ADVISER FACTSHEET

JAMES HAY PARTNERSHIP

Tech Talk

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The lifetime allowance charge – a clear choice

It was announced before The Budget in March that the standard lifetime allowance would be reducing to £1m from 6 April 2016. The reduction in the standard lifetime allowance will mean many more people having to consider whether it will impact on their retirement plans. The aim of this Tech Talk is to highlight that stopping accruing benefits in a pension scheme and avoiding a lifetime allowance charge is perhaps not so clear cut as first envisaged.

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For professional advisers only

Overview

The legislation to bring into being the new standard lifetime allowance (SLA) of £1m is part of the Finance Bill currently working its way through parliament. Also contained in the Bill is legislation introducing transitional protection in the form of fixed protection 2016 and individual protection 2016. Both forms of protection will follow similar lines to that which was available in 2014.

One point of difference is that, unlike the previous forms of protection, there is no cut off date for applications. As long as the individual can satisfy the conditions for applying for the particular form of protection, they can request the reference number at any time, irrespective of whether that's today, next month, next year, or even 10 years from now.

Until the end of July it was possible to make an application in writing and to have a temporary number issued. Now that online application is available, those individuals who have a temporary number will have to re-apply for a permanent number. (For more details on fixed and individual protection, please refer to our Tech Talk covering the subjects.)

The reduction in the SLA to £1m will result in a lot more individuals being caught by an LTA charge; people in the past who probably never gave it a second thought – senior managers in the NHS and local government, doctors, and headmasters, to name but a few – may now be affected. In the case of money purchase arrangements, even people with only a few years to retirement and reasonably sized pension savings could be affected.

For example, with fifteen years to retirement and a presumed net return of 5% and CPI of 1%, individuals with pension funds of £500,000 and above could find themselves with an LTA charge to pay in 2031/32. For someone with a fund of £500,000 who continued to pay £10,000 gross into their pension they would exceed the SLA of £1.149m, and likewise someone with a fund of £600,000 who ceased funding their money purchase arrangement would also breach this SLA.

In the situation where an individual exceeds their LTA, if they were to take the excess over this amount as a lump sum, then they would pay a tax charge of 55% on the excess. Undoubtedly individuals will focus on the headline rate of tax of 55%, even though I am sure that most would find 45% of something preferable to 100% of nothing. In addition, it is often forgotten that the tax charge is only on the excess and not on the fund as a whole. Depending on circumstances the effective rate of tax can be very low, which will be covered in some of the examples contained in this Tech Talk.

Scenarios

Given the concerns over the reduction in the SLA, a number of individuals will have already taken the decision to stop funding their pension arrangements. In many instances this decision will have been driven solely by the wish to avoid paying the 55% tax charge without fully appreciating the implications of taking that course of action.

In attempting to clarify as to whether or not this is an appropriate course of action we will consider three slightly different scenarios. It is accepted that the following perhaps oversimplifies the situation, however the purpose of this Tech Talk is to provoke some thought around this topic.

For the three examples that follow, the following assumptions are made:

- For simplicity, no increase in salary, tax bands, etc. over period
- 5% investment return
- SLA increases by CPI from April 2018
  - CPI: 2%
- Maximum PCLS taken when funds fully crystallised
- Excess over LTA retained in pension
  - Retained amount tax charge @ 25%

EXAMPLE 1

Nat has around five years to retirement and earns £100,000 per annum. He has no other income. His employer pays an annual £20,000 into his money purchase arrangement at the beginning of each tax year. His fund was worth £850,000 at 5 April 2016 and therefore he is not eligible to apply for individual protection 2016, though he could apply for fixed protection 2016. His options are to cease the funding of the pension, and take the salary instead as he is in the fortunate position that his employer will increase his salary to reflect the ending of their pension contributions, or remain an active member of pension and continue to receive the employer contributions.

The increase in salary would be £17,240 (the employer factoring in their NI costs), however as Nat's income now exceeds £100,000, he will lose part of his personal allowance. The combination of the loss of his personal allowance, plus income tax and NIC, means the equivalent of a 62% 'tax' take, leaving him with £6,551 to redirect to his ISA.

	Fixed Protection 16	Continued
Original fund	£850,000	£850,000
Contributions plus growth	—	£350,878
SIPP value at retirement	£1,084,839	£1,200,878
Lifetime allowance	£1,250,000	£1,082,432
Retained amount tax charge	—	£29,611
Benefits		
Pension commencement lump sum	£271,210	£270,608
Drawdown fund	£813,629	£900,658
ISA savings	£38,008	—

The SIPP funds at retirement are approximately £1.08m and £1.2m respectively. If Nat is relying on fixed protection with an LTA of £1.25m then there is no LTA charge to consider, however if contributions continued to made to his pension, then the LTA charge would amount to £29,611.

EXAMPLE 1 (CONTINUED)

If, on one variation of this scenario we were to presume Nat died before age 75, and the fund was used to provide drawdown for a beneficiary, then the tax rate on his whole fund, presuming he hadn't crystallised it at the time of his death would only be 2.5% (£29,611/£1,200,878), which is quite efficient tax planning.

There is little difference in the PCLS between the two options, therefore in this simplified scenario, it could be argued that it comes down to the differential in the drawdown funds while also factoring in the ISA pot. If the ISA fund is regarded as tax free income and grossed up by basic rate tax then it comes to a little over £47,500.

Adopting the same approach for the difference in the pension commencement lump sum under fixed protection adds another £750 approximately. Thus, for the purpose of comparison if we were to add these amounts to the drawdown fund the difference between the two options is still £38,780 in favour of Nat remaining an active member of his pension, even ignoring the possibility of passing on the majority of the fund to beneficiaries tax free.

EXAMPLE 2

Scott also has around five years to retirement and earns £100,000 per annum. He has no other income. His employer pays an annual £15,000 into his SIPP at the beginning of each tax year and he pays £5,000 gross. His fund was worth £950,000 at 5 April 2016 and again he is not eligible for individual protection. If he ceases contributions to the pension scheme, the company will not increase his salary.

His options are to stop funding the SIPP and thereby rely on fixed protection 2016, whilst redirecting the equivalent of his personal net pension contribution of £3,000 to his ISA, or he can continue to fund the pension.

	Fixed Protection 16	Continued
Original fund	£950,000	£950,000
Contributions plus growth	—	£378,506
SIPP value at retirement	£1,212,467	£1,328,506
Lifetime allowance	£1,250,000	£1,082,432
Retained amount tax charge	—	£61,518
Benefits		
Pension commencement lump sum	£303,117	£270,608
Drawdown fund	£909,351	£996,379
ISA savings	£17,406	—

The SIPP funds at retirement are around £1.21m and £1.33m respectively. There is a greater tax charge in this example of £61,518 as the starting point was closer to the current SLA of £1m, and there is a higher PCLS for Scott of about £32,500 if he relies on fixed protection 2016.

Taking the same approach as in the previous example and grossing up this amount and the ISA pot means the differential of £24,600 is still in favour of Scott continuing to fund his pension. The effective tax charge, again presuming Scott died before age 75 would be 4.6% (£61,518/£1,328,506).

EXAMPLE 3

In the previous two examples we only considered the situation where the member is solely concerned with an LTA issue, however a number of individuals who have potential LTA issues may also be affected by the tapered annual allowance.

Theresa has around seven years to retirement and earns in excess of £210,000 per annum and so is caught fully by the tapering of the annual allowance, thereby restricting her to £10,000 if she wishes to avoid paying an annual allowance charge. Her employer normally pays £30,000 into her pension each year, and she pays the appropriate amount to fully utilise her annual allowance each year, meaning she has no carry forward to work with.

Her fund was worth £800,000 at 5 April 2016 and she is concerned about both the annual allowance and the lifetime allowance. If she ceases to be a member of the pension scheme, the company will not increase her salary, and neither will they pay a reduced contribution into her pension. She fully funds her ISA each year.

Her options are to stop funding the pension and rely on fixed protection or she has the choice between continuing to fully fund the pension up to the £40,000 annual allowance or have her company stop the contributions and only make the personal contribution of £10,000 which will avoid any annual allowance charge for Theresa. If she continues to fund her pension at the previous levels she would have an annual allowance charge (AAC) to pay each year of £13,500 (45% of £30,000).

In many instances the individual will pay the AAC themselves, however it is possible to have the pension scheme pay the charge in return for a reduction in the scheme benefits. If certain conditions are met, the scheme becomes jointly and severally liable for the charge. In this example Theresa does not satisfy the conditions, and therefore if she asks the scheme to pay the charge, they would do so on a voluntary basis only.

	FP16	Continue – MP	Continue – SP	Reduced
Original fund	£800,000	£800,000	£800,000	£800,000
Contributions plus growth	—	£667,645	£557,728	£411,171
SIPP value at retirement	£1,125,680	£1,467,645	£1,357,728	£1,211,171
Lifetime allowance	£1,250,000	£1,126,162	£1,126,162	£1,126,162
Retained amount tax charge	—	£85,371	£57,891	£21,252
Benefits				
Pension commencement lump sum	£281,420	£281,541	£281,541	£281,541
Drawdown fund	£844,260	£1,100,734	£1,018,296	£908,379

Note: MP – member pays AA charge personally; total of £94,500 SP – scheme pays AA charge

The PCLS is similar between ceasing membership and continuing to fund, however fund sizes after the PCLS will obviously vary depending on the option chosen by Theresa. The point to emphasise is that if Theresa pays the AAC personally, she will pay a total of £94,500, but this is will come out of her net income.

The gross amount would be approximately £172,000 at an assumed tax rate of 45%, and – if she were to take this amount from her drawdown pot to replenish her savings – then the pot would reduce to around £929,000, which is still greater than if she were to cease funding her pension altogether. The best outcome would appear to be if she can get the scheme to pay the AA charge.

Comment

It seems clear: remain an active member of the scheme. This is obviously not the case, and individual member's scenarios will have to be considered on a case by case basis, taking into account years to retirement, funding levels and by whom, as well as whether the tapered annual allowance is of relevance.

Another critical input is that of CPI, if it continues along similar lines to the current rate, then the increase in the SLA could be marginal over the pertinent time frame for the member and therefore the corresponding LTA charge increases. This will reduce the net drawdown fund, diminishing the differential between the two options of continuing to fund the pension or ceasing membership and relying on fixed protection 2016.

All in all, a somewhat unenviable task for advisers to communicate to their clients.

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Further information

Visit the Technical Hub for further information:

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