

Pension lifetime allowance (Lecture P1443 – 16.06 minutes)

The lifetime allowance (LTA) was the maximum value that a pension fund can reach without an LTA charge crystallising when benefits are crystallised. However, changes were made to this in the 2023 Budget.

Previously, if the value of total tax-relieved pension rights exceeds the LTA at certain 'benefit crystallisation events' (e.g. when benefits are first taken from the fund, or aged 75), the excess has been subject to an LTA tax charge of:

- 25% if the excess is left in the fund to be drawn as taxable income; or
- 55% if it is drawn out as a lump sum.

The whole regime of benefit crystallisation events was complicated and gave rise to some unexpected outcomes.

However, given the small number of individuals who had pension funds in excess of the lifetime limit, this was not something that many general practitioners ever had to get their head around.

The LTA was introduced in 2006 at £1.5 million, had risen to £1.8m by 2012, but was subsequently reduced 3 times before rising again to £1,073,100. Various types of 'protection' have been available, both on the introduction of the LTA and whenever it has been cut. So some taxpayers can have a higher value of pension rights before incurring an LTA charge.

FA2023 abolishes the lifetime allowance (LTA) charge for pension purposes for 2023/24 and any subsequent tax year.

The lifetime allowance existed in 2023/24 but has now been abolished.

Lump sums paid out in excess of the LTA in 2023/24 were subject to the recipient's marginal rate of income tax.

These provisions effectively mean that rather than attracting the LTA charge in 2023/24 (at a rate of 55% if taken as a lump sum or 25% if taken as a taxable income stream), any value in excess of the LTA will be taxed at the individual's marginal rate of tax. For those who are taking the money out as a lump sum, the immediate impact will be a reduction of 10% (for those who are paying additional rates of tax) but possibly more. The real reduction arises from those who chose to withdraw money as income, since there will be no upfront 25% charge; the income will just be taxed as it is withdrawn.

Although the LTA has been abolished the previous provisions and the protections which clients might have in place will still be relevant as it will determine the tax-free lump sum that can be withdrawn from the pension. The tax-free amount is 25% of the previous LTA figure ($25\% \times £1,073,100 = £268,275$), unless the person has 'protection'.

Protections

The LTA was introduced in 2006 and there were two protections introduced at this stage. These had to be registered with HMRC by April 2009 with no late registrations accepted.

Enhanced protection removed funds from the limits entirely but meant that no further contributions to any pension schemes were allowed.

Initially, primary protection gave a lifetime allowance that was enhanced by a factor linked to the amount by which pension rights at 6 April 2006 exceeded £1.5m.

Since April 2012, this factor has been a flat rate of 120%. So if the pension fund was valued at £2m in 2006, the lifetime allowance would be £2.4m.

The various subsequent protections are listed below:

- Fixed protection 2012 had to be claimed by 6 April 2012 and gave entitlement to a LTA of the greater of £1.8m or the actual allowance for the tax year in which the benefit crystallisation event occurred. No further contributions could be made.
- Fixed protection 2014 had to be claimed by 6 April 2014 and gave an entitlement to a LTA of the greater of £1.5m and the actual allowance for the tax year in which the benefit crystallisation event occurred. No further contributions could be made.
- Individual protection 2014 where the protected lifetime allowance is the lower of the value of the pension at 5 April 2014 and £1.5m. Additional contributions were allowed and this had to be claimed by 5 April 2017.
- Fixed protection 2016 where the lifetime allowance was fixed at £1.25m and no further contributions could be made. There was no deadline for application for this protection however, applications for protection under this regime will close after 5 April 2025.
- Individual protection 2016 where the protected lifetime allowance was the lower of the value of the pension at 5 April 2016 and £1.25m. Additional contributions were allowed. There was no deadline for application for this protection however applications for this will also close after 5 April 2025.

Late registration for other protections may be made if there is a reasonable excuse for failure to register earlier. There is some case law on this point which has been ambiguous regarding the potential success in doing this.

Those protections continue to be valid in the new regime as they will give entitlement to a higher tax-free lump sum than the standard.

There is one protection above where there is a transitional provision. Enhanced protection (first one above) gave protection for the whole of the fund from any LTA charge, with no additional contributions being able to be made. Under the new regime, the lump sum allowance for those with enhanced protection will be based on the value of the fund on 5 April 2023. Enhanced protection therefore will not protect future growth from tax charges.

There are transitional provisions which need to be considered.

If a protection was validly held at Budget Day 2023 (15 March 2023), then post-cessation events which would have previously invalidated the protection will no longer do that. This only applies to events after 5 April 2023 but it does mean that those who could not make further pension contributions could now do so if they wanted to. This may enable them to build a larger IHT protected fund.

It might still be possible to apply for protections and if this is done after 15 March 2023, they will still be subject to the normal restrictions. It is unlikely that applying for protection now is going to be provide any particular advantages for most clients.

The new regime

It was not seen as being possible for the government to simply abolish the lifetime allowance and so the intention was to reform the system with the following outcomes:

- Keep a 25% tax-free pension commencement lump sum at the same level as before (so linked to the previous lifetime allowance or any enhanced amount available);
- Tax other lifetime benefits at normal income tax rates and
- Prevent tax leakage that might arise if the LTA was abolished completely.

The basic provisions see two new allowances: the lump sum allowance and the death benefit lump sum allowance. The former is set at £268,275 and the latter at £1,073,100.

There is no facility within the legislation for these amounts to be increased. Existing protections and enhancements will adjust those new allowances, as discussed above.

The lump sum allowance caps the amount that can be taken tax-free as a pension commencement lump sum and/or the tax-free element of any uncrystallised funds pension lump sum.

The death benefit lump sum allowance caps the amount taken tax-free in aggregate during the individual's lifetime and on death. This includes amounts counting towards the lump sum allowance, as well as the serious ill-health lump sums and most non-charitable lump sum death benefits for those who die under 75.

For an individual who dies before age 75 holding only uncrystallised funds, this gives broadly the same outcome as under the current rules. The first £1,073,100 of the lump sum would be tax-free and the remainder would be taxed as under the LTA rules. Where the new rules differ from the old regime is where the lump sum is from a drawdown fund and the member dies before their 75th birthday. Under the previous rules, the fund is tested against the lifetime allowance when it is designated for drawdown, but there is no further test on death. The fund could therefore be paid out tax-free, even if it has grown beyond the lifetime allowance. From 6 April 2024, the death benefit is only tax-free to the extent of the remaining lump sum and death benefit allowance, with the remainder being taxed as pension income of the recipient.

The details of this are discussed below in relation to the different lump sums that can be received by an individual.

IHT planning and crystallisation of benefits for beneficiaries

Firstly, it is important to understand the different terminology which applies when we are looking at beneficiaries of pension funds as they can be dependents, nominees or successors.

- Dependents are spouses, civil partners, children under 23 (or older if dependent due to physical or mental impairment) or anyone who is dependent due to physical or mental impairment or who is financially dependent or in a financial relationship which is one of mutual dependence.

- Nominees are people who are not dependents but are nominated by the member. They must be an individual.
- Successor is anyone who is nominated by a dependent, nominee or other successor to receive benefits.

Nomination forms

It is important that members of pension funds understand the nomination process for pension funds.

Each pension fund has own rules and pension members are encouraged to complete nomination or expression of wishes forms. However, it is important to remember that these do not bind the trustees and they can decide who to pay to. In most cases, those wishes will be followed but if another party emerges post-death who appears to have a claim on the money, they can be swayed.

It is important that the forms are completed as clearly as possible so there is no possibility of misunderstanding so better to name specifically rather than putting a class of persons.

The executors will not have any influence over who pension is paid to as this is the remit of the pension trustees, who may have no actual knowledge of the deceased member.

It is, of course, important to make sure that is kept updated.

What happens when the pension member dies

Practical issues

The type of benefits which can be paid out will depend on the type of pension, whether or not benefits have been crystallised and if they have, the type of pension in payment.

Typically, you can see dependent's scheme pensions, beneficiary's annuities and beneficiary's drawdown pensions although the latter two will only arise in defined contribution pension funds.

Tax treatment for beneficiaries

The tax treatment of any pension fund will depend on the age at which the individual dies. The nature of the benefits which might be provided to the beneficiaries is dependent on the pension fund.

For example, some pension funds will not allow income drawdown. So the options below are theoretical options under tax law but may be limited from a practical perspective.

Sometimes, there is a guaranteed minimum period over which a scheme pension or annuity will be paid so that if the member dies before the end of that, their pension would continue to be paid to another person, usually nominated by the member. The terms of this would depend on the actual pension and this income simply remains taxable as pension income on the recipient, regardless of their identity. These types of payments do not follow the normal rules for IHT planning etc. for pensions.

A dependents' scheme pension would also be taxed as income as it is also a continuation of the member's pension entitlement.

In relation to other types of payments, the tax treatment is as follows:

- If the individual dies before age 75, the beneficiaries can take the whole pension fund as a lump sum or draw an income from it tax free, using income drawdown. This assumes the total amount being paid is less than the lump sum allowance or death lump sum allowance. This is discussed below. Dependents (but not other beneficiaries) can also choose to buy an annuity which would also be tax free. This assumes the funds are designated the relevant beneficiary within two years. If they are not, then benefits will become taxable.
- If the individual dies after age 75, beneficiaries will have three options:
 1. Take the whole fund as cash in one go. This would be subject to tax at the marginal rate of the beneficiary.
 2. Take a regular income through income drawdown or an annuity (if you are a dependent) the income being subject to income tax at the beneficiary's marginal rate
 3. Take periodical lump sums through income drawdown with those lump sums being treated as income so subject to income tax at the beneficiary's marginal rate of tax.

No IHT will arise assuming that there is no flaw in the drafting of the pension rules so that the pension fund reverts back to the estate.

Any amounts withdrawn from a pension fund which is not then spent by the recipient will be in the estate for IHT purposes so it might be better to retain those within the pension fund.

Care must be taken when lump sum payments are made to non-qualifying persons as these are subject to a 45% tax charge. A non-qualifying person is someone who is not an individual or someone who is individual receiving the money in their capacity as trustee, person representative, director of a company, partner in a firm or member of an LLP.

This can be an issue if you have an individual who is uncertain about who they want to pay the money from their fund to, as they might think leaving funds into a trust (for example) would then give flexibility for the trustees to decide.

If the trustees subsequently transferred the money to a beneficiary, then they would get a credit for the tax paid on the money received from the pension fund but that may not be as helpful as someone getting the money tax free in the first place.

Lump sum payments made to charities would be tax-free which is an option for those with pension funds who do not have dependents or do not want to benefit those dependents.

The question as to what is withdrawn from a pension fund following the death of the member may depend on the pension fund administrators. Many do not want to have to provide an income stream to the beneficiaries and so will only pay the amount out as a lump sum.

If the member has died under the age of 75, then it is tax-free so it may not matter that the payment is being received in one lump but if the member is over 75 and it is taxable, getting all the money at once may push the recipient into higher rates of tax.

Note: One of the proposals put forward in HMRC's July 2023 policy paper was the removal of the income tax exemption for pension income on funds from members who died before reaching age 75. This proposal has not been taken forward, so it will remain possible for unlimited amounts to

pass tax-free if they are taken via dependant/nominee/successor drawdown rather than as a lump sum death benefits.

Where does the lump sum allowance and death benefit allowance come into all this?

If a lump sum death benefit is being paid out, then this is a relevant benefit crystallisation event which means that you have to test the amounts being paid out against the available lump sum allowance and the death benefit allowance.

If amounts paid out are in excess of this, then there will be an income tax charge on the excess amounts (rather than it being tax free). If the amount is already being taxed as income (i.e. because the member was over 75 when they died) then there would be no need to consider this point.

Example

Judy dies on 2 October 2024, aged 52. She had neither Enhanced Protection nor Primary Protection and had not asked for a transitional tax-free amount certificate.

On 1 March 2024, she took a serious-ill-health lump sum of £800,000 from one of her two pension schemes. In her other pension scheme, she had uncrystallised rights of £300,000 at her death available to her beneficiaries. Her sole beneficiary is her daughter.

As a result of the tax-free serious-ill-health lump sum, the value of the previous BCE is £800,000.

As she was not entitled to protection, Judy's unadjusted lump-sum and death-benefit allowance immediately before death was £1,073,100. In order to find her available lump-sum and death-benefit allowance, however, we must deduct the 'appropriate percentage' of the previous benefits.

The appropriate percentage is 100%, since Judy became entitled to a serious-ill-health lump sum before 6 April 2024.

Her available lump-sum and death-benefit allowance is hence:

$$£1,073,100 - £800,000 = £273,100.$$

Judy's uncrystallised funds of £300,000 therefore exceed her available lump-sum and death-benefit allowance by £26,900. If Judy's daughter takes those funds as a lump-sum death benefit, she will pay income tax at her marginal rate on £26,900 but the remainder will be tax-free.

Planning in relation to pensions

When considering what is best to do, particularly where someone has a short life expectancy, another possibility is to take advantage of the serious ill-health lump sum which enables all of the remaining value of the pension fund to be extracted tax-free but is only available where the individual is expected to live for less than one year. It might be worth considering where money could be left to a spouse IHT-free and then passed on to other beneficiaries.

There is a balance between withdrawing (and spending) money in pension funds and retaining those funds so they can be transferred to beneficiaries.

Particularly when approaching retirement, it may be a good idea to consider if other savings can be used to boost pension savings.

Let us take an example of an individual with a healthy salary and plans to retire early. He has a current pension fund of £250,000 and also £250,000 in ISAs. He currently pays £8,000 net into his pension fund.

This individual has spare capacity within his previous annual allowance and could increase his contributions. If he utilised all of his £250,000 savings, that would give gross contributions of £312,500 and there would be an additional £62,500 of tax relief via Self Assessment as he is a higher rate taxpayer. He could use that money to start putting money back into his ISAs if he wished.

This has the added advantage of taking those funds out of his estate for IHT purposes since the pension fund is excluded but an ISA would be included.

Contributed by Ros Martin