New pensions tax rules: the ‘ghost’ of the lifetime allowance?

Personal tax

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While the new pension tax rules have relaxed the annual allowance limits and abolished the lifetime allowance charge, there are still a number of potential traps for the unwary.

Key Points

What is the issue?

The annual allowance limits have been relaxed, but all the old complexities remain.

What does it mean for me?

Whilst the lifetime allowance charge has been abolished, the tax treatment of ‘lifetime allowance excess’ pension scheme funds has not been completely aligned with that of funds within the lifetime allowance. Individuals should also consider whether a lifetime allowance charge could be re-introduced by a future government.

What can I take away?

The recent pensions tax reforms substantially increase the opportunities for making pension scheme savings. However, careful planning as to the amount and timing of both pension scheme contributions and distributions will be essential.

Since April 2006, contributions to and distributions from UK registered pension schemes have been subject to a series of tax exemptions, ‘normal’ tax charges and ‘special’ tax charges.

Contributions to a registered pension scheme:

- Contributions are normally fully exempted or relieved from UK income tax. Employer contributions, including any made by salary sacrifice, are not liable to national insurance contributions. Personal contributions are not deductible for NIC purposes, though.
- Contributions to a scheme that operates on a defined contribution basis are ‘tested’ against the relevant individual’s available annual allowance. If the registered pension scheme operates on a defined benefit basis, the benefit accrual during the tax year (as measured on a prescribed statutory basis) is tested instead. The annual allowance charge is imposed on any excess at the individual’s marginal tax rate.

Distributions from a registered pension scheme:

- Distributions are tax-free up to a certain amount (normally 25% of the total benefits value). They are thereafter subject to income tax.
- Prior to 6 April 2023, the lifetime allowance charge was imposed on any lifetime allowance excess. Depending on the precise circumstances, such excess was subject either to the charge at 25% plus income tax, or solely to the charge at 55%.

There are many thousands of different possible annual allowance and lifetime allowance figures, due to the impact of the annual allowance tapering-down and carry-forward rules, the various lifetime allowance ‘protections’ and the impact of previous withdrawals on an individual’s available lifetime allowance.

In the 2023 Spring Budget, it was announced that with effect from 6 April 2023 the following changes would be made (and the necessary provisions have been inserted in the Finance (No. 2) Bill 2023):

- The annual allowance rules are to be somewhat relaxed (although not made any simpler).
- The lifetime allowance charge is to be abolished altogether. All distributions (in excess of the 25% tax-free amount) will in future normally be subject only to income tax.

The abolition of the lifetime allowance charge is potentially beneficial to individuals with substantial pension fund schemes, as it means that any lifetime allowance charge 'excess' benefits will now only be subject to income tax (not penal tax). It should also be somewhat easier to work out how much money should be paid into a registered pension scheme. Previously – even where there was clearly sufficient 'annual allowance headroom' – the uncertainty as to future investment returns meant that it was impossible to predict the extent to which the ultimate distributions might exceed the lifetime allowance and therefore be taxed at much higher rates.

However, a future government might reintroduce the lifetime allowance charge – and the 'ghost' of the lifetime allowance' is also evident in other ways.

The annual allowance: where are we now?

Three key changes have been made to the annual allowance rules; namely:

- The standard annual allowance has been increased from £40,000 to £60,000.
- The level of adjusted income (essentially, UK taxable income plus employer pension contributions) at which annual allowance tapering-down starts to apply has been increased from £240,000 to £260,000. (This is provided also that threshold income – essentially, UK taxable income plus, in certain circumstances, salary sacrifice pension contributions but minus any personal pension contributions – exceeds £200,000.)
- Irrespective of an individual's adjusted income level, the annual allowance cannot now be reduced below £10,000 (previously this was £4,000). (Certain

types of withdrawals from a registered pension scheme operating on a defined contribution basis are capable of permanently reducing an individual's annual allowance to the money purchase annual allowance level. This has also been increased from £4,000 to £10,000.)

However, no fundamental changes have been made to the way in which annual allowance testing applies. All the old annual allowance rules – including the complex tapering-down and carry-forward provisions – continue to apply.

As previously, not only can it be quite complicated to calculate an individual's available annual allowance, but it can also often be difficult to know until the end of the tax year to what extent an individual will be impacted by tapering-down. This is due, for example, to the impact of uncertain levels of year-end bonuses or self-employment income.

Furthermore, a salary increase can easily push a member of an employer-run defined contribution scheme with salary-related contribution levels into 'annual allowance excess' territory. Defined benefit scheme members can be especially vulnerable, as their salary increases will normally increase the level not only of their current but also of their past benefit accruals. All such increases are subject to annual allowance testing.

The increase in the various annual allowance limits, however, may make it attractive for some individuals to increase their pension contribution levels – particularly via a NIC exempt salary sacrifice arrangement. However, the precise circumstances must always be considered. In certain cases, for example, making salary sacrifice (rather than personal) contributions may result in an individual's personal allowance being tapered down.

Tax treatment of distributions: where are we now?

Notwithstanding the abolition of the lifetime allowance charge, traps remain for the unwary. A big distribution from a registered pension scheme can easily 'push' an individual into a higher tax band and could, for example, result in a basic rate (20%) taxpayer being taxed at 40% on most of the distribution. However, by 'spreading' distributions over a number of tax years, an individual can often ensure that they are taxed at lower tax rates. Sometimes a series of small distributions may even be entirely covered by the individual’s personal allowance.

The lifetime allowance charge, by contrast, was imposed at fixed rates and applicable even where a distribution was entirely covered by the relevant individual’s personal allowance. Furthermore, lifetime allowance testing was normally applied to all remaining defined contribution pension scheme funds when the individual reached age 75.

The government has announced that the lifetime allowance itself is to be abolished with effect from 6 April 2024. The precise implications of this are not yet quite clear. For example, how will serious ill-health lump sums taken before age 75 – currently tax-free only insofar as they do not exceed the lifetime allowance – be impacted?

The Labour Party, meanwhile, has announced its intention to re-introduce the lifetime allowance charge if it wins the next general election. Whilst we can’t know what may happen in the future, individuals with pension scheme funds exceeding their available lifetime allowance who have reached the normal minimum pension age (currently 55) may wish to consider whether to take full withdrawals before then. Do bear in mind, though, the potential risk of such withdrawals pushing individuals into a higher tax band, the resulting loss in future tax-free investment returns and the increased inheritance tax exposure (see below).

In the case of an individual with a ‘lifetime allowance excess’ pension fund, the tax-free cash facility continues to be restricted to 25% of the lifetime allowance. As the standard lifetime allowance is £1,073,100, normally the maximum amount of tax-free cash in such cases will therefore be £268,275. It currently appears that this limit may be frozen indefinitely. However, the abolition of the lifetime allowance charge should enable individuals with *enhanced* or *fixed* lifetime allowance protections applied for before 15 March 2023 to start making additional pension contributions if they wish to top-up their pensions savings but still retain their enhanced lifetime allowance levels and corresponding tax-free cash entitlements. Previously, such individuals would have lost their enhanced lifetime allowance levels by making further pension contributions

The international angle

Registered pension scheme

Annual allowance testing continues to be applicable to registered pension scheme members working abroad – even though normally they won't receive any UK income tax relief (sometimes not even local tax relief) on their contributions. The annual allowance tapering-down rules also fully apply to such persons (although, in practice, their UK taxable income is unlikely to be sufficiently high for them to be impacted by this).

The increase of the standard annual allowance from £40,000 to £60,000 should mean that, in a few years' time (assuming the annual allowance legislation is not amended again), an individual returning to the UK from abroad will, after exhausting their annual allowance headroom in the tax year of return, potentially also be able to contribute up to a further £180,000 by virtue of the carry-forward rules.

However, any personal (as opposed to employer) contributions made in the tax year of return will only be eligible for UK income tax relief if and insofar as the individual has matching UK taxable remuneration in that tax year. (This is a key consideration for individuals – even high-earnings ones – who only return to the UK towards the end of the year).

The abolition of the lifetime allowance charge is, potentially, especially beneficial to non-UK resident individuals. Whilst the provisions of a double tax treaty between the UK and the member's country of residence may well remove the UK's income taxing rights, the lifetime allowance charge (being a 'special' tax charge) has always been applicable notwithstanding the double tax treaty position.

Non-UK pension plans

Annual allowance testing will also continue to be applicable where UK income tax exempted or relieved contributions are made by or in respect of an individual working in the UK to a non-UK pension plan.

Annual allowance testing operates in broadly the same way as for a registered pension scheme but subject to the special rules applicable to non-UK pension plans. (In certain circumstances, only a portion of the contributions will be subject to annual allowance testing – and with somewhat different carry-forward rules.)

It should not, however, be assumed that the pensions tax rules will always operate in relation to non-UK pension plans in a more generous manner. In particular, special UK statutory rules – whereby ‘lifetime allowance excess’ distributions from non-UK pension plans can in certain circumstances be classified as unauthorised payments – could sometimes result in penal UK tax charges being imposed on such distributions, notwithstanding the abolition of the lifetime allowance charge.

Death planning

Registered pension schemes have long enjoyed a near total exemption from inheritance tax. Indeed, the scope of this exemption has been extended in recent years, as an omission by a seriously ill person to withdraw monies from a registered pension scheme can now no longer potentially give rise to an inheritance tax charge.

Previously, the idea of using a registered pension scheme as an inheritance tax shelter was made considerably less attractive by the fact that, although most post-death distributions were not subject to the lifetime allowance charge, the charge could not usually be avoided.

In particular, all remaining defined contribution ‘lifetime allowance excess’ pension funds would normally be subject to a 25% lifetime allowance charge liability on reaching age 75. Typically, this would have been deducted from the pension fund, reducing future benefits.

An individual might, therefore, now consider not taking any registered pension scheme withdrawals during their lifetime, as no tax charges should then arise either before or on death. Any post-death distributions will, however, normally be subject to income tax at the recipient’s marginal tax rate. Inheritance tax will not apply where the fund is, for example, covered by the individual’s nil rate band or spouse exemption.

In certain circumstances (for example, where the intended beneficiaries are non-UK resident, living in countries where double tax treaties remove the UK’s taxing rights) the abolition of the lifetime allowance charge could make such death planning attractive. However, individuals under the age of 75 should be mindful of the possibility of the lifetime allowance charge being re-introduced.

It is also important to remember that where an employee (aged under 75) dies, any post-death lump sum payment under a registered pension scheme (either a ‘normal’ pension scheme or a ‘standalone’ scheme providing only death benefits) is now to be subject to income tax (previously the lifetime allowance charge) if and insofar as exceeding the deceased employee’s available lifetime allowance. This is another instance of the continued relevance of the lifetime allowance.

Excepted group life policies should therefore continue to be a potentially attractive way for employers to provide employee life cover – as any post-death lump sum payment under such a policy will normally be completely tax-free.

Other reforms

The Finance (No.2) Bill 2023 also makes certain other pensions tax reforms. In particular, low earning employees who make personal contributions to an employer-run pension scheme were sometimes previously unable to obtain income tax relief on such contributions – as under a net pay arrangement (operated by most employers) such relief is given by way of a PAYE reduction.

A non-taxpaying employee (whose income is fully covered by the personal allowance) was therefore previously unable to benefit, as PAYE would not have been applicable in any event. As from 6 April 2024, however, such individuals will receive a special ‘relief payment’ from HMRC, subject to making a claim.

Final thoughts

The recent pensions tax reforms substantially increase the opportunities for making pension scheme savings, but the old complexities surrounding the annual allowance rules remain. Individuals may also need to consider the impact of a future government reintroducing the lifetime allowance charge and the other ways in which the lifetime allowance continues to be relevant. Careful thought as to the amount and timing of both pension scheme contributions and distributions will be essential.

Note: This article covers pension tax issues. It does not constitute financial advice, which may only be given by an authorised financial advisor.