LIFETIME ALLOWANCE PROTECTION EXPLAINED

One could forgive clients and providers alike for being "punch drunk" over the changes to pension plans over the last 15 years. The government is desperate for more tax and pensions is an easy target, since limits on relief and tax on bigger pension funds only hit a relatively small proportion of the better off.

Over 15 years the maximum tax free pension fund (or equivalent pension fund in the case of a final salary scheme) has been reduced from £1,800,000 to £1,000,000 from April 2016. This increases to £1,073,100 from the 2020/21 tax year.

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1. ENHANCED PROTECTION (2006)

Provides protection from a potential lifetime allowance (LTA) charge for individuals with pension rights at 5th April 2006, whether they are valued at more than £1.5 million or not.

You cannot make contributions to a money purchase arrangement after 5th April 2006 (some SERPS payments excepted), neither can your employer make contributions to provide you with benefits. You can still accrue benefits under a defined benefits or cash balance arrangement. The permitted level of benefit accrual is limited to the greater of two options:

- 5% pa (compound) - or the increase in the retail prices index (RPI) if greater, and

- An amount based on your pensionable service and scheme accrual rate on 5 April 2006 and your final salary when benefits first come into payment.

Many individuals went for enhanced protection and continued in their final salary scheme based on the premise that if their increase in service benefits did not exceed 5% pa then they would not have to pay LTA tax even though contributions had continued. The problem with this approach is that you only know if your benefits have exceeded this level when you claim. This means you have no certainty and could be free from the LTA tax or you could have to pay 55% of all your benefits above the LTA limit at the time of retirement.

If you have enhanced protection you can also have primary protection, but not fixed protection.

2. PRIMARY PROTECTION (2006)

You can only have primary protection if you had built up pension savings of more than £1.5 million before 6th April 2006. You should have applied for primary protection before 6 April 2009.

Unlike enhanced protection, primary protection allowed you to carry on saving. However, whereas enhanced protection protected your funds whatever their value, primary protection only protected your funds as a percentage of the LTA, great if LTA goes up but a bit of a disaster if it falls!

Let us say Fred has a fund worth £2 million on "A Day" when the new LTA was £1,500,000. Fred's protected LTA becomes 2,000,000/1,500,000 or 133% of the LTA. Post April 2012 Fred's maximum pension is fixed at 133% of £1,800,000, or the LTA if greater, but his maximum tax free cash becomes 25% of the LTA on the date he retires.

If you have primary protection you can also have enhanced protection, but not fixed protection.

You cannot give up primary protection to get fixed protection instead. However, you can lose it if you get divorced and your pension savings are reduced below £1.5 million because of a pension sharing order.

3. FIXED PROTECTION (ONGOING)

Fixed protection does not affect individuals who already have primary protection or enhanced protection in place.

3.1 Fixed Protection 2012 (FP 2012)

The purpose of fixed protection is to provide protection for those who:

- Had no protection, but have benefits ***currently valued*** at between £1,500,000 and £1,800,000.

- Had no protection, and have benefits below £1,500,000 but who believe their benefits will exceed £1,500,000 by retirement due to investment growth or benefit revaluation (***not*** future accrual).

Anyone who opted for 2012 fixed protection retains a lifetime allowance of £1,800,000 until such time as the new lifetime allowance escalates to a figure greater than £1,800,000.

In exchange for no taxation of your equivalent pension fund below £1,800,000, all contributions and accrual (except for an allowance for CPI) had to cease on 5th April 2012.

3.2 Fixed Protection 2014 (FP 2014)

This came into effect from 6th April 2014. Pension benefits will be free from the lifetime allowance tax if they are below the LTA equivalent of £1,500,000. This figure is the same as a full pension of £75,000 or tax free cash of £195,652 plus a scheme pension of £65,217.

Under no circumstances can you accrue further pension benefits post 6th April 2014 otherwise your fixed protection will be lost.

3.3 Individual Protection (IP 2014)

- To qualify your accrued benefits must have been equivalent to £1,250,000 or more on 5th April 2014.

- IP will only protect benefits up to the equivalent of £1,500,000.

- IP had to be applied for in the period 6th April 2014 to 6th April 2017.

You cannot apply for individual protection if you already have primary protection.

3.4 Fixed Protection 2016 (FP 2016)

You can now apply for this online please.

The protection came into effect on 5th April 2016 and your pension benefits will be free from the lifetime allowance tax if they are below the LTA equivalent of £1,250,000. This figure is the same as a full pension of £62,500 or tax free cash of £163,046 plus a scheme pension of £54,348.

Under no circumstances can you accrue further pension benefits post 6th April 2016 otherwise your fixed protection will be lost.

3.5 Individual Protection (IP 2016)

You can now apply for this online.

Applying for Individual Protection is far more arduous than fixed protection and is only effective if the value of your accrued pensions is in excess of the new allowance of £1,000,000.

The reason everyone should apply for individual benefits is that it allows you to accrue further benefits whilst fixed protection does not. Even if you have no intention of accruing benefits, a well meaning employer auto-enrolling you in their pension plan, an FSAVC provider accidentally taking a premium from you or many other circumstances can lead to you losing fixed protection through no fault of your own. For the sake of a form the individual protection is worth doing.

Please also remember that benefits such as life cover can be construed as pension accrual and any death benefits or ill health benefits from an occupational scheme could lead to fixed protection being lost.

4. LIFETIME ALLOWANCE TAX CHARGE

At retirement (and each time you take UFPLS) your benefits will be checked against your maximum Lifetime Allowance (£1,073,100 in 2020/2021). If they exceed the current LTA or your protected LTA (whichever is greater) you will have to pay tax of 25% on each pension payment, or 55% if paid as a lump sum, on all benefits above the Lifetime Allowance.

The choice of which option to take depends upon your other income tax:

	55% Lump Sum	**25% Pension**
Pension Fund	£100,000	£100,000
LTA Charge	(£55,000)	(£25,000)
Net Fund	£45,000	£75,000
Money Received After Tax At 20%	£45,000	£60,000
Money Received After Tax @ 40%	£45,000	£45,000
Money Received After Tax @ 60%	£45,000	£30,000
Money Received After Tax @ 45%	£45,000	£41,250

The LTA has been dropping over the years and can be predicted to be (assuming 2.5% CPI)

From	**To**	**Protection**	**Value**
Before 2006		Enhanced	Value of Fund
Before 2006		Multiple of LTA (Primary)	
06/04/2006	06/04/2012	Fixed Protection	£1,800,000
06/04/2012	06/04/2014	Fixed Protection	£1,500,000
06/04/2014	06/04/2016	Fixed Protection	£1,250,000
06/04/2016	06/04/2016	Individual Protection	£1,250,000
06/04/2016	06/04/2018		£1,000,000
06/04/2019	06/04/2020		£1,025,000
06/04/2020	06/04/2021		£1,050,625
06/04/2021	06/04/2022		£1,076,891
06/04/2022	06/04/2023		£1,103,813
06/04/2023	06/04/2024		£1,131,408
06/04/2024	06/04/2025		£1,159,693
06/04/2025	06/04/2026		£1,188,686
06/04/2026	06/04/2027		£1,218,403
06/04/2027	06/04/2028		£1,248,863
06/04/2028	06/04/2029		£1,280,085
06/04/2029	06/04/2030		£1,312,087

4.1 When Is The LTA Tested?

The system for testing the LTA is called Benefit Crystallisation Events or BCEs. There are now 15 (perhaps more) different times a BCE is triggered. The following is a list of events which could give rise to a benefits crystallisation test for LTA purposes:

Event	Description
1	Money Purchase to Drawdown
2	Taking PCLS
3	Money Purchase to Annuity
4	Money Purchase to Scheme Drawdown
5	Uncrystallised Pensions Lump Sum
6	Uncrystallised MP at age 75
7	Drawdown Funds at age 75
8	Payment of Uncrystallised Funds on Death
9	Scheme Pension (FS) Increases > Inflation or 5%
10	Taking FS benefits
11	LTA Excess Lump Sum
12	Serious Ill Health Lump Sum
13	Uncrystallised FS at age 75
14	Lump Sum Death Benefits
15	Transfer to a QROPS

The First BCE since 2006 (When LTAs were introduced) will trigger a BCE against pre-2006 benefits. Where those benefits are drawdown then the benefit will be assessed as the Government Actuary's Department (GAD) maximum income at the last review x 80% x 25 to create an equivalent fund to test against the LTA.

If you are in drawdown or have any pension benefits not crystallised into scheme pensions by the time you get to age 75 you will be tested again against the LTA applicable at the time, or the LTA you have if higher.

When a benefit crystallisation event occurs your LTA is assessed as follows:

4.2 Final Salary Schemes

For those in final salary schemes the value of your pension plan is 20 x the pension you are to receive plus the value of any tax free cash you receive. For those who retired before 2006 the multiple may be 25 x the pension alone.

Some websites such as the NHS have useful annual allowance and lifetime allowance ready reckoners on their websites.

4.3 Employers Scheme Pension

The value is 20 x the value of pensions in payment plus any tax free cash taken.

4.4 Those In Drawdown Or Those Who Have Not Crystallised Their Fund

Remember you are reassessed at age 75 unless your pension plan is considered to be a "Scheme Pension" or a Recognised Non Qualifying UK Scheme (RNUKS is the successor to Qualifying Recognised Overseas Pension Scheme QROPS). You do not avoid the lifetime allowance tax charge if you are now retired and below age 75. At age 75 the lifetime allowance will be 20 x your pension (25 x if the pension started pre 2006) plus tax free cash you have had plus the value of your draw down pension plan. If this exceeds £1,073,100 for the 2020/21 tax year then you have to pay tax.

4.5 Employers Life Insurance

Most life cover provided by employers is written under pension legislation. This means that if you die your employer's life cover is added to your pension funds for LTA purposes and if the combined value exceeds the LTA, you pay 55% tax on the surplus.

5. WHAT IS THE TAX LIABILITY IF YOU EXCEED THE LIFETIME ALLOWANCE?

Once your lifetime allowance exceeds your agreed limit, surplus pension funds pay a tax charge of either 55% if you take the surplus in the form of a lump sum, or 25% if the remaining pension fund is to be used to produce a taxable pension.

The tax liability is assessed on each crystallisation of your pension plans and again (subject to the type of pension you are receiving) at age 75 regardless of whether you have taken benefits or not.

Typically under the current regime the maximum pension commencement lump sum (PCLS) is equivalent to 25% of the total pension fund.

6. SHOULD YOU GO FOR FIXED PROTECTION?

It is not really possible for us to advise on this within general notes such as these. An individual's choice will entirely depend on their current circumstances and pension scheme options. For instance, if you have 10 years before your final salary pension is due to be paid then the accrual over that period will probably still be worthwhile despite the fact you will have to pay tax on it. On the other hand, if you have one or two years to go then 55% tax on £250,000 is a big hit and taking fixed protection may well be the answer (see worked example below).

If you are due a big salary hike just before retirement (for instance a merit award) then it may be worth paying the annual allowance tax plus the lifetime allowance tax, but again you need to work through the figures.

7. IF I GO FOR PROTECTION CAN I IMPROVE MY CIRCUMSTANCES?

7.1 Consider a Family SIPP / SSAS

Several companies offer a group or family SIPP and SSAS arrangement, whereby the group can agree targeted benefits for the whole scheme.

For instance, if the husband had a pension fund of £1,000,000 and the wife a fund of £100,000 then the scheme trustees may declare a targeted pension for both members of the same sum. This being the case, then all future growth within the SIPP would go to the wife's fund thus not creating additional problems for the husband.

8. ISSUES WITH FINAL SALARY SCHEMES

8.1 Does Your Scheme Apply Abatement? (Final Salary Schemes)

Several major national schemes (LGPS for instance) will not allow employees to leave service, take their pension and return to work whether or not they try and get further pension accrual when they do return to work. In these circumstances the scheme insists on an "abatement" of the pension in payment so that the new salary plus pension does not exceed what the pension would have been had the member retired.

Therefore, before you decide whether or not to leave your pension scheme you must check out what the terms of opting out (and perhaps claiming pension benefits) are.

8.2 As A General Rule Pay The Tax By Reducing Your Pension

Most final salary schemes offer a level of tax free cash which is well below the equivalent 25% maximum allowed under the new pensions regime. These schemes then offer members the opportunity to take more tax free cash at the cost of reducing the pension paid to them.

The amount of pension lost in exchange for tax free cash (PCLS) is usually outrageous. On a recent scheme comparison the member lost £1 pension for every £12 tax free cash. If that member wanted to buy an equivalent pension on the open market it would have cost him £36.

9. CAN I IMPROVE MY CIRCUMSTANCES IF I DO NOT TAKE FIXED PROTECTION?

9.1 Choose The Order In Which You Take Benefits

If you have both money purchase (say a personal pension) and final salary pensions then take your final salary pensions first up to the lifetime allowance, subsequently taking your personal pensions which will push you over the lifetime allowance. Dealing with the lifetime allowance using a money purchase plan is a lot easier (and cheaper) than the final salary alternative.

9.2 Consider a Family SIPP / SSAS

Several companies offer a group or family SIPP and SSAS arrangement, whereby the group can agree targeted benefits for the whole scheme.

For instance, if the husband had a pension fund of £1,000,000 and the wife a fund of £100,000 then the scheme trustees may declare a targeted pension for both members of the same sum. This being the case, then all future growth within the SIPP would go to the wife’s fund, thus not creating potential problems for the husband.

9.3 Get Your Employer To Change Your Death In Service Plan

If death in service is written as a “Relevant Life Insurance” rather than a pension plan it does not affect your pensions lifetime allowance. This can save your beneficiaries 55% of your benefits. However, there can be problems with such a change particularly if your health is no longer good. Ask us for specific advice if this route may be an advantage to you.

10. WHAT HAPPENS IF I AM IN DRAWDOWN?

You should check your lifetime allowance position now and if your benefits (including other scheme benefits) generate a lifetime allowance figure of over £1,073,100 then consider:

- Switching to flexible drawdown and taking large benefits before age 75.
- Investing into a QROPS.
- Switching to a guaranteed draw down scheme pension.
- Converting to a scheme pension / annuity.

11. A WORKED EXAMPLE (FINAL SALARY)

Joe is a 59-year-old doctor in the NHS. He earns £155,000 a year and has 31 years service. Like most doctors, he intends to continue working in the NHS after his 60th birthday.

Joe is a member of the 1995 NHS scheme which allows additional pension accrual up to 45 years, so he is a long way off that. He will get a pay rise of 3 per cent between 2014 and 2015 to £159,660 and CPI inflation for September 2014 is 1.26%.

11.1 Annual Allowance (AA) Calculation

First of all we have to work out what his accrual will cost and what benefits he will get for it if he stays in the scheme.

	Received	AA Equivalent
Starting Salary	£155,000	
Starting Pension (30/80ths)	£60,063	£961,000
Starting Tax Free Cash	£180,188	£180,188
Total starting Pension		£1,141,188
CPI over year	1.26%	£1,155,567
Ending Salary	£159,650	
Ending Pension (38/80ths)	£63,860	£1,021,760
Ending Tax Free Cash	£191,580	£191,580
Total Ending Pension		£1,213,340
So Contribution for the year is considered to be:		£57,773
The Annual Allowance is		£40,000

In this instance he has a £17,773 annual allowance tax charge.

Note the annual allowance equivalent fund has no relationship to the lifetime allowance equivalent fund.

Post April 2016 Joe will also have a lower AA if his alternative chargeable income (see Tax on Pension Contributions notes) is greater than £150,000. Therefore, in this instance if his salary were equal to his alternative chargeable amount (very unlikely the ACA is usually higher) then his annual allowance would be £35,185.

The cost to Joe for another year's benefits is

Personal Contribution @ 8.5%	£13,570
Less tax relief	(£6,107)
Net personal cost	£7,464
AA Payment	£57,773
AA (Assuming no carry forward)	£40,000
Excess AA payment	£17,773
Tax at 45%	(£7,998)
Net cost	£7,464
Plus tax charge	£7,998
Total cost	£15,462

Joe's benefits increase by:

	Starting	**Ending**	**Extra**
Pension	£60,063	£63,860	£3,798
Tax Free Cash	£180,188	£191,580	£11,393

Before any lifetime allowance tax this still looks a pretty good deal. Joe could, of course, also use carry forward provisions to mop up any overpayment should there be an annual allowance liability.

In this example, post 2016 his tax bill rises to £10,164.

11.2 Lifetime Allowance Calculation

The lifetime allowance calculations use completely different criteria than the annual allowance. Again in tabular form:

	Starting	**Ending**	**Extra**
LTA Equivalent of Pension	£1,201,250	£1,277,200	£75,950
LTA Equivalent of Tax Free Cash	£180,188	£191,580	£11,393
Total LTA Equivalent Fund	£1,381,438	£1,468,780	£87,343

If Joe leaves the scheme in April 2015 his lifetime allowance tax will be:

	Value	LTA Equivalent
Final Pension	£63,860	£1,277,200
Final TFC	£191,580	£191,580
		£1,468,780

	LTA Equivalent	Tax Due
LTA Limit is:	£1,250,000	
So Joe's Benefits exceed limit by:	£218,780	
Tax Free Cash can pay:	£191,580	£105,369
Pension has to pay	£27,200	£6,800
	£218,780	£112,169

If he waits until 6th April 2016 his tax will rise by a further £137,500 (tax free cash) or £7,800 a year pension.

11.3 Pension Penalty

If you recall our comments in section 8.2, Joe is penalised by the NHS pension scheme due to the conversion rate of pensions to tax free cash. The excess the pension has to pay is £6,800. The NHS will not allow the individual to pay the 25% tax due so this must be paid from the pension fund. The pension fund will probably use a conversion rate of £12 cash for each £1 pension given up so the loss of pension benefits is £567 per year.

If you wanted to buy a pension of £567 a year at age 60 which was equivalent to the pension provided by the NHS it would cost you approximately £20,000.

11.4 Summary

In this example Joe's comparison of benefits is as follows:

	Starting	Ending	Extra Pension	Extra Cash
Pension	£60,063	£63,860	£3,798	
Tax Free Cash	£180,188	£191,580		£11,393
Cost (including AA)	-	(£7,246)		(£7,246)
LTA Tax on Tax Free Cash		(£105,369)		(£105,369)
Loss of Pension Benefits due to LTA			(£567)	
Total Benefits			£3,231	(£101,223)

In commercial terms, if Joe retires in 2016/17 tax year he will get £3,231 extra pension at a cost of £101,223. Whilst this is still a commercial return, most people would prefer to have opted out the preceding year.

12. OTHER ALTERNATIVES TO PENSIONS

There are a number of other alternatives to pension planning for high earners who are close to or above the new limits.

12.1 Individual Savings Plans

An annual allowance of £20,000 per person. No tax relief going in, but the income is tax free and you can pass your ISA to your spouse on death.

12.2 Fund Your Partner's Pension

We are constantly surprised at how often wives and civil partners are completely forgotten in the pension planning area. Not only do you get the same tax relief funding as your spouse's pension, but quite often the benefits will be received at a lower rate of tax.

Please note that whilst every effort is made to ensure that the information contained within this explanation is correct, these notes are by necessity brief and of a generalised nature. Clients should seek specific personalised advice prior to undertaking any arrangement. These notes are named 09.2020 Lifetime Allowance Protection Explained and were last updated in September 2020. Whilst we have done our best to ensure facts are current to this date laws and options are changing constantly so always check before action.

Investments are subject to market risk, including the possible loss of the money you invest. Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments. Diversification does not ensure a profit or protect against a loss in a declining market. Performance data shown represent past performance, which is not a guarantee of future results. Note that hypothetical illustrations are not exact representations of any particular investment, as you cannot invest directly in an index or fund-group average.

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