ADVISER FACTSHEET

JAMES HAY PARTNERSHIP

Tech Talk

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Benefit Crystallisation Events

There are thirteen benefit crystallisation events, many of which are naturally associated with members taking benefits from their registered pension schemes, as well as certain non-UK pension schemes. This Tech Talk will primarily focus on those benefit crystallisation events along with the ones carried out when the individual attains age 75.

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Introduction

When an individual takes benefits from their pension prior to age 75, a benefit crystallisation event (BCE) is likely to occur. Concurrent with the BCE is a lifetime allowance test. The purpose of the BCE is to determine the value of the benefit that is being crystallised, which is then tested against the remainder of the individual's lifetime allowance (LTA).

At present there are thirteen BCEs, though the initial number has been added to over the years, the most recent being a BCE 5C and a BCE 5D which were introduced in 2015 for the purpose of restricting the tax advantages under the new pension freedoms. The other main BCEs, which might be termed non-benefit payment triggers, are:

- BCE 5, 5A, 5B – tests at age 75
- BCE 8 – transfer to a QROPS
- BCE 3 – scheme pension in payment increases above prescribed level (only post 75 BCE)

BCEs only catch authorised member payments; if for any reason a pension scheme administrator made a payment that was not an authorised payment then it would be dealt with under the unauthorised payment legislation and tax charges would apply.

The test is done when the BCE occurs, this being generally when the individual first takes benefits from their pension, or when, for instance, they move from drawdown to a lifetime annuity prior to age 75, though there is an offset for the previous BCE when the funds were originally designated to drawdown (see below for more detail). There are further tests at age 75 and on death before age 75 where the individual's funds are uncrystallised at the time of their death. The current standard lifetime allowance is £1.0m.

Having calculated the value associated with the BCE, it is then tested against the individual's personal LTA. The LTA is simply a mechanism to control the tax advantages of a pension, just like the annual allowance. In theory there is no limit to the total pension rights an individual can hold, however when their benefits are tested against their LTA, and they exceed it, then a lifetime allowance charge is applied.

Benefit BCEs

The BCEs associated with taking pension benefits are as follows:

- BCE 1 – funds are designated to drawdown
- BCE 2 – scheme pension (most commonly, final salary benefits)
- BCE 4 – purchase of a lifetime annuity
- BCE 6 – member becomes entitled to a relevant lump sum

It is important to be aware that the BCE 6 relating to the payment of a pension commencement lump sum (PCLS) comes before the BCE associated with the pension income (through BCE 1, 2 or 4). Although this may, at first glance, appear to be somewhat irrelevant, it has implications and in particular where an individual has a protected lump sum. It ensures that the pension commencement lump sum (PCLS) can be paid where the member is near their lifetime allowance limit, albeit subject to the maximum that can be paid tax-free. If the BCE 6 took place after the crystallisation of the associated pension benefit there might be no available lifetime allowance left, meaning that no PCLS could be paid.

Another instance where a BCE 6 occurs is when an uncrystallised funds pension lump sum (UFPLS) is paid to an individual under the age of 75. As the name implies, the payment of the UFPLS has to be made from funds that have not yet been crystallised, and the individual has to have at least part of their LTA remaining.

The value attributed to the BCE is dependent on the way the benefit will be paid. In the case of a BCE 1 it is the sums and market value of the assets that are designated for drawdown, whereas with a BCE 4 it is the cost of purchasing the lifetime annuity from the insurance company. The amount that crystallises through BCE 6 is the amount of relevant lump sum paid to the individual with the scheme administrator comparing this amount (and the capital value of any other benefits crystallised at that point) with the individual's available lifetime allowance. A BCE 2 is somewhat different in that the value attributed to the event is determined by multiplying the annual level of the scheme pension payable at that date by what is called a relevant valuation factor. Unless otherwise agreed with HMRC, the relevant factor is 20.

SCENARIO 1 – STRAIGHTFORWARD BCE

Jill took the benefits from her final salary pension scheme on 1st August 2017, consisting of a £40,000 scheme pension (BCE 2) and £120,000 PCLS (BCE 6). She had no other pension arrangements and no protection in place.

The amount crystallised through the BCE 2 was £800,000 (20 x £40,000) and the amount crystallised through the BCE 6, £120,000. As Jill has no form of protection in place she was subject to the standard lifetime allowance of £1.0m and the scheme administrator calculated that the benefits she had taken used 92% of her LTA.

If an individual were to crystallise their benefits in the form of a BCE 1, i.e., drawdown, and then elect to purchase an annuity (or a scheme pension) before age 75 with all or part of their drawdown fund, an allowance is made for the amount that had previously been designated to drawdown. This is perhaps best illustrated by the use of the following example.

SCENARIO 2 – DRAWDOWN FOLLOWED BY ANNUITY PURCHASE

Lars decided to crystallise all his SIPP benefits worth £400,000 in May 2016. He took a pension commencement lump sum (PCLS) of £100,000 and used the remainder to provide a drawdown pension. Two BCEs occurred; a BCE 1 for the designation of funds for a drawdown pension and BCE 6 for the provision of the PCLS.

The amount crystallised through the BCE 1 was £300,000 and the amount crystallised through the BCE 6, £100,000. As Lars has no form of protection in place he was subject to the standard lifetime allowance of £1.0m and the scheme administrator calculated that the benefits he had taken used 40% of his LTA.

In August 2017, Lars decided to use half his drawdown pension fund to purchase a lifetime annuity. In the intervening period he had not taken any income from the drawdown fund and his fund had grown to £340,000.

A further lifetime allowance test was triggered through a BCE 4 when the annuity contract was purchased for £170,000. However, the amount crystallised is reduced by £150,000 to reflect the amount that crystallised previously through BCE 1 when the funds were originally designated to provide drawdown pension.

The amount crystallised was therefore only £20,000 (£170,000 – £150,000), and Lars has now used 42% of his personal LTA.

Note that if Lars's drawdown fund had been worth £300,000, or less, at the point he purchased the annuity for £170,000, while the BCE 4 still occurs, no further LTA is used up.

In the situation where an individual is phasing their retirement then all prior BCEs have to be revalued and aggregated to determine how much LTA the individual has left at the current BCE and whether there is any LTA charge to pay. To achieve this, the amount crystallised at previous BCEs is revalued using the adjustment factor CSLA/PSLA where CSLA is the standard lifetime allowance (SLA) at the present BCE and PSLA was the SLA at the previous BCE. If any form of fixed or individual protection applies at a BCE then for revaluation purposes, CSLA and/or PSLA is replaced with the individual's personal LTA where this is greater. Care should be taken if an individual has lost certain forms of protection and previously crystallised benefits when they held the protection, as this could result in an incorrect revaluation (see Scenario 4).

In most scenarios the percentage used by the previous BCE is sufficient in determining how much LTA an individual has left.

SCENARIO 3 – REVALUING PREVIOUS BCE

Alexis crystallised £625,000 of her SIPP on 1st July 2016, taking the maximum PCLS and designated the remaining fund to flexi-access drawdown. Two BCEs occurred; a BCE 1 for the designation of funds for a drawdown pension and BCE 6 for the provision of the PCLS. The SIPP is her only pension arrangement and she holds fixed protection 2016.

The amount crystallised through the BCE 1 was £468,750 and the amount crystallised through the BCE 6, £156,250. Alexis used up 50% of her LTA (625,000/1,250,000 = 50%).

In September 2017 Alexis crystallised the remainder of her SIPP, which was then valued at £800,000, taking the maximum PCLS and again designating the remaining fund to flexi-access drawdown. At the time of the subsequent BCEs, her remaining LTA was 50% of £1.25m (revaluation 625,000 x 1.25/1.25)

The permitted maximum PCLS was £156,250 (25% of £625,000) and the remaining fund of £643,750 was used to provide a drawdown pension. As Alexis exceeded her personal LTA of £1.25m there was a LTA charge of £43,750 (25% of £175,000) to pay, leaving her with a net drawdown fund of £600,000 from this exercise.

SCENARIO 4 – LOSS OF FIXED PROTECTION

Raul successfully applied for fixed protection giving him a LTA of £1.8m. In June 2012 he crystallised £900,000, when the standard lifetime allowance was SLA £1.5m, using up 50% of his personal LTA. Due to a mistake, he paid a small contribution into his Sipp in June 2013 thereby invalidating his fixed protection, however he then applied for fixed protection 2014. He now wishes to crystallise the remaining £600,000. The SIPP is his only pension arrangement.

- Previous BCE
  - £900,000 x £1.5m/£1.8m = £750,000
  - Equivalent to 50% of his LTA (£750,000/£1.5m)
- Current BCE
  - £600,000/£1,5m = 40% of LTA used
- Remaining LTA
  - 10%; currently £150,000

There is one complication to the revaluing of previous BCEs worth noting, and that occurs where the individual holds Primary Protection and the BCEs straddle 6 April 2014. In this scenario a previous BCE(s) occurred before 6 April 2014 and a subsequent one(s) on or after 6 April 2014. If this is the case then the adjustment factor for any BCE prior to 6 April 2014 is derived from £1.5m/PSLA rather than CSLA/PSLA. The £1.5m will apply until the CSLA is greater than this figure.

SCENARIO 5 – PRIMARY PROTECTION

Roberto holds primary protection with an enhancement factor of 0.4. He crystallised benefits on the 01/07/07 (SLA £1.6m) and 31/08/15 (SLA £1.25m). The amounts crystallised were £1.6m and £600,000 respectively. He intends to take the remainder of his unvested rights now and the amount to be crystallised is £0.5m.

His LTA headroom calculation is as follows:

- (£1.8m x 1.4) – (£1.6m x 1.5/1.6) – (£0.6m x 1.0/1.25)

  = £2.52m – £1.5m – £0.48m = £0.54m

Taking the full £500,000 means Roberto is still within his personal LTA

BCEs at age 75

A scheme member's benefits in their pension scheme(s) will always have been tested against their lifetime allowance by their 75th birthday. It is immaterial whether they have drawn their benefits or not, for they are valued and tested for lifetime allowance purposes at that point against at least one of the following BCEs:

- BCE 5 – tests the prospective entitlements the individual holds under a defined benefits arrangement at that specific moment in time
- BCE 5A – tests the net growth since the original designation of funds into drawdown pension.
- BCE 5B – tests any remaining uncrystallised funds held in a money purchase arrangement

Although schemes may insist that benefits are taken before the member reaches age 75, there is nothing in the legislation requiring the individual to do so, and therefore where a scheme will allow the individual to defer taking their benefits beyond age 75, the BCE 5 and 5B ensures all their benefits are tested for lifetime allowance purposes at age 75.

The amount crystallised under BCE 5 is presumed to be the level of benefits the member would become entitled to on their 75th birthday if benefits were paid at that point. It only relates to defined benefits arrangements and the prospective entitlement to a scheme pension and any separate lump sum where applicable. The crystallised values of the potential scheme pension entitlement and lump sum are as described previously.

The BCE 5B was added in 2011 when legislation was introduced to allow individuals to defer taking their money purchase pension benefits beyond age 75. This BCE only applies to unused funds in an arrangement, and the amount crystallised is the value of those funds. The actual value attributed to the BCE is dependent on whether the arrangement is an other money purchase arrangement or a cash balance arrangement.

In the case of an other money purchase arrangement, the remaining unused funds simply mean the value of the uncrystallised element of the individual's arrangement(s). Where it is a cash balance arrangement, the value of the funds under the arrangement will not necessarily reflect the true value of the undrawn rights the member is entitled to under the arrangement. It is not the actual funds held in the cash balance arrangement at that time that are used to value the BCE 5B, but rather, what funds would be necessary if the individual decided to draw benefits at that point.

A BCE 5A, as mentioned before, tests the net growth on the original amount designated to drawdown and operates in a similar way to that of the purchase of an annuity or a scheme pension from funds that had already been designated to drawdown as outlined in Scenario 2. The offset of the amount under the original BCE 1 avoids any overlapping, or double charging, and therefore it is only the investment growth, less any payments of income from the fund, that is tested.

SCENARIO 6 – BCE AT AGE 75

Nigella is nearing her 75th birthday and has fully utilised her LTA. On crystallising her benefits previously she took her maximum PCLS (BCE 6) and designated £1.35m into drawdown (BCE 1). As she has other sources of income she has not taken any income from her drawdown fund which is now valued at £1.6m. She also still has an uncrystallised fund worth £200,000.

If she were to crystallise the £200,000 before her 75th birthday the following options are available:

- Lifetime allowance excess lump sum (pre-75 only)
  - LTA charge rate – 55%
  - Amount received £90,000
- Retained amount
  - LTA charge rate – 25%
  - Amount retained £150,000
    - income taxed at marginal rate

Alternatively, if she decided not to crystallise the £200,000 then on her 75 birthday, as well as the BCE 5A testing the investment growth on the fund previously designated to drawdown, there would also be a BCE 5B on the uncrystallised fund. The following tax charges would apply:

- BCE5A
  - £1.6m – £1.35m = £250,000
  - £250,000 @ 25% = £62,500
- BCE5B
  - £200,000 @ 25% = £50,000

If the pension scheme structure was set up as multiple arrangements with the individual designating funds to drawdown under the arrangements at different times, each BCE is assessed separately. This means that in BCE 5A tests, if under one arrangement the drawdown 'pot' showed a capital loss on the original amount designated under the BCE 1 and under another arrangement the 'pot' had a gain, the former cannot be offset against the latter.

It should be noted that if the individual cannot be traced or they fail to provide sufficient information, the scheme administrator may assume that at age 75 they have no remaining LTA and will apply the appropriate tax charge at 25% on the whole amount of the investment growth and/or uncrystallised funds. One reason for doing so is that the scheme administrator is jointly and severally liable with the individual for the payment of any LTA charge. If it subsequently transpires that the individual had sufficient LTA to avoid in whole or part this charge, then the scheme administrator can request a repayment of the tax charge from HMRC. This could equally apply at any BCE prior to age 75 where the individual fails to provide sufficient information on their personal LTA to the scheme administrator, including whether or not they hold any form of LTA protection.

BCE post age 75

The only BCE that occurs after age 75 is a BCE 3 where a scheme pension in payment is increased beyond a permitted margin. This BCE can also occur pre-75 where the pension is increased in a similar manner. Given that this is the only BCE post age 75, there is therefore no associated BCE when an individual finally takes benefits from their pension arrangement after that age, or if they were to die with remaining uncrystallised funds as they will already have been tested on the member's 75th birthday under the appropriate BCE.

Comment

In the majority of instances valuing a BCE and how much LTA headroom an individual has left is relatively simple. More often than not the percentage remaining of an individual's LTA will suffice. However, there are exceptions and therefore at times it is necessary to go back to first principles and to understand the mechanics of the legislation in order to be able to determine what level of LTA an individual has remaining.

It is hoped that this Tech Talk will shed some light on advisers' understanding of BCEs associated with taking pension benefits. In more complex scenarios the Technical Support Unit is available to offer guidance on the complexities of the legislation in this area.

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Further information

Visit the Technical Hub for further information:

www.jameshay.co.uk/technicalhub

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