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The Benefit Crystallisation Process Post A-Day

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How the lifetime allowance is used up at successive benefit crystallisation events (BCEs)

There is no limit on the benefits that may be provided for an individual under registered pension schemes. However, where the total value of an individual's benefits, from all schemes, exceeds the lifetime allowance the individual will have to pay an additional tax charge, called the lifetime allowance charge, on the excess. The standard lifetime allowance is £1.5m for 2006/07 and will increase to £1.8m by 2010/11.

Each time a benefit crystallisation event (BCE) occurs, a portion of the individual's lifetime allowance is used up. BCE's include:

- designation of funds to provide unsecured pension (USP);
- payment of a pension commencement lump sum;
- purchase of a lifetime annuity; and
- designation of funds to provide alternatively secured pension at age 75.

At each BCE the value crystallised to provide benefits is calculated and compared with the individual's available lifetime allowance to determine whether a lifetime allowance charge is payable.

Understanding the benefit crystallisation process will help in understanding whether or not an individual is likely to use up all of their lifetime allowance and hence whether or not they will benefit from transitional protection.

Example

Fred is age 60. He has four separate pension arrangements.

Pension arrangement A – Final salary pension in payment of £12,500 per annum at A-Day.
Pension arrangement B – Personal pension paying pension under income withdrawal/drawdown. At A-Day the fund is worth £260,000.
Pension arrangement C – Uncrystallised money purchase arrangement worth £350,000 at A-Day.
Pension arrangement D – Uncrystallised money purchase arrangement worth £70,000 at A-Day.

First benefit crystallisation event after A-Day

Fred decides to vest pension arrangement C in December 2006, i.e. in the 2006/07 tax year when the lifetime allowance is £1.5m.

As this is Fred's first BCE after A-Day, we need to account for pre-commencement pensions, i.e. pensions in payment that vested before A-Day, namely pension arrangements A and B.

For the purposes of the new pension regime, pension arrangements A and B are deemed to vest immediately before pension arrangement C. We use a factor of £25 for every £1 p.a. of pension in payment when determining how much lifetime allowance is used up in relation to pre-commencement pensions.

Pension arrangement A – is deemed to use up 25 x £13,000 (pension in payment has increased from £12,500 as a result of post A-Day increases) = £325,000 of the lifetime allowance in 2006/07 i.e. **21.67%** of the standard lifetime allowance.

Pension arrangement B – we need to use the maximum allowable pension under the unsecured pension rules in the 25 x pension formula at the time of the deemed vesting in December 2006. Assume this is £19,340 p.a.. The amount of income withdrawals actually being paid is irrelevant, as is the fund value.

So pension arrangement B uses up 25 x £19,340 = £483,500 of the lifetime allowance in 2006/07 i.e. **32.23%** of the standard lifetime allowance.

Notes:-

a) No allowance is made for tax-free cash taken from the pre-commencement pension arrangements, A or B, before A-Day, this is implicit in the 25:1 factor.

b) The amount of lifetime allowance used up by the pre-commencement income withdrawal pension arrangement B (£483,500) is significantly more than the actual value of the arrangement (worth £260,000 at A-Day). Great care must be taken with income withdrawal arrangements as it is easy to underestimate the amount of lifetime allowance it will use up. This may also incorrectly influence the decision whether or not to apply for enhanced protection.

So in summary, the pre-commencement pension arrangements A and B i.e. pensions that commenced before A-Day, are deemed to have used up **53.9%** of Fred's lifetime allowance. He therefore has **46.1%** of his lifetime allowance remaining.

What triggered the above deemed vesting of pension arrangements A and B was of course the fact that Fred wanted to vest pension arrangement C, which is assumed to be worth £350,000 in December 2006 (investment growth between A-Day and December 2006 has effectively been ignored).

Pension arrangement C – Fred decides to take the maximum pension commencement lump sum from this arrangement and use the remainder to provide him with an income under the unsecured pension rules.

His pension commencement lump sum is £87,500 (25% of £350,000) and the remaining £262,500 is used to provide an income between zero and £19,530 (using factors as supplied in consultation and current gilt yields).

The amount of lifetime allowance used up is just the value of the funds crystallised/vested i.e. £350,000.

Pension arrangement C therefore uses up a further **23.33%** of Fred's lifetime allowance.

So, Fred now has **22.77%** of his lifetime allowance remaining.

<u>Subsequent BCEs</u>

Let us assume that Fred decides to vest pension arrangement D in December 2010 i.e. in the tax year 2010/11 when the lifetime allowance is £1.8m.

Assume pension arrangement D has grown from £70,000 to £110,000 in this period.

Benefits are vested in the same form as for pension arrangement C i.e. a combination of a 25% pension commencement lump sum and unsecured pension.

This uses up £110,000 of the lifetime allowance, which expressed as a percentage of the lifetime allowance in 2010/11 (£1.8m) is **6.11%**.

So, after vesting all four arrangements, Fred has used up all but **16.66%** of his lifetime allowance.

Common sense would suggest that as all arrangements have vested, no further action is required as far as the lifetime allowance is concerned. However, in a late controversial move by HM Revenue & Customs (HMRC), benefits will now also need to be tested again at age 75 when benefits move from unsecured pension to alternatively secured pension (or earlier if an annuity is bought).

Not only is this unfair, but it makes planning very difficult. It is arguably a back door minimum income under the unsecured pension rules.

Conversion from unsecured pension to alternatively secured pension at age 75

So, how does this work?

Firstly, it only applies to unsecured pension funds and does not for example apply to final salary schemes i.e. pension arrangement A.

Further, it does not apply to pre-commencement unsecured pension funds provided no further funds are added after A-Day i.e. pension arrangement B as this commenced before A-Day.

So, we only need concern ourselves with pension arrangements C and D.

In simple terms, the growth on the unsecured pension fund between the date of vesting and age 75 (or annuity purchase if earlier) is deemed to use up a further amount of lifetime allowance.

So, if we assume that nil income is taken from pension arrangements C and D, which is perfectly allowable, then it is not unreasonable to assume that pension arrangement C grows in value over 15 years to £830,000 (from £262,500 i.e. 75% of £350,000 at age 60) and pension arrangement D grows in value over 10 years to £170,000 (from £82,500 i.e. 75% of £110,000 at age 65) by 2021 when Fred is 75.

Clearly we do not know what the lifetime allowance will be in 2021, but it is probably safest to assume that it stays the same after 2010/11 as there has been no commitment to increase the lifetime allowance beyond that date.

So, the increase in value of pension arrangement C over the period is £ 567,500 (£830,000 - £262,500). This uses up **31.53%** of the assumed £1.8m lifetime allowance.
Similarly for pension arrangement D, the increase in value is £87,500, which uses up **4.86%** of the assumed £1.8m lifetime allowance.

So, as Fred only had **16.66%** of his lifetime allowance remaining before he reached age 75, he will be subject to the more penal tax regime on benefits in excess of this.

The excess amount therefore will be **19.73%** (31.53% + 4.86% - 16.66%) of £1.8m = £355,140.

Fred has the choice of either:-

a) paying 55% (£195,327) tax and receiving £159,813 as a lifetime allowance excess lump sum, or

b) paying 25% tax (£88,785) with the residual £266,355 remaining in the pension fund and being used to provide a taxable pension under the alternatively secured pension rules.

Had Fred registered for enhanced protection, there would have been no tax charge at age 75 and all of the funds could have moved into alternatively secured pension to provide a taxable pension (hence saving £88,785 in tax).

Despite only having unvested pension arrangements worth £420,000 at A-Day, we have seen that Fred could easily breach the lifetime allowance without paying any further contributions after A-Day. He could well have benefited from enhanced protection.

Clearly had the lifetime allowance continued to increase beyond 2010/11 then this would have mitigated Fred's situation to the point where enhanced protection wouldn't have been required. Further, Fred could have elected to draw an income from his unsecured pension funds which would also have helped (as the growth on the unsecured pension funds at age 75 would have been smaller).

It is however important to make allowance for the impact of the 25:1 factor on pre-commencement pensions, particularly income withdrawal arrangements. Also, it is important to consider the impact of the 2nd BCE at age 75. In many cases, particularly where the pension scheme invests in property, it will not be possible to take all investment income and growth as pension – hence a growth in the unsecured pension fund between vesting and age 75 will be almost inevitable.

One interesting aside is that the scheme administrators of pension arrangements C and D are obliged to write to Fred annually, letting him know the percentage of the lifetime allowance he has used up from each of these pension arrangements. Oddly however, no one is charged with the responsibility of writing to Fred in this vein regarding pension arrangements A and B. This could cause difficulties in years to come as clients inevitably lose track of earlier BCEs.

Hopefully the above will help in both understanding the supposedly more simple benefit crystallisation process as it will operate after A-Day and also to help analyse transitional protection situations.

Transitional protection

Further information can be found in the "Protecting members' rights from tax charges" in the HMRC Guidance Manual at www.hmrc.gov.uk/manuals/rpsmmanual/index.htm

What is primary protection?

Primary protection is only available if, at 5 April 2006, the value of an individual's pension rights in tax privileged pension arrangements is in excess of the standard lifetime allowance (SLA) of £1.5m.

If an individual claims primary protection then tax relieved contributions can continue to be made, or further benefits accrued, under registered pension schemes after 5 April 2006.

Under primary protection, individuals will have a personal lifetime allowance, which is greater than the SLA.

Example

Jacob has protected pension rights of £3m at A-Day, this equating to his personal lifetime allowance under primary protection.

If, at the time that benefits come into payment, the SLA has increased from £1.5m to £2m, then Jacob's personal lifetime allowance will similarly increase from £3m to £4m.

What is enhanced protection?

This can be claimed by any individual with pension rights in tax privileged arrangements, including those with pension rights of less than £1.5m, on 5 April 2006.

Enhanced protection fully protects the value of an individual's pension rights on 5 April 2006. Such rights will not be subject to the lifetime allowance charge on benefits in excess of the lifetime allowance when they are brought into payment. Effectively, this means that if the value of the rights increases faster than the increase in the standard lifetime allowance, the individual will still be protected from this tax charge (either 55% or 25% depending upon whether excess benefits are taken as a lump sum or pension).

It is a condition of enhanced protection that no further contributions can be paid into a registered pension scheme by the individual, or on their behalf, after A-Day. Similarly, if the individual is an active member of a final salary scheme then they cannot accrue any further benefits (above a specified level of indexation) after this date.

There is a misconception creeping into more and more views I hear put forward on enhanced protection. Having enhanced protection does not mean that the lifetime allowance is not relevant to that individual. Someone with enhanced protection will go through exactly the same benefit crystallisation process as someone who does not have the benefit of enhanced protection. The principal benefit of enhanced protection is that those individuals who have such protection will be exempt from the lifetime allowance charge, if one should apply.

You could be forgiven for thinking this is just a technical nicety, but it is important to understand the mechanics behind the benefit crystallisation process. Here are a couple of reasons that spring to mind as to why individuals who have enhanced protection need to monitor the percentage of the lifetime allowance they have used up. Firstly, what if they lose enhanced protection? They then revert to the standard method for future benefit crystallisation events, hence they will need to know how much, if any, unused lifetime allowance they have available. Secondly, for those individuals who have enhanced protection, but do not have pension commencement lump sum protection (where those pension commencement lump sum rights exceeded £375k at A-Day), then their pension commencement lump sum is restricted to being no more than 25% of their unused standard lifetime allowance.

Can both forms of transitional protection apply?

If the value of an individual's pension rights at 5 April 2006 exceeds £1.5m they may register for both forms of transitional protection.

Where both forms of protection apply, enhanced protection will take precedence.

The rules surrounding transitional protection are very complex and specialist advice must be sought before taking any action.

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