7.3 Serious ill-health lump sum

7.3.1 Conditions of payment

There are circumstances when the whole of the member's pension rights may be commuted.

The conditions for payment of the serious ill-health lump sum are that:

- a registered medical practitioner has certified that the member will not survive 12 months;
- it is payable within the LTA;
- the serious ill-health lump sum will extinguish all uncrystallised rights of the member under the scheme; and
- the arrangement(s) to be commuted are uncrystallised. However, if the member has reached his or her 75th birthday, BCEs 5A and 5B (and any LTA used by virtue of those BCEs) are ignored for these purposes.

The serious ill-health lump sum is payable at any age. Payment of the lump sum is a BCE 6 below the age of 75. Within the LTA it will be free of tax in these circumstances and any excess will be subject to income tax at marginal rates of tax. If it is paid when the member is 75 or over, payments are taxed as pension income at marginal rates of income tax. The member is liable, but the administrator will generally deduct tax from the payment under PAYE.

The scheme administrator must report a serious ill-health lump sum to HMRC when the recipient of the payment:

- is a director of the sponsoring employer in the year of payment (or has been in the previous six years);
- is connected to such a director in the same period;
- alone or with others, represented the sponsoring employer in that time; or
- is connected to that employer (e.g. by ownership).

The scheme administrator must also report where the member is relying on either an enhanced LTA entitlement, or an entitlement to enhanced protection.

The serious ill-health lump sum can be a valuable benefit for a member who is in the unfortunate position of having a poor prognosis and in need of cash, perhaps for medical treatment. Furthermore, the tax-free status of the lump sum is attractive. However, in many cases, there are reasons why this should be the last option to be considered.

For example, the terms of the commutation may not be attractive and any payments not spent – and therefore remaining in the member's estate – could be subject to inheritance tax, having already suffered an income tax charge.

Law: FA 2004, Sch. 29, para. 4

Guidance: PTM 063400

7.3.2 Tax charges and reporting

If (when added to other crystallisations) the lump sum exceeds the LTA, the excess will be taxed as pension income at marginal rates of tax. Normal PAYE rules will apply to these payments, with tax deducted and paid to HMRC by the scheme administrator, before the remaining lump sum is distributed.

The serious ill-health lump sum will be taxed at marginal rates of income tax if the member has reached his or her 75th birthday.

Guidance: PTM 016400; *Pension schemes newsletter* March 2023

7.4 The uncrystallised funds pension lump sum

The uncrystallised funds pension lump sum (UFPLS) was introduced by the *Taxation of Pensions Act* as part of the government's policy of flexible money purchase benefits. It allows the member to take lump sums directly from a money purchase fund without the necessity of establishing a flexi-access drawdown plan. Particular features of the option are:

- It is paid in respect of uncrystallised rights and only from a money purchase arrangement.
- It must not represent rights attributable to a disqualifying pension credit (a consequence of divorce where no pension commencement lump sum is available).
- The lump sum is only available from normal minimum pension age or earlier on grounds of permanent incapacity.
- The whole payment is treated as a BCE 6 and recorded against the LTA.

- The facility is unavailable if the member claims transitional protection of the lump sum. This means that the lump sum exceeds 25% of total benefits under the arrangement or the member has claimed primary or enhanced protection and the value of lump sum rights at 5 April 2006 exceeded £375,000, or the value of the available portion (proportion of the remaining LTA) is less than 25% of the sum.
- Payment of an uncrystallised funds pension lump sum triggers the application of the money purchase annual allowance.
- The lump sum must not exceed the available LTA. (In practice, more could be paid, but the excess would not be treated as an uncrystallised funds pension lump sum if the member was not yet aged 75, and would be taxed as an LTA excess lump sum. Any excess is taxed as income.)

Within the LTA, 25% of the uncrystallised funds pension lump sum is free of tax and the remaining 75% is taxed as pension income.

The UFPLS is an alternative means of "drawing down" uncrystallised funds. It is not drawdown.

Where it is available, it provides a simpler and potentially cheaper means of taking withdrawals from a money purchase pension fund without crystallising more than is necessary, and without the complexity of phased retirement or phased drawdown. Tax rules do not limit the number of UFPLS that can be taken from uncrystallised funds held in a money purchase arrangement.

So, this is a useful option for no frills products such as low-cost pensions, group money purchase schemes, or stakeholder plans because it does not involve the administration and cost of establishing a drawdown arrangement and keeping it under review. However, as UFPLS triggers the money purchase annual allowance (MPAA), it is not a suitable option for those needing to draw on pensions for a temporary period, with a view to recommencing future contributions (e.g. during a period of temporary unemployment). Future pension funding is limited by the MPAA.

For a 40% or 45% taxpayer who is sensitive to tax and has a substantial pension fund, flexi-access drawdown offers the most appropriate solution if it is structured properly. The decision will be influenced by the projected income profile for the years after partial or full retirement and how it might be affected by changes in circumstances on the way. If it is assumed that there would be other sources of income that would gradually reduce over time, the amended rules encourage the member to phase the tax-free pension commencement lump sum.

Example

By way of example, the member might take a tax-free "income" for ten years before age 75 by taking pension commencement lump sums each year, and then withdrawing pension income later. If the individual dies before age 75, the balance of the fund will be paid tax free, but on death at or after age 75, it will be taxed at marginal rates of the beneficiaries.

Law: FA 2004, s. 166(1); Sch. 29, para. 4A

Guidance: PTM 063300

7.5 Short service lump sum – occupational pension schemes

If a member has not completed two years' scheme service under a defined benefit occupational scheme (30 days under a money purchase occupational scheme), then DWP rules allow that, subject to scheme rules, there should be no preserved benefit. The options open to the member under DWP rules are:

- to qualify for a preserved benefit in respect of personal contributions;
- to qualify for a preserved benefit in respect of all contributions (unlikely in practice);
- to transfer a sum to another registered pension scheme based on employer and member contributions. This option is only available under DWP rules if the member has completed three months' service or the scheme rules allow a shorter (or no) period; or
- to lose all benefit and take a short service lump sum (refund of personal contributions).

None of these options is a BCE.

If the member takes a refund of personal contributions, the refund is subject to income tax (because those contributions will have received tax relief when the contributions were paid).

The conditions of short service lump sum are:

- the scheme is an occupational scheme (not a personal pension plan or work-based personal pension plan);

- service terminated before normal pension age;
- there have been no previous BCEs in respect of the scheme;
- the refund extinguishes all rights under the scheme; and
- the payment is made before age 75.

The refund may include investment growth within the limit that applies to the short service lump sum. Any excess may be a scheme administration payment, but HMRC will wish to monitor abuse. The allowable refund is the value of personal contributions paid and interest at a commercial rate. Any excess over the value of contributions paid may be treated as a scheme administration payment and will be taxed as interest under ITTOIA 2005, s. 369 and be paid gross. If the payment exceeds the value of contributions plus interest, the excess will be unauthorised.

The short service lump sum is subject to income tax at the basic rate on the first £20,000 and at a rate of 50% beyond that.

Under PA 2014, s. 36, where benefits provided by a scheme are exclusively money purchase benefits, there will be an entitlement to "short service benefit" immediately after the member has completed 30 days' qualifying membership of the scheme. The obvious effect of this section is that short service refunds are only available within the initial 30 days. Alternatively, the member has a statutory right to transfer after the 30 days have elapsed.

Law: FA 2004, Sch. 29, para. 5
Guidance: PTM 045000

7.6 Refund of excess contributions lump sum

One of the controls on input is the annual limit for relief. This allowance relates to personal contributions and is applied separately from the annual allowance that refers to aggregate contributions from all sources.

The annual limit is a restriction on contributions that can enjoy income tax relief. If it is exceeded, the member simply does not qualify for tax relief on the contribution (and HMRC will recover any relief given at source).

If the annual limit is exceeded, the provider is not entitled to refund contributions without the member's consent. Rather, the member has a choice of either leaving the contributions invested or, within six years of the end of the tax year in which the excess arose, withdrawing a lump sum representing the value of the excess contribution. The effect of