

# Tax Year End: Planning for a reduced Lifetime Allowance

From 6 April 2012, the lifetime allowance (LTA) for pension savings, currently £1.8 million, will be reduced to £1.5 million. What are the implications for your clients who expect to have built up pension entitlements of £1.5 million or higher? And what can they do to mitigate the impact of a reduced LTA?

Benefits above the LTA incur a tax charge of 55% if paid as a lump sum or 25% if paid as an income, which itself is then taxable under PAYE rules. It's important to remember that the LTA tax charge aims to recover the tax relief received during the accumulation period, leading to a theoretical tax-neutral position for benefits in excess of the LTA. Broadly speaking, tax neutrality places excess pension saving on a par with other non-pension forms of saving. However, even tax-neutral benefits in a registered pension scheme still offer other valuable features such as exemption from inheritance tax and ring-fencing from bankruptcy proceedings. Nevertheless people with substantial pension pots, who didn't qualify for protection in 2006, may view the reduction in LTA as a blow to their plans.

## Fixed protection

Registering for fixed protection may help. However, the protection is limited to a retained LTA of £1.8 million and it comes at a price. The individual must accept that they can have no further benefit accrual. This will mean stopping all contributions (including payments from an employer) to a money purchase pension plan after 5 April 2012, while final salary accrual will be limited to CPI increases on the pension accrued at the start of the year (which, in practice, means that many active members of final salary schemes would have benefit accrual – and would lose fixed protection – before they reached pension age).

Whether or not to apply for fixed protection will therefore lead to several questions and planning issues. And because everything hinges on projections and assumptions:

- Will the LTA increase in future, when and by how much?
- When does the person expect to have finally taken all their pension benefits?
- Will employer pension contributions continue and for how long?
- And, if not, will their employer offer some other benefit in lieu?

The further into the future we are projecting, the more difficult it will be to determine whether fixed protection will convey any benefit.

In Table 1 we compare the position of Angus who anticipates taking all pension benefits in 2014 with that of Malcolm who doesn't expect to finish taking pension benefits until 2021. It can be seen from the comparison that fixed protection often works best for those individuals who expect to finish taking all benefits in excess of £1.5 million in the reasonably short term.



However, there are a number of variables which can impact on these calculations. In a typical money purchase situation, these include:

- the current fund value;
- the projected return on existing and future benefits;
- future contributions, particularly those from an employer;
- the projected LTA when benefits are taken;
- the rate of recovery tax charge on benefits above the LTA;
- the projected date when all benefits are tested for LTA purposes. Note: drawdown arrangements are tested at outset and again at the earliest of annuity purchase or reaching age 75, while any remaining un-crystallised funds are tested at age 75.

The further forward we project, the more sensitive the calculation becomes to the assumptions used. However, even in short term calculations, relatively small changes can sometimes lead to a significantly different outcome. This is illustrated by the examples in Tables 2 and 3 where we have adjusted the variables to show the effect of a) a slightly lower current fund value (of £1.3 million) on Angus' position and b) the impact of a lower average rate of return.

## Table 1: Short vs long term projection comparison

### Assumptions:

- Current fund value is £1.4 million
- Employer contributes £50,000 per annum
- Average investment return is 6% per annum compound after charges
- Standard lifetime allowance will remain at £1.5 million
- Recovery tax charge for LTA excess remains at 55%

	Angus 2014		Malcolm 2021	
	Fixed protection	No Protection	Fixed protection	No protection
Projected fund (exc. future contributions)	1,667,422	1,667,422	2,365,271	2,365,271
Projected fund (future contributions only)	n/a	109,180	n/a	609,040
Total fund	1,667,422	1,776,602	2,365,271	2,974,311
LTA charge	n/a	152,131	310,899	810,871
Benefit	(A) 1,667,422	(B) 1,624,471	(A) 2,054,372	(B) 2,163,440
Value of additional contributions (B) – (A)	n/a	-42,951	n/a	109,068
Outcome*	<b>Fixed Protection is better</b>		<b>No Protection is better</b>	

## Table 2: Impact of a lower current fund value on outcome for Angus

**Assumptions:** Current fund value £1.3 million. Otherwise as Table 1

Angus 2014	Fixed protection	No protection
Projected fund (exc. future contributions)	1,548,321	1,548,321
Projected fund (future contributions only)	n/a	109,180
Total fund	1,548,321	1,657,501
LTA charge	n/a	86,625
Benefit	(A) 1,548,321	(B) 1,570,876
Value of additional contributions (B) – (A)	n/a	22,555
Outcome*	<b>No protection is better</b>	

## Table 3: Impact of a lower average rate of return on short term projection

**Assumptions:** Average rate of return 3% after charges (reflecting use of lower risk funds). Otherwise as Table 1

Angus 2014	Fixed protection	No protection
Projected fund (exc. future contributions)	1,529,818	1,529,818
Projected fund (future contributions only)	n/a	104,545
Total fund	1,529,818	1,634,363
LTA charge	n/a	73,900
Benefit	(A) 1,529,818	(B) 1,560,463
Value of additional contributions (B) – (A)	n/a	30,645
Outcome*	<b>No protection is better</b>	

Manipulation of the variables can also influence the outcome for longer term calculations.

**Table 4** illustrates how Malcolm's 'best outcome' could be affected if we were to assume that future contributions would only continue for a maximum of three years at which point we assume he leaves service and the pension is paid up.

**Table 5** takes things a step further and additionally assumes the LTA will start increasing again after 2015/2016 and will be £1.8 million by the time Malcolm takes benefits in 2021. Malcolm is now projected to be better off without Fixed Protection (unless the employer offers another benefit in lieu of pension contributions).

It's clear that while the decision whether or not to apply may, in some cases, be relatively simple it will more often require in-depth analysis and informed advice will be essential.

## Table 4: Impact of cessation of employer contributions on longer term projection

**Assumptions:** Employer contributions continue for a maximum of three years. Otherwise as Table 1

Malcolm 2021	Fixed protection	No protection
Projected fund (exc. future contributions)	2,365,271	2,365,271
Projected fund (future contributions only)	n/a	239,348
Total fund	2,365,271	2,604,619
LTA charge	310,899	607,540
Benefit	(A) 2,054,372	(B) 1,997,079
Value of additional contributions (B) – (A)	n/a	-57,293
Outcome*	<b>Fixed protection is better</b>	

## Table 5: Effect of increasing LTA on longer term projection

**Assumptions:** Employer contributions continue for a maximum of three years.

LTA has risen to £1.8 million by 2021

Otherwise as Table 1

Malcolm 2021	Fixed protection	No protection
Projected fund (exc. future contributions)	2,365,271	2,365,271
Projected fund (future contributions only)	n/a	239,348
Total fund	2,365,271	2,604,619
LTA charge	310,899	442,540
Benefit	(A) 2,054,372	(B) 2,162,079
Value of additional contributions (B) – (A)	n/a	107,707
Outcome*	<b>No protection is better</b>	

\*The outcomes are based on the premise that the employer's contributions would be lost if Fixed Protection applied. The employer may offer another benefit in lieu of pension contributions that would lead to a better outcome.

## What about defined benefit (DB) schemes?

So far, we have focused on money purchase schemes but what about defined benefit schemes? Although it's not strictly necessary to opt out of a DB scheme to qualify for Fixed Protection, active members would often lose protection within the first year or soon afterwards. This is due to the 'benefit accrual' limits: CPI (or other increase covered in the scheme rules before 9 December 2010) on the pension accrued at the start of the year. The implication is that applicants need to opt out of a DB scheme before 6 April 2012 or risk losing protection.

So the comparison would be continued accrual without Fixed Protection or a deferred pension with Fixed Protection. So far so good, but DB schemes present additional layers of complexity even under the simplified regime and advisers should beware of any temptation to oversimplify the comparison of continued DB accrual versus opt out and Fixed Protection. Rather, each case should be considered on its own merits. Much depends on the rules of the particular scheme and other benefits that are conditional upon continued active membership, such as death in service, dependants and ill-health benefits.

## Summary

- Fixed protection offers a limited degree of protection. At best, its benefits are likely to be transitory, and could become less relevant over the longer term, particularly where the value of future benefits given up exceeds the tax saved.
- Fixed protection works best for those individuals without the earlier forms of protection, who expect to finish taking all benefits in excess of £1.5 million in the reasonably short term.
- Fixed protection may also help those with longer timescales. But, the longer the timescale, the more difficult it becomes to evaluate the benefits (if any) of fixed protection on purely financial grounds.
- The position for members of defined benefit (DB) schemes is particularly complex. There is a risk that some people may decide mistakenly to opt out of their DB scheme due to failing to appreciate the true monetary value of the benefits they're giving up.
- The deadline for applications is 5 April 2012. This is tight given the complexity of the issues for many individuals.
- However it's worth bearing in mind that fixed protection can be revoked later if circumstances dictate. So, if more time is needed, it may be best to register in the meantime.
- A hasty decision to opt out of a generous pension scheme may not be so easy to unwind. However continued active membership after 5 April 2012, no matter how short, may lead to benefit accrual and invalidate fixed protection.
- Individuals with the earlier forms of protection from 2006 (primary protection and/or enhanced protection) are ineligible for fixed protection and do not need to do anything. A few individuals with enhanced protection only may feel that fixed protection would now be more suitable for them. In this case they could revoke enhanced protection and reapply for fixed protection but should not do so without careful consideration and full advice.
- Fixed protection will be an important consideration when giving advice on pension transfers, divorce, automatic enrolment and NEST and when resolving complaints which involve the provision of monetary compensation.
- For further information go to [www.scottishwidows.co.uk/extranet/financial-planning/pension-planning](http://www.scottishwidows.co.uk/extranet/financial-planning/pension-planning)
- To access the Fixed protection application form, go to: <http://www.hmrc.gov.uk/pensionschemes/protection.htm>

**Every care has been taken to ensure that this information is correct and in accordance with our understanding of the law and HM Revenue & Customs practice, which may change.**

**However, independent confirmation should be obtained before acting or refraining from acting in reliance upon the information given.**