Pension rules to smile about

Major changes to the pensions rules came into force on 6 April. How will you be affected and what should you consider doing?

If you have a defined contribution pension scheme the big changes are:

- you can now access your pension fund pretty much as you wish once you are 55 (57 from 2028). This isn't linked to stopping work unless you want to access your pension early because of ill health
- your fund is free of inheritance tax (IHT) if you die under 75.

Members of private sector defined benefit (also known as final salary) schemes may also be able to convert to a defined contribution scheme to take advantage of the new rules.

And from April 2016, those who have already purchased an annuity might be able to sell it and get a lump sum back into their pension as the Government is proposing to change the rules.

Of course in all instances you need to balance the income and lump sums you take against your income requirements for the rest of your life. You can take the whole lot in one year if you wish but then none is left for you to pay yourself a pension in the years ahead.

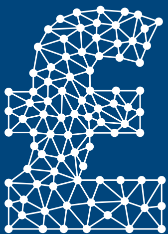
Not all providers offer every option so you might need to transfer your pot to someone else – but if you do, you need to watch out for charges.

You can also combine the two approaches, for example, if your pension fund is worth £600,000 you could:

- take 25% as tax-free cash, which is £150,000
- use £200,000 to buy an annuity – giving you taxable income for the rest of your life of about £9,000 a year
- put £250,000 into a flexi-access drawdown fund from which you choose to take out £25,000 per annum (taxable) for about ten years.

Take your money flexibly

There are now two ways you can get a flexible income from your pension pot. The main differences are how you take the tax-free part and what sort of income you want.



1 Taking lump sums of cash – your pot stays where it is and every time you take out cash, 25% of the amount is tax free and 75% is taxed as income, at whatever rate applies to you. This is sometimes referred to as uncrystallised fund pension lump sums (UFPLS).

2 Getting a flexible income – you can take 25% of your whole pension pot as a single, tax-free cash sum. The rest is invested within six months but still inside your pension fund (you can choose different investments with different risks) and whatever you choose to take out by way of a pension is taxed as your income – again at whatever rate applies to you. This option is known as flexi-access drawdown. Most providers won't allow you to do this if your fund is less than £30,000, because after taking 25% tax free the £22,500 remaining won't provide much of a monthly income for the rest of your life and it isn't worth the admin.

Defined contribution pension plans

(formerly known as money purchase arrangements)

Contributions are invested to build up a pension pot, which in the past was usually used to buy an annuity. An annuity is simply an insurance policy that guarantees you a regular income for the rest of your life. In effect, your pension provider is taking a gamble on how long you will live and therefore how much it needs to pay out. As life expectancy has increased the amounts payable under annuities have come right down.

Types of annuity

Single annuity – only you get paid an income either for life or for a fixed number of years
Joint annuity – payments continue to your spouse/ partner after you die
Guaranteed period – you fix the number of years where payments to your spouse/ partner continue after you die (sometimes this can be a lump sum)
Escalating annuity – increases every year to reduce the effect of inflation
Enhanced annuity – if your health is bad you may get more money from your annuity

Food for thought

Saving IHT

Because your pension pot when you are under 75 is outside your estate for IHT, it might make sense to spend other savings, such as those in an ISA, in preference to drawing your pension. The idea is that when you die, what's left in your estate is a pension pot exempt from IHT.

If you die aged 75 or over, you can choose who to leave your remaining pension pot to. Your beneficiaries can draw their shares as they wish – either in one year or over several – and whatever they take is taxed as their additional income for that year.

Mortgage

One new idea is to use your pension as a savings vehicle to build up a lump sum to repay your mortgage, instead of chipping away at the mortgage capital each month through a repayment mortgage. You'll need to have or switch to an interest-only mortgage.

The main idea is to take advantage of the tax relief on your contributions, the tax-free income and growth within the pension fund and the availability of a 25% tax-free lump sum.

A long-term strategy like this carries risks. The rules might change for the worse in the interim – notably in relation to tax-free lump sums, higher-rate relief on contributions, contribution limits and flexible access.

Pension investments

Some people with personal pension plans which may have limited investment opportunities are considering converting their funds to self-invested pension plans. These can be more expensive to run but are far more flexible for those who want to use their pension to get involved in things like peer-to-peer lending, crowdfunding or any of the other emerging UK-based investment markets, including social enterprises such as wind turbines and other investments with social or community benefits.

Scams and traps

Some companies offer to help you get money out of your pension before you're 55. This could be an unauthorised payment and you'd pay up to 55% tax on it.

Great care is required when deciding on your pension strategy as the rules are complicated, the sums involved can be considerable and the consequences of getting it wrong are potentially financially disastrous. As well as advice from us on the tax consequences of different courses of action, you may well need advice from an Independent Financial Adviser or pension specialist.

Pension scheme advantages

Contributions form both employers and employees to pension schemes, which are approved by HMRC, benefit from tax relief. In certain schemes, including some which comply with the auto-enrolment rules, employees' contributions are paid from pre-tax pay – so they automatically get tax relief at source at their highest marginal rate. These so-called trust-based schemes are generally only used where there are a large number of members. By contrast, contributions to other schemes, such as group personal pension schemes are made net of basic-rate tax and the pension administrator reclaims this tax from HMRC. If the individual is a higher-rate taxpayer, the difference between the higher-rate relief and the tax relief given through the contributions needs to be claimed in the individual's tax return. The notice of coding – which determines how much tax is deducted from your earnings – may also be amended based on the contributions which are expected to be made. This means that the additional higher-rate tax relief is given throughout the year rather than having to be claimed (and possibly refunded) after each 5 April.