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Pension flexibility from April 2015 gets the green light

On 21 July, the Government published its official response to the “Freedom and choice in pensions” consultation, launched with the 2014 Budget, which closed on 11 June. The response outlines the decisions that the Government has taken in order to give individuals greater flexibility when accessing their pension savings from April 2015, but the key points are as follows:

Defined Contribution (DC) scheme flexibility

From 6 April 2015, members of DC registered pension schemes will be able to draw down on their pension savings whenever and however they wish after the age of 55.

The tax-free pension commencement lump sum (usually 25% of an individual’s pot) will continue to be available but any amount in excess of this tax-free lump sum will be treated as income and subject to income tax at their marginal rate(s).

Those who want the security of an annuity will still be able to purchase one. However, those who do not want to purchase an annuity or withdraw their money out in one go, and who would therefore prefer to keep their pension fund invested and access it over time, will still be able to purchase a drawdown product.

DC Transfers

To ensure maximum choice up to the point of retirement, the government will amend the tax and pensions legislation to ensure that the statutory right to transfer from one DC scheme to another will be extended from one year before the scheme’s normal retirement age to the scheme’s normal retirement age.

Annuity Changes

The government is clear that annuities will remain the right choice for many at some point during their retirement, although they also acknowledge that there is a clear demand for more flexibility to allow new products that fit with the changing nature of retirement.

The government therefore intends to change the current tax rules in order to:

- Allow lifetime annuities to decrease in payment. This will allow providers to offer products which meet individuals’ needs more closely, for example by allowing annuity payments to reduce once an individual becomes eligible for the State Pension
- Allow lump sums to be taken from lifetime annuities, on the condition that this is specified in the contract at the point of purchase. This will allow providers to structure much more flexible products that are capable of meeting specific circumstances, such as care needs
- Remove the ten-year guarantee period for guaranteed annuities, which will allow payments made to beneficiaries from guaranteed annuities to continue beyond the current ten year maximum. This will allow providers to create annuities that ensure more of an individual’s fund is returned to their families in the event of their death; and
- Allow payments from guaranteed annuities to be paid to beneficiaries as a lump sum, where the value is under £30,000. This will allow beneficiaries to

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receive pension payments as a lump sum if they wish, rather than having to spread these out over several years.

£10K money purchase annual allowance for pension contributions

A money purchase annual allowance (AA) of £10K for defined contribution (DC) savings will apply to anyone who takes advantage of the new pension flexibility rules after 5 April 2015 (unless the DC fund is valued at no more than £10K and is being commuted under the small pot rules).

The trigger for invoking the £10K money purchase annual allowance will be the first time that someone takes benefits 'flexibly' after 5 April 2015, over and above the initial tax-free lump sum. This reduced AA will not apply to people buying an annuity and individuals already in capped drawdown on 5 April 2015 will not be subject to this reduced AA either, unless they subsequently withdraw more than the capped amount after this date.

Normal Minimum Pension Age

The government will increase the normal minimum pension age (NMPA) from 55 now, to 57 from 2028, alongside the increase in State Pension age to 67. Thereafter, the NMPA will remain ten years below State Pension age. The government is clear that this increase should also apply to public service pension schemes, but not to public service schemes for Firefighters, the Police and the Armed Forces.

Defined Benefit (DB) schemes

Transfers from private sector DB to DC schemes (excluding pensions already in payment) will still be allowed, but only if the individual has first received independent financial advice from a professional financial adviser who is independent from the DB scheme and authorised by the FCA.

Transfers from funded public service DB schemes to DC schemes will also continue to be permitted but transfers from unfunded public service schemes will be banned. A further consultation will also be issued by the government to determine if full or partial withdrawals from a DB scheme (thus enabling a type of flexible drawdown under DB schemes) should be permitted. If this was permitted, this could alleviate an unnecessary burden on DB schemes having to arrange lots of transfers-out to DC schemes, for those who do wish to take advantage of the new pension flexibility.

Death benefit tax charge to come down from 55%

The 55% tax rate on lump sum death benefits paid from crystallised pots will be reduced. The new tax rate will be confirmed in the Autumn Statement but this reduction should encourage more people to seek sustainable income models, rather than strip their funds out to avoid a 55% tax charge on death.

Comment

The forthcoming changes will mean that pension savers will no longer be faced with overly complex and restrictive rules on how they can access their pension pots and the simpler rules should make drawdown cheaper. For those who do want to take advantage of the new flexibility though, increased freedom and flexibility will mean that important decisions loom on the horizon. What to draw and when, how much to spend and where to invest must all be carefully considered so good quality advice will be critical.

Buying an annuity, however, should still remain the right choice for many at some point during their retirement, especially now that the government have given providers the green light to offer more flexible annuity products than those that are currently available.

Accessing pension benefits early is not suitable for everybody and is likely to reduce your income at retirement. It is important to carefully review your individual circumstances before making a decision

Pension or ISA?

Now that the government have given members of Defined Contribution (DC) schemes the green light to draw down on their pension savings whenever, and however, they wish after the age of 55 from 6 April 2015, how, if at all, does the increase in the ISA contribution limit to £15,000 from 1 July 2014 impact on the Personal Pension v ISA choice for investors?

Before attempting to answer this question though, it is perhaps best to first remind ourselves of how the two compare:-

	Personal Pension	ISA
Maximum personal contribution each tax year	Greater of £3,600 and 100% of Relevant UK earnings	£15,000 (from 1 July 2014)
Tax relief on the contribution	Yes	No
Taxation of the fund	Income and gains tax free - apart from the non-reclaimable 10% tax on UK dividends	Income and gains tax free - apart from the non-reclaimable 10% tax on UK dividends
Minimum age benefits can be accessed	55 (unless got a protected pension age or retiring early due to ill-health)	No minimum age
Maximum age benefits can be accessed	No maximum (subject to scheme rules allowing this)	No maximum
Taxation of the benefits	25% tax free lump sum. The balance is subject to income tax	Whole amount is tax free
Lifetime Limit	£1.25m (subject to the various protections available)	None
Included in the estate for IHT?	No	Yes

Subject to affordability, and due to the generous tax reliefs available, it goes without saying that people should try and utilise both their ISA and Pension allowances as much as possible. Given that, in practice though, many people with some surplus cash to invest will probably want to make a decision to invest in one vehicle or the other, which route is likely to be the more suitable? The ISA or the Pension? There is of course no blanket 'right' or 'wrong' answer to this question because each case will have to be judged on its merits taking into account the current and likely future tax status of the individual and the importance (or not) of being able to access the funds whenever they want.

Tax relief going in

A key difference between the two is the fact that contributions to a personal pension qualify for tax relief but contributions to an ISA do not. Regardless of the income tax status of the investor, the fact that any personal pension contribution is automatically grossed up by 20% can make a significant difference to the amount growing tax free within the fund, especially where regular contributions will be made and/or the term to retirement is relatively long.

Tax relief coming out

Only 25% of a personal pension fund can be paid tax free. The balance is subject to income tax and (from 6 April 2015) as an alternative to drawing a regular income, the balance could either be 'stripped out' in one go or taken in ad-hoc instalments as and when required.

Because, however, large withdrawals in excess of the tax free lump sum could easily take a basic rate taxpayer into higher or even additional rate tax, it may be prudent to restrict any withdrawals to an amount that keeps an investor within the basic rate band. Withdrawals from an ISA on the other hand are not added to income and are completely tax free, so this could make the ISA route look more attractive, especially if the investor expects to be paying, or close to paying, higher rate tax when a withdrawal is made.

Importance of access

Another standout difference between the two of course is access. An ISA gives unrestrained access at any time but a pension can't (currently) normally be taken before age 55. And, based on the Governments recent budget proposals, in the future this minimum age will rise to 10 years below whatever the prevailing State Pension Age is at the time benefits are taken.

IHT

Last, but not least, any lump sum death benefits paid from a personal pension are currently free of IHT, and on death before age 75 any lump sum paid from an uncrystallised personal pension would be wholly tax free as long as the amount paid falls within the deceased members available lifetime allowance.

With the exception of any ISA funds that are invested in Business Property Relief qualifying AIM shares, however, the full value of an ISA would be included in the deceased's estate on death. So, unless the deceased's estate was within their available Nil Rate Band or (if not) any excess funds over and above their available Nil Rate Band was passed to a surviving spouse or to charity, IHT at 40% would be payable.

Conclusion

From a tax perspective, the initial 'tax relief' boost that the pension delivers will make the pension take some beating, especially if higher rate relief can be secured on the amount 'going in' to the pension but a withdrawal in excess of the 25% tax free cash can be kept below the higher rate band.

Conversely, an investor who is a basic rate tax payer at the time of making a contribution but who is likely to pay higher rate tax at the time of making a (potentially large) withdrawal could give the ISA greater appeal. Tax is not the only consideration though, and any decision to invest in an ISA or Personal Pension should really only be made after financial advice has been sought and all the factors relevant to a particular investor have been fully considered.

The value of your investment can go down as well as up and you may not get back the full amount invested

HMRC consultation on IHT trust charges

One way to reduce your Inheritance Tax liability is to transfer money out of your estate into a suitable trust. Putting it simply a trust enables you (the settlor) to pass money or other assets to trustees (selected by yourself) which they are then responsible for managing for the benefit of the trust beneficiaries (also nominated by you). There are a wide variety of trusts available however it is important to stress that in most circumstances you will be giving up access to your capital as well as any growth in its value.

For most trusts established after 21 March 2006 a transfer of money or other assets will constitute a chargeable lifetime transfer (CLT) and, if the value of the gift plus other CLTs made in the previous 7 years exceeds the nil rate band (currently £325,000) then the excess can be subject to an IHT charge. Should death occur within 7 years of the gift additional IHT may also be payable.

In addition to this, there may also be an IHT charge based on the value of the trust assets every 10 years and if capital leaves the trust. Broadly, this is calculated as 6% of the amount that exceeds the nil rate band (NRB), although calculations can be more complex than this.

Under the existing rules, the nil rate band available to a trust is reduced to take account of other trusts created by the same settlor on the same day (related settlements), and any other chargeable transfers made in the seven year period prior to the creation of the trust.

On 6th June HMRC published their 3rd consultation document covering proposals for reforming the basis on which IHT charges are calculated for 'relevant property trusts. As just alluded to, in certain circumstances calculations can prove complex as trustees need details of related settlements and

transfers made before the trust was established, so the aim is to make these calculations much more straightforward for trustees.

However, the proposed changes also have a direct impact for financial planning as under the current provisions each trust established by an individual essentially has its own 'nil rate band'. Under the proposed changes individuals will have a 'settlement nil rate band' (SNRB) which they would have to allocate between all the trusts they establish after 6 June 2014.

What do these proposals mean?

Individuals who create a number of trusts will find that the trust IHT charges are much more of an issue to consider.

Not only will decisions need to be made on how to allocate the SNRB to new trusts but care will need to be taken around amending or adding further property to trusts set up pre-7th June 2014 as this will trigger the new rules to apply to that trust.

Some of the key issues that may need to be considered are:

Lump sum gifts

It will still be possible to gift an amount up to the nil rate band every 7 years without an immediate IHT charge. However, where settlors have more than one 'relevant property trust', the trusts could end up paying more IHT under these proposals than under the existing rules.

Life assurance

Any trusts of life policies established after 6 June 2014 will be subject to the new rule as per any other 'relevant property trusts' set up after this date. Usually a life policy will have a nil or negligible value although if you are in ill-health at the time of the trust's decennial anniversary the policy could be deemed to have a 'market value'. Likewise, if there is a claim on the policy the trust would then hold the proceeds and have a value.

So, whilst it may not be necessary to initially allocate any of an individual's SNRB to a trust that holds a life policy, in the above circumstances action may need to be taken to allocate a percentage of the SNRB to the trust at a later date in order to mitigate the impact of any periodic IHT charges.

If the proposals go ahead it will also no longer be possible to split a larger sum assured into a series of smaller policies in separate trusts in order to mitigate trust IHT charges.

Pensions

A common financial planning option to protect pensions from IHT is to establish a pilot trust to receive any lump sum death benefits from a pension scheme in the event the member dies before taking benefits. These are often referred to as 'spousal bypass trusts' as it means that the death benefits are paid to the trust rather than (as is usually the case) the surviving spouse, the objective being that the death benefits do not then form part of the estate of the surviving spouse on their subsequent death. These trusts are typically set up during a members lifetime with a nominal amount (for example £10).

The good news, however, is that the relevant date for the purposes of the new proposals will usually be the date the member joined the pension scheme, rather than the date the spousal bypass trust is established, so it may still be advantageous for you to consider establishing such a trust now, even though these would be effected after 6 June 2014. The proposals will still have an effect, however, on spousal bypass trusts used in connection with a pension scheme that the member joined after 6 June 2014 or where the scheme is established by deed-poll rather than a trust-based arrangement. This can be a complex area and you should seek guidance based on your circumstances.

Summary

The percentage of the SNRB allocated to a trust can be increased, reduced or withdrawn altogether until the first occasion of charge in respect of the trust in question but cannot be reduced after that point. This first occasion of charge will normally be the first ten-year anniversary of the trust or an earlier exit of capital from the trust.

It is important to stress that these proposals are still at the consultation stage and therefore still potentially subject to change. However, it is important for all individuals considering making use of trusts to consider how these changes will affect any planning.

Levels and bases of and reliefs from taxation are subject to change and their value depends on the individual circumstances of the investor

Levels and bases of and reliefs from taxation are subject to change and their value depends on the individual circumstances of the investor.
The value of your investments can fall as well as rise and investors may not get back the full amount originally invested. Past Performance is not a guide to future performance.
Equity investments do not include the same security of capital which is afforded with a cash account.