AWFM Fact File

"Revised Income Drawdown"

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Yet more changes were announced at the Conservative Party Conference by the Chancellor on **29th September 2014**. It does seem as though the landscape for pension funds is becoming increasingly friendly when it comes to flexibility and tax, although to compensate, the annual contribution allowance has been reduced in this tax year and may be reduced still further in the future.

For those new to Income Drawdown, it is the main alternative option to Annuity Purchase. Income Drawdown involves leaving your accrued pension funds invested and regularly selling investments in the fund to provide an income, as opposed to handing over pension funds to an Annuity provider who take on the investment risk and pay out a guaranteed income for life. Income Drawdown provides greater flexibility over when and how much income and tax free cash you draw as well as greater death benefits, including the ability to pass on the pension fund to a nominated beneficiary on death without the need to lower your pension income.

The key changes to Income Drawdown as a result of the Chancellor's recent budget statements in 2014 and some of the main attractions are as follows:

- The existing Unsecured Pension (USP) and Alternatively Secured Pension (ASP) was replaced by a single Drawdown product with two strands – "Capped Drawdown" for those who can't prove guaranteed income of more than £12,000 (previously £20,000) per annum and "Flexible Drawdown" for those who can. These are transitional arrangements because from April 2015, those with "Capped Drawdown" plans can opt for "Flexi-Access Drawdown" and "Flexible Drawdown" plans will automatically convert to "Flexi-Access Drawdown".

- "Flexi-Access Drawdown" removes any restriction on the amount drawn from the fund each year, subject only to there being sufficient funds to meet the withdrawals. It will therefore be possible to take the whole of the pension fund in one lump sum from April 2015. As is the case currently, some tax free cash must be drawn first before taxable income can be drawn but the amounts involved are flexible, subject to certain calculations. Any income drawn from the fund in excess of the tax free cash entitlement will be taxed at the individuals' marginal income tax rate. This is where a degree of tax planning may become necessary.

- An alternative option has been introduced for people who haven't yet selected a retirement product (i.e. have "uncrystallised" pension funds) which is to be known as an "Uncrystallised Funds Pension Lump Sum". This essentially allows you take anything from a small amount up to the maximum value of the pension fund as a lump sum, with 25% always being tax free and the remaining 75% taxed at your marginal rate of income tax. There is no flexibility over the amount taken as tax free cash and the amount taken as taxable income which is in contrast to "Flexi-Access Drawdown" which allows you to choose, subject to certain calculations. Care needs to be taken if large amounts are drawn in any one tax year, as many could find themselves giving up large amounts of the pension in 40% or even 45% income tax.

- The tax payable on pension funds at death has now been reassessed. From April 2015 the 55% tax charge that existed on passing "Crystallised" Income Drawdown benefits to beneficiaries as a lump sum is to be removed. There is, however, still a distinction between a pension fund holder who dies before age 75 and one who dies after age 75, as follows:

    - <u>Member dies before age 75</u> – providing the administration of death benefits is made within 2 years of death, the beneficiary of the pension fund will be able to inherit the fund as a lump sum **completely tax free**, regardless of whether it is in a "Crystallised" Income Drawdown account (tax free cash has been taken) or "Uncrystallised" pension fund (no tax free cash has been taken). The person receiving the pension fund will **pay no tax** on the money they withdraw from that pension fund, whether it is taken as a single lump sum or as a regular income. If the decision on how the pension benefits are drawn is delayed till after two years from the member's death then the death tax treatment will be the same as if death of the member occurred post age 75.

    - <u>Member dies after age 75</u> – the fund can still pass to a nominated beneficiary (or beneficiaries) who will then also be able to access the pension fund at any age but this individual will **pay tax at their marginal rate of income tax** on any withdrawals made from the fund. This is also the case on death before age 75 where the administration of the death benefits of the pension fund takes more than 2 years from the death of the pension fund member.

It is clear therefore that there will be a significant tax advantage to the beneficiaries of a pension fund member who dies before age 75 than for those of a member who dies after age 75.

The announcement states that there are no restrictions on how much of the pension fund the beneficiary can withdraw at any one time. In theory this means that the whole of the fund can be taken in one go subject to tax at the marginal rate, however it also goes onto say "There will also be an option to receive the pension as a lump sum payment, subject to a tax charge of 45%." The chancellor announced in his 2015 Summer Budget that the 45% tax charge will now only apply to death lump sum benefits paid out to institutions. Individual beneficiaries will be taxed at their marginal rates of tax.

- Tax free cash availability (pension commencement lump sum) to remain – even past the age of 75. There used to be a benefit in accessing all of the tax free cash by age 75, but now it very much depends upon an individual's tax position. It is therefore important to receive an individual assessment.

Comment & Planning points

These changes to Income Drawdown over the last few years have been a big improvement on the previous situation where many clients were (unfairly) restricted on the amount of income they were able to draw as various factors came together. The complete removal of all income restrictions in April 2015 for all those in "Flexi-Access Drawdown" will make the options simpler to understand but it may well be that people are tempted to empty their pension funds and find themselves with no income in their later retirement years. In our opinion, the Government have not sufficiently addressed this risk at this stage.

Those who have elected for Income Drawdown because they want to pass on some of their pension fund to their children will be better able to do this with these new proposals. They will now be able to pass on benefits without too onerous a tax charge (or even no tax charge if death occurs before age 75), which is something many of our clients have been hoping for, especially when the younger generations have neglected their pension funding.

The new pension rules will also allow pension funds to be passed on from beneficiary to beneficiary on death, and not just dependents. It should however be noted that pension scheme trustees (the pension administrator usually) will always offer the pension fund to any surviving dependent first and may in some cases overturn the nominations of a pension fund member. The same tax rules described above will apply, depending on whether death occurs pre-age 75 or post and the pension fund will be designated a "nominees' Flexi-Access Drawdown Fund". These new rules will make passing pension funds on from generation to generation much more achievable and may even make pension funds a much more intrinsic part of Inheritance Tax and wealth preservation planning, bearing in mind that pension funds are still deemed to be outside of a member's Estate for Inheritance Tax calculations.

It may also potentially be attractive for some individuals to increase their withdrawals to much larger levels even bearing in mind income tax thresholds, if for example they wish to make additional gifts out of income to avoid Inheritance Tax. This will need a careful analysis of the various taxes that interplay in this arena.

On death of a pension fund holder it now seems that where a pension fund would usually be passed to a spouse (presumably of a similar age) it may now be better to pass some or all of the fund onto children. This is on the basis that the surviving spouse has sufficient retirement income. This is particularly attractive if the member died before age 75, as the children or grandchildren could then inherit the pension fund tax free.

All of these benefits being introduced will now be dependent on whether pension providers can keep up with the government's announcements, and in some cases whether they are willing to spend the large amounts required in order to update their systems to cater for these new rules. It can therefore not necessarily be taken as a given that a current pension provider will offer all of these benefits and retirement options. As ever, receiving financial advice as to the right retirement product for you as an individual will be key.

And finally a word of warning

There is some momentum building from the legislators to seemingly encourage individuals to opt for the flexible approach to drawing pension benefits as set against Annuity Purchase. In our opinion there is still very much a place for using Annuity Purchase for pension funds for those who need or desire a fixed income through retirement. Individuals should not necessarily be "courted" by the attraction of "Flexi-Access Drawdown" without having a detailed assessment of their financial situation from a suitable qualified and registered financial adviser.

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