The Lifetime Allowance

Introduction - What is the Lifetime Allowance?

The Lifetime Allowance (LTA) is a limit on the total value of Pension benefits (excluding State Pension) that can be withdrawn during your lifetime, regardless of whether it is via lump sums or income, without giving rise to an LTA tax charge. The standard LTA for 2020/21 is £1,073,100. At present, it is scheduled to rise each tax year in line with increases in the Consumer Price Index (CPI).

The LTA is not a limit or ceiling as such, but is an allowance. If your Pension benefits are currently, or likely to in the future, exceed the LTA, then it is important to understand the tax consequences, and when such charges are payable.

Background

The LTA was introduced on 6 April 2006, following the introduction of Pension Simplification Legislation. It was designed to limit the amount of benefits an individual can receive – or 'crystallise' – from a UK registered Pension scheme that has enjoyed tax privileges.

The LTA was originally set at £1.5 million in April 2006, and had increased to £1.8 million by April 2010. Since then, it had been gradually reduced and by April 2016 had reached its minimum of £1 million.

From 2017/18, the LTA has increased annually by CPI. Where futures rates of CPI are unknown, and therefore increases in the LTA uncertain, current legislation stipulates that the LTA will be indexed with CPI until it reaches £1.8m.

What needs to be considered?

- When your benefits are tested against the LTA.
- The LTA charge and how this will be paid.
- When the LTA charge is due.
- What options you have for benefits in excess of the LTA.

The LTA in Practice

Whenever benefits are taken from a pension, you use up a percentage of the LTA. This is known as a Benefit Crystallisation Event (BCE), whereby the amount of benefits crystallised is tested against the LTA. The Scheme Administrator who calculates the amount of LTA used will issue a BCE statement to the member.

HMRC have produced an exhaustive list of what constitutes a BCE. However, for the purposes of this factsheet, the most common are detailed below.

BCE	Applicable to	Description	Test against LTA calculation
1	INCOME DRAWDOWN	Movement of money held under a Money Purchase arrangement into Drawdown.	Total value of amount moved into drawdown. Assets moved are valued at market value.
2	SCHEME PENSION	Member becomes entitled to a scheme pension (whether form a Defined Benefit or Money Purchase scheme).	20 times the pension payable to the individual in the first year (plus the value of any lump sums).
4	LIFETIME ANNUITY	Member become entitled to a Lifetime Annuity under a Money Purchase arrangement from either uncrystallised funds or those held within a drawdown fund.	Total value of member's rights (market value) under arrangement which is used to purchase the lifetime annuity (less amounts previously crystallised under BCE 1 in relation to drawdown funds).
5A	TEST AT AGE 75 (DRAWDOWN)	A member who has a Drawdown fund, which was established after 6 April 2006, under a Money Purchase arrangement reaches age 75.	The total value of the drawdown fund (market value) less the amount originally crystallised under BCE 1 in relation to drawdown funds.
5B	TEST AT AGE 75 (UNCRYSTALLISED MONEY PURCHASE FUNDS)	A member who has a Drawdown fund reaches age 75 and still has uncrystallised funds held within a Money Purchase arrangement.	The value of the uncrystallised fund.
6	LUMP SUM PAYMENTS	A payment of a relevant lump sum (other than death) before age 75. This may include: • Pension Commencement Lump Sum (PCLS) • Serious ill-health lump sum • Uncrystallised Funds Pension Lump Sum (UFPLS) • LTA excess lump sum, where a charge arises because the individual has no lifetime allowance remaining.	The amount of the lump sum payment.

BCE	Applicable to	Description	Test against LTA calculation
7	DEATH BENEFIT LUMP SUM PAYMENTS (DEATH BEFORE AGE 75)	A payment arising from a lump sum death benefit (either from a defined benefit scheme or uncrystallised funds lump sum death benefit) whereby two conditions are met: 1. The individual died before age 75 and; 2. The lump sum is payable within two years of death.	The amount of the lump sum death benefit payment.

When benefits are tested against the LTA, and the tested value falls below the current, or available, LTA, no tax charges are due. However, benefits crystallised in excess of the available LTA are subject to tax charges, and the amount depends upon the way in which the excess benefits are taken.

The LTA Charge

The Scheme administrator is responsible for verifying the amount crystallised each time there is a BCE in order to ensure appropriate tax is paid on funds taken above the LTA. The Scheme Administrator calculates the value of benefits coming into payment, and confirms the percentage of the LTA being used. The calculation method used will depend on the type of BCE, as detailed previously.

If the percentage of the LTA crystallised is in excess of the available LTA, then the overage becomes known as the 'Chargeable Amount' and a LTA tax charge is applied. The tax rate levied depends on the way in which the excess is paid:

55% If the excess is paid as a one off lump sum, with no further tax applied.

25% If the excess is retained to pay Pension benefits (for example, held within the Pension fund). Tax will then be payable on income received from the fund at the members marginal rate.

The liability for paying the LTA charge falls jointly on both the member and the Scheme administrator, if the member is alive. If however the charge arises on the member's death, the recipient of the payment (i.e. the beneficiary or beneficiaries) is liable. It is usual practice for the Scheme Administrator to deduct the tax charge before payment is made. When the Scheme Administrator deducts the charge, they will make payment to HMRC.

Examples

Below provides a series of hypothetical examples showing how benefits are treated for LTA purposes.

Example 1. Amy (59) - Self-Invested Personal Pension (SIPP) - No LTA Charge

Amy is age 59 and has a Self-Invested Personal Pension (SIPP) worth £500,000. Amy is planning to retire in 12 months' time, although in anticipation of her retirement wishes to clear her interest only mortgage of £100,000 and purchase a new car. Amy is a higher-rate taxpayer, and does not want to take any taxable monies from her SIPP. Amy therefore decides to withdraw the maximum available amount of tax-free cash, known as a Pension Commencement Lump Sum (PCLS) equivalent to 25% of the value of her SIPP (£125,000).

In order to withdraw a PCLS of £125,000, she will be required to crystallise the full balance of her SIPP (£500,000). Where £125,000 is withdrawn tax-free, the remaining £375,000 crystallised element is designated into Flexi-Access drawdown.

Her PCLS of £125,000 is tested against the current LTA of £1,073,100 under BCE 6, and the balance of £375,000 designated into Drawdown is tested under BCE 1. In light of these two BCEs, Amy will have used up 46.59% of her LTA (£500,000 / £1,073,100).

She therefore has a remaining LTA of 53.41% to use when crystallising any future Pension benefits.

Example 2. Elijah (65) - Defined Benefit Pension - No LTA Charge

Elijah has been a member of the Civil Service Pension Scheme for 35 years, and having just reached age 65, now wishes to retire. Elijah has been presented with an immediate retirement quotation from the scheme and has been offered an initial starting Pension of £18,500 per annum and a tax-free lump sum of £55,000. For the purposes of valuing the benefits for the LTA, the Scheme administrators will perform the following calculation:

Benefit	LTA Valuation Method	LTA Value
Initial Starting Pension	£18,500 x 20	£370,000
Tax Free Lump Sum	£55,000	£55,000
Total Value		**£425,000**

The value of Elijah's benefits under the scheme, for LTA purposes, is £425,000. On accepting the immediate retirement quote, the Scheme Administrators will confirm he has used up 39.60% of his LTA (£425,000 / £1,073,100).

He will therefore have a remaining LTA of 60.40%.

Example 3. Rowan (58) - Self-Invested Personal Pension (SIPP) - LTA Charge

Rowan, now age 58, accepted a Cash Equivalent Transfer Value (CETV) from a Defined Benefit Pension scheme 2 years ago, and transferred the CETV to a SIPP. His SIPP is now valued at £1,300,000. He has no LTA protection, so based on the current value of his SIPP is £226,900 over the standard LTA of £1,073,100. Rowan is wanting to look at his options and understand the mechanics of how the LTA excess charge applies.

Tax Free (25%)	Taxable (75%)	LTA Overage
£268,275	£804,825	£226,900
	£1,073,100	**£1,300,000**

Rowan's options could include:

1. Crystallising up to the current LTA, and leaving the excess over the LTA uncrystallised

The maximum PCLS that Rowan could extract from his Pension is limited to 25% of the current LTA of £1,073,100, which equates to £268,275. Any withdrawals from the balance, which could be designated into a Flexi-Access Drawdown arrangement, would be subject to Income Tax at his marginal rate. If Rowan decided to crystallise the amount of £1,073,100, £268,275 will be tested against the LTA under BCE 6, and the balance of £804,825 tested under BCE 1.

Rowan would not immediately trigger an LTA excess tax charge, given he has only partially crystallised the value of his SIPP up to the current LTA. However, by doing so, he does not avoid the liability to an LTA charge, but is merely deferring it until age 75 (or earlier if he decides to crystallise any of the excess beforehand).

At age 75, the following two tests will be conducted on Rowan's Pension fund:

a) Crystallised Fund - Where these benefits have already been tested against the LTA, a final test is run (under BCE 5a) to look at the difference in the value originally placed into Flexi-Access Drawdown (£804,825) and the value of the fund at age 75. If the value at age 75 is less than the original crystallised amount, no further LTA tax is due. However, if the value at age 75 is higher, then the difference (growth) is tested against any available LTA. As Rowan has used 100% of his LTA under this option, any excess is taxable.

b) Uncrystallised Fund - If the excess over the LTA remains uncrystallised, a final test is run to assess his remaining uncrystallised funds against the LTA under BCE 5b. Given he has already used up 100% of his LTA, the value of his uncrystallised fund at age 75 will be subject to an LTA tax charge of either 55% or 25%, dependant on the way in which the excess is taken.

2. Crystallise the full balance, and incur the LTA charge before age 75

If Rowan decided to crystallise the full balance of £1,300,000, £268,275 would be received tax free, and the balance of £804,825 would be designated into Flexi-Access Drawdown without any LTA charges, with withdrawals subject to Income Tax at his marginal rate. The £226,900 excess over the current LTA of £1,073,100, would be taxed according to the way in which Rowan decides to take the excess:

As a Lump Sum – If Rowan wishes to withdraw the excess above the LTA as a lump sum, then he will be subject to a tax charge of 55%. From the sum of £226,900, after paying the 55% charge of £124,795, Rowan would receive a lump sum of £102,105. No further taxation would be applied to the lump sum received after the LTA excess charge of 55% has been deducted. Rowan would need to bare in mind that this lump sum will then sit inside of his estate for Inheritance Tax purposes and, depending on the value of other assets, could be liable to IHT at 40%.

Example 3. Rowan (58) - continued:

As an Income (Retained within the fund) – Alternatively, Rowan could elect to pay a lower charge of 25% on the £226,900 excess over the LTA, which equates to a charge of £56,725, and retain the remaining balance of £170,175 within his SIPP in Flexi-Access Drawdown. Where the excess would then sit inside his SIPP and fall outside of his estate for IHT purposes, income withdrawn from the fund will then be subject to Income Tax at his marginal rate.

The suitability of either option would depend upon his individual circumstances and objectives.