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The Lifetime Allowance – transitional protections

On Wednesday 8th July, The Chancellor of the Exchequer delivered the first budget of the new Conservative Government. As expected he announced that the Lifetime Allowance will be cut to £1m from 6th April 2016. It will then be indexed in line with CPI from 6th April 2018.

This will be the 3rd such cut in recent years.

We thought that this would be an opportune time to re-visit some of the key points around the existing protections in this area. This summary, by its nature, is not however exhaustive. We have also made brief reference to the interaction with protected lump sum rights where applicable.

This is a complex area with extensive detail applicable. HMRC's Registered Pensions Scheme Manual and Taxation of Pensions Manual should be referred to for full details.

Background

The Lifetime Allowance (LTA) came into force for registered pension schemes on 6th April 2006 under the Finance Act 2004. This applies to all members of all arrangements in registered pension schemes. It is worth remembering that retirement and/or death benefits can be provided outside of a registered scheme by Excepted Group Life Schemes (including "Relevant Life" policies) and Employer Financed Retirement Benefit Schemes (EFRBS).

Upon a Benefit Crystallisation Event, the Scheme Administrator must test the pension benefits crystallising against the member's available LTA and any excess crystallised is subject to the Lifetime Allowance Charge. See our Guides on "Pension Freedoms" for more detail.

Legislation originally allowed for future increases by Treasury Order; however, most recently the changes have been downwards.

The level of the LTA has changed since introduction as follows:

Tax Year	LTA
2006/07	£1,500,000
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
2012/13	£1,500,000
2013/14	£1,500,000
2014/15	£1,250,000
2015/16	£1,250,000
2016/17	*£1,000,000*

Since the LTA was introduced, and subsequently reduced in recent years, a number of measures have been made available that enable members to take pension benefits valued at more than the standard LTA and either not be subject to an LTA charge, or pay a lower charge than would otherwise apply. These LTA protections are summarised below.

Primary Protection (April 2006)

This applies to individuals who had total relevant pension savings in approved pension schemes valued in excess of £1.5 million as at 5th April 2006. Other than in exceptional circumstances the individual had to register for this protection with HMRC by 5th April 2009. A certificate with a specific reference number was then issued by HMRC to the member; the member will need to produce this to the Scheme Administrator on crystallising rights.

Broadly, the value of accrued relevant rights was determined in the same way as now applies on crystallisation. Pensions already in payment were valued at 25 times the rate of annual pension in payment (to take account of the tax free cash assumed taken); for existing drawdown plans the maximum possible pension under the GAD provisions for the plan was used in the calculation.

There was an overriding limit on the value of certain benefits that could be registered; this corresponded to the maximum permitted benefits on leaving service at 5th April 2006 under whichever of the previous occupational tax regimes may have applied to the member.

Individuals were granted a personal Lifetime Allowance greater than the standard LTA in place when benefits are taken. The individual's personal Lifetime Allowance is increased annually in line with the standard LTA, but the latter is at least equal to £1.8m for tax years following 5th April 2012.

Primary Protection cannot be given up. A pension debit after 6th April 2006 may reduce or eliminate the member's Primary Protection however.

Where an individual registers for Primary Protection and has lump sum (TFC) rights greater than £375,000 at 5th April 2006, the individual also gains protection on the monetary amount of the lump sum (revalued as above) and can take this at retirement subject to sufficient (Personal) Lifetime Allowance being available. Where lump sum rights were less than £375,000 the maximum Pension Commencement Lump Sum is restricted to 25% of the SLA (but this being read as £1.5m if higher under Finance Act 2013); though scheme specific tax free cash protection could also apply.

Enhanced Protection (April 2006)

This was available to all individuals with benefits in schemes that became registered pension schemes on 6th April 2006. Individuals did not need to have accrued relevant pension savings in excess of £1.5m as at 5th April 2006. Individuals could apply for both Primary and Enhanced Protection. Other than in exceptional circumstances, the individual had to register for this with HMRC by 5th April 2009. A certificate with a unique reference was issued to the individual by HMRC.

As with Primary Protection, there was an overriding limit on the value of certain benefits that could be registered; this corresponded to the maximum permitted benefits on leaving service at 5th April 2006 under whichever of the previous occupational tax regimes may have applied to the member. Excessive benefits had to be surrendered / refunded.

Where this form of protection applies, there will be no lifetime allowance charges in respect of the individual. To retain Enhanced Protection, no further “relevant benefit accrual” is permitted under any registered pension scheme after 5th April 2006. In money purchase schemes this occurs where a relevant contribution is paid after 5th April 2006. Cessation also applies where a member informs HMRC that they no longer wish to retain it; a new arrangement is made for the member under a registered scheme other than in permitted circumstances (e.g. a permitted transfer **is** allowed whilst a pensions credit is not); or where an arrangement receives an impermissible transfer. Growth in the existing fund does not count as accrual.

For Cash Balance and Defined Benefit (DB) schemes, the test for “relevant benefit accrual” takes place on the first or subsequent crystallisation date after 6th April 2006; or upon a permitted transfer out of the scheme to an “other money purchase arrangement”. This represents a fundamental difference to the test for members with Fixed Protection (2012) or Fixed Protection 2014; see sections below.

Subject to the above:

- For money purchase funds accrued at 6th April 2006, full investment returns achieved thereafter are protected.
- The position for Cash Balance and DB schemes is more complex; generally, a.) Accrued rights at 6th April 2006 can continue to be linked to earnings (subject to limits) and b.) Continuation of pensionable service or contributions does not in itself count as “relevant benefit accrual”. However, a test is performed upon crystallisation/transfer to ascertain if the member’s “appropriate limit” has been breached. The “appropriate limit” is the greater of two values; “the indexed amount” and “the earnings recalculation amount”.

On a side note, since April 2011, it has been possible for somebody with Enhanced Protection to be subject to an Annual Allowance charge under a DB scheme; without invalidating their protection.

If an employer, under the duties of the Pensions Act 2008, automatically enrols an employee with Enhanced Protection into a workplace scheme, the employee will have one month to opt-out so as not to lose their protection. Regulations effective 1st April 2015 allow employers to exclude enrolling such employees where they have reasonable grounds to believe the employee has Enhanced Protection (this also applies to individuals with Fixed Protection & Fixed Protection 2014).

Where an individual registers for Enhanced Protection and has lump sum (TFC) rights greater than £375,000 at 5th April 2006, the individual also gains protection on the lump sum. This is expressed as a % of the fund value and stated on the protection certificate. They can take up to this % at each crystallisation provided Enhanced Protection has not been lost. Where lump sum rights were less than £375,000 the maximum Pension Commencement Lump Sum is restricted to 25% of the SLA (but this being read as £1.5m if higher under Finance Act 2013).

It is possible for Scheme Specific Tax Free Cash protection to apply for these individuals too; this could apply if a member lost their Enhanced Protection and had TFC rights > £375,000 on 5th April 2006 and is not otherwise covered under Primary Protection.

Where an individual loses Enhanced Protection they must inform HMRC within a prescribed time period or they will be subject to a financial penalty.

Fixed Protection (2012)

This was available to all individuals under registered pension schemes who did not have Enhanced Protection or Primary Protection and registered for it prior to 6th April 2012. Individuals with only scheme specific tax free cash protection could also register. There was no need for a minimum value of pension benefits. The tax legislation is applied to these individuals such that their Lifetime Allowance is the higher of either the standard LTA or an underpinned £1.8m.

No further "benefit accrual" can occur for these individuals under any registered schemes after 5th April 2012 or this protection will be lost. This covers:

- Relevant contributions to money purchase schemes (with very limited exceptions).
- "Benefit accrual" under cash balance & defined benefit schemes.

Under the latter a **crucial difference to Enhanced Protection** is that "benefit accrual" (as distinct from "relevant benefit accrual" under Enhanced Protection) can occur at any time until benefits are taken. This is thus an ongoing test. "Benefit accrual" occurs if rights under the arrangement exceed the "relevant percentage".

Fixed Protection will also be lost where a new pension arrangement is made for the member under a registered scheme after 5th April 2012, other than in "permitted circumstances" (e.g. a permitted transfer is allowed whilst a pensions credit is not); or where an existing arrangement receives an impermissible transfer. Receipt of a pension credit into an existing arrangement will not cause Fixed Protection to be lost.

Members with Fixed Protection will retain maximum lump sum rights of up to £450,000.

HMRC provide a set formula to calculate Pension Commencement Lump Sum (PCLS) where a member with Fixed Protection also benefits from scheme specific tax free cash protection (see **HMRC Protected TFC Formula** section below for full details). In broad terms, their maximum PCLS from the scheme will comprise (Money Purchase scheme):

- Protected TFC amount on 5th April 2006 x 1.2*
- + 25% of fund growth; after the fund value as at 5th April 2006 has been re-rated in line with the applicable LTA (1.8*/1.5). This cannot produce a negative figure.

*until such time LTA exceeds £1.8m

It is the member's responsibility to tell HMRC that Fixed Protection (2012) no longer applies. They must do this within prescribed time limits or they will be subject to a financial penalty.

Fixed Protection 2014

This was available to all individuals under registered pension schemes who did not have Enhanced Protection, Primary Protection or Fixed Protection (2012) and registered for it prior to 6th April 2014. Individuals with only scheme specific tax free cash protection could register as could individuals with Individual Protection 2014. There was no need for a minimum value of pension benefits. The tax legislation is applied to these individuals such that their Lifetime Allowance is the higher of either the standard LTA or an underpinned £1.5m.

No further "benefit accrual" can occur for these individuals under any registered schemes after 5th April 2014 or this protection will be lost. This covers:

- Relevant contributions to money purchase schemes (with very limited exceptions)
- "Benefit accrual" under cash balance & defined benefit schemes.

As with Fixed Protection (2012), under the latter, a crucial difference to Enhanced Protection is that "benefit accrual" (as distinct from "relevant benefit accrual" under Enhanced Protection) can occur at any time until benefits are taken. This is thus an ongoing test. "Benefit accrual" occurs if rights under the arrangement exceed the "relevant percentage".

Fixed Protection 2014 will also be lost where a new pension arrangement is made for the member under a registered scheme after 5th April 2014, other than in "permitted circumstances" (e.g. a permitted transfer is allowed whilst a pensions credit is not); or where an existing arrangement receives an impermissible transfer. Receipt of a pension credit into an existing arrangement will not cause Fixed Protection 2014 to be lost.

Members with Fixed Protection 2014 will retain maximum lump sum rights of up to £375,000.

HMRC provide a set formula to calculate PCLS where a member with Fixed Protection 2014 also benefits from scheme specific tax free cash protection (see **HMRC Protected TFC Formula** section below for full details). In broad terms their maximum PCLS from the scheme will comprise (Money Purchase scheme):

- Protected TFC amount on 5th April 2006 x 1.2*
- + 25% of fund growth; after the fund value as at 5th April 2006 has been re-rated in line with the applicable LTA (1.5**/1.5). This cannot produce a negative figure.

*until such time LTA exceeds £1.8m
** Until such time LTA exceeds £1.5m

It is the member's responsibility to tell HMRC that Fixed Protection 2014 no longer applies. They must do this within prescribed time limits or they will be subject to financial penalties.

Individual Protection 2014

This form of protection is available for individuals with benefits under registered pension schemes ("relevant arrangements") valued in excess of £1.25m at 5th April 2014. Where the value ("relevant amount") exceeds £1.25m the individual's protected LTA amount is set at the applicable level, subject to a cap of £1.5m. Benefits are valued along the lines of the method used for Primary Protection but with account taken of any benefits that have crystallised after 5th April 2006. The calculations under the latter can be extensive.

Applications for Individual Protection have to be made by individuals (or someone on their behalf) using HMRC's online system by 5th April 2017. If successful, a certificate will be issued by HMRC with a unique reference number and stating the amount protected. This is not issued if the individual already benefits from the more valuable Enhanced Protection, Fixed Protection (2012) or Fixed Protection 2014, but will be subsequently if they lose those protections.

Members with Primary Protection cannot apply for Individual Protection.

If the standard LTA rises above the individual's protected LTA, the individual will default back to the former. Similarly, if the member's pension rights are subject to a pension debit, then their protected LTA will be reduced accordingly, or if the debit reduces this below the level of the then standard LTA it will cease to apply. Individuals must inform HMRC of such debits within prescribed time periods or face a penalty / fine.

The member will be entitled to a PCLS of 25% of their protected LTA.

HMRC provide a set formula to calculate PCLS where a member with Individual Protection also benefits from scheme specific tax free cash protection (see **HMRC Protected TFC Formula** section below for full details). In broad terms their maximum PCLS from the scheme will comprise (Money Purchase scheme):

- Protected TFC amount on 5th April 2006 x 1.2*
- + 25% of fund growth; after the fund value as at 5th April 2006 has been re-rated in line with the applicable LTA (individual's protected LTA**/1.5). This cannot produce a negative figure.

*until such time standard LTA exceeds £1.8m
** Until such time standard LTA exceeds individual's protected LTA

A reminder on Scheme-specific Tax Free Cash Protection

This applies to occupational scheme members who had existing lump sum rights in excess of 25% in the scheme as at 5th April 2006. It did not apply to holders of Retirement Annuity Contracts (RACs).

It does not apply to individuals with Enhanced Protection or Primary Protection who also had tax free cash protection under those provisions as it exceeded £375,000 on 5th April 2006.

Unless the transitional arrangements under Finance Act 2014 apply (this covered transfers 17/03/2014 – 05/04/2015) it is a condition that the protected TFC must be paid from the original scheme* with all benefits arising under all arrangements at the same time.

*or a scheme to which the member transferred under HMRC's "block transfer" rules.

HMRC has a set formula for calculating the TFC payable on drawing benefits (see **HMRC Protected TFC Formula** section below for full details). The formula since April 2012 in broad terms involves working out (Money Purchase scheme):

- Protected TFC amount on 5th April 2006 x 1.2*
- + 25% of fund growth post 5th April 2006 calculated at date of crystallisation. This cannot produce a negative figure.

*until such time standard LTA exceeds £1.8m

A partial transfer to another pension scheme will result in the loss of Scheme-specific Tax Free Cash Protection for that part paid to the receiving scheme. Scheme-specific Tax Free Cash Protection is retained for the part that remains, but the entitlement is reduced by a quarter of the amount transferred out.

In some circumstances, the whole fund (Money Purchase scheme) can be paid as a tax free lump sum, i.e. where the member was entitled to take all of their uncrystallised rights as a lump sum on 5th April 2006 and certain conditions are met. This is known as a Stand-alone Lump Sum and does not have to be connected to becoming entitled to a pension, in the same way that a Pension Commencement Lump Sum does. The right to a Stand-alone Lump Sum can be lost on transfer to another pension scheme, unless certain conditions are met.

HMRC Protected TFC Formula

As described above, HMRC specify the method for calculating TFC where there is a protected entitlement. The descriptions above are a simplified version; the formula in full is:

(VULSR x ULA/FSLA) + ALSA, where:

- VULSR is the uncrystallised protected TFC amount at 5th April 2006.
- ULA is the greater of £1.8m and the standard Lifetime Allowance at the time the lump sum is being paid.
- FSLA is £1.5 million.
- ALSA is calculated as shown below. If ALSA is negative, then nil is used.

ALSA = [LS + AC - (VUR x CSLA/FSLA)]/4, where:

- LS is the amount of pension commencement lump sum actually paid.
- AC is the amount crystallised by becoming entitled to a pension in connection with which the PCLS is paid. (In practice for a money purchase arrangement, LS + AC is just the value of the fund at the time the PCLS is being paid. It is more complex for defined benefit arrangements.)
- VUR is the uncrystallised fund at 5th April 2006.
- CSLA is the current standard Lifetime Allowance, or
    - £1.8 million if the member has Fixed Protection (2012)
    - £1.5 million if the member has Fixed Protection 2014
    - The individual's personal Lifetime Allowance if they have Individual Protection 2014
- FSLA is £1.5 million

Transitional Protections 2016

In his March budget, the Chancellor indicated that as a consequence of the LTA being reduced to £1m from 6th April 2016, a new protection regime would apply for those with pension rights above £1m to ensure it is not retrospective.

From April 2016 there will be two new protections available – Individual Protection 2016 and Fixed Protection 2016. If an individual applies for either of these protections they will be given a reference number, but no certificates will be issued. Applications for these protections will be via an online system, but HMRC have advised that this will not be available until July 2016. Between April and July 2016 anyone wishing to apply for either of these protections can do so in writing to HRMC, who will respond in writing.