

Are You Protected?

You may not realise you need to protect your Pensions against the Lifetime Allowance Charge

The Finance Act 2004 introduced a new set of regulations known as Pension Simplification Rules and these include a new Lifetime Allowance.

The new rules came into force on 6th April 2006 (known as 'A' Day) and effectively scrapped all other pension legislation and replaced 8 different regimes with one 'simple' set of rules. Pension rules simplified? Wonderful news! However, there is a mass of legislation to interpret and a vast number of transitional rules to consider.

One significant change is the abolition of historic Maximum Benefit Rules. The new Lifetime Allowance (combined with the Annual Allowance – which is another subject entirely) effectively replaced these rules.

The Lifetime Allowance is the upper limit on the value of an individual's pension funds that can be held without the imposition of a tax charge. The tax charge for funds in excess of the Lifetime Allowance is 55% of the excess fund and should be avoided if at all possible! In the tax year 2006/07, the Lifetime Allowance is £1,500,000 and this is set to increase gradually over the next five years to a limit of £1,800,000 by tax year 2010/11. There are no set increases yet known after this date.

Many individuals may think their funds are nowhere near these levels – and not likely to reach them – so they might assume they are safe from this punitive tax. But beware!

A pension is valued and tested against the Lifetime Allowance at different points in its existence, to check that it is not exceeded; for example when a lump sum is drawn. However, it may also be tested again in the future, because another check is compulsory when an annuity is purchased, or when the pension-holder reaches age 75. Each test may be conducted using a different method, depending on the type of pension held.

For example, a final salary pension is valued at 20 x the potential pension if it has not paid the member any benefits, or 25 x the pension if it is in payment.

A Personal Pension that is not drawn is valued, for Lifetime Allowance purposes, as identical to the fund value. If, however, the pension has already out paid a lump sum – and the fund is held in an Income Drawdown arrangement - it is valued as the Maximum allowable Withdrawal limit per year x 25 – irrespective of the amount of withdrawal the individual is taking. This almost always results in a much higher figure.

Let us look at an example.

If a man was aged 65 on 1st January 2006, had a pension fund of £1,000,000 and drew the maximum lump sum allowable, it would leave him, on 'A' Day, with a fund of £750,000 – so one might assume there would be no need for concern about the need for protection against a potential Lifetime Allowance charge, because the fund is only half the lifetime allowance at 'A' Day.

However, the pension will, in fact, be valued at 25 x Maximum permitted withdrawal – and the maximum withdrawals would be £63,000 (assuming gilt rates are 4.25%).

This therefore means the fund has a value - for Lifetime Allowance purposes - of £1,575,000 – already £75,000 over the limit but, as the plan is in payment, our pensioner may think there is no need to test again. Sadly this is not the case. It will be tested against the limit again in the future: when an annuity is purchased or at age 75.

Many people in a similar situation may draw less than the full, allowable level of income from their pension fund in order to minimise the tax payable and may well supplement the income with other investments. If the person in our example drew £30,000 per year to ensure he remained a basic-rate taxpayer then in January 2011, at age 70, his fund will be worth £825,000, assuming 6% growth is achieved after charges.

Let us imagine that he then buys an annuity. His fund will be tested to check it does not exceed the allowance and it will be valued at £1,955,250 (assuming Gilt Rates remain at 4.25%). We know that, by 2011, the Lifetime Allowance will have increased to £1,800,000 - resulting in a tax charge of 55% of 155,250 - or **£85,387!**

As you can see, forward planning and regular reviews are absolutely essential. In the example shown, our pensioner would have been far better advised to draw a little more income from the fund during the previous five years, or by obtaining protection.

It is possible to apply to HMRC for protection against this tax **providing you apply before April 2009.**

There are two different forms of protection, each with their own rules. If these rules are breached the protection may be withdrawn.

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