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# FREEDOM AND CHOICE: NEW WAYS TO TAKE PENSION TAX FREE CASH AND INCOME

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From April 2015, it will be possible to take money purchase pension benefits as almost any mix of lump sum and income. This article summarises the key details of these reforms.


This article focuses on the ways the 'Freedom and Choice in pensions' reforms affect members of money purchase schemes when taking their benefits from April 2015. The details of the reforms have emerged piecemeal in the period between the initial announcements in the March Budget and the December Autumn Statement. The final details are still being resolved via the Taxation of Pensions Bill, which is still making its way through Parliament at the time of writing. For further details of the reforms, see also Chris Jones' article 'Pension death benefits won't tax you' in this issue.

## FLEXI-ACCESS DRAWDOWN (FAD)

- All new drawdown plans taken out from 6 April 2015 will be flexi-access drawdown (FAD).
- There won't be any limits on income levels, as with flexible drawdown under the current rules.
- There won't be any minimum secure pension income requirement.
- The member can take 25% tax free cash from their designated drawdown fund, subject to having available lifetime allowance (LTA).
- The balance of the fund can remain invested. It can be paid as a lump sum, when the member's marginal rate of income tax applies. It can be used to provide flexible income, again subject to the marginal rate of income tax. Or any combination of these is possible.
- Once any income is taken, the £10,000 money purchase annual allowance applies (see below).
- All pre April 2015 flexible drawdown arrangements automatically become FAD.

### EXAMPLE

Ted has a PPP valued at £200,000. He has no other sources of taxable income in 2015/2016. He has a number of options if he wishes to use FAD.

One option is to crystallise the whole fund via FAD then take £200,000 as a lump sum. This isn't particularly tax efficient, so Ted should avoid it unless he needs the funds. He'll receive 25% or £50,000 as tax free cash and the balance of £150,000 will be taxed as income. The personal allowance reduces by £1 for every £2 of income over £100,000, to a minimum of nil. Therefore, Ted gets a nil personal allowance. As a result he receives:

| | | | |
|---|---|---|---|
| 25% tax free cash | | | £50,000 |
| Taxable lump sum | | | £150,000 |
| | | | £200,000 |
| Income tax: | £31,785 x 20% | (£6,357) | |
| | £118,215 x 40% | (£47,286) | (£53,643) |
| Net amount | | | £146,357 |

£53,643 / £150,000 x 100 = 35.76% tax paid.

In addition, if he does want to rebuild his pension fund in future, he's now caught by the MPAA.

Ted could also use FAD to take his full tax free cash entitlement immediately, and a tax efficient income only as needed. He'd receive £50,000 tax free and could leave the remaining £150,000 fund invested in a tax advantaged pension environment. If it turns out that he does need further income in 2015/2016, he could withdraw up to £10,600 without any liability to income tax. In future years, provided he has no other taxable income, he could withdraw up to the amount of his personal allowance without triggering a tax liability. Ted would have to consider whether the amounts he was withdrawing were sustainable in the long term.

Another option is for Ted to crystallise just some funds via FAD. For example, he might designate 25% (£50,000) of his fund. He could then take £12,500 tax free cash and leave the balance of his fund invested – £37,500 on a crystallised basis and £150,000 uncrystallised. He would then be able to access further tax free cash by crystallising further tranches of his remaining uncrystallised fund. At no point would he be required to take an income from the crystallised fund.

With both these options, so long as he takes just tax free cash he keeps the full £40,000 annual allowance and the ability to use carry forward. This only changes once he actually withdraws any income. Many people will take a flexible approach as they move towards full retirement, with some periods of employment or consultancy work. So this gives considerable scope for further funding of their pension via member or employer contributions after they've started to take their money purchase benefits.

## CAPPED DRAWDOWN

- No new capped drawdown arrangements can be set up post April 2015.
- Any existing plans can remain in place. They will operate in the same way as currently, with three yearly reviews and income restricted to 150% of GAD.
- It will be possible to convert capped drawdown to FAD on the member's request.
- Capped drawdown plans will automatically convert to FAD if the member takes income exceeding 150% GAD.
- The member retains the standard £40,000 annual allowance where their income remains within GAD limits. This is provided they don't trigger the MPAA via any other arrangements.
- It will be possible to transfer existing capped drawdown plans from provider to provider.

Individuals aged 55 and over may want to consider designating some funds for capped drawdown before 6 April 2015, if they haven't already done so. If their drawdown product allows, they'll be able to designate further funds in the same arrangement post April 2015 and remain within the capped drawdown regime. This means they can retain the full £40,000 annual allowance for contributions, while being able to take drawdown income within the 150% GAD limits. However, the existing anti tax free cash recycling provisions will apply. Currently these provisions apply if someone takes at least £12,500 tax free cash (1% of the £1.25 million LTA) over a 12 month period, but this will reduce to £7,500 from April 2015.

## UNCRYSTALLISED FUNDS PENSION LUMP SUM (UFPLS)

- This is a new concept: a lump sum drawn directly from uncrystallised money purchase pensions.
- 25% of the lump sum is paid tax-free.
- The balance of the lump sum is taxed at the member's marginal rate of income tax.
- It's possible to take a series of UFPLSs, each of which will be treated as a mix of 25% tax free cash and 75% taxable funds.
- The disadvantage is that unlike FAD, it isn't possible to take the tax free cash without receiving taxable income.
- Once an individual takes a UFPLS, the £10,000 money purchase annual allowance applies (see below).
- Some restrictions apply to members with primary protection, enhanced protection or lifetime allowance enhancement factors affecting their tax free cash entitlement.

### EXAMPLE

Bill is 66 in 2015/2016 and needs funds for essential maintenance on his house of approximately £20,000. His income for 2015/2016 is made up of the state pension of £6,029 and an index linked occupational pension of £7,105. This covers his day to day expenditure. He's got limited emergency cash funds, as he used his occupational pension scheme tax free cash to repay debts.

However, he does still have an uncrystallised PPP fund of £50,000. He's got more than 60% of the LTA remaining available and doesn't have any forms of protection or other factors that would restrict his ability to use UFPLS.

It might seem simple enough for him to withdraw the funds he requires directly from his pension fund. But working out his tax liability isn't that simple. For example, not everyone's aware that the state pension is taxable. In fact, in order to obtain just over £20,000 net, he'll have to withdraw a UFPLS of £23,600:

| | |
|---|---|
| 25% tax free cash | £5,900 |
| Taxable lump sum | £17,700 |
| | £23,600 |
| Income tax £17,700 x 20% | (£3,540) |
| Net amount | £20,060 |

His £10,600 personal allowance is used by his existing pension income of £6,029 + £7,105 = £13,134. His total taxable income of £6,029 + £7,105 + £17,700 = £30,834 falls within the personal allowance of £10,600 plus the basic rate band of £31,785 = £42,385. So he's liable to 20% income tax on the taxable element of the UFPLS.

The £26,400 balance of his pension fund remains invested. He can take further UFPLS sums if wanted, each of which will be treated as comprising 25% tax free cash. He's now caught by the £10,000 MPAA. Bill might be able to avoid this if he can take the required funds under the small pots rules.

## NEW RULES FOR LIFETIME ANNUITIES

- One of the lesser known features of the new flexibilities is that it will be possible for lifetime annuities to reduce as well as increase in value, outside of the existing limited range of prescribed circumstances. This may lead to providers developing new types of lifetime annuity to provide for long term care costs, for example.
- Taking income from this new type of a lifetime annuity will trigger the MPAA, after concerns that it might provide a loophole in respect of the anti income recycling provisions that apply when someone uses UFPLS or takes income from FAD.

## MONEY PURCHASE ANNUAL ALLOWANCE

- To prevent widespread abuse of the new flexibility, a new anti-avoidance measure will be introduced – the money purchase annual allowance (MPAA). It's set at £10,000 a year from 6 April 2015.
- The MPAA applies:
  - when income is taken from flexi-access drawdown (FAD),
  - when income above 150% GAD is taken post 5 April 2015 from a capped drawdown fund,
  - when an uncrystallised funds pension lump sum (UFPLS) is received,
  - when a payment from a new style reducible lifetime annuity is taken,
  - from 6 April 2015 for those already in flexible drawdown. Their situation improves, as they currently have no annual allowance.
- The MPAA doesn't apply:
  - where an individual commences FAD, but doesn't receive any income, that is, they just take tax-free cash,
  - where an individual is in capped drawdown (ie pre 6 April 2015) and doesn't receive income above 150% GAD after 5 April 2015,
  - when small pots are accessed.
- The MPAA only applies to money purchase contributions. Someone who's affected can still fund a defined benefits scheme up to the normal £40,000 annual allowance limit, plus any carry forward allowance.
- The MPAA can't be carried forward.

For more details on the operation of the MPAA, see 'Closing in: the money purchase annual allowance' which appeared in the November 2014 edition of Techtalk.

This article was based on the guidance and draft legislation issued as at 3 December 2014. It will not reflect any changes to the Taxation of Pensions Bill from that date.