Summer Issue 2014

MoneyWorks

Nicholsons

What do the Budget changes mean for pensions?

Budget 2014 was expected to yield few surprises with many commentators predicting that the Chancellor would save any notable changes for 2015 in the run up to the next election. However, George Osborne announced radical reforms to UK pension rules which (although subject to consultation) should result in individuals being able to have full flexibility and freedom to do what they want with the pension savings they have accumulated.

Immediate Impact

Whilst the reduction of the annual allowance to £40,000 and lifetime allowance to £1.25m from 6 April 2014 were already known, there were radical reforms proposed with regards to how individuals can access their pension benefits.

Changes from 27 March 2014

Flexible Drawdown: The yearly guaranteed minimum income requirement which is needed to allow someone to access flexible drawdown has been reduced from £20,000 to £12,000. This means that anyone who can demonstrate they have £12,000 of 'guaranteed' pension income (e.g. from state pension and/or annuities) will not be subject to any restrictions on the level of withdrawals they can take from their drawdown arrangement.

Capped drawdown: For individuals who are ineligible for flexible drawdown but who still want the flexibility to draw an income from an invested pension fund without buying an annuity, the maximum yearly income limit has been increased from 120% to 150% of the otherwise available annuity based on GAD tables. This increased income amount applies to drawdown income years starting after 26 March 2014.

Triviality limit increased from £18,000 to £30,000: Individuals over age 60, with total pension savings of £30,000, or less, can now take all their pension savings as a trivial commutation lump sum.

Small pots limit increased from £2,000 to £10,000: For individuals over age 60, small pension pots of up to £10,000 can also now be taken as a lump sum and the number of small personal pension pots that can be taken as a lump sum has been increased from two to three. These payments can be made regardless of the value of the individuals total pension savings and can be made in addition to any trivial commutation lump sum payments.

Changes from 6 April 2015

From 6 April 2015, everyone in a defined contribution (DC) scheme will be able to access their entire pension from age 55. The pension commencement lump sum will remain tax free. Any income can then be drawn without limit and will be taxed at the saver's marginal rate for income tax.

These proposals, assuming they remain unchanged, will therefore provide significantly more choice for pension savers. It should be noted, however, that the government has proposed a ban other than in exceptional circumstances, for a member of a public sector defined benefit (DB) scheme to transfer to a DC scheme. The Government will consult on whether, and if so to what extent, similar restrictions should be imposed on transfers from private sector DB schemes to DC schemes.

What does this mean for annuities?

Whilst the reaction in the financial markets appeared to be based on an assumption that investors will shun annuities the reality is that this conclusion is not necessarily correct as

Money Works is published by

Nicholsons

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many pensioners will still require security of income in old age and many will be relying solely on their pensions to provide this.

In addition, for many people it may simply not make sense to extract a fund, the majority of which may end up subject to higher rate tax, only to then invest in products where income and gains are taxed further.

However that is **not** to say that annuity rates would not come under pressure if the proposals go ahead. The clear argument against annuities of course was always that, unless purchased with a guarantee period or dependents pension, they offered poor value if the annuitant died in the early years and including these options added to the cost.

Although at present there isn't a compulsion to purchase an annuity, the budget proposals arguably result in annuity purchase becoming even more of a voluntary choice. This could therefore mean that individuals wanting to purchase an annuity might disproportionately be those who expect to live a long time. Insurers may then be forced to respond by reducing annuity rates and demand may fall further to just those who expect to live a long time.

Clearly though, with historically low gilt yields and many individuals failing to shop around for the best annuity rate it is clear that the government feels the annuity markets are not working. The hope and expectation is that giving more flexibility will prompt providers of retirement income products to develop more innovative solutions to better meet the needs of pensioners.

Summary

Whilst making pension savings more accessible will be welcomed in many quarters this has come as a surprise, particularly given the focus on Britain's pension savings 'gap' in recent years and against the backdrop of auto-enrolment. What is clear is that advice is essential to ensure you make the correct decision.

The Financial Conduct Authority does not regulate taxation advice

The tax treatment depends on the individual circumstances of the investor and may be subject to change in the future

Transferable Nil Rate Band

Inheritance Tax (IHT) is chargeable on assets held at death and certain lifetime gifts which are over and above the 0% threshold known as the "nil-rate band" (NRB). The rate of tax on death is 40%, subject to any available reliefs and exemptions. Given, however, that the NRB is currently frozen at £325,000 until tax year 2017/18, and it has been estimated that an extra 5,000 estates will be brought into the IHT net as a result, this article provides a reminder of the importance of establishing whether or not a 'transferable NRB' can be claimed.

What is the transferable NRB?

The Finance Act 2008 introduced legislation to allow a claim to be made to transfer any unused NRB on a person's death to the estate of a surviving spouse or civil partner who dies on or after 9 October 2007, irrespective of when the first spouse or civil partner died.

The amount that can be transferred is the percentage of unused NRB on first death, and this percentage is then applied to the value of the then NRB when the survivor dies.

The maximum percentage of unused NRB that can be claimed is 100% (which would double the NRB available) and this allowance can be built up from the estates of more than one deceased spouse or civil partner, subject to the overall 100% limit not being exceeded.

So, if 100% can be claimed and a surviving spouse dies when the NRB is still £325,000, their own NRB will be doubled to £650,000.

Claiming the additional NRB

On second death, the personal representatives of the surviving spouse or civil partner will need to submit a form, **IHT402** to HMRC together with form **IHT400** to claim the amount of unused NRB that is available for transfer.

These claim forms have to be submitted within 24 months from the end of the month in which the survivor dies, together with a copy of the following documents:

- If a Will was made, the Will of the first to die and the grant of probate
- If no Will was made, details of how the estate was devolved under the intestacy rules and the grant of letters of administration.
- Deed of variation (if applicable).

Valuations of the following, where relevant, would also be required in order to complete the IHT402 form:

- Any potentially exempt and chargeable lifetime transfers which the first to die had made in the 7 years before their death
- Any gifts with reservation made by the first to die
- Any assets held in trust to which the first to die was beneficially entitled
- Any assets owned personally by the deceased on first death, including their share of any jointly held assets, that passed to a non-exempt beneficiary (e.g. to children)
- Any assets that passed on first death into a discretionary will trust
- Any assets that passed on first death into an 'interest in possession' trust if the beneficiary with the IIP was anyone other than their spouse; and
- Any other IHT exemptions and reliefs (such as business property relief) that may apply.

Whilst this might not seem to be an onerous process, it is therefore important that the relevant documentation on first death, including evidence of the value of any gifts made in the 7 years before first death is recorded, and kept, in order to make this claim.

It is possible in some cases that the personal representatives may find themselves in a position where they could make a claim but are unable to do so simply because these documents have not been retained or have been misplaced.

It is also important to remember though that whilst NRB planning is no longer necessary for most people following the introduction of the 'transferable NRB' from 9 October 2007, there will still be circumstances where NRB planning using a Discretionary Will Trust (rather than leaving all the assets outright to the spouse or civil partner absolutely) may still be appropriate.

For example:

- Married couples with substantial estates that already exceed the combined NRB, or whose estates do not yet exceed the combined NRB, but it is expected that, following first death, the subsequent growth in assets will exceed the combined NRB on second death
- Either or both spouses already have an increased or the maximum additional NRB to claim from a former deceased spouse; and/or
- It is desired to avoid the full value of the combined estate, including the family home, from being assessed as assets of the surviving spouse for long term care purposes. Any assets held in a discretionary will trust should also be protected from third parties in the event that the surviving spouse is made bankrupt, or subsequently re-marries and gets divorced.

Summary

When considering Inheritance Tax it is important to take account of the possible availability of a 'transferable' NRB, but even if there is one, there may still be circumstances where leaving assets in trust on death may still be suitable. As ever, it always makes sense to take advice before putting any IHT planning in place and we would be happy to make recommendations based on your individual circumstances.

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Reaching state pension age before 6 April 2016?

From October 2015 some individuals will be able to top up their state pension by making the new Class 3A voluntary national insurance contributions which will be made available from that date for a limited time only. The aim of introducing this facility is to enable people who will not get the new flat-rate pension (and who may have lost out because of the structure of the current second-tier pension) to top up their state pension entitlements.

Although It may seem preposterous to voluntarily contribute more into the system by way of additional national insurance contributions, for those who are eligible to make the class 3A contributions it is worth serious consideration as this may actually offer real value for money.

The contribution rates are age related and qualifying individuals will be able to purchase up to a maximum £25 of additional weekly state pension (or £1,300 p.a) and for a 65 year old, for example, the cost will be £890 for each additional £1 of weekly pension, translating into a maximum cost of £22,250 (£890 x £25). The annual pension is also increased in line with the consumer prices index (CPI) and provides a 50% spouses pension in the event of death.

The initial outlay may seem large but when you consider that this equates to a rate of 5.84% this is significantly better than annuity rates available on the open market. For example, the same amount would buy an RPI (retail prices index) linked annuity with a 50% spouses pension of just £724.62* (an effective annuity rate of just 3.25%) so class 3A contributions start to look like a good deal.

The table below highlights the cost per £1 of additional pension purchased which will depend on the individual's age attained at the time they make the class 3A contribution.

Age	Cost of max £25 per week	Equivalent annuity rate
65	£22,250	5.84%
66	£21,775	5.97%
67	£21,175	6.14%
68	£20,675	6.29%
69	£20,025	6.49%
70	£19,475	6.68%
71	£19,025	6.83%
72	£18,450	7.05%
72	£17,975	7.23%
74	£17,350	7.49%
75	£16,850	7.72%

Who can make class 3A contributions?

Two conditions need to be met - You must be entitled to the Basic State Pension or Additional State Pension before 6 April 2016 and the additional contribution must be made between 12 October 2015 and 1 April 2017.

Should everyone who is eligible to do so make these additional contributions?

Not necessarily as, whilst the rates look attractive, there are still other considerations. For example, those individuals in poor health may not want to hand over a significant lump sum for which they may not receive value for money over the long-term. Likewise, individuals wanting a higher level of initial income and who are less concerned about the impact of inflation may decide that annuity rates on the open market would offer better value for their money. As always, it is important to seek advice based on your individual circumstances.

That said, however, making class 3A contributions may appeal to individuals looking for a long-term retirement income and who expect to live a long time. Just like considering retirement income options when crystallising a pension though, it will be important to consider what is right for you, particularly as you cannot get your lump sum back once you have made the class 3A contribution.

If you would like further information on this topic or wish to discuss whether this is relevant to you please do not hesitate to contact us and we will be happy to offer further guidance.

*Source: www.moneyadviceservice.org.uk, based on an annuity purchase price of £22,250, for 65 year old male, increasing with RPI, 50% spouse's pension, paid annually in arrears. Please note the RPI inflation measure is usually a higher rate than CPI so the comparison with the additional state pension that could be purchased is not like-for-like.

Do you need income protection insurance?

If you couldn't work due to a serious illness, how would you manage? Could you survive on savings or your sick pay from work? If not, you will need some other way to pay the bills and you might want to consider income protection.

What is income protection?

Income protection insurance (which used to be known as permanent health insurance or long-term disability insurance) is a long-term insurance policy designed to support you if you can't work because you are ill or injured.

It replaces part of your income if you can't work and it pays out until you can start working again or until you retire or the end of the policy term, whichever is sooner.

There's a waiting period before the payments start, and this is normally set to start after your sick pay ends, or after any other insurance you have stops covering you.

Despite the fact though that Income Protection can provide the vital funds to help pay the bills and cover everyday household expenditure, why do many people not have any income protection insurance?

Cost is an obvious reason, but another is understanding the options available and qualifying the level of cover.

The level of cover available needs to be restricted because human nature being as it is, if someone is financially better off after claiming on the insurance policy than they would be if they were still working, the likelihood of most people returning to work would be reduced. It is therefore for this reason that income protection policies taken out by an individual are often restricted to providing cover of 55% (less any other cover and state benefits) of their pre-disability income. If a claim is made though, the income will then be paid tax free.

The options available can be confusing but we have summarised below some of the most important that need to be understood:

Incapacity will usually be defined on one of the following four bases:

- **Own occupation** – unable, following illness or accident, to perform their own occupation and are not working in another job.
- **Suited occupation** – unable, following illness or accident, to perform an occupation suitable to them given their education and training.
- **Any occupation** – unable, following illness or accident, to perform any occupation at all.
- **Activities of daily living (ADLs)** – unable, following illness or accident, to perform a number of defined functions such as dressing and undressing, washing and eating. The policy will explain the number of functions and their definitions.

Deferred Period – this is the period following illness or injury after which a claim will be paid. This is most commonly 4 or 13 weeks although it is also possible to choose a deferment period of 26, 52 or even 104 weeks. The longer the deferment period the lower the premium will be, and vice versa.

Proportionate benefit – to encourage the return to work of a policyholder recovering their health, many life offices offer to pay a reduced benefit if the policyholder takes a part-time or lower-paid job after recovering their health.

These are a few of the considerations but ultimately the cover will be preferential to relying on state benefits and the erosion of assets which you may have spent many years building up!

Summary

It doesn't matter whether or not you have children or other dependents; if illness would mean you couldn't pay the bills, you should consider income protection insurance.

This is most likely if you're self-employed or employed and you don't have sick pay to fall back on. However, you also need to be sure you can afford to keep paying the premiums, which can be expensive, because if you stop paying the premiums the cover will cease.

You may **not** need income protection though if any of the following applies:

- Your partner or family would support you for as long as you are unable to work
- You could get by on your sick pay. For example, if you have an employee benefits package which gives you an income for six months or more, so you can keep paying the mortgage and other bills as long as you are not off work for too long. But consider how you will cope after the sick pay ends.
- You think you could survive on government benefits. Be careful though, they're much less than many people think.
- You have enough in savings to support yourself – but remember that your savings may need to see you through a long period without being able to work.
- If you're already near retirement age, perhaps you could afford to retire early – and if you are unable to return to work you may be entitled to take your pension early.