THE SOCIETY OF PENSION PROFESSIONALS

making pensions work

The Lifetime Allowance:

a review of options

September 2023

The Lifetime Allowance:
a review of options

Foreword

In this year's Spring Budget, the Chancellor announced the intention to abolish the lifetime allowance (LTA) (the maximum value of tax-relieved benefits that an individual could take from UK-registered pension schemes). There had been wide speculation that the Budget would change some of the rules, but the decision to abolish the LTA completely was a surprise. The Finance Bill clauses in the L-Day legislation published on 18 July 2023 gave more detail on how the regime and the legislation will need to be adjusted to allow for the changes, but exactly how this will work in practice is not yet clear.

In this paper, we aim to consider, from a neutral viewpoint, the features of the LTA and discuss the potential consequences of (i) retaining it, (ii) abolishing it, and (iii) abolishing and then reinstating it.

Jasmine Smiley
Chair, Financial Services Regulation Committee, SPP

Faye Jarvis
Chair, Legislation Committee, SPP

Shayala McRae
Deputy Chair, Legislation Committee, SPP

Background

The LTA was first introduced with the annual allowance (the maximum amount that can be paid into an individual's pension each year without an annual allowance charge applying) in April 2006. It is important to remember that, at that time, the annual allowance was £215,000, rising to £255,000 by the 2010/11 tax year (and it did not apply in the tax year in which benefits were taken). This meant that, in practice, the annual allowance was relevant to only a very small number of people, and it was the lifetime allowance that really served to provide a cap on individuals' pension benefits.

The annual allowance was reduced to £50,000 in the 2011/12 tax year and is currently £60,000. The annual allowance is also now tapered for high earners. For anyone with 'adjusted income' over £260,000 for the 2023/24 tax year, the annual allowance reduces by £1 for every £2 of 'adjusted income' above that amount. The tapering stops at £360,000, so everyone retains an allowance of at least £10,000. This restricts a high earner's ability to build a large pension pot.

Given the significant reduction in the amount of the annual allowance, people have been questioning the need for the LTA for a number of years.[1] It is perceived by some to be an unnecessarily punitive taxation, given there is also a restriction on the annual amount of tax relieved pension savings an individual can make.

Who is impacted by the LTA?

There is, among some, a perception that the LTA only impacts the top 1% of the wealthiest pension savers leading to the contention that removing the restriction will only serve to further enrich those individuals[2]. However, as illustrated in our examples overleaf, the LTA impacts a much broader section of savers than that, who will consequently be required to pay a tax charge on the excess amount over the LTA.

1 *TISA calls for reform of DC pensions tax relief (professionalpensions.com)* / *TISA Comments on pension related changes in the 2023 Spring Budget - TISA*
2 *Labour pledges to reverse lifetime allowance abolishment - Pensions Age Magazine*

PERSON A with only defined benefit (DB) benefits

AMY is a headteacher in a London school and is now planning to retire at age 65 having completed 38 years of service. She is entitled to a pension of 1/60ths of her salary for each year of pensionable service in the Teachers' scheme, and her Final Pensionable Salary is £85,000.

Amy is therefore entitled to a pension of £53,833 on retirement (38/60 * 85,000). This pension is multiplied by 20 in order to test it against the LTA, giving £1,076,660. This exceeds the LTA of £1,073,100.

RETIREMENT AGE	PENSION	EXCESS OVER LTA
65	**£53,833pa**	**£3,560**

PERSON B with defined contribution (DC) benefits

IMRAN has worked as an engineer for 30 years and has paid 5% of his pensionable salary into his employer's DC pension scheme throughout. His employer has then matched this contribution and also paid an additional contribution of 4% of pensionable salary – meaning that each month 14% of Imran's salary has been paid into Imran's pension pot. Imran started on a salary of £60,000 and has had salary increases of 3% each year.

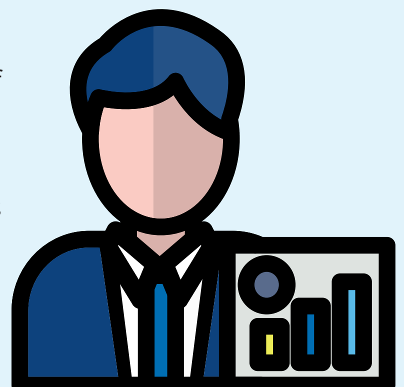
If the average investment return on Imran's pension pot over the years has been 7% pa, on retirement at age 60, Imran will have a pot of £1,088,850. which, If we apply an annuity conversion factor of, say, 16:1, converts into a pension of £68,050 pa. The pot of £1,088,850 is in excess of the LTA of £1,073,100.

RETIREMENT AGE	PENSION	EXCESS OVER LTA
60	**£68,050pa**	**£15,750**

PERSON C with DB and DC benefits

CHRIS worked as a civil servant at the Treasury, rising to the position of Senior Civil Servant, with a Final Pensionable Salary of £75,000 after 20 years of pensionable service. Chris then changes career path and moves into the private sector. In doing so, they take a role which pays £65,000. Chris decides to pay 9% pension contributions, which is matched by their employer, (so the overall contribution into their DC pension scheme is 18% of pensionable salary). They receive salary increases of 3% pa. They then retire 15 years later at age 60.

Firstly, looking at Chris's DB pension, at date of leaving the Civil Service, this would have been £25,000 pa (20/60 * 75,000). If this pension then attracts a revaluation of 2.5% pa, the DB pension at retirement would be £36,210. This pension is multiplied by 20 in order to test it against the LTA, giving £724,200.



Turning to the DC pension, if the average investment return on Chris's pension pot over the years has also been 7% pa, at retirement, Chris will have a pot of £351,300. If we again allow for an annuity conversion factor of 16:1, this will give a pension of £21,960.

Chris's total pension at retirement will be £58,170pa (36,210 + 21,960). The LTA valuation of Chris's total benefits is £1,075,500 (724,200 + 351,300). This exceeds the LTA of £1,073,100.

RETIREMENT AGE	PENSION	EXCESS OVER LTA
60	**£58,170pa**	**£2,400**

The PLSA Retirement Living Standards Report[3] suggests that for a "comfortable" retirement, an individual who is mortgage/rent free and living outside London would need an annual income of £37,300 pa. Although around £10,600 of this currently comes from the state pension, the remainder would be expected to be paid from private retirement savings.

While our examples illustrate numbers that are in excess of the PLSA's standards, it is important to note that none of the individuals in these examples would be in the top 1% of earners in the UK. In addition to this, the standards are based on the assumption that the recipient is mortgage and rent-free and lives outside London. These assumptions will not be correct for many future retirees. Data from the English Housing Survey, for example, shows that the proportion of people over age 45 who rent has increased significantly since 2011-12, and the current cost of living crisis means some homeowners are having to extend their mortgage terms. The DC pension benefits are also non-increasing in payment and, therefore, provide no inflation protection. Current levels of inflation, however, are likely to mean that the amount needed for a "comfortable" retirement will increase the figures suggested by the PLSA.

Consumer impact

Importantly, what consumers need above all else is certainty around the future of the LTA, not only in terms of how any changes will be implemented in the short term but also whether those changes will be maintained in the longer term, especially in the event of a change of Government. Planning for retirement requires decisions to be made now, which will impact savings drawn potentially a long time in the future. Instability in the system and uncertainty over the future of such a major component of the tax regime as the LTA could mean that some people make no or poor decisions regarding their future income. This is not to suggest that pensions must stay the same, pensions must, of course, innovate in order to meet the needs of members – however, consumer confidence is critical. Confidence in the pensions system is more likely to be maintained in a settled environment where changes are gradual, well considered and based on cross-party political consensus (the introduction of auto-enrolment after the last pensions commission is a good example of this).

Also, the practical impact of this uncertainty is that scheme administrators are in limbo as to quotations and communications to issue to members. Scheme administrators might typically issue retirement quotations 4 to 6 months in advance of a member's chosen or assumed retirement date, which entails being in a position to issue appropriate detail to an April 2024 retiree by November 2023 – not leaving much time for Government to finalise its planned legislation, let alone for pension schemes to understand and implement the necessary changes.

Pensions are a complicated subject, not least because pension tax issues are not straightforward, and this can create an ongoing barrier to engagement for many people. Alongside certainty, reducing complexity in the private pension system can support improved outcomes by encouraging saving by consumers who would better understand what happens to the money they pay in and can plan appropriately for the long term.

Removing the LTA

In a DC pension landscape, the LTA can penalise good investment returns and therefore inhibit extra savings by those who are keen to avoid the risk of hitting this threshold. The removal of the LTA will, therefore, also remove this barrier to pension saving.

It can also be argued that in the current annuity market, DC savers are treated less generously than DB savers when measuring their pension savings against the LTA, primarily because for DC schemes, it is simply the fund value (i.e. including all investment growth) that is measured against the LTA whereas for DB schemes it is the value of the annual income x 20, plus any tax-free cash. In conditions where this is the case, as those with a DB benefit are more likely to be older, this, in turn, can exacerbate intergenerational unfairness.

Various forms of LTA protection have been introduced, as the rules have changed. The first, given when the rules were introduced in April 2006, was for those whose benefits were at that time expected to exceed £1.5m at retirement. In return for ceasing contributions or "benefit accrual" they were shielded from LTA charges regardless of the benefit value at crystallisation. The LTA was steadily reduced from its high point of £1.8 million in 2010/11, and other levels of protection were made available in 2012, 2014 and 2016 for those close to the LTA at those times. Whilst it is right that people's benefits are protected against changes that they could not have foreseen, it does introduce further intergenerational unfairness as, in future, those without existing protection will have their entitlement to tax-free cash limited to £268,275, equivalent to 25 per cent of the current LTA.

3 https://www.retirementlivingstandards.org.uk/

There is also a valid argument to state that the removal of the LTA itself could go some way to simplifying pensions and therefore make them more attractive to consumers. The overly burdensome, regularly changing tax regime discussed above undermines consumer confidence in pensions; previous research by Hymans Robertson found that only 23% of UK savers feel in control of their pension and that almost half (48%) do not feel in control because the system changes too much.[4]

One way in which removing the LTA could bring simplification for DB schemes, for example, is in relation to member options at retirement. DB Schemes may want to offer Pension Increase Exchange (where members exchange future pension increases for a higher initial pension) and/or Bridging pension options (where members exchange some of their pension that would be payable after State Pension Age for a temporary pension paid up to State Pension Age). Such options are popular with members but currently very inefficient from an LTA perspective as the higher starting pension would use up more of the allowance and might cause LTA protections to be lost.

We note that the Government is keen to encourage those who have retired early back to work or for those who were thinking of retiring early to reconsider and the LTA could have been a barrier for these workers. With that in mind, removing the LTA could also be argued to currently have some economic rationale.

Retaining the LTA

We were particularly challenged by the process changes required by the Finance Bill clauses. Given the degree to which individuals are expected by existing legislation to understand and comply with their tax obligations in relation to pension allowances, we understand that Government may have legitimate concerns that LTA charge compliance was not always robust and that it is appropriate to consider measures to address this issue. However, the current processes for deduction and payment of tax on LTA were largely defined by the changes to pension taxation that took effect in 2006, when decumulation patterns were much less complex. The changes enacted in 2015, coupled with market conditions, have resulted in more complex investor behaviour, a longer product lifecycle and a wider range of tax outcomes, but without any holistic review of the underlying income tax compliance regime, which is complex and has been enacted piecemeal. To add to this complex landscape, there are also multiple legislators, regulators and rule-making authorities in charge of pensions.

We have seen that the process for removing the LTA is complex in its own right and it could be argued that adding new and significant process changes into this already challenging landscape would clearly increase the complexity more than if we were to retain the LTA but subject it to a more holistic review.

The LTA generates additional revenue for the Government. According to HMRC's update of private pension statistics[5], the total value of LTA charges reported by schemes in 2021 to 2022 was £497 million, which is a £106 million increase from the figure reported over 2020 to 2021. It could also be argued that the LTA is 'fair' given the tax relief awarded on pension contributions and the potential value of tax-free investment returns on the pension assets, and in particular those that are deemed to be over the allowance.

Many employers pay cash in lieu of pension contributions to those employees who are close to the LTA or have LTA protection. There are also some employers who offer such employees participation in an unfunded pension arrangement (known as an employer-financed retirement benefits scheme) so that they can continue to build up pension benefits. The automatic enrolment legislation includes an exception whereby employees with LTA protection do not have to be auto-enrolled. Retaining the LTA means such arrangements can continue on their current terms. Whereas removing the LTA means that employers may have to revisit these arrangements. Employers will want to ensure, for example, that an employee with LTA protection is not able to now opt-in to the employer's pension scheme whilst also retaining a contractual right to the cash in lieu.

Removing and then reinstating the LTA

As highlighted above, instability in the pensions system and uncertainty around its future direction undermines confidence in the system and is likely to negatively impact engagement. This is supported by a recent survey of pension savers by AJ Bell, showing that almost three-quarters expected the LTA to be re-introduced in some capacity in the future, with many holding back from changing their plans because of this. 21% said they thought it would 'definitely' and 52% that it would 'probably' be re-introduced. A further 23% said they were unsure, while just 4% said they felt confident the LTA would not return.[6]

Equally, advisers are taking a similar view, with a survey[7] by AJ Bell finding that 72% expect a future Government to reintroduce the LTA in some form - that either policy will never be fully implemented or will be immediately rowed back if the Government

4 *Government urged to implement a capped rate of tax relief on pensions, rather than move to TEE - Hymans Robertson (Focus group studies were carried out in September 2015 by Populus. These findings were then used as the basis for an online survey of over 2000 people were surveyed by Populus between the 18th – 20th September 2015)*
5 *Private pension statistics commentary: September 2023*
6 *Savers expect Lifetime Allowance to be resurrected by future government | AJ Bell (AJ Bell survey of 2005 SIPP holders in April 2023)*
7 *Nearly three quarters of advisers expecting return of LTA under future govts - Pensions Age Magazine*

changes. Only 5% do not believe a future Government will reinstate the LTA. This is consistent with another survey by Standard Life, where over two thirds (69%) of advisers believe it would be risky for clients to plan on this measure being in place long-term and only 9% think it would be safe for clients to plan on it being in place in future.[8]

Reinstating the LTA will potentially also add an extra layer of complexity if it is decided to offer some form of protection for those who have restarted pension contributions having previously ceased doing so due to concerns about losing protections. And what of the knock to consumer confidence if having made DC contributions in 2023/24 tax year results in the loss of a protection instead?

Where salary supplements have been offered as an alternative to pension contributions, the uncertainty over the future status of the LTA creates a dilemma for employers, who are likely to generally want employees to have pension contributions over cash, so they may want to increase pensions contributions and reduce cash in lieu as soon as possible. But what if the measure is then reversed? And what if employees had already earmarked that extra cash for something else?

Any move to reinstate the LTA for just part of the saver population - e.g. to exclude only NHS doctors from it – may go some way to addressing the short-term issue of NHS waiting lists, but will introduce yet another layer of disparity and is likely to further reduce consumer confidence for the many who will yet again be subject to the restriction[9].

Conclusion

The Society of Pension Professionals does not take a firm view as to whether there should be an LTA or not. There is an economic rationale for both having an LTA and not. However, the LTA being abolished and then reinstated at a later date will increase complexity for a pension system which is already in dire need of, dare we say it, simplification. The cost of abolishing the LTA for schemes is not insignificant; it requires system changes, process changes, updates to member communications, updates to scheme rules and more. The cost of then re-instating the LTA at a later date should not be underestimated, nor should the inevitable complexity of these changes for both schemes and, importantly, their members who may ultimately pay for these changes.

The Society of Pension Professionals (SPP)

SPP is the representative body for a wide range of pension advisers and service providers. The breadth of our membership profile is a unique strength for the SPP and includes actuaries, lawyers, investment managers, administrators, professional trustees, covenant assessors, consultants and specialists.

Harnessing the expertise of its broad membership, the SPP strives to deliver value to its members and improve how pensions work, positively impacting outcomes for pension scheme members, the pensions industry and its stakeholders.

The SPP Vision

A secure retirement for all, supported by a thriving and diverse pensions industry, operating within clear and trusted regulation.

The SPP Mission

To deliver value to our members through education, experience and opportunity to influence. To support the wider pensions industry, government and associated bodies in delivering an effective operating and regulatory environment.

For more information on the SPP, please visit our website or email info@the-spp.co.uk

NOTICE: This document is provided for information only. You may not rely on any part, or all, of this document in deciding whether to take any action or to refrain from action. You may not use this document in part or in whole, or reproduce any statement it contains, without the prior consent of The Society of Pension Professionals. No liability (other than any liability which cannot be excluded by law) arising from your failure to comply with this Notice rests with The Society of Pension Professionals or with any individual or organisation referred to in this document. Liability is not excluded for personal injury or death resulting from The Society of Pension Professionals' (or any other party's) negligence, for fraud or for any matter which it would be illegal to exclude, or to attempt to exclude, liability.

8 *IFA's mostly support budget changes but Lifetime Allowance doubts remain (standardlife.co.uk)*
9 *Finance (No. 2) Bill - Hansard - UK Parliament*

THE SOCIETY OF PENSION PROFESSIONALS

making pensions work

The Society of Pension Professionals
124 City Road, London, EC1V 2NX
T: 020 7353 1688 E: info@the-spp.co.uk www.the-spp.co.uk

A company limited by guarantee. Registered in England and Wales No. 3095982