



Protecting your Pension Fund from Tax Liability

Jim Spicer of MPL Wealth Management Ltd gives a very timely review of protecting pension funds

Executive Summary

If you have a large pension fund you may be surprised to know that the Government could tax part of your fund when you retire. This is called the Lifetime Allowance Charge and is 55% for lump sum payments. Typically, this will affect people who had built up pension funds of £1.5 million or more as at 5th April 2006. It is possible that you may have applied for Protection and received a Certificate to ensure you avoid the tax charges that may be applied in the future. Jim Spicer of MPL Wealth Management Ltd says "Clients should check their Certificates as they may not be providing the correct protection. The problem will be that tax-free cash is left unprotected within the overall pension fund." If you haven't applied for Protection, the deadline is 5th April 2009 and you can amend existing certificates to obtain the correct Protection but only up to 5th April 2009.

What is the Lifetime Allowance?

A significant deadline approaches on 5th April 2009 which is the final date for applying for Protection of pension funds built up to 5th April 2006. On 6th April 2006, legislation was introduced which simplified eight legacy pension regimes into one. The new rules now restrict the maximum pension fund or equivalent that can be used to pay pension benefits without additional tax liabilities. These limits include any pension that came into payment before 6th April 2006 as well as those after this date. These benefits must be paid within the newly introduced "Lifetime Allowance" - unless you have obtained "Transitional Protection".

The Lifetime Allowance was initially set at £1.5 million for the tax year 2006/07, rising in annual steps:-

2007/08	£1,600,000
2008/09	£1,650,000
2009/10	£1,750,000
2010/11	£1,800,000

What will happen to the Lifetime Allowance in the future?

The Pre-Budget Report 2008 announced that the Lifetime Allowance for the tax years 2011/12 to 2015/16 inclusive will remain at £1.8 million. The allowance for future years will be set by Treasury Order each year, but will not be allowed to reduce from one year to the next.

What does protecting your pension fund mean? (called Transitional Protection)

To ensure that your pension fund is not taxed when you finally take your benefits you can apply for "Transitional Protection". This offers an individual the chance to protect pension rights built up before 6th April 2006 under the old pension rules, fully or partially from the Lifetime Allowance Charge. In addition you can protect the tax free cash rights which are normally 25% of your pension fund. Lump sum payments over the Lifetime Allowance are subject to 55% tax (Lifetime Allowance Charge) whilst pension income payments will be subject to 25% tax in addition to the individual's highest marginal rate of up to 40%. Application for "Transitional Protection" is only available from 6th April 2006 to 5th April 2009 inclusive, after which there will no longer be any opportunity to apply or to amend any Protection Certificates.

There are three types of transitional protection available using pension benefits valued at 5th April 2006:

1. Primary Protection – The individual must apply (minimum fund £1.5m at 5th April 2006)
2. Enhanced Protection – The individual must apply (any fund size but no further contributions or additional benefits may be added after 5th April 2006)
3. Protection of tax free lump sums from occupational schemes – Scheme administrator records details

Have clients taken action?

Most people affected by this legislation will have been made aware of these limits and the availability of Protection by their financial advisers. They may have applied for and received their Protection Certificates. Those that haven't applied should do so before 5th April 2009 or the opportunity will be lost. MPL advise that, as a matter of urgency, clients should check their existing Certificates as they may have received a Certificate that doesn't give them the correct protection. There could also be clients who have obtained Enhanced Protection for funds below £1.5m on 5th April 2006, who may believe they will receive 25% of their eventual fund as a tax free lump sum. They will be restricted to only 25% of the Lifetime Allowance applicable in the year during which their pension is taken. Advisers should inform their clients of this restriction to avoid possible complaints in years to come.

On the following page are two examples where an existing certificate may give a lower benefit than the client believes they will receive:

Example 1.

A client has Enhanced Protection and did not apply for Primary Protection as well. No further pension contributions have been made from 6th April 2006. The client established an Income Drawdown contract at age 60 in 2005 with a fund of £500,000 by taking tax free cash of £125,000 but little or no income at present. The client also had other pension benefits totalling £1.3m on 5th April 2006. It is possible that the Certificate could have been issued in two different ways depending upon how the client answered the questions.

1. A 25% lump sum Certificate (tax free cash) and no restriction on final benefits with no Lifetime Allowance Charge.
2. A Certificate which doesn't state a 25% lump sum protection. Therefore the eventual final lump sum is restricted to 25% of the Lifetime Limit, which may be below 25% of the fund value, thereby restricting the tax free cash payment. The fund will not suffer a Lifetime Allowance Charge.

As already stated, the Treasury has announced that the Lifetime Allowance is being frozen at £1.8m until 2015/2016. Therefore if there is any growth in the client's fund above the Lifetime Allowance, the tax-free cash limit will not be similarly increased above 25% of the prevailing Lifetime Allowance. In this case the client needs to amend the previous application to obtain the correct 25% lump sum Certificate.

Example 2.

A client has applied for both Primary and Enhanced Protection. The certificate reads "Enhanced with dormant Primary". The total pension benefits on 5th April 2006 were £1.8m and part of these benefits were from an existing Annuity giving an annual pension before tax of £20,000 pa. The client may have received a 25% Certificate or may have received a protection without a lump sum Certificate. In this case the client should amend his original application to obtain the 25% lump sum Certificate. If the certificate is not amended, the tax-free cash will be restricted to 25% of the then Lifetime Limit.

Clients and their advisers need to check that they have the correct Protection in place to avoid disappointment when they eventually take their tax free cash. It is important to note that there will be no opportunity to retrospectively amend Protection Certificates after 5th April 2009.

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