

## **Pension income (Lecture P1442 – 15.06 minutes)**

Authorised member payments are payments that a pension scheme is authorised to make to, or in respect of, the members of the pension scheme.

These include:

- pensions permitted by the pension rules or the death benefit rules;
- lump sums permitted by the lump sum rule or the lump sum death benefit rules;
- payments pursuant to pension sharing order or provision.

Effectively, for money purchase schemes, the following are allowed:

- a drawdown pension for the member, his dependent, nominee or successor;
- an amount to purchase a short-term annuity for the member, his dependent, nominee or successor;
- an amount to purchase a nominee's or successor's annuity;

There are then a series of lump sum payments that can be made:

- a pension commencement lump sum ;
- a pension commencement-excess lump sum ;
- a serious ill health lump sum;
- an uncrystallised funds pension lump sum;
- a short service refund lump sum;
- a refund of excess contributions lump sum;
- a trivial commutation lump sum;
- a winding up lump sum.

### *Income withdrawals*

The regime for pension income changed with effect from 6 April 2015 when 'pension freedom' was introduced. The changes apply only to defined contribution schemes although it is possible to transfer from a defined benefit into a defined contribution scheme. Careful advice would need to be taken if this is proposed as it is likely to be beneficial in very few circumstances.

The new regime allows an individual who has reached the age of 55 to choose between flexi-access drawdown or to take an uncrystallised fund pension lump sum (UFPLS).

Flexi-access drawdown allows for income to be withdrawn in any amount over any period (subject to any restrictions placed on this by the pension fund).

Up to 25% of the value can be taken as a tax-free pension commencement lump sum and then further withdrawals will be taxed as income at the marginal rate of tax. The pension fund should withhold tax at source on any income withdrawals.

If you are using an uncrystallised fund pension lump sum, the first 25% of each withdrawal is tax-free with the balance taxed as income. Again, tax will be deducted at source from the income element of each withdrawal. You can take a one-off UFPLS or a series of these.

Are you better off taking an up-front tax-free lump sum or using the UFPLS process to get each income payment with an element of tax-free money? It is an almost impossible judgement to take. Many people would not see the situation in quite such a linear way and probably want the lump sum to have some money to spend on something to celebrate their retirement!

There is still always the option to buy an annuity with their pension fund with many individuals still opting for a 25% tax free sum and then buying an annuity with the balance. These are seen as low risk.

There are various types of annuities available such as single life, joint life, fixed term, investment linked and so on. Decreasing term plans are becoming more popular where you take more now and less when the state pension kicks in.

Of the above options, remember that taking more than the lump sum will potentially bring in the money purchase annual allowance provisions. If you are taking an annuity, only flexible annuities trigger the MPAA.

Whilst an annuity will give security, it dies with the holder whereas surplus funds in drawdown can be passed to nominated beneficiaries tax-free. This is discussed below.

### *Lump sums*

The details above about the available lump sum allowance and available death benefit allowance depends on whether there have been any relevant benefit crystallisation events before. For the avoidance of doubt, these figures tell us what amounts can be paid tax-free from the fund.

To put this in simpler terms, if they have used up any of their lifetime allowance previously, it is only the tax-free amount of the previous benefit crystallisation event which is deducted from the lump sum and death benefit allowances.

Pensions funds are supposed to provide these details to the pension holders at the commencement of this regime but it is not entirely clear whether all funds will do so.

With the lump sum allowance, you would just deduct the relevant proportion of the pension commencement lump sums or uncrystallised funds pension lump sums as shown above. With the death benefit allowance, you would reduce the allowance by the relevant proportion of the above two amounts as well as any serious ill health lump sum or any lump-sum death benefits.

### *Example*

Vera receives a pension commencement lump sum in May 2024 of £25,000. There was a relevant benefit crystallisation event of £100,000 that occurred before 6 April 2024.

Her basic lump sum allowance is £268,275 as she does not have protection.

Because of the previous BCE, the available lump sum allowance is:

$$268,275 - (100,000 \times 25\%) = £243,275.$$

The lump sum she is now receiving is well within that amount so can all be paid tax free. The lump sum allowance to be carried forward to the next BCE is £218,275 (being £243,275 less £25,000).

#### *Pension commencement lump sum*

This is simply the amount which can be paid by the pension fund which is typically up to 25% of the pension fund (since it is a requirement that three times the lump sum is retained to pay income although that is watered down since pension freedom).

It is tax-free assuming availability of the lump sum allowance/death benefit allowance.

#### *Uncrystallised funds pension lump sum*

This is referred to above and is paid out of funds which have not been used to provide any benefits.

#### *Pension commencement excess lump sum*

This is a new authorised lump sum that pension schemes can pay members who have used up their lump sum allowance. It used to be that a lump sum could not be paid unless it was tax free. This overrides that. The whole amount is taxable.

#### *Serious ill health lump sum*

These can be paid where a member of a registered pension scheme is terminally ill. This allows all of the benefits under the scheme to be paid out in the form of a lump sum. Before payment the administrator must have received evidence from a registered medical practitioner confirming that the member is expected to live less than one year.

The lump sum must either be paid in respect of an uncrystallised arrangement and extinguish the member's benefit entitlements under that arrangement or be paid in respect of uncrystallised rights under an arrangement that is not an uncrystallised arrangement and extinguish those uncrystallised rights.

These are normally exempt from income tax. This would not be the case if the individual is under the age of 75 and the payment exceeds the lump sum and death benefit allowances which are available to the individual. It would also not be the case if the individual is aged 75 or over, in which case it is taxed at the individual's marginal rate of income tax.

#### *Short service refund lump sum*

Rights within a pension scheme are preserved once an individual has a minimum level of qualifying service (normally two years) and if the member leaves early, they have the right to refund of own contributions or transfer of accrued rights.

This will never apply once the individual has reached the age of 75 and there is a tax charge to reflect the fact that the contributions have had tax relief. That charge is 20% in respect of first £20,000 and 50% on balance, including interest. Liability arises on the scheme administrator and not on the individual, so no repayment can be made if the marginal rate of tax is less than these percentages.

### *Refund of excess contributions*

Where member has paid pension contributions in excess of that which can obtain tax relief, the excess may be repaid but this must be done before the end of 6 years of the end of the tax year in which the excess contributions were made. Amounts repaid may be reduced by any relief at source given and paid tax-free as no tax relief has been given.

### *Winding up lump sum*

This applies where an occupational pension scheme is wound up and the benefit rights are commuted into a lump sum. The payment cannot exceed the current maximum (£18,000) and the individual is taxed on 75% of the sum if the benefits have not crystallised or 100% if the benefits have.

Winding up lump sums do not use any lump sum allowance or death benefit allowance but members will need to have those available, either in whole or part.

### *Small pension pots*

If an individual has several small pension pots, they may be able to take them as cash lump sums – up to three small pots of £10,000 each from non-occupational pension schemes and an unlimited number from occupational pension schemes, subject to rules.

In reality, it is unlikely that you would advise multiple pension pots due to the costs of running these but if they are there, it is worth considering the options. Small pot crystallisation does not trigger the MPAA.

A small lump sum payment can be made from any arrangement regardless of whether the rights are uncrystallised or represent a pension in payment. The value of the pension is commuted and to allow this the following conditions must be met:

- the member has reached the minimum retirement age or satisfies the condition for ill-health early retirement;
- each payment must not exceed £10,000 at the time it is paid to the member;
- the payment must extinguish all member benefit entitlement under the arrangement.

It must extinguish the benefits under a single arrangement so it could be that there are continuing benefits from the scheme as a whole although this is unusual.

Where the payment represents uncrystallised benefit rights, 25% of the payment is free of income tax and the balance is chargeable to income tax as pension income. If the payment represents crystallised rights, all the payment is chargeable to income tax as pension income. It could be a mixture of both.

Small pots do not use any lump sum allowance or death benefit allowance but members will need to have those available, either in whole or part.

### *Trivial commutation*

Trivial commutation applies where a defined benefit pension member commutes one or more pension arrangements as long as the following conditions are met:

- the member has reached the minimum retirement age or satisfies the condition for ill-health early retirement;
- the lump sum extinguishes the member's entitlement to defined benefits under the registered pension scheme making the payment;
- all commutations take place within a 12-month period from the date of the first period;
- the value of all member's crystallised rights must not exceed £30,000 including all pensions;
- the member has not been paid a trivial commutation lump sum previously
- the lump sum is paid when the member has available lump sum allowance and death benefit allowance.

If no other benefits have been paid out, then 25% of the payment is tax free with the balance being taxable pension income.

Trivial commutation amounts do not use any lump sum allowance or death benefit allowance but members will need to have those available, either in whole or part.

Legislation sets out the formula as to how you work out whether the total benefits crystallised by the member is under £30,000. You take the total tax-free benefits and multiply by 4, then add in the relevant pension rights that are being crystallised.

The following example comes from the HMRC December pension scheme bulletin:

Member A has:

- £265,775 remaining of their lump sum allowance;
- become entitled to £15,000 uncrystallised pension rights within the scheme;
- not received a serious-ill health lump sum and has no protections in place.

Valuation of crystallised rights (for TCLS) =  $((£268,275 - £265,775) \times 4) = £10,000$

Value of member A's relevant pension rights =  $£10,000 + £15,000 = £25,000$

£25,000 is less than £30,000, so Member A is entitled to receive their full uncrystallised pension rights from the scheme as a TCLS.

*Contributed by Ros Martin*