

Pensions Simplification – Basic Facts

Over recent years, the government have initiated several investigations into UK pension provision, and you may have seen articles in the media about them.

As a result of these exercises, it made significant changes to the tax framework in which pensions sit. There is now just one tax regime covering all pensions, in place of the eight previous regimes, and there is increased protection for members of pension schemes, notably final salary pension schemes.

This document outlines the changes that were made through the Pensions Act 2004, the Finance Act 2004, and some amendments to those Acts (*italicised texts*). In some instances there is greater pensions flexibility than there used to be and, for the majority of people, pensions are much simpler than they were.

Most of the changes were effective from 6 April 2006, known as A-day. Where this is not the case, the effective date has been shown.

Please take time to read the **Important Notes** section at the end of this document. It contains some words of caution and shows where you can obtain further information.

Minimum Retirement Age

- Between 6 April 2006 and 5 April 2010, it was legal for those over age 50 to begin any pension benefits. This includes any retirement lump sum payment and annuity income or drawdown.
- From 6 April 2010 onwards, it is not normally possible for individuals under age 55 to commence pension income benefits.

Multiple Pension Scheme Membership

- An individual can now be a member of as many pension schemes as they wish, at the same time, regardless of the types of scheme and their personal circumstances.

Increases In Annuity (Pension Income)

- It is no longer a legal requirement for an annuity (pension income) purchased from Protected Rights funds to increase each year it is paid.
- It is no longer a legal requirement for an annuity (pension income), purchased from money purchase occupational pension scheme funds accrued after 5 April 1997, to increase each year it is paid.
- The removal of these requirements enables a non-increasing annuity (level annuity) to be purchased.

A level annuity offers a higher level of starting income, although that income will lose its purchasing power over time because of the effects of inflation.

Pension Contributions

- There is a single limit on the tax-advantaged contributions that can be paid each year into pension schemes, by and for an individual. This limit is known as the 'Annual Allowance'.
- The first Annual Allowance, for the 2006/07 tax year, was set at £215,000. It has increased in subsequent tax years, *but reduced to £50,000 in 2011/12 to enable government to limit the tax relief granted to high earners.*

From 6 April 2011, in limited circumstances an individual will be able to make contributions (or have pensions input) in excess of the Annual Allowance, but still receive tax relief. Those whose pensions input was below £50,000 in the three immediately preceding tax years can carry unused allowance forward.

- With the benefit of tax relief individuals can contribute up to the higher of:
 - a) £3,600 gross and
 - b) 100% of UK earnings.

- There is no limit on the amount that employers can contribute to pension schemes in respect of an employee. For large contributions, employers' corporation tax relief may not be available immediately.
- If the total combined individual and employer contributions exceed the Annual Allowance then the individual will be taxed, *at their marginal rate, on the excess (assuming no carry forward available)*. This tax is known as the Annual Allowance charge.
- In some instances, for example with final salary occupational pension schemes, the actual contributions made by, and for, a particular member may not be clear. An estimated contribution will therefore be calculated, based on the increase in pension that has accrued from one year to the next.

Maximum Pension Benefits

- The maximum pension limits that HMRC (formerly Inland Revenue) had in place, for example a pension equal to 2/3rds of salary from an occupational pension scheme, have been removed.
- Instead, the total value (in cash terms rather than annual pension amounts) of **all** an individual's tax privileged pensions must fall below a new limit, known as the Standard Lifetime Allowance.
- The first Standard Lifetime Allowance, for the 2006/07 tax year, was £1.5m. *This increased each tax year until 2010/11 when it reached £1.8m, but will be reduced for 2012/13 to £1.5m.*
- If the total value of an individual's pensions exceeds the Standard Lifetime Allowance, the excess is subject to a tax charge. This is known as the Lifetime Allowance Charge and must be paid when the excess funds are used to provide benefits.
- The Lifetime Allowance Charge is 55% if the excess funds are paid as a cash lump sum, and 25% if they are used to provide pensions income (which will then also be subject to income tax, just like any other pensions income).
- If individuals had already accrued very high value pensions that were worth more than the first Standard Lifetime Allowance at A-day (£1.5m), they can apply to the HMRC to protect those pensions from the Lifetime Allowance Charge. This protection had to be sought, from the HMRC, prior to 6 April 2009.

As HMRC unexpectedly lowered the Standard Lifetime Allowance with effect from 6 April 2012, some special provisions have been made so that those with high value pensions can protect themselves from tax charges. A new form of protection, known as Fixed Protection was introduced.

Retirement Cash Lump Sums

- Prior to 6 April 2006, the Government set different limits on the amount of cash that could be taken upon retirement from different types of pension scheme. These limits have been removed in favour of one simple limit. The maximum cash sum available from a scheme is 25% of the capital value of the benefits held under that scheme.
- For money purchase pension schemes, such as personal pensions, the maximum cash lump sum available is 25% of the fund value. The fund value can include Protected Rights, and 25% of those rights can be taken as a lump sum.
- For defined benefit pensions, such as final salary pension schemes, the scheme must calculate the value of the pension to ascertain the maximum that can be taken as a cash lump sum. Guaranteed Minimum Pensions accrued whilst being contracted-out cannot be exchanged for a cash lump sum.
- At A-Day, some occupational pension scheme members had rights to take more than 25% of the value of the pension then accrued as a cash lump sum, and those rights were automatically retained within that pension scheme. They can also be uplifted in line with the increase in the Standard Lifetime Allowance. However, benefits accrued from A-day must fall inside the new 25% limit. If benefits are transferred from the scheme, the 25% limit must apply to all benefits.

Note – it is important for scheme members and employers to retain earnings information in respect of the tax years up to and including 2005/06. Without this, it will not be possible to check if rights to cash sums above 25% of pre A-day rights can be paid.

As HMRC have reduced the Standard Lifetime Allowance from 6 April 2012, special rules have been introduced to ensure that cash sums uplifted using the £1.8m can still be paid, even if the Standard Lifetime Allowance is below £1.8m.

- If the lump sum taken, in total from all pension schemes, exceeds 25% of the Standard Lifetime Allowance (£375,000 for 2006/07) then a tax charge will be made.

Deferral Of State Pensions & Lump Sum Option

- The government encourages those individuals who do not need to commence their State pensions at State Pension Age to defer its commencement.
- If it is deferred, when State benefits are started, an option is available to take the deferred pension payments as a cash lump sum.

Commutation Of Trivial Pensions

- The ability to commute pensions of a trivial size was available prior to 6 April 2006 for some pension schemes and some pension benefits. The ability to offer such commutation is now extended to all pensions, including those in payment, but new rules are in place to prevent abuse of the facility. The rules are:
 - The total value of all an individual's pensions must be less than 1% of the Standard Lifetime Allowance, (£16,000 for the 2007/08 tax year). Pensions in payment (as well as those due to come into payment in the future) all count towards this limit.

From 1 December 2009, a member of an occupational pension scheme could take their pension fund under a triviality option if it alone was worth no more than £2,000. This "scheme specific" commutation does not apply to other types of pension. Some further limited relaxations of the rules were also made where the fund available to purchase an annuity is small.

With effect from 6 April 2012, the "1% of the SLA" limit is being replaced by a flat limit of £18,000.
 - The individual must be over aged 60 (*until 5 April 2011 they must also be under age 75*).
 - The triviality payment must extinguish all the individual's rights under the scheme making the payment.
 - All (*non scheme specific*) triviality payments must be paid within one 12-month period.
- A pay as you earn (PAYE) tax charge must be made on 75% of the triviality lump sum (*be it scheme specific or not*), but the remaining 25% is available free of income tax.
- These new rules may increase or decrease your retirement options depending on your personal circumstances.

Annuities With Lump Sum Death Benefits

- It is possible for insurance companies to offer an annuity that pays out a cash lump sum upon the death of the annuitant. *Until 6 April 2011, the cash lump sum could only be paid where the annuitant died before age 75. From 6 April 2011 it can be paid at any age.*
- The lump sum can represent the difference between the annuity instalments paid prior to death and the amount of funds originally used to purchase the annuity. They are known as 'value protected' annuities.
- The lump sum paid would be subject to a tax charge. *From 6 April 2011, the tax charge is 55% of the lump sum.*
- An alternative type of annuity, called a 'short term' annuity, is also permitted. This allows part of a pension fund to be used to provide an annuity for a specified period of up to 5 years (providing age 75 is

not exceeded *where the annuity was purchased prior to 6 April 2011*) and leave the balance of the pension fund invested.

Drawdown Pension (formerly Income Drawdown or Income Withdrawals)

From 6 April 2011 two versions of drawdown pension became available, namely 'capped drawdown' and 'flexible drawdown'.

Capped drawdown

- The minimum and maximum amounts that can be taken under a drawdown arrangement were revised. *Between 6 April 2006 and 5 April 2011*, for individuals under age 75, the minimum amount was £0 per annum (zero) and the maximum was 120% of the highest annual annuity that could otherwise be purchased, based on rates set by the government actuary.

From 6 April 2011, subject to some transitional rules, the maximum reverts back to the 100% limit, but the limit applies at all ages, not just ages below 75.

- *Between 6 April 2006 and 5 April 2011*, the maximum had to be reviewed every five years or earlier if any further funds under the arrangement are used for drawdown, or an annuity is purchased or the funds are subject to a pensions share following a divorce.

From 6 April 2011, subject to some transitional rules, the normal review period reverts to three years for those under age 75, but reviews are required every single year for those over age 75.

- Upon death, a dependant's annuity or drawdown may commence, or the value of the unused pension funds may be paid as a one-off lump sum, subject to a tax charge

Until 6 April 2011, lump sums were taxed at 35%. From 6 April 2011 onwards, the tax charge is 55%.

- *Between 6 April 2006 and 5 April 2011*, once age 75 was reached an annuity had to be purchased or drawdown could continue subject to revised limits. After age 75, drawdown was known as Alternatively Secured Income (ASI) or Alternatively Secured Pension (ASP).

From 6 April 2011, ASP ceased to exist because normal drawdown rules were extended to cover all ages.

- *Between 6 April 2006 and 5 April 2007*, the minimum ASP was £0 per annum and the maximum was 70% of the highest annuity that could be purchased for someone, of the same sex, who is 74 years and 364 days old. *From 6 April 2007 until 5 April 2011* the minimum and maximum ASP were 55% and 90% respectively of the same highest annuity. Upon death in ASP, severe restrictions are placed on the use of remaining pension funds, and those funds were liable to an Inheritance Tax charge.

From 6 April 2011, ASP ceased to exist because normal drawdown rules were extended to cover all ages.

Flexible drawdown

- *Under flexible drawdown, there is no limit on the amount that can be drawn from the available pension fund. It is therefore possible to take the entire fund as a one-off income payment, subject to income tax under the Pay As You Earn system.*

To avoid the risk of people taking all of their pension funds and spending them, and then falling on to the State for income benefits, flexible drawdown is only available to those who meet a minimum income requirement (MIR). The MIR is initially £20,000 per annum.

Personal Pension Waiver Of Premium

- It is no longer possible to add waiver of premium benefit to an existing pension contract or include it in a new pensions contract, unless a contractual right to do so existed on 5 April 2006.

Benefits On Death Before Retirement (Vesting)

- Cash lump sums up to the Standard Lifetime Allowance may be paid free of tax *where they are paid before age 75*. These could include the return of pension funds or contributions, and the life assurance benefit offered by a defined benefit pension scheme.

From 6 April 2011, lump sum death benefits can be paid where death occurs after age 75, but they are subject to a 55% tax charge.

- Dependant's pensions may also be paid and these do not count towards the Standard Lifetime Allowance.

Protection For Pension Scheme Members

- The Pensions Act 2004 contains several measures that aim to provide greater protection for members of pension schemes, particularly those in final salary schemes. These measures include:
 - The introduction of a new regulator, known as the Pensions Regulator, to replace the Occupational Pensions Regulatory Authority (OPRA).
 - The introduction of the Pensions Protection Fund.
 - A minimum knowledge requirement for occupational pension scheme trustees.
 - The requirement for 50% of an occupational pension schemes trustees to be nominated by the scheme membership.
 - The introduction of a Financial Assistance Scheme.
 - Reduced period for the attainment of rights in occupational pension schemes.

Prior to A-day, scheme members who leave their employer within the first two years of employment commonly receive no retirement benefits from their occupational pension scheme. Now, early leavers will be entitled to some benefits when they have completed just 3 months service.

- *The Pensions Regulator has issued a wide variety of guidance, particularly for trustees of money purchase pension schemes, in relation to member retirements, and in relation to the importance of keeping complete and up to date scheme member records.*

Important Notes

1. This document outlines our understanding, as of *December 2010*, of the changes in pensions and tax law that have been introduced by, the Finance Act 2004, the Pensions Act 2004 and some amendments to those acts. The changes are summarised here and this document should not be treated or relied upon as a statement of law. Whilst every effort has been made to ensure that it is correct, it does not constitute legal advice and Pearl, NPI and London Life cannot accept any legal responsibility for it. Pearl, NPI and London Life always recommend that you seek independent financial advice regarding the matters raised in this document.
2. **There may be a difference between what the law will permit and what your pension scheme, or other pensions arrangement, is willing to offer.**
3. The changes in law will not affect the investments, bonuses, or charging structures of your policies with us. If your policy contains a guaranteed annuity rate or an option to switch funds free of a Market Value Adjuster at a particular point in time, those options will remain unchanged, providing they do not breach the law.
4. **Further information.**

For news of the latest changes affecting pensions, please see the [latest news](#) section of our websites.

More information on Pensions Simplification is available on our websites:

www.london-life.com/simple
www.npi.co.uk/simple
www.pearl.co.uk/simple

Additional information on the Government's pension reforms can be found on the website of the Department for Work and Pensions, at:

www.dwp.gov.uk/lifeevent/penret/penreform/

If you require financial advice as a result of the changes in pensions law and taxation outlined in this document, please speak to your financial adviser.