



Removing the annuity requirement for pensions

Briefing Note

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Informed Choice
Independent Financial Advice

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Introduction

Contained within their proposals for the Finance Bill 2011 were a number of measures from the Treasury to change annuity and other retirement income rules.



These were broadly categorised as removing the requirement to purchase an annuity with your pension fund by age 75.

The 'age 75 rule' started to be removed earlier in the year, when the coalition government extended the maximum retirement benefits age to 77 ahead of these new proposals which will see it scrapped altogether.

Within this briefing note, we look in more detail at the proposals to scrap the requirement to buy an annuity by age 75, changes to the rules for unsecured pensions (income drawdown) and some of the other pension rules that will be changing over the next couple of years.

Whilst a long running theme of the government for its pension policy has been 'simplification', some people will find these new rules anything but simple. We have already started to identify some investors who now have difficult decisions to make about the timing and nature of their pension benefits, as a result of the new rules being introduced.

Please do let us know if you have any questions about your own retirement planning in light of these new rules. You can call me on 01483 274566, email martin@icl-ifa.co.uk or talk to me on Twitter @martinbamford.

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Deferring pension benefits

The headline announcement made by the Treasury on 9th December 2010 was the removal of the effective requirement to annuitise by age 75.

We refer to this as an effective requirement, because since 6th April 2006 it has been possible to defer the purchase of an annuity past age 75 by using a retirement income option called Alternatively Secured Pension, or ASP.

In practice, from 6th April 2011 there will be no requirement to crystallise any registered pension scheme benefits that remain uncrystallised. Crystallisation is essentially the act of starting to draw benefits from a pension plan, in the form of cash or income.

Whilst uncrystallised pension rights can remain uncrystallised after age 75, they will still be subjected to a Lifetime Allowance test when an individual reaches their 75th birthday. This will be an important consideration and we take a closer look at changes to the Lifetime Allowance later in this briefing note.

Under current rules, it is not possible to take any tax-free cash benefits from a pension plan once an individual reaches their 75th birthday. Any entitlement to a pension commencement lump sum (tax-free cash) must be taken by age 75 or this entitlement is lost.

The new rules will enable lump sum benefits to be permitted from age 75 onwards. This means that an individual who has an entitlement to tax-free cash from their pension will still be able to draw this after their 75th birthday under the terms of the new regime. The existing rules will still be used to calculate the amount of these lump sum benefits.

Unsecured pensions

With the removal of the 'age 75 rule' comes a series of changes to Unsecured Pensions, often referred to as Income Drawdown. These new rules introduce the concept of Capped Income or Flexible Income from an Unsecured Pension.

Capped Income

The new rules for a Capped Income will replace the existing income limits for Unsecured Pensions from 6th April 2011. It also replaces the existing income limits for Alternatively Secured Pensions at the same time.

Capped Income will place a maximum income limit of 100% of the equivalent Government Actuary's Department (GAD) maximum. This means that in any policy year it will be possible to draw up to 100% of a comparable annuity amount from an Unsecured Pension, either pre or post age 75.

The minimum income requirement for Unsecured Pension from 6th April 2011 will remain at nil, enabling people in retirement using this income option to vary their pension income between these two levels depending on their income requirements.

The maximum income limit under the Capped Income rules will be reviewed every three years, bringing back into force the triennial review replaced only recently by an income review once every five years (the quinquennial review).

These new rules will apply to those who already have an Unsecured Pension, from the earlier of the end of the current five year review period, the first scheme income year anniversary following the 75th birthday or the first scheme income year anniversary following a transfer to a new Unsecured Pension provider.

Those who have entered Alternatively Secured Pension before 22nd July 2010 will also see the new Capped Income rules apply, from the start of the first annual income period in which 6th April 2011 falls. This will allow those in ASP to stop taking an income, if they wish, as soon as their next income anniversary enters a period ending on or after 6th April 2011.

Flexible Income

An alternative Unsecured Pension option being introduced on 6th April 2011 is for a Flexible Income. This option will be available to people from age 55 assuming they have satisfied the Minimum Income Requirement (MIR). We have looked in more detail at the MIR in the next section of this briefing note.

Once an individual has self certified that they meet the MIR, the upper limit for income available from their Unsecured Pension will be removed. This means that, in practice, individuals will be able to withdraw any amount from their Unsecured Pension each year.

It will also be a requirement for those using Flexible Income to stop being an active member of any defined benefit (final salary) pension scheme before they can make an election to use Flexible Income.

Any contributions made to a defined contribution (money purchase) pension scheme in the year that an election is made for Flexible Income will be subjected to an Annual Allowance charge. This will result in their pension contribution being taxed at their highest marginal income tax rate.

Pension income drawn under the terms of Flexible Income will be subject to income tax at the individuals highest income tax rate, which could discourage higher earners from withdrawing too much each year from their pension if some of this income would be subject to income tax at 40% or 50%.

Minimum income requirement

From 6th April 2011, those wanting to elect for Flexible Income within their Unsecured Pension, either before or after age 75, will first have to self-certify they qualify with a Minimum Income Requirement (MIR).

This means that they will need to have secured at least £20,000 a year of income from various pension sources.

This MIR can be satisfied from any pension income that is both guaranteed and payable for life. It can include annuity income, scheme pensions and State pension income. There is no requirement under the new rules for this income to be escalating in payment, so it can include level income.

Whilst initially being set at £20,000 per annum, the MIR will be reviewed once every five years by Treasury Order.

Individuals who satisfy the MIR and then elect for Flexible Income whilst non-resident in the UK, to avoid paying UK income tax on the income withdrawn, will be taxed on all withdrawals if they return to the UK with five years of electing to take Flexible Income.

Death benefits

The taxation of death benefits from Unsecured Pensions, before or after 75, is changing from 6th April 2011.

Where someone dies before age 75 with an uncrystallised pension fund, there will be no death benefit tax charge, assuming the total value of their pension benefits are within the Lifetime Allowance.

If you die on or after your 75th birthday with uncrystallised pension benefits, these will be subject to a tax charge of 55%.

The same 55% tax charge on death will also apply to any crystallised pension benefits, regardless of age.

This is a worse position than the current death benefit tax charge of 35% which is applied to lump sum death benefits from Unsecured Pensions where the individual dies before their 75th birthday. It is an improvement for people in Alternatively Secured Pensions, where a combined tax charge on death of up to 82% can currently apply.

It will remain possible to give lump sum death benefits to a registered charity without a tax charge applying.

The new rules also confirm that, under normal circumstances, no inheritance tax liability will arise from pension death benefits. Under current rules, it is rare for an inheritance tax charge to be applied to pension death benefits, unless HM Revenue & Customs believe that an individual has deliberately deferred the crystallisation of their pension benefits to avoid tax charges.

Other considerations

The changes described in this briefing note are not happening in isolation. They need to be considered in tandem with a series of other pension changes that are scheduled to take place in 2011 and 2012.

Lifetime Allowance

In October this year, the government announced that the Lifetime Allowance for pension benefits would be reduced from the current level of £1.8m to £1.5m, from 6th April 2012. The Lifetime Allowance is the limit on the total amount of pension benefits you can draw before tax penalties are applied.

The reduction in the Lifetime Allowance to £1.5m takes it back down to the level at which it was originally introduced on 6th April 2006.

Because some individuals did not register for the available protections from the Lifetime Allowance tax charges when it was introduced in 2006, in the reasonable expectation that it would be at least £1.8m in the future, it will become possible to register for Fixed Protection.

The relevant form for Fixed Protection is not yet available from HM Revenue & Customs, although it must be registered before the Lifetime Allowance reduction to £1.5m occurs on 6th April 2012. It will be possible to protect pension benefits of up to £1.8m, although any excess above this amount will still be subject to a tax charge of 55%.

Annual Allowance

The Annual Allowance is the maximum pension contribution that can be made each year, subject to the individual having sufficient earnings. From 6th April 2011, the Annual Allowance is being reduced to £50,000 from the current level of £255,000. In practice, higher earners (those earning more than £130,000 a year) have seen restrictions on the amount they can contribute to their pension during this and the previous tax year.

The new rules published on 9th December 2010 look set to make an additional minor change to the Annual Allowance rules. Under current rules, pension contributions made in the year that pension benefits are crystallised are not subject to the Annual Allowance. From 6th April 2011, contributions made in the same year as benefits are crystallised will still be subject to this Annual Allowance test.

The only exemptions to this Annual Allowance test applying in the year when pension benefits are crystallised will be death or serious ill health. HM Revenue & Customs is defining serious ill health as making someone unlikely to be able to undertake gainful work, in any capacity, at any time in the future.

Trivial commutation

For people with small total pension benefits, it has been possible to exercise the right to trivial commutation and take the entire pension fund as cash, with a quarter tax-free and the remainder subject to income tax. The trivial commutation limit has been set at 1% of the Lifetime Allowance since its introduction in April 2006.

The rules published for consultation on 9th December 2010 say that the trivial commutation limit will remain at £18,000. This breaks the link with the Lifetime Allowance. Trivial commutation will also become available from age 75 onwards. Under current rules, trivial commutation must be exercised before age 75.

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