Joint ACA/APL Regional Sessional Meeting

Pension tax pitfalls

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What are we covering?

Pension tax pitfalls

- Dependants' scheme pension tests
  - Current legislation
  - Finance Bill 2016 changes
- Tax protection issues on scheme reorganisation
  - Background
  - Overview of protections
  - Example issues

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Dependants' scheme pension tests

Current legislation

- Scheme members' pensions are tested against the Lifetime Allowance when they come into payment…
- ….however, on death of a scheme member the survivor's pension is not tested against the Lifetime Allowance.
- Introduction raised concerns on possibility of restructuring benefits to avoid tax.

Dependants' scheme pension and LTA

EXAMPLE

- *James has a pension of £60,000 p.a on his retirement in 2016/17 tax year, with an attached survivor's pension of £30,000 p.a*
- *The standard LTA is £1m.*
- *The HMRC value of James' pension is £1.2m*
- *James therefore faces a tax charge on the £200k excess*
- *If instead James had a pension of £50,000 p.a with an attached survivor's pension of £80,000 p.a, James would not face a tax charge*

The dependants' scheme pension test was introduced in the Finance Act 2004 to avoid abuse of the system by re-shaping benefits to avoid LTA charges

Dependants' scheme pension tests

AT DEATH

- *Is the dependant's pension payable greater than the 'initial member pension limit' calculated as*
  - *a) the member's pension in the 12 months before death (or that would be payable in the first 12 months if the member died within 12 months of retirement); plus*
  - *b) 5% of the tax free lump sum paid at retirement*
- *The limit is apportioned by reference to the amount of each dependant's scheme pensions payable*
- *If Yes then the pension fails the test and the excess pension is treated as an unauthorised pension.*

EVERY YEAR AFTER DEATH

- *Is the dependant's pension payable greater than the 'current member pension limit' calculated as*
  - *The 'initial member pension limit' plus*
  - *the 'permitted margin' (cumulative 5% p.a or cumulative RPI from death to calculation)*
- *Test does not need to be carried out if there are more than 50 pensioners in the scheme and all dependant scheme pensions are increased by the same amount over the year.*
- *If test fails, then the excess pension is treated as an unauthorised pension.*

Tests are only carried out where members became entitled to benefits after 6 April 2006 and died on or after the age of 75.

Possible areas for concern

- Distorted tax free lump sums
  - Member commuting more than 25% cash due to protections
  - Member commuting for cash with low commutation factors
- Surrender of member pension for dependant's pension at retirement
- PIEs if only impacting member's benefits
- LTA cases where excess is commuted on single life basis
- LTA/AA tax charges paid via reduction to member's benefits only
- Top up schemes
- Reduction of member's pension for early retirement
- High pension increases (over inflation and/or over 5% p.a)
- Schemes with few pensioners

Not received much publicity yet but immediate issue as relevant to options exercised at retirement, benefit design and administration.

Changes in Finance Bill 2016 (dated 28 April 2016)

- Tests no longer apply if aggregate dependants' pension is less than £25,000 (limit for 2016/17 tax year and increasing by max(5%, infl) each year)
  - So if dependants' pension is below this limit at death and doesn't increase by more than 5% p.a it will not need to be tested each year.
- Test each year will no longer need to be carried out if
    - The scheme has more than 50 pensioners; AND
    - The dependant is in a group of 20 pensioner or more who all receive the same increase rate.
- Tests no longer apply in cases where member used enhanced protection

Tax protection issues on scheme reorganisation

Lifetime Allowance protections - background

Tax year	Lifetime Allowance	Protection
2006/07	£1,500,000	Enhanced Protection Primary Protection Lump Sum Protection Protected Pension Age
2007/08	£1,600,000	
2008/09	£1,650,000	
2009/10	£1,750,000	
2010/11	£1,800,000	
2011/12	£1,800,000	Fixed Protection 2012
2012/13	£1,500,000	
2013/14	£1,500,000	Fixed Protection 2014 Individual Protection 2012
2014/15	£1,250,000	
2015/16	£1,250,000	Fixed Protection 2016 Individual Protection 2016
2016/17	£1,000,000	

Overview of protections

Primary protection

- Available if value of benefits on 5 April 2006 exceeded £1.5m
- Gives member personal LTA which is set at same percentage above £1.8m as benefits at 5 April 2006 were above £1.5m
- Individuals had to apply by 5 April 2009

Enhanced protection

- Available whether or not value of benefits on 5 April 2006 exceeded £1.5m
- Benefits not subject to LTA
- Individuals had to apply by 5 April 2009
- No further ‘relevant benefit accrual’

Overview of protections

Lump sum protection

- Available if individual had entitlement on 5 April 2006 to a PCLS of more than 25% of benefits and had no other lump sum protection in place (primary or enhanced)
- Entitles individual to take a lump sum of more than 25% of value of benefits without payment being unauthorised
- No application process

Protected pension age

- Available if member had NMPA on 5 April 2006 of less than 55 and scheme rules on 10 December 2003 conferred that right to members
- Entitles member to take benefits from ages under 55 without payments being unauthorised
- No application process

Overview of protections

Individual Protection 2014

- Available if value of benefits on 5 April 2014 exceeded £1.25m
- Gives member individual LTA of lesser of value of benefits on 5 April 2014 and £1.5m
- LTA at crystallisation is higher of standard LTA and individual LTA
- Individual has to apply by 5 April 2017

Individual Protection 2016

- Available if value of benefits on 5 April 2016 exceeded £1m
- Gives member individual LTA of lesser of value of benefits on 5 April 2016 and £1.25m
- LTA at crystallisation is higher of standard LTA and individual LTA
- No application deadline

Overview of protections

Fixed Protection 2012

- LTA at crystallisation is higher of standard LTA and £1.8m
- Individual had to apply by 5 April 2012
- No further ‘relevant benefit accrual’ allowed

Fixed Protection 2014

- LTA at crystallisation is higher of standard LTA and £1.5m
- Individual had to apply by 5 April 2014
- No further ‘relevant benefit accrual’ allowed

Fixed Protection 2016

- LTA at crystallisation is higher of standard LTA and £1.25m
- No application deadline
- No further ‘relevant benefit accrual’ allowed

How do schemes know if members have protection?

- LTA protections are attached to individuals
  - Individuals must apply for them.
  - Schemes will not know if members have protections in place unless member notifies them
  - Can rule out enhanced and fixed protections for accruing members
- Lump sum and pension age protections are attached to schemes
  - No need to apply for them.
  - Depend on scheme rules.
  - Schemes should know from records which members have protections.

How can protections be lost?

- Primary and Individual Protection (2014 and 2016) are robust and difficult to lose except
  - On pension debit
- Enhanced and Fixed Protection can be lost on:
  - ‘relevant benefit accrual’
  - a transfer that is not a ‘permitted transfer’
  - a new arrangement relating to the individual is made other in permitted circumstances
- Protected pension age and lump sum protection can be lost on
  - Transfer other than block transfer (where all rights of 2 or more members are transferred within a year of first joining receiving scheme)

Enhanced and Fixed Protection – permitted transfers

- Transfer to a money purchase or recognised overseas pension scheme and value of sums and asset received are actuarially equivalent to the rights being transferred.
- Transfer to a defined benefit or cash balance scheme in connection with:
  - A winding-up of the transferring scheme;
  - A relevant business transfer between non-associated employers affecting more than 20 employees; or
  - A retirement benefit activities compliance exercise

Enhanced and Fixed Protection – transfer in connection with winding up

- The receiving arrangement must relate to the same employments as the transferring arrangement being wound up.
- Partial wind ups where a participating employer is leaving a scheme and securing all members' rights from that employments by transfer or annuity purchase are permitted where:
  - The scheme comprises a number of different sections;
  - The scheme rules provide for individual sections to be wound up
  - Each section operates in respect of a particular participating employer;
  - If an employer has more than one section all sections relating to the employer are wound up

Enhanced and Fixed Protection – relevant business transfers

- All or part of a business or undertaking that involves at least 20 employees is transferred from one party to another; and
- If both parties to the business transfer were companies they would not be treated as members of the same group

Example issue in practice –

Block transfer between group pension schemes

- Aim is to rationalise pension arrangements within group by transferring all DB liabilities to single scheme.
- In practice no PPA issues.
- May have members with both defined benefit and lump sum protections.
- Enhanced/fixed protection population can be unknown in size.

Example issue in practice –

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Transfer to combine main and top-up benefits in single scheme

- Aim is to buy out and wind up top-up scheme alone
- Small population of deferred members with benefits split between the two schemes
- Not possible to buy out the benefits unless combined
- Not known if members have enhanced/fixed protection

Questions