



## The reduced Lifetime Allowance

**Case study two:  
Member aged 50 whose projected pension benefits are  
estimated at £1.5 million by planned retirement age**

December 2011

## Case study

- We are going to run through a case study to compare the outcomes of staying in the Harmsworth Pension Scheme or opting out and applying for fixed protection.
- When you have finished reading through the case study you can print a copy of the slides and substitute your own figures to reach your own conclusions.
- However, your own circumstances may be very different and you will only get the advice you need from an independent financial adviser.

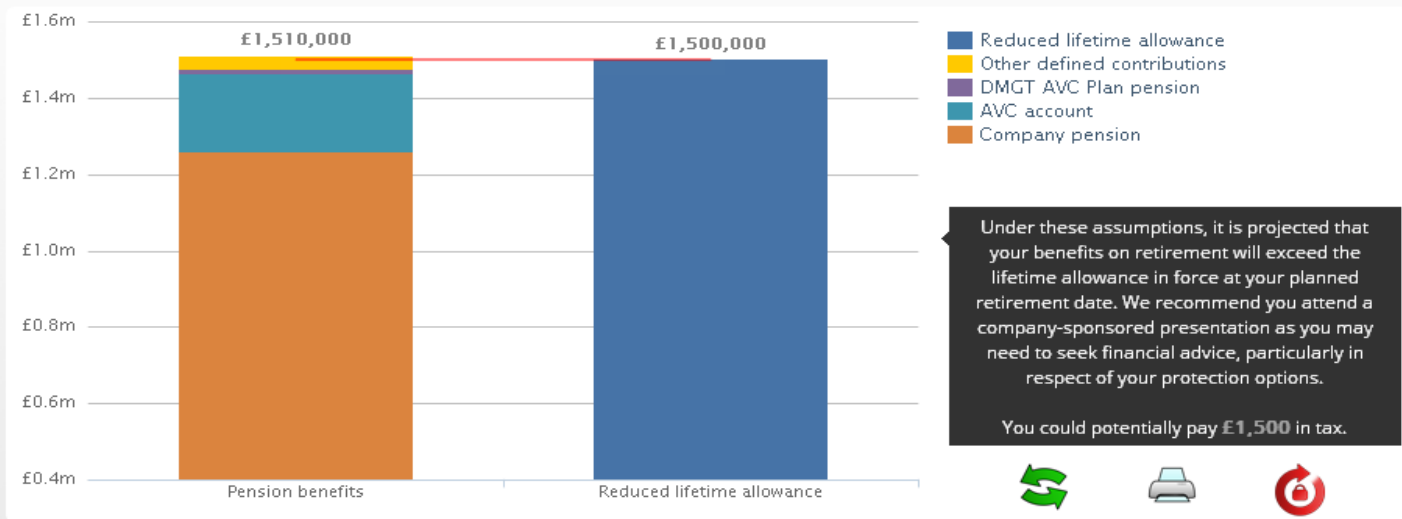
# Adam

- Adam is a Plus member of the Harmsworth Pension Scheme.
- Adam uses the LTA planner to estimate the value of his benefits built up to 31 March 2012 at his planned retirement age of 65.
- The Planner estimates Adam's benefits to be valued at around £1.5 million by age 65.



# lifetime allowance planner

Logout



Other defined benefit (pension):  a year    Other defined contributions (value):     Monthly AVC contributions:

Retirement age: **65**    Inflation: **3%**    Investment return: **6%**    LTA to increase after 2016?

# Adam

- Adam wishes to compare the estimated benefits if he stays in the Scheme until age 65 or opts out from 31 March 2012 and applies for fixed protection.
- Adam reviews the slides from the Lifetime Allowance workshop he attended (see audio slides) in order to recall some of the factors he needs to consider:
  - The age at which he plans to take benefits
  - The time period to his planned retirement age
  - His proximity to the LTA
  - His expectations for future increases to the LTA
  - His marginal tax rate now and in retirement
  - What he might do with any pension allowance and how much he might have built up by retirement

# Adam

- Adam considers each point
- The age at which he plans to take benefits
  - Adam plans to take benefits at age 65
- The time period to his planned retirement age
  - Adam is age 50 now so he has 15 years to go until his planned retirement age
- His proximity to the LTA
  - Adam's pension benefits built up to 31 March 2012 are expected to fully utilise the reduced LTA of £1.5 million from 6 April 2012. However, if he applies for fixed protection of a LTA of £1.8 million, the value of his benefits built up to 31 March 2012 is not expected to fully utilise his protected LTA at retirement.

# Adam

- His expectations for future increases to the LTA
  - As Adam has 15 years to go until retirement he would like to consider the potential impact on his benefits in the following 2 scenarios:
    - The LTA remains at £1.5 million by his planned retirement date
    - The LTA is frozen until the end of the 2015/16 tax year and then increases at 3% each year until the 2026/27 tax year when he plans to take benefits  
i.e. the LTA is £1.5 million  $\times 1.03^{11} = £2,076,350$  at Adam's planned retirement age.
- His tax rate now and in retirement
  - Adam's total taxable income exceeds £150,000 so he currently pays tax at 50%
  - Adam expects his income in retirement to be taxed at a marginal rate of tax of 40%

# Adam

- What might he do with any pension allowance
  - Adam would use the pension allowance to repay his mortgage. Adam currently pays interest on his mortgage at 6% per annum
  - Once Adam has repaid his mortgage (which he expects to have done in 5 years' time) he will invest the pension allowance in equity investments. Adam expects to receive a 6% per annum return on his investments after all taxes and charges
  - Adam believes the returns will be primarily capital gains so that he may use his annual Capital Gains Tax exemption (currently £10,600 per annum) to minimise the tax payable on his investment returns. Adam also considers ISA investments so that no higher rate tax is payable on any dividend income and capital gains are automatically exempt from tax (without using his annual exemption).
- Adam is now ready to estimate the potential benefits he might get back with continued pension provision relative to opting out of the Scheme for a pension allowance

## What might Adam's net benefits be at age 65 if he continues to build up Scheme benefits?

- If Adam stays in the Scheme, he will receive a credit of 30% of his Pensionable Pay (currently £100,000) into his Credit Account each year.
- Adam estimates the value by age 65 of the credits to his Credit Account between 31 March 2012 and age 65...

## What might Adam's net benefits be at age 65 if he continues to build up Scheme benefits?

- Adam expects inflation to be at around 3% per annum and his salary to increase by around 3% each year
- Remember your Credit Account increases in line with the CPI measure of inflation up to a maximum of 5% each year

Scheme year	Plus section 30% x salary x CPI	Credit account at retirement
01/04/2012	$30\% \times \text{£}100,000 \times 1.03^{14}$	£45,378
01/04/2013	$30\% \times \text{£}103,000 \times 1.03^{13}$	£45,378
01/04/2014	$30\% \times \text{£}106,090 \times 1.03^{12}$	£45,378
01/04/2015	$30\% \times \text{£}109,273 \times 1.03^{11}$	£45,378
01/04/2016	$30\% \times \text{£}112,551 \times 1.03^{10}$	£45,378

## What might Adam's net benefits be at age 65 if he continues to build up Scheme benefits?

Scheme year	Plus section 30% x salary x CPI	Credit account at retirement
01/04/2017	30% x £115,927 x 1.03 <sup>9</sup>	£45,378
01/04/2018	30% x £119,405 x 1.03 <sup>8</sup>	£45,378
01/04/2019	30% x £122,987 x 1.03 <sup>7</sup>	£45,378
01/04/2020	30% x £126,677 x 1.03 <sup>6</sup>	£45,378
01/04/2021	30% x £130,477 x 1.03 <sup>5</sup>	£45,378
01/04/2022	30% x £134,391 x 1.03 <sup>4</sup>	£45,378
01/04/2023	30% x £138,423 x 1.03 <sup>3</sup>	£45,378
01/04/2024	30% x £142,576 x 1.03 <sup>2</sup>	£45,378
01/04/2025	30% x £146,853 x 1.03 <sup>1</sup>	£45,378
01/04/2026	30% x £151,259	£45,378
<b>Total</b>		<b>£680,670</b>

## What might Adam's net benefits be at age 65 if he continues to build up Scheme benefits?

- Allowing for future expected salary increases and future inflationary increases to his Credit Account Adam expects his Credit Account from post April 2012 credits to be around £680,670 at age 65.
- Because Adam expects his salary to increase broadly in line with the CPI measure of inflation, the calculation could be simplified. He could just do the calculation for the first year and multiply this by 15
  - $15 \times £45,378 = £680,670$
- However, if he expected higher salary increases (or lower salary increases) he would need to go through the calculation on a step by step basis as illustrated in slides 10 and 11

## What might Adam's net benefits be at age 65 if he continues to build up Scheme benefits?

- If Adam continues to build up pension in the Scheme, he will forfeit the option to apply for fixed protection.
- If the LTA is frozen at £1.5 million, the pension benefits he has built up to 31 March 2012 are expected to fully utilise his Lifetime Allowance so the £680,670 built up from 1 April 2012 would all be subject to a LTA charge.
- Adam expects he would take the £680,670 as a taxed lump so may get back £306,302 ( $£680,670 \times (100\% - 55\%)$ ) at retirement
- This assumes no future change in the rate of tax applicable to pension benefits above the LTA!

## What might Adam's net benefits be at age 65 if he continues to build up Scheme benefits?

- If the LTA increases to £2,076,350 by Adam's retirement, he may have £576,350 (£2,076,350 less £1,500,000) of his LTA remaining for benefits built up after 31 March 2012.
- On this basis, £576,350 of the additional £680,670 Scheme benefits built up from 1 April 2012 could be within his LTA and the balancing £104,320 (£680,670 less £576,350) may exceed his LTA.

## What might Adam's net benefits be at age 65 if he continues to build up Scheme benefits?

- If Adam were to take both the additional benefits built up within his LTA and the excess above his LTA as a taxed lump sum, he may receive £450,389 at retirement:

Tax-free cash	£576,350 x 25%	£144,088
Taxed cash within LTA £576,350 x 75% = £432,262	£432,260 less 40% tax	£259,357
Excess cash above LTA	£104,320 less 55% LTA charge	£46,944
Total		£450,389

- This assumes that Adam has a minimum pension income in payment of £20,000 gross each year and chooses to take his Scheme benefits built up from 6 April 2012 as a cash sum at retirement. It also assumes no future change to current UK retirement options or tax rates!

## What might Adam's net benefits be at age 65 if he opts out of the Scheme from 31 March 2012?

- If Adam opts out of the Scheme, he will receive a 15% pension allowance each month.
- In addition to his formal pension allowance, Adam will save an additional 6% of his Pensionable Pay because he will no longer need to pay member contributions
- Adam estimates he will receive gross pension allowances totalling £21,000 (15% + 6% x £100,000) in the first year
- Adam's total taxable income exceeds £150,000 so he pays tax at a marginal rate of 52% (including employee NICs)
- After tax, Adam expects to take home an additional £10,080 in the first year ( $£21,000 \times (100-52\%)$ )

# What might Adam's net benefits be at age 65 if he opts out from 31 March 2012?

- Adam expects his Pensionable Pay to increase at 3% per annum so he estimates his future pension allowances as follows:
  - Year 1: £10,080
  - Year 2: £10,080 x 1.03 = £10,382
  - Year 3: £10,382 x 1.03 = £10,694
  - Year 4: £10,694 x 1.03 = £11,015
  - Year 5: £11,015 x 1.03 = £11,345
  - Year 6: £11,345 x 1.03 = £11,685
  - Year 7: £11,685 x 1.03 = £12,036
  - Year 8: £12,036 x 1.03 = £12,397
  - Year 9: £12,397 x 1.03 = £12,769
  - Year 10: £12,769 x 1.03 = £13,152
  - Year 11: £13,152 x 1.03 = £13,547
  - Year 12: £13,547 x 1.03 = £13,953
  - Year 13: £13,953 x 1.03 = £14,372
  - Year 14: £14,372 x 1.03 = £14,803
  - Year 15: £14,803 x 1.03 = £15,247
- This assumes Adam's pension allowance is taxed at 50% in future years. If Adam thought his tax rate may reduce to 40% from, say, year 10, he could multiply the year 10 figure (and subsequent years' figures) by 50/40 to get an approximate idea of what the net pension allowance might be each year.

## What might Adam's net benefits be at age 65 if he opts out from 31 March 2012?

- If Adam invests his net pension allowances at the end of each year to achieve a 6% net per annum investment return, he estimates he may build up a sum of £281,766 by age 65:

Year	Year beginning	Net cash allowance x investment growth	Value of cash at retirement
1	01/04/2012	£10,080 x 1.06 <sup>14</sup>	£22,790
2	01/04/2013	£10,382 x 1.06 <sup>13</sup>	£22,145
3	01/04/2014	£10,694 x 1.06 <sup>12</sup>	£21,518
4	01/04/2015	£11,015 x 1.06 <sup>11</sup>	£20,910
5	01/04/2016	£11,345 x 1.06 <sup>10</sup>	£20,317
6	01/04/2017	£11,685 x 1.06 <sup>9</sup>	£19,742
7	01/04/2018	£12,036 x 1.06 <sup>8</sup>	£19,184
8	01/04/2019	£12,397 x 1.06 <sup>7</sup>	£18,641

## What might Adam's net benefits be at age 65 if he opts out from 31 March 2012?

Year	Year beginning	Net cash allowance x investment growth	Value of cash at retirement
9	01/04/2020	£12,769 x 1.06 <sup>6</sup>	£18,113
10	01/04/2021	£13,152 x 1.06 <sup>5</sup>	£17,600
11	01/04/2022	£13,547 x 1.06 <sup>4</sup>	£17,102
12	01/04/2023	£13,953 x 1.06 <sup>3</sup>	£16,618
13	01/04/2024	£14,372 x 1.06 <sup>2</sup>	£16,148
14	01/04/2025	£14,803 x 1.06	£15,691
15	01/04/2026	£15,247	£15,247
<b>Total</b>			<b>£281,766</b>

- Although Adam is unlikely to invest the pension allowances received until year 6 (when he expects to have repaid his mortgage), he will be saving 6% per annum in interest on the repayments to his mortgage in the meantime, which will have the same effect on his overall financial position as investing to achieve a 6% per annum investment return

# Adam

- If the Lifetime Allowance is frozen at £1.5 million, Adam estimates he might get back £306,302 from future pension provision in the Scheme or £281,766 by opting for the pension allowance.
- If the Lifetime Allowance increases to £2,076,350 by Adam's retirement date, he estimates he may get back £450,389 from the Scheme but only £281,766 by opting for the pension allowance
- On this basis, Adam decides to continue to build up benefits in the Scheme and hence forfeit his option to apply for fixed protection.
- Adam is aware that the pension allowance would have given him more flexibility and that he won't be able to take benefits from the Scheme until at least age 55.

# Sensitivities

- The estimates used in this example are extremely sensitive to the assumptions made
- We assumed that Adam's salary increased at 3% per annum and the CPI measure of inflation (and hence his Credit Account balance) increased by the same amount
- Adam's salary may increase by more or less than inflation in the future. The timing of future salary increases will also impact what he gets back under each option
- We assumed Adam would be able to invest his net pension allowance to achieve a net (of all taxes and charges) investment return of 6% per annum
- Adam's investment returns between now and age 65 could be more or less than 6% per annum

# Sensitivities

- We assumed Adam's cash allowance would be taxed at 52% in every year up to retirement. If Adam paid tax at 42% on his pension allowance (in some or all years), the numbers would have differed. For example, if Adam had paid tax at 42% on his pension allowances throughout, the accumulated lump sum at age 65 would have been estimated at £340,500.
- Adam's tax rate between now and retirement may change.
- We assumed the LTA charge will still be 55% at Adam's retirement age. The rate of LTA charge between now and Adam's retirement may change.
- Adam may not have the options for taking benefits at age 65 as assumed in our example. For example, he may no longer have the option to take a tax-free pension commencement lump sum and he may not be eligible to take his additional benefits built up in the Scheme as a lump sum.
- If Adam needed to take his pension benefits as a pension, there would be a survival period required before annual pension payments would make up for any lump sum accumulated by opting for the pension allowance.

## Only an example!

- The example was intended to give an illustration of the factors to think about only, you need to think about your own circumstances and expectations
- You should take advice if you are not sure what to do
- IFA Promotions web site – [www.unbiased.co.uk](http://www.unbiased.co.uk)

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