The New Pension Freedom Rules

Contents

Introduction

A Pensions Revolution **3**

The New Rules – Key Points **4**

The Finer Detail

The New Freedom to draw your Pension from 55 **6**

The New Death Tax Rules **7**

New Restrictions on Contributions **8**

Rules around Guidance **9**

The Financial Planning Implications

For those saving towards Retirement **11**

For those already in Retirement **12**

For those coming up to Retirement **12**

General Financial Planning Implications for Everyone **13**

About Us **16**

Contact Us **16**

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1.

Introduction

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A Pensions Revolution

In March 2014 George Osborne announced a series of new rules relating to pensions. Collectively these rule changes are now widely referred to as 'Pension Freedom'. **They came into effect in April 2015.**

The rules changed the way millions of people will plan their retirements and will affect many generations, not just those at the point of retirement now.

It was not as if pensions had been left untouched prior to this; for the past decade just about every aspect of pensions – their tax treatment, allowances, restrictions, benefits, investment options and availability had been radically altered in one way or another.

In this respect retirement planning and the way pensions could be used was already subject to a changing environment. The April 2015 changes moved everything on again, providing a completely new set of considerations.

As with many areas where change has taken place, this presents a fresh challenge for those of you looking to manage your finances to ensure you have a successful and comfortable retirement.

Our guide aims to inform you of the main headlines that surround the rule changes and how they impact different situations and circumstances.

This is an overview, not a detailed analysis.

We are especially keen to emphasise how the new rules will change the way you approach *financial planning*.

This is not a technical guide – some of these areas remain complex and detailed aspects may change depending on your circumstances.

The information contained in this guide is our understanding of the rules as at 1st July 2015. You should only act or make decisions relating to your situation or your pension after taking appropriate, regulated advice.

The New Rules – key points

- Anybody aged 55 and over with a private pension will be able to draw on their fund, as they like, exercising flexible options which suit their circumstances;
- This only applies to money purchase pensions – more commonly known as "defined contribution schemes" such as private pensions;
- However, there are some knock-on effects for those of you who have "defined benefit schemes" such as a final salary pension (because you may be able to transfer to a defined contribution scheme and use the new 'freedom');
- The tax rules on the death of a pension investor are also different, as of April 2015;
- There are new rules applying to contribution limits and the maximum amount that can be accumulated in total into a pension;
- There are many factors around all of this which will be dependent on individual circumstances (for example, your tax position and your overall savings and wealth position);
- There are a number of complicating factors that have arisen in practice which you need to be aware of (for example, some pension providers are restricting what can be taken and/or encashment charges are being imposed).

You will also note two other major points; the changes apply to people taking (drawing down) their pensions from age 55 and they apply – in the main - to private pensions.

This may suggest that it is only people with a private pension and close to or approaching retirement age who need to be concerned with the new rules. This is not the case, the impact of these new rules will knock on to younger people and also to those with defined benefit (final salary or occupational) pension schemes.

Everyone with a pension should be reviewing their plan of action given these new rules.

2.

The Finer Detail

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The new freedom to draw your pension from age 55

Pension investors aged over 55 from April 2015 will be able to access their pensions with complete freedom. Instead of being forced, under the old rules, to convert savings into annual income (an annuity), they will be able to take out as much as they like, as often as required.

Historically, most pension investors with private pensions bought annuities. This turned a pension into a regular income that lasted for life.

A small number of wealthier savers were able to use an "income drawdown" plan, where the pension pot remained invested as an income was drawn.

All income drawdown restrictions on income were lifted as of April 2015.

The options available to pension savers changed from April 2015. Post-April 2015 savers have three main choices:

- **You can withdraw all of your pension money immediately.**
- **You can leave it invested and take income when required.**
- **Or you can buy an annuity.**

It is worth pointing out that these options are not exclusive of each other. In other words you could combine or blend different options in an overall plan of action.

Withdrawals, however they are taken, will be liable for income tax. However whichever of the three options is exercised the saver will still be entitled to a tax free lump sum, normally 25% of the total pot.

People who have already bought annuities are excluded from these new freedoms.

These changes have led to a widespread reporting of the 'death of annuities'; however this may be exaggerated. We explain why a little later in this report.

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The new 'death tax' rules:

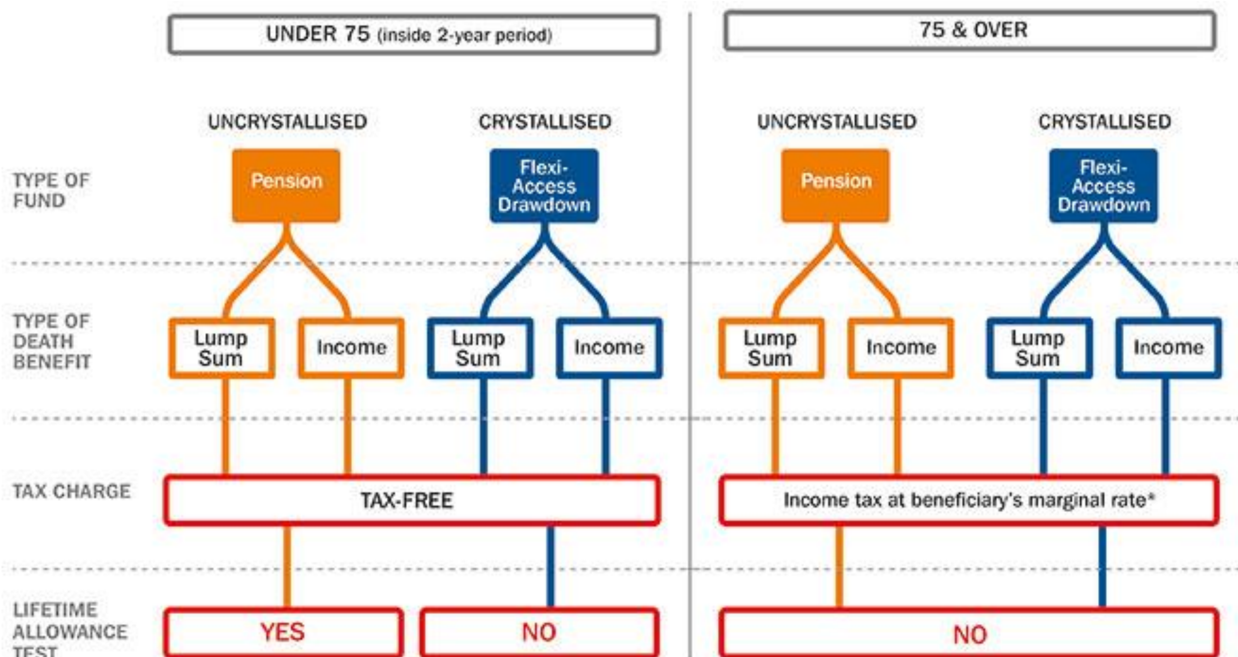
Under the previous rules pension funds were subject to a 55% tax charge - unless the pension investor died before age 75 and had not taken any tax-free cash or income, in which case the pension was passed to beneficiaries as a tax-free lump sum.

This changed from April 2015. It is now feasible for an individual's pension fund to potentially cascade down through generations of your family potentially free of all tax.

Death Benefits – The options

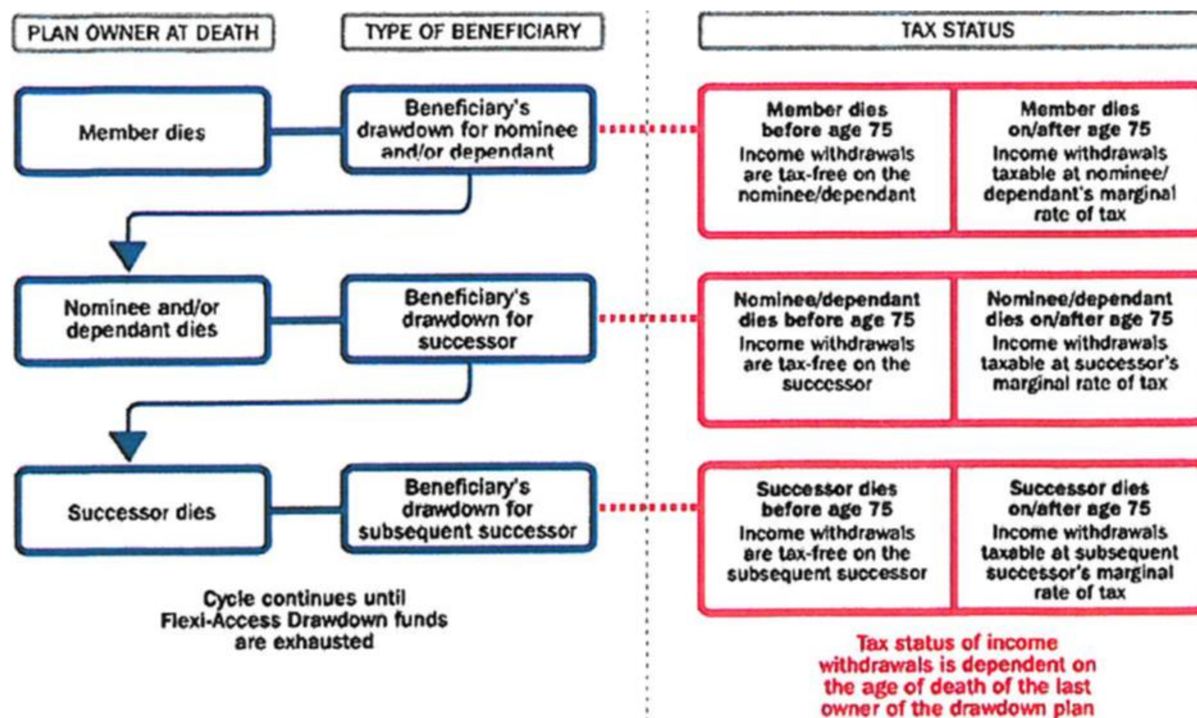
Death benefits are either subject to income tax at marginal rates on the beneficiary or tax free. The only differentiator for determining which will apply is the age at which the member dies.

Where the death of the member occurs prior to age 75, any benefits left to the beneficiary will be tax-free. However, where the member dies at age 75 or any time after, the benefits will be subject to income tax at the beneficiary's marginal rate of income tax. The diagram below illustrates the position.



Under the Pension Freedom rules, pensions can now be viewed in a different light. As the opportunity arises for pensions to be left to future generations as a legacy.

The diagram below illustrates this further:



In most planning scenarios the pension fund should be viewed, first and foremost, as a retirement savings plan, with its main purpose as a means of providing retirement income. However, the improved death benefit and legacy position, of any fund value that is still in place on death, may be highly influential in how plans are structured and in what way they are drawn.

The legacy consideration has become a significant factor, since the rules were changed.

New restrictions on contributions

Some of you may already have 'clocked' a potential and very large loophole in these new rules. At the current time you can pay £40,000 per year into a pension and get tax relief at your highest marginal rate of tax.

From April 2015 you can take all the pension money out as you like, when you like.

For someone over 55 this would suggest they could pay in £40,000 – maximise their income tax relief on the contribution and then withdraw the £40,000 the following week getting 25% of this amount tax free!

This opportunity has been restricted by a change in the rules relating to how much you can contribute if you are withdrawing income under a drawdown plan. In this case if you are making withdrawals from a drawdown plan you will be restricted in the level of contributions you can make. These new proposed rules and the restrictions are complex – however put simply, you will not be able to make contributions freely if you are withdrawing monies from your pension.

HMRC have in place new rules to stop or restrict this so-called 'recycling'.

You need to be very wary and careful therefore if you are continuing to make contributions (or want to) and are seeking to access your funds from your pension post your age 55.

There is a Money Purchase Annual Allowance (MPAA) now in place, which is £10,000 for tax years 2015/16 and 2016/2017 and for future tax years is set at £4,000.

As stated the rules around the recycling and the MPAA are convoluted, the above is merely a brief summary and a flag for you to be aware of.

It is essential you take advice on this point should you consider it may affect you or any decisions you have to make.

Rules around guidance

It is a requirement under the new rules that anyone taking a pension, using the new freedoms, should be given access to guidance and the Government have put in place services to support this. This is through the Pension Wise service.

However already considerable confusion reigns around what constitutes guidance and how this differs from advice.

This is not clear cut in any way, however you wish to view it. We would suggest the guidance service tells you what you ***can*** do, not what you ***should*** do (advice will tell you what you should do).

There are so many complicating factors when drawing upon a pension that guidance can only ever help to a restricted point. Any individual withdrawing money may have to consider and work out the best income structure so as to minimise tax, or they may need to balance short term considerations against longer term ones.

A very large proportion of people have more than one pension and, in many cases, more than one ***type*** of pension. If, for example, you have a private pension **and** an occupational pension, you could have restrictions imposed by one on the other. Your pension provider may not know this (and cannot advise you in any case) and could pay money to you which could cause you to lose valuable contribution allowances in the future, impact on your wider allowances or cause an unwanted tax bill.

There is not the space in a guide of this sort, which is produced to give you an overview, to highlight all the dangers, but there are many. Guidance will not properly flag these up for you; getting good advice will.

3.

The Financial Planning Implications

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Financial Planning Implications

A combination of the new freedoms with the changes to the tax treatment on death have altered how pensions should be viewed for millions of people. The financial planning implications are many and varied. We can now consider some of the major ones below:

For those saving towards their retirement

Pensions have clearly become much more attractive. Many people previously found the inflexibility of pensions at the point of retirement a compelling reason to avoid pensions and to use alternative savings vehicles, such as ISAs.

The Pension vs. ISA debate has certainly shifted towards pensions, but this does not mean that pensions should be favoured over ISAs. It has always been a balanced question, largely determined by personal circumstances. However for many people who have used ISAs instead of pensions this will need to be reviewed.

The introduction of Auto-enrolment into the workplace will mean millions of workers will be offered employer-sponsored pensions over the next few years; many for the first time. These will include employer contributions and a combination of this and the new flexibility should encourage higher savings levels.

A proportion of savers also invest for the future using 'buy to let' property investments – a planning approach which has generally paid off over the past 10-20 years, as a combination of low interest rates, rising rents and house prices has produced a positive backdrop for this approach. Conversely pensions have been seen as inflexible and, in relation to annuity rates, poor value. The Pension Freedom change will shift this comparison. For those people who have worked on the "my property is my pension" basis there could be good reasons now to look at this afresh.

Anyone heading towards retirement – and that really means anyone in the workplace of any age – should review how much they are saving, their saving strategy and their overall long term financial plan. The new rules will probably suggest in many cases a shift in direction.

Financial Planning Implications

For those already in retirement

For anyone who has already entered into an annuity the position is clear: you are committed and the new rules do not affect you, you will continue to receive your annuity income as is. For those of you who have yet to draw a pension. or are currently using a drawdown plan. then you will be able to benefit from the new rules. You should review how and when you may be able to draw down your income, structure your overall plans (allowing for the new death tax rules) and reposition your plans accordingly.

The new rules applying to death taxes may well change your approach to Inheritance Tax Planning or how you structure taking your pension in your own lifetime; the balance between maximising your lifetime income requirement and the desire to hand money down to the next generations may well have changed as a result of the new rules.

For those coming up towards retirement/planning to retire soon

Under the new rules you have three options as described earlier: take an annuity; take your whole fund in one go or take monies as and when required.

Two aspects of these options which have not been well publicised are that you can (a) mix and match your options; for example, you can convert some of your pension to an annuity and take casual flexible withdrawals from the remainder. In this respect balancing your approach; and (b) you can take flexible withdrawals now but convert to an annuity later. In this case you may well like the idea of an annuity and the guarantee/certainty it provides, but wish to hold back, thinking that there may be better annuity rates (income levels) to be obtained in a few years.

A Series of General Financial Planning Considerations for Everyone:

1. These changes apply to private pensions.

One key factor is that, in the main, these changes apply to private pensions only. Pensions such as Personal Pensions, SIPPs, Stakeholder Schemes, Group Personal Pensions and most Additional Voluntary Contribution schemes. They do not apply to occupational schemes, such as company final salary schemes and the Public Sector pension scheme. There is small exception to this where occupational scheme members will be able to be benefit from the death tax change after age 75.

However the main changes are for those people who have private pensions. This, without question, moves the comparison between the two types of scheme in favour of private pensions. This does not mean those of you with company pensions should abandon them, because the guaranteed benefits of your type of scheme and their often generous terms will still make them a better option.

There may be circumstances where the new rules ***are better.*** At the very least you should examine the transfer option. Transfers will be available for those of you with company/final salary schemes, but it appears transfers from most Public Sector schemes will **not** be permitted.

2. Annuities should not automatically be rejected.

Much comment has been passed as a result of the announcements around the changes, that annuities are 'dead in the water'; with the improved flexibility of being able to take benefits as you like, why tie yourself into an annuity?

A fairly priced annuity may still present the best option; because annuities represent a guaranteed income for life with all the certainty this brings. Survey after survey suggest the majority of people need certainty at retirement. The annuity is the only option likely to produce this. The other options are more risky and not many people want to take on risk in their retirement.

Annuities have been poor value for many years because of low interest rates; annuity income levels could well improve in the future. In addition there are new style annuity products being introduced which are providing more flexibility, especially in terms of keeping the door ajar to improved rates in the future, should general rates improve.

Finally, in circumstances of ill health, certain medical conditions or where some lifestyle factors apply, annuity income levels **can be enhanced**, which could be valuable for many retirees.

The UK government seems to be modelling its pension reforms around the way other countries manage their pensions, for example, Norway, Holland and Australia, which all have flexible arrangements for their retirees. However all of these countries also have a high proportion of retirement income paid through annuities.

Greater flexibility does not mean people should reject annuities.

3. Decisions will be largely based on personal circumstances and tax

The government should be applauded for opening up more choice; this can only (on the average) be a good thing. However people should approach matters with great care; the tax changes are predicted over the next ten years to be positive for the UK Treasury. Emphasising how the changes are mechanical ones. These predictions may turn out to be incorrect; especially if at an individual level retirees can plot their income to maximise the amounts they receive whilst minimising the amount of tax.

The need therefore for anyone planning their way forward is to combine their expenditure requirements with a carefully prepared appraisal of how they can draw on their pension to cover this expenditure in the most tax efficient way possible.

Other factors need to be brought into this planning (for example other savings, the need to cover care fees in the future, the desire to pay off debt, leaving money to beneficiaries and so on) and an overall financial map needs to be created which weighs up all considerations.

This will allow a personal plan of action to be formed which will be based on personal circumstances aimed at maximising your position around the new flexibility and tax position.

It is always a difficult position to generalise about pensions and about "what to do", because the position is so heavily affected by personal circumstances. The key element here is that the changes announced throughout 2014 will alter the way millions of people deal with their pensions. Each and every person with a pension scheme will need to review their planning accordingly.

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