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March 2009

Adrian Walker assesses the impact of the Chancellor's proposed freezing of the Lifetime Allowance on pension commencement lump sum rights.

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In the January issue of informer I reported on the Chancellor's pre-Budget announcement to freeze the Lifetime Allowance (LTA) beyond the 2010/11 tax-year, and discussed some of the potential repercussions for retirement funding through registered pension schemes.

For some clients the freezing of the LTA could also have potential implications on pension commencement lump sum (PCLS) rights. Clients affected will be those with pre A-Day PCLS rights in a registered pension scheme that at A-Day exceeded 25% of the fund value in that scheme. Such rights would only be applicable to clients who at A-Day had pension rights in occupational schemes or Section 32 contracts.

how will the announcement affect their PCLS rights?

Clients with a protected pre A-Day PCLS will have their rights protected within their existing pre A-Day scheme. The Finance Act 2004 provides for the protected lump sum at A-Day to grow at the rate of increase in the LTA until benefits crystallise under that arrangement.

In the first five-year cycle since the start of the new regime, the cumulative rate of increase to the A-Day protected lump sum will be 20% by the end of the 2010/11 tax year. Many clients, due to recent market conditions, will have seen the capital value of these funds reduce. In such circumstances, the PCLS rights would have increased as a proportion of that fund value due to the automatic indexation of their pre A-Day rights.

Freezing the Lifetime Allowance until at least the end of the 2015/16 tax year at £1.8 million will result in no extra indexation from the 2011/12 tax year to that ending on 5 April 2016. In all likelihood the potential impact on clients' protected PCLS rights will be a decrease in the proportion of the fund eventually available as a PCLS when compared with the current position.

is there anything that will improve this tax-free cash position?

Yes – due to changes introduced in the Finance Act 2008 there is potential to improve clients' tax-free cash position. All clients will receive the core indexation linked to the increase in the LTA that will apply to the pre A-Day protected lump sum. Legislation now provides that where investment performance since A-Day has outperformed (in real terms) the increase in the LTA, clients will have an added PCLS of 25% of that real investment outperformance.

Where crystallisation of such benefits is some way in the future, a new investment benchmark related to outperformance against the increase in the LTA could create real added value of an increased PCLS. While of course the tax treatment should not dictate investment planning, this may create a need to review the investment choice available under their existing contract. Perhaps where this

prepare for the
big freeze

To download Adrian Walker's article on the freezing of the Lifetime Allowance from the January issue of **informer**, visit the articles section of **www.informerlive.co.uk**

choice is 'inadequate' the client may need to consider transferring the benefit to another registered pension scheme where investment management can be more effectively delivered. At the same time, clients will need to ensure such a transfer will not affect their pre A-Day protected tax-free cash rights.

how can such lump sums be protected on transfers?

There are only two methods available where a transfer of pre A-Day rights with protected pre A-Day tax-free cash can be passed to the receiving scheme:

Block transfers

These rules apply where two or more members of a registered pension scheme request a transfer of their benefits in the same transaction to a scheme of which neither has been a member for more than 12 months. The only exception to the '12-month rule' is when the transfer is made to a personal pension scheme where pre A-Day membership was for the purpose of accepting contracted-out rebates only. In this instance, the 12-month period begins from when that arrangement ceased to accept contracted-out rebates only (eg if the policy accepted a transfer from another scheme).

Clients are able to repeat the use of the block transfer rules. Under these rules, the pre A-Day protected tax-free cash rights of any individuals concerned will remain with transfers made after A-Day – regardless of how many times in the future a client makes a transfer.

This alternative is not available for clients with pre A-Day Section 32 contracts, as each Section 32 contract is recognised as a registered pension scheme in its own right and therefore cannot have more than one member.

Scheme wind-up transfers

Any protected pre A-Day tax-free cash rights can also be retained if trustees wind-up an occupational scheme and transfer to a post A-Day Section 32 arrangement. The same rules apply where a client has a pre A-Day Section 32 contract with protected cash, and wind-up of the scheme is deemed under HM Revenue & Customs rules to be 'member driven'.

Unlike block transfers, once a client transfers their pre A-Day rights to a post A-Day Section 32 arrangement, any later transfer of benefits from the post A-Day Section 32 will lose the client their protected pre A-Day cash rights.

summary

Clearly the freezing of the LTA will have a significant impact for clients holding protected pre A-Day tax-free cash rights. Delivering outperformance against future increases in the LTA and thereby creating increased PCLS rights on benefit crystallisation could help to insulate existing benefits for certain clients from the impact of the freeze in the LTA. The review of existing contracts and investment choices in this area could present an opportunity to demonstrate the real value of advice.

This article is based on Skandia's interpretation of the law and HM Revenue & Customs practice as at 27 February 2009. We believe this interpretation to be correct but cannot guarantee it.

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