

Tax-Free Cash Sum

Method of calculation

In a salary related scheme, it is usual to allow members to exchange part of their pension for a tax-free cash sum. This term is known as 'commutation'.

The scheme's method for calculating the tax-free cash sum will generally be detailed in the scheme booklet.

The maximum tax-free cash sum permitted by HMRC is typically 25% of the capital value of benefits, subject to a maximum of £268,275.00 across all arrangements. This maximum value is frozen from 6 April 2023 and is based on 25% of the Lifetime Allowance that was in force on 6 April 2023.

Some members may have entitlement to a higher 'protected' tax-free cash sum based on their accrued entitlement at 5 April 2006, or they may be entitled to a higher tax-free cash sum if they are registered for a particular 'protection' (e.g. Primary Protection, Enhanced Protection, Fixed Protection 2012, Fixed Protection 2014, Individual Protection 2014, Fixed Protection 2016 or Individual Protection 2016).

The maximum tax-free cash sum payable from a salary-related scheme is generally based on the following formula:

$$\text{Cash sum} = \frac{20 \times \text{Full Scheme Pension}}{3 + \{20 / \text{Comm. Factor}\}}$$

For example, the tax-free cash sum at normal pension date (age 65, say) for a member whose full scheme pension is £9,000.00 per annum and for whom the commutation factor is 15.00 would be calculated as follows:

$$\text{Cash sum} = \frac{20 \times \text{£}9,000.00}{3 + \{20/15.00\}} = \text{£}41,538.47$$

If a member has AVCs, it is possible that the tax-free cash sum may be further increased (subject to HMRC limits). In addition, the scheme rules will normally allow for any AVCs to be taken in their entirety in the first instance before commuting from the scheme pension.

Some schemes (particularly those in the public sector) provide the tax-free cash sum as a separate benefit to the pension, typically based on an accrual rate of 3/80ths of salary. The accrual rate for the pension is usually lower in these circumstances (e.g. a pension based on 1/80ths of salary).

Historically, it has not generally been permissible to mix and match these benefits. However, since 6 April 2006 (and the introduction of Tax

Simplification) some schemes have chosen to allow some of the member's tax-free cash sum to be exchanged for additional pension. Similarly, some schemes do now allow the balance between the tax-free cash sum provided by the scheme and the maximum amount permitted by HMRC to be commuted from the member's scheme pension.

Residual pension

Where members exchange some of their pension for a tax-free cash sum, it is necessary to calculate the pension equivalent of this cash sum and then reduce the full scheme pension accordingly. The resulting reduced pension is known as the 'residual pension'.

The pension equivalent of the cash sum is calculated by dividing the amount of cash by a commutation factor, which will be dependent on the member's age at retirement and the value of the pension being commuted.

The scheme's actuary is responsible for determining the commutation factors.