THE RECYCLING RULE

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Tax-free cash recycling happens when you use your tax-free cash (or Pension Commencement Lump Sum) to significantly increase pension contributions and gain additional tax relief. This could apply even if you pay the contribution before receiving any tax-free cash. HM Revenue & Customs (HMRC) can impose a tax charge of up to 70% of the value of the tax-free cash.

HMRC has emphasised the recycling rule is intended to prevent the systematic exploitation of pension tax rules to generate artificially high amounts of tax relief and normal retirement planning will not be caught. Please remember that pension and tax rules change, and their benefits depend on your individual circumstances. This factsheet is a brief guide to a complex subject, based on our understanding of current legislation and HMRC guidance as at 6 April 2020 which may change in future. It isn't personal advice. We aren't tax advisors, if you are unsure how to proceed or whether you might be affected by this rule it is important you take advice.

WHEN COULD YOU BE AFFECTED?

You could incur a tax charge if ALL all of the following happen:

- you take tax-free cash from a pension,
- as a result of taking tax-free cash, the contributions paid into a pension are significantly greater than they would otherwise have been (see 'What counts as a significant increase?' below),
- the recycling was pre-planned (HMRC will consider each case and any evidence which points to preplanning),
- the amount of tax-free cash you take, together with any tax-free cash taken in the previous 12 months, exceeds £7,500 and;
- the cumulative amount of the additional contributions exceeds 30% of the tax-free cash (see example 2).

The recycling rules are not intended to catch genuine retirement planning, however you could be inadvertently caught and incur a tax charge of up to 70% of the value of your tax-free cash, so it's important to be aware of.

WHAT COUNTS AS A SIGNIFICANT INCREASE?

To decide 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 received and compare this to actual contributions.

HMRC will generally consider an increase of 30% or more on expected contributions to be significant. To prevent you from making gradual increases, the contributions are measured over five tax years: 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 significantly greater. 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. Example 2 shows how this might work in practice.

IS THERE A WAY AROUND RECYCLING?

The recycling rule applies where you plan to recycle tax-free cash by any means, including indirectly or even via another person. In short, if the intention is there and the result is a significant increase in pension contributions, this could be considered recycling.

SOME EXAMPLES

Example 1

You take tax-free cash of £5,000 from a pension and reinvest all of this in another pension plan. As long as you received no other tax-free cash in the previous 12 months, it would not be caught under the recycling rules, even if this was pre-planned, as the tax-free cash was below £7,500.

Example 2

You retire and receive £40,000 tax-free cash from your pension. You had been paying pension contributions of £20,000 a year for the previous 10 years and before you retired you had intended to use the tax-free cash to increase your contributions. The contributions were then increased as below:

Contributions do not increase by more than 30% in any one year, however, the cumulative increase is 67.5% (20%+22.5%+25%). This is more than 30% and therefore represents a significant increase. The increase of £13,500 also exceeds 30% of the tax-free cash (30% of £40,000 = £12,000). As the increases were pre-planned, you are caught by the rules and might have to pay up to £28,000 tax on the original £40,000 tax-free cash.

	Contribution paid	Increase over previous contribution	Increase as a percentage of £20,000
Year tax-free cash paid	£24,000	£4,000	20%
First year after tax-free cash	£24,500	£4,500	22.5%
Second year after tax-free cash	£25,000	£5,000	25%
Cumulative increase		**£13,500**	**67.5%**

Example 3
You receive £40,000 tax-free cash and reinvest £10,000 in a pension plan. There are no other contributions in the year of retirement 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.

Example 4
You receive £60,000 tax-free cash. You plan to use part of the tax-free cash to pay off your mortgage and part to top up your pension. Over the previous few years you have been contributing £3,000 a year to your pension.

After paying off your mortgage you reinvest £30,000 in a pension plan. However, as this investment was preplanned, it is a significant increase and represents more than 30% of the tax-free cash, it is caught by the recycling rules. Consequently you could have to pay up to £42,000 tax on the tax-free cash of £60,000.

Example 5
You have been paying contributions of £5,000 a year into a pension. You then make a £100,000 contribution and afterwards take pension benefits, including £100,000 tax-free cash. However, as this contribution was pre-planned, it is a significant increase and represents more than 30% of the tax-free cash, it is caught by the recycling rule. It does not make a difference that the tax-free cash was paid after the contribution.

HOW TO FIND OUT MORE

You can find further information, including a number of other examples, at **https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm133800**

ANY MORE QUESTIONS?

Email us at: **pensionshelpdesk@hl.co.uk**

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