AJ Bell Investcentre

ADVISER GUIDE

# Pension transfers

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The information contained in this guide is based on our understanding of current law, practice and taxation which may be subject to change

## Background

There are many reasons why it may be in a client's best interest to transfer their pension. These include greater investment choice, improved service, online functionality, flexibility in how benefits can be taken, reduced fees, improved death benefits, consolidation, diversification or because a scheme is closing.

Where the pension to be transferred contains safeguarded rights of £30,000 or more, then there is a requirement for the member to receive financial advice before the trustees can release the funds. Safeguarded rights are defined as any rights other than money purchase or cash balance arrangements and so, as well as defined benefits, include things like guaranteed annuity rates (GARs) and guaranteed minimum pension (GMP) rights. The adviser giving the advice must be a pension transfer specialist. For more information on the requirements for transfers involving safeguarded rights, please see our separate 'Defined benefit transfers guide'.

Transfers between pension schemes can be made in cash, assets transferred 'in specie', or a combination of the two. When assets are transferred in specie, the receiving provider will need to confirm that it is able to accept the assets before the transfer can take place.

## Drawdown transfers

A transfer may contain both uncrystallised funds and drawdown (crystallised) funds. Importantly, unlike uncrystallised funds, a single drawdown fund cannot be split upon transfer. In other words, a drawdown fund in one pension scheme has to be transferred in its entirety to the receiving scheme. It is not possible to only transfer a specific portion of that existing drawdown fund. Problems can arise if there are distressed or illiquid investments in the portfolio which cannot be moved. With uncrystallised funds, it may be possible to leave these behind, but the 'all-or-nothing' requirement means this is not an option for drawdown funds.

However, as with many pension rules, there are exceptions. There are two sets of circumstances that allow drawdown funds to be split: for partial annuity purchases and for pension sharing orders. Where an existing drawdown fund is being used to purchase an annuity, a member does not have to use the full drawdown fund. Instead, they can use just part of that drawdown fund to buy the annuity, with the remainder left in the pension scheme continuing in drawdown.

Similarly, if a member is going through a divorce and the courts issue a pension sharing order, then the member's existing drawdown fund may be split to provide the member's ex-spouse with a pension as part of those divorce proceedings.

In both scenarios, if the member's drawdown fund was a capped drawdown arrangement, then the maximum annual income would be reviewed immediately after the annuity had been purchased or pension sharing order implemented to reflect the fact that the drawdown fund has been depleted. The new maximum income would then come into effect at the start of the next pension income year.

A transfer may contain both an uncrystallised element and drawdown funds – in which case it is possible to transfer just the uncrystallised element, just the drawdown funds, or the drawdown funds and part of the uncrystallised funds. As long as the drawdown funds stay together, there is freedom to split the uncrystallised element if required.

When crystallised pension funds are transferred from one scheme to another, they can only be transferred on a 'like-for-like' basis. When it comes to drawdown transfers, this means the transfer will either be a capped-drawdown-to-capped-drawdown transfer or a flexi-access-drawdown-to-flexi-access-drawdown transfer. Of course, it is possible to make a capped drawdown transfer and, upon receipt in the new scheme, immediately convert it to flexi-access drawdown, and many providers will facilitate this as a streamlined process.

In addition to drawdown funds having to stay together on transfer, they also have to be ring-fenced within the receiving scheme.

This means that, once transferred into the new scheme, they cannot simply be added to any existing drawdown funds already held in that scheme. They must be separately designated to form their own 'pot' or drawdown arrangement under the new scheme. Some schemes may keep the actual physical assets/investments separate, but in most cases the split between separate drawdown funds or funds that have not yet been crystallised will be purely notional.

If a consolidation exercise is being carried out, with several drawdown pots being brought together under one scheme, then you would end up with multiple arrangements.

It is understandable why capped drawdown arrangements are kept separate. Each arrangement will have its own pension year and maximum income which needs to be reviewed every three years (or annually after age 75). When it comes to flexi-access drawdown, the need for separate arrangements is a lot less clear and is largely a legacy issue, as the relevant rules haven't been updated to take into account pension freedoms.

If uncrystallised funds are also transferred, they can be added into an uncrystallised arrangement along with any other uncrystallised funds, whatever the source. This means in most circumstances you will only ever have one uncrystallised arrangement, whereas you can have many drawdown arrangements. When the time comes to crystallise additional funds, HMRC rules allow these to be added to any existing crystallised arrangement regardless of whether those funds were originally crystallised under the existing scheme or first crystallised elsewhere and then transferred in. The only exception to this rule is for drawdown funds that started before A-Day (6 April 2006). These funds can never be added to after A-Day.

If there is more than one drawdown arrangement in a scheme, when it comes to the next crystallisation event, funds can be added to any of the drawdown arrangements (pre-A-Day funds aside). In most cases it won't make a significant difference which arrangement you add the newly-crystallised funds to.

However, there are two sets of circumstances where this might be important.

First, if there is a flexi-access drawdown arrangement from which no income had been taken, and a capped drawdown arrangement. Further funds can be added to the capped drawdown arrangement to allow the client to access a further pension commencement lump sum (PCLS) and, importantly, take more income without triggering the Money Purchase Annual Allowance (MPAA).

The second scenario relates to those who may potentially have a lifetime allowance issue. When the member reaches age 75, any funds in drawdown are tested against the lifetime allowance again. At this point, there is a 'credit' for the amount of funds previously designated to drawdown and it is the growth that is tested.

### Example

| | Arrangement A | Arrangement B |
|---|---:|---:|
| Fund value at age 75 | £10,000 | £1,000,000 |
| Amount originally put into drawdown | £110,000 | £900,000 |
| Amount tested against LTA at age 75 | - | £100,000 |

In the table above, £110,000 was originally put into drawdown in arrangement A. At age 75, this arrangement is now valued at £10,000, as income has been taken. At age 75, benefit crystallisation test BCE 5A takes place. The amount tested at this event (£10,000) is reduced by the amount previously crystallised (£110,000). Where this produces a negative result (-£100,000), the amount tested is cancelled out, so no lifetime allowance is used.

However, when we look at arrangement B, the amount tested is £1,000,000 and the amount previously crystallised is £900,000, leaving £100,000 to be tested against the lifetime allowance at age 75. The fact that there is £100,000 'spare' in arrangement A is not relevant as each arrangement is tested separately.

Therefore, if the client in this scenario was looking to take further pension benefits, they might choose to designate further drawdown funds into arrangement A, as it offers more room for fund growth in anticipation of the BCE 5A test and could result in a smaller amount being tested against the LTA.

### Investment pathways

From 1 February 2021, whenever a drawdown transfer is made, there will be a requirement for advisers to consider the suitability of pathway investments when advising on investment of the drawdown fund.

This requirement is regardless of whether new investments are being made, or whether the transfer is in specie with no changes. It also applies even if the new provider doesn't offer pathways due to meeting the exemption. In this scenario, the onus is on the adviser to consider other pathway investments available elsewhere.

## Block transfers

Some pension members will have 'scheme-specific' protection relating to pension rights built up before A-Day. This may entitle them to take more than 25% of their pension fund as a tax-free PCLS, or to access their pension at an earlier age.

As the name suggests, these protections are specific to the pension scheme where the rights were accrued and are usually lost on transfer. However, if a 'block transfer' (sometimes also known as a 'buddy transfer') is made, then the rights can be carried across to the new scheme.

There are three conditions for a transfer to be a block transfer. All three must be satisfied for the protection to be retained.

1. **There must be two or more members. All members involved in the block transfer must be transferring from the same transferring scheme to the same receiving scheme.**

   However, there is no requirement for both members to have scheme-specific protection – so one member with protection could 'buddy up' with someone who has no protection.

2. **All of the sums and assets relating to those members must be transferred as a single transfer**.

   The instruction to transfer for both/all members must come through as one request. It does not mean that all assets must be transferred on the same day as this may not be practical, especially when transferring in specie. Partial transfers cannot satisfy the block transfer conditions.

3. **None of the members can have been a member of the receiving scheme for more than 12 months prior to the (completion of the) transfer.**

   Setting up a new arrangement within a scheme the individual has already been a member of for more than 12 months would not get round this issue. It must be a completely separate scheme (with a different pension scheme tax reference (PSTR) from HMRC).

If any of the conditions are not satisfied, the transfer cannot be a block transfer. It could still be a recognised transfer, so there are no unauthorised payment issues. However, the member would lose their right to the protected benefit entitlement on the funds that were transferred to the new scheme. If any funds remained in the transferring scheme, these would still retain the protection.

There aren't any restrictions on the type of scheme that can accept a block transfer. However, it's not possible to do a block transfer from a retirement annuity contract or a deferred annuity contract (Section 32 policy), as these schemes only have one member, so a transfer could never meet the block transfer criteria. If someone has a protected PCLS under a one-member scheme, then the statutory permissive override may be useful to allow them to take the protected amount and still access flexi-access drawdown rather than having to purchase an annuity. See the section below for more information.

If an individual has scheme-specific protection in relation to more than one pension scheme, it is not possible to consolidate these into one scheme and keep all the protected amounts, even if the block transfer conditions are met. The protection is only retained in respect of the first transfer.

When it comes to accessing the pension, the fund must be fully crystallised in order to use the protection (whether it is protected PCLS or a protected retirement age); it is not possible to partially crystallise. This includes any other funds that have been transferred in, or contributions made, that didn't originate from the scheme where the protection was acquired.

However, if someone fully crystallised but just took their protected PCLS, they can continue making contributions, or transfer other funds in, and take these at a later date. The crucial point is that they must crystallise everything that is in the pension fund at the time of the benefit crystallisation event.

If a member has a protected retirement age which they use to crystallise benefits early, they would not need to do a block transfer if they wanted to continue benefitting from their protected retirement age. In other words, the right to a protected pension age is 'used' or 'locked in' at the moment a member takes benefits. This was not always the case; before 6 April 2015, a member had to continue doing block transfers in order to continue withdrawing income before the normal minimum pension age. However, if they subsequently make other transfers in, or make further contributions, they will need to wait until age 55 to access these additional benefits.

## Statutory permissive override

When pension freedoms were introduced in 2015, there were many changes that needed to be made in a short space of time. To help with this, legislation was put in place that meant any money purchase arrangement could offer the new types of pension payments without having to update their scheme rules. This statutory permissive override can be found in the Finance Act 2004 s273B and allows payments of drawdown pension for members, dependants, nominees and successors, along with other pension freedom payments.

This means any money purchase (defined contribution) pension scheme can designate funds to drawdown for the member or, on their death, for their beneficiary, regardless of what is written in their scheme rules. If the original scheme does not have the functionality to physically make the payments, then they only need to make the designation and then make a like-for-like drawdown transfer to a scheme that can facilitate the payments.

The receiving scheme will need confirmation:

- that the funds are designated into flexi-access drawdown in the member's name;
- of the date of designation;
- of the amount designated; and
- whether the MPAA has been triggered.

In practice, the MPAA will never be triggered if the ceding scheme does not have the ability to pay income, but the ceding scheme needs to include this in its written confirmation to the new scheme.

## Transfers and lifetime allowance protection

In most cases, lifetime allowance protection will not be lost when transferring between two registered pension schemes. Primary and individual protection can only be lost (or reduced) by a pension sharing order following a divorce.

Enhanced and fixed protection are lost if contributions are made, or if there is relevant benefit accrual. Making a permitted transfer from one pension scheme to another, including setting up a new arrangement to receive a permitted transfer, will not cause loss of protection.

However, there is a grey area relating to transferring a defined benefit pension to a money purchase arrangement. To be a permitted transfer, "the value of the sums and assets received by the other money purchase arrangement must be actuarially equivalent to the rights being transferred" (Pensions Tax Manual PTM092420).

The question arises whether 'enhanced' transfer values are actuarially equivalent. In most cases, the answer will be 'Yes', as long as normal actuarial practice has been followed. But if someone is transferring from defined benefit to money purchase with enhanced protection and has an enhanced transfer value, it may be worth getting this confirmed by the trustees/actuary of the defined benefit scheme.

## Transfer issues on divorce

On divorce, pensions can be split in two ways – either with an earmarking or attachment order, or by a pension sharing order (PSO). PSOs were introduced in 2000 and this is by far the most common way to split pensions for couples divorcing today. It is still theoretically possible for attachment orders to be put in place, but this is unusual. Most attachment orders we see relate to divorces prior to 2000.

Under an earmarking order, the ex-spouse is entitled to a share of the pension when it is withdrawn. It could be a share of PCLS, a share of income or both. They may also be awarded a share of the pension on death of the member. However, decisions as to when to take benefits and how the funds are invested remain entirely with the original member. Under pension freedoms, there is no requirement to take income, so the ex-spouse may receive nothing. There can be lots of issues with attachment orders, especially when the divorce was acrimonious. For this reason, some providers may refuse to accept a transfer with an attachment order in place. If the funds can be transferred, then the ceding provider has to inform the new scheme of the attachment order within 21 days of the transfer completing or the order is not enforceable. In many instances, it may be worth going back to court and replacing an attachment order with a PSO.

If the scheme administrator is aware of a PSO, then it may not possible for the member to transfer out until the PSO has been dealt with. The ex-spouse receiving the pension credit must transfer to an arrangement in their own name. In some circumstances, this could be an arrangement within the same scheme, but this is not always possible. Public sector defined benefit schemes will usually make the ex-spouse a pension credit member, but many private sector defined benefit schemes will insist that they transfer out.

For the member whose pension is being shared, the pension debit will not cause loss of enhanced or fixed protection but primary or individual protection may be reduced or lost.

If the ex-spouse receiving the pension credit holds enhanced or fixed protection, then the pension credit should be transferred into an existing arrangement to ensure there is no loss of these protections. If they set up a new arrangement to receive the transfer, then their protection would be lost. There is no direct impact of receiving a pension credit for primary or individual protection holders, other than the credit makes it more likely they will exceed the level of protection that they hold.

More information on PSOs can be found in our guide on Pension sharing orders.

## Ill health transfers

Care needs to be taken when transferring pensions in the knowledge of ill health. All pension transfers in the two years prior to death must be reported by the personal representatives on form IHT409. Where the member was in good health, there is unlikely to be an issue, but if the member was in ill health at the time of the transfer, then the pension may be subject to Inheritance Tax (IHT). If the pension is caught, then it would be a chargeable lifetime transfer, so there would be no spousal exemption. However, the value that would be chargeable would be significantly less than the transfer value. For more information, see our guide on Pensions and IHT.

## Transfer of death benefits

When the member dies, benefits can be paid out as a lump sum or, under a money purchase scheme, be used to provide beneficiary's drawdown for a dependant or nominee. Where the drawdown option is chosen, the benefits must be designated to the beneficiary by the scheme administrator before they can be transferred – it is not possible to transfer the death benefits before they have been designated, as you cannot transfer a deceased member's fund.

If a money purchase scheme does not offer beneficiary's drawdown, then you may be able to use the statutory permissive override for the benefits to be transferred to a scheme that can facilitate this. The ceding scheme would need to make the designation to beneficiary's flexi-access drawdown, confirm the amount and date of the designation and the age of the member at date of death (i.e. whether funds will be taxable).

## Overseas transfers

Transferring from a UK registered pension scheme to a qualifying recognised overseas pension scheme (QROPS) is a recognised transfer, meaning that it is an authorised payment.

Although no unauthorised payment charges will be payable, there are two possible tax charges that could still arise.

First, the transfer is a benefit crystallisation event (BCE 8), so the value of the transfer will be tested against the lifetime allowance, and the lifetime allowance charge may be due on the transfer. Any excess will always be charged at 25%, as the amount crystallised is retained in a pension scheme (albeit an overseas scheme).

Secondly, the transfer may be subject to the overseas transfer charge (OTC).

Where any one of the following conditions applies, no OTC will be chargeable.

1. The member is resident in the same country in which the QROPS receiving the transfer is established.
2. The member is resident in a country within the EEA and the QROPS is established in a country within the EEA.
3. The QROPS is set up by an international organisation to provide benefits in respect of past service as an employee and the member is an employee of that organisation.
4. The QROPS is an overseas public service pension scheme and the member is an employee of an employer who participates in that scheme.
5. The QROPS is an occupational scheme and the member is an employee of a sponsoring employer of the scheme.

In broad terms, this means that where the member is transferring their pension to a country that they are not resident in, the OTC will apply, unless it is their employer's scheme or both the pension and the member are in an EEA country.

Regulations have been but in place that will amend legislation from 1 January 2021 so that the second condition listed above will apply when the member is resident in the UK or in a country within the EEA and the QROPS is established in a country with the EEA.

In relation to the member, residence means residence for tax purposes. The definition will vary from country to country.

Where the OTC applies, it is 25% of the ‘transferred value’.

Where the OTC arises on a transfer and the lifetime allowance is exceeded, the lifetime allowance charge is deducted first, then the OTC is applied to the residual balance.

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