SLAUGHTER AND MAY/

CLIENT BRIEFING

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ALL CHANGE FOR TAX-FREE LUMP SUMS

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The new tax year has arrived, bringing with it two new tax-free lump sum allowances in place of the lifetime allowance (LTA). This step-change in pensions taxation has been delivered by HMRC on an incredibly tight timetable, with significant late tweaks to the legislation (and further amendments expected on some points of detail), presenting a huge challenge for pension schemes in getting reporting and retirement processes ready for the new regime. This Briefing summarises where we are now, and some of the further changes that are expected.

THE NEW TAX-FREE LUMP SUM ALLOWANCES

From 6 April 2024, individuals are entitled to two new tax-free lump sum allowances:

- **The lump sum allowance (LSA):** a fixed cumulative limit of £268,275 (25% of the 2023/24 LTA) on the tax-free cash that can be paid to a person as pension commencement lump sums (PCLS) and as the tax-free part of uncrystallised funds pension lump sums (UFPLS) or stand-alone lump sums. This tax-free cash was previously tested against the LTA. Serious ill-health lump sums and trivial commutation and other small lump sum benefits are not tested against this allowance.
- **The lump sum and death benefit allowance (LSDBA):** a fixed cumulative limit of £1,073,100 (the 2023/24 LTA) on the tax-free elements of lump sums that can be paid in life and death, to or in respect of an individual. In addition to the PCLS and tax-free elements of UFPLS and stand-alone lump sums, tax-free elements of serious ill-health lump sums and most lump sum death benefits use up this allowance.

SOME IMPORTANT DIFFERENCES FROM THE OLD LTA REGIME

Only the tax-free elements of lump sums paid under the new regime use up these two allowances - pensions are not tested. This is a key difference from the LTA, where crystallised pension benefits also used up the allowance. The availability of the allowances is tested each time a "relevant benefit crystallisation event" (RBCE) occurs: that is, when a relevant lump sum entitlement arises.

A wider range of death lump sums are tested against the LSDBA than under the LTA, including (for example) pension protection lump sum death benefits paid on deaths before age 75, with only charity and trivial commutation lump sum death benefits falling completely outside it.

There are no age 75 related tests in the new regime – another significant change.

There are transitional provisions to determine how benefits that crystallised before 6 April 2024, and were tested against the LTA, are dealt with in the new regime – see below for further detail.

TAX PROTECTIONS/ENHANCEMENTS

For both new allowances, holders of valid LTA protection and/or lump sum protection retain higher protected amounts. For example, an individual with fixed protection 2014 has an LSDBA of £1.5mn and an LSA of £375k.

Eligible individuals have until 5 April 2025 to apply for Fixed Protection 2016 and Individual Protection 2016 - previously, there was no fixed deadline for applications for these two forms of protection.

COLLECTING TAX ON LUMP SUMS

Where payment of a relevant lump sum takes the total amount of tax-free lump sums over either of the new allowances, individual recipients are taxed on the excess at their marginal rate of income tax. (Under the LTA regime, until 6 April 2023, a 55% LTA tax charge was payable).

On a retirement, where lump sums are tested against the allowances, the individual's income tax on any excess is collected by pension schemes under PAYE. (This contrasts with the LTA tax charge, which was a joint and several tax liability of the scheme and the individual and was paid by schemes on their quarterly scheme returns).

On a death, HMRC has helpfully confirmed that the personal representatives (PRs) will continue to provide information on death benefit lump sum payments to HMRC, and HMRC will continue to calculate and assess the tax due from beneficiaries where the allowance has been exceeded.

WHAT DOES THIS MEAN FOR LUMP SUMS ON RETIREMENT?

In the final version of the legislation, after ironing out some issues, the lump sums available on retirement are very similar to those available under the old regime. In most circumstances it should be possible after 6 April 2024 to offer the same options around pension commutation to members with significant pensions savings as were previously possible:

- A tax-free pension commencement lump sum (PCLS) can be paid in connection with a pension, where the member has LSA and LSDBA available. The "permitted maximum" is modelled on the LTA approach and is the lower of the available LSA/LSDBA and (broadly) 25% of the capital value of the lump sum and pension.
- Where the member has used up all of their LSA, the remaining benefits can be commuted into a "pension commencement excess lump sum" (PCELS) if scheme rules permit, with no maximum limit. This is similar to the lifetime allowance excess lump sum (LTAELS) under the old regime but there are some differences: for example, the PCELS **must** link to a pension, and be paid in the same time frame as the PCLS. These requirements will typically be met in the defined benefit context.
- It appears that a PCELS cannot be paid in relation to money purchase benefits where it is possible to pay an UFPLS instead under the tax rules (which will be the case for most individuals, other than those with certain protections or enhancements). This may be of significance for recipients, as an UFPLS triggers the £10k money purchase annual allowance, but a PCELS does not.

Retirement processes: Schemes will need to gather information on retiring members' available allowances, just as they did in relation to the LTA, in order to communicate benefit options and work out whether any PAYE is due. In the Pensions Tax Manual (PTM17100) HMRC notes that if a member fails to provide information, the scheme should assume the individual has no LSA available. Trustees should retain documentary evidence in case they later need to demonstrate they took reasonable care in determining the tax position, for example if requesting that HMRC issue a PAYE direction that the tax liability should fall on the employee rather than the scheme. There is currently no HMRC guidance on how this process will work in the pension context.

Reporting to members: Schemes will need to report on lump sums on retirement, showing the amount of the LSA/LSDBA used up, with annual statements being provided where there is a pension in payment, and reporting within 3 months of the lump sum payment otherwise. Annual reporting applies to pensioners over age 75 under the new regime (in contrast to the position under the old LTA regime), so schemes will need to re-start this process for existing pensioners over this age.

Reporting to HMRC: New Event Report 24 is triggered where the lump sum is more than the member's available LSA/LSDBA. It is also triggered where the member relies on a protection and if they didn't have the protection, the standard allowance would have been exceeded. This includes reporting where greater than 25% lump sum protection (scheme specific lump sum protection) is relied on - which wasn't required in relation to payment of PCLS in the LTA regime.

WHAT ABOUT LUMP SUMS ON DEATH?

It will not be necessary for schemes to check the deceased's remaining LSDBA where lump sums paid on death are potentially tax-free, since HMRC will assess and collect any tax due in this circumstance, and available LSDBA does not have to be reported by schemes to HMRC.

As with LTA, some death lump sums are always taxable and are not checked against the LSDBA: for example, a defined benefit lump sum death benefit (such as a salary multiple) payable on death under age 75, where the lump sum is paid outside the "two-year window". Schemes will continue to apply PAYE where these lump sums are paid to individuals.

Reporting to PRs: Schemes will have to report to the personal representatives on death lump sums paid, including reporting the amount of the lump sum and the LSDBA used, within 3 months of the final lump sum being paid.

Reporting to HMRC: Event Report 24 is only triggered where the aggregate of the death lump sums paid by a single scheme in respect of the deceased individual exceed £1,073,100.

TRANSITIONAL PROVISIONS

Where an individual has crystallised benefits before 6 April 2024, these benefits will affect the availability of the new allowances. Default standard transitional calculations apply unless the individual obtains a "transitional tax-free certificate" (TTFAC), showing their actual tax-free cash usage. The position is different where the individual has enhanced or primary protection.

Standard transitional calculations: Where an individual has used up all of their LTA, the default position is that there is no access to the new allowances – the person is treated as having used up all of their LSA and LSDBA. Where some (but not all) of the LTA has been used, the default position in most circumstances is that 25% of the total LTA used is set off against the new allowances. Where either a serious-ill health lump sum (SIHLS) entitlement arose for someone under age 75, or lump sum death benefits were paid on a death before age 75, 100% of the total LTA used is set off against the LSDBA.

The standard calculations are structured so that schemes paying retirement benefits after 5 April 2024 will simply need information on the total amount of LTA already used and whether the member has been paid a SIHLS before 6 April 2024. However, the standard calculations may overstate the tax-free cash actually paid, for example, if an individual did not take maximum tax-free cash at retirement, or where lifetime benefits (including pension) used up LTA, reducing capacity for tax-free cash on death. An affected member (or their PRs) may want to apply for a TTFAC.

TTFAC process: An application can be made to any scheme of which the individual is (or was, immediately before death) a member and must be made (and the certificate issued) before the first RBCE:

- The application must be accompanied by complete evidence of all tax-free lump sums and lump sum death benefits before 6 April 2024.
- The scheme must determine the application within 3 months. The only ground for refusing an application is insufficient evidence.
- The certificate must show the percentage of LTA used (as a percentage of the standard LTA), the "lump sum transitional tax-free amount" (totalling all pre-6 April 2024 tax-free lump sums paid in the member's lifetime) and the "lump sum and death benefit transitional tax-free amount" (totalling all tax-free lump sums paid in life or in respect of the member's death before 6 April 2024).
- If the scheme becomes aware that the certificate is inaccurate, they must cancel it (they cannot amend it). HMRC are still working through how past RBCEs will be dealt with, including any benefits that would turn out to be unauthorised, but future RBCES will be subject to the standard transitional calculation.

Reporting to members on LTA: In order that individuals have up-to-date notice of their LTA percentage used, anyone who is a member of a scheme, and has had a BCE before 6 April 2024 but is not a pensioner, must be provided with an LTA statement in 2024/25. This scenario is likely to be rare in a defined benefit scheme – it could occur if, for example, a partial transfer has been made to a QROPS, and uncrystallised benefits remain. This is a one-off obligation for the current tax year only.

Transitional provisions and reporting to members: Schemes reporting to members on LSA/LSDBA usage under the scheme must also include information on benefits crystallised in the scheme before 6 April 2024, but convert these into LSA/LSDBA used. Where no TTFAC is in place, the assumptions used are similar to the standard transitional calculation. However, where a TTFAC is in force, the actual amounts of tax-free cash received by the member should be reported. HMRC is planning to amend the legislation so that members are required to notify schemes of a TTFAC, and for schemes to only have to switch to the TTFAC reporting basis once they are aware the member has a TTFAC.

STATUTORY OVERRIDES

LTA limit provisions: Late changes were made to the legislation, adding provisions modifying scheme rules which limit benefits by reference to the LTA or the LTA charge. The modifications have effect up until 6 April 2029. The provisions are not straightforward. They do appear to result in benefit limits being retained by statutory override, up until 6 April 2029, where the rule in question refers to the LTA, but there are some areas where the override provisions may not provide a complete solution. As yet, no statutory modification powers have been provided to enable schemes with restrictive amendment powers to hard-code the effect of these provisions into their rules before 6 April 2029.

Lifetime allowance excess lump sum: Any rule which refers to a member's entitlement to or to the payment of an LTAELS is now to be read, as far as possible, as referring to a PCELS. There is a transitional provision so that where entitlement to an LTAELS arose before 6 April 2024 but it is paid later, the pre-6 April 2024 tax treatment applies.

INTERNATIONAL ASPECTS

There are detailed provisions relating to international aspects, including a new "overseas transfers allowance" for transfers to a QROPS, equal to the level of an individual's LSDBA, and application of the overseas transfer charge where the total value of an individual's transfers to QROPS exceeds their available allowance.

FURTHER REGULATIONS

Pensions Schemes Newsletter 158 sets out "further minor technical changes" that will be made in a second set of regulations, noting that these changes will not affect the vast majority of pensions savers as they relate primarily to specific protections or to individuals who plan to transfer to a QROPS. The amendments will have retrospective effect to 6 April 2024. HMRC encourages schemes to make affected members aware of the need for further legislative changes, and notes affected members may need to wait for the regulations to be in place before taking or transferring certain benefits. Affected members might include those with enhanced or primary protection or scheme specific lump sum protection, as well as members requesting QROPS transfers. Schemes should take particular care to identify and inform members with scheme specific lump sum protection, since members typically are not aware of this.

FUTURE COMMUNICATIONS AND GUIDANCE

HMRC is still engaging actively with stakeholders on the LTA abolition and will continue to issue information in future newsletters. A helpful consolidated set of frequently asked questions will be published in a newsletter later this month. Some updates to the Pensions Tax Manual have been published, but the PTM still does not, as yet, always track the FAQs. Also, it reflects the legislation as currently enacted, so does not yet pick up the changes expected in the next round of regulations.

AND FINALLY…

It remains a risk that the new regime will not survive a change of Government, as Labour have said they would reverse the changes. It remains to be seen whether proposals for further change are set out in the Labour manifesto. Having regard to the complexity of the transitional provisions on the abolition of the LTA, the idea of yet further change is a somewhat daunting prospect for pension schemes and their members.

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