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Tax-Free Lump Sum Recycling Rules

Tax-free cash recycling happens when an individual uses their tax-free lump sum (also known as Pension Commencement Lump Sum) to significantly increase pension contributions and gain further tax relief on monies that had already benefited from tax relief.

In order to prevent the abuse of the generous tax relief system, HMRC has introduced specific conditions to determine whether recycling event has taken place. Anyone who falls foul of these rules could face penal tax charges .

What are the Rules?

The specific conditions outlined by HMRC are set out below. If an individual answers ‘Yes’ to all the conditions listed below then recycling rules are broken and the tax free lump sum will be treated as an unauthorised payment and HMRC can impose a penal tax charges. If the answer is ‘No’ to any of the questions, then recycling of the tax-free lump sum has not happened.

- Has the individual received tax free lump sum?
- Is the amount of tax free lump sum received, together with any tax free lump sum taken in the previous 12 months, greater than £7,500?
- As a result of taking the tax-free lump sum, have contributions paid into a pension increased significantly and by more than what might have been expected?
- Has the cumulative amount of the additional contributions exceeded 30% of the tax-free lump sum received?
- Is the recycling pre-planned?

What counts as significant increase? (see condition 3 above)

To ascertain whether contributions have been significantly increased, HMRC will look at the contributions which might have been expected if the tax-free cash had not been taken and compare that amount with the contributions that have been paid as a result of receiving the tax-free lump sum.

As a rule of thumb, HMRC will accept that a significant increase has not occurred unless the amount of the additional contributions, as a result of taking the tax free lump sum, is more than 30% of the contributions that might otherwise have been expected.

To prevent an individual making piecemeal or gradual increases, the amount of additional contributions is measured on a cumulative basis to determine whether or not a significant increase has occurred. The additional contributions are measured over a five tax year period: the tax year the tax-free cash is taken and the two tax years either side.

If the cumulative increase over these years exceeds 30%, this would be classed as significant increase. To calculate the increase, each of these five tax years is measured individually against the expected contribution for that year and the percentage figures obtained added together.

What is pre-planning? (see condition 5 above)

Pre-planning means that an individual has to make a conscious decision and therefore be aware of that fact, to use the tax-free lump sum to pay significantly greater pension contributions.

Where an individual takes a tax free lump sum and only subsequently decide to use it to pay greater pension contributions, there is no pre-planning.

The onus is not on the individual to prove the absence of the intention to use the tax-free lump sum to pay the significantly greater contributions. Instead, it is on HMRC to show that pre-planning took place. HMRC will take into account any evidence that points towards pre-planning.

To satisfy this condition, such pre-planning must take place at the 'relevant time'. The 'relevant time' is when the tax-free lump sum is taken. Even if the contributions increase before the tax-free lump sum is taken this can be pre-planning. In this case the 'relevant time' is when the contributions are increased.

Some Examples where recycling does not apply:

Example 1

Peter takes a tax-free lump sum of £7000 from a pension on 01 April 2016 with the intention of using all of this to pay a pension contribution into another pension plan. As the amount of the tax free lump sum does not exceed £7,500 and as long as no other tax-free lump sum has been paid to Peter in the previous 12 months, the recycling rules are not triggered.

Example 2

John takes £40,000 tax-free lump sum from his pension plan and re-invests £10,000 as a pension contribution into another pension plan. There are no other contributions in the tax year when the tax free lump sum was drawn or the two tax years either side. As the contribution is less than 30% of the tax-free cash it would not be caught by the recycling rules.

An example of where recycling does apply:

Example 3

Looking at Example 1 above, Peter takes another tax-free lump sum of £10,000 to further significantly increase his contributions to a pension plan. Because the individual has received another pension commencement lump sum within the previous 12 months (the lump sum of £7,000 taken on 01 April 2016), the amount of the later lump sum of £10,000 must be aggregated with the amount of that previous lump sum. The aggregate amount exceeds £7,500 so the recycling rule is triggered because:

- the individual specifically took the tax-free lump sum of £10,000 in order to pay £10,000 back into a pension plan as a tax relievable contribution,
- that lump sum of £10,000 together with the earlier lump sum of £7,000 exceeds £7,500,
- the amount of the increase is more than 30% of what could be expected, and
- the amount of the significantly increased contribution (£10,000) exceeds 30% of the tax free lump sum £10,000 (ie £10,000 x 30% = £3,000).
- The recycling rule applies to the second lump sum, resulting in a deemed unauthorised payment of £10,000.

IMPORTANT NOTE

This brief guide is based on our understanding of current legislation and HMRC guidance as at 6 April 2017. It is a summary and is not intended to cover every situation. You should not take, or refrain from taking, any action based on this information. Tax treatment can change and depends upon your circumstances. Please remember that taking money out of a pension will impact your standard of living later in retirement. This information is not advice and if you are unsure about the suitability of an investment, you should seek Independent Financial Advice.

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