BENEFIT CRYSTALLISATION

There are various occasions when a person's pension benefits have to be tested against (and will use up part of) their lifetime allowance. These are known as **benefit crystallisation events** and they most commonly occur when a pension benefit starts to be paid or where a lump sum benefit is paid. If the crystallised value is more than the remaining lifetime allowance available, a lifetime allowance tax charge applies to the excess amount. The way the crystallised value is calculated depends on which of the eleven benefit crystallisation events (BCEs) has occurred:

BCE 1 : Drawdown pension

Where funds are designated to provide a member with an income drawdown.

The crystallised value is the market value of the fund.

BCE 2 : Scheme pension

Where a member becomes entitled to a scheme pension (whether from a defined benefits arrangement or a money purchase arrangement).

The crystallised value is 20 x the yearly scheme pension.

But, if the scheme pension is bought from income drawdown funds, the crystallised value is reduced by the amount originally moved into income drawdown at the outset - to reflect that these funds have effectively already been tested against the lifetime allowance through BCE 1 (that is, when the funds were designated to provide drawdown).

However, there is no BCE 2 where a scheme pension is purchased from a drawdown pension fund that represents benefits crystallised before 6 April 2006.

BCE 3 : Excessive increase to scheme pension

Where a scheme pension in payment is increased at any point beyond a certain level, it is known as the **permitted margin**.

This permitted margin is, in effect, an ongoing cost of living measure. It is measured on an annual rate of increase of the greater of 5% or RPI (although there can be circumstances where the scheme administrator has agreed a different percentage with HMRC).

The crystallised value is 20 x the additional increase.

There is an exemption to cover schemes with 50 or more pensioner members that give the same rate of increase to all members of a particular class of pensioner, so long as there are at least 20 pensioner members in that particular class. In such circumstances, there is no BCE 3.

Increases made after the member's 75th birthday can still be caught through BCE 3. This is the only BCE that can apply after the member's 75th birthday.

BCE 4 : Lifetime annuity purchase

Where a member becomes entitled to a lifetime annuity, purchased under a money purchase arrangement, except where the lifetime annuity is purchased:

- from a drawdown fund after age 75;
- from a drawdown fund which represents benefits that were crystallised before 6 April 2006; or
- before the minimum pension age (unless the member is in ill-health or entitled to a protected pension age). This is treated as an unauthorised payment.

If the lifetime annuity is bought from uncrystallised funds, the crystallised value is the market value of the fund used to buy the lifetime annuity.

But, if the lifetime annuity is bought from income drawdown funds, the crystallised value is the market value of the member's income drawdown fund at the time the lifetime annuity is being bought **less** the amount originally moved into income drawdown at the outset. The reason for this deduction is to reflect that these funds have effectively already been tested against the lifetime allowance through BCE 1 (that is, when the funds were designated to provide drawdown).

Example: Lifetime annuity bought from income drawdown funds

Sandra had a SIPP. In October 2010 she crystallised the full fund (£400,000) taking tax free cash of £100,000. The remaining funds (£300,000) were designated for income drawdown.

In January 2014 Sandra decided to use the full drawdown fund to buy a lifetime annuity. Her fund had grown to £370,000 as she had drawn very little pension from it.

Buying the lifetime annuity triggered a lifetime allowance test through BCE 4 and the amount crystallised was reduced by the amount that crystallised previously through BCE 1 (when the funds were originally designated to provide drawdown).

So, the crystallised value of the benefits that were tested against Sandra's available lifetime allowance was £70,000 (that is, £370,000 - £300,000).

BCE 5 : Defined benefit test at age 75

Where a member reaches age 75 with uncrystallised scheme pension and lump sum benefits from a defined benefit scheme.

The crystallised value is 20 x the yearly scheme pension plus the amount of any separate tax- free cash payable.

If tax- free cash can only be taken by commuting part of the pension, the crystallised value of the benefits is simply 20 x the yearly scheme pension before commutation.

BCE 5A : Test at 75 for drawdown pension

Normally, benefits are only tested against the lifetime allowance once. But for income

drawdown funds brought into payment after 5 April 2006, there can be two tests during the member's lifetime:

- The first when initially going into income drawdown, and
- The second if the fund is used to buy an annuity, provide a scheme pension, or where the member reaches age 75 (if earlier).

The crystallised value of the benefits at the first test is the value of the funds designated for drawdown, after any tax- free cash has been paid (as the tax- free cash is a crystallisation event in its own right).

For the second crystallisation event, it is the value of the remaining drawdown fund (or the value of the scheme pension) less the amount originally moved into drawdown that is tested against the remaining lifetime allowance. This second test doesn't apply to drawdown pension funds that were already in income drawdown before 6 April 2006.

Example: Victoria retired in August 2007 on her 70th birthday. Her only pension provision was her SIPP fund worth £1.2M, from which she took tax- free cash of £300,000 and moved the remaining £900,000 into income drawdown.

Age 70 - Victoria's first crystallisation test

- The **crystallised value** of the benefits was simply the market value of the fund being brought into payment, i.e., £1.2M. This was the total of two events - the payment of tax-free cash and moving the money into drawdown.
- The standard lifetime allowance for tax year 2007/08 was £1.6M, so Victoria used up 75% (1.2/1.6 x 100) of her lifetime allowance, leaving 25% available for future benefit crystallisation events.

Age 75 - Vitcoria's second crystallisation test

Victoria didn't take any income from her SIPP drawdown fund and her successful investment strategy grew her fund to £1.4M. On reaching her 75th birthday in August 2012, she decided to stay in income drawdown rather than commit to an annuity, and so the second crystallisation event was triggered at 75 against the remaining SIPP fund.

- The **crystallised value** for the second test was £500,000 (£1.4M - £900,000).
- The standard lifetime allowance for tax year 2012/13 was £1.5M. Victoria's available lifetime allowance is 25%. This meant he had £375,000 left to use.

The crystallised value of £500,000 was more than Victoria's available lifetime allowance of £375,000, so a lifetime allowance tax charge arose on the £125,000 excess fund. As Victoria was remaining in income drawdown, the tax charge was £31,250 (25% x £125,000).

After the member's death

For funds already in drawdown, there's no lifetime allowance test when they're used to provide lump sum death benefits or survivors' pensions.

Since 6 April 2015, any uncrystallised funds designated, **within two years** of the member's death, to provide drawdown for a beneficiary will be tested against the original member's lifetime allowance.

Uncrystallised funds designated for drawdown after two years will not be tested against the lifetime allowance, but any income will be subject to income tax instead of tax free.

The second test where a member with a drawdown pension fund reaches age 75.

The crystallised value is the market value of the member's drawdown fund at 75 **less** the amount originally moved into income drawdown at the outset. The reason for this deduction is to reflect that these funds have effectively already been tested for lifetime allowance purposes through BCE 1 (when the funds were designated to provide drawdown).

BCE 5A doesn't arise where the drawdown pension fund represents benefits that had been crystallised before 6 April 2006.

BCE 5B : Test at 75 on unused funds

This BCE was introduced from 6 April 2011. Funds in a money purchase scheme no longer have to be designated for income drawdown or annuity purchase at age 75, but can be left as 'unused funds'.

However, the market value of these funds are tested against the lifetime allowance at 75 and, even though benefits aren't coming into payment, a lifetime allowance charge could arise.

BCE 5C : Drawdown pension for a beneficiary

This BCE was introduced from 6 April 2015. It applies if the original member dies before age 75 and uncrystallised funds are designated, within two years of death, to provide drawdown for a beneficiary.

The crystallised value is the market value of the fund.

There is no BCE 5C test if the drawdown designation is made later than two years from the date of the member's death. But, any income taken would be taxable, rather than tax free (within the available lifetime allowance) if paid within two years.

BCE 5D : Lifetime annuity for a beneficiary

This BCE was introduced from 6 April 2015. It applies if the original member dies before age 75 and uncrystallised funds are used, within two years of death, to provide a lifetime annuity for a beneficiary - but only if the date of death was after 2 December 2014.

The crystallised value is the market value of the fund.

There is no BCE 5D test if the lifetime annuity purchase is made later than two years from the date of the member's death, or if the date of death was before 3 December 2014. But, any income taken would be taxable, rather than tax free (within the available lifetime allowance) if paid within two years and the date of death was after 2 December 2014.

BCE 6 : Lump sum on crystallisation

Where the member becomes entitled to:

- Tax- free cash (also known as a pension commencement lump sum) when uncrystallised benefits are drawn under an arrangement;
- an uncrystallised funds pension lump sum (UFPLS);
- a serious ill-health lump sum; or
- a lifetime allowance excess lump sum.

These are collectively referred to as 'relevant lump sums'.

The crystallised value is the amount of the lump sum.

BCE 7 : Lump sum death benefit

Where a lump sum death benefit is paid in respect of the member, either from a defined benefits scheme or from the uncrystallised funds of a money purchase arrangement.

BCE 7 only occurs if the member dies before reaching age 75 and, from 6 April 2015, the lump sum is paid **within two years** of the member's death.

The crystallised value is the amount of lump sum the recipient (or recipients) receives.
From 6 April 2015, there's no BCE 7 if the lump sum is paid out after two years - instead, a lump sum death benefit:

- from uncrystallised money purchase funds would be taxed at 45% if paid in tax year 2015/16, or the recipient's marginal rate of income tax if paid after 5 April 2016; and
- from a defined benefit scheme would be taxed as an unauthorised payment if paid in tax year 2015/16 or, if paid after 5 April 2016, would be subject to income tax at the recipient's marginal rate.

BCE 8 : Transfer overseas

Where benefits in a UK registered pension scheme are transferred to a qualifying recognised overseas pension scheme.

The crystallised value is the total of:

- any money transferred from the scheme; and
- the market value of any assets similarly transferred.

If any of the benefits have already been crystallised under BCE 1 (drawdown) or BCE 2 (scheme pension) an overlap provision applies - the amount crystallised under BCE 8 is reduced by the amount previously crystallised under BCE 1 or BCE 2.

There is no BCE 8 in respect of any part of a transfer overseas from a drawdown pension fund that represents a pension in payment on 5 April 2006.

A transfer from a UK registered pension scheme to a non-UK pension scheme that isn't a qualifying recognised overseas pension scheme doesn't trigger BCE 8. Such a transfer is an unauthorised payment.

BCE 9 : Pension or lump sum errors

Certain pension or lump sum payments made in error, for example, an overpayment of tax free cash because the calculation was based on an incorrect level of pension. Full details can be found in The Registered Pension Schemes (Authorised Payments) Regulations 2009.

The value of the amount crystallised depends on the type payment made.

Hybrid Pension Schemes

A hybrid pension scheme can potentially provide benefits on either a money purchase or defined benefit basis. The calculation of the crystallised value is, therefore, normally dictated by the type of benefits provided.

But, if a member of such a scheme reaches age 75 without having taken their benefits, the crystallised value is taken as the **highest** of the values calculated under either:

- **BCE 5** - the accrued defined benefit at age 75; or
- **BCE 5B** - the unused funds at age 75.

Pre 6th April 2006 Benefits

If someone has existing pensions in payment before 6 April 2006 (known as a **pre-commencement pensions**), including pensions paid by income drawdown, and these are the only pension benefits the individual has, they'll never be considered for lifetime allowance purposes.

But, if the person has other uncrystallised benefits then, when the first benefit crystallisation event (BCE) occurs on or after 6 April 2006, the amount of lifetime allowance available will first be reduced by the crystallised value of any pensions in payment before 6 April 2006. The newly crystallised benefits will then be tested against the person's remaining available lifetime allowance.

Valuation of pensions already in payment before 6 April 2006

For the purpose of this test, any pensions in payment before 6 April 2006 are valued at 25 times the yearly pension - but the calculation of 'yearly pension' depends on the type of pension being paid:

- **Lifetime annuities and scheme pensions** - 25 times the yearly pension in force on the day that first BCE occurs (**not** the yearly rate in payment on 5 April 2006).

- **Capped drawdown** - This depends on the date of the first BCE:
    - **First BCE before 6 April 2015** - 25 times the maximum yearly income allowed under capped drawdown on the day that first BCE occurs.
    - **First BCE after 5 April 2015** - 25 times 80% of the maximum yearly income allowed under capped drawdown on the day that first BCE occurs.

  The intention of this change is to counteract the effect of the increase in capped drawdown limits from March 2014 (an increase from 120% to 150% of the basis amount).

But it means there could be a benefit in delaying a first BCE until after 5 April 2015, as it would result in a lower amount of lifetime allowance being used up.

- **Flexible drawdown and flexi-access drawdown** - This depends on the date the fund first became flexible drawdown or flexi-access drawdown:
    - **Flexible drawdown declaration made in a drawdown year that began pre 27 March 2014** - 25 times the maximum yearly income that could have been paid under capped drawdown when it was designated for flexible drawdown.
    - **Flexible drawdown declaration made in a drawdown year that began after 26 March 2014** - 25 times 80% of the maximum yearly income that could have been paid under capped drawdown when it was designated for flexible drawdown.
    - **Flexi-access drawdown (and not in flexible drawdown pre 6 April 2015)** - 25 times 80% of the maximum yearly income that could have been paid under capped drawdown when it was designated for flexi-access drawdown.

Example: valuing a pension in payment before 6 April 2006 for lifetime allowance purposes

On 5 April 2006 Andrew was receiving a scheme pension of £40,000 a year, escalating at 5% a year.

On 1 June 2007 Andrew decided to crystallise benefits under his SIPP, taking tax free cash and using the remaining fund for income drawdown. At that time his pre-commencement pension had increased to £42,000 a year.

Before testing the SIPP benefits against the lifetime allowance, Andrew's available lifetime allowance had to be reduced to reflect the pension currently in payment. It was reduced by £1.05M (that is, 25 x £42,000) which represented 65.62% of the standard lifetime allowance at that time (£1.6M).

This left him with an available lifetime allowance of 34.38%.

Unauthorised Payments

Unauthorised payments are never tested against the lifetime allowance.

The reason for this is that unauthorised payments attract unauthorised payment tax charges, which are at least equal to the highest lifetime allowance tax charge.

Trivial Funds

The payment of any lump sum under pension triviality or small pots rules is not a benefit crystallisation event. So the lump sum is not tested against, and doesn't use up any of, the person's lifetime allowance.

Despite this, trivial commutation lump sums and winding up lump sums can only be paid if the member has some unused lifetime allowance available. However, small pot lump sums and lump sums paid by commuting a survivor's pension can be paid even if they have no unused lifetime allowance left.



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