



Merseyside Pension Fund Fact Sheet 16: Fixed Protection February 2012

Introduction

The maximum value of pension benefits that an individual may accrue over their lifetime without incurring a tax charge is known as the Lifetime Allowance (LTA). From 6 April 2012 the LTA, is reducing from £1.8m to £1.5m.



This means there will be tax implications for anyone who already has pension benefits valued at £1.5m or more, or anyone who anticipates that the value of their pension benefits will grow in the future to over £1.5m.

Anyone who elects to do so before 6 April 2012 may retain an individual LTA of £1.8m, this is known as Fixed Protection. However, in order to retain Fixed Protection, the value of a person's pension benefits can only grow within very restricted limits.

Anybody who feels that they will be affected by the reduction to the LTA will need to consider whether Fixed Protection is appropriate for their circumstances.

How is the value of pension benefits calculated for LTA purposes?

At retirement the value of pension benefits is measured against the LTA. To determine the value of pension benefits the following formula is used:

$$\text{Value of Pension Benefits} = 20 \times \text{Pension} + \text{Lump Sum}$$

Example 1:

For example, if a member retires with a pension of £70,000 pa and a lump sum of £210,000 the value of their pension benefits is:

$$20 \times \text{£70,000} + \text{£210,000} = \text{£1.61m}$$

This individual's pension value is less than £1.8m, which means that if they were to retire before 6 April 2012, their benefits would be measured against an LTA of £1.8m, meaning there would be no tax charge payable.

However, if this person was retiring on or after 6 April 2012, their benefits would be measured against the reduced LTA of £1.5m. Their benefits would therefore be greater than the LTA and so they would face a tax charge.

If you draw pension benefits from different sources it is the total of all your retirement benefits that is measured against the LTA.

What is fixed protection?

Fixed Protection is a means by which you can retain a personal LTA of £1.8m. To benefit from Fixed Protection, HM Revenue and Customs must be in receipt of your written application **before 6 April 2012**. They have made it clear that late applications will **not** be considered.

There is an obvious benefit to retaining an LTA of £1.8m; however, in order to retain Fixed Protection there are very strict limits on the rate at which your pension benefits may grow.

Fixed Protection will be lost if the value of pension benefits in any tax year grows by more than the annual increase in the Consumer Prices Index (CPI). This is the case even if the value of benefits is below £1.5m when you apply. For the tax year 2012/13 the maximum by which the value of your benefits may grow, without losing Fixed Protection, is 5.2%.

Your benefits will increase every year you are in the Scheme because you will build up another year of membership. Furthermore, every time you receive a pay rise your pension and lump sum will be worth more as they will be linked to a higher pay figure.

You will also lose Fixed Protection if you make any contribution to a Defined Contribution (Money Purchase) arrangement. This includes paying into an AVC arrangement. So you will lose fixed protection if you pay £1 into an AVC fund, regardless of whether the total value of benefits increases by more than CPI.

Example 2:

The following example illustrates how pension growth affects Fixed Protection:

Value of Benefits at 5 April 2012				
Service	Pay	Pension	Lump Sum	Value of Benefits (20 x Pension = Lump Sum)
34 years	£160,000	£70,666	£180,000	£1.59m

In this example the member has benefits valued above £1.5m. If they have already applied for Fixed Protection, they may feel that they have a protected LTA of £1.8m and need not worry about a tax charge.

What happens if the member receives a pay rise of 2.5%?

Value of Benefits at 5 April 2013				
Service	Pay	Pension	Lump Sum	Value of Benefits (20 x Pension = Lump Sum)
35 years	£164,000	£75,166	£184,500	£1.69m

In the course of the year the member has built up another year's pension membership and had their benefits linked to a higher pay figure. The growth in their pension value is actually 6% which is greater than the CPI figure of 5.2%.

In this case the member has lost fixed protection and when they retire any value above the standard LTA of £1.5m will be taxed.

Should I apply for fixed protection?

There is no penalty for applying for fixed protection and then losing it, but if you apply and then experience pension growth in excess of the permitted maximum you must inform HM Revenue and Customs or face a penalty.

Whether Fixed Protection will be of value to you is a complex decision. The Fund will be able to supply you with information about the value of your pension benefits but we cannot advise you on whether you should apply.

The decision will depend on your individual circumstances. The following list is not intended to be exhaustive but some of the things you might like to consider in reaching a decision are;

- The current value of your pension benefits.
- How far you are from retirement and what your anticipated career progression is during that time. The further you are from drawing benefits, the more difficult the decision as more variables come into play.
- Your intentions at retirement. For example do you expect to maximise the amount of tax free cash you take or are you anticipating taking the largest annual pension available.
- There are also a number of external factors which will be out of an individual's control but which will have an effect on whether tax is paid.
- What will CPI be between now and retirement?
- Will the government increase the LTA limit of £1.5m in the future?
- How will future changes to the LGPS interact with the LTA rules?

Unfortunately, the answers to these will only be known in hindsight.

Please Note:

If you have previously applied for Primary Protection and/or Enhanced Protection you **cannot** also apply for Fixed Protection. If you have either of these other types of protection you are strongly advised to seek financial advice as to which protection best meets your needs.

Can I opt out of the Scheme to retain fixed protection?

If you opt out of the LGPS your benefits will be deferred and will increase each year in line with CPI. This means that benefits will be increasing in line with the maximum amount allowed under Fixed Protection. You will be assured of maintaining Fixed Protection.

However, you are advised to be very cautious before considering this approach. To illustrate why, we return to the individual in Example 2.

Example 3:

Suppose the member retires on 5 April 2013 with a pension of £75,166 and a lump sum of £184,500. They have lost fixed protection and so must pay tax on the value of benefits over £1.5m.

In this example, the effect of paying that tax would be to reduce the pension payable every year from £75,166 to £72,818.

There is clearly a penalty to the member as a result of the tax, but they are still better off than if they had opted out of the scheme in April 2012 in an effort to keep fixed protection. If they had done that they would have avoided a tax charge but would instead be drawing a pension of £70,666 and would have received a lump sum that was £4,000 lower.

Everybody's circumstances are unique, but in this case the extra benefits the member earns being in the Scheme outweigh the effects of the tax charge.

If you leave the Scheme you will also be giving up valuable life insurance benefits for your family, an enhanced retirement package should you fall ill, tax relief on all your pension contributions plus a generous contribution from your employer towards your retirement.

How is the tax charge calculated?

The amount of any tax charge payable is highly dependent on individual circumstances and decisions made at retirement. Broadly speaking though, if the tax charge is recovered through pension the excess value is taxed at 25% and if it is recovered through lump sum it is taxed at 55%.

How can I find out more?

HM Revenue and Customs have produced a newsletter designed to provide further information on Fixed Protection. The newsletter contains information about how to apply for Fixed Protection and can be accessed online at:

<http://www.hmrc.gov.uk/pensionschemes/newsletter50.pdf>

Contact Us

The Fund will not be able to give you advice about whether or not Fixed Protection is right for you. The decision is a complex one and is highly dependent on your own personal circumstances.

If you are unsure whether to apply or not you are strongly advised to seek independent financial advice.

If you require any further information about your pension benefits or the Local Government Pension Scheme in general, please contact us using the details below:

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