Pension Commencement Lump Sum Recycling

HMRC introduced rules in the Finance Act 2006 to prevent pension commencement lump sum (PCLS) payments being used to abuse the generous pension contribution tax relief system (i.e. getting a 'double-hit' of tax relief, once on the original contribution and then again when the individual uses their PCLS to pay pension contributions).

PCLS recycling occurs where all of the following is proved:

1. The member concerned has received a PCLS which, either alone or when added to any other such lump sums in the past 12 months, was more than £7,500.

and

2. There has been a significant increase in the level of contributions made by the member, employer or third party on their behalf to any registered pension scheme. A significant increase is generally considered to be more than 30% of the contributions that might otherwise have been expected.

   This is measured on a cumulative basis over that tax year, the two tax years before, and two tax years after, PCLS is taken – thus covering a total period of 5 tax years, and ensuring that contributions cannot be increased in stages (perhaps in the lead up to the PCLS being received and then again thereafter).

and

3. The cumulative amount of the additional contributions is more than 30% of the PCLS paid.

and

4. The re-investment was 'pre-planned' i.e. the member intended to increase contributions in view of the PCLS available. Please see the 'Pre-planning' section for more information.

Penalties for PCLS recycling

Where PCLS recycling does take place, the whole PCLS amount is treated as an unauthorised member payment and any of the following charges may be applied:

- An unauthorised member payment charge, on the member, of 40% of the PCLS paid.
- An unauthorised member payment surcharge, on the member, of 15% of the PCLS paid. This applies where the total unauthorised payments that are made within a 12 month period are 25% or more of the individual's rights under those pension schemes.
- A scheme sanction charge, on the scheme administrator, of between 15% and 40% of the PCLS paid.

The member must inform the scheme administrator about the recycling within 30 days of when the deemed unauthorised payment occurred. Failing to do so might result in a fine of up to £300, plus further fines of up to £60 per day for each day the notification is late.

The member would also need to declare the unauthorised payment to HMRC on their self-assessment tax return.

‘Pre-planning’

HMRC’s Pensions Tax Manual (PTM) says that pre-planning occurs when the individual makes a conscious decision from the outset to take a PCLS to enable, whether directly or indirectly, significantly greater contributions to be paid into a registered pension scheme in respect of that individual.

Such pre-planning must take place at a ‘relevant time’ which, depending on the circumstances, may be at or before the time the PCLS is paid. Where a PCLS is taken before contributions are significantly increased, the ‘relevant time’ is when the PCLS is taken. However, where the significant increase occurs before a PCLS is taken then the ‘relevant time’ is when the increase to the contributions takes place.

Note that where an individual takes a PCLS and only subsequently decides to use it to pay greater contributions, there is no pre-planning. Here, the onus will not be on that individual to prove the absence of the intention to recycle the PCLS. Instead, the onus is on HMRC to show pre-planning took place.

You can find more information on PCLS recycling in the PTM, including examples to illustrate when the recycling rule would and would not apply.

Drawdown pension re-investing

A member can take an income from their drawdown fund and re-invest this income. The advantages of this are:

- Income tax is payable at the member’s highest rate(s) on any income taken, whilst tax relief can similarly be obtained at up to the highest rate(s) on contributions made back into the pre-retirement plan.
- Re-investing income back into a pre-retirement plan will result in a further 25% PCLS being available when those benefits are eventually crystallised. However, if a PCLS has also recently been drawn from the plan then care needs to be taken that it is not regarded as PCLS recycling.

Note: Taking any income from a flexi-access drawdown arrangement is normally a trigger event for the Money Purchase Annual Allowance (MPAA), which is set at £10,000 with effect from 6 April 2023

Also, subject to the maximum Annual Allowance (or MPAA where applicable), personal contributions in excess of £3,600 (gross) must be supported by sufficient relevant UK earnings in order to obtain tax relief on the contribution.

Key point summary

Drawdown pension re-investment may be a consideration as a tax-efficient vehicle for all members who are taking income from their arrangements which is not required to meet other needs.

Advisers should also be aware of the PCLS recycling rules when members take benefits and contributions are still being made by them or on their behalf.

This represents Zurich’s understanding of PCLS recycling. This is subject to change and Zurich does not accept responsibility for any action taken or refrained from, by any person relying on this information.

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