## Pensions – what's the latest news?

## Michael Steed's blog – August 2012

**There's been quite a lot of movement in the way pensions work in the last few years and some more in the pipeline, so as AAT members we need to understand where we are, so we can advise our clients and our employers accordingly.**

**So where are we with state pension provision?**

People who have made 30 year's NIC contributions will be able to claim a full state pension from their normal retirement age. The pension retirement age has changed and is likely to change again, especially for women, so it's essential to know what your retirement age is. There's a calculator available on the Directgov [link to: http://www.direct.gov.uk/en/Pensionsandretirementplanning/StatePension/DG_4017919] website which will tell you when you will reach state pension age under the current law. The current law already provides for the state pension age to increase to:

- 67 between 2034 and 2036
- 68 between 2044 and 2046

However, the government announced in November 2011 that state pension age will now increase to 67 between 2026 and 2028. This change is not yet law.

When you reach the state pension age, you've still got choices; you don't need to retire and you don't have to take the pension. If you put off claiming your State Pension, you may be able to get extra State Pension or lump-sum payment when you do claim it.

(If you go on working after State Pension age, you don't have to carry on paying National Insurance contributions as an individual, but if you are an employee the employer will still have to carry on making them).

There's also the proposal for a flat rate pension for all pensioners of £140 per week to replace the state pension and the state second pension, but I've not heard anything on this recently.

If you are not sure where you stand with your state pension, you can easily get a forecast via the Direct.gov.uk website [link to: http://www.direct.gov.uk/en/Pensionsandretirementplanning/StatePension/DG_4017919]

**Personal or company schemes?**

This may be a false choice for some – if you are self-employed, there's no chance of a company scheme unless you incorporate.

For company schemes, there will be tax relief on the contributions and for the employees, the sums paid into the scheme by the company will be tax and NICs free.

It's worth considering salary sacrifice as a mechanism for paying into company schemes. For an employee this effectively means giving up some salary which is subject to tax and NICs and to take an equivalent pension, which is exempt for tax and NICs, so there are potentially savings to be made.

Final salary schemes (defined benefit schemes) are largely a thing of the past, so my comments here are concerned only with personal pension schemes and defined contribution company schemes. In both cases this means that the pension you draw is based on the value of the fund at the time you take the pension.

**Limits on tax relief**

From 6 April 2011, the new £50,000 limit for contributions into personal pension schemes is much lower than the previous level of £255,000 but it will not affect most pension savers, and will still allow them to make substantial, tax-efficient pension contributions. In any event there is a three year roll-forward for unused contributions, so the change is unlikely to affect most taxpayers.

**The end for compulsory annuities**

New rules from 6 April 2011 mean there is no effective requirement to buy an annuity with a pension pot upon reaching age 75. Not only that but the alternatively secured pension (ASP) route (as an alternative to annuitisation) has been removed. Instead the "drawdown" options have been expanded.

The idea of 'drawdown' has been available since 1995 and enables individuals to leave their personal pension pot invested, still leading (one hopes) to benefit from investment growth while the individual withdraws income from it.

Under the changes there are two new options:

**1.** 'Capped' drawdown – here, there is a cap on the annual amount that can be withdrawn, set at 100% of the equivalent annuity the member can buy with their fund value. This is calculated by the scheme's administrator (triennially below age 75 and annually over 75) and is by reference to the Treasury's values of notional annuitisation.

**2.** 'Flexible' drawdown works in exactly the same way, but there is no limit on the income withdrawn - it is a radical idea because it potentially allows taking 'income' out as one cash lump sum (albeit only 25% tax free).

Because of the increased risk to the Treasury of individuals outliving their resources and falling back on the state, unsurprisingly there are more stringent conditions. In particular, members need to satisfy the Minimum Income Requirement (MIR). The MIR has been set at £20,000 per annum and includes income from all secure pension sources (effectively state pensions, final salary pensions and certain types of annuities).

**Macro economics**

One of the big long-term worries about pensions is the annuity rate.  Although retirees are no longer required to take annuities – they can go for drawdown instead, many will do so.

It's obviously a good idea to shop around and looking at a few comparison websites as I did the other day, it seemed to be broadly true that you  may get a better deal if you take your pot away from your existing pension house!

The other issue for retirees is the effect of Quantitive Easing (QE) on pensioners. The Government has used this measure sparingly and for good reasons – pumping extra money into the economy drives inflation up. But its other effect is that it drives annuity rates down.  This is because the new money created by the Bank of England is used to buy Government Gilts and this extra demand pushes yield down and hence annuity rates (which are directly related to yield rates).

**Paying into your children's pension pots**

Something we've briefly alluded to on the tax update series is the provision for making contributions into other peoples' pension pots – in reality this is likely to be family members or life partners. In order to get this tax relief for non-earning beneficiaries, it is as easy as putting money into their pension and getting the upfront tax relief paid for by the Government.

## Cashing in your small pension (trivial commutation)

Many pension providers offer the opportunity to convert 100% of a "small" pension into a one off cash payment. This is known as trivial commutation – you are commuting rights under the pension scheme into a lump sum. 25% will be free of tax (so follows the normal pension rules) and the remaining 75% will be taxable as non-savings income in the year in which it is paid.

If a trivial commutation lump sum payment is made in exchange for a pension already in payment, then all of that payment will be taxable as normal income in the year in which it is paid, so no 25% tax-free sum is available (as presumably that has already been paid).

There are three rules that must be taken into account to see if trivial commutation applies:

- The commutation must be made at any time on or after your 60th birthday;
- The total capital value of the pension that you wish to cash in, plus all of the other pensions to which you are entitled must be within the definition of "trivial", which is currently not more than £18,000.

- All trivial commutations that you wish to make must be made within 12 months of the date on which you cash in the first of them. You do not need to cash in all of the pensions you have, but you must cash in the whole of each individual pension.

**The £18,000 limit**

In order to decide whether you are within the £18,000 limit you must add the value of all your pension entitlements together. How this works will depend on whether you are receiving the pension or not.

**For pensions not yet in payment**

- If you have a pension from a former employer which is based on your earnings in employment (known as a 'defined benefit' pension scheme) they, or the pension scheme administrators, will be able to provide you with a cash value for commuting your pension;
- If you have a personal pension scheme which is based on your own contributions (known as a 'defined contribution' pension scheme) you may have a recent statement showing a capital value of your fund which will give you a guide, but it is recommended to get a commutation figure from the pension provider.

**For pensions already in payment**

- For the purposes of testing against the £18,000 limit, these are valued at 20 times the annual pension income, so a pension of £750 a year, for example, would be given a capital value of £15,000. Any tax-free lump sums that may have been received at the time the pension commenced are added to this capital value).
- It is important to remember that this valuation is for testing against the limit only and the actual amount the scheme will pay out may well be different.

New for April 2012 is that the £18,000 rule has been relaxed in certain circumstances. It is now possible to have pension funds greater than £18,000, but to be able to take up to two small funds (not exceeding £2,000 each) in a lifetime.  This would allow a bit of housekeeping on small fairly useless funds and to convert them to cash, rather than having a tiny pension from them.

---

**Tax on death benefits from a company pension**

**If you die before starting to draw your company pension**

Most company pensions provide for a 'Death-in-Service' benefit, similar to a life assurance policy. This means that if you die before starting to draw your company pension a lump sum is paid to a chosen person (known as the 'beneficiary').
The money can be paid free of income tax if it's not worth more than the pension holder's available 'lifetime allowance' (£1.5 million in tax year 2012-13). Any excess amount above the lifetime allowance will pay a tax charge of 55 per cent. This tax is paid by the beneficiary.
If you die in service, some pension schemes pay a dependants' pension. A dependants' pension counts as taxable income for the beneficiary.

**If you die after you start to draw your company pension**

If you die after you start to draw your company pension, any pension protection or annuity protection lump sum death benefit paid following your death will be taxed at a special lump sum death benefits rate. The Income Tax rate is 55 per cent for deaths after 5 April 2011. It will be paid by the scheme administrator.

If a dependant's pension is provided it may be subject to a guarantee period and will stop paying after the guarantee period has expired. It is important to check the scheme rules.

**Tax on death benefits from a personal or stakeholder pension**

**If you die before taking any benefits**

If you die before taking any benefits, the death benefits are normally paid as a lump sum. This usually consists of the return of the pension fund together with the proceeds of any life assurance.
If the amount of the lump sum - plus the value of any other registered pension scheme benefits - exceeds the Lifetime Allowance (£1.5 million in tax year 2012-13) the excess is taxed at 55 per cent. The beneficiary has to pay this.
Death benefits can also be used to provide dependants' pensions instead of being taken as a lump sum. If a dependant's pension is provided this counts as taxable income for that dependant.

**If you die after taking benefits**

If you die after taking benefits, any death benefits payable as pension income to a dependant will be taxed as income in the normal way. If the pension scheme provided for a lump sum payment this will be taxed at 55 per cent for deaths after 5 April 2011. This is payable by the scheme administrator.

**Tax on a pension you pass on or inherit**

If you want to include a pension in your will, or if you get a pension from someone who has died, there may or may not be tax to pay, depending on the individual circumstances and the type of pension(s) involved.

**Death Benefits from a State Pension**

Your basic State Pension is paid only to you, and can't be passed on to someone else when you die. However, if you put off claiming your State Pension (deferral), your surviving spouse or civil partner may be entitled to some of the deferral amount you had built up.

If you have contributed towards an additional State Pension your spouse or civil partner may get some of this additional pension when you die. This additional State Pension was formerly known as the State Earnings-Related Pension Scheme (SERPS) or State Second Pension. Surviving widows over the age of 65 do not get the widow's bereavement allowance.

**Auto-enrolment**

October 2012 sees the first of the auto-enrolment provisions taking effect. This forces employers to make provisions for and make contributions to, personal pensions schemes for qualifying employees, where they are not yet in a scheme. The qualifying employees are aged 22 or over, are under State Pension age and earn more than £8,105.00 a year

The first employers affected by this are the largest employers and then over a 5 year period the smaller employers will also be affected. The sort of business that many AAT members will be advising (SMEs) will only be affected from 2014 and 2015 onwards. The entry date (or "staging date") can be found on the Pensions Regulator's website.

Sources consulted in this blog: The Direct Gov website; The Pensions Advisory Service website.