

## Tech Talk

September 2014

# Taxation of Pensions Bill: Taking benefits

In two recent Tech Talks we provided an overview of the proposed changes contained in the draft clauses of the Taxation of Pensions Bill (including draft guidance), and an introduction to the money purchase annual allowance. The content of this Tech Talk looks at the taking of benefits from 6 April 2015.

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## Overview

The draft clauses of the Taxation of Pensions Bill (TPB) introduce two new ways in which an individual can take money from their pension arrangements. The first extends the concept of flexible drawdown to everyone from 6 April 2015 under the term flexi-access drawdown, and the second allows individuals to take a new form of authorised lump sum named an uncrystallised funds pension lump sum. There are also some changes to the structure of annuities.

This Tech Talk will only cover the areas of the TPB that impact on the taking of benefits from a money purchase arrangement. The treatment of the money purchase annual allowance rules (MPAA) is covered in the previous Tech Talk - [Taxation of Pensions Bill: Money purchase annual allowance rules](#).

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## Annuities

There are two basic forms of annuity associated with pension income; a lifetime annuity and a short term annuity, the latter of which is a form of drawdown pension. There are strict rules defining an annuity (in both cases), however, from 6 April 2015 there is to be a relaxation of some of these rules.

In the case of a lifetime annuity, it will be acceptable from 6 April 2015 for the payments from the annuity to either increase or decrease, and the current restriction of a maximum term certain guarantee of ten years is to be removed. The latter will allow annuity providers the opportunity to offer a continuation of an annuity beyond the member's death with a term certain guarantee greater than

the current ten years. The other change is that it will no longer be a requirement that the member must be offered the opportunity to select the insurance company, which seems to create a degree of confusion with respect to the provision of an open market option. The increased flexibility, it is presumed, will impact on the annuity rates on offer. Similar rules will apply to a dependant's annuity purchased after 5 April 2015.

If an individual crystallises their benefits after 5 April 2015, takes a pension commencement lump sum (PCLS) and then elects to purchase a lifetime annuity with the balance of their fund, this will not trigger the MPAA rules.

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## Drawdown

From 6 April 2015 an individual will be able to buy a short term annuity from their drawdown fund, whether this be a flexi-access fund or an existing capped drawdown fund for a term of no more than five years, and where the annuity is payable at least on an annual basis. Unlike at present, the income from the annuity could go down as well as up, and it would no longer be a requirement that the individual is given the opportunity to select the insurance company. Although schemes may continue to offer this option, in effect it implies that the scheme administrator could decide which annuity provider to choose.

Where an individual designated funds within an arrangement for capped drawdown pension prior to 6 April 2015, they will have two choices going forward from that date; this includes the scenario where they designate further funds for drawdown.

1. They can retain their fund as a capped drawdown fund and continue to draw income of up to 150% of the basis amount limit. If they have uncrystallised funds within the arrangement, when they elect to draw benefits from these funds they can simply designate these to their existing capped drawdown fund, subject to the existing capped drawdown rules.
2. They can convert their capped drawdown fund to a flexi-access drawdown fund, either by notifying the scheme administrator that they wish to do so, or by taking more than the annual maximum capped drawdown amount, i.e. exceed 150% of the basis amount. If they adopt the latter approach as a means to enter flexi-access drawdown, or if they used the first method and then subsequently take an income payment, this will have immediate implications with regard to their annual allowance. If the individual designates other uncrystallised funds in that arrangement to drawdown at a later date, these will also be flexi-access drawdown.

Care therefore needs to be taken when advising clients, as the situation could arise where they have accessed flexi-access drawdown through one arrangement, whilst remaining within the 150% basis amount with another. In such a scenario the MPAA rules will apply to the client if they have received an income payment under the flexi-access drawdown arrangement.

If an individual is in flexible drawdown prior to 6 April 2015, their drawdown fund will automatically be converted to flexi-access drawdown. Unlike at present, the individual will not face an annual allowance charge on all pension funding in future tax years, albeit the MPAA restrictions will apply if the individual has received an income payment under either flexible or flexi-access drawdown. Further designation of funds under this arrangement for drawdown will be on a flexi-access basis.

Where an individual has not crystallised any of their arrangements prior to 6 April 2015, when they do so on or after that date, their designated drawdown fund will be a flexi-access drawdown fund. They will normally be able to take 25% as a PCLS, and if they restrict themselves to the PCLS, namely they do not take any income from their designated drawdown fund, they will retain the £40,000 annual allowance. If, however, they withdraw any income, even through the use of a short term annuity, they will be restricted to the MPAA going forward.

Similar rules will apply to dependants' drawdown options after 5 April 2015. However, income taken from a dependant's flexi-access drawdown fund on its own will not result in the dependant triggering the MPAA rules.

Where an individual intended to use phased drawdown as a means to fund their retirement, from 6 April 2015, they will have to give careful consideration as to how this may impact on any future pension funding.

## EXAMPLE 1

Phil is 55 on 1 June 2015 and works in a high-pressure sales environment. His intention is to cut his hours from then by working only four days a week. To supplement his reduced income he intends to take funds from his money purchase pension arrangement, which is worth £800,000. However, he will remain an active member of the pension arrangement, as there is a significant employer contribution of £20,000 each year, as well as his own personal contributions of £10,000. He has no other pension savings.

If Phil was solely to use a PCLS to boost his income (taking no income from the associated flexi-access drawdown fund), then he would retain the full £40,000 AA. However, if he were to crystallise a smaller amount and take a combination of PCLS and flexi-access drawdown income, he would be restricted to the lower MPAA of £10,000. In the second scenario, Phil may be liable to an AA charge on £20,000 in the future.

## Uncrystallised funds pension lump sum

From 6 April 2015 individuals will have an alternative way to access their pension savings through an uncrystallised funds pension lump sum. To qualify as an uncrystallised funds pension lump sum, the payment must satisfy the following:

- it must be payable from uncrystallised rights held under a money purchase arrangement;
- the member must have more lifetime allowance remaining than the amount of the lump sum if they are under age 75 when it is paid;
- if the member is 75 or over when the lump sum is paid, they must have at least some lifetime allowance remaining at that time; and
- the member must have reached normal minimum pension age (55) or meet the ill-health conditions.

Normally 25% of the amount paid will be free of tax, with the remainder taxed as income at the individual's marginal rate. As this is a new form of an authorised lump sum and not a PCLS, then an individual with scheme specific lump sum protection would not be able to take more than 25% of the uncrystallised funds pension lump sum tax free. Also, where someone has a protected pension age, they will only be able to take an uncrystallised funds pension lump sum at 55.

Individuals who have either Enhanced and/or Primary Protection with a protected lump sum will not be able to be paid an uncrystallised funds

pension lump sum. Similarly, those individuals who have a lifetime allowance enhancement factor (from Primary Protection, pension credits from previously crystallised rights, non-residence, transfers from recognised overseas pension schemes or pre-commencement pension credits) and the available portion of their lump sum allowance is less than 25 per cent of the proposed uncrystallised funds pension lump sum, will be unable to access this option.

In a situation where the individual is under the age of 75 when they take the uncrystallised funds pension lump sum, the full amount taken will be tested against their remaining LTA as a BCE 6. If the uncrystallised funds exceed the remaining LTA, the amount up to the lifetime allowance may be paid as an uncrystallised funds pension lump sum and the excess paid as a lifetime allowance excess lump sum.

If the individual is over 75 at the time of taking the lump sum, they must have at least some of their LTA remaining for it to be treated as an uncrystallised funds pension lump sum. If they have sufficient LTA, then 25% of the funds taken will be free of tax with the remainder taxable as income. However, if their remaining LTA is less than the amount they wish to take, they will be restricted to 25% of their remaining LTA tax free; the balance again being taxed as income.

Taking an uncrystallised funds pension lump sum means the MPAA rules will apply to the individual.

## EXAMPLE 2

Derek is 77 and has 10% of the LTA remaining. As he has no form of protection in place, this amounts to £125,000. However, his remaining uncrystallised money purchase fund is worth £200,000, which he wishes to take in its entirety on 1 September 2015. Although the whole amount is still an uncrystallised funds pension lump sum, only £31,250 is free of tax (25% of £125,000) and the remaining £168,750 is subject to income tax at his marginal rate.

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## Death benefits

The treatment on the death of a member who is in flexi-access drawdown is the same as at present for those in capped drawdown, with the lump sum paid as a flexi-access drawdown fund lump sum death benefit. Where the member remained in capped drawdown prior to their death (post 5 April 2015) then a drawdown pension fund lump sum death benefit would be paid. These forms of death benefit lump sums can be paid to beneficiaries,

though as of yet, there is no indication as to what the tax charge (presently 55%) will be on these payments.

There is no facility to pay an uncrystallised funds pension lump sum after the death of the member.

A dependant's pension will still be an option from drawdown funds.

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## Pre-commencement pension rights

If an individual had pension rights in payment before 6 April 2006 (pre-commencement pension rights), those rights are only tested against the LTA when the first BCE occurs. The purpose of this test is to determine how much of the LTA is still available for those new rights being crystallised. If that first BCE were to occur before 6 April 2015, in the case of a drawdown pension, the method used to test the pre-commencement rights is to multiply the maximum amount available under drawdown by a factor of 25. However, the TPB includes changes to this method where the first BCE occurs after 5 April 2015.

Where the individual has pre-April 2006 rights in capped drawdown, and the first BCE occurs after 5 April 2015, the amount of LTA deemed to have been used up by the pre-commencement rights will be 25 times 80% of the maximum available under capped drawdown at the time of the first BCE. The same calculation applies where the individual was in capped drawdown prior to 6 April 2015 and subsequently converts their drawdown fund to flexi-access. In such a scenario the 80% would be applied to the maximum amount available under capped drawdown at the point the fund became a flexi-access drawdown fund.

### EXAMPLE 3

Abbie took benefits from a personal pension prior to 6 April 2006. There was a review of her drawdown limits in January 2015, when the basis amount was calculated at £20,000, and therefore Abbie can take between zero and 150% of this amount during a drawdown pension year. She also had a further £300,000 of uncrystallised rights which she crystallised on 1 August 2016. This is her first BCE.

Abbie's pre-commencement rights used up £600,000 of her LTA -  $((£20,000 \times 1.5) \times 0.8) \times 25$ .

In cases where the individual was in flexible drawdown prior to 6 April 2015, for the purpose of calculating the amount of LTA used up by pre-commencement rights, the value will be 25 times the maximum capped drawdown amount that could have been paid at the time the individual completed a valid declaration. However, if the

declaration was made in a drawdown pension year that started on or after 27 March 2014, it will be calculated on the basis of 25 times 80% of the maximum available under capped drawdown. The different treatment is simply due to the maximum amount being increased from 120% to 150% of the basis amount from that date ( $80\% \times 150\% = 120\%$ ).

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## Additional proposals

There are a number of additional areas of legislation that will be amended by the TPB.

Minor changes are to be made to small pots legislation and trivial commutation lump sums from 6 April 2015; these were covered in the original overview of the TPB Tech Talk - [Pension Freedoms](#). One aspect not covered was that if a member were to die after the TPB receives Royal Assent, then a trivial commutation lump sum death benefit may be paid to their beneficiaries in respect of any guaranteed annuity payments they were due to receive after the member's death. The trivial commutation lump sum death benefit limit is also being raised from £18,000 to £30,000.

There are existing rules in place to prevent the recycling of lump sums as a means to significantly increase contributions to the member's pension. From 6 April 2015, there will be a change to one of the rules. If the member takes a PCLS, along with any other such lump sums in the previous 12 month period that exceed £10,000 in total, rather than the current 1% of the lifetime allowance, then recycling may be deemed to have occurred.

There is to be an extension to the rules which currently cover those individuals with temporary periods of non-residency and who are in flexible drawdown. This will be extended to encompass such people receiving income from flexi-access drawdown, dependant's flexi-access drawdown, or who take the income element of an uncrystallised funds pension lump sum. The pension will only be taxed when the individual becomes UK resident again and the cumulative withdrawals during the period of temporary non-residency exceed £100,000.

Many pension schemes' rules will not facilitate payments under the proposed flexibility. However, the legislation will allow scheme trustees or managers the option to override the scheme rules, should they choose. They will not, though, be compelled to offer the benefits under the new flexible access provisions.

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## Comment

We live in interesting times for retirement wealth planning; a phrase I never thought I would associate with pensions! The proposed freedoms available from 6 April 2015 will hopefully provide individuals the opportunity to plan their retirement more effectively.

We can only hope with the associated complexity, as opposed to the Government's belief that it is a sign of their commitment to simplifying the pension tax rules, that individuals will seek advice from suitably qualified advisers.



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