AJBell Investcentre

ADVISER GUIDE

The pensions lifetime allowance

Contents

Key points

- Individuals can withdraw up to their lifetime allowance from a pension with no tax implications. However, there will be a lifetime allowance charge on any excess over the lifetime allowance.
- A benefit crystallisation event (BCE) is when the amount of pension benefits is tested against the lifetime allowance. There are 13 BCEs in all.
- There may be a second BCE at age 75 if a person has previously crystallised into drawdown and the drawdown fund at age 75 is bigger than the drawdown fund at the first BCE.
- If someone uses up more than 100% of their lifetime allowance, then there is a tax charge on the excess amount. The tax charge is 55% if the excess is paid to the individual as a lump sum or 25% if the excess is retained within the pension.
- When crystallising retirement benefits, the scheme administrator is responsible for calculating any lifetime allowance charge. The scheme administrator and the individual are usually jointly responsible for paying the lifetime charge.
- More and more people face paying a lifetime allowance charge on their pension benefits. Financial advisers and planners will want to work with their clients to minimise any charges. These are complicated decisions to make. Everyone's circumstances will be different and personal to them, as will be their objectives and wishes.

IMPORTANT

This information is based on current understanding of current pension tax rules. This is provided for information only; we do not provide advice.

Tax rules may change in the future and the tax treatment depends on personal circumstances. This guide and the included case studies are provided for professional advisers' use only.

Overview

The pension lifetime allowance is one of the most significant tax rules for pensions. Understanding how it works – and how any lifetime allowance charge is calculated – is of importance in helping clients plan their later life and inheritance finances.

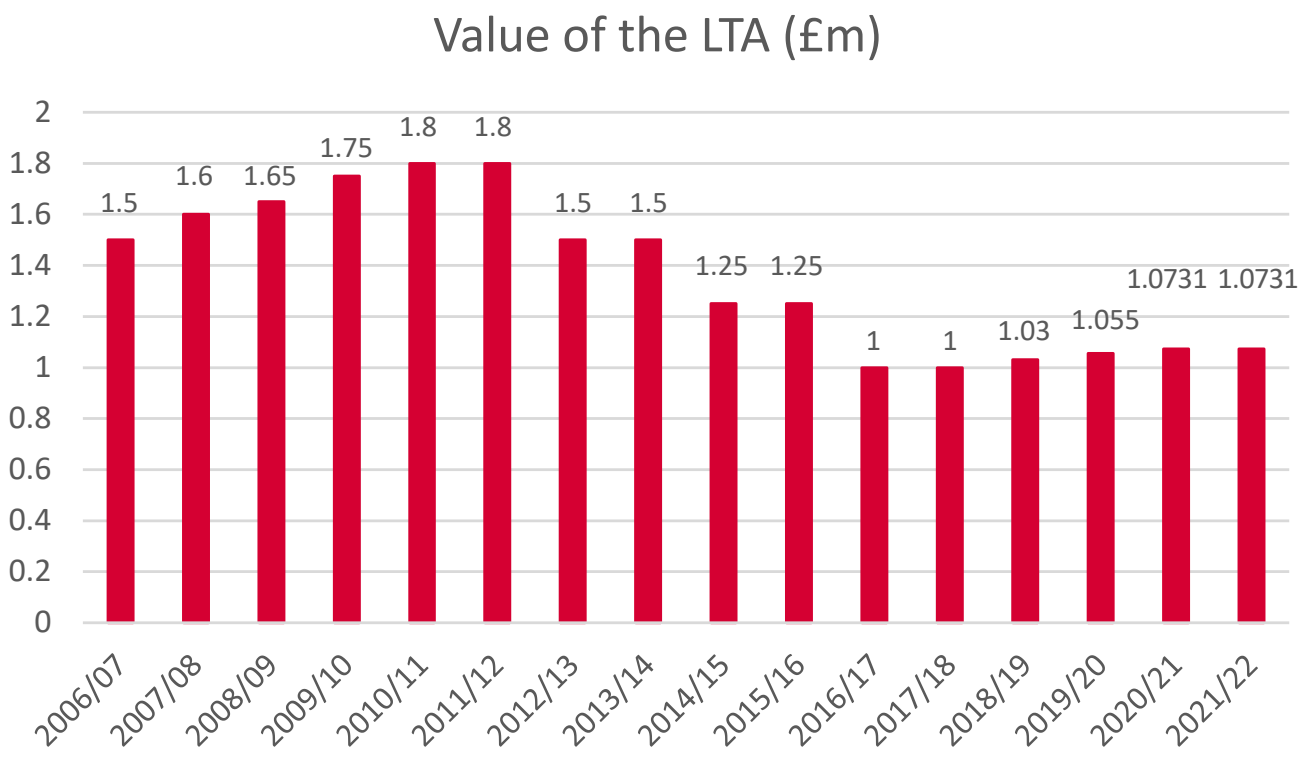
To encourage people to save for later life, the Government offers generous tax advantages to those saving in a pension. However, to stop people abusing these tax advantages, the Government put two checks on pension saving: one on the level of contributions (the annual allowance), and the other on the amount people take out of a pension (the lifetime allowance).

People can take as much money as they want from out of a pension. But there is a limit on how much they can take out tax-efficiently; if they take out more than their lifetime allowance, then a tax charge will apply on the excess.

A benefit crystallisation event (BCE) is when the amount of pension benefit is tested against the lifetime allowance – for example on designating drawdown, taking a pension commencement lump sum (PCLS) or on death.

This guide explains what the different BCEs are and how the lifetime allowance charge is calculated and paid, and explores the different factors to consider when advising clients how to avoid or reduce any lifetime allowance charge.

The value of the lifetime allowance



When the lifetime allowance was first introduced in April 2006 – as part of the A-Day pension reforms – it was £1.5 million. The first five years of increases to the lifetime allowance were set out in legislation.

However, the lifetime allowance was subsequently cut three times – in 2012, 2014 and 2016 – eventually falling to £1 million. Between 2018/19 and 2020/21 the lifetime allowance increased each year in line with the increase in the Consumer Price Index (CPI) in the previous September. From 2021/22 the lifetime allowance is frozen at £1,073,100 for five years.

Benefit crystallisation events

A BCE is when the amount of pension benefit is tested against the lifetime allowance. There are 13 BCEs in all.

Taking pensions

BCE 1 Where funds are designated to provide a drawdown pension

BCE 2 Where an individual becomes entitled to a scheme pension

BCE 3 Where a scheme pension is increased beyond an allowable amount

BCE 4 Where an individual becomes entitled to a lifetime annuity

Unused funds at age 75 or on earlier death

BCE 5 Where an individual reaches age 75 under a defined benefit arrangement without having drawn all or part of their entitlement as a scheme pension and/or lump sum

BCE 5a Where an individual reaches age 75 with a drawdown pension fund

BCE 5b Where an individual reaches age 75 with unused money purchase funds

BCE 5c Where an individual dies before their 75th birthday and any uncrystallised funds are designated to provide their beneficiaries with a drawdown pension

BCE 5d Where an individual dies before their 75th birthday and any uncrystallised funds are used to provide a purchased dependants or nominees annuity*

Lump sums

BCE6 Where an individual becomes entitled to a relevant lump sum

Death

BCE7 Where a relevant lump sum death benefit is paid on the death of an individual

Transfer to Qualified Recognised Overseas Pension Scheme (QROPS)

BCE8 Where an individual's benefits are transferred to a QROPS

Other

BCE9 Where certain payments are made to or in respect of an individual:

- payments of 'arrears' of pension after death
- lump sums based on pensions errors
- pension commencement lump sum (PCLS) – paid after death

* The death must have happened on or after 3 December 2014 with the entitlement arising on or after 6 April 2015 but before the end of a two-year period.

Normally, BCEs use up an individual's available lifetime allowance in the chronological order in which they happen. Where BCEs occur simultaneously, the individual must decide the order the BCEs take for the purpose of the lifetime allowance test. The exception to this is where the individual becomes entitled to a PCLS (which is paid free of Income Tax). The BCE for this always happens immediately before the BCE for the associated pension benefit, which is taxable.

Valuation of pension benefits

Money purchase

The valuation of money purchase pension benefits for the purpose of comparing against the lifetime allowance is based on the actual fund value (market value of the assets) used to secure the benefits – for example, the drawdown fund or the amount used to buy a lifetime annuity.

Benefits that were in payment before 6 April 2006 also have to be included when valuing benefits. The benefits are valued at the first crystallisation event after 6 April 2006.

Annuities in payment are valued at 25:1, and capped drawdown benefits are valued at 80% of the Government Actuary's Department (GAD) maximum income valued at 25:1.

Defined benefits

The value of the scheme pension paid or bought by the defined benefit scheme is multiplied by a factor of 20:1.

The factor of 20 is used regardless of the features of the scheme pension, including what level of attached spouse's pension applies, what rate the pension will increase by, and whether there is any guarantee period.

If the pension scheme offers a separate lump sum, then this is valued under a different BCE (BCE6).

Example – David

David is aged 67. He is retiring from his employment. He has built up 23 years of service and his final salary is £46,000. His pension schemes offer a pension worth 1/80 of final salary for each year of service, and a separate cash sum of 3/80 of final salary for each year of service.

BCE 2: David's pension = 1/80 x 23 x £46,000 = £13,225
Value for the purposes of comparing against the lifetime allowance = £13,225 x 20 = £254,500

BCE 6: David's lump sum = 3/80 x 23 x £46,000 = £39,673
This is the value to use when comparing against the lifetime allowance.

Measuring the amount of lifetime allowance used up

The amount of pension benefits compared at a BCE is measured as a percentage of the current lifetime allowance. (An exception to that would be if the person had applied for transitional protection of the lifetime allowance where a different protected lifetime allowance would be used.) The percentage is always expressed to two decimal places and is rounded down.

This percentage is added to any percentage used up previously under the same or any other registered pension scheme.

Example – Ezra

Ezra is 65 in June 2017. His SIPP is worth £600,000. He takes £400,000 as drawdown, when the lifetime allowance is £1,000,000. There are two BCEs:

- BCE6: £100,000 PCLS uses up 10% (£100,000 / £1,000,000)
- BCE1: £300,000 drawdown uses up 30% (£300,000 / £1,000,000)

In August 2020, Ezra takes his remaining SIPP benefits, which have grown in value to £215,000. The lifetime allowance is now £1,073,100:

- BCE6: £53,750 PCLS uses up 5% (£53,750 / £1,073,100)
- BCE1: £161,250 drawdown uses up 15.02% (£161,250 / £1,073,100)

In total, Ezra has used up: 40% + 20.02% = 60.02% of the lifetime allowance

The second drawdown BCE

When a person designates funds into drawdown, there is a BCE (BCE1) and a test against the lifetime allowance. There may be a second BCE at age 75 if that person is still in drawdown and the drawdown fund at age 75 is bigger than the drawdown fund at the first BCE. This BCE (BCE5a) measures the investment growth in the drawdown fund against the lifetime allowance.

Example – Karen

Karen is 67 in August 2012, when the lifetime allowance is £1.5 million. Her SIPP is worth £1.2 million. She decides to take her PCLS and designate the remainder into drawdown. She doesn't take any income from her drawdown fund.

- BCE6: £300,000 PCLS – this uses up 20% of the lifetime allowance (£300,000 / £1,500,000)
- BCE1: £900,000 drawdown – this uses up 60% of the lifetime allowance (£900,000 / £1,500,000)

This uses up a total of 80% of her available lifetime allowance, leaving 20% remaining.

In August 2020, Karen turns 75. Her drawdown pot is now worth £1,330,000

- BCE5a: £1,330,000 – £900,000 = £430,000 / £1,073,100 = 40.07%

As she only has 20% of her lifetime allowance available, this means she has to pay a lifetime allowance charge on the excess.

Each separate drawdown arrangement has to be considered. So even if the overall drawdown fund has fallen in value since the original designation, if one drawdown arrangement has enjoyed investment growth, then this will result in a BCE for that arrangement and some of the lifetime allowance will be used up.

The lifetime allowance charge

If someone uses up more than 100% of their lifetime allowance, then there is a tax charge on the excess amount. The tax charge is:

- 55% if the excess is paid to the individual as a lump sum; or
- 25% if the excess is retained within the pension.

Example – Karen (continued)

In August 2020, Karen uses up 40.04% of the lifetime allowance in a BCE5a. However, she only has 20% of the lifetime allowance available.

Her excess = 40.04% – 20% = 20.04% x £1,073,100 = £215,049

The lifetime allowance charge is 25% as the benefits remain in the drawdown pot

- 25% of £215,049 = £53,762

Karen's drawdown pot is now worth:

- £1,330,000 – £53,762 = £1,276,238

The scheme administrator and the individual are usually jointly responsible for paying the lifetime charge. AJ Bell deducts the tax charge before making a 'retirement' payment.

However, if the charge arises on the member's death, the personal representatives are responsible for calculating the charge and the recipient of the payment is liable to pay the charge.

Reporting and monitoring

When an individual crystallises benefits, it's the scheme administrator's responsibility to calculate how much lifetime allowance is used up and if any charge is due. The scheme administrator issues a statement for every BCE showing how much lifetime allowance has been used up, the value of any lifetime charge due and whether the scheme administrator has accounted for the charge due – or intends to.

The individual must, as part of their self-assessment, confirm the value of the benefits in excess of the available lifetime allowance, and the tax charge paid by the pension plan. The scheme administrator also sends out an annual statement showing the percentage of the standard lifetime allowance the individual has used up.

Lifetime allowance protections

When the lifetime allowance was first introduced in 2006, and on the three occasions it fell (in 2012, 2014 and 2016), if individuals had benefits worth more than or – in some cases – approaching the new lifetime allowance, they could apply for protection. This meant they could take a higher amount of benefits than the new lifetime allowance without paying a lifetime allowance charge.

- 2006 – enhanced protection and primary protection
- 2012 – fixed protection 2012
- 2014 – fixed protection 2014 and individual protection 2014
- 2016 – fixed protection 2016 and individual protection 2016

Lifetime allowance planning

Since the lifetime allowance was introduced in 2006, there has been a significant increase both in the number and in the value of lifetime allowance charges that have been paid.

HMRC statistics show in 2017–18 tax year alone, £185 million was paid as lifetime allowance charges. This is 30 times the value paid in 2006–07.

Financial planning to address the possibility of paying a lifetime allowance charge now affects far more than a few lucky 'fat cats', but instead has far-reaching implications for many more thousands of people saving for retirement.

Pension savers face dilemmas such as those below.

- **Whether to continue pension funding if they are approaching the lifetime allowance** – this may depend on how close they are to the lifetime allowance, the amount of additional fund they could build up if they continued funding, and the cost to themselves of doing that. If they are receiving an employer pension contribution, they may want to approach their employer and ask if the remuneration could be paid in a different form – for example a bonus or higher salary.
- **Whether to crystallise or to remain invested until age 75** – this will depend on many factors, including whether the individual expects to live beyond age 75 (based on their own health and their family medical history). If they expect to die before 75, they may want to consider crystallising immediately.
- **Whether to take a drawdown income to reduce or eliminate any lifetime charge at age 75** – by taking a drawdown income, an individual may be able to reduce the size of their drawdown fund to a value similar to or lower than the amount they originally designated, reducing the potential of a charge arising from a BCE5a. This may depend on whether the individual wants to accept an income into their estate which may count for Inheritance Tax (IHT) purposes, and whether instead they can spend the money or gift it to others.

These are complicated decisions for individuals and their financial advisers and planners to make. Everyone's circumstances will be different and personal to them, as will be their objectives and wishes.

Example – Emily

Emily is 60 years old and is about to stop work. She has built up a SIPP fund of £1,273,100 and does not have any lifetime allowance protection. She has other sources of income. She wants to use her PCLS to help her children get on the property ladder.

She places £1,073,100 (the lifetime allowance) into drawdown:

- she takes her maximum PCLS of £268,275, leaving a remaining drawdown fund of £804,825; and
- £200,000 remains uncrystallised.

Emily has a choice now whether to:

- Option 1 – crystallise the £200,000 fund at age 60 (meaning an immediate lifetime allowance charge). She could then withdraw an income from the drawdown fund which will be equal to the investment growth in the fund. This way her drawdown fund at age 75 is equal to the fund at age 60, and she avoids a second lifetime allowance charge at age 75.
- Option 2 – leave the £200,000 uncrystallised, and don't withdraw an income from the drawdown fund. She will then face two lifetime allowance charges at age 75 – one on the uncrystallised SIPP fund, and one on the drawdown fund.

Option 1 – fully crystallise

- 25% LTA charge on remaining £200,000 fund = £50,000
- Total of £954,825 in drawdown (£804,825 + £150,000)
- Need to withdraw income of £38,193 each year to avoid future LTA charge at age 75 (assuming 4% a year net growth over 15 years)

Fund at 75 = £954,825

Plus £572,895 (£38,193 x 15) has been withdrawn

Total = £1,527,720

Option 2 – leave funds invested

- At age 75 (assuming funds are untouched and 4% net growth):
  - Drawdown fund = £1,449,000
  - SIPP fund = £360,000
- BCEs at age 75:
  - BCE 5A = £1,449,000 – £804,825 = £644,175 x 25% = £161,044
  - BCE 5B = £360,000 x 25% = £90,000
- Deduct LTA charge 25%:
  - Drawdown = £1,449,000 – £161,044 = £1,287,956
  - SIPP fund = £360,000 – £90,000 = £270,000
- **Combined fund remaining = £1,557,956**

Whether Emily chooses option 1 or option 2, she will end up with a very similar fund. However, there are several key factors to consider:

- **Income Tax.** If she takes a drawdown income, she will have to pay Income Tax on the withdrawals. If she doesn't need an income, she may decide to leave the funds within the drawdown pot and consider passing to her children.
- **IHT implications.** Emily needs to consider the value of her estate and whether there are any IHT implications of taking an income from the drawdown fund. She may want to keep the pension fund intact and shielded from IHT.
- **Likelihood of death before 75.** If Emily believes it's likely she may die before age 75, she may want to consider crystallising all her fund at age 60. There would be no further crystallisation event on death before age 75.
- **Other options.** There are different options Emily could consider – for example, not crystallising any fund at age 60, or phased crystallisation between 60 and 75.

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