Pension lump sums

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The Government provides tax relief to support saving to produce an income in retirement. However, it also allows part or all of a pension to be taken as a lump sum in certain circumstances. Before April 2006, there were no fewer than eight different sets of tax rules in use for pensions, with different rules governing the circumstances in which lump sum payments could be made. However, the *Finance Act 2004* introduced a single set of rules applying to saving in all kinds of pension schemes. These rules split benefits into authorised and unauthorised benefits. Unauthorised payments are subject to additional tax charges, such that HMRC does not expect many to be made. However, the amount and type of benefit an individual can receive depends on pension scheme rules.

Under the current rules, lump sums only count as authorised payments if specific circumstances. For example, there is the option of a tax-free pension commencement lump sum, usually 25% of an individual's pot. There are also rules allowing small amounts of pension saving can be taken as a lump sum. Provided certain conditions are met:

- An individual aged 60 and over, with overall pension savings of less than £30,000 may be able to take them all in one lump sum – this is 'trivial commutation';
- Regardless of their total pension wealth, if they are aged 60 or over, they may be able take a 'small pot' worth less than £10,000 as a lump sum.

Increases to the thresholds for trivial commutation and small pots were announced in Budget 2014 and legislated for in the *Finance Act 2014* (section 42).

The Government is also consulting on proposals to introduce increased flexibility for people with defined contribution pension savings from April 2015. Under the new system, people aged over 55 would be able to withdraw their savings at a time of their choosing subject to their marginal rate of income tax (Budget 2014, para 1.165). These changes are to be legislated for in a Pension Tax Bill to be introduced to Parliament in the autumn. For more detail, see SN 6891 Flexibility for DC pension savers from April 2015.

Contents

1 Background

The lifespan of private pensions can be divided into three stages (contributions, investment and withdrawal). At each stage there are tax implications for the individual concerned. The UK tax treatment of pensions follows and "exempt, exempt, taxed" (EET) model":

- (Exempt). Pension contributions by individuals and employers receive tax relief and employer contributions are exempt from national insurance contributions;
- (Exempt). No tax is charged on investment growth from pension contributions; and
- (Taxed). Pensions in payment are taxed as other income, but individuals are able to take up to 25% of their pension fund as a lump sum on retirement.[1]

This is discussed in more detail in Library Standard Note SN 625 Tax and private pensions.

The last major reform of the system was the introduction of the pension tax simplification regime under the *Finance Act 2004.* As a December 2002 consultation document explained, the aim was a radical simplification of the tax rules governing pensions:

> **Principles of reform**
>
> 1.5 In reshaping the tax rules for pensions, the Government seeks to achieve a transparent, consistent and flexible system which can be readily understood. Simplicity should hold compliance costs down, deliver clearer incentives to save and so encourage real competition among suppliers of pensions in the retail savings market.
>
> **The main proposals**
>
> 1.6 Unlike previous changes to the taxation of pensions, this reform proposes a clean break. Pension rights built up before the reform is implemented will be respected. All pension saving after implementation will follow a single set of rules which will apply to

[1] HM Treasury, *Removing the requirement to annuitise by age 75*, July 2010, para 2.3

> saving in all kinds of pension schemes. And there will be a single set of simple rules about how pension savings are turned into benefits.[2]

More detailed proposals for reforms were announced in December 2003[3] and the changes were legislated for in the *Finance Act 2004*.[4]

Pension tax law now splits benefits into authorised and unauthorised benefits. However, the amount and type of benefit an individual can receive depends on pension scheme rules. HMRC explains:

> **What benefits can I have from a pension scheme?**
>
> The tax rules do not set any limits on the amount or type of benefits you can take from a pension scheme. But when you take benefits, how much and how they are given to you will affect how the benefits are taxed.
>
> **Authorised and unauthorised benefits**
>
> The tax legislation splits benefits into authorised and unauthorised benefits.
>
> Unauthorised benefits will have an extra tax charge on them and so we do not expect many to be paid. For more details on unauthorised benefits please see RPSM09208000.
>
> The tax legislation sets out if a payment is an authorised or unauthorised payment.
>
> Normally you benefits will be authorised benefits. These include the main benefit types of
>
> - a pension paid for life,
> - a lump sum benefit paid when the pension starts,
> - a lump sum benefit if you die before you start a pension, and
> - a pension paid to one or more of your dependants following your death.
>
> Benefits paid to you are described in more detail in the rest of this section. Benefits paid following your death are described in Chapter 10 – RPSM10200000.
>
> **What do the rules of your pension scheme say?**
>
> The amount and type of benefit that you can actually receive will depend on what the rules of the pension scheme you belong to say. When you join your pension scheme you should be given information about what benefits you will get, and when benefits can be paid you. You should also be told about any changes to your benefits.
>
> You should speak to the administrator of your pension scheme if you have a question on what benefits you are entitled to from your scheme. See RPSM09200060 for Information on how to find out who the administrator of your scheme is.[5]

Unauthorised benefits will have an extra tax charge on them and so HMRC does not expect many to be paid.[6]

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[2] HM Treasury, *Simplifying the taxation of pensions: increasing choice and flexibility for all*, December 2002

[3] HM Treasury, *Simplifying the taxation of pensions: the Government's proposals*, December 2003

[4] The background is described in more detail in Library Standard Notes SNBT 2984 *Pension tax simplification*

[5] HMRC, Registered Pension Schemes Manual (RPSM), page RPSM09200030

Under current rules authorised payments include:

- a scheme pension – pension paid by the scheme administrator, or an insurance company selected by the scheme administrator, payable for life and except in certain specified circumstances cannot reduce;
- a lifetime annuity – an annuity paid for life or, if greater, a guaranteed period of up to 10 years, for which the member had the opportunity to select the insurance company and which except in certain specified circumstances cannot reduce; or
- a drawdown pension – there are two types of drawdown pension, capped drawdown and flexible drawdown.[7]

Lump sum payments are authorised in set circumstances:

Lump Sums

Authorised payments of lump sums to members are set out under section 166 *FA 2004* and to dependants in section 168 *FA 2004.*

Trivial commutation

A trivial commutation lump sum can be paid when the member is 60 or over and the total value of their pension rights under all registered pension schemes is less than the commutation limit, and the lump sum extinguishes all of the rights the member has under the scheme. The current trivial commutation limit is £30,000.

Small pots

The *Registered Pension Schemes (Authorised Payments) Regulations 2009 (SI 2009/1171)* allow for up to three small personal pension funds of £10,000 or less to be paid out as lump sums. Also a lump sum can be paid where, were it not for the fact that the lump sum would not extinguish all of the rights under the scheme because of an annuity in payment, the lump sum could have been paid as a trivial commutation lump sum. There is no limit on the number of lump sums up to £10,000 that may be paid out of an occupational pension scheme.

Pension commencement lump sums

A tax-free lump sum known as the pension commencement lump sum ('PCLS') can be paid only in connection with the member becoming entitled to a pension. Aside from the temporary changes mentioned below, the PCLS must be paid no more than six months before they become entitled to the associated pension and no more than 12 months after the entitlement to the associated pension arises. The PCLS must be paid from the same scheme as the associated pension. Paragraphs 1 to 3A of Schedule 29 to FA 2004 set out the conditions for a lump sum to be a PCLS.

Schedule 5 of FA 2014 introduced a number of temporary changes to the PCLS rules where the intended PCLS is paid before 6 April 2015. These changes allow for a lump sum to be an authorised PCLS where entitlement to the associated pension occurs more than six months after payment of the PCLS, provided the entitlement to the associated pension arises by 5 October 2015. The changes also allow for the

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6 ibid

7 HMRC, Tax Impact and Information Note – Pension Flexibilities, August 2014

associated pension to be paid from a scheme other than the scheme from which the PCLS is paid.[8]

An overview of the rules can be found on HMRC website – Taking a small pension pot as a lump sum. More detailed guidance can be found in HMRC's *Registered Pension Schemes Manual* (RPSM). For example, see, for example, the section on *Members Benefits: Lump Sum Benefits*. The Money Advice Service has produced a number of leaflets on *Pensions and Retirement* including "Your pension: it's time to choose".

2 Small amounts of pension saving

According to the ABI, the average (mean) annuity in 2013 was bought with a pension fund of around £35,600 but the median was around £20,000, so half of people buy an annuity with less than this.[9]

2.1 Trivial commutation

People with small pension pots may be able to take all of it as a lump sum. The purpose is to ensure that "members will not be forced to purchase an annuity with very small amounts of pension savings which could prove to be uneconomic and disproportionately bureaucratic for both schemes and members."[10] However, in devising policy, this is "weighed against the need to make sure that pension savings, which attract favourable tax treatment, are ring-fenced to generate income in retirement."[11]

The pension tax simplification rules introduced in April 2006 included provision for a "trivial commutation lump sum" to be paid in certain circumstances. In its 2002 document, *Simplifying the taxation of pensions: increasing choice and flexibility for all* the Labour Government said it proposed to allow people aged 65 or over with total pension savings under £10,000 to take them as a lump sum. It described this as a valuable existing concession which would help people with relatively small pension savings:

> 5.35 The reform proposals will extend a valuable existing concession in order to help people with relatively small pension savings. It can be administratively inconvenient, and correspondingly expensive, to turn such small funds into pension income. The current rules do permit some small benefits to be paid as a lump sum rather than as an income stream – a process known as trivial commutation.
>
> 5.36 These rules, which allow conversion of all pension rights to lump sums for funds smaller than would deliver benefits of £260 a year, are overdue for reform. In future the new rules will be more liberal. They will allow people over 65 whose total matured pension funds from all sources amount to no more than £10,000 in value to take them, if they wish, as a lump sum. The first 25 per cent of the lump sum will be tax free, and the remainder taxed as income. The Department for Work and Pensions (DWP) will need to make matching changes to its rules.
>
> 5.37 It will be important for this rule to apply to accumulated funds from *all* of someone's matured pension savings, including any part which represents protected rights – that is, funds saved by people who pay lower national insurance contributions by contracting out so as not to receive the state second pension. This measure is not intended to be a way of allowing people to fragment their funds in order to extract

8 HMRC, Tax Impact and Information Note – Pension Flexibilities, August 2014; HMRC, RPSM 9100330; *Finance Act 2004* section 166, section 29 para 12

9 ABI, The UK Annuity Market Facts and Figures 2013

10 HC Deb, 4 April 2005, c1174W

11 HC Deb, 1 Jun 2009 : Column 101-2W

capital from pension savings built up with tax breaks. So it will not be possible to commute funds in this way more than once.

5.38 Relaxing the commutation rules will help people on lower incomes who will find larger lump sums attractive. It will end the practice of forcing people to buy small protected rights annuities, which rarely offer good value since relatively few providers are willing to accept very small funds for turning into annuity income. [12]

In December 2003, it announced that it had refined its proposals in response to consultation responses:

A79. The Government proposes to allow members to commute voluntarily small pensions provided that:

- such commutations occur during a single period of 12 months, selected by the member, starting no earlier than the member's 60th birthday and ending no later than the end of the day before his or her 75th birthday;

- commutation must extinguish all pension rights or payments due to the member from the scheme or the annuity. If a scheme has a number of arrangements or tranches, all the benefits from all such arrangements or tranches must be extinguished by the trivial commutation;

- no further voluntary commutation of benefits on triviality grounds outside the chosen twelve month period will be permitted; and

- the member may take the entire scheme benefit as a lump sum from any number of schemes or annuity contracts up to an aggregate of 1 per cent of the lifetime allowance (the total amount commuted to date must not exceed 1 per cent of the lifetime allowance applicable at the date of the latest commutation).

A80. For this purpose:

- it does not matter whether the member's total benefits across all pension schemes amount to more than 1 per cent of the lifetime allowance, provided that he or she commutes no more than 1 per cent on triviality grounds; and

- any tax free lump sums in respect of non-trivial benefits that the member may already have taken or plans to take during the year will not count towards the 1 per cent limit.[13]

Provision was made for this in Part 4 of the *Finance Act 2004* (section 166 and schedule 29).

Although initially, the trivial commutation limit set at 1% of the lifetime allowance (LTA), the two were decoupled when the lifetime allowance reduced from £1.8 million to £1.5 million from April 2012.[14]

The Government announced in Budget 2014 that the trivial commutation limit would increase from £18,000 to £30,000 with effect from 27 March 2014 (see section 2.3 below).

[12] HM Treasury and Inland Revenue, Simplifying the taxation of pensions: increasing choice and flexibility for all, December 2002
[13] HM Treasury and Inland Revenue, Simplifying the taxation of pensions: the Government's proposals, December 2003
[14] HM Treasury, *Restricting pensions tax relief through existing allowances: a summary of the discussion document responses*, October 2010, para B.13

2.2 Small pots

One effect of the rules introduced in April 2006 was that it was no longer possible to commute some sums that could previously have been commuted. Previously, it had been possible to commute a pension if was less than £260 per annum and no account had to be taken of any other pensions in payment.[15] At the time of *Budget 2008* it was announced that changes would be made to help more members of occupational pensions with small pensions:

> 8. Additionally, some easements will be made to the rules for 'trivial commutation' – the circumstances in which pension rights giving rise to very small pension entitlements can be commuted into a lump sum up to 25 per cent of which would be tax free. Regulations under the widened power set out above will provide that it will be possible to commute some small 'stranded pots' as well as pension savings below £2,000 in occupational pension schemes. These will have effect in addition to the current rule that restricts the aggregate of an individual's pension savings to £16,000 for trivial commutation.[16]

The *Finance Act 2008* (section 92 and schedule 29) made provision for "stranded pots to be commuted as lump sums and to allow a *de minimus* limit for commutation payments by occupational pension schemes."[17] The detailed rules are in the *Registered Pension Schemes (Authorised Payments) Regulations 2009* (SI 2009 No. 1171).[18]

These regulations also made provision for a small lump sum payment to be made to a scheme member in very limited circumstances "typically following the discovery of certain errors, unanticipated rights or to resolve certain obligations."[19] Regulations also have been made to cover the payment of certain lump sums representing commuted equivalent pension benefits (contracted-out rights earned between 1961 and 1975).[20] In *Budget 2010,* the Labour Government explained that it was open to considering proposals for additional flexibility for members with personal pensions, provided they did not increase Exchequer costs or add significant costs for HMRC.[21]

In April 2011, the current Government said it would explore ways to allow personal pensions of less than £2,000 to be taken as a lump sum:

> 2.39 The Government acknowledges the high number of responses calling for an equalisation of the current rules which allow small pots of less than £2,000 to be commuted for occupational pension schemes, but does not currently extend to

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[15] Chris Lewin and Ed Sweeney, 'Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions', July 2007, para 82; DWP, *Deregulatory review – Government response,* October 2007, para 2.10.2

[16] HMRC, Budget 2008 Notes, BN 42, *Pensions: Regulation making powers*

[17] *Finance Bill 2008*, Explanatory notes, para 76, Clause 89 and Schedule 29; Finance Bill Deb, 5 June 2008, c514

[18] IDS Pension Service, *Pensions tax and regulation*, July 2010, para 1.22; See also, HMRC, *Registered Pension Schemes Manual*, para 09105470

[19] HMRC, *Registered Pension Schemes Manual*, para RPSM 09104905, *Registered Pension Schemes (Authorised Payments) Regulations 2009* (SI 2009/1171) and *Occupational and Personal Pension Schemes (Authorised Payments) Amendment Regulations 2009* (SI 2009/2930)

[20] RPSM09105300 – Technical Pages: Member benefits: Lump sums: Commuted equivalent pension benefits (EPBs)

[21] HM Treasury, Budget 2010, HC 451; See also, HMRC website – Budget 2010 - pensions

> personal pensions. The Government will therefore explore ways to implement an alignment of the trivial flexibility with managing any fiscal risks.[22]

In December 2011, it announced that:

> Regulations will be introduced to enable individuals to access those savings held in small personal pension schemes i.e. £2,000 or less, by way of lump sum payment (commutation).[23]

The Registered Pension Schemes (Authorised Payments) Regulations 2009 (SI 2009/1171) provided that if an individual had a pension pot worth no more than £2,000 in a personal pension, it could be taken as a lump sum. An individual can only take a lump sum twice under this rule.[24] In more detail, the RPSM explains that:

> The conditions that need to be met instead, for such a **small lump sum** to be an authorised member payment under Regulation 11A, are that:
>
> - the payment is made on or after 6 April 2012, and
> - the payment is made to a member who has reached the age of 60, and
> - the 'small lump sum' payment does not exceed £2,000, and
> - the payment extinguishes the member's entitlement to benefits under the **arrangement**, and
> - the member has not previously received more than one payment under Regulation 11A.[25]

In an interim report on its review of pensioners' taxation, the Office of Tax Simplification (OTS) said that the limit on the number of small personal pension funds that could be commuted, while intended as an anti-avoidance measure, added complexity to the system:

> 3.3.139 The rationale for limiting commutation of small personal pension funds to two is that individuals have more control over personal pension funds and could fragment larger pots into smaller ones to access their funds by way of small lump sums. This is against the policy intent of providing tax reliefs for pension saving in return for an income in retirement. Therefore to manage fiscal risks there is a limit of two small personal pension pots per lifetime.
>
> 3.140 Whilst the OTS understands this limitation as a proxy for anti-avoidance, it does have the unfortunate effect of adding to complexity and confusion for those with small personal pensions. It could also burden pension providers with the costs and complexity of administering more small pots than would be the case without the restriction. We do question how significant an avoidance risk exists, given the small amounts involved.[26]

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[22] HM Treasury, Early access to pension saving: a summary of responses to the call for evidence, April 2011
[23] HM Treasury, Commutation of Small Personal Pension Funds, December 2011
[24] HMRC website – taking a small pension pot as a lump sum.
[25] RPSM09105485 - Technical Pages: Member benefits: Lump sums: Other commutation payments relating to trivial benefit rights: Payments under a scheme that is not an occupational or public service pension scheme
[26] OTS, Review of pensioners' taxation: Interim report, March 2012

In its final report published in January 2013, it recommended that consideration should be given to annual uprating of the fixed trivial commutation limits of £18,000 and £2,000 and for removing the 12-month window for trivial commutations.[27]

2.3 Budget 2014 changes

In recent years, there has been increasing concern about the extent to which annuities offered value for money, particularly for those with small amounts of pension saving.

An article in the *Financial Times* on 18 January 2014, for example, argued that people with funds below £10,000 were usually offered very low rates by insurance companies and that this left them "little of no chance of living long enough to even recoup their initial investment, let alone achieve a return." Taking a small pot as a lump sum was not always an option, either because providers were unwilling to release small pots or because the complexity of the rules made it difficult for savers to work out whether they were eligible.[28]

In the report of its Thematic Review of Annuities published in February 2014, the Financial Conduct Authority said:

> There are particular groups of consumers where it appears that the market is not working well. There is an apparent lack of choice and ability to switch for those with small pension funds and lower annuity rates available to these consumers generally, which is likely in part to be due to the fixed costs of providing an annuity representing a larger proportion of the customer's funds.[29]

In Budget 2014, the Government announced that, in order to allow people greater freedom and choice now over how to access their defined contribution pension, from 27 March 2014, it would increase the overall size of pension savings that could be taken as a lump sum, from £18,000 to £30,000:

> **1.164** As a first step towards this reform, the Budget introduces a number of immediate changes, to allow people greater freedom and choice now over how to access their defined contribution pension. From 27 March 2014 the government will:
>
> - reduce the amount of guaranteed pension income people need in retirement to access their savings flexibly, from £20,000 to £12,000
> - increase the capped drawdown limit from 120% to 150% to allow more flexibility to those who would otherwise buy an annuity
> - increase the size of a single pension pot that can be taken as a lump sum, from £2,000 to £10,000
> - increase the number of pension pots of below £10,000 that can be taken as a lump sum, from 2 to 3
> - increase the overall size of pension savings that can be taken as a lump sum, from £18,000 to £30,000.[30]

[27] OTS, Review of pensioners' taxation: Final report, January 2013, box H2
[28] Josephine Cumbo, How pension system fails thousands of small savers, *Financial Times,* 18 January 2014
[29] FCA, Thematic Review of Annuities, TR 14/2 February 2014
[30] Ibid

The proposed changes in the lump sum rules were generally welcomed.[31] Provision was made for them in the *Finance Act 2014* (section 42).[32]

The Government explained that this would be a short-term measure, in advance of more far-reaching reforms to be introduced from 2015:

> **1.165** Under the current tax system, people are charged 55% if they choose to withdraw all of their defined contribution pension savings at the point of retirement. This means the majority of people instead purchase an annuity and receive taxable income over the course of their retirement. Under the new system, an individual will be able to withdraw their savings at a time of their choosing subject to their marginal rate of income tax. The government anticipates that under these circumstances some people will choose to draw down their pension sooner in order to suit their personal situation. This will increase income tax revenue in the short to medium term. [33]

Members of defined benefit schemes would still be able to benefit from the increased trivial commutation limit, which would remain in place once the new tax framework for defined contribution was introduced.[34] In August 2014, the Government announced that the age at which individuals could make use of these rules would be lowered to 55:

> […] the trivial commutation and small pot rules will continue to apply to defined benefit schemes. These rules allow individuals to take up to £30,000 of total pension savings as a lump sum, or a £10,000 small pot as a lump sum regardless of total pension wealth. The age at which an individual can make use of these rules will also be lowered from 60 to 55.[35]

The longer-term changes and the impact of the Budget announcements are discussed in more detail in Library Note SN 6891 Flexibility for DC pension savers from April 2015.

3 Tax-free lump sum

3.1 Rules

A pension commencement lump sum does not result in any income tax liability arising on the scheme member receiving it. HMRC explains:

> You'll probably be given the option to take part of your pension savings as a tax free lump sum. Some schemes - particularly public sector schemes - will automatically give you a lump sum in addition to your pension.
>
> In a defined benefits scheme you give up ('commute') part of your expected pension to provide your lump sum. For example you could be given £12 lump sum for every £1 pension given up.
>
> In a money purchase or cash balance scheme the amount of any lump sum is taken off the pension pot that is used to provide your pension.

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[31] See, for example, HC Deb 20 March 2014 c953 [Gregg McClymont]; TUC, Pension changes go in wrong direction 20 March 2014; Age UK, welcome help for savers but no gains for the poorest pensioners, 19 March 2014

[32] For details of the Government's plans see HMRC Tax Information and Impact Note – Increasing pension flexibility

[33] HM Treasury, Budget 2014, HC 1104, March 2014

[34] HM Treasury, Freedom and choice in pensions, Cm 8835, March 2014, para 5.18

[35] HM Treasury, Freedom and choice in pensions: government response to the consultation, Cm 8901, July 2014, p7

The maximum tax-free lump sum you can normally have is whichever is the lower of the following amounts:

- 25% of the total value of the pension pot(s) from the same pension scheme that you're putting into payment. For example if you have money under two pension pots in the same scheme, say final salary pension and additional voluntary contributions, and take both pension pots at the same time, the 25% limit applies to the total of both pension pots. You could use one pension pot to pay the lump sum and the other to pay the pension if you wanted to

- 25% of your remaining unused lifetime allowance based around the normal £1.25 million lifetime allowance unless you have:

  - fixed protection in which case use £1.8 million

  - fixed protection 2014 where your lifetime allowance is protected at £1.5 million

  - individual protection 2014 which will give you a protected lifetime allowance equal to the value of your pension rights on 5 April 2014 up to an overall maximum of £1.5 million.[36]

The details rules are in the *Finance Act 2004* (section 166, paras 1 to 3 and 13 and Schedule 29).

Following the announcement of increased flexibilities for DC pension savers in Budget 2014, the Government made a change to the rules so that people would not lose the advantage of a tax-free lump sum if they did not decide what to do with their savings within six months. Exchequer Secretary to the Treasury, David Gauke, explained:

> Usually people lose the advantages of a tax-free lump sum if they do not decide what to do with the rest of their pension savings within six months of taking the lump sum. On 27 March, the Government announced that those who had already taken a tax-free lump sum from their defined contribution pension savings, but had not yet secured their pension, would be given more time to decide what they wished to do with the rest of their retirement savings. We also did not think it would be fair to prevent people from taking their tax-free lump sum now simply because they wished to wait to access their pension savings more flexibly from next April, so the Government promised to introduce new provisions in the Bill to ensure that people do not lose their right to a tax-free lump sum if they would rather use the new flexibility this year or next.
>
> The provisions are technically quite detailed, but their purpose is not. Full pension flexibility for defined contribution savings will be introduced in April 2015, and until that happens we want people to be able to take their tax-free lump sum and to have until October 2015 to make their pension choices without tax consequences. The changes made in new clause 13 and new schedule 5 will enable people to take a tax-free lump sum and to wait until April 2015 to decide how they want to access their pension savings: by transferring the rest of their pension savings to another pension provider to enable them to access them more flexibly; by repaying the lump sum when the scheme that paid it will accept it in order to access the whole of their savings more flexibly; or by receiving the rest of the pension savings as a lump sum under the higher limits that clause 40 provides. Those changes also ensure that people who have the right to

[36] HMRC, Taking your pension – the basics/Taking part of your pension as a lump sum

> receive a tax-free lump sum at an earlier age, or of a larger amount than is normally allowed, can use the new flexibility and keep those rights.[37]

Provision for this was made in the *Finance Act 2014* (section 43 and Schedule 5).

3.2 Background

The option of taking a tax free lump sum on retirement has been part of the pension system for many years. David Blake explains its origins as follows:

> One interesting anomaly which has remained purely for historical reasons is the tax-free lump sum that is available on retirement. Civil servants were granted a lump sum on retirement in return for a lower pension thereafter as a result of the *Superannuation Act* of 1909. The Inland Revenue (whose civil servants could also have the lump sum) was asked whether the lump sum would be taxable, and it said that it would not be. It gave no reason for this decision, although presumably the reason was that the lump sum was a capital payment, not income, and hence not taxable (in 1909). While there is no real logic to this argument, the lump sum (where a lump sum has been permitted) has remained free of tax ever since, although there have been legislative measures to deal with the permissible size of the lump sum.[38]

Before the introduction of pension tax simplification in April 2006, the amount of any lump sum that could be made depended on which tax regime applied. For example, under the main set of tax rules for people in occupational schemes, (the 1989 regime), the "tax free lump sum at retirement is limited to 2.25 times initial pension or 3/80ths of capped final remuneration for each year of service up to 40 years." For people with personal pensions, the tax rules dated from 1988 and allowed tax free lump sums of up to 25 per cent of matured pension savings.[39]

In its 2002 consultation document, the Labour Government proposed retaining the option of a tax-free lump sum on the grounds that it encouraged pension saving:

> 5.4 Pensions receive favourable tax treatment in order to encourage people to save for their retirement. The deal between the Government and the pension saver is that this favourable tax treatment is conditional on using most of the savings built up in this way to generate retirement income and not for other purposes.
>
> 5.5 Generous as tax relief is, the Government recognises that people do need encouragement to lock away their money, perhaps for decades, until they are ready to begin to draw benefits from their pension savings in their later years. The tax free lump sum provides that encouragement. It can provide a substantial capital sum, perhaps allowing people to put their financial affairs into good order when they retire. It may even offer once in a lifetime opportunities such as visiting family members in other countries or paying for home improvements to make retirement more comfortable.
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[37] HC Deb 2 July 2014 c902

[38] David Blake, *Pension schemes and pension funds in the United Kingdom,* Second Edition, 2003, p41-2; See also, Work and Pensions Committee, *Pension Reform*, Fourth Report 2005-06, HC 1068-II, Q90 [Philip Davis]

[39] HM Treasury and Inland Revenue, Simplifying the taxation of pensions: increasing choice and flexibility for all, December 2002,p6-7

5.5 Generous as tax relief is, the Government recognises that people do need encouragement to lock away their money, perhaps for decades, until they are ready to begin to draw benefits from their pension savings in their later years. The tax free lump sum provides that encouragement. It can provide a substantial capital sum, perhaps allowing people to put their financial affairs into good order when they retire. It may even offer once in a lifetime opportunities such as visiting family members in other countries or paying for home improvements to make retirement more comfortable.[40]

In December 2003, it said that the new rules would allow "up to 25 per cent of the capital value of the pension below the lifetime allowance to be taken as a tax free lump sum." People with a prior right to a tax free lump sum in excess of the new limits – the lower of 25 per cent of fund value or £350,000 – would be able to protect this.[41]

When the *Finance Bill 2003-04* was before Parliament, the then Financial Secretary to the Treasury, Ruth Kelly explained that the Government's decision to "merge upwards":

Mr. Laws: [...] I wonder whether the Minister will put on record the answer to a number of questions about the tax-free lump sum, so that we can understand how the Government's policy is developing. First, will she clarify the purpose of, and justification for, the tax-free lump sum? As we discussed this morning, the previous Chancellor described the tax-free lump sum as an "anomaly" within the taxation of pensions. However, the Government have chosen not only to consolidate that anomaly but to extend it. [...] So that we have it on the record, can we be told the Government's thinking about the purpose and justification of the tax-free lump sum?

[...]

Ruth Kelly: I am delighted that the hon. Gentleman has taken such an interest in the tax-free lump sum. We have decided to merge upwards for several reasons. The first is for pure simplification. We are increasing the permitted lump sum as part of a wider objective under tax-simplification proposals to merge occupational and personal pension regimes and to remove the distortions that are caused by having two different regimes. We did not want some people who currently benefit from a particular privilege to have it reduced under the simplified proposals. We decided in each case to level upwards, so that there would be practically no losers under the new regime compared with the number of winners. We are prepared to commit the Exchequer to financing that levelling-up of the legislation.

The second point, which is highly relevant, is that the tax-free lump sum is very popular. That is not a silly point. People save in pensions partly because they know that when they retire they will have access to a tax-free lump sum, perhaps to fund a more active early retirement before they use the rest of their income as an annuity. It is an attractive element of the overall pensions regime and encourages people to use the pensions vehicle rather than a different savings vehicle.[42]

The *Finance Act 2004* allows for a tax-free lump sum of up to 25% of the value of the fund (referred to in the legislation as a "pension commencement lump sum"). The total of the tax-free lump sums an individual gets from all their pension schemes cannot exceed 25% of the

[40] HM Treasury, *Simplifying the taxation of pensions: increasing choice and flexibility for all*, December 2002; Box 5.3; See also, Pensions Commission, *Second Report*, November 2005, p325; See also Finance Bill Deb, 8 June 2004, c506-7 [Ruth Kelly]

[41] HM Treasury and Inland Revenue, Simplifying the taxation of pensions: the Government's proposals, December 2003, para 1.6 and 5.1

[42] Finance Bill Deb, 8 June 2004, c506

lifetime allowance for that year. HMRC says that “this limit is so high it should not affect most people”:

> **The pension commencement lump sum**
>
> Your scheme may pay a lump sum at or around the time when you first start taking pension benefits. If it satisfies certain conditions, this lump sum can be paid free of income tax.
>
> The tax rules allow a lump sum of up to 25% of the value of the fund providing you with pension benefits to be paid free of income tax, providing other conditions are also satisfied. So if the value of your pension fund is £100,000, as long as the lump sum you receive is £25,000 or less, it can normally be paid tax-free.
>
> The tax rules also broadly say that the total of the tax-free lump sums you get from all your pension schemes cannot be more than 25% of the **lifetime allowance** for the tax year in which you receive the lump sum. The lifetime allowance for the tax year 2006/07 running from 6 April 2006 to 5 April 2007 was £1.5 million. So the total lump sums you could have had free of tax would have been £375,000. As this limit is so high it should not affect most people.
>
> Before 6 April 2006 some people had the right under their scheme’s rules to either
>
> – a lump sum of more than 25% of the fund value, or
>
> – more than £375,000.
>
> There are special rules to protect these rights. More information can be found at RPSM03201060 and RPSM03201061 and at RPSM03201040 and RPSM03201042.
>
> If your lump sum is more than the limits described above, the excess will be an unauthorised payment. This means the lump sum can still be paid but it will have extra tax on it. If you receive an unauthorised payment, you must include it on your self assessment tax return if you receive one, or let your tax office know that you have tax to pay.
>
> There are more conditions, such as that you must have reached the age of 50 (or from 6 April 2010, 55) when you receive the payment, and that the amount must be tested against the lifetime allowance. There are more details on these conditions in the Technical pages of this manual, from page RPSM09104100.
>
> Please note your pension scheme does not have to give you a lump sum of the maximum amount. It is up to your pension scheme to decide what level of benefits it gives you.[43]

In July 2010, the current Government included the tax-free lump sum in its principles for a new tax framework on retirement:

> **Box 2.A: Principles for a new tax framework for retirement**
>
> 1 The purpose of tax-relieved pension saving is to provide an income in retirement.
>
> 2 Any changes to the pensions tax rules should not incur Exchequer cost and should not create any opportunities for tax avoidance.

[43] HMRC, RPSM, page RPSM 09200040; *Finance Act 2004,* s166 (1) (a)

3 Individuals should have the flexibility to decide when and how best to turn their pension savings into a retirement income, provided that they have sufficient income to avoid exhausting savings prematurely and fall back on the state.

4 In line with the EET model, pension benefits taken during an individual's lifetime should be taxed at income tax rates. **The tax-free pension commencement lump sum will continue to be available.**

5 On death, pension savings that have been accumulated with tax relief should be taxed at an appropriate rate to recover past relief given, unless they are used to provide a pension for a dependant.[44] [emphasis added]

Reductions in the lifetime allowance in recent years (with the aim of restricting spending on pension tax relief) have reduced the maximum amount that can be taken as a lump sum.[45] In a 2010 consultation document, the Government said:

B.14 When a pension is drawn a tax-free lump sum of up to 25 per cent of the value of funds can be paid up to a maximum of 25 per cent of the standard LTA. Any reduction in the LTA would consequently reduce the maximum tax-free lump sum that could be paid. The Government's view is that the value of the tax-free lump sum should continue to be determined in this way.[46]

However, it expected that the vast majority of pension scheme members would be unaffected. [47] The maximum tax-free lump sum reduced from 450,000 in 2011/12 (25% of £1.8 million) to 375,000 in 2012/13 (25% of 1.5 million) and to 312,500 in 2014/15 (25% of 1.25 million).

Under the new system to be introduced from April 2015, the tax-free pension commencement lump sum will continue to be available.[48]

3.3 Debate

Some commentators have proposed restrictions in the amount of pension saving that can be taken tax-free in order to reduce the share of pension tax relief going to higher earners.

In a report published in November 2011, Centre Forum (which describes itself as an independent liberal think tank) proposed a further change affecting higher rate taxpayers:

The tax relief permitted on pension lump sums disproportionately benefits the wealthy at taxpayers' expense. The result is a regressive system where those with the most generous entitlements also receive the highest rate of tax relief. At a time when the public finances are under strain wealthy individuals are able to shelter considerable amounts of pension income from the tax system.

This paper proposes that those individuals taking lump sums above the higher rate tax threshold (£42,475) should have to pay tax analogous to income tax at the higher rate. This would mitigate the regressive outputs of the current pension system whilst

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[44] HM Treasury, Consultation on removing the requirement to annuitise, July 2010

[45] HM Treasury, *Restriction of pensions tax relief: a discussion document on the alternative approach,* July 2010

[46] HM Treasury, *Restricting pensions tax relief through existing allowances: a summary of the discussion document responses*, October 2010. The background to this is discussed in more detail in, Library Standard Note SN 5901 Restricting pension tax relief

[47] HC Deb, 9 December 2010, c31WS; HMRC website – impact of a reduced lifetime allowance on pension saving:

[48] HM Treasury, Freedom and choice in pensions, Cm 8835, March 2014, page 21

> ensuring that the average pensioner can still benefit from the flexibility that a tax-free lump sum provides at retirement.[49]

Some responses to the report suggest such a change in policy would be controversial. For example:

> Mike Morrison, head of pensions at Axa Wealth, said that he would oppose any proposal to curtail tax relief for wealthier individuals. While he admits that there is an obvious need to find new ways to raise funds in the UK, Mr Morrison claimed that a tax on lump sums withdrawn from pension pots would be the "final nail in the coffin" for pensions. He said: "Such a move could cost new retirees thousands of pounds, especially when a tax-free lump sum is one of the key incentives of saving into a pension in the first place. "Pensions are in crisis already and there must be measurements in place to encourage the nation to save and avoid poverty in retirement, and maintaining pension incentives is key to this. This proposal, alongside the current reforms to higher rate tax relief, would be disastrous for saving and the middle classes, who stand to bear the brunt."[50]

The Institute for Fiscal Studies (IFS) has suggested introducing a cash limit on the amount that can be taken as a tax-free lump sum:

> The argument that is usually made for the tax-free lump sum, which means that up to a quarter of a pension pot can escape income tax altogether, is that it is compensation for the fact that pensions are constructed to be a highly inflexible form of savings, available only after a certain age. If, for reasons of public policy, we want people to lock money away for long periods, we are likely to have to provide them with a good reason for doing so.
>
> That is a strong argument, but it has its limits. At the moment, the size of the lump sum that can be taken tax-free is limited only by the lifetime limit on the size of a pension pot: with a £1.25 million lifetime allowance, this means that £312,500 can be taken tax-free. While there are good reasons that we might actively encourage people to save a certain amount for their retirement, it is less clear that people who already have, say, a £1 million pension fund ought to be subsidised for saving yet more, at the expense of other taxpayers. There is therefore a powerful case for introducing a cash limit on the amount that can be taken as a tax-free lump sum, at a level considerably below £312,500. Unfortunately, no reliable current estimate exists of the revenue that this would raise.
>
> More fundamentally, while the case for providing a 'bonus' for saving in a pension is strong, a tax-free lump sum seems like a singularly ill-designed form for such an inducement to take. Encouraging withdrawal of a tax-free lump sum seems a perverse way of encouraging people to build up a pension, if one of the pension's main purposes is to provide a regular retirement income (and keep people off means-tested benefits). The current system also provides a significantly bigger bonus for higher-rate taxpayers than for basic-rate taxpayers. As the Mirrlees Review notes, there are many alternative ways of incentivising pension saving that do not have these features. For example, the government could simply top up pension funds at the point of annuitisation, again subject to a cap: a 5% top-up would be broadly equivalent in value to the tax-free lump sum for a basic-rate taxpayer (20% of 25%).[51]

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[49] *A relief for some: how to stop lump sum tax relief favouring the wealthy*, November 2011

[50] See, for example, FT adviser, 'Wealthy benefit most from pension tax relief says think tank'

[51] IFS Green Budget 2013, chapter 9; See also IFS, Green Budget, February 2012, p194

The PPI found that changes to the 25% tax-free lump sum would mean pension tax relief was more evenly distributed but would not improve incentives to contribute to a pension:

> Currently individuals are able to take a tax-free lump sum up to the value of 25% of their pension fund. Under the current system, 77% of individuals have a lump sum of under £40,000 while only 24% of the tax on lump sums goes to these individuals. Similarly, while 2% of lump sums are worth £150,000 or more, they attract 32% of tax relief on lump sums. The projected cost of this tax relief on lump sums is £4 billion.
>
> The report considers two potential restrictions to the tax-free lump sum. The figures below do not take into account any possible behavioural change, in that individuals are assumed to take their full lump sum entitlement in all scenarios.
>
> If the tax-free portion of the lump sum were limited to 20% of the pension fund, the reduction in tax relief received would be proportionately the same for all individuals. In practice, any change would be likely to only apply to future contributions, so initial savings would be small and take a number of years to build up. If such a change were applied to current lump sums the cost of tax relief could decrease from £4 billion to £3.5 billion.
>
> An alternative approach would be to cap the size of lump sums that are available tax-free. For example, a cap of £36,000 would mean that 75% of current lump sums would be unaffected but the largest 25% of lump sums would be capped. Again, this is most likely to be applied to new pension contributions so would not make significant savings for many years. If tax relief were limited to the first £36,000 of the current tax-free lump sums, the proportion of tax relief going to lump sums of £150,000 and over would reduce from 32% to 7%. The cost of tax relief on lump sums could halve to £2 billion. In practice individuals may choose to take larger amounts of the pension fund as an annuity, which would reduce the tax foregone on the lump sum but increase the amount of tax on pension income.
>
> Like the recent changes to tax relief, these changes to the lump sum would mean that pension tax relief is more evenly distributed and reduces the cost of tax relief; however they will not improve incentives for anyone to contribute to a pension, and will reduce the value of tax relief.[52]

The Government has said there are no estimates of the potential revenue yield from imposing a lower cap.[53]

[52] PPI, Tax relief for Pension Saving in the UK, July 2013
[53] HL Deb 7 April 2014 c249WA; HC Deb, 24 October 2011, c24W; See also HC Deb, 19 Mar 2009, c1296W