the art of finance

Lifetime Allowance Guide.

Lifetime Allowance guide

The Lifetime Allowance (LTA) is currently £1,073,100 but it would be more than fair to say that the LTA has had a few changes.

When the LTA was reduced to £1,000,000 back in 2016, it was set to increase in line with price inflation, specifically the Consumer Prices Index (CPI). However, the government have recently announced that the LTA will be frozen until April 2026.

What is the Lifetime Allowance?

It was part of the government's attempt to achieve a single, simplified pension regime on the 6th April 2006. You should pay attention to this date as it's important! It's known as A-Day.

So, on A-Day, we were introduced to the Lifetime Allowance along with the…

- Annual Allowance,
- Pension Commencement Lump Sum cap at 25%

That doesn't mean that we're restricted to having pension benefits less than the Lifetime Allowance. Technically, you can hold an unlimited amount in a pension plan, in an unlimited number of pension plans in fact. But if the value of the pension benefits exceeds the LTA, then a Lifetime Allowance charge will come into play.

When we access our pension, they are tested against the LTA. This is known as a Benefit Crystallisation Event (BCE). So, BCEs are certain events where the pension benefits are tested against the LTA.

For example, when we access our tax-free cash, the Pension Commencement Lump Sum (PCLS), this is known as BCE 6. A very cool and memorable name. BCE 6 covers relevant lump sum which translates to PCLS, as well as Uncrystallised Fund Pension Lump Sum (UFPLS). The purpose of the BCE is to determine the value of the benefit that is being crystallised. This value is then tested against the LTA.

For example:

Megan has a personal pension which is valued at £750,000. She would like to gain access to a tax-free lump sum of £25,000 in order to pay for her house extension.

- She will crystallise in total, £100,000
- She will receive £25,000 as a tax-free lump sum and that'll be paid to her bank account.
- The remaining crystallised funds, £75,000, will sit in a flexi-access drawdown (FAD) account.
- Her remaining uncrystallised funds, £650,000, will remain as they are. It is possible to withdraw further PCLS entitlement from this pot.

But how is this assessed against the lifetime allowance?

Technically, two BCEs have happened here.

- **We've got BCE 6 – lump sum payments.**
  We'll use the value of the lump sum, £25,000.
- **We've also got BCE 1 – fund moved into drawdown.**
  We'll use the market value of the fund, £75,000.

In total, £100,000 has been crystallised.

- 2021 the LTA is £1,073,100.
- £100,000 / £1,073,100 x 100 = 9.31%

That means Megan has 90.69% of her LTA remaining and it'll be based on whatever the LTA is when the BCE occurs.

Your calculator may also be saying 9.31879 and you'll be thinking… shouldn't we round up? Nope, not for the LTA! **We always round down.**

There are certain orders of crystallisation, too. BCE 6 will come before the BCE associated with pension income (1, 2 and 4). This helps ensure that the PCLS will be paid (or at least some of it) where the pension member is close to their LTA limit. If BCE was last, it could mean that the member could exceed their LTA limit and so no PCLS could be paid!

Benefit Crystallisation Event (BCE)	What's happening?	How do we value against the LTA?	How is it taxed if in excess of LTA?
BCE 1	Funds going into drawdown. This is usually accompanied by BCE6, the PCLS.	Market value of the fund.	25%
BCE 2	A member becomes entitled to a scheme pension (this is most commonly through a Defined Benefit scheme). Just like BC1, this is usually accompanied by BCE6, PCLS.	£ scheme pension in first year x 20	25%
BCE 3	Scheme pension increases. The scheme pension is already in payment and is excessively increased beyond the annual limit set by HMRC. This complex one is also the only one which can occur after an individual's 75^{th} birthday!	Additional increase x 20	25%
BCE 4	Lifetime annuity	Market value of fund used	25%

	The value being used to purchase an annuity. If drawdown funds are used, the amount tested will be a lot lower as it'll be the difference between what was designated in drawdown BCE 1 and used to purchase an annuity so they're not tested twice.		
Unused funds (funds not yet crystallised) at age 75 or on death if earlier			
BCE 5	Member of DB scheme turns 75 and have not taken some/all of scheme pension and/or lump sum	Lump sum + 20 x annual scheme pension	25%
BCE 5A	Member of drawdown fund & reaches age 75	Drawdown was already tested under BCE 1. They'll test the market value of the drawdown fund less the market value which has already been used when tested under BCE	25%
BCE 5B	Member of uncrystallised defined contribution plan and reaches age 75	Market value of uncrystallised (now crystallised so known as unused) funds.	25%
BCE 5C	The member has passed away before age 75 with uncrystallised (unused) funds. The funds are designated to dependant/nominee drawdown within 2 year window.	Market value of funds designated.	25%
BCE 5D	The member has passed away before age 75 with uncrystallised (unused) funds. The funds are used to purchase lifetime annuity for dependant/nominee within 2-year window.	Market value of fund used.	25%
Lump sums			

BCE 6	Lump sum payment Member gains access to relevant lump sum (PCLS, UFPLS, serious ill-health paid before 75, lifetime allowance excess lump sum paid before age 75. The payment of an UFPLS is restricted to the amount of remaining LTA. If a larger lump sum is paid, the excess is treated as a lifetime allowance excess lump sum.)	Value of lump sum paid.	55%
BCE 7	Lump sum death benefit Member has passed away before age 75 and the payment of a lump sum death benefit is paid if paid within 2 years.	The value of the lump sum benefit.	55%
Transfer			
BCE 8	QROPS Transfer to a qualifying recognised overseas pension scheme (QROPs) before age 75	Market value of transfer less any reduction for overlap (such as previous BCE 1 or BCE 2 test).	25%
BCE 9	Prescribed event e.g. lump sums based on pension errors	Regulations will value and prescribe	55%

- If the excess is taken as a **lump sum**, we're talking about a **55% tax charge** on the excess above the LTA. There is no income tax liability though.
- If the excess is taken as an **income** (annuity, scheme pension and drawdown for example), we're talking about a **25% tax charge** on the excess above the LTA. This may seem the obvious choice, but after the charge, the member may have to pay income tax.

Benefit type	Value for LTA
Lump sum (PCLS & UFPLS)	The amount of the lump sum.
Lifetime Annuity	Amount of fund used to purchase the annuity
Drawdown	Amount of fund designated into drawdown.
Scheme pension (DBs)	20 x the initial annual pension income

If you haven't taken any of your pension savings by the time you reach 75, you will need to pay a tax charge of 25% on anything that is over the lifetime allowance that applies at that point.

If you haven't taken your pension savings and you die before 75, any death benefits that exceed the lifetime allowance at that point will have a tax charge. It will depend on how these are paid - as a lump sum (55%) or pension income (25%). It'll be the beneficiary's burden then, as the pension member is not around to deal with the charge! HMRC will send them a tax bill.

It was common to say that having a pension which exceeded the LTA wasn't the worst problem to have in the world. True. When the LTA was first introduced way back in 2006, it was set at £1,500,000 where it steadily increased to the highest point of £1,800,000. Unfortunately, the LTA has significantly decreased since then which means many more people are going to be subject to this tax charge.

Tilney had previously calculated that a 30-year-old with a pension pot of £270,000 could already be on track to breach the lifetime allowance by age 67. So, a fair few assumptions were used to get to that figure and that's just an inherent issue of trying to project future values. What is making it incredibly more difficult for financial advisers, however, is trying to predict when the government will change things and in what way.

Legislation does change and that's to be expected but we have seen an incredible amount of change over the recent years with regards to the Lifetime Allowance. Which brings the question, how on earth can we get a handle on creating a sensible plan?

Rishi Sunak has made a couple of comments about pensions recently and described death benefits as "indefensibly generous". This had everyone preparing themselves for big changes which didn't result to anything from the recent budget. The fact remains, however, that pension death benefits can be very generous, especially for defined contribution plans. If the pension member passes away before the age of 75, and as long as the pension monies are all organised and sorted within two years, the death benefits will be free from Income Tax and not even considered against Inheritance Tax!

Death is a BCE and so the pension benefits will be tested against the LTA. You cannot escape this test and potential charge on death unfortunately.

With our students, we often see them mixing up the Lifetime Allowance with Income Tax liabilities. Remember, they are two different taxes.

- The LTA charge will apply if benefits exceed the LTA – whether that's on the pension member's death or during their lifetime.
- The Income Tax liability for the person who inherits the person all depends on the magic age of 75. It doesn't matter whether the benefits were previously crystallised before death.

Remember when we said that you should remember A-Day?

Pensions in payment before 6 April 2006

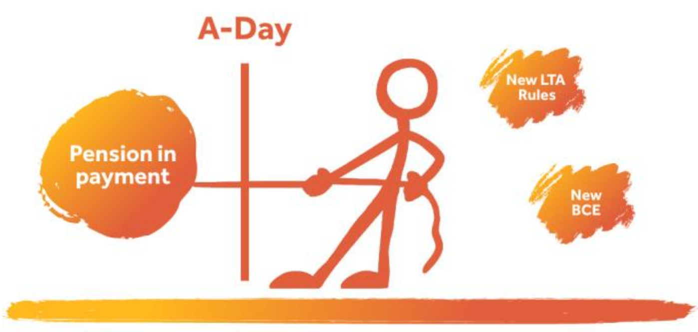
It's safe to say that there's a fair few people who have accessed their pension before A-Day. It's not fair for them to be tested against this newly introduced Lifetime Allowance. Pensions taken or in payment before A-Day will never trigger an LTA test by itself.

In other words, if an individual only has pension benefits which are already in payment before A-Day (remember 6 April 2006) then they will never be considered for the LTA. This is because there have been no BCE since A-Day.

No BCE after A-Day? Then we can leave the poor retirees alone.

When issues do arise, it is when we have benefits in payment before A-Day **AND** a new BCE which has occurred after A-Day. Unfortunately, that then means we need to drag the old pre-A-Day benefits into the new regime.

When the pre A-Day benefits are valued, they can exceed the LTA. If this happens then there won't be any LTA charge levied on them. What it does mean, however, is that there won't be any LTA available for the brand-new BCE that's taking place!



Old pre A-day benefits in payment & new BCE afterwards

They will be treated as being crystallised IMMEDIATELY before the brand-new BCE which is after A-Day. But how are they assessed?

Assessing pre A-Day Lifetime annuities and scheme pensions

- The level of annual income in payment when the new BCE occurs is x by 25.

Let's look at an example. An annuity was initially secured for £13,000 back in 2004. It is, however, an escalating annuity which means it will increase every year to offset the effects of inflation. The member has another pension which they have decided to withdraw from in 2007. We've got an issue here, as the newest BCE is after A-Day and so we need to drag the annuity into the new tax regime and test the benefits. In 2007, the annual annuity income has increased to £15,000. We will use this income, not the initial amount, and x by 25. That's because we are dragging the old annuity into the new tax regime and we'll treat it as if as a BCE immediately before the newest one. As a result, we'll use the newest income figure, £15,000!

£15,000 x 25 = £375,000.

The reason why they are valued at 25:1 rather than 20:1 is because the individual will most likely have taken a tax-free lump sum when the benefits were originally taken. The 25 factor takes this into account by ignoring the lump sum (even if it is known!).

Nice and easy right? But what about everything else? Well… this depends on the date of the first BCE since A-Day…

Capped Drawdown

If the BCE was before 6 April 2015

Psst... this is when pension freedoms when introduced.

25 x the maximum yearly income allowed under capped drawdown (as calculated by GAD) on the day that new BCE occurs.

What about if the BCE occurs after 5 April 2015

25 x 80% the maximum yearly income allowed under capped drawdown on the day the new BCE occurs.

So why are we making it difficult?

For Capped Drawdown plans, you are limited by a maximum amount of income. The maximum amount of income that can be taken during a pension year is 150% of the Government Actuary's Department rate (often known as GAD).

However, the GAD rates have changed over the years. The amount of maximum income as calculated by the GAD needs to be multiplied by 80% to reduce the new maximum GAD of 150% back down to the previous 120% GAD figure (and if we divide 120 by 150 = we'll get 0.80).

Let's look at an example.

A member had a pension scheme in payment before A-Day and it is a capped drawdown plan. In 2016, the maximum income payable from the plan was £20,000 and the member was withdrawing £10,000. They had decided to withdraw the tax-free cash from another pension plan.

As a result, the pre A-day pension scheme, the capped drawdown plan, will reduce the LTA by…

£20,000 x 80% x 25 = £400,000.

If the new BCE occurred before pension freedoms 6 April 2015, then we would use £20,000 x 25. This is because the maximum GAD figure was lower, at 120%!

This will immediately reduce the LTA available before we then assess how much the new tax-free cash withdrawal will take.

Flexi-Access Drawdown and Flexible Drawdown

Flexi-Access Drawdown was introduced on pension freedoms, 6 April 2015. Before that, Flexible Drawdown existed. Any existing Flexible Drawdown plans at pension freedom were converted to the new Flexi-Access drawdown.

When assessing against the LTA, it gets more complex. It all depends on the date the pre A-Day drawdown fund became Flexible or Flexi-Access drawdown…

It can be summed up ***roughly*** as follows…

Flexi-Access Drawdown plan which was previously Capped Drawdown

25 x 80% of the maximum income that would have been permitted to take under capped drawdown in the year converted to flexi-access drawdown

Pre 27 March 2014

25 x 100% the maximum yearly income that could have been paid under capped drawdown when it was designated to flexible drawdown.

After 26 March 2014

25 x 80% of the maximum yearly income that could have been paid under capped drawdown when it was designated for flexible drawdown.

It's very rare that you'll come across this situation. A-Day was over 15 years ago and for most people, they have accessed all their pension savings already if they have pensions in payment before A-Day. Not everyone, however… but it isn't the most vital information you need pluck immediately out of your head when working with pensions on a day-to-day basis. Unfortunately, the CII like to test you on it!

We therefore hope that this guide has proven handy, whether to top up your pensions game or in preparation for your next exam!

*Tilney Source
"We have based this assumption on the premise that the lifetime allowance of £1,073,100 in the 2020/21 tax year will be frozen until April 2026 and thereafter will be increased in each tax year in line with Consumer Price Indexation (CPI). In this example we have used a CPI rate of increase of 2% p.a. with a compounded annual investment return of 5% net of costs".