SAUNDERSON HOUSE

Pointers Newsletter

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Autumn Statement Update and a Detailed Look at the Forthcoming Pension Revolution

While the UK economy is recovering well, with unemployment now down to 6% and no signs of inflation, the government's finances remain in poor shape. Weak tax revenues, due to disappointing income tax receipts, and lower than expected oil and stamp duty revenues, mean that the UK will still be borrowing close to c£100bn in the current fiscal year.

With a general election set for 7 May 2015, Chancellor George Osborne's ability to sweeten the electorate with tax cuts and other giveaways in the final Autumn Statement of this Parliament therefore appeared limited. Nevertheless, the Chancellor did yesterday announce the following changes of particular note:

- Stamp Duty Land Tax on residential property purchases has been radically reformed with immediate effect. The changes will reduce the Stamp Duty payable on purchases below £937,500, but result in higher tax bills for buyers of more expensive properties. Those who had already exchanged but not completed on a property will be able to choose whether to pay Stamp Duty under the old or new rules.

- The considerable tax advantages of ISAs, including freedom from income tax and CGT, will become transferable between spouses and civil partners on death. Further detail on these changes will be published by HMRC in due course.

- The personal allowance will increase from £10,000 currently to £10,600 in 2015/16, and the higher rate tax threshold from £41,865 to £42,385. The annual ISA allowance will increase to £15,240, and pension allowances are unchanged.

The main focus of this bulletin is the game-changing pension changes proposed earlier this year (and unchanged by the Autumn Statement), which are currently before Parliament and scheduled to come into effect from 6 April 2015.

New Pension Freedoms

Upon reaching Minimum Pension Age (currently 55), individuals can choose to take their tax-free cash and then draw down on their pension investments over time, rather than buy an annuity. Currently, unless an individual has sufficient other guaranteed pension income to elect for Flexible Drawdown, the maximum income each year is capped (at c150% of what an annuity could provide).

From April 2015, this cap will be removed (and Flexible Drawdown replaced). Instead, all individuals will be able to take as much or as little as desired, though the income will still be subject to tax. Additionally, a new lump sum withdrawal option (25% tax-free and 75% subject to income tax) will be added to the existing choices of annuitisation, drawdown and tax-free cash when crystallising.

New Annual Allowance Rules

The government was concerned that individuals might take advantage of this new freedom by making pension contributions (all of which would receive tax relief) and then immediate lump sum withdrawals (25% of which could be tax-free). As a result, those who access a pension under the new flexible rules (or who previously elected for Flexible Drawdown) will thereafter only receive tax relief on contributions of up to £10,000 gross each year, with limited exceptions.

Perhaps the most significant of these exceptions is that those aged under 75 and already in drawdown before April 2015 will not be affected as long as they remain within the current capped drawdown limits and do not access other pensions flexibly.

Changes to the Taxation of Pensions on Death

As more individuals may use drawdown pensions given their new flexibility, the government has proposed an overhaul of the taxes applying to pensions on death, including the abolition of the 55% tax charge that applied in certain circumstances.

Noting that pensions typically do not form part of an individual's estate and so escape Inheritance Tax, the current and new rules (where the Lifetime Allowance has not been breached) are as follows:

	Uncrystallised or in drawdown	Death before age 75	Death aged 75 or over
Current Rules	Uncrystallised	Tax-Free (any nominated beneficiary)	55% Tax (any nominated beneficiary) or Income Tax (dependents only)
	In Drawdown	55% Tax (any nominated beneficiary) or Income Tax (dependents only)	55% Tax (any nominated beneficiary) or Income Tax (dependents only)
New Rules	Either	Tax-Free (any nominated beneficiary)*	Income Tax (any nominated beneficiary)**

* The ongoing income received by widows and widowers under joint life annuities will also become tax-free where the deceased passed away before age 75, where previously this would have been subject to income tax.

** For a short transitional period until April 2016, a 45% tax rate will apply where taken as a lump sum rather than through a beneficiary's drawdown pension.

The new rules will apply to payments of pension death benefits made from 6 April 2015 onwards (even where death occurred in the 2 years before this date), and are of particular benefit to anyone intending for their pension to provide for future generations – and especially those aged under 75 and already in drawdown.

Currently, death benefits can only remain within the pension tax wrapper (and thereby benefit from further tax-free growth outside of the estate for Inheritance Tax purposes) where there is proof of the dependency, usually through marriage, age or impairment.

However, the new rules will allow death benefits to remain within a pension whoever the beneficiary, further increasing flexibility under the new legislation. The beneficiary will then be able to draw as much or as little as desired from the beneficiary's drawdown pension, only subject to income tax if the deceased was over age 75. On the beneficiary's subsequent death, the pension can again be inherited by their successors in the same way.

Case Study

Mrs Smith died on 15 August 2014 aged 65 with an uncrystallised SIPP valued at £1m, which is transferred into a dependant's drawdown pension for her widower after 6 April 2015. The fund grows tax-free, and Mr Smith can choose to make tax-free withdrawals at any time. Mr Smith subsequently dies on 20 September 2020 aged 72 at which point his dependant's drawdown pension is valued at £1.2m. Mr and Mrs Smith's three children now inherit successors' drawdown pensions of £400,000 each, from which they can each also make tax-free withdrawals at any time.

More Lifetime Allowance Tax Charges

The new rules introduce a new Benefit Crystallisation Event to test any uncrystallised funds on death before age 75 which pass to a beneficiary's drawdown fund, with any excess over the Lifetime Allowance subject to a 55% tax charge. Any excess over the Lifetime Allowance can currently pass to a dependant's drawdown fund without a Lifetime Allowance tax charge applying.

Defined Benefit Pension Transfers

The new pension flexibilities described above will have little effect on Defined Benefit (DB) pension entitlements. Those wishing to draw on their pension as and when they want or to leave their pension to their children will not be able to do so through a DB pension. This may lead to increased interest in the possibility of transferring DB pensions to alternative arrangements (such as a SIPP) that will support such flexibility.

However, great care should be taken when deciding to transfer a DB pension, given the value of a guaranteed and inflation-protected income for life and ongoing benefits for a surviving spouse. A decision to transfer should take this into account, alongside the personal circumstances of the individual, their attitude to investment risk and alternative means of generating flexible income or a tax-free lump sum on death. Nevertheless, in limited circumstances, a transfer may be appropriate.

Case Study

John is a retired widower aged 55, in poor health but with considerable wealth, who wants as much of this as possible to pass to his two sons on his death. John has a DB pension that will pay £20,000 per annum from age 60 and increase in line with inflation. John has significant other assets and income and as such will not 'need' the additional income. Currently, if John dies before age 60, his sons will receive a return of his contributions under the scheme's rules, equating to just £30,000. If John dies after age 60, his sons will receive nothing.

John could consider transferring his DB pension to his SIPP. The current transfer value is £400,000. In the event of his death before age 75, the full £400,000 and any tax-free growth would be available to pass on to his sons tax-free. Even if John dies after age 75, his sons could access the fund subject to their marginal rates of income tax.

Minimum Pension Age

With the Minimum Pension Age having increased from 50 to 55 back in April 2010, the government has announced that it will increase again from 55 to 57 from April 2028 onwards, in line with future State Pension Age changes. While this will delay access to pension savings for those born from April 1973 onwards, it is intended that the Minimum Pension Age will remain 10 years before State Pension Age, and therefore those born even later may have to wait still longer once plans to increase the State Pension Age to 68 are confirmed. The effect of these changes should be borne in mind, particularly by those planning early retirement.

Overfunded Pensions

For those continuing to make pension contributions, the reduction in the standard Lifetime Allowance from £1.8m in April 2012 to £1.25m from April 2014 as well as the future increases to the Minimum Pension Age may have significant implications. The powerful effect of compound growth (we have used 6% per annum in the table below) means that even those seemingly far from the current standard Lifetime Allowance could breach this before reaching their Minimum Pension Age.

Age	Minimum Pension Age	Current fund value which projects to £1.25m at minimum pension age (c£)
54	55	1,180,000
52	55	1,050,000
50	55	930,000
45	55	700,000
40	57	460,000
35	58	330,000
30	58	240,000

Where further pension contributions are likely to result in breaching the Lifetime Allowance, it is wise to consider other investment options – including pensions for spouse and children (who can receive tax relief of £720 each on contributions of up to £3,600 gross each tax year, even if they are non-earners), ISAs and taxable investments to allow for the regular use of annual CGT exemptions.

Current legislation allows unused Annual Allowances to be carried forward to future tax years, so high earners can catch up on pension contributions if legislation or other circumstances change. Following significant reductions to the standard Lifetime Allowance in recent years, one might hope it would be increased in the future, though this is not guaranteed.

Deferring State Pension

For those not immediately requiring the income, deferring the State Pension can be advantageous over the long term. The rules that apply depend upon the date an individual reaches State Pension Age. For those reaching State Pension Age on or before 5 April 2016 (men born on or before 5 April 1951 and women born on or before 5 April 1953), most can expect to maximise the State Pension received within their lifetime by deferring claiming by between 4 and 8 years. The advantages are greatest for: women, those with above average life expectancy, and those who might pay income tax at a lower rate in the future or who will have flexible income in retirement. Though the new rules for those reaching State Pension Age on or after 6 April 2016 are less attractive, individuals should still seek advice as to whether they might be better off deferring.

Warning! Auto–Enrolment Can Damage Your (Pension) Health!

The government is introducing auto-enrolment into pension schemes between October 2012 and February 2018. Auto-enrolment entails eligible employees being automatically enrolled (and re-enrolled every three years) into their employer's qualifying pension scheme without any active decision on their part. **Individuals who currently benefit from Enhanced Protection or Fixed Protection should take care to ensure that they 'opt out' of auto-enrolment every three years to preserve their protection and avoid an unnecessary tax charge. As long as employees opt out within 30 days of auto-enrolment it is considered that the employee has not joined the scheme and the protection is safeguarded.** Employers with fewer than 50 employees have staging dates from March 2015 onwards.

For further information about our services, or about the way we work in general, or to arrange a meeting, please contact:

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