

# Pensions flexibility – the new rules

## A radical Budget

The 2014 Budget proposals have been described by some retirement planning experts as a pensions revolution. The radical proposals came as a surprise and are designed to change the retirement landscape by breaking the link between pensions and annuities.

At this stage the broad outline of the reforms is clear, but not all of the detail. There are some interim measures in the Finance Bill currently going through parliament, but many of the longer term proposals are out for consultation, with draft legislation likely to be introduced later this year, but some of the detail may not be finalised until next year's Finance Bill or possibly later. The general election is due on 7 May 2015, and so some of the proposals might fall by the wayside, while others could take a different shape. This uncertainty means that as far as possible, you should build flexibility into any plans you make.

## A changing landscape

These new reforms come at a time when the world of pensions is already undergoing a variety of other significant changes:

- The annual allowance was reduced again for tax year 2014/15, this time to just £40,000 – compared with the £255,000 it was as recently as 2010/11. The annual allowance basically sets the maximum tax-efficient limit for *contributions* to all your pension arrangements during a tax year.
- There was also another cut in the lifetime allowance. This effectively sets the maximum tax-efficient limit for the overall *value* of your pension benefits. The lifetime allowance is now £1.25m against a peak of £1.8m.
- Automatic enrolment of employees and other workers into pension schemes is gradually progressing through the labour force, having started in October 2012 for the largest employers. This will not come fully into operation until October 2018.
- The current structure of the state pension – basic state pension plus, for employees, the State Second Pension (S2P) – will be replaced by a new single-tier state pension, from April 2016. This will cover both the employed and the self-employed, and it will be worth a maximum of about £150 a week in today's terms, before any transitional increments apply.
- In the background the earliest age at which people will be allowed to start drawing their state pension is set to rise: it will be 66 for both men and women by October 2020, with another year added between April 2026 and April 2028



### Focus point

*The radical proposals are designed to change the retirement landscape by breaking the link between pensions and annuities.*

## The pre-Budget pension rules

The Chancellor's proposals focus on money purchase pension arrangements, sometimes called defined contribution (DC) pensions. These types of pension schemes allow you to build up a fund of money that you use to provide a retirement income and a tax-free lump sum. Benefits from any defined benefit pension schemes (where the benefits are linked to the employee's earnings) are not directly affected by the Budget reforms for the most part, as explained below.

A good way to understand the various changes is to take a quick look at the main pre-Budget 2014 rules for drawing retirement benefits from defined contribution schemes. The law – but not necessarily your pension scheme's rules – permitted the following from age 55:

- You could draw up to 25% of the fund free of tax as a lump sum. This could be at any time in an eighteen-month window, beginning six months before any pension income started.
- The balance had to be used to provide an income. There were a variety of options, but the main ones were:
  - *Buy an annuity* Annuities normally guarantee an income throughout life – however long that may be – and can include benefits for dependants. However, the death benefits from annuities are limited.
  - *Choose capped drawdown* This allowed withdrawals directly from the pension fund, but they were subject to maximum amounts that were subject to review and which broadly matched 120% of a non-increasing annuity you could buy on the open market.
  - *Select flexible drawdown* This is effectively drawdown without any annual limits or compulsory reviews of income, but it was only available to individuals with at least £20,000 a year of secure (state or occupational scheme or pension annuity) pension income already being paid.



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Under the old rules you could draw up the total value of your pension benefits as a lump sum if they were not more than £18,000 and you were at least age 60. This so-called 'trivial commutation' was 25% tax-free and 75% taxable. Similarly, regardless of the total value, it was possible to turn into cash 'small pots' of two personal pensions and an unlimited number of occupational pensions, each worth up to £2,000.

## Finance Bill 2014: The interim changes

The pension changes are being introduced in two main steps. The Finance Bill currently going through parliament includes a range of pension measures, most of which are interim provisions pending the planned changes from April 2015:

- *Capped drawdown* The limit for capped drawdown increased from 120% to 150% of the broadly equivalent market annuity rate for drawdown years starting on or after 27 March 2014. So, for example, if you are 65, the maximum capped drawdown as at May 2014 would be 8.85%. If you began withdrawals before that post-Budget start date, you will have to wait until the next drawdown anniversary before any change becomes possible.
- *Flexible drawdown* From 27 March 2014 the minimum secure income for flexible drawdown was reduced from £20,000 to £12,000. As the basic state pension is about £5,900 a year in 2014/15, many more people will now be able to take advantage of this option. However, this option will not be available to you in 2014/15 if a contribution has already been made to a defined contribution scheme for your benefit since 6 April 2014.
- *Commutation and small pots* The total pension wealth limit for full commutation as a lump sum was increased to £30,000 from 27 March 2014. The 'small pots' ceiling was increased dramatically from £2,000 to £10,000 and the number of personal pensions that could be converted to cash under these rules was increased from two to three.
- *Pension commencement lump sum* The government has said that the Finance Bill will extend the period of time before a pension must begin after the lump sum is paid to 18 months. This legislative change was primarily aimed at those people who drew their lump sum before the Budget and either did not buy an annuity subsequently or bought and then cancelled their annuity in the light of the Budget announcements. However, it has been extended to cover those drawing their lump sum later.

While the legislation to cover these relaxations is in this year's Finance Bill, it will not have the full force of law until the Bill receives Royal Assent, probably in July. This timescale, and the need to modify administrative systems and amend scheme rules, means that your pension provider may not be willing and/or able to offer any of the increased flexibility today.

One other pension element in the Finance Bill introduces ‘individual protection’, which is a transitional measure following the reduction in the lifetime allowance from 6 April 2014. You will be able to claim individual protection shortly after Royal Assent provided:

- The total value of your pension benefits at 5 April 2014 exceeded £1.25m; and
- You have not claimed primary protection, an earlier form of lifetime allowance protection, introduced in April 2006.

If you claim ‘individual protection’, you will have your own personal lifetime allowance, which will be the greater of:

- The value of all your pension benefits at 5 April 2014 (subject to a maximum of £1.5m); and
- The lifetime allowance at the time when you draw benefits.

### Focus point

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## Pension Bill 2013: Class 3A national insurance contributions

There is to be a new class of national insurance contributions (NICs), Class 3A, which will become available from 12 October 2015 until 1 April 2017. These NICs will allow anyone who reaches state pension age before the new single tier pension starts to make a lump sum payment to top up their additional state pension (S2P) in £1 a week increments up to a maximum of £25 a week. Normally you will be eligible to contribute if you are a man born before 6 April 1951 or a woman born before 6 April 1953.

The cost per £1 a week of top-up just depends on your age. For example, adding £5 a week to your pension (£260 a year) if you are age 65 would cost £4,450. The government says that the levels of contribution are “actuarially fair”, but in practice they seem very generous compared to current market rates for inflation-linked annuities.

The legislation for Class 3A NICs has been added to the Pensions Bill 2013, which includes the main provisions for the new single-tier state pension.

## Class 3A: Cost for £1 a week extra pension

Exact Age	Cost	Exact Age	Cost
63*	934	70	779
64*	913	71	761
65	890	72	738
66	871	73	719
67	847	74	694
68	827	75	674
69	801	76	646

\* Women only

## Future legislation and consultation

One consequence of the radical nature of the Budget proposals is that there is now a period of consultation on a range of measures. Some of these may not necessarily reach the statute book in next year's Finance Act, though most should be introduced earlier.



### Focus point

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## Pension flexibility

From 6 April 2015 all members of money purchase pensions will be able to draw money from their pensions as they think fit, subject to the rules of their scheme also permitting this. The tax-free lump sum of up to 25% of the fund will remain, with the rest of the fund taxable as income. The change means that capped drawdown will disappear and effectively flexible drawdown – with no minimum income requirement – will become available to everyone. Annuity sales are expected to plummet as a result.

In theory the flexibility will allow a pension fund to be treated in the same way as any other investment: you will be able to take withdrawal whenever you want and you will be able to take part of the fund or all of it. However, in practice, the tax treatment will discourage the extraction of large sums in a single year, as the example of Jane illustrates below.

## Death benefits

The tax position on death under the current rules is that any money remaining in a pension fund that is being used for drawdown is subject to a flat tax charge of 55%. The same tax rate also applies to any fund that is not in drawdown if the death occurs from age 75 onwards. Normally there is no inheritance tax due, so with the

right trust structure, £1,000 of pension fund can become £450 of cash for your chosen beneficiaries.

The Budget statement said that “...the government believes that a flat 55% charge will be too high in many cases in the future” and promised to “engage with stakeholders” in reviewing the rule. Whether this will mean a reduced tax rate for all, a two-tier system of pension and inheritance tax, or something else remains to be seen.

## Flexible pensions and rigid tax

In 2015/16 Jane has £40,000 of taxable income. She decides – without taking advice – that she will use the new pension flexibility to take one personal pension plan she held, worth £120,000, as a single lump sum.

£30,000 of the amount she withdraws is classed as tax free lump sum. The other £90,000 is treated as taxable income. Her tax situation before and after is shown below:

	Without Pension Lump Sum	With Pension Lump Sum
Income	40,00	40,00
Pension taxable lump	nil	90,00
Total income	40,00	130,00
Personal allowance	<u>10,00</u>	<u>nil</u>
Taxable income	<u>29,50</u>	<u>130,00</u>
<i>Tax Payable:</i>		
Basic rate (20%)	5,90	6,35
Higher rate (40%)	<u>nil</u>	<u>39,28</u>
Total tax	<u>5,90</u>	<u>45,64</u>

Although Jane was a basic rate taxpayer before drawing on her pension, she ended up paying an effective rate of 44.2% (£39,743) on the taxable part of her pension lump sum. This was because the extra income not only took her into higher rate tax, but was also enough to take her income over £121,000, meaning she lost her entire personal allowance. Had she taken advice and split the withdrawal over two tax years – which could mean a separation of just a couple of days – she could have saved herself over £4,650 in tax, assuming unchanged tax rates, allowances and bands.



### Focus point

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## Minimum pension age

The standard earliest age at which you can draw pension benefits is currently 55. A consultation document published alongside the Budget proposed that this minimum age should increase in line with the state pension age (SPA), with the first rise being to 57 in 2028, coinciding with SPA reaching 67. However, the document also asked for views on whether a ten-year gap between the minimum pension age and SPA should be reduced to five years, “to allow more time for people to accumulate pension wealth before they reach retirement.”

## Transfers from defined benefit schemes

Remember, the new pension flexibility will only be available for defined contribution (money purchase) arrangements. Defined benefit pension schemes will continue to be limited to providing a regular pension, which is similar in many ways to an annuity. In its consultation document the government says it “recognises that the attractiveness of transferring from defined benefit to defined contribution may increase as a result of the changes” being proposed. This raises two major issues:

- The government is now by far the main provider of defined benefit schemes, but many of these public sector arrangements are unfunded, i.e. no more than a state promise based on future tax flows. However, transfers out of such unfunded schemes require the Exchequer to find real money, which “the government believes... would... be unfair on both the taxpayer and remaining scheme members.”
- If you are a member of a defined benefit scheme, in most instances it will generally not be in your best financial interest to give up the scheme’s implicit promises by transferring to a defined contribution arrangement. This type of pension switch was at the root of the 1990s pensions miss-selling scandal.

The government has promised legislation “to remove the option to transfer from a public service defined benefit scheme to a defined contribution scheme, except in very limited circumstances.” For schemes outside the public sector there will be consultation on a variety of options, from doing nothing to mirroring the public sector transfer ban. No timetable is given for any legislation, but it could well take effect some time before full flexibility arrives in April 2015.

## Tax relief past age 75

At present there is no tax relief on your personal contributions to pensions that you make once you have reached your 75th birthday. The government now wants to consult on whether to revise or abolish this ceiling.



### Focus Point

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## The right to financial guidance

The complexity of the new options has prompted the government to introduce a new right from April 2015 to impartial financial guidance at the point of retirement for anyone with a defined contribution pension. How this will operate in practice is now the subject of discussion between the Treasury, the Financial Conduct Authority and pension providers. One point is already clear: what will be on offer is just guidance, not advice, so you will still be left with the final responsibility for the retirement choices you make.

## What to do now

There are still many uncertainties about the fine detail of the new flexible pension regime, which makes giving definitive advice difficult. However, you should be starting to consider a number of questions as the new framework takes shape.

### If you are approaching or at retirement...

- *How important is a guaranteed retirement income to me?* You may no longer be forced to buy an annuity, but this type of investment does have the virtue of providing a guaranteed income for as long as you live.
- *How important is a retirement lump sum to you?* If you do not need an immediate lump sum, and your pension provider allows it, from April 2015 you may be able to make regular withdrawals from your pension to provide income, with 25% tax-free and the remainder taxable.
- *How will my funds be managed if I choose drawdown?* Your investment strategy may need to change, but how will depend on the levels of withdrawals you want, your appetite for risk and your ability to cope with a fall in your drawdown income.
- *Should I pay Class 3A contributions?* They might look like a bargain, but Class 3A NICs are not right for everyone's circumstances.

- *Should I claim individual protection?* If the value of your benefits is over £1.25m, you could be facing a tax charge of up to 55% on the excess, despite the Chancellor's reforms. There is still scope to protect against this potential tax charge.

## If you are some way from retirement...

- *Does my pension investment strategy need to change?* If you are now thinking of drawing on your pension fund in retirement rather than buying an annuity, your pension investment approach will almost certainly need a review.
- *Would investing in ISAs make more sense for me than contributing to pensions?* Alongside the reforms to pensions, the Budget also introduced an increase to ISA investment limits and a relaxation of the investment rules from 1 July 2014. ISAs are more flexible than pensions, but do not qualify for tax relief.
- *Should I transfer my old pension benefits?* This could be a final opportunity to move some old benefits to gain the new flexibility, but any decision to do so first requires a detailed analysis of all your options.
- *How does the reduction in the lifetime and annual allowance affect me?* The lowering of both allowances could mean you need to revise the timing and size of pension contributions.

## If you are an employer...

- *Is my business ready for the impact of auto-enrolment?* By April 2015 auto-enrolment will apply to virtually all employers with 50 or more employees. The DWP now expects overall take up by employees to be about 85%, a cost you need to budget for.

- *How are my employees going to be informed about the changes?* Communication is a key part of pension provision for employees. You should aim to be providing the answers before the questions start coming in from your employees.
- *What do I do with any old pension schemes?* This is an area that needs similar careful examination to individual transfers and there is no one right answer.
- *Do I need to adapt my remuneration strategy for senior employees?* The increased flexibility of pensions may prompt greater interest in exchanging pay or bonuses for employer pension contributions. However, high-earning employees will need to be aware of the restrictions imposed by the annual and lifetime allowances.



### Focus Point

*As expert financial advisers, we are well versed in the many complexities of retirement planning. Get in touch to see*

## How we can help

As expert financial advisers, we are well versed in the many complexities of retirement planning. We can help you by:

- Explaining the new retirement options open to you and how they can be used.
- Reviewing your current investment strategies in the light of any revised plans for how you take your retirement income.
- Arranging an analysis of your pension transfer options.
- Assessing your auto-enrolment pension options, if you are an employer
- Integrating your auto-enrolment benefits with other retirement planning, if you are an employee.
- Keeping you up to date with the development of the pension reforms announced in the Budget.

Above all, what we offer is individual advice – not plain vanilla guidance – tailored to your circumstances.

Levels and bases of and reliefs from, taxation are subject to change and their value depends on individual circumstances.

The value of investments and income from them can go down as well as up and you may not get back the original amount invested.