

A Guide to Lifetime Allowance



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On 6th April 2006 the Government's new pensions regime came into effect. A 'standard lifetime allowance' was introduced, which represents the maximum amount that may be accumulated within all of your pension arrangements, excluding State pension(s), without incurring a tax liability.

When you decide to crystallise your retirement benefits, either in part or in full or in the event of your death, the accumulated value of all of your pension arrangements, excluding State pension(s), will be calculated. Occupational defined benefit ('final salary') entitlements, or pensions already in payment (including Income Drawdown) will be given a capital value, using factors as advised by HM Revenue & Customs (HMRC), in order to determine whether you are within your standard lifetime allowance. Any award under a pension sharing order may also affect your standard lifetime allowance.

If the standard lifetime allowance at that date is exceeded and 'transitional arrangements' have not been put in place, any excess funds taken will be subject to a one-off tax charge. Therefore, you need to be aware of the percentage of lifetime allowance you have used to determine if you have sufficient remaining lifetime allowance for benefits to be paid without a lifetime allowance charge becoming payable.

If the member chooses to take Unsecured Pension then the valuation basis is based on the actual fund value (market value of the assets) used to secure either:

- **Income withdrawals**
- **Short-term annuities**

Clients who decide to take their benefits in stages (more commonly referred to as phased retirement) will find that they will use up a proportion of the standard lifetime allowance in force each time benefits are taken.

If the member chooses to take Alternatively Secured Pension (only available for those aged 75 or over) then the valuation basis is simply the fund value, using the market value of the assets, used to secure the Alternatively Secured Pension.

If the member chooses to take a Secured Pension then the valuation basis used depends on the option chosen when benefits are crystallised. These are:

Lifetime Annuity - The benefits will be valued on the basis of the fund value used to secure the lifetime annuity, or

Scheme Pension - A scheme pension involves paying a pension for life out of the scheme assets or buying an annuity out of the scheme assets. See below for the appropriate calculation.

The value of the annual amount of pension promised by the scheme is multiplied by a standard valuation factor of 20:1. This factor includes an allowance for dependants' benefits up to the level of the member's pension at date of death and for annual increases of 5%. Any defined benefit scheme that provides better levels of dependants' pensions or increases can apply to HMRC for a scheme specific valuation factor which can be higher than 20:1.

Defined lump sums (otherwise than by commutation) are valued using a factor of 1:1 are added to the above value.

How is the lifetime allowance charge calculated?

The lifetime allowance charge can be applied in either of two ways or a combination of both depending on how the excess benefits value above the standard lifetime allowance is taken. The charge is:

- 55% if taken as a lump sum, or
- 25% if taken as income.

How can the lifetime allowance charge be avoided?

Different rules apply where benefits are protected. People who had benefit values at A-Day (6th April 2006) of over £1.5 million can use primary protection to reduce or eliminate the chance that a lifetime allowance charge will apply. The amount of 'tax-free cash' that they built up before A-Day can also be protected.

Enhanced protection protects the tax-free cash that has been built up before A-Day and completely eliminates the risk of a lifetime allowance charge being due. Where enhanced protection is chosen, no further premiums can be paid after A-Day to money purchase schemes and benefit accrual after A-Day is restricted in defined benefit schemes.

Primary and enhanced protection can't be sought for people with benefits over and above pre A-Day HMRC maximums. If there is a surplus at 5 April 2006 this would have to be dealt with before the person could apply for either primary or enhanced protection. The excess over the Maximum Permitted Pension must be surrendered. Where scheme rules permit on 5 April 2006, regulations mean this could be in the form of a refund to the employer, subject to tax at 35%. Alternatively, the excess could be reallocated to other scheme members. The surrender must take place between 6 April 2006 and the date on which HMRC is notified of the election for enhanced protection. All applications for transitional protection must be registered with HMRC by 5th April 2009.

Somebody applying for enhanced protection can also apply for primary protection if their benefits value exceeds £1.5 million on 5 April 2006.

Changes to the Standard Lifetime Allowance as of April 2011.

For the Finance year 2012/2013, the standard lifetime allowance (LTA) will be reduced to £1.5 million. Provision is included in the legislation for the LTA to be increased by Treasury order in subsequent years, although there is no indication of when this might happen and the consultation document suggested that it might stay at £1.5m until at least 2015/16 (the same timescale as applied to the original £1.8 million freeze).

Complex transitional provision (fixed protection) will be introduced, which is most likely to be attractive for those individuals who:

- Have no transitional protection, but have pension benefits currently valued in excess of £1.5 million, or
- With pensions currently valued at less than £1.5 million, but who feel that the investment growth/benefit revaluation may take their pension value over £1.5 million.
- Transitional protection will be included for many benefits already based on the LTA (e.g. primary protection and scheme specific protected tax-free cash) by means of linking the benefits to an 'underpinned lifetime allowance' (ie. The greater of the standard lifetime allowance in the tax year benefits are drawn and £1.8 million).
- Enhanced and primary protection will be retained, but enhanced protection will no longer be exempt from the AA test.
- The trivial commutation level will be set at £18,000 and de-linked from the LTA.
- It can be increased by Treasury order in the future.

In 2011/12 an individual will have the opportunity to make a total contribution of up to the annual allowance of £50,000 for 2011/12 plus the carry forward of any unused annual allowance for tax years 2008/09, 2009/10 and 2010/11.

What the changes mean

The restriction of the standard lifetime allowance to £1.5 million from tax year 2012/13 will mean that those individuals without enhanced or primary protection, and with pension benefits valued already in excess of £1.5 million, or likely to exceed £1.5 million by the time benefits are crystallised, may need to seek 'fixed protection'. Such protection will enable them to be provided with benefits with a value of up to £1.8 million without suffering a lifetime allowance tax charge. However, such protection can only be retained where, broadly, no further pension contributions are payable to a money purchase scheme, and benefit accrual under a DB scheme is severely limited, from tax year 2012/13 onwards.

The need to keep within the £1.8 million limit will mean some individuals will cease contributions now. However, others may wish to maximise contributions in 2011/12 before the fixed protection restrictions apply.

For further information or to book an initial consultation,

Please call us free on 020 8760 9940.

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