

Protected cash after the Finance Act 2008 - a significant change

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FA2008 has now received Royal Assent and there is a significant change in the calculation of protected tax free cash. Previously paying a post A Day contribution could add significantly to the protected tax free cash, but it will now no longer do so. The reason for this is that everyone can now increase their tax free cash in respect of post A Day accrual - even when there isn't any!!

In simple terms tax free cash will now be calculated as protected tax free cash increased in line with the increase in LTA (approx rpi) plus 25% of the growth of the fund in excess of the increase in the LTA. (NB this is not the same as increasing the protected tfc in line with fund growth.)

EG At A Day (LTA £1.5m) : TFC £30,000 Fund £60,000

In 2015 (Assumed LTA £2.1m) : Fund £120,000 Revalued Protected TFC £42,000, + 25% (£120,000 - £84,000) = £42,000 + £9,000 = £51,000

At A Day the tfc was 50% of the fund. Under the old rules with no further contribution it would have been £42,000 i.e. 35%, but under the new rule it is 42.5%

The key point here is that we would now exclude for transfer on the basis of 42.5% protected tax free cash.

For those of you looking for more detail below is an article taken from the PFS website.

"The change to the rules regarding the calculation of protected cash in the Finance Act 2008 opens up new opportunities to maximise tax-free cash but may require a new recommended strategy.

Key points

HMRC has altered the way pre-A-day protected lump sums are revalued to their crystallisation.

Old ideas and accepted financial planning norms need to be reconsidered.

Post-A-day accrual is no better via a separate arrangement than by adding to an arrangement made before A-day when it comes to maximising lump sums.

Prior to the changes in the Finance Act 2008 a member with protected pre-A-day tax-free cash under a scheme would have his or her cash under that scheme calculated in two parts. Firstly, the member's protected tax-free cash as at 5 April 2006 would be increased in line with the increase in the standard lifetime allowance over the period up to when the member took tax-free cash. Any additional tax-free cash entitlement under the scheme could only apply where the member had relevant benefit accrual. In such cases this would trigger the calculation of the additional lump sum amount (ALSA) calculation.

ALSA is defined as:

$$[LS + AC - (VUR \times CSLA/FSLA)] / 4$$

For this purpose LS is the lump sum paid and AC is the crystallised fund in respect of pension benefits when the lump sum was paid. VUR is the value of the member's uncrystallised pension rights as at 5 April 2006.

The following example will help to illustrate how this works.

Example

Value of member's protected lump sum at 5/4/2006 £100,000

Capital value of member's pension rights at 5/4/2006 £200,000

Standard lifetime allowance when benefits drawn £2m

Value of member's tax-free cash and pension rights when benefits drawn £400,000

Applying the above and assuming there was relevant benefit accrual the maximum tax-free cash sum is calculated as:

$$(\text{£}100,000 \times \text{£}2\text{m}/\text{£}1.5\text{m}) = \text{£}133,333 + \text{ALSA}$$

$$\text{ALSA} = [\text{£}400,000 - (\text{£}200,000 \times \text{£}2\text{m}/\text{£}1.5\text{m})] / 4 = \text{£}33,333$$

The aggregate tax-free cash sum is:

$$\text{£}133,333 + \text{£}33,333 = \text{£}166,666$$

If no relevant benefit accrual had occurred the member's maximum tax-free cash sum would have been:

$$\text{£}100,000 \times \text{£}2\text{m}/\text{£}1.5\text{m} = \text{£}133,333$$

As can be seen from the above, the payment of even a £1 contribution (that is, relevant benefit accrual) could generate a significant additional tax-free cash sum from the scheme.

The inclusion of the ALSA formula had meant that the accepted wisdom prior to the Finance Act 2008 change was for an individual, where allowed, to pay a further contribution of at least £1, which would constitute relevant benefit accrual and trigger the ALSA calculation, giving the potential of a higher tax-free cash sum.

The Finance Act 2008 has removed the relevant benefit accrual requirement, which means that the ALSA formula will apply automatically.

This change could be particularly significant for those individuals who have protected pre-A-day tax-free cash, which is held under a money purchase scheme to which no further contributions can be paid on or after A-day (that is, no relevant benefit

accrual). For example, there may be individuals with protected cash held under a section 32 arrangement, which does not permit the payment of further contributions. This change may enable the individual to obtain a higher tax-free cash sum from that scheme where the member's chosen investment funds have performed well. This is demonstrated by the following example.

Example

Ralph Barnes' benefits and protected cash are as follows:

Value of protected lump sum as at 5/4/2006 £150,000
Capital value of member's pension rights as at 5/4/2006 £250,000
Standard lifetime allowance (£2m assumed at date benefits drawn)
Value of Ralph's cash and pension rights when benefits drawn £500,000

No relevant benefit accrual has applied under Ralph's scheme on or after A-day.

Ralph's total cash entitlement:

A. $£150,000 \times £2m/£1.5m = £200,000$
Plus
B. ALSA $[£500,000 - (£250,000 \times £2m/£1.5m)] / 4 = £41,667$

Total £241,667

Prior to the Finance Act 2008 change, Ralph's tax-free cash would have been restricted to £200,000.

The Finance Act 2008 change also requires a different strategy when maximising tax-free cash entitlement, where an individual is able to pay ongoing pension contributions. If fund growth since A-day has not kept pace with the increase in the standard lifetime allowance, paying further contributions to the scheme will make no difference to the cash entitlement until the scheme's fund value exceeds the A-day figure, revalued in line with the standard lifetime allowance. Only once this threshold is passed does the ALSA calculation result in more cash (ALSA can never be negative). In contrast, a contribution to another scheme will always generate a 25% pension commencement lump sum. Consider the following example.

Example

As at 5 April 2006, Brenda Jones had an old executive pension plan with a value of £50,000 and protected cash of £14,000. No further contributions have been made to the scheme on or after 6 April 2006. She now wishes to draw her benefits. The scheme is currently worth £51,000.

Under the revised provisions following the Finance Act 2008 she will receive a maximum allowable pension commencement lump sum of £15,400, calculated as below:

$£14,000 \times (£1,650,000 / £1,500,000) + 25\% \times [£51,000 - £50,000 \times (£1,650,000 / £1,500,000)] = £15,400$

In this case, the growth under her executive pension plan (2%) has not kept pace with the increase in the standard lifetime allowance (10%), meaning there is no additional cash arising from the ALSA element of the calculation (in the square brackets).

If Brenda were able to pay a further contribution of £4,000 to the scheme just before she is due to retire, bringing her fund up to £55,000, this would not increase her tax-free cash entitlement at all. There would still be no additional cash arising from the ALSA element of the calculation:

$$25\% \times [\£55,000 - \£50,000 \times (\£1,650,000 / \£1,500,000)] = \£0$$

Were Brenda to pay the £4,000 contribution to a separate scheme this would have provided an additional £1,000 cash sum.

The Finance Act 2008 change means that where an individual wishes to pay further contributions, the starting point for maximising cash is to make the contribution to a new scheme. A contribution to the existing scheme can never produce more cash than the new scheme, but could produce less.

Well done to anyone who has read down to here!!