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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 (special rules apply if the MPAA rules are triggered in the period 6 April 2015 to 8 July 2015). 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 MPAA rules 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.