Life Time Allowance charge - Don't fall in the traps!

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Saving money into a pension is an important way of building tax efficient funds for use in your retirement. HMRC has made some important changes to how much you are able to amass within a pension. Not only with significant reductions in the annual allowance of how much you can pay in each year but also reductions in the Life Time Allowance (LTA), an allowance for the amount of pension (income or lump sums) that can be taken without triggering an extra tax charge.

The headline tax rates for exceeding the LTA often scare several of my clients. There is the 55% tax if your benefits are taken in the form of a lump sum and the 25% tax charge if your benefits are taken as income.
When individuals read these figures, they often fall into traps when thinking about this allowance which can lead them into making poor decisions with regards to their pension planning.

Trap 1 – You must stop paying in when you reach the LTA

This simply isn’t the case. In terms of your wider planning, there could be several positive reasons for continuing to contribute to a pension once you reach your LTA. You will still be able to receive tax relief on contributions at your highest marginal rate and make use of your annual allowance of up to £40,000. If you decide to decline employer contributions in favour of another form of remuneration, cash equivalent for example, this income will attract tax and national insurance rather than being paid tax free into your pension plus, the pension fund is generally free of Inheritance Tax (IHT).

Employer contributions are free money, so should never be turned away.

Trap 2 – You pay a tax charge as you reach LTA is reached

Once you past the LTA nothing happens, you are simply building additional capital over your allowance, you are not subject to any immediate penalties.

Trap 3 – The tax charge kicks in as soon as you start taking benefits

The charges only start when you have no LTA remaining. Each time you access your pension (crystallisation), either taking tax free cash or income, you use a percentage of your LTA. This means that by phasing your retirement the timing of the LTA charge can be managed and any potential tax charges delayed until age 75 when the LTA is re-tested.

Trap 4 – The penalty for taking benefits over the LTA is 55%

This is only payable if the excess is taken as a lump sum or a series of lump sums (so not on income). This would almost be the worst thing you would do if you go over the LTA and would not represent good planning.

Trap 5 – When you die there is another LTA test

If your funds are already crystallised, there is no second LTA test on death. If your death happens before the age of 75 your beneficiaries will be able to inherit the pot without any further LTA charges or tax.

Conclusion

In my experience, whatever the taxman gives you with one hand he is going to try to take away with the other. Reductions in the annual allowances, tapering of annual allowances for high earners and the reduction in the LTA are a prime example of this.

That being said, if you are considering the impact of the LTA and have fallen into one of the traps outlined above, all is not lost. By building a detailed plan after an assessment of your wider objectives, there are several steps you can take to avoid these traps.

If you have any questions or would like to have a discussion regarding any of the points raised, please do not hesitate to contact us at Wingate Financial Planning.