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Pension flexibility
A revolution in the rules applying to pensions

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Introduction

On 6th April 2015, new pensions freedoms were introduced. These saw significant and far reaching rule changes applied to pensions. These were the biggest changes seen in a generation, possibly ever.

The rule changes were mainly aimed at defined contribution pension schemes, such as Self-Invested Personal Pensions (SIPPs), Personal Pensions and Stakeholder Pensions; pensions which are often referred to as 'private pensions'. However, some of the changes also impact upon defined benefit schemes (for example, occupational final salary schemes) and the wider implications of these changes touch just about anyone with a pension.

They also throw up interesting questions about wider financial planning decisions; for example, how does a saver balance out the position between ISAs and pensions? Should more money be put towards ISAs or towards a pension (if this is a relevant consideration)? Or should a pension fund, which can be drawn in full (subject to tax deductions), be used to clear an outstanding mortgage?

It is no exaggeration to state that the pension rules provide a totally different approach to pension planning for millions of people than was ever possible before.

The rules in a nutshell:

Drawing benefits:

Total freedom over how to draw from a defined contribution pension

How does this work in practice:

Anyone with a private pension can currently take their fund from age 55 - how they like and when they like. Essentially, there are three ways individuals will be able to withdraw their money:

1. Taking the whole fund as cash in one go – 25% tax free and the rest taxed as income;
2. Taking smaller sums from time to time with 25% of each withdrawal tax free and the rest taxed as income;
3. Taking up to 25% tax free and a regular taxable income from the balance of the fund (from income drawdown or from an annuity. Income drawdown keeps the money invested, an annuity turns the fund into a lifetime income).

Who should consider their options:

1. Anyone with a private pension heading towards retirement.
2. Anyone with a pension of any type who is at the point of retirement, including people with defined benefit schemes who may wish to consider whether a transfer to a private (defined contribution) pension is now valid and desirable.

Comment

The freedom to draw a pension “as and when” to suit the pension investor has a number of implications. Whereas historically (pre April 2015), most people bought annuities with their pension fund, a drawdown or phased retirement options now look far more attractive for many and the annuity option could become somewhat side-lined.

There are some potential downsides. Money drawn out of a pension too quickly may mean the pension fund runs down to zero within an individual's lifetime, i.e. they run out of money. Monies drawn are taxable beyond the tax free amount (normally 25% of the fund); heavy withdrawals, timed badly, could mean an individual tripping into a higher tax band and paying unnecessary taxes.

New rules which came into effect on 1 October 2018 mean that your financial adviser will have to provide you with a valuation of how much the benefits of a defined benefit (DB) scheme would cost to replace before you transfer out, using the Transfer Value Comparator.

Benefits in the event of death:

Flexibility for beneficiaries and potential for tax free benefits from a defined contribution pension

How does this work in practice:

If death occurs before age 75

1. The beneficiaries can receive the whole pension fund as a tax-free lump sum or draw an income from it, which will also be tax free. They can take the income either via an annuity or via income drawdown.

If death occurs after age 75

The beneficiaries will have three options:

1. They can take the whole fund as a lump sum in one go, however this will be taxed at the beneficiary's marginal rate.
2. They can take a regular income via an annuity or via income drawdown: any income taken will be taxed at the marginal rate of tax of the beneficiary.
3. The fund can be paid to a trust as a lump sum less a 45% tax charge.

If death occurs and an annuity is in payment

When an individual buys an annuity, they can choose to have a joint life annuity or they could have a guaranteed period or value protection. Survivor's benefits are tax free if death occurs before age 75.

A joint life or dependant's annuity can be paid after death to a spouse, partner or dependant. On their subsequent death, any value protection or remaining guarantee period can be paid to anyone.

Who should consider their options:

Anybody with a defined contribution pension, a private style plan such as a personal or stakeholder pension, SIPP or Additional Voluntary Scheme. Anyone with an annuity in payment, as described above, who died on or after 3rd December 2014, prior to age 75.

Comment

The possibility now exists to manage a pension in such a way that it can be passed over tax efficiently and down through the generations. There is clearly a balance here with the pension supporting an income in lifetime and acting as a fund (or income) for beneficiaries. This will require careful analysis and financial planning steps being reviewed.

Contributions:

Contributions are restricted if benefits are drawn under the pension freedoms introduced in 2015.

How does this work in practice:

Pension contributions are normally subject to a £40,000 annual allowance, although a 'tapered annual allowance' now applies to individuals whose income is over £240,000, which could reduce the allowance to as low as £4,000 gross per year.

Anyone who makes taxable withdrawals from a defined contribution pension using pension freedoms has a restricted annual allowance of £4,000.

The restricted annual allowance does not apply if:

1. The pension is worth £10,000 or less and is taken as a 'small pot'. This can be done up to three times from a defined contribution pension;
2. Withdrawals that are taken from a "capped" drawdown arrangement, which started before April 2015, do not exceed the annual capped drawdown limit.
3. The pension is taken as a lifetime annuity (other than a flexible annuity).

This £4,000 limit does not apply to any benefits building up in a final salary pension (but the tapered annual allowance does).

The purpose of this restriction is to stop the recycling of tax free benefits from a pension back into the same or another pension to gain tax relief, which would clearly be a significant benefit at the expense of the tax system.

Who should consider their options:

Anybody with a defined contribution pension who is planning to take income from it using pension freedoms.

Comment

Individuals seeking to withdraw money from their pension after the age of 55 need to be wary. Anyone who still wants to make contributions or finds their circumstances change and they make contributions later, after they have made previous withdrawals, could be caught by this restriction.

There are many circumstances where it is feasible to do both (make withdrawals and contributions) which are case specific, especially where so many people are likely to move jobs, continue working after retirement on a part time or temporary basis, or move employment status (for example, into a self-employed basis). It is important to consider both the restrictions applied but also the opportunity to continue making contributions well into retirement and to get advice and help in these cases.

Other key points:

Defined contribution / defined benefits – pension transfers

Essentially, the pension changes that came into force in 2015 apply to Defined Contribution pensions such as SIPPs, personal pensions and stakeholder schemes. They did not generally affect defined benefit schemes (final salary, occupational schemes). The historical 'norm' has been that occupational schemes are nearly always favourable, with better terms all round. The 2015 changes mean it's now possible to transfer out of most defined benefit schemes.

Those seeking to take advantage of pension freedoms who have accumulated benefits in a defined benefit / occupational / final salary type scheme may well want to investigate a transfer at, or close to, retirement to a defined contribution scheme (e.g. a SIPP). It should be noted that it is not possible to transfer out of most Public Service schemes.

The transfer option is one where advice from a qualified adviser is critical. In fact, if you're transferring out of a workplace defined benefit pension scheme and the value of your pension benefit is more than £30,000 you'll have to take professional advice from a regulated financial adviser that is also a Pension Transfer Specialist.

Retirement age changes

The current age at which pension freedoms become available is age 55; this minimum age may rise to 57 in 2028 and then rise further from there in line with State Pension Age rises, although this has not yet passed into law.

Who should consider their options:

Anyone with a pension coming up to retirement.

Comment

As stated in the introduction, the main targets of the pension freedom rules are people with private pensions; they have most relevance to those at, or close to, their retirement point. However, there is a clear knock-on impact to all pensions. For example, anyone with a final salary scheme (defined benefit scheme) may be able to benefit from transferring to a defined contribution scheme, however this should be weighed up very carefully considering the security the defined benefit scheme offers.

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