DB to DC case study – lifetime allowance charge

Are you concerned that if you transfer a client's defined benefit (DB) scheme to a defined contribution (DC) scheme there might be a possibility that a lifetime allowance charge may arise?

This guide is designed to give intermediaries information that they can use to help control and develop their business and should not be relied upon by clients. It should be noted that the FCA rules on defined benefit transfers continue to require advisers to start from the assumption that transferring will be unsuitable. However, the FCA also states this doesn't prevent an adviser from recommending a transfer where this can be demonstrated to be suitable to the client.

Meet Julia: a case study

Julia:

- was approaching 60 and was divorced;
- left her employer after lengthy service in a senior position, and
- was in the fortunate position of having a deferred DB pension entitlement of £41,000 a year.

Using a commutation factor of 15:1 under the DB scheme, she was able to:

- convert part of her pension for a pension commencement lump sum (PCLS) of £189,230, and
- receive a reduced yearly pension of £28,385.

She didn't have any other benefits elsewhere.

The information in this case study is based on our understanding of current taxation law and HM Revenue and Customs (HMRC) practice, which may change. The tax treatment depends on the individual circumstances of each client and may be subject to change in future.

Julia's existing scheme

If she had taken benefits from the DB scheme there was no prospect of a lifetime allowance charge arising. The 20:1 factor used to value the scheme pension plus the face value of any PCLS, would have produced a value of £820,000 on full pension alone (or £756,930 if PCLS and the reduced pension were chosen), well below the standard lifetime allowance (ignoring any ability she had to apply for lifetime allowance protection).

Julia’s dilemma

Due to a range of ‘soft factors’, Julia considered a transfer to a DC scheme. These factors included:

- the inflexibility of the DB scheme pension not suiting her circumstances or financial plans;
- she had recently divorced and had grown-up children and young grandchildren, and
- she wasn’t in ill health, but death benefits had also been a major consideration in her desire to improve the death benefit options available and expand the range of possible beneficiaries.

Her adviser carried out a comprehensive review of her circumstances, that examined:

- her income needs in retirement;
- the roles that the existing and receiving schemes played in meeting her objectives;
- the comparable death benefits available;
- the results of the transfer value comparator, and
- her attitudes to transfer risk and investment risk.

Julia's adviser recommended that she transfer benefits to a DC scheme. As part of the financial review and personal recommendation, her adviser recommended an appropriate investment strategy that matched her attitude to investment risk. Her adviser believed this would deliver the level of investment return required to meet or better the guaranteed income she could get under the DB scheme.

Julia's adviser explained that unlike her guaranteed yearly income from her DB scheme she was transferring to a capital at risk DC scheme where the value of her pension pot could fall as well as rise. This could negatively impact the income she could receive in retirement.

The transfer and part crystallisation

The cash equivalent transfer value (CETV) paid to the DC scheme was £1.45 million. The advice given recognised the fact that a transfer to a DC scheme would ultimately lead to a lifetime allowance charge in future. However, the adviser had outlined a strategy to carefully manage the ‘excess’ funds and delay and minimise the lifetime allowance charge arising.

With no DC contributions paid or DB accrual on or after 6 April 2016, Julia was eligible to register with HM Revenue and Customs (HMRC) for fixed protection 2016 and an increased lifetime allowance of £1.25 million (individual protection 2016 wasn't available as the value of benefits - held in the DB scheme on 5 April 2016 – didn’t exceed £1 million).

Julia turned age 60 shortly after the transfer and following receipt of the fixed protection 2016 reference number from HMRC, (which she disclosed to the DC scheme) she immediately crystallised benefits worth £1.25 million:

- exhausting 100% of her available lifetime allowance;
- taking 25% as PCLS (£312,500), and
- moving the balance of the crystallised funds (£937,500) into drawdown.

Second benefit crystallisation event

Her adviser explained that the drawdown funds would be tested again at age 75, or on earlier annuity purchase. As she had no lifetime allowance remaining, a strategy was agreed to regularly monitor the drawdown funds and take any investment growth on these funds as income payments. The aim of this was to minimise or eliminate any lifetime allowance charge applying at the second benefit crystallisation event.

Funds over the lifetime allowance

While Julia has no lifetime allowance remaining she isn't under any obligation to take the remainder of her uncrystallised funds at this stage – and before age 75 only benefits actually being crystallised are tested against the lifetime allowance.

The remaining £200,000 uncrystallised funds can remain invested and the tax charge deferred to a later time until:

- she decides to take benefits; or
- age 75 if earlier, or
- her death if before age 75.

This could be as long as 15 years away as things stand and she has the potential for tax-advantaged growth on those funds in the meantime.

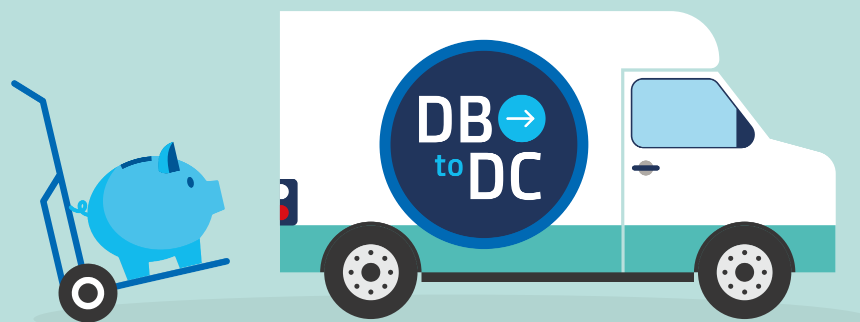
If Julia dies before age 75 the 'excess' uncrystallised funds would be tested although they'd be paid in full to the beneficiaries who'd then be liable for the lifetime allowance charge. Julia has nominated her adult children and grandchildren to receive the death benefits.

If chosen by the DC scheme trustees when exercising their discretion, it may be beneficial if the selected beneficiaries choose to:

- designate the 'excess' uncrystallised funds into drawdown within the standard two-year period, and
- take the death benefits as income.

This means only an initial 25% lifetime allowance charge is deducted (the subsequent income would be tax free as death occurred before age 75) rather than taking the 'excess' uncrystallised funds as a lump sum with a 55% lifetime allowance charge.

The advice given recognised the fact that a transfer to a DC scheme would ultimately lead to a lifetime allowance charge in future but the adviser had outlined a strategy to carefully manage the 'excess' funds and delay and minimise the lifetime allowance charge arising.



Summary

The prospect of a lifetime allowance charge isn't the end of the world. A DB to DC transfer may still be worth considering and advisers can help clients maximise the advantages of a transfer while minimising any lifetime allowance charge that may apply.

In Julia's case, a lifetime allowance charge will apply at some point but it wasn't a barrier to the transfer proceeding due to:

- the comprehensive review of her circumstances;
- the adviser's expertise, and
- the agreed advice strategy.

Julia was able to take advantage of:

- the high CETV available;
- the PCLS amount available under the DC plan being greater than the DB scheme, and
- a recommendation from her adviser to take a 'safe withdrawal rate' providing a broadly comparable level of income that would have been available under the DB scheme.

The transfer did mean that she lost the benefit of:

- a dependant's pension (although it wasn't appropriate in her circumstances), and
- automatic indexation of her pension in payment.

But, Julia had dramatically improved the death benefit options available and widened the range of possible beneficiaries. She had also achieved another of her key objectives in improving the flexibility of her benefit options giving an opportunity to manage her income needs with maximum tax efficiency.

Aegon Retirement Choices SIPP, Aegon SIPP and One Retirement

Any financial review and personal recommendation to transfer benefits from DB to DC will include an assessment of the suitability of the receiving scheme, the investment choices, benefits, and options that are available.

The Aegon Retirement Choices (ARC) SIPP, Aegon SIPP and One Retirement offer the full income and death benefit flexibilities that were introduced for DC schemes in April 2015. They give clients more control over their pension savings and also a wide investment choice that can be tailored to meet their individual risk appetites.

You should be comfortable with the investment choices that you make for your client as they may lose features, protections, guarantees or other benefits when they transfer. Please also remember that a transfer to the ARC SIPP or One Retirement is moving to an investment based product where the client's capital is at risk and the final value of their pension pot may be less than has been paid in.

For more information on DB to DC transfers, have a look at our DB transfer hub, which aims to help with the suitability assessment and important areas to consider before deciding if a transfer is suitable.

aegon.co.uk/dbhub

If you have any questions, please speak to your usual Aegon contact.