FINANCE UPDATES

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THE LIFETIME ALLOWANCE

How might the big freeze affect you?

Most people get nowhere near breaching the pensions lifetime allowance, but that's likely to change over the next five years.

The lifetime allowance is currently £1,073,100. This is a limit on the amount of pension benefits you can withdraw from all of your pension schemes – whether as lump sums or retirement income – without triggering an extra tax charge of up to 55%.

In March's Spring Budget 2021, however, Chancellor Rishi Sunak froze this allowance up to and including the 2025/26 tax year and removed the annual link to the Consumer Prices Index (CPI), which is used to determine how much the allowance increases by each year.

This will be bad news for some and it stands to reason that this 'stealth tax grab' will affect more savers as time goes by, making it more important than ever to consider how best to utilise their pension tax allowances if they're to save for their retirement in the most tax-efficient way.

Had the UK's public finances not been ravaged by COVID-19 over the last year, the lifetime allowance would have increased in line with the CPI rate of inflation from the previous September on 6 April 2021, which was 0.5%.

It would probably have continued to rise modestly every year, giving savers more room to continue to benefit from making tax-efficient pension contributions and investment growth.

Instead, the Treasury hopes to recoup around £800 million by the end of the five years, starting with £80m this year and rising to £300m in 2025/26.

The five-year freeze means, if you already have a sizable sum saved in your pension pot, you have an increased risk of exceeding the lifetime allowance and potentially facing a tax charge at some point in the future.

WHO WILL IT AFFECT?

The freeze announced will have a small impact this year on those not already affected but over the next five years, it will hit more of those with the largest pension pots.

That includes savers with pension wealth close to the £1,073,100 limit when they are approaching retirement and those with pension wealth over this limit when they retire.

These individuals might have been expecting the lifetime allowance to continue to increase when the CPI increases, and it might influence their pension savings behaviour.

Nigel Peaple, director of policy at the Pensions and Lifetime Savings Association, expects the freeze to "affect about 10% of savers, not all of them wealthy, but usually those on higher salaries with a lot of pension savings".

For example, it's fairly easy for a well-paid public-sector worker with a defined-benefit pension scheme to accrue lifetime entitlement in excess of the lifetime allowance by 2025/26.

Young high earners, highly-paid members of the NHS such as doctors and consultants, and headteachers – many of whom will be on defined-benefit pensions – might be affected.

MONITOR YOUR PENSION POTS

Any risk of breaching the lifetime allowance is higher the longer you plan on waiting to take your pension benefits, assuming you carry on making contributions.

If you're close to the lifetime allowance, you should regularly monitor the value of your pots to avoid breaching the threshold.

Most people contribute into defined-contribution pensions from their salary which grow over time. For these, especially those which have been consolidated into a single pot, the value is relatively easy to view online.

For defined-benefit schemes, which are usually schemes where the amount of retirement income you're paid is based on how many years you worked for your employer or your final salary, you might have to rely on annual statements.

The value of a defined-benefit scheme for lifetime allowance purposes is usually calculated by multiplying the projected first-year pension payments by 20 and adding any tax-free lump sum taken at the start, but you should check this with your scheme administrator.

Once you know the total value of your pension pot, it's easy to see how close you are to the £1,073,100 limit. If you're one of the few who might be near the cap and are planning to retire before April 2026, you may need to consider your options to avoid being charged.

TAX CHARGES

Any pension benefits you take before 2025/26 that exceed your lifetime allowance will trigger one of two types of tax charge.

A 55% charge will apply on excess funds that are taken as a lump sum. A 25% charge awaits if excess funds are taken as retirement income, which will then be taxed at your marginal income tax rate.

For higher-rate taxpayers, these potential penalties are unlikely to change their behaviour, although it is possible to manage how and when benefits are taken to postpone the charge.

People aged 55 or over can choose to crystallise up to 100% of their lifetime allowance and leave any excess uncrystallised if their pension scheme allows benefits to be taken at age 55.

CHANGING BEHAVIOURS

For well-paid people working in the NHS, the freeze is likely to prompt some to take early retirement and others to reduce the number of hours they work or give up additional responsibilities.

Others might simply choose to stop contributing to their pension pots, perhaps in return for a pay rise or another employee benefit.

An alternative is to consider paying into other tax-efficient savings, such as ISAs, to provide a retirement income.

If none of those options are on the table, continuing to pay into your pension and exceeding the lifetime allowance might offer more benefits than stopping contributions altogether.

TESTING THE LIFETIME ALLOWANCE

Pension providers must test against the lifetime allowance whenever you decide to start taking your pension benefits sometime after your 55th birthday.

This benefit crystallisation event checks how much of the lifetime allowance you have left, whether you have breached the allowance and if a tax charge needs to be applied.

This process occurs every time you flexibly access your pension pot, with your pension provider giving you a statement showing how much of the lifetime allowance you have used.

Lifetime allowance at age 75

Historically, once you reached the age of 75 you had to buy an annuity. That's no longer the case, but turning 75 remains a key point as far as the lifetime allowance is concerned.

When most people reach the age of 75, HMRC tests any growth you have enjoyed on your pension funds.

Your pension providers will carry out a final test to assess the extent of unused funds in your pension pot and your drawdown account. If it shows you have used 100% of your lifetime allowance at 75, a 25% tax charge applies on the excess.

The good news for younger high earners is that the freeze is only for five years and it's hoped the annual link to the CPI increases will be reinstated, meaning the lifetime allowance should be higher by the time this test is carried out.

Speak to us about planning for your retirement.

IMPORTANT INFORMATION

The way in which tax charges (or tax relief, as appropriate) are applied depends on individual circumstances and may be subject to future change. Pensions eligibility depends on individual circumstances and pension benefits cannot normally be taken before age 55.

This document is solely for information purposes and nothing in it is intended to constitute advice or a recommendation. You should not make any pension decisions based on its content.

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