LIFETIME ALLOWANCE MANAGEMENT – CLIENTS WITH FUNDS GREATER THAN PREVAILING LTA OR PROTECTED LTA

CASE STUDY

FOR FINANCIAL ADVISERS ONLY

The lifetime allowance (LTA) has reduced from the previous level of £1.25m to £1m from the start of the 2016/17 tax year. Two new forms of protection have been introduced; namely Fixed and Individual 2016. Clients wishing to draw benefits from their pension savings can now make an online application for either or both forms of protection through HM Revenue & Customs using the following link:
https://www.gov.uk/guidance/pension-schemes-protect-your-lifetime-allowance

Fixed Protection 2016 – clients can "fix" their lifetime allowance at £1.25m on the condition that they cease accrual and or contributions into any registered pension scheme.

Individual Protection 2016 – as an alternative to fixed, they can lock in the value of their pensions as at 5 April 2016 while retaining the ability to contribute in future. The value of their pension savings must be in excess of £1m as at 5 April 2016 to apply for this and it's the value on that day that is locked in – to a ceiling of £1.25m

Choosing which protections to apply for will create dilemmas for clients and advisers alike. For many, funding as aggressively as possible in the 2015/16 tax year using maximum reliefs and carry forward from previous years was the desired option.

Many clients have substantial pension pots that remain unvested. Since pension freedoms were announced we have seen many clients restructure legacy final salary arrangements with movement to money purchase. Due to exceptionally low gilt yields many transfer values have been very significant. So significant, that clients run right into LTA challenges, even with previously applied for protections.

CASE STUDY:

Donny 59, had applied for Individual Protection (2014) at £1.5m and has a certificate. The total value of his now consolidated unvested money purchase pots is £2.3m. He is married with adult children and is very interested in how he can use his pension to pass on a legacy to other family members. He has taken nothing from his pensions previously.

In respect of the Lifetime Allowance there are many areas that need to be considered.

Donny could crystallise £2.3m with Benefit Crystallisation Event (BCE) 6 Pension Commencement Lump Sum (PCLS) and BCE 1 (drawdown) and this would create the following:

LTA excess £800,000

Max PCLS 25% of £1.5m = £375,000

Remaining fund within LTA = £1,125,000

This would leave him with the following options:

OPTION 1 – **LTA EXCESS TAKEN AS LUMP SUM**

LTA excess charge 55% = £440,000

Danny receives a total lump sum of £735,000 made up of his PCLS of £375,000 and an LTA excess lump sum of £360,000.

The fund value designated to drawdown or used to buy annuity = £1,125,000.

If designated to drawdown, the opening value of the crystallised fund = £1,125,000.

If the fund is initially designated to flexi-access drawdown, at age 75, or earlier if Danny decides to buy a lifetime annuity, there will be a second LTA test. The amount tested would be the difference between (i) the current value of the drawdown fund on date of age 75 test, and (ii) the designated amount of £1,125,000.

This second test encourages taking the growth of the fund as income (taxable at marginal rate). The aim, in order to avoid a second LTA charge is to take income, in line with growth, to ensure that the fund value is equal or lower than £1,125,000 when the second test is applied which will be at age 75 if no annuity purchase takes place beforehand.

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OPTION 2 – **LTA EXCESS RETAINED IN SCHEME TO PROVIDE INCOME**

LTA excess charge 25% = £200,000

LTA excess retained in scheme = £600,000

PCLS paid = £375,000

The fund designated to drawdown or used to buy annuity £1,125,000 + £600,000 = £1,725,000.

If designated to drawdown, the opening value of the crystallised fund = £1,725,000.

If the fund remains in drawdown there will be a second LTA test at age 75.

The age 75 test is the current market value of drawdown fund at age 75 less the amounts designated to the drawdown fund. The amount designated to drawdown is the value after the 25% lifetime allowance retained excess charge is deducted, in this case study £1,725,000.

This option would probably be more beneficial from a "legacy/death benefit perspective" as more assets are retained within the pension scheme, whereas with Option 1, the residue post LTA test is taken as a lump sum and removed from the pension wrapper.

OPTION 3 – **ONLY DESIGNATING UP TO VALUE OF £1.5M (IP 14)**

Donny could retain £800,000 uncrystallised if he only crystallises £1.5m. Doing this would mean that he does not exceed his personal LTA at his retirement BCE's.

However, that remaining £800,000 would be tested against the LTA when he dies, or if he reaches age 75, whichever happens first. In either case it would be LTA excess in its entirety as there is no LTA left to use. Its value may grow so there is a risk that the value of that £800,000 will be in fact greater when it is later identified as LTA excess (leading to a higher tax charge).

If the later test is the age 75 test, any growth in the drawdown fund from the original £1.5m BCE would also be tested and would be subject to the LTA charge.

If the later test is the death test, the beneficiary or beneficiaries receiving the benefit will pay the LTA excess tax charge.

Of course, if the future values are lower rather than greater, then leaving the £800,000 uncrystallised at the original BCE would be an advantage.

In summary, the choices boil down to:

1. Crystallise everything when Donny takes retirement benefits and pay the LTA excess tax charge
2. Crystallise up to the LTA when Donny takes retirement benefits and find that the LTA excess tax charge he has to pay when it is identified later is more than it would have been if he had exercised Option 1
3. Crystallise up to the LTA when Donny takes retirement benefits and find that the LTA excess tax charge you have to pay when it is later identified is less than it would have been if he had exercised Option 1
4. Crystallise up to the LTA when Donny takes retirement benefits and his beneficiaries then have to pay the LTA excess tax charge when they receive death benefits

One final planning opportunity:
As Donny has Individual Protection 14 (and not fixed) he can make a withdrawal using "small pots" legislation of up to £30,000, if his pension scheme structure allows. If this was done, £30,000 would not be tested against the LTA. A withdrawal under small pots rules is not classed as a BCE, hence there is no test against the LTA. For Danny to make a withdrawal using "small pots" he would need some LTA available at the time he makes the small pots withdrawals.

If Donny had designated the full £1.5m and had no LTA left, a small pots withdrawal could not be made, showing the order and timing of events is crucial here.

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