



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.

The reforms have now made their way into many pages of legislation. There are still minor refinements being proposed, as evidenced by the Spring Budget plans (now deferred) to cut the money purchase annual allowance. In addition, 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 where it still stands in 2017/18 – compared with the £255,000 allowance in 2010/11. Since 6 April 2016 the annual allowance has also 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 2017/18 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 gross 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, thereby reducing his investment income to no more than £2,000 and, 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 £123,000 of total income in 2017/18.

- 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 progressing through the labour market, having started in October 2012 for the largest employers and now being focussed on the smallest. Following a change announced in November 2015, this is not now fully scheduled to be in operation until April 2019. However, a government review of auto enrolment is due this year, which could prompt further changes.
- The **state pension** system has been completely redesigned with the old 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 £159.55 a week 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

The initial 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 can 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.



Action point

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

Under these old rules you could draw out 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.
- **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.

A fourth pair of transitional protections has been introduced as a result of the April 2016 reduction in the lifetime allowance. These protections largely mirror their 2014 and 2012 predecessors, but with lower limits and no end date for applications.



Action point

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.

Legislation... and more 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, there were amendments in the Finance Act 2016 and further technical changes proposed in the Spring 2017 Budget, but now on ice.

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 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 £10,000 a year (probably to be reduced to £4,000), although your total annual allowance will remain at £40,000 (unless you are affected by the new taper rules).

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 discourages the extraction of large sums in a single year, as the example of Jane illustrates below.

Example – Flexible pensions and rigid tax

In 2017/18 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	<u>11,500</u>	<u>nil</u>
Taxable income	<u>28,500</u>	<u>130,000</u>
Tax Payable:		
Basic rate (20%)	5,700	6,700
Higher rate (40%)	<u>nil</u>	<u>38,600</u>
Total tax	<u>5,700</u>	<u>45,300</u>

Although Jane was a basic rate taxpayer before drawing on her pension, she ended up paying an effective rate of 44% (£39,600) 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 £123,000, 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 £5,600 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.

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 occurred 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**, there is no tax charge if benefits are paid as a lump sum or drawn via flexi-access drawdown or annuity by the beneficiary/beneficiaries.
- On **death on or after age 75**, the lump sum is taxed at the marginal rates of income tax of the beneficiary/beneficiaries. Alternatively, they can draw funds out as taxable income at any age.
- If **flexi-access drawdown** is chosen by the beneficiary/beneficiaries 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

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 most pension schemes, except for those of the armed forces, police and firefighters.



Action point

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

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.
- 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.

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 claim one of the 2016 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 have arrived in 2017/18 with the launch of the Lifetime ISA for under-40s. ISAs can be more flexible than pensions and are now inheritable by surviving spouses or civil partners. Contributions do not qualify for tax relief and there are no IHT exemptions. However, there is 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.

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 – large and medium 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 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 tight restrictions applying to the annual and lifetime allowances.



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.

How we can help

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

-  **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.*
- 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 you 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.

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