AWFM Fact File

"Pension Lifetime Allowance"

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After "Pension Simplification" in 2006, it is clear that the jargon and indeed complexity of certain pensions have not gone away. For many, the Lifetime Allowance will not be a significant issue but every pension fund is now tested against the Lifetime Allowance so it is relevant to everyone, if only by virtue of needing to report on it.

With the reduction in the Lifetime Allowance to £1m with effect from 6th April 2016 more people are likely to be affected by this pensions technical calculation and then potential tax charge. If a pension fund exceeds the Lifetime Allowance (LTA) a tax charge will apply when funds are withdrawn.

The Lifetime Allowance, since it was introduced has been as follows:

2006/7	2007/8	2008/9	2009/10	2010/11 & 2011/12	2012/13 & 2013/14	2014/15	2016/17
£1.50m	£1.60m	£1.65m	£1.75m	£1.80m	£1.50m	£1.25m	£1.00m

Protection against Lifetime Allowance reduction
It was and has always been possible to protect a pension fund against the imposition and then reduction in the Lifetime Allowance. The first protection was available from April 2006 when the Lifetime Allowance was first introduced.

Since then, some individuals may have protected their LTA at £1.8m, the LTA in 2011/12. Others may have protected at £1.5m when the LTA was going to be reduced to £1.25m. Still others may yet need or want to protect at £1.25m against the reduction down to £1m.

In many cases, protection now means that you would need to stop paying into or being an active member of any of your existing pension schemes.

What is a Benefit Crystallisation Event?
The term Benefit Crystallisation Event (BCE) is relevant. When a BCE occurs, the value crystallised must be measured for LTA purposes. There are now 13 potential BCEs, summarised as best we can as follows:

BCE 1	The designation of a fund to be used for Drawdown
BCE 2	Member of a Company scheme becoming entitled to a scheme pension
BCE 3	Where a scheme pension is in payment but is then increased by an amount greater than anticipated
BCE 4	When a lifetime annuity is purchased
BCE 5	When a Defined Benefit (DB) scheme member reaches age 75 without having drawn all benefits
BCE 5A	When a member with funds designated for Drawdown but not yet drawn, reaches age 75
BCE 5B	When a member with an undrawn money purchase plan reaches age 75
BCE 5C	The designation after 6/4/15 but before end of relevant 2 year period of relevant unused uncrystallised funds as available for payment to a dependent or nominee, of dependent's flexi-access drawdown pension.
BCE 5D	A person becoming entitled after 6/4/15 but before end of relevant 2 year period, to a dependents' annuity or a nominee's annuity in respect of the individual life (a) the annuity is purchased using relevant unused uncrystallised funds and (b) the individual died on or after 3 December 2014.
BCE 6	A lump sum (relevant) is paid out
BCE 7	A lump sum death benefit (relevant) is paid out
BCE 8	Transfer to a Qualifying Recognised Overseas Pension Scheme (QROPS)
BCE 9	A catch-all provision

For most pensions, whilst the above table is complicated, the pension fund will be relatively simple to calculate against the Lifetime Allowance and will probably only need to be tested once. This is not the case for Drawdown pensions.

Drawdown Pensions

Assume an individual has 2 different pensions. They have a Final Salary arrangement paying an income at retirement of £20,000 per annum and it crystallised (commenced) in 2010/11 when the Lifetime Allowance was £1.8m. A Final Salary pension (assuming no tax free cash) is calculated as 20 times the annual pension at retirement so this fund will have used up £400,000 of the Lifetime Allowance. This is expressed as £400,000/£1,800,000x100 = 22.22%.

This individual may also have a pension Drawdown fund worth £700,000 at the age of 65 in 2014/15 when coming to draw the pension benefit. Assuming no Lifetime Allowance protection was put in place, and assuming the whole of the fund is converted to Drawdown at age 65, the calculation against the Lifetime Allowance would be £700,000/£1,250,000x100 = 56%.

So far, this individual has used up 78.22% of their Lifetime Allowance.

If the individual retains the Drawdown fund past age 75, at age 75 the Drawdown fund is re-tested against the Lifetime Allowance. Using our example, if the fund which was worth £700,000 has now grown to say £1.1m, the increase in the growth of the fund is tested against the new Lifetime Allowance (assumed to be £1m for the sake of this example). So the calculation at age 75 will be (£1,100,000-£700,000)/£1,000,000x100 = 40%.

At age 75 therefore, this individual will have exceeded the Lifetime Allowance by 18.22%. This has happened because the Lifetime Allowance was reduced and they were not protected, and the value of the pension fund increased significantly, perhaps because the individual did not draw enough from their pension fund.

Once past the age of 75 there are no further checks against the Lifetime Allowance in most cases with a couple of technical exceptions which shouldn't worry most people. Lump sum death benefits from Drawdown funds are not BCEs as they come from funds that have already been tested against the Lifetime Allowance.

Drawdown contracts in existence before 6th April 2006 and not altered, are exempt from any further BCEs.

It should be noted that this is the simple method of calculation which may not always give an accurate result against the legislation method. It will however be quite close in most circumstances.

Lifetime Allowance Charge

In the case above, the individual has exceeded their Lifetime Allowance at age 75 by 18.22%. The Drawdown pension fund administrator must check the fund against the limit and will be responsible, along with the member, to pay the tax rate.

If the individual takes the amount as a lump sum, the Lifetime Allowance excess lump sum would be charged at 55%. If retained to pay pension benefits it is charged at 25%. For most Drawdown pensions therefore, it would seem to be appropriate to take the 25% tax charge option if this arises. The charge in this example would be approximately £182,200 times 25% resulting in a tax charge of £45,550 on reaching age 75.

If you have any questions or need an independent review of your pension arrangements, please contact us to discuss your situation further. AW Financial Management LLP is an Independent Financial Adviser regulated by the Financial Conduct Authority.

Information given in this document should not be taken as advice as it is intended for guidance only. If you wish to have an assessment of your own situation, you should contact the office for advice.