Sackers

Pensions tax changes – the revised allowances and removing the LTA

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Introduction

Following on from this year's Spring Budget, on 11 July 2023 the Finance (No.2) Bill received Royal Assent and, just a week later, draft clauses for inclusion in the next Finance Bill to deal with abolishing the LTA were published.

Key points

- With effect from 6 April 2023, the Finance (No.2) Act 2023 ("the Act") brings into force various increases in the AA and, in anticipation of the LTA's removal, replaces the LTA charge with income tax payable at an individual's marginal rate.
- The Finance Bill 2023-24 ("the Bill") paves the way for the LTA's demise.
- As HMRC's accompanying policy paper and the Bill's explanatory note explain, removing the LTA brings with it a number of complications, including where to draw the dividing line between tax-free lump sums and lump sums subject to marginal rate tax in its absence. Much of the Bill therefore focuses on how member and death benefit lump sums will be taxed from 6 April 2024 onwards.
- The Bill also helps clarify the position going forwards regarding LTA and lump sum protections, as well as the future function of benefit crystallisation events.
- Benefits taken as pension income will continue to be taxed at marginal rate.
- The Bill's clauses deal with the post-LTA regime from 6 April 2024. There are no details as yet of any transitional arrangements, including how to factor in benefits coming into payment now. In addition, the inevitable new reporting and disclosure requirements have yet to emerge. With the deadline of 6 April 2024 looming, these essential pieces are urgently needed to complete the jigsaw.
- HMRC and HMT are running a technical consultation on the draft clauses, which closes on 12 September 2023. This aims to ensure the legislation works as intended, although the consultation notes that the "final contents of the next Finance Bill will be a decision for the Chancellor".

Background

In this year's Budget, the Chancellor announced a raft of radical changes to the pensions tax system. Many of these were brought into force retrospectively by the Act, from 6 April 2023.

Annual allowance

The AA limits the total tax-relieved pension savings an individual can make each tax year across all registered pension schemes. From 6 April 2023:

- the standard AA increased from £40,000 to £60,000
- the money purchase AA, which applies to any subsequent DC savings by individuals who flexibly access their DC benefits, increased from £4,000 to £10,000
- the minimum tapered AA increased from £4,000 to £10,000, and the threshold at which the taper applies from £240,000 to £260,000. The taper works by reducing the AA by £1 for every £2 of income over the taper threshold. This means that the minimum £10,000 taper now applies to individuals whose income is £360,000 or more.

Lifetime allowance

The LTA limits the total amount of tax-relieved pension savings that an individual can build up over their lifetime across all their registered pension schemes without incurring an additional tax charge. A requirement to test a member's benefits against the LTA is triggered by certain events, known as a benefit crystallisation event ("BCE"), such as a pension becoming payable in a DB scheme or funds being designated to a drawdown facility in a DC arrangement. A BCE also occurs when a member reaches age 75.

From 6 April 2023:

- the LTA charge is removed, with benefits exceeding the LTA instead being taxed at an individual's marginal rate
- other lump sums which could also be subject to an LTA charge of 55% in certain circumstances (such as serious ill-health lump sums, DB lump sum death benefits and uncrystallised funds lump sum death benefits) are also now taxed at the recipient's marginal rate.

As the LTA framework remains in place until 6 April 2024, trustees and scheme administrators are still required to operate LTA checks when paying benefits, including issuing BCE statements.

The cap on maximum tax-free cash

From 6 April 2023, the maximum tax-free PCLS an individual can take is limited by an overall cap. The standard amount for this purpose is frozen at £268,275, being 25% of the 2022/23 LTA of £1,073,100. However, members with certain protections, such as valid enhanced or fixed protection ("EP" and "FP"), will retain their entitlement to a higher PCLS. For example:

- where a member holds valid EP, their maximum PCLS is limited to the lower of £375,000 or 25% of the value of their benefits being crystallised. The cap here is calculated as 25% of £1.5 million, being the LTA at A-Day when EP was introduced

- similarly, where a member holds valid FP12, their maximum PCLS is limited to the lower of £450,000 or 25% of the value of their benefits being crystallised. The cap here is 25% of the LTA of £1.8 million which FP12 protected.

Members holding valid EP or FP applied for before 15 March 2023 (the date of the Spring Budget), can build up or pay contributions towards new pension benefits, join new arrangements or transfer benefits from 6 April 2023 without risking losing protection. Any contributions the member makes from 6 April 2023 can also count towards the PCLS. Crucially, where an individual makes a successful late application for either EP or FP (ie on or after 15 March 2023) all of the original restrictions around new benefits, contributions or arrangements, and the need to take care on transfers, will continue to apply for the protection to be maintained.

The EP example assumes that the individual does not have a separate protected lump sum. Where a member has such a protection, their benefits will need to be valued as at 5 April 2023 to help establish their PCLS cap. HMRC's LTA guidance helpfully sets out a number of examples explaining how this works in more detail.

Taxing lump sums from 6 April 2024

Two new allowances will make their debut from next April: the “lump sum allowance” and the “lump sum and death benefit allowance”.

Broadly speaking, a tax-free PCLS will continue to be calculated using the same formula as now, with the standard maximum PCLS being limited to the lower of £268,275 or 25% of the value of benefits being crystallised. This is being defined under the Bill as the individual’s “lump sum allowance”. Tax-free elements of certain other lump sums, such as an UFPLS and trivial commutation and winding-up lump sums, will also be brought within scope and count for the purposes of this allowance.

A new overall “lump sum and death benefit allowance” of £1,073,100 is also being introduced, designed to limit the total amount of tax-free lump sums payable to or in respect of an individual across all registered pension schemes. As well as capturing the PCLS and tax-free elements of certain other lump sums, as the name suggests, certain death benefits which are payable tax-free will also count towards the lump sum and death benefit allowance.

The two new allowances are intended to mark the threshold above which marginal rate tax will begin to bite. But the Bill’s drafting suggests that, rather than triggering an unauthorised payment as currently, a PCLS exceeding the new tax-free maximum will be taxed at an individual’s marginal rate.

As a consequence of the above changes, both the LTA excess lump sum provisions and the requirement to have available LTA to take certain lump sums will be removed.

Other key changes

Impact on LTA protections

Individuals holding a valid LTA protection will retain their rights to a higher level of tax-free lump sum, as well as to higher tax-free parts of lump sums and lump sum death benefits. For example, a member with FP12 will have a lump sum allowance of £450,000 and a lump sum and death benefit allowance of £1.8 million (representing the LTA FP12 protected).

For individuals with valid EP, the plan is to limit the tax-free part of any lump sum or lump sum death benefit by reference to the total value that could have been paid on 5 April 2024. Marginal rate tax will then apply on any excess.

New deadline for certain protections

When the LTA was last reduced in April 2016 to £1 million, transitional protections in the shape of FP16 and individual protection 2016 were introduced to help individuals with pension rights already at or around that figure. While there is currently no deadline as such for applications, individuals who want to rely on either of these protections must apply to HMRC before taking any benefits. A new deadline of 5 April 2025 is now proposed for applications.

Role of BCEs

With the LTA being removed from 6 April 2024, the current role of BCEs in triggering a test against the LTA will become redundant. As such, many of the existing BCEs will be removed, leaving only the payment of certain lump sums and lump sum death benefits as new "relevant BCEs". The tax-free element of these "relevant BCEs" will be established by reference to the new lump sum allowance and lump sum and death benefit allowance described above.

Benefits taken under the LTA regime

No detail has been given on any transitional arrangements where members have taken some benefits whilst the LTA existed. Given the potential administrative implications of having to take account of previous benefits, we await these with interest.

Next steps

Removing the LTA and its knock-on effects will inevitably bring with it a requirement to update scheme administration processes. There will also be an onus on schemes to keep careful records and to check with members to assess what lump sums may have been taken previously which would count for the purposes of the new allowances.

With more detail still to follow in regulations, the 6 April 2024 timeframe is beginning to look a little on the tight side.

If you would like to discuss the implications of the above, **please speak to your usual Sackers contact**.

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