However, this will extinguish all other benefits which will otherwise have been payable out of the scheme.

Alternatively, the member can choose to have the pension paid in accordance with the rules of the scheme or bring funds together by transferring accumulated benefits from one approved pension scheme to another. The member should obtain independent financial advice before deciding how to proceed.

Applicable Legislation

Legislation was introduced by sections 5 and 6 of the Income Tax (Pensions) Act 2008, as follows:

- For occupational schemes – sections 2(2)(ff), 2(6) and 10B have been inserted in the Income Tax (Retirement Benefit Schemes) Act 1978;
- For personal pension schemes – sections 5A and 22B have been inserted in the Income Tax Act 1989.

The new legislation is supported by the following Orders and Regulations which are applicable to all approved pensions:

- SD 508/08 Income Tax (Approved Pension Schemes) (Trivial Commutation Lump Sums) Regulations 2008; and

- SD 509/08 Income Tax (Approved Pension Schemes) (Rate of Tax on Trivial Commutation Lump Sums) Order 2008.

Triviality Conditions

Not all small pension funds qualify for triviality. Therefore, before the option can be exercised, a number of conditions must be satisfied. The conditions are:

- a) **Age of the member** – a trivial commutation lump sum can only be paid when the member has reached 60, but has not reached 75. Trivial commutation lump sums cannot be paid before 60, even if the scheme could pay a pension earlier.

It may be possible to commute a pension before the member reaches 60, but only if the pension would have come into payment due to serious ill-health or if the member's employment has a customary retirement age of less than 60 (e.g. professional athlete).

- b) **Commutation limit** – pension funds that are below the commutation limit can be paid as a trivial commutation lump sum. The commutation limit set in 2008/2009 was £16,500. This amount will be reviewed annually as part of the Budget. Any amendment to the limit will be published by the Income Tax Division.

The valuation of the pension fund is the full amount of fund available to pay all pension benefits (including tax-free lump sums) to the member. A defined benefit scheme may be considered to be a trivial pension if the amount of the annual pension multiplied by 20 is less than the commutation limit.

- c) **Multiple schemes** – regulations allow pension schemes to be looked at individually. Therefore, the triviality option can be exercised in respect of one or more schemes provided the total value of the funds being commuted is less than the limit.

The commutation limit will reduce with each successive commutation, and it is possible a small pension will not qualify because the commutation limit remaining after earlier commutations is too low. Commutation of a pension which is not within the commutation limit would constitute an unauthorised payment and will be subject to income tax at the higher rate.

- d) **Commutation period** – if a person is a member of more than one scheme, triviality may be exercised in respect of one or more of those schemes; but it can only be exercised during the commutation period.

The commutation period starts on the date on which the first trivial commutation lump sum is paid and ends 12 months later. All triviality claims must be made within the 12 month commutation period. This is a one-off opportunity; therefore, if multiple triviality claims are likely, the member should delay the first claim until all other claims are established. All trivial commutation lump sums must be paid before the member reaches 75.

Commuting a trivial pension after the commutation period will constitute an unauthorised payment and will be subject to income tax at the higher rate.

- e) **Contracted-out Pension Rights** – Any alternative or additional DHSS legislation must be satisfied before trivial contracted-out pension rights may be commuted.

- f) **Income Tax** – up to 30% of the trivial fund can be paid free of income tax; the remaining part of the trivial commutation lump sum is liable to income tax at 10%. The tax must be deducted before the trivial commutation lump sum is paid to the member

and should be remitted to the Income Tax Division within 14 days of the deduction.

If the member is not liable to pay income tax (for example the person's total taxable income is less than their personal allowance), a claim for a repayment of the tax can be made at the end of the tax year. The total value of the trivial commutation lump sum, together with evidence of the tax deducted at source, should be included on the member's income tax return.

Unauthorised Payments

If a trivial pension:

- is commuted before the member is 60;
- is commuted outside the commutation period; or
- exceeds the commutation limit (including aggregate of all commutations);

the amount commuted will constitute an unauthorised payment. A tax liability at the higher rate will result on the whole of the amount paid.

Trivial Commutation Lump Sums – Check List

A check list is provided in appendix 1 of this Practice Note. The check list should help pension providers and members to determine whether trivial commutation is possible.

Independent Financial Advice

Exercising the triviality option will extinguish all future pension benefits which would have been payable by the scheme. If a lump sum payment falls outside the conditions set out above, it will constitute an unauthorised payment and will be liable to income tax at the higher rate. Tax-free lump sum benefits and any liability to tax at the lower rate will be lost. Members considering whether to commute trivial pension benefits to lump sums are encouraged to seek independent financial advice before they do so.

Examples

- 1) J is a member of a pension scheme, he is 65 and the total fund value is £14,500. He has no other pension arrangements.

J can exercise the triviality option; 30% (£4,350) can be paid as a tax-free lump sum, with 10% income tax (£1,015) being deducted from the balance.

- 2) N is a member of two different pension schemes, she is 61 and the fund values are £10,000 and £11,000.

N cannot commute both schemes because the total would exceed the £16,500 commutation limit. N could, however, commute one scheme. It does not matter which, as both are below the commutation limit.

- 3) P is 60 and a member of three different pension schemes, two are small, valued at £3,000 and £5,000. The third pension is a final salary pension scheme which will pay P a pension of £10,000 per year. P commutes the smallest pension and receives a trivial commutation lump sum on 1 September 2008. Because of an oversight P forgets to process the paperwork needed to commute the £5,000 pension – this oversight is

corrected and a claim for triviality is filed on 1 August 2009.

P can receive a trivial commutation lump sum following the second claim. This is because the claim is made within the commutation period of 12 months from the date of the first commutation.

- 4) R is a member of two different pension schemes, he is 63 and the fund values are £10,000 and £50,000. Recognising the fact he can exercise the triviality option, he commutes the smaller scheme. R receives the trivial commutation lump sum on 1 September 2008. Fifteen months later R receives a letter from another pension provider reminding him that his pension will soon commence. R had forgotten about this pension and would like to commute it on the grounds of triviality – the total value of the fund is only £3,000.

R cannot commute this pension because the commutation period ended on 31 August 2009, three months before he was notified about it.

- 5) T is a member of three small pension schemes with an aggregate value of £14,500. T will be 75 on 1 February 2009 and would like to commute all of the pensions.

T can commute all of the pensions, provided each trivial commutation lump sum is paid before her 75th birthday. Trivial commutation lump sums paid after her 75th birthday will constitute unauthorised payments and will be liable to tax at the higher rate even if the claim was made before she was 75. Members must ensure all triviality claims are identified early; all claims must be completed within the commutation period and all trivial commutation lump sums must be paid not later than 75. Note that in this case the commutation period will be shorter than 12 months.

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Assessor of Income Tax

This Practice Note is intended only as a general guide and must be read in conjunction with the appropriate legislation. It does not have any binding force and does not affect a person's right of appeal on points concerning their own liability to income tax.

Comments and suggestions for improvements of issued Practice Notes and suggestions for future Practice Notes are always welcome.

Appendix 1

Trivial Commutation Lump Sums Check List

The following checklist should help you to decide whether a triviality claim will be possible. If any of your answers appear in the shaded boxes triviality is not normally available.

	Yes	No
1) Is the member at least 60?		
2) Is the member under 75?		
3) Has the member received any trivial commutation lump sums <u>more</u> than 12 months before this claim?		
4) Is the total value of this pension fund <u>more</u> than the commutation limit (£16,500 in 2008/2009)?		
5) If other trivial commutation lump sums have been received, is the total value of this pension fund <u>more</u> than the amount of the commutation limit remaining after deduction of those other lump sums?		
6) If this pension includes contracted-out pension rights, are you satisfied that the payment of a trivial commutation lump sum would be in accordance with applicable DHSS legislation?		

If you have answered 'no' to question 1, triviality may be possible if the member suffers serious ill-health or is in an employment where retirement earlier than 50 is customary (e.g. professional athlete). You should contact the Income Tax Division for further information if this applies.

If all of the answers are outside the highlighted areas, triviality is available and a trivial commutation lump sum can be paid as an authorised payment. In accordance with current statute:

- 30% of the lump sum can be paid without deduction of income tax;
- the balance of the lump sum is liable to tax at the lower rate of 10%; and
- the tax must be paid to the Assessor within 14 days of the date on which the trivial commutation lump sum is paid.