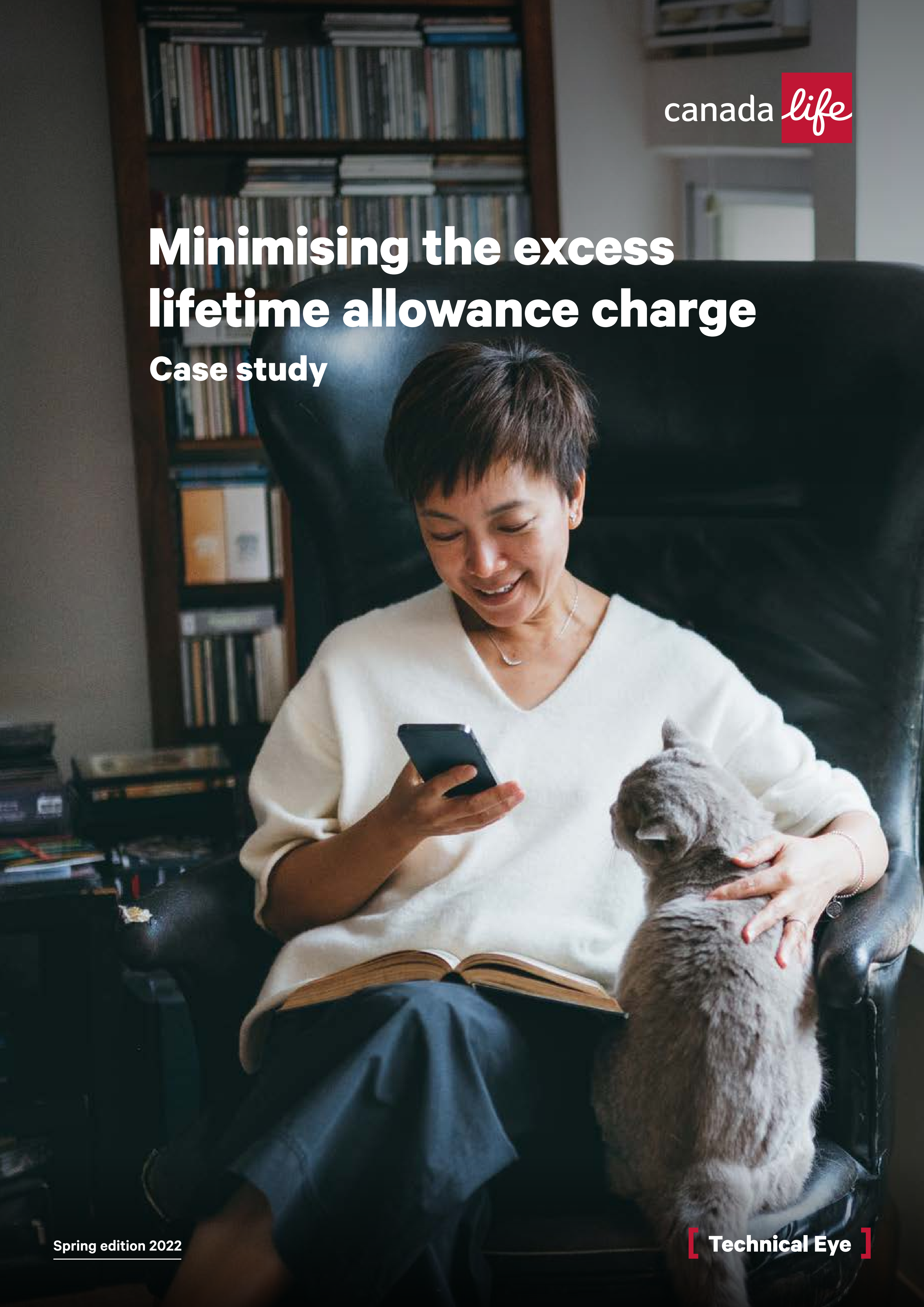

Minimising the excess lifetime allowance charge

Case study

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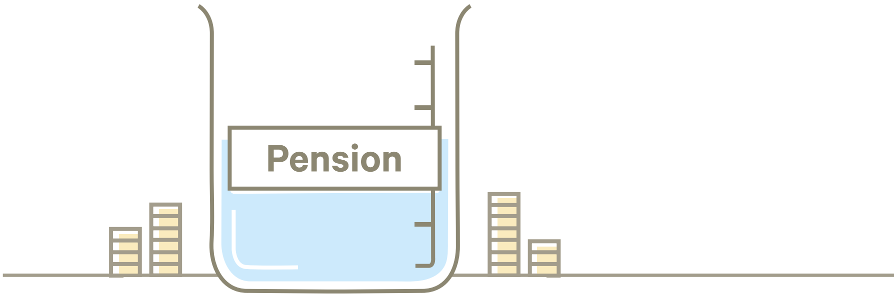
[Technical Eye]

Kevan Ramanauckis
Pension Technical Specialist
Kevan.Ramanauckis@canadalife.co.uk



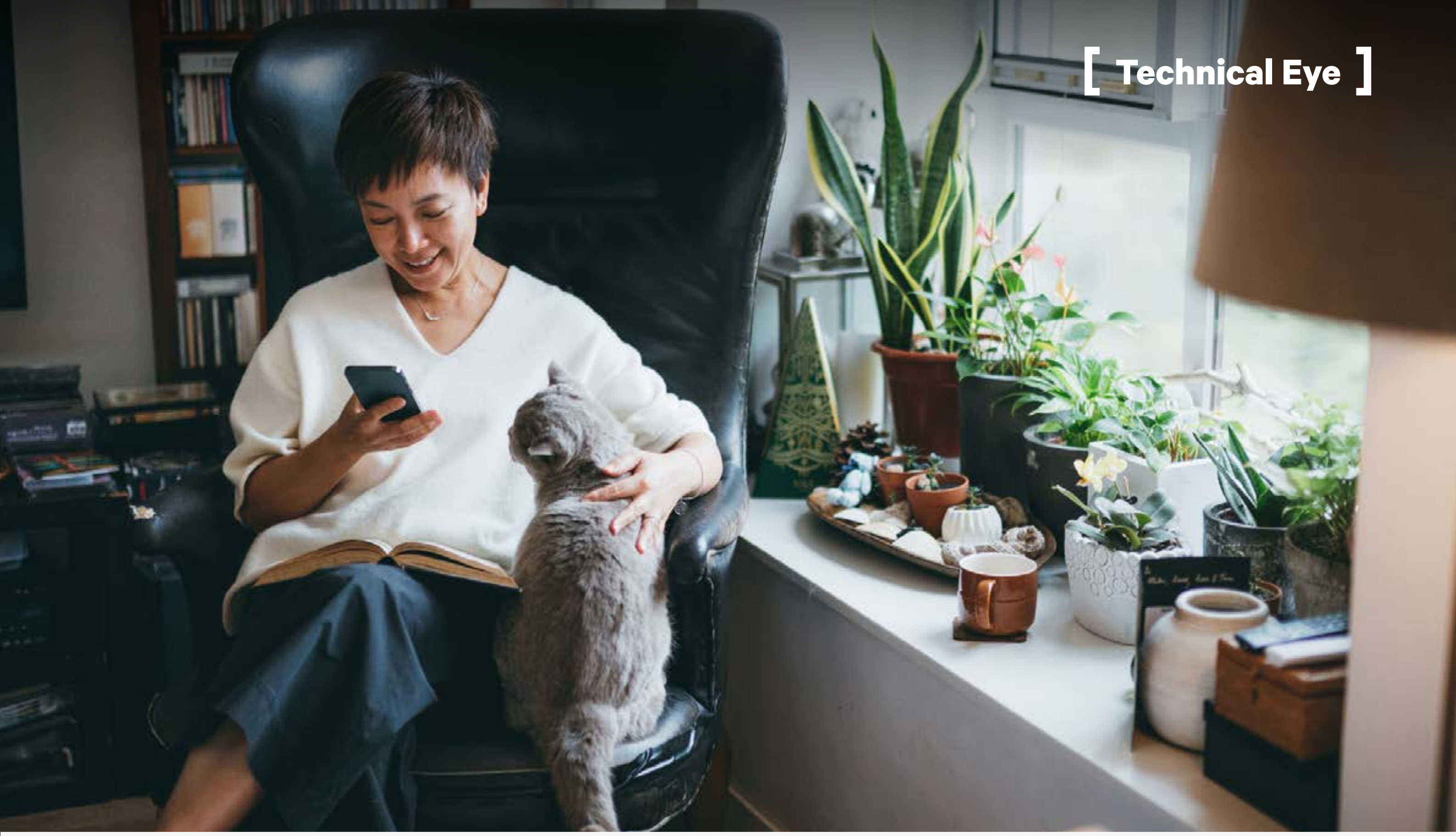
Since the pension Lifetime Allowance (LTA) was introduced in 2006, it has created its own set of challenges. Not only did it place a tax limit on the future value of a pension fund, but the allowance has also fluctuated widely since it was launched, making it difficult to plan for. In 2010 and 2011, it was £1.8 million, falling to £1 million in 2016. Today, it is fixed at £1,073,100 until April 2026.

Here we use a case study to illustrate a strategy that could help minimise the impact of the LTA on clients who need to take a regular income from their pension savings in retirement. We will explore three different retirement income strategies, all of which ensure the client's income needs are met and maintains their invested funds. We then compare the excess LTA tax charge at age 75.

CASE STUDY

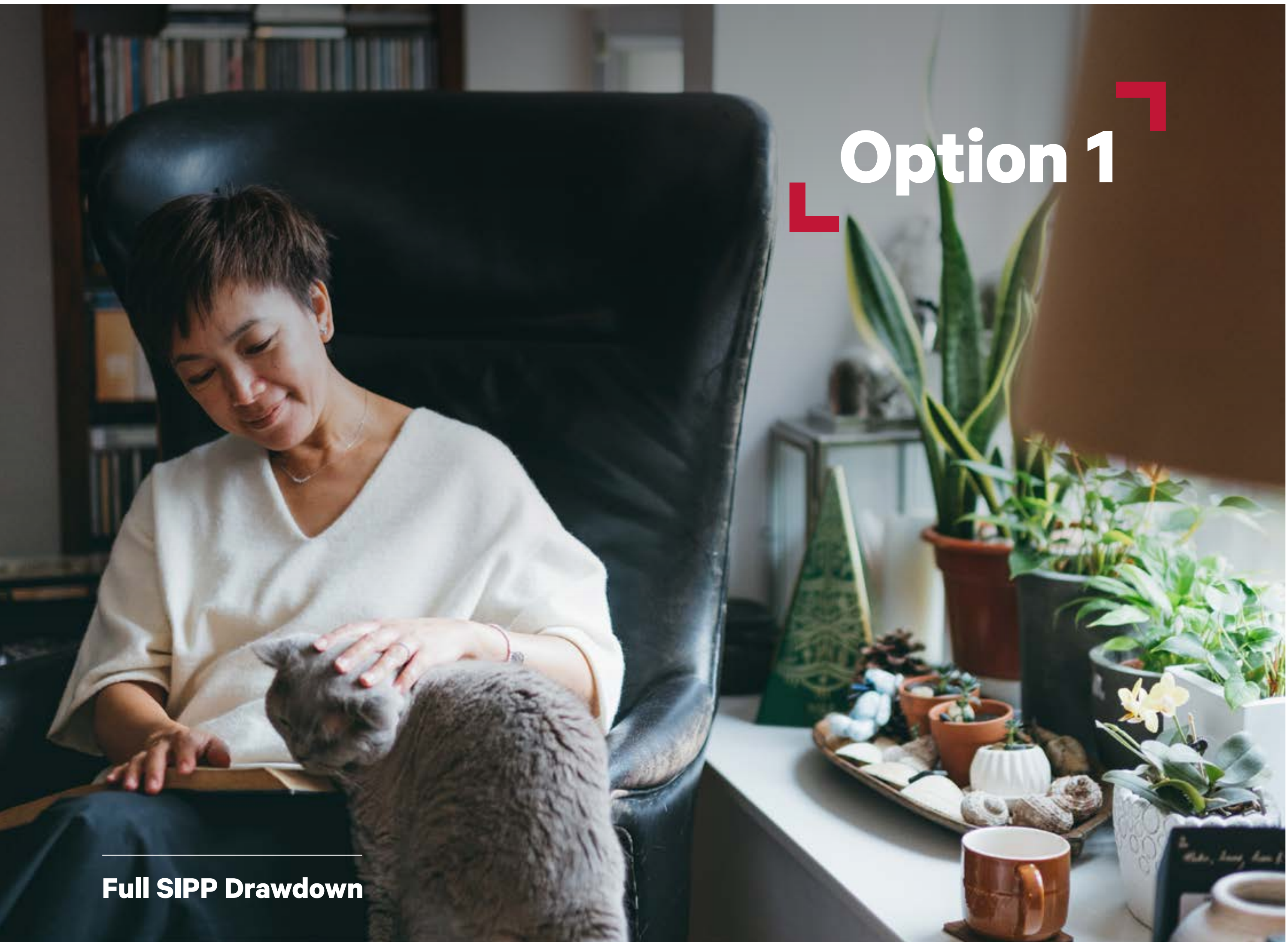
In 2012, Anne retired at age 65 with a pension fund of £1.5 million, which was at the LTA threshold of £1.5 million at that time. She took a tax-free lump sum of £375,000 and wanted an income of £20,000 a year. As Anne approaches age 75, let's examine what the outcome might be using three different approaches. N.B. This case study assumes:

+ Canada Life annuity rates are as at summer 2021. To secure £20,000 p.a. for a 65-year-old with a 30-year guarantee period, the annuity purchase price would be £490,436
+ Investment returns are 4% net
+ The LTA increases by 2% after April 2026
+ Current HMRC guidance and legislation



Between April 2014 (when the LTA was £1.25 million) and April 2020 (when the LTA was £1.055 million), HMRC collected around £1.36 billion in excess LTA tax charges.

Source: HMRC October 2021

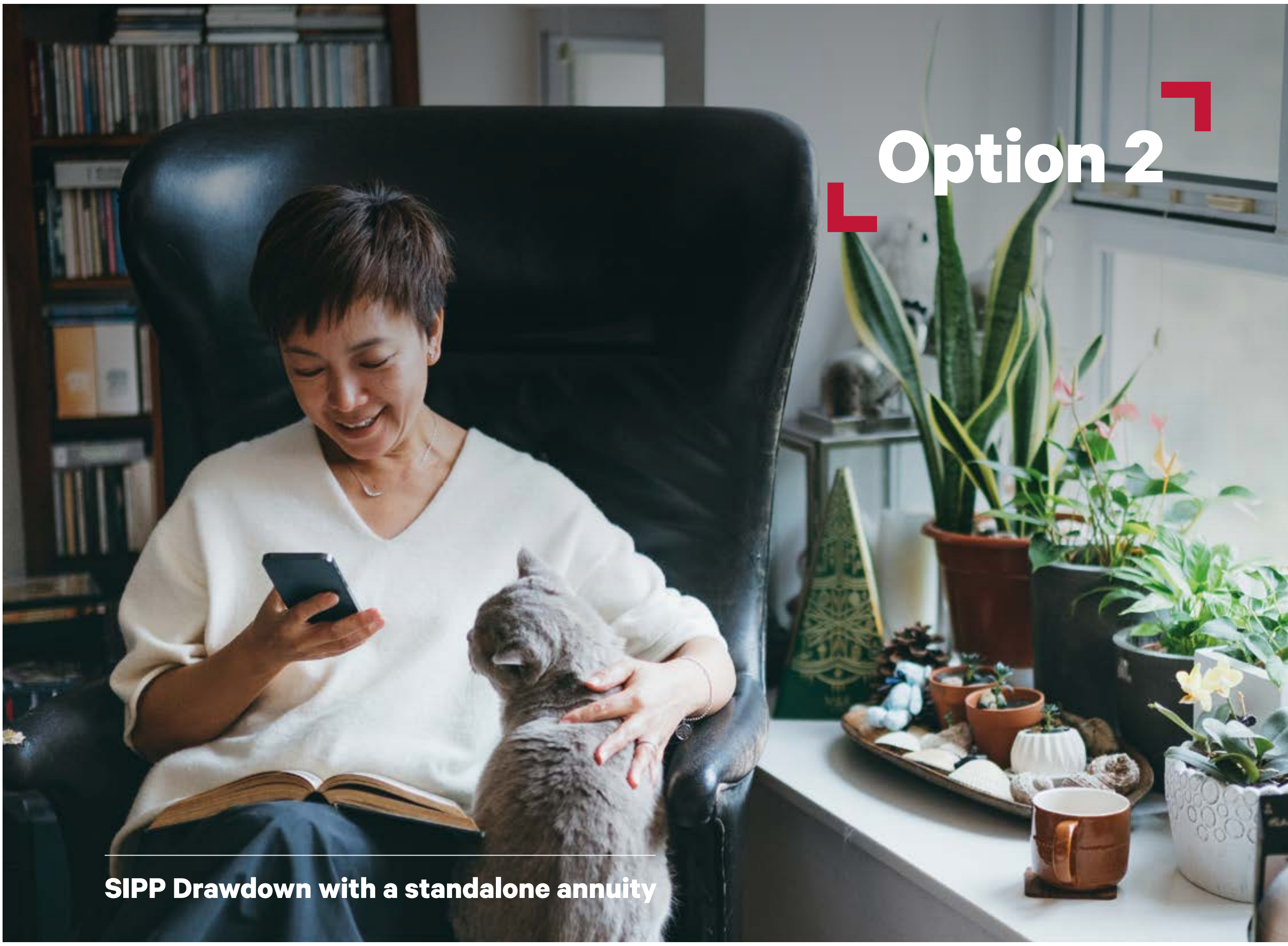


Option 1

This is the default retirement strategy where the client remains fully invested to maintain flexibility. However, because we don't know in advance what the fund value will be at age 75, we don't know how much excess tax charge will be due on the investment. At the same time, we don't know what the future LTA will be as this is subject to change.

Anne invested £1,125,000 into her SIPP Drawdown in 2012 and has withdrawn £20,000 a year (paying income tax). Assuming 4% net investment returns, she has seen the value of her SIPP Drawdown pension grow to £1,415,548 by age 75. The growth that is tested via BCE 5a is £290,548. The age 75 tax charge is 25% on the excess growth, resulting in Anne's pension administrator paying HMRC £72,627 in tax (see table on page 16).

The question is, was Anne expecting this tax charge and if not, would she have made different decisions along the way? While her SIPP Drawdown has a value of £1,342,911, which she can pass down the generations free of inheritance tax, she may have preferred to enjoy more of her pension fund rather than let the government get their hands on it, albeit she would have had income tax considerations on any withdrawals.



SIPP Drawdown with a standalone annuity

Option 2

This strategy is more likely to be used for a client that prefers certainty over flexibility. They have a low capacity for loss and could be a cautious investor. However, the client loses control of the annuity purchase price. It is no longer an asset of the SIPP Drawdown. The guaranteed income isn't flexible, so it cannot be reduced or stopped by Anne or her dependants. This means, after age 75 any dependants income will be taxed at their marginal rate, even if they don't need it.

Anne split her crystallised fund into a guaranteed annuity costing £490,436, paying £20,000 for a minimum of 30 years. The balance of £634,564 is invested in the SIPP Drawdown, no withdrawals. Again, using the same investment and CPI assumptions the resulting SIPP investment at age 75 is worth £939,310. Meaning the growth that is tested via BCE 5a is £304,746. The age 75 tax charge is 25% on the excess growth, resulting in Anne's pension administrator paying HMRC £76,187 in tax.

Again, this is a large tax charge that Anne may or may not have been expecting. That being said, she has peace of mind knowing that her £20,000 will be paid irrespective of investment market performance and for at least 30 years. This has given her the confidence to remain invested with the rest of her pension assets, which are still held within the pension wrapper and can be passed down through the generations free of IHT.

Option 3

Annuity held within the SIPP Drawdown

Option 3 saves between £46,450 and £50,000 in excess tax charges

- £ Option 1: Full SIPP Drawdown **£72,637/LTA TAX CHARGE** or **43 months** income
- £ Option 2: SIPP Drawdown with Conventional Annuity **£76,187/LTA TAX CHARGE** or **45 months income**
- £ Option 3: SIPP Drawdown including Flexible Lifetime Annuity **£26,187/LTA TAX CHARGE** or **15 months income**

+ Also, for consideration

Remember that a pension may not be the only asset a 75-year-old can use to fund their retirement. They could switch off all the income and withdrawals from the pension, reinvest the guaranteed income back into the invested drawdown, growing the value of the pension or "family trust". They can then use property wealth (releasing equity from a main residence, second home and/or buy-to-lets, subject to lending criteria) to release tax free capital/income. This creates a debt on the estate, which may improve the client's inheritance tax position.

Option 3 is an increasingly popular strategy as it does what both Option 1 and 2 can do, and more. The annuity remains an asset of the SIPP Drawdown from outset and you know exactly what the value of this income producing asset will be at age 75 for LTA purposes. The whole plan offers flexibility and tax control throughout the life of the client and, since death benefits remain an asset of the SIPP Drawdown, any remaining guaranteed income instalments can be put into a Dependent SIPP Drawdown when Anne dies. That means beneficiaries will only pay income tax on income paid while the rest can pass down through the family tax efficiently, creating a true family trust.

If we look at the numbers (see table below), Anne did the same as Option 2 but bought and held the annuity within the SIPP Drawdown. At age 75, the invested SIPP Drawdown has grown to £939,310 and the annuity asset is worth £290,436 (purchase price of £490,436 minus income paid of £200,000). So, the value of the SIPP Drawdown at age 75 is £1,229,746 (£939,310 plus £290,310).

Meaning the growth that is tested via BCE 5a is £104,746 taxed at 25%, resulting in Anne's SIPP Drawdown administrator paying HMRC just £26,187. And remember - the annuity asset can still pay or re-invest a further £20,000 for at least 20 years (or be commuted to a lump sum if the client dies).

In summary

If you have clients who need regular income from their pension, then all income options need to be considered. As you've seen, Option 3 can offer the best of both worlds. It gives peace of mind, keeps clients invested for longer and reduces the tax charge, should they breach the LTA.

	Option 1	Option 2	Option 3
	SIPP Drawdown	Annuity as a standalone	Annuity held within the SIPP Drawdown
2012 crystalised fund value	£1,125,000	£634,564	£634,564
2012 annuity fund value	£0	£0	£490.436
2012 SIPP Drawdown value	£1,125,000	£634,564	£1,125,000
Current crystalised fund value	£1,415,548	£939,310	£939,310
Current annuity fund value	£0	£0	£290.436 (£490,436 10x £20,000)
Current SIPP Drawdown value	£1,415,548	£939,310	£1,229,746
Growth subject to LTA	£290,548	£304,746	£104,746
LTA charge @ 25%	£72,637	£76,187	£26,187
Total value of SIPP Drawdown after LTA charge	£1,342,911	£863,123	£1,203,559 (plus 20 years of guaranteed £20,000)

Legal disclaimer

This document is based on Canada Life's understanding of applicable UK tax legislation and current HM Revenue & Custom's practice, as at March 2022 and could be subject to change in the future.

It is provided for professional advisers only. Any recommendations are the adviser's sole responsibility.

For more information, please contact our technical team at **ican@canadalife.co.uk**

Canada Life Limited, registered in England no. 973271. Registered office: Canada Life Place, Potters Bar, Hertfordshire EN6 5BA.
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