

## Protecting Pension Rights From The Lifetime Allowance Charge

The Government introduced a new simplified set of pensions tax rules on 6 April 2006. These rules make pensions more flexible and easier to understand, and they enable most people to increase their pensions savings.

The new rules cover all tax-privileged pension schemes so they impact upon the pension rights people have already built up. As a result, the pension benefits of a small number of individuals could be adversely affected by new taxes, unless they take action to protect them.

### How the new tax rules work

The Government allows each individual to hold benefits in tax-privileged pensions up to a limit, known as the lifetime allowance.

If an individual's pensions have a combined value, in capital terms, which is less than the lifetime allowance, then there will not be any liability to the Lifetime Allowance Charge.

If an individual's pensions have a combined value, in capital terms, which is more than the lifetime allowance, then there will be a liability to the Lifetime Allowance Charge.

The initial lifetime allowance, for the 2006/07 tax year, was set at £1.5m. The lifetime allowances for the following four tax years have also been set at £1.6m, £1.65m, £1.75m and £1.8m. Where different benefits are valued in different tax years, a proportionate adjustment is made to determine if the relevant limit is exceeded.

The vast majority of individuals are not expected to suffer any Lifetime Allowance Charge because the lifetime allowance has been set at a very high level.

### Example where a Lifetime Allowance Charge would be due

*Mr Smith was the manager of a manufacturing company for 30 years and he built up significant pension rights in his company sponsored pension scheme. He retired in 2000 and took his company pension and, on 5 April 2006, his annual rate of pension was £56,000.*

*Following his retirement, he took up consultancy work on a self employed basis and made contributions to a personal pension plan. In June 2007, he decides to give up work completely and take the benefits from his personal pension, which is then valued at £250,000.*

*When considering the Lifetime Allowance Charge we have to take into account the capital value of all Mr Smith's pensions, even where they existed prior to 6 April 2006, when the new tax rules became effective.*

*Mr Smith was receiving a pension on 5 April 2006 of £56,000 pa. The Government has set a factor to value existing pensions such as this, and it is 25. So, the capital value of Mr Smith's pension is deemed to be £56,000 x 25 = £1,400,000.*

*In 2007/08, the lifetime allowance is £1,600,000. Since Mr Smith is already in receipt of benefits valued at £1,400,000, he can take benefits with a value of up to £200,000 in 2007/08 without suffering any Lifetime Allowance Charge.*

*However, since his personal pension is valued at £250,000, Mr Smith is liable to the Lifetime Allowance Charge on the amount exceeding the lifetime allowance, which in his case is £50,000 (£1,400,000 (existing pension) + 250,000 (personal pension) - £1,600,000 (Standard Lifetime Allowance for 2007/08)).*

## **How much is the Lifetime Allowance Charge**

The amount of the charge depends upon how the 'excess' rights are used.

If the pension scheme permits it, all of the excess can be taken as a lump sum and the charge would then be 55%. If the excess is used to provide pensions income, then the tax charge is 25%, but the income would itself be taxed under the Pay As You Earn system, just like other pensions income.

*In our example above, if Mr Smith chooses to use his £50,000 excess to provide lump sum benefits, he would suffer a tax charge of 55% of £50,000 = £27,500, so he would receive a lump sum of £22,500 (£50,000 - £27,500).*

*If Mr Smith chooses to use his £50,000 excess to provide pensions income benefits, he would suffer a tax charge of 25% of £50,000 = £12,500, so he would have £37,500 (£50,000 - £12,500) to use to buy pensions income.*

The scheme administrator of Mr Smith's personal pension is responsible for deducting the Lifetime Allowance Charge and passing it to HM Revenue and Customs. Mr Smith is required by law to pass sufficient information on all of his pensions to the personal pension scheme administrator to ensure that a Lifetime Allowance Charge is deducted where appropriate. Should he fail to do so, he would be liable to fines and penalty charges.

## **Protecting Pension Rights**

The Government has recognised that a small number of individuals have already built up pension rights with a value over the lifetime allowance. Applying the new tax charge to those rights could have a severe, and unforeseen, adverse financial impact on those individuals.

As a result, it has granted certain options to protect pensions built up prior to 6 April 2006. The two key options are known as Primary Protection and Enhanced Protection and each is outlined below.

### **Primary Protection**

This option is available to those who have tax-privileged pension benefits, including pensions in payment, on 5 April 2006 with a total capital value of more than the Standard Lifetime Allowance of £1.5m.

Applications for this protection can be made to HM Revenue and Customs until 5 April 2009. Only pension rights that fell inside the former Revenue benefit limits can be protected. If any rights exceeded those permitted by the former Revenue benefit limits,

they may be kept but they cannot be protected from the Lifetime Allowance Charge.

Under primary protection, the Standard Lifetime Allowance is replaced by a higher personal lifetime allowance, so more pension is protected from the Lifetime Allowance Charge.

*In our example above, if Mr Smith's personal pension was worth £115,000 at 5 April 2006, he could have applied for primary protection to obtain a personal lifetime allowance of £1,515,000 (£1,400,000<sub>(existing pension)</sub> + £115,000<sub>(personal pension)</sub>), which equates to 101% of the Standard Lifetime Allowance.*

*On retirement in June 2007, he would be liable to a Lifetime Allowance Charge on just £34,000 (£1,400,000<sub>(existing pension)</sub> + £250,000<sub>(past personal pension)</sub> - £1,616,000<sub>(personal lifetime allowance)</sub>) rather than on £50,000 had no protection been obtained.*

*If Mr Smith had chosen to retire at a later date, for example in August 2008, his personal lifetime allowance would be increased in line with the increase in the Standard Lifetime Allowance. So, his personal lifetime allowance for 2008/09 would be 101% of the Standard Lifetime Allowance for that tax year, so would be £1,666,500.*

**IMPORTANT NOTE:** If the rate of growth shown by Mr Smith's personal pension is higher than the increase in the Standard Lifetime Allowance, his Lifetime Allowance Charge liability would increase, even though he has primary protection.

## Enhanced Protection

This option is open to **everyone**, regardless of the value of their tax-privileged pensions on 5 April 2006.

As with primary protection, applications for enhanced protection can be made to HM Revenue & Customs until 5 April 2009. Again, only those pension rights that fell inside the former Revenue benefit limits can be protected.

However, enhanced protection differs from primary protection in several notable respects:

- At 5 April 2006, any rights in excess of those permitted by the former Revenue benefit limits cannot be left under the pension. The excess must be surrendered before an application for enhanced protection is made.
- Subject to the above, full protection from the Lifetime Allowance Charge is given to the rights built up at 5 April 2006.
- **Enhanced protection can be lost, and once lost it cannot be regained.** It would be lost if:
  - a) a contribution is made to any tax-privileged pension after 5 April 2006 either by you or on your behalf. This broadly means pension contributions must have ceased by 5 April 2006. However, contracted out rebates and premiums for life assurance cover under existing pension arrangements may continue without affecting enhanced protection.
  - b) a defined benefit (final salary) pension increases at a rate faster than allowed by the Revenue. The allowable rate of growth is broadly the higher of:

- (i) 5% pa or, where it exceeds this, in line with inflation as measured by the Retail Prices Index; and
- (ii) your benefits at 5 April 2006 calculated on current earnings, but there is a cap to the permitted increases in earnings to avoid abuse of the rules.

If an individual had pensions as at 5 April 2006 valued at more than the Standard Lifetime Allowance of £1.5m, that individual could apply for both primary and enhanced protection. In such circumstances, enhanced protection would be deemed to apply unless it was subsequently lost, in which case primary protection would then apply.

Enhanced protection may benefit an individual who believes their pensions will exceed the Lifetime Allowance in the year they retire.

*In our example, if Mr Smith's personal pension was worth £90,000 at 5 April 2006 he was not eligible for primary protection because his pensions in total were worth £1,490,000 (£1,400,000 (existing pension) + £90,000 (personal pension)) - less than £1.5m. However, he could apply for enhanced protection, providing he has ensured that no pension contributions were made after 5 April 2006, and he would obtain full protection from the Lifetime Allowance Charge.*

*If he then chose to retire in, say, March 2008, and his personal pension had grown to £340,000, he would have total benefits worth £1,740,000 (£1,400,000 (existing pension) + £340,000 (personal pension)). Although this exceeds the Standard Lifetime Allowance of £1,600,000 for the 2007/08 tax year, obtaining enhanced protection means he would not suffer any Lifetime Allowance Charge.*

## **Further Protection**

In addition to primary and enhanced protection, the Government has provided further options to protect some pension rights and to protect high tax-free lump sum rights. Each is outlined below.

Pension Credit Protection - As part of a divorce settlement, it is possible for an individual's pension rights to be split, and the extra pension received by the ex-spouse (or ex-registered civil partner) in this way is known as a pensions credit.

If a pensions credit was received **before** 6 April 2006 it can be protected, provided you do not have primary protection, and you apply **before** 5 April 2009. Protection is achieved through an increased lifetime allowance.

The extra lifetime allowance is calculated by increasing the amount of the pension credit in line with inflation, as measured by the Retail Prices Index, for the time it was held to 5 April 2006, and then comparing that figure with the £1.5m Standard Lifetime Allowance.

For example, if a pension credit of £40,000 was granted on 5 April 2002, and inflation between then and 5 April 2006 was 12.5%, then that pension credit would have a 5 April 2006 value of £40,000 x 1.125 = £45,000.

Their lifetime allowance would therefore be (£1,500,000 + £45,000) / (£1,500,000) = 103% of the Standard Lifetime Allowance of £1.5m.

Pension credits received **after** 5 April 2006 can only be protected if they are in respect of a pension which came into payment **before** 6 April 2006. Again, protection is achieved through an increase in lifetime allowance but applications must be made within six years of the pensions sharing event.

Overseas Rights Protection – An individual who does not qualify for UK tax relief on their pension contributions, or qualifies only because of earlier residency in the UK but who is not employed by a UK resident, can obtain protection for rights built up **after** 5 April 2006 in a registered (approved) pension scheme.

Protection is again achieved by an increase in the lifetime allowance, and the size of the increase is calculated by comparing the value of the pension rights accrued with the Standard Lifetime Allowance applicable at the end of the period of accrual.

For example, an individual worked overseas and accrued a defined benefit pension of £45,000 pa in a UK registered pension scheme between 6 April 2006 and 5 April 2011.

The value of their UK pension is £45,000 x 20 = £900,000 (the factor 20 having been set by Government) and the Standard Lifetime Allowance for 2010/2011 is £1,800,000, so, the individual's personal lifetime allowance would be

$(£1,800,000 + £900,000) / (£1,800,000) = 150.0\%$  of the Standard Lifetime Allowance of £1.5m.

Overseas Transfer Protection – An individual who has rights in certain overseas pension schemes can transfer those to a UK registered pension scheme and obtain protection for those rights. Some rights may have to be excluded from protection depending upon an individual's circumstances after 5 April 2006.

Protection is again achieved by an increase in the lifetime allowance, and the size of the increase is calculated by comparing the value of the pension rights which can be protected with the Standard Lifetime Allowance applicable at the time the transfer is received.

For example, if £150,000 in respect of rights accrued overseas can be fully protected, and was transferred to a UK registered pension scheme during the 2006/2007 tax year, then the individual's personal lifetime allowance would be:

$(£1,500,000 + £150,000) / (£1,500,000) = 110\%$  of the Standard Lifetime Allowance of £1.5m.

Lump Sum Rights Over £375,000 & Protection – Under the new tax rules, the maximum which can normally be taken as a tax-free lump sum is 25% of the Standard Lifetime Allowance, so, on 6 April 2006, the maximum is £375,000. However, when primary and/or enhanced protection is applied for, lump sum rights exceeding £375,000 (as calculated on 5 April 2006) can be protected. An allowance in respect of lump sum rights from benefits taken **prior** to 6 April 2006 must be made.

Lump sum rights can be increased between 5 April 2006 and the date they are paid, but the rate of increase differs depending upon which protection you are registered for - primary or enhanced.

a) If registered for enhanced protection – then the percentage of rights which can be taken as a lump sum is protected.

For example, if, on 5 April 2006, the value of total benefits is £1,800,000 and the maximum lump sum available is £900,000 then the protected lump sum is 50% of your rights. If, when benefits are taken, they are valued at £3,000,000, then 50% i.e. £1,500,000 may be taken as a tax-free lump sum.

b) If registered for primary protection – then the amount of lump sum is protected, and may be increased in line with the increase in the Standard Lifetime Allowance.

For example, an individual had a maximum tax-free lump sum of £500,000 on 5 April 2006. He chooses to retire during the 2010/11 tax year when the Standard Lifetime Allowance has increased by 20% to £1,800,000 from its starting level of £1,500,000. His maximum tax-free lump sum will have increased in proportion i.e. by 20% to £600,000 from its £500,000 starting point.

## **Applications For Protection**

If you want to apply for the protection benefits explained in this document, **you** must apply to HM Revenue and Customs (HMRC). **Only you can apply**, no one else can do so on your behalf.

There is a dedicated form for applications, APS200, and it is available from the HMRC website ([www.hmrc.gov.uk](http://www.hmrc.gov.uk)), with notes to guide you on its completion.

**Please remember:** Applications for primary protection, enhanced protection (plus associated lump sum protection) and some pensions credit protection must be made before 5 April 2009. For other types of protection applications can be made broadly within six years of the event for which you are applying.

## **Advice**

**We strongly recommend you speak to your financial adviser to discuss your options before you apply for protection.**

If you do not have a financial adviser, you can contact IFA Promotion Ltd on 0800 0853250 (or [www.unbiased.co.uk](http://www.unbiased.co.uk)), who can provide details of Independent Financial Advisers in your area. There may be a charge for such advice.

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