Pre-6 April 2016 state pension lump sums

Personal tax

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The Low Incomes Tax Reform Group highlights a common query on the tax position of pre-6 April 2016 state pension lump sums.

Those reaching state pension age can defer claiming their state pension. Under the new state pension rules, such deferrals cannot lead to the individual claiming a lump sum. Instead, when the pension is claimed, it will be paid at a higher rate than would have been the case – the 'reward' for the deferral being the accrual of an additional amount of regular pension income.

Under the 'old' state pension rules, those reaching state pension age before 6 April 2016 were also able to defer claiming their state pension. However, when they eventually claim the pension, they can choose to take either a lump sum or a higher regular income.

If such pensioners opt for a lump sum – which can now amount to tens of thousands of pounds – this has a specific tax treatment, set out in Finance (No 2) Act 2005 ss 7-10. This was previously discussed in *Tax Adviser*, December 2017 (www.taxadvisermagazine.com/171201_lump_sums).

LITRG has recently received several queries relating to the treatment of gift aid donations and pension contributions to relief at source schemes when determining the tax rate applicable to the lump sums. Tax relief for these kinds of payment is given by extending the basic and higher rate tax bands by virtue of Income Tax Act 2007 s 10(6). But are they taken into account when determining the tax rate on state pension lump sums? When read together, the interaction of the F(2)A 2005 and ITA 2007 provisions is perhaps less than clear.

F(2)A 2005 s 7 sets out that it is ‘Step 3’ income from the income tax calculation (ITA 2007 s 23) that must be used in determining the tax rate applicable to state pension lump sums. Step 3 income is not adjusted for gift aid donations or contributions to relief at source pension schemes.

F(2)A 2005 s 7(5)(c)-(e) then says that the rate of tax applicable to the state pension lump sum is determined by comparing the Step 3 income figure to the various tax rate limits for the year of assessment – that is, the basic, higher or additional rate.

This raises the question of which limits to consider – whether before or after adjusting for gift aid donations and contributions to relief at source pension schemes. ITA 2007 s 10(6) sets out that the basic and higher rate limits can be extended in respect of gift aid donations and pension contributions made under relief at source. There does not appear to be an explicit confirmation in the F(2)A 2005 provisions that it is the extended limits that are taken into account, although it is presumed that was the intention of the legislation.

This interpretation appears to be supported by the following wording in the Employment Income Manual at EIM74651 (tinyurl.com/mr3zhyry), which confirms use of the individual’s ‘marginal rate’:

> ‘any state pension lump sum is taxed at the highest rate of tax that applies on the individual’s total income. This highest rate is the one that applies after the set-off of all reliefs and allowances that are deducted in “arriving at” and “from” total income. This rate of tax is commonly referred to as the individual’s “marginal rate”.
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> ‘This approach was confirmed during the committee stage of the Finance Bill debate.’

This would therefore lead to the conclusion that income is calculated as set out at Step 3 – that is, income after deducting reliefs set out at ITA 2007 s 24 and allowances, such as the personal allowance. This is then compared with the tax rate limits that apply **to the individual** for that year; i.e. as extended in respect of gift aid donations and contributions to relief at source pension schemes.

As discussed in our July 2019 article (www.taxadvisermagazine.com/190730_sp_lump_sums), people are prone to misunderstanding the taxation of pre-6 April 2016 state pension lumps. Prior to the

pandemic, LITRG had urged HMRC to improve GOV.UK guidance, but little progress was made other than to include a single line on the state pension deferral page (tinyurl.com/45s7c4b9) stating in over-simplified terms:

> ‘You’ll be taxed at your current rate on your lump sum payment. If you’re a basic rate taxpayer your lump sum will be taxed at 20%.’

Problems in this area are likely to affect dwindling numbers as fewer pre-6 April 2016 state pensioners continue to defer. However, the tax consequences of a mistake are significant. LITRG would be pleased to hear of any examples of problem cases members have encountered. Contact ksizer@litrg.org.uk.