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A NEW ERA FOR PENSIONS: ARE YOU UP-TO-DATE?

April 2015 saw the most radical changes to the pension rules for almost a generation, with individuals granted greater flexibility over how and when they take their pension savings. This guide provides an overview of the major reforms to help you maximise your income in retirement.

Accessing pension funds

In the 2014 Budget the Chancellor unveiled a raft of changes to pensions, heralding the start of a new era for pension saving. The reforms give savers complete freedom over their 'pension pots' and how they choose to generate an income in retirement.

Following the changes, there are now four options available to individuals taking benefits from their defined contribution (DC) pension pots for the first time:

- **Flexi-access drawdown (FAD)**
- **Uncrystallised funds pension lump sums (UFPLS)**
- **purchase of a lifetime annuity**
- **scheme pension**

These are available only from age 55 (or earlier where the individual is in ill-health). Here we explore these options in more detail.

Flexi-access drawdown

This is the new form of income drawdown, allowing savers aged 55 and over to take taxable income from their DC savings. The main feature is the removal of the maximum 'cap' on withdrawals.

When amounts are transferred into the drawdown arrangement, the individual can take a tax-free lump sum from the remainder of the fund. This is 25% of the amount transferred and the lump sum. So if someone has a pension pot of £100,000, the transfer of £75,000 into flexi-access drawdown will enable £25,000 to be taken tax-free.

Transferring some or all of a pension pot into a formal drawdown arrangement (together with the lump sum) is an example of ***crystallising*** the amount transferred. If the total amount crystallised (when added to any earlier crystallisations) exceeds the lifetime allowance (LTA), there will be a special tax charge to the extent the LTA is exceeded. The current LTA is £1.25 million – it is set to fall to £1 million from April 2016.

If not all of the pot is transferred (because the full amount of potential pension is not needed), then it is quite possible to have crystallised and uncrystallised pots.

Uncrystallised funds pension lump sum (UFPLS)

A UFPLS allows access to a pension pot without entering a formal drawdown arrangement. Normally 25% of the lump sum received will be tax-free, with the remainder taxed as income in the year of receipt.

To qualify as a UFPLS it must be:

- payable from uncrystallised rights held under a money purchase arrangement
- paid when all or part of the member's LTA is available.

As with the other options available, you must have reached normal minimum pension age (55) or meet the ill-health conditions.

Note that a UFPLS cannot be paid from a drawdown fund.

If someone takes a UFPLS on or after 6 April 2015, they will be subject to the 'money purchase annual allowance' rules (see later) from that date. Any excess money purchase pension contributions will not benefit from tax relief because the individual will be liable to the annual allowance charge on the excess contributions.

Purchase of a lifetime annuity

Traditionally, many individuals bought an annuity – an insurance product that provides a guaranteed annual income for life.

From April 2015 there is more flexibility to vary the amount of income you take, along with an option to take lump sums in some circumstances. Individuals will continue to be able to use some or all of their pension savings to purchase a lifetime annuity if they want to, after taking their tax-free cash. Many will continue to consider that purchase of an annuity is an attractive option as it provides certainty as to the amount of income that will be received.

It was announced at the 2015 March Budget that the Government would legislate from April 2016 to allow people who are already receiving income from an annuity to agree with their annuity provider to assign their annuity income to a third party in exchange for a capital sum. Individuals will then have the freedom to take that capital as a lump sum, or place it into drawdown to use the proceeds more gradually.

Scheme pension

A scheme pension is a pension entitlement provided to members of some pension schemes, which provides an absolute entitlement to a lifetime pension.

The member will normally access 25% as tax-free cash, with the remaining funds converted into a scheme pension.

Other measures

April 2015 also saw changes to the rules on other aspects of pensions, including small pension pots, death benefits and anti-avoidance measures.

Small pots

Amended rules allow for up to three small personal pension pots of £10,000 or less to be paid out as lump sums, while the age limit for taking small pot lump sums has been reduced from 60 to the normal minimum pension age (currently 55 but it may be earlier in the case of ill health).

These are taxed in the same way as a UFPLS, i.e. 25% tax-free and the rest is taxable income.

There is an advantage to using the small pot rule rather than the UFPLS route as taking funds out under the small pot rules does not trigger the £10,000 'money purchase annual allowance' (see later).

Amendment to pension scheme rules

There is now a limited right for scheme trustees and managers to override their scheme's rules to pay flexible pensions and lump sums from DC pots.

Death benefits

People of any age will be able to inherit pension pots. Inherited pension wealth will not count towards the LTA of the beneficiary.

Under the new rules, when someone dies before the age of 75 the pension pot can pass to beneficiaries tax-free as a lump sum, subject to the member having sufficient LTA available to cover the full amount of any uncrystallised funds in the pension pot.

If death occurs at age 75 or over, the beneficiary can either:

- draw down themselves from the pot, which will be taxed at their marginal rates, or
- take it as a lump sum, which will be taxed at a flat 45% rate. From 2016/17, the 45% will be replaced by the beneficiary's marginal tax rates.

These changes signal the end of the 55% 'death tax'.

Anti-avoidance: recycling

The tax-free lump sum cannot be used for 'recycling'. Recycling refers to the process of reinvesting funds into a pension scheme in order to obtain tax relief on the contributions. This anti-avoidance provision was introduced several years ago.

Individuals could exploit the new system to gain a tax advantage by 'recycling' their earned income into pensions and then immediately taking out amounts from pensions. So, for example, an individual could make a £40,000 pension contribution and immediately withdraw that sum as a UFPLS. Tax relief would be obtained on the £40,000 but only £30,000 of the UFPLS would be taxed as income. Therefore a reduced annual allowance has been introduced for DC savings (see 'limits on pension contributions' overleaf). This is the **money purchase annual allowance (MPAA)** and it is set at £10,000 for 2015/16. Where annual pension contributions to DC arrangements exceed the MPAA, the individual will be liable to a tax charge based on the excess contributions.

Q. To what extent can a person access funds without triggering the money purchase annual allowance rule?

A. The £10,000 rule will not apply if a person receives:

- a tax-free lump sum
- a lump sum from a small pension fund
- a lifetime annuity
- no more than the permitted maximum from a pre-6 April 2015 income drawdown fund (see below).

Q. What about those already in drawdown as at 6 April 2015?

A. The options available depend on the type of drawdown. Flexible drawdown will be automatically converted to flexi-access drawdown on 6 April. Capped drawdown will continue in its current format unless the individual wants to switch to flexible access. This will, however, trigger the MPAA rules.

From April 2015 Pension Wise is offering free and impartial guidance to help individuals with defined contribution pensions who are considering accessing their pension pot. Appointments can be booked via their website – www.pensionwise.gov.uk/appointments.

Whilst good news for retirees, this increased flexibility means it is all the more important to seek expert advice and carry out a thorough review of the options available.

Limits on pension contributions

Tax relief on pension contributions

Tax relief on pension contributions made by an individual into a qualifying pension scheme is limited to the higher of 100% of their net relevant UK earnings, or £3,600 per annum.

Contributions above these levels will not receive any relief and there will be a tax charge to the extent that the increase in pension savings in a tax year exceeds the annual allowance (see below).

The annual allowance (AA)

The total of all contributions (either personal, company or third party) that can be contributed within each tax year is limited by an 'annual allowance'. The level of the annual allowance for 2015/16 was originally set at £40,000. However, the Summer Budget proposed that this be increased for 2015/16 to £80,000 with the condition that tax allowable pension savings from 9 July 2015 to 5 April 2016 are capped at £40,000. For 2016/17, the annual allowance will revert back to £40,000.

The AA charge is due on any pension savings over and above the AA available for the year. The effect of the AA charge is to remove tax relief on any pension savings over the available AA and to raise a tax charge on the individual based on the amount of employer contributions.

The amount payable depends on the rate at which tax relief has effectively been given on the excess pension savings, which in turn depends on how much taxable income the individual has and the amount of the excess pension savings.

The three year carry forward rule

Any unused AA for the previous three tax years can be carried forward and added to the current year's allowance. An individual must have been

a pension scheme member during a tax year to bring forward unused relief from that year and the unused relief for any particular year must be used within three years.

Note that where premiums in one year are less than the annual allowance, and this is followed by premiums exceeding the annual allowance in a later year, the unused relief carrying forward is reduced.

The rules are complex so please talk to us before taking action.

Changes from April 2016

In the 2015 July Budget the Chancellor announced that from April 2016 those with income (including the value of any pension contributions) above £150,000 will have their annual allowance tapered away to a minimum of £10,000.

To ensure the measure works as intended, pension input periods are to be aligned with the tax year (rather than the complex rules which applied before 9 July 2015).

Top tips for maximising your pension

Whatever your pension arrangements, planning to maximise the amount you will receive in retirement is crucial. Here are our top tips:

- ★ **Check your state pension entitlement** – Check that your national insurance contributions (NICs) are up to date and consider paying voluntary NICs to ensure that you receive the full State Pension. You can check whether you are likely to have a gap in your NICs record by requesting information about your State Pension forecast from the Future Pension Centre: **www.gov.uk/future-pension-centre**.
- ★ **Carry forward unused allowances** – Ensure you utilise any unused annual allowances from the last three years' pension input periods to help minimise or avoid a potential tax charge. Certain rules and restrictions apply – see earlier.
- ★ **Stop paying national insurance** – If you are planning to defer your retirement and continue working, you no longer need to pay NICs when you reach the State Pension Age (SPA), but you will need to show your employer proof of age. If you are self-employed, you stop paying Class 2 contributions as soon as you reach SPA and Class 4 contributions from the start of the tax year after the one in which you reach SPA. You do not receive a State Pension until you make a formal claim. If you do not claim, the pension will be deferred.
- ★ **Look for lost pensions** – Keeping track of your pensions is not always easy, especially if you are enrolled in more than one scheme or have changed employers during your career. If you think you might have a lost pension, as a first step you should contact the Pension Tracing Service – see **www.gov.uk/find-lost-pension** or call 0845 6002 537.
- ★ **Shop around for the best deal** – Although you are no longer required to purchase an annuity, if you choose to do so, you should always shop around to ensure you receive the best rate possible. The deal offered by your existing provider may not be the most attractive option.
- ★ **Property** – If you own your own home you might want to consider selling and buying something cheaper to release value tied up in your property to supplement your retirement income. Many pensioners also use investment properties, such as buy-to-lets, to help fund their retirement. However, care should be taken as any investment always carries an element of risk.
- ★ **Work for longer** – If you're heading for a shortfall in your retirement income you might want to consider working for longer. Or why not take a part-time role, enabling you to enjoy a partial retirement whilst boosting your income at the same time?

Please contact us for further strategies to help maximise your personal wealth.

Looking ahead: the State Pension shake-up

In addition to the reforms detailed earlier, the State Pension is also set to be overhauled in a bid to make the system fairer and simpler.

The new flat-rate state pension

From 6 April 2016 the basic and additional State Pensions will be replaced with a new single tier flat-rate pension. Those due to reach SPA after this date will receive a flat-rate pension, worth no less than £148.40 per week. For those who do not have an NICs record before 6 April 2016, single tier State Pension will be given to people with at least 35 years of NICs – this is up from the current requirement of 30 years. To receive the State Pension individuals must have at least 10 years of NICs, although for those with between 10 and 34 years the amount of the state pension they receive will be reduced proportionately.

An individual's NICs record before 6 April 2016 is used to calculate a 'starting amount', which will be the higher of either:

- the amount an individual would get under the current State Pension rules (which includes basic State Pension and Additional State Pension)
- the amount an individual would get if the new State Pension had been in place at the start of their working life.

The new system will also see an end to 'contracting out', including for those in occupational pension schemes. Individuals who contracted out of the second state pension as part of a Defined Benefit or Defined Contribution scheme will have a reduction in their starting amount.

If the starting amount is less than the full new State Pension, an individual may be able to get more State Pension by adding more qualifying years on their NICs record after 5 April 2016 (until they reach the full new State Pension amount or reach the SPA – whichever is first).

Voluntary Class 3A NICs

Those who reach SPA before 6 April 2016 will continue to claim their basic State Pension (plus any additional State Pension that they may be entitled to). However, as this may be worth less than the new flat-rate pension, there will be an opportunity to make additional NICs.

From 12 October 2015 to 5 April 2017 eligible individuals can make a 'Class 3A voluntary contribution' to top-up their state pension by up to £25 per week. However, it is important to weigh up the cost of any top-up contributions and the increase in the annual value of the State Pension.

The Government has created a State Pension calculator to help determine how much is needed to top-up a State Pension – see **www.gov.uk/state-pension-topup**.

We can help you to plan for a comfortable future at the end of your working life. Please contact us for more information and advice.

Jargon buster

Annual allowance
The amount that can be contributed into a pension each year and still receive tax relief.

Annuity
A financial product that is purchased from an insurance company and provides a regular, guaranteed income for life.

Auto-enrolment
A new Government initiative which sees eligible employees automatically enrolled into a workplace pension.

Basic state pension
A regular payment from the Government that you can claim when you reach the State Pension Age.

Capped income drawdown
One of two methods of income drawdown available prior to 5 April 2015. Investors take capped withdrawals of income.

Defined benefit scheme
Also referred to as a final salary scheme. This type of pension scheme promises to pay out a guaranteed amount of income based on how much you earn when you retire.

Defined contribution scheme
Sometimes called a money purchase scheme. Money paid in by you or your employer is put into investments by the pension provider in an attempt to grow the fund.

Flat-rate pension
This will replace the basic and additional state pension from April 2016. The Government will pay out a flat-rate but generally an individual will need to have 35 years' NICs to receive the full amount.

Flexi-access income drawdown
A new method of taking out pension savings and an alternative to an annuity. There are no limits on the amount that can be withdrawn but a reduced money purchase annual allowance applies from the date of the first withdrawal.

Lifetime allowance
The limit on the value of pay-outs from a pension scheme(s) that can be made without attracting a tax charge. For 2015/16 the lifetime allowance is £1.25 million.

Money purchase annual allowance
This reduced annual allowance of £10,000 applies to individuals who have accessed their pension savings flexibly from an UFPLS, a flexi-access drawdown fund or a flexible annuity.

Uncrystallised funds pension lump sums
A type of benefit that enables those aged 55 and over to make a 25% tax-free cash withdrawal, with the remaining 75% taxed as income.