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Chartered Accountants & Registered Auditors

KEY GUIDE

Pensions freedom – drawing from your pension

Radical reform

The changes announced 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 alter the retirement landscape by breaking the link between pensions and annuities.

he reforms have now made their way into many pages of legislation, although there are still minor refinements being made, witness last year's Autumn Statement change to the money purchase annual allowance. Further, even more fundamental changes to the tax treatment of pensions have been kicked into the long grass, but may yet reappear under the new Chancellor. This uncertainty means that as far as possible, you should build flexibility into any plans you make.

A changing landscape

The reforms arrived at a time when the world of pensions was 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. Since 6 April 2016 the annual allowance has become subject to a tapered reduction to a minimum of £10,000 if, broadly speaking:
  - Your total income (from all sources *after deducting* personally made pension contributions) exceeds £110,000; and
  - Your total income (from all sources) *plus* pension contributions made by or through your employer exceeds £150,000.

Action point

As far as possible, you should build flexibility into any plans you make.

Example – Tapering the annual allowance

In 2016/17 Tony has earnings of £108,000 from TonyTech Ltd and investment income of £9,000. TonyTech makes a contribution to its director's self-invested personal pension of £40,000 in the year.

- Tony's total income from all sources is £117,000. He does not personally make any pension contributions, so the £110,000 threshold is triggered (even though his earnings are below £110,000).
- Tony's total income including employer pension contributions is £157,000, so the £150,000 threshold is also triggered.

Tony's annual allowance is reduced by £3,500 – half the excess over £150,000 – to £36,500. As a result he will face a 40% tax charge on the £3,500 by which TonyTech's contribution exceeds Tony's restricted annual allowance.

Tony could have avoided this by transferring most of his investments to his wife, so reducing his investment income to no more than £2,000, as a result, and not breaching the £110,000 threshold. He would also have recovered some personal allowance which is subject to phasing out between £100,000 and £122,000 of total income.

- The lifetime allowance effectively sets the maximum tax-efficient limit for the overall *value* of your pension benefits. There have been three cuts in this allowance, with the latest taking place in April 2016. The lifetime allowance is now £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. Following a change announced in November 2015, this is not now fully scheduled to be in operation until April 2019. However, a goverment review of auto enrolment is due this year, which could prompt further changes.
- The state pension system has been completely redesigned with the odd mix of basic state pension plus, for employees, the state second pension (S2P), replaced in April 2016 by a new single-tier state pension. This new state pension covers both the employed and the self-employed, and it is worth a maximum of about £155.65 a week in 2016/17 (£159.55 in 2017/18), before any transitional adjustments apply (which they generally will).
- 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.

Background to the current pension rules

Action point

A good way to understand the various changes that took effect April 2015 is to take a quick look at the previous rules for drawing retirement benefits from defined contributions schemes.

The reforms focussed on money purchase pension arrangements, sometimes called defined contribution 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 various changes is to take a quick look at the pre-April 2015 rules for drawing retirement benefits from defined contribution schemes. The law – though not necessarily your pension scheme's rules – originally 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.

Interim Measures

The move 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 these earlier 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 still claim individual protection by 5 April 2017 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.

Action point

There is to be a new class of national insurance contributions (NICs), Class 3A, which is available from 12 April 2016 until 1 April 2017.

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 pair of protections has been introduced as a result of the April 2016 reduction in the lifetime allowance. These protections largely mirror their 2014 predecessors, but with lower limits and no end date for applications.

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 2014 Budget did not reach the statute book until the Finance Act 2015 and further technical changes are contained in the Finance Bill 2017 draft clauses.

Pension flexibility

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 of 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.

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 £4,000 a year from 2017/18, although your total annual allowance will remain at £40,000

Example – Flexible pensions and rigid tax

In 2016/17 Jane has £40,000 of taxable income. She decides – without taking advice – that she will use the 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	11,000	nil
Taxable income	29,000	130,000
Tax Payable:		
Basic rate (20%)	5,800	6,400
Higher rate (40%)	nil	39,200
Total tax	5,800	45,600

Although Jane was a basic rate taxpayer before drawing on her pension, she ended up paying an effective rate of 44.2% (£39,800) 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 £122,000, 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 £5,400 in tax.

Action point

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 the rules of their scheme also permitting this.

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.

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 are now:

- On **death before age 75** the 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**, the lump sum is taxed at the marginal rates of income tax of the beneficiary(ies). 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.

Minimum pension age

Action point

Be aware that pension flexibility will only be available for defined contribution (money purchase) arrangements.

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 extended the legislation to ensure this block applies to overseas transfers. However, for other schemes the option of transfers to defined contribution arrangements remains, but with two extra safeguards:

- There is a 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 was 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, were charged with 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.

Action point

If you talk to either the Citizens' Advice Bureau or the Pensions Advisory Service, you receive guidance not advice so you'll still be left with the final responsibility for the retirement choices you make.

The FCA also requires product providers to supply 'a second line of defence' alongside Pension Wise. This means that 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, came into being on 12 October 2015 and remains available until 5 April 2017. These NICs allow anyone who reached SPA before the new single tier pension started 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 are 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 was added to the Pensions Act 2014, which includes the main provisions for the new single-tier state pension.

Example – Class 3A: worth it or not?

Graham turned 65 in March 2016 and is contemplating topping up his state pension using Class 3A contributions. If he wants the maximum £25 a week (£1,300 a year) it will cost him £22,250. He needs to consider the following:

- The pension is fully taxable, so it is worth £1,040 a year to him if he is a basic rate taxpayer, but only £780 if he is a higher rate taxpayer.
- The pension increases in line with CPI inflation, for which the Bank of England has a central target of 2.0% (over the last ten years to November 2016 annual CPI inflation averaged 2.3%).
- Class 3A also buys a 50% widow's pension.
- If inflation averages 2.0% a year then it will take Graham 18 years to get his original investment back if he is a basic rate taxpayer. If he pays higher rate, the breakeven occurs after a further five years. The *average* life expectancy for a man aged 65 is 21 years, according to the Office for National Statistics.

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

Action 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.

What to do now

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

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 me?* 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 relative to annuity rates, but Class 3A NICs are not right for everyone's circumstances.
- *Should I claim one of the new protections?* If the value of your benefits is over £1m, you could be facing a tax charge of up to 55% on the excess. There is scope to protect against this potential tax charge but it must be claimed.

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 recent Budgets have also introduced increases to ISA investment limits and relaxations of the investment rules. More changes will follow in 2017/18 with the arrival of the Lifetime ISA for under-40s. ISAs are more flexible than pensions and now inheritable by surviving spouses or civil partners. Contributions do not qualify for tax relief and there are no IHT exemptions. However, there will be limited government-financed bonus payment for this lifetime ISA, effectively equivalent to basic rate 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 allowance and tapering of the annual allowance affect me?* The lowering of both allowances could mean you need to revise the timing and size of pension contributions.

Action point

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.

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 also need to be aware of the tighter restrictions applying to the annual and lifetime allowances.

How we can help

As 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 benefits with other retirement planning if you are an employee.
- Keeping up to date with further pension and ISA 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 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. This publication represents our understanding of law and HM Revenue & Customs practice and the contents of the Finance Bill 2015/16 as at 9 January 2017.

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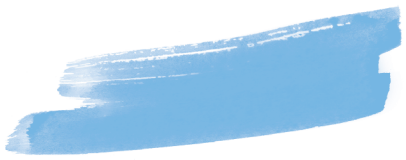
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