

Protecting pension tax-free cash

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It is not uncommon for successful individuals to accumulate significant pension benefits throughout their careers; these might be in employer-sponsored, individual or a mixture of the two types of scheme.

New pension rules were introduced in April 2006, with the objective of 'simplifying' what had become an extremely complex pension world. The new rules set relatively simple criteria for maximum contributions and benefits, including the amount which may be received as a tax-free lump sum. However, for those individuals who had accrued pension benefits, prior to 6th April 2006, which provided more generous benefits than the new rules would otherwise allow, special 'transitional' protection was available. One aspect of this transitional protection, which is not very well understood, relates to the impact on tax-free lump sum benefits, now known as the pension commencement lump sum (PCLS).

There are four types of PCLS protection:

.... new rules set relatively simple criteria for maximum contributions and benefits....

1. **Scheme specific** – where the lump sum is greater than 25% of the fund value but no other benefit protection has been applied for;
2. Transitional protection for **standalone** lump sums - where there are no other pension benefits and no formal protection has been applied for;
3. Where **primary protection** has been applied for and the pre-6th April 2006 lump sum is > £375,000 (i.e. >25% of the then lifetime allowance of £1.5m);
4. Where **enhanced protection** has been applied for and the pre-6th April 2006 lump sum is > £375,000.

What follows is a simplified explanation of the way that transitional protection works and the implications for future investment and financial planning.

1. Scheme specific – where the lump sum is greater than 25% but no other benefit protection has been applied for

In this scenario the total value of tax-free cash available on 5th April 2006 is increased in line with the growth in the lifetime allowance (LTA) of £1.5m from 6th April 2006 to the date benefits are taken, PLUS an additional amount based on the growth of the scheme's assets.

The formula used to calculate this entitlement is:

Lump sum available @ 5th April 2006 (indexed by LTA) + (25% x [retirement fund – 5th April 2006 fund (indexed by LTA)]).

The ultimate amount of tax-free cash entitlement will depend on whether the pension fund experiences good or bad future growth.

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Let's look at an example of **good fund growth**. Mike Jones had a fund of £900,000 on 5th April 2006 and a lump sum entitlement of £600,000. He takes benefits in 2010/11 when his fund is worth £1.6m. The **maximum lump sum he may take is £850,000** [i.e. £600,000 x (£1.8m/£1.5m)] + (25% x [£1.6m - (£900,000 x (£1.8m/£1.5m))].

Let's now take the same scenario but assuming poor fund growth. Mike had a fund of £900,000 on 5th April 2006 and a lump sum entitlement of £600,000. He takes benefits in 2010/11 when the fund is worth £1m. The **maximum lump sum he may take is now £720,000** [i.e. £600,000 x (£1.8m/£1.5m)] + (25% x [£1m - (£900,000 x (£1.8m/£1.5m))]. Higher fund growth will, clearly, allow Mike to take a higher lump sum. In this situation it might be better for growth assets to be held within the pension fund and more defensive assets to be held on other wrappers, such as an offshore bond or ISAs.

2. Transitional protection for standalone lump sums - where there are no other pension benefits and no formal protection has been applied for

In this scenario the entire fund must qualify as a lump sum on 5th April 2006 based on HMRC rules for occupational schemes applying at that time. This means that 100% of the entire fund value can be paid as a tax-free lump sum, whenever benefits are taken. However, protection is lost if:

- 'Relevant benefit accrual' occurs (which means that additional contributions are made or defined benefits are increased above a small amount);
- If pension benefits are not taken in their entirety (i.e. benefits are 'phased' over several months or years);
- If a transfer IN or OUT of other than stand alone lump sum benefits is made; or
- If the fund paid as a pension.

.... 100% of the entire fund value can be paid as a tax-free lump sum.....

Let's consider the example of Jane Swift, who has an executive pension plan from a previous employment. The plan was worth £500,000 on 5th April 2006 and Jane had an entitlement to take the entire fund as a tax-free lump sum at that time. The fund grows to £1.5m when she comes to take benefits. Even though lifetime allowance has only grown by 20% (from £1.5m to £1.8m) over that period, Jane can take the entire £1.5m fund value as a tax-free lump sum.

Where stand alone lump sum protection applies, it therefore makes sense to maximise returns, as, under current rules, the entire amount would be available as a tax-free lump sum. A transfer of a poorly performing or investment-restricted plan to, say, a self-invested plan to improve the chances of higher returns is possible but this must not be mixed with non-stand alone lump sum benefits and benefits must be 'activated' all in one go.

3. Where primary protection has been applied for and the lump sum on 5th April 2006 is > £375,000

In this scenario the amount of tax-free lump sum entitlement as at 5th April 2006 is protected and is indexed by the growth in the lifetime allowance (LTA) from 6th April 2006 until the date benefits are taken, i.e. **the lump sum is not calculated as a percentage of the fund**. The calculation is:



....a more defensive pension investment strategy might, therefore be more appropriate....

Pre-5th April 2006 lump sum x (current LTA/£1.5m) = maximum lump sum.

For this reason if the pre-5th April 2006 lump sum is > 25% of the fund, it could become < 25% of fund on crystallisation if the fund grows faster than the LTA. It should also be noted that no tax-free lump sum is available from any pension contributions made after 5th April 2006.

To illustrate how this works in practice, let's consider Barry Meads, who has an executive pension plan (EPP) worth £3m on 5th April 2006 with a lump sum entitlement of £2m (based on HMRC occupational pension funding rules applying at that time). Barry applied for primary protection plus lump sum protection of £2m. He takes benefits in 2010/11 when the LTA is £1.8m. The maximum lump sum he may take is therefore **£2.4m (£2m x £1.8m/£1.5m)**.

Let's now look at the case of Mandy Withers, who has a personal pension which was originally funded by a transfer from an occupational scheme, with a 'certified' amount of tax-free lump sum. Her plan was worth £2.4m on 5th April 2006 and there were no protected rights benefits (i.e. the value of invested rebates arising from contracting out of the state second pension or – previously - SERPS). The certified amount of tax-free cash on 5th April 2006 was £0.5m and Mandy applied for primary protection and lump sum protection of £500,000. She takes benefits

in 2010/11 when the LTA is £1.8m. The maximum tax-free lump sum is therefore **£0.6m (£0.5m x £1.8m/£1.5m)**.

We now know that the pension lifetime allowance will be frozen for five years after 2010/11. This increases the likelihood of high investment growth converting a lump sum entitlement that was > 25% on 5th April 2006 into one that is < 25% and also of the entire fund breaching the indexed lifetime allowance. A more defensive pension investment strategy might therefore be more appropriate, perhaps balanced by holding growth assets either in one's own name or another wrapper, such as an investment bond or ISA.

4. Where enhanced protection has been applied for and the pre-6th April 2006 lump sum is > £375,000

In this scenario the lump sum is **protected as a percentage of the fund** as at 5th April 2006, not the cash amount as it is for primary protection. The formula is:

$[(\text{lump sum on 5}^{\text{th}} \text{ April 2006} / \text{fund on 5}^{\text{th}} \text{ April 2006}) \times 100\%]$.

The eventual lump sum entitlement is calculated by applying the resulting percentage to the fund when benefits are taken. The lifetime limit is not relevant as enhanced protection applies.

Let's look at the example of Darren Jones, who had £3m in a pre-March 1987 executive plan on 5th April 2006 and a lump sum entitlement under HMRC rules at that time of £1.5m. He applies for enhanced protection and lump sum entitlement of 50% ((£1.5m/£3m) x 100). Darren's fund is worth £5m when he takes benefits, therefore his maximum lump sum entitlement is £2.5m, being 50% of the whole fund.

Or consider the case of Sophie Farrow, who had £2.4m in a personal pension on 5th April 2006. The plan was funded from a transfer of occupational benefits and thus the lump sum entitlement under HMRC rules on 5th April 2006 was £480,000, i.e. 20%. Sophie applied for enhanced protection and lump sum entitlement of 20% ((£480,000/£2.4m) x 100). Her fund is worth £3m when she takes benefits and the LTA is £1.8m. Therefore her maximum lump sum entitlement is **£600,000, being 20% of the whole fund.**

In this scenario maximising fund growth clearly makes sense as the fund is protected against exceeding the lifetime allowance and the lump sum entitlement is preserved as a percentage of the fund.

Help is at hand

For the lay person with significant pension benefits prior on 5th April 2006, far from being simplified, the options available can be complex and are highly sensitive to the chosen investment strategy pursued. A thorough knowledge and understanding of pension rules and investment principles are not just desirable but essential when formulating a plan of action.

If your eyes are glazing over by now, don't worry, there are professional advisers out there who understand (and even love) this stuff. A small investment in their fees might be the best investment you ever make so that you can get your hands on as much tax-free cash from your hard earned pension, when the time finally comes to turn on that pension tap.

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