Safehands
Independent
Financial
Advisers Ltd.

KEY GUIDE

Pensions freedom – drawing from your pension

Radical reform

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

While the reforms have now made their way into many pages of legislation, it is possible further, even more fundamental changes will emerge as a result of a pension consultation issued alongside the summer 2015 Budget. This uncertainty means that as far as possible, you should build flexibility into any plans you make.

A changing landscape

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

- The annual allowance basically sets the maximum tax-efficient limit for *contributions* to all your pension arrangements during a tax year. This allowance was reduced for a second time in 2014/15 to just £40,000 – compared with the £255,000 as allowance in 2010/11. From 2016/17 it will be subject to a tapered reduction to a minimum of £10,000 if, broadly speaking:
    - Your total income (from all sources) exceeds £110,000; *and*
    - Your total income (from all sources) plus all pension contributions (including employer's) exceeds £150,000.
- The lifetime allowance effectively sets the maximum tax-efficient limit for the overall value of your pension benefits. There have been two cuts in this allowance, with another now due in April 2016. From 2016/17 the lifetime allowance will be £1m against a peak of £1.8m in 2011/12. The allowance will begin to increase again from 2018, but only in line with the Consumer Prices Index.
- 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, also from April 2016. This will cover both the employed and the self-employed, and it will be worth a maximum of about £151.25 a week in 2015/16 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.

Background to the current pension rules

The Chancellor's reforms focussed 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) were not directly affected by the 2014 reforms for the most part, as explained below.

A good way to understand the increased flexibility that was introduced from 6 April 2015 is to take a quick look at the main pre-Budget 2014 rules for drawing retirement benefits from defined contribution schemes. The law – though 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 two 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.

Under these 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.

Focus point

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 change to the new flexible regime was implemented in two stages. The first element, in the Finance Act 2014, introduced a range of mainly interim measures, designed as a bridge to stage two, which took effect from 6 April 2015. However, some of the 2014 measures remain relevant:

- *Capped drawdown* The limit for capped drawdown was increased from 120% to 150% of the broadly equivalent market annuity rate for drawdown years starting on or after 27 March 2014. From 6 April 2015 the option to take new capped drawdown was withdrawn as limits on the amount of withdrawals were removed. However, if you started capped drawdown before 6 April 2015 the 150% ceiling will continue to apply unless you opt for the new flexi-access rules to apply (see below).
- *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.

One other pension element in the Finance Act 2014 introduced 'individual protection', which is a transitional measure following the reduction in the lifetime allowance from 6 April 2014. You can now claim individual protection 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.

A further set of protections are due to be introduced as a result of next year's reduction in the lifetime allowance. The method of claiming either protection is likely to change from the rules that applied for earlier protections, with further details due soon.

Taxation of Pensions Act 2014 and other legislation

One consequence of the radical nature of the Budget proposals was a rush to consult on a range of measures and a rapid push through parliament of the relevant second stage legislation in the Taxation of Pensions Act 2014. Even so, some of the additional changes proposed since the Budget did not reach the statute book until the Finance Act 2015.

Pension flexibility

Since 6 April 2015 all members of money purchase pensions have been able to draw money from their pensions as they think fit, subject to their pension scheme rules (which can be a major obstacle). The flexibility has two main forms:

- *Flexi-access drawdown* This is very similar to the former flexible drawdown, which was very little used because a minimum income requirement which limited its scope. You may put part (or all) of your pension fund into a drawdown fund, from which you can take out any amount you wish over whatever period you choose. When you place funds in drawdown, you will also be able to draw a pension commencement lump sum free of tax from the remaining funds. The maximum lump sum is 25% of the total fund used (drawdown fund plus lump sum), unchanged from earlier rules.
- *Uncrystallised funds pension lump sum* This allows you to take a portion (or all) of your pension as a one-off lump sum without first moving into drawdown. 25% of what you receive will normally be tax free, with the balance taxed as pension income.

Focus point

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.

One downside of using either option is that it will restrict the amount of contributions you can make to all money purchase pension arrangements to £10,000 a year, although your total annual allowance will remain at £40,000. (unless you are affected by the new taper rules from 2016/17).

Annuity purchase and scheme pensions are still available. There have been some useful relaxations to the rules on what an annuity can provide and to whom, similar to the new flexi-access provisions.

In theory the flexibility allows a pension fund to be treated in the same way as any other investment: you can take withdrawals whenever you want and you can 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 old rules was that any money remaining in a pension fund that was being used for drawdown was subject to a flat tax charge of 55%. The same tax rate also applied to any fund that is not in drawdown if the death occurs from age 75 onwards. Normally there was no inheritance tax due, so with the right trust structure, £1,000 of pension fund could become £450 of cash for your chosen beneficiaries.

The rules for drawdown funds and uncrystallised money purchase funds from 6 April 2015 are:

- On death before age 75 there is no tax charge if benefits are paid as a lump sum or drawn via flexi-access drawdown or annuity by the beneficiary(ies).
- On death on or after age 75, there is a lump sum flat rate charge of 45%. This will change to the marginal rate of income tax of the beneficiary(ies) from 2016/17. Alternatively the beneficiary(ies) can draw funds out as taxable income at any age.
- If flexi-access drawdown is chosen by a beneficiary(ies) they have the opportunity of passing any remaining funds down to the next generation (and so on), subject to the same tax rules.

Similar rules apply to any death benefits payable under new annuities. Defined benefit schemes are largely unaffected by these changes.

Focus point

By 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.

Example – 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 uncrystallised funds pension lump sum option to take £120,000 from a personal pension plan she owns.

£30,000 of the amount she draws is classed as a 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	40,000	40,000
Pension taxable lump sum	nil	90,000
Total income	40,000	130,000
Personal allowance	10,600	nil
Taxable income	29,400	130,000
Tax Payable:		
Basic rate (20%)	5,880	6,357
Higher rate (40%)	nil	39,286
Total tax	5,880	45,643

Although Jane was a basic rate taxpayer before drawing on her pension, she ended up paying an effective rate of 44.2% (£39,763) 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 £121,200, 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 £4,800 in tax.

Minimum pension age

The standard earliest age at which you can draw pension benefits is currently 55. The government has now decided 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. The new minimum will apply to all pension schemes, except for those of the armed forces, police and firefighters.

Transfers from defined benefit schemes

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

- The government is by far the main provider of defined benefit schemes, but beyond local authorities, most 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.
- 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 mis-selling scandal.

The government decided that "members of unfunded public service defined benefit schemes will be prevented from transferring to defined contribution schemes in order to protect the Exchequer and taxpayers" and has recently extended the legislation to ensure this block applies to overseas transfers. However, for other schemes the option of transfers to defined contribution arrangements will remain, but with two extra safeguards:

Focus point

The new pension flexibility will only be available for defined contribution (money purchase) arrangements.

- There is a new requirement for an individual to take advice from a Financial Conduct Authority (FCA) authorised professional financial adviser, independent of the defined benefit scheme, before a transfer can be accepted where the value is £30,000 or more; and
- New guidance has been provided for trustees on the use of their existing powers to delay transfer payments and take account of scheme funding levels when setting transfer values.

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. The operation of this service, branded 'Pension Wise', was developed in discussion between the Treasury, the FCA, pension providers and other interested parties. Two long-established bodies, the Citizens' Advice Bureau and the Pensions Advisory Service are supplying the guidance, after recruiting additional staff. Talk to either and one point will become clear: what is on offer is just guidance, not advice, so you will still be left with the final responsibility for the retirement choices you make.

Early in 2015 the FCA announced that it would be requiring product providers to supply 'a second line of defence' alongside Pension Wise. As a result providers now have to issue personalised risk warnings to you if you take advantage of pension flexibility.

Pension Act 2014: Class 3A national insurance contributions

A new class of national insurance contributions (NICs), Class 3A, will be 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 Act 2014, which includes the main provisions for the new single-tier state pension.

Focus point

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.

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

What to do now

Now that the new flexible pension regime is in operation, you should consider a number of questions it raises:

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, 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 flexi-access drawdown?* Your investment strategy may need to change, but how will depend on the levels of withdrawals you want, your capacity 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. Next year a similar issue arises when the lifetime allowance is cut to £1m.

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, last year's Budget also introduced an increase to ISA investment limits and a relaxation of the investment rules. ISAs are more flexible than pensions and now inheritable by surviving spouses or civil partners. However contributions do not qualify for tax relief.
- *Should I transfer my old pension benefits?* You may have the 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 do reductions 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?* Auto-enrolment is now being phased in for virtually all employers with fewer than 30 employees – larger employers have already had to auto-enrol. The Department for Work and Pensions 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.

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 further pension developments.

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.

This publication is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The Financial Conduct Authority (FCA) does not regulate tax advice, so it is outside the investment protection rules of the Financial Services and Markets Act and the Financial Services Compensation Scheme. This publication represents our understanding of law and HM Revenue & Customs practice and the contents of the Finance Bill 2015/16 as at 17 September 2015.

Safehands Independent Financial Advisers Ltd.

Safehands Independent Financial Advisers Ltd
St George's House
29 St George's Road
Cheltenham
Gloucestershire
GL50 3DU

Tel: 01242 516784
Mobile: 07866 315795
Email: markmanning@safehandsifa.co.uk
Web: www.safehandsifa.co.uk

Mark Manning MIFS DipFA