HINDSIGHT Collegiate Underwriting

Autumn 2013

'Lifetime allowance special'

Welcome to the latest edition of our Hindsight publication.

In this edition of Hindsight we want to look at the history of lifetime allowances prior to the change due in April 2014 when the lifetime allowance will be reduced to £1.25m. So far every change has cost IFA's and Insurers money as the opportunity to make a decision for the customer has been missed by a small minority. Eventually the customer will want to access those pension funds and the consequences of not getting the advice right or in fact just missing the need to deal with that customer will be obvious. Invariably this will lead to a complaint that will need investigating. Defences are usually thin on the ground and it becomes a loss calculation exercise with both the IFA and Insurer being out of pocket.

We have provided a number of claims scenarios based on real life claims to highlight the issues faced by the IFA.

My thanks go to Mark Gibbon, our Managing Director and Martin Archer, our Legal Director for producing this newsletter.

We hope that you will find these articles informative and useful.

If you have any comments on the content, or suggestions for future issues, please write to us or e-mail us at newsletter@collegiate.co.uk

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History

In 2006 the Pensions Industry faced 'A' Day the dawn of pension simplification. The old 'complex' rules on contributions based on earnings were swept away and replaced with a 'simple' rule that allowed an annual allowance of £255,000 but introduced a lifetime allowance of £1.5m with a schedule of proposed increases to the lifetime allowance culminating in a limit of £1.8m in April 2012.

Moving from one set of rules that limited the level of contributions but with no limit on the total value of pension funds to one that only limited contributions to a small extent but did limit the overall pension fund value would inevitably cause problems. Someone who had contributed in accordance with the old rules could find themselves in breach of the new either immediately or sometime in the future.

The Government recognised this and introduced rules to help those people. These were the primary protection and enhanced protection elections that could be made by 5 April 2009. A late election could be made provided there was a reasonable excuse.

Enhanced Protection

Enhanced protection provided the customer with an unlimited lifetime allowance provided no further pension contributions were made after 5 April 2006. Primary protection provided an individual specific lifetime allowance based on the value of pension funds at 5 April 2006 compared to the lifetime allowance of £1.5m. As an example if pension funds at 5 April 2006 were worth £1.8m the individual lifetime allowance would be 1.2 x the actual limit at the time funds were accessed.

Since 5 April 2009 we have seen a number of claims where no election was made in time. The most typical claims have involved funds that were just under the lifetime allowance at 5 April 2006. This meant that primary protection was not available. Pension contributions have continued to be made so no late election for enhanced protection can be made. Those contributions are often not particularly significant. The value of pension funds is now significantly over the lifetime allowance.

Where no contributions have been made then it is still possible to make a late election but this must be done as soon as there is a realisation that this election is required. Although HMRC will initially refuse to accept this there is a growing set of cases from Tribunal hearings establishing what a reasonable excuse is and in particular whether having an IFA looking after your affairs who fails to deal with the election is a reasonable excuse for the taxpayer. In the case of IRBY v HMRC 2012 the taxpayer won at Tribunal following the failure of his pension trustees to make an election where his fund was in excess of £4m at 5 April 2006. This was the first case won at Tribunal on this point.

Another problem area has been customers who have already taken substantial benefits from a final salary pension scheme but have built up additional personal pension funds on top which have not been accessed. In this situation the value of the pension benefits taken are not valued until the first time pension benefits are accessed after 5 April 2006. They are then valued at 25x the pension in payment at the date other funds are accessed and compared to the lifetime limit at that date.

Case Study

The customer retired on a final salary pension of £60,000 per annum in 2004. They had built up a personal pension fund of £300K by August 2013. They now want to access those pension funds. How much of the lifetime allowance have they used? What is the current level of pension in payment? Multiply this by 25. Compare to the current lifetime allowance of £1.5m. £60,000 plus RPI from 2004-2013 x 25 will be in excess of £1.5m and the customer has used all his lifetime allowance. Are there any problems? This will depend on reviewing the level of funding in the personal pension at 5 April 2006 and 5 April 2012 to determine whether an enhanced protection election or a fixed protection election should have been made. It seems certain that at the least a fixed protection election should have been made. Additionally if contributions have been made since that date is there a loss? Tax relief is available on pension contributions and capital gains and income tax relief is available in the pension wrapper. However there will be a tax of 55% on withdrawal.

Loss calculation

Where the negligence claim is based on no claim for enhanced protection being submitted and the funds are greater than the lifetime limit at the time of taking benefits, the loss has to be calculated by reference to the amount that the fund would have been had no further contributions been paid. If this is greater than the lifetime allowance then the loss is the tax charge paid on this compared to the tax payable if the amount was taken as tax free cash and income. This will be adjusted for any impact that any additional pension contributions have on the loss.

The lifetime allowance charge is either:-

- 25% of the amount in excess of the lifetime allowance where the balance is then taken as a pension and taxed as income or

- 55% of the whole lump sum which is then paid net

If a pension was taken then 25% would be available as tax free cash and the balance paid as a pension and taxed as income.

The loss from not making an enhanced protection election is therefore 25% of the excess over the lifetime allowance as this is paid as a tax charge rather than being available as tax free cash. The balance is paid in the same way. If the individual elects to take the excess as a lump sum and pay a higher charge then the extra 30% is a replacement for the tax charge that would have been collected if the excess was taken as pension.

Fixed Protection

From 6 April 2012 the lifetime limit was reduced to £1.5m from £1.8m. Fixed protection was available where pension savings were expected to be greater than £1.5m when benefits were taken. An application had to be made to HMRC before 6th April 2012. There was no provision in the legislation for late election.

Fixed protection protected pension savings up to £1.8m from the lifetime allowance charge but there were conditions including:-

- No new contributions to a money purchase arrangement
- Cease building up benefits in a registered pension scheme
- Restrictions on transfer of benefits

Breaching conditions invalidated fixed protection. It is worth noting that auto enrolment started from October 2012 and this could breach conditions for fixed protection (and enhanced protection). There is an opt-out mechanism and provided this is exercised within one month of auto enrolment then fixed protection may not be lost.

This makes fixed protection similar to enhanced protection albeit with a more limited upside. Enhanced protection offered full protection from the lifetime allowance charge whereas fixed protection is giving £300,000 extra lifetime allowance.

We have seen a number of claims concerning the failure to make an election for fixed protection). These included:

- 'Young' customers with several hundred thousand in their pension pot
- Customers who had a fund value at 5 April 2012 close to £1.8m
- Customers who had taken benefits from other pension schemes with personal pensions that took them over the limit
- Customers approaching retirement with substantial funds continuing to make contributions

Loss Calculation

For fixed protection this is limited to funds up to £1.8m. Anything over that would have been taxed under the old regime anyway subject to enhanced and primary protection elections previously made, which are not affected by the new changes. As explained above the lifetime allowance charge is either 25% where balance is taken as income or 55% if the whole lump sum is taken. The loss is, therefore, 25% of the value of the pension fund over £1.5M to a maximum of £1.8M plus any loss, if any, on contributions wrongly made.

New lifetime allowance

The lifetime allowance limit is being reduced to £1.25m. This will affect even more people than the last change. The good news is that the maximum loss has reduced as the lost limit is £250,000 which at 25% is £62,500 plus any loss, if any, on contributions wrongly made.

What is clear to us is that this new change will cost someone money and we would like it not to be our Insured's or our Insurer.

With that in mind

What should IFA's do

- Ensure that for each customer you have a complete summary of pension savings including any final salary schemes
- Identify customers who, without making further pension contributions, could with growth have a pension fund in excess of £1.25m
- Write to each client setting out the issues
- Make an application to HMRC before 5 April 2014 where a fixed protection election is appropriate
- Where a client decides they do not want to make an election because they want to continue making pension contributions despite evidence that the pension fund might grow above £1.25m ensure advice is put in writing
- Warn about auto enrolment
- Ensure that where further pension contributions could lead to the fund being in excess of the lifetime limit appropriate advice is given to the client about the suitability of the contribution

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