

Talking points – PCLS protection

Bulletin 20 | September 2008

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There are three types of lump sum protection: primary, enhanced and scheme specific

They apply in different circumstances and require different calculations to establish how much a member is entitled to. In order to choose the best type of protection for a client, it is worth considering, amongst other factors, the impact that the choice of each could have on the lump sum benefits. In this Talking Point we look at the options and in each case the ways in which the permitted amount may increase in the future.

Pension commencement lump sums (PCLS) are not, apart from any applicable lifetime allowance charge, subject to income tax. Without protection the maximum pension commencement lump sum available is 25% of the standard lifetime allowance (£412,500 in 2008/09) or 25% of the value of the pension if lower. The exception to this rule is where an individual has protected lump sum rights. Lump sum protection under primary and enhanced protection can only be relied on if the member has made an election to HMRC and meets certain conditions. Scheme specific protection is a standalone protection and therefore the rules differ significantly.

Primary protection

To qualify for primary protection on a lump sum, the member must have had:

- » uncrystallised lump sum rights at 5 April 2006 of more than £375,000, and;
- » total pension assets in excess of £1,500,000 at 5 April 2008.

HMRC will issue a primary protection certificate to the individual quoting the monetary value of the lump sum rights (provided they are over £375,000) at 5 April 2006; this becomes the individual's authorised pension commencement lump sum. The figure quoted is increased at the same rate as the standard lifetime allowance to give the individual's total future PCLS entitlement. Where the client has lump sums payable under more than one scheme the PCLS does not need to be paid proportionately from each scheme.

However, an individual cannot just take a PCLS from a scheme without also becoming entitled to some income as a result of the crystallisation event that has occurred, however they may choose nil income from this entitlement. The only exception to this would be if it is possible to crystallise the whole fund under the scheme as a PCLS – the HMRC refer to this as a standalone lump sum.

If a member does not have enough lifetime allowance remaining to cover their primarily protected PCLS then the lifetime allowance charge will still be applied as normal to any excess.

Enhanced protection

In order to qualify for enhanced lump sum protection the individual must have:

- » total lump sum rights (crystallised and uncrystallised) in excess of £375,000 as at 5 April 2006, and;
- » also meet all other enhanced protection rules.

HMRC will issue a certificate confirming enhanced protection. This certificate will show the percentage of the value of total benefits coming into payment, if more or less than 25% of the lifetime allowance that can be paid as a pension commencement lump sum.

Where this form of lump sum protection applies, it takes precedence over scheme specific protection.

If a scheme provides a lump sum of less than the percentage quoted on the certificate, the 'unused portion' of the percentage cannot be used by another scheme (or the same scheme at a later benefit crystallisation event). For example, an individual with enhanced protection has an allowable lump sum percentage of 27%, but one of the schemes of which he is a member only provides a pension commencement lump sum of 25%. The remaining 2% cannot be used at a later benefit crystallisation event. If it is not used it is lost.

Scheme specific protection

There is no minimum monetary amount of lump sum benefits required for scheme specific PCLS protection. However, in order to qualify, the individual's entitlement must contain lump sum rights in excess of 25% of the uncrystallised rights within that scheme as at 5 April 2006. Primary or enhanced protection of the PCLS will override any scheme specific protection as it covers all pension entitlements under all schemes. Where scheme specific protection applies, the scheme will generally be an occupational scheme including section 32 policies. The pension entitlement must not have been transferred since A-day unless the transfer was part of a block transfer (see below). The PCLS must also be taken from the scheme all at one time and cannot be phased.

There is no need to register for scheme specific protection or report it to HMRC, but the scheme must be able to prove the entitlement and confirmation of the entitlements must be passed to any receiving scheme in the event of a block transfer. The entitlement will need to be recorded as a monetary amount at 5 April 2006 and can be increased at the same rate as the lifetime allowance (special rules apply where benefit accrual has occurred).

Transfers

It is possible to make transfers to any registered pension scheme without invalidating enhanced or primary PCLS protection. However, this is not the case with scheme specific protection.

In order to transfer with scheme specific protection, the transfer must be a block transfer, which is basically a transfer that consists of two or more members' benefits being transferred in a single transaction to the same registered pension scheme. The transferring members must not have been members of the receiving scheme for more than 12 months before the date of transfer unless the receiving scheme solely comprises of contracted out benefits. A single transaction is where:

- » the total scheme assets are transferred from a single scheme to another single scheme; and
- » the transaction is made under a single agreement for a transfer between the two schemes.

It is not essential that all of the assets are passed from the transferring scheme to the receiving scheme on the same day but both schemes need to be aware of the intention to rely on scheme specific protection.

Our view

Given the different types of PCLS protection and different ways in which the protection can change over time, all cases need to be reviewed on an individual basis. PCLS protection needs to be considered carefully in cases where a transfer is proposed from a scheme under which the individual has the potential of more than 25% PCLS, such as an EPP or SSAS. These schemes may not have enough information, due to lack of detail provided by the ceding employer, to calculate the PCLS at A-day so ensuring full information is provided and used in the calculations is essential. This is particularly important when relying on scheme specific protection.