

The reduction in the lifetime allowance from 6 April 2012

To date, the main focus of our series of High Earners & Contributors Survival Guides has been on the reduction in the annual allowance with effect from 6 April 2011 and on the ensuing impact on employers, trustees, individuals and scheme administrators. This Survival Guide looks ahead instead to the forthcoming reduction in the lifetime allowance from £1.8 million to £1.5 million on 6 April 2012.

Background

When the Government announced its final decision in respect of the reduction in the annual allowance last October, there was a fairly widespread feeling that 'it could have been worse' – the level of the annual allowance was higher than expected and the factor for valuing defined benefits more generous. In addition, the availability of carry forward and inflation protection meant that the number of individuals who would end up paying additional tax was reduced.

However, the sting in the tail was a reduction in the lifetime allowance from £1.8 million to £1.5 million with effect from 6 April 2012. HM Treasury has the power to increase this in future years, but has given no indication that it plans to do so.

Now that employers and individuals have come to terms with the reduction in the annual allowance, the focus has shifted to ensuring that schemes and individuals are also appropriately prepared to deal with the reduction in the lifetime allowance.

Impact on primary and enhanced protection

Under the existing lifetime allowance legislation, individuals with large pension pots had until 5 April 2009 to notify HMRC that they wished to opt for one or both of the two types of protection: primary or enhanced.

Primary protection was available to individuals whose benefits at A-Day (6 April 2006) were greater than the then lifetime allowance (£1.5 million), and allowed them to register a personal enhanced lifetime allowance percentage (e.g. 120% of the standard lifetime allowance), based on the percentage by which they exceeded the lifetime allowance at A-Day.

Under enhanced protection, individuals are simply taken out of the scope of the lifetime allowance altogether so long as they abide by a series of strict conditions. In particular, no further contributions can be made to defined contribution schemes, by either employees or employers, and pension benefits in a defined benefit scheme must not grow beyond certain limits. If these conditions are breached, enhanced protection is lost immediately, potentially leaving individuals subject to the lifetime allowance charge.

Members with primary and enhanced protection will be relieved to note that the change in the lifetime allowance from £1.8 million to £1.5 million will not affect their existing protection. So, for example, the percentage protected under primary protection will be revised to ensure that the monetary amount protected is not reduced.

There will, however, be one change for members with enhanced protection. Previously they were automatically exempt from the annual allowance; now, however, there is no such exemption.

A new type of protection: fixed protection

To help protect those who will be affected by the reduction in the lifetime allowance from £1.8 million to £1.5 million, HM Revenue and Customs (HMRC) are also introducing a new kind of protection, known as 'fixed protection'.

Where a member has fixed protection, their lifetime allowance will be the greater of £1.8 million and the standard lifetime allowance (i.e. effectively £1.8 million, given that the standard lifetime allowance is not expected to increase in the foreseeable future). The lifetime allowance charge will apply on benefits in excess of £1.8 million.

Conditions for fixed protection

Members with current primary or enhanced protection will not be able to apply for fixed protection (although if a member previously had enhanced protection, but lost it before 6 April 2012, they will now be able to have fixed protection).

In order for the member to retain fixed protection, there must be no further contributions (either employer or employee) to a defined contribution scheme, and there must be no increase in benefits in a defined benefit scheme above CPI or a percentage set out in scheme rules as at 9 December 2010.

Where fixed protection is lost, members will become subject to the standard £1.5 million lifetime allowance from that point onwards.

There is no explicit requirement for individuals to opt out of further accrual in a defined benefit scheme in order to take advantage of fixed protection. In practice, however, this will be the safest way of ensuring that fixed protection is retained.

It should be noted that the level of increase permitted in order to retain fixed protection is not the same as that allowed under enhanced protection, which permits (in broad brush terms) increases in line with the highest of 5%, RPI and salary.

Also, under enhanced protection, the test as to whether benefit accrual in excess of the permitted level has occurred takes place only at the point when the member retires (or otherwise crystallises their benefits); under fixed protection, however, it

appears that an annual test will be required to establish that benefits have not increased by more than the relevant percentage over that year.

Additional restrictions (for example on transfers) will also apply to members wishing to retain fixed protection.

Relying on fixed protection

Draft regulations have now been published which explain the information that individuals will need to provide in order to apply for fixed protection. It appears that the forms will be very straightforward with members only required to provide their name, address, date of birth and NI number and a declaration that they do not already have primary or enhanced protection. They will not be required to put a value on their pension benefits. This contrasts with the rather more complex forms that had to be completed for primary and enhanced protection.

HMRC expect to issue the forms in August 2011 once the Finance Bill has received Royal Assent and the final regulations have come into force. Forms must be returned to HMRC on or before 5 April 2012. Once HMRC have accepted the notice, they will issue a certificate to the individual with a unique reference number.

Where benefit accrual occurs which invalidates the fixed protection, the draft regulations require the individual to notify HMRC within 90 days from the date on which the fixed protection is lost. This is likely to prove a challenging target, given that individuals (especially those in defined benefit schemes) may need to carry out detailed calculations to know whether they have breached the rules.

Other draft regulations set out the information requirements that will apply as a result of fixed protection. Members will need to tell their scheme administrator where they are relying on fixed protection. The scheme administrator will then need to report to HMRC where members with fixed protection draw their pension or otherwise crystallise their pension benefits and the value of benefits crystallised exceeds the standard lifetime allowance.

Other consequences of the change

The lifetime allowance is also used to define other limits in tax legislation. These references are now being amended to ensure that there are no unintended effects on other benefits.

Cash protection

Scheme specific lump sum protection applies where individuals were entitled to tax-free cash of more than 25% of their total pension entitlement at A-Day. Individuals did not register these entitlements but, where the pension scheme agreed, the higher level of tax-free cash could be protected.

Similarly, members with primary protection were also able to register an entitlement to tax-free cash where this exceeded £375,000 (25% of the lifetime allowance as at A-Day).

In both cases, the pre-A-Day cash entitlement was indexed in line with the lifetime allowance. The cash entitlement will now be linked to the greater of £1.8 million and the standard lifetime allowance.

Members with enhanced protection were also able to register an entitlement to tax-free cash in excess of £375,000. Under enhanced protection, the protection given to tax-free cash is calculated by reference to the overall percentage of benefits that

could be taken as cash at A-Day. This protected percentage will also be preserved.

However, for individuals with significant pensions savings without any form of cash protection, there will now be a potential reduction in maximum tax-free cash. The upper limit will now be 25% of the new lifetime allowance of £1.5 million, i.e. £375,000, rather than 25% of £1.8 million, i.e. £450,000. (This is subject to 25% of the individual's total pension entitlement, if less.)

Trivial commutation

Currently the maximum limit for the trivial commutation of benefits is 1% of the lifetime allowance (looking across all the schemes of which the individual is a member). The legislation is being amended to replace references to '1% of the standard lifetime allowance' with '£18,000', thereby preserving the current level. HM Treasury will have the power to increase this limit by order.

Similar changes apply where benefits are commuted on the grounds of triviality where the scheme is being wound up and/or where the member dies.

Death benefits

Where a member died before 6 April 2012, but death benefits are not paid until after that date, the £1.8 million lifetime allowance will continue to apply.

Next steps

For most individuals, the reduction in the lifetime allowance should have no effect. However, those individuals who were expecting to build up pension benefits in excess of £1.5 million should now consider registering for fixed protection if they do not have primary or enhanced protection. Those individuals who had enhanced protection but have lost it will get a second chance to register some level of protection. Meanwhile, individuals who are intending to retire before 6 April 2012 in order to take advantage of the higher lifetime allowance should make sure that they inform their scheme administrator well in advance so that the retirement process can be completed before 6 April 2012.

For pension schemes, the introduction of fixed protection should not lead to the creation of new administrative processes on the same scale as the reduction in the annual allowance. However, where members of the scheme have fixed protection, they will need to be able to assist members in testing to ensure that the annual percentage increase has not been exceeded and may also need to report to HMRC when a member with fixed protection draws their benefits.

Where can I get further information?

For further information, please get in touch with Jane Beverley on 020 7839 8600 or by email to jane.beverley@puntersouthall.com or discuss with your usual Punter Southall contact.

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