# Pension Freedom

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*Neville Pereira* provides an update on the flexibility offered by pension freedom

It has been three years since the over 55's were handed new freedoms to allow them to spend up to 100pc of their pension fund as they choose.

The Government's announcement on the relaxation of pension rules has changed the investment landscape. With higher rate tax relief, tax efficient growth, a tax free lump sum of up to 25% and an inheritance tax (IHT) free asset, a pension is now, arguably, the most tax efficient investment of all. A total of £6.5 billion was withdrawn through pension freedoms in 2017, nearly £1 billion more than the previous year. In most cases the pots accessed were small and less than £30,000

compared: contrast this with the value of the state pension (worth about £200,000 if an indexed linked income had to be purchased on the open market).

However, many people are viewing pension assets as a family trust that can be passed on to their chosen beneficiaries, free of IHT.

## Beneficiaries

### Age 75

Under the new pension rules from April 2015, if you die before the age of 75, the pension can be passed on to anyone regardless of whether they are a dependent. This pension fund can then be taken via a lump sum or as an income stream and is completely free of tax. Unlike the old rules, it does not matter if the pension was accessed in any way. Regardless of whether the income or lump sum taken is from the pension pot, it is passed on tax-free, as long as the person who died was aged under 75.

However, not all pension funds benefit from this new rule and one should clarify and seek confirmation as to what the contractual position is with the pension provider in question. A transfer to a modern plan may be required to benefit from pension freedom legislation.

On death after aged 75, the position is similar to the above in that the member will be able to nominate any beneficiary to receive the death benefit free of IHT. However, income withdrawn from the inherited pension fund will be subject to income tax at the beneficiary's marginal rate where the funds are taken as income. There are no restrictions on the level of withdrawals that can be taken i.e. the nominated beneficiary can take the whole fund at once subject to their marginal rates of tax.

The new rules also allow the nominated beneficiary to pass on any unused funds on their death to their own nominated beneficiary.

## Defined Contribution or Defined Benefit

These new rules only apply to 'defined contribution' (DC) pensions, also known as 'money purchase' schemes, which are the most widely held in the UK.

Defined benefit (DB), or ‘final salary’ schemes as they’re also known, have separate rules. There is an existing ban on transfers once benefits are in payment, and this will continue. Members of unfunded public sector DB schemes cannot transfer their plans to a new DC scheme.

Pre-retirement members of funded DB pension schemes can however, transfer to a DC scheme to access the new income flexibility. It will be advisable to seek advice before deciding whether or not to take advantage of the new pension rules.

**Inheritance Tax**

On death, a defined contribution pension falls outside the deceased’s estate and is not subject to IHT, that would typically be at 40%. The lifetime allowance (see Pensions Tax Manual, **PTM08000**, for further detail), since April 2018, is £1,030,000 and it is likely to increase in line with inflation at the end of the current tax year. Under current legislation and, unless someone has historically registered for the various types of pension protection enabling them to have a larger pension pot to benefit in the manner outlined above, it will be possible for a married couple to pass on over £2M of monies held in a pension free of IHT, to their chosen beneficiaries. However, if a person uses the new pension freedom to withdraw their entire pension pot and puts the money, after any income tax that is payable, into a bank account or other investment, then the money is considered to be savings and will become part of their estate for IHT purposes.

**Pension contribution tax relief**

It should also be remembered that there are limits on the amount of pension savings an individual can make each year which can benefit from tax relief, including any employer contributions. This limit, called the 'Annual Allowance' (see Pensions Tax Manual, **PTM05000**, for further detail), is currently set at £40,000.

New restrictions on contributing limits to pension will remain subject to a £40,000 annual allowance limit, with the ability to carry forward unused relief from the previous three years. With planning, potentially, up to four years' annual allowance can be paid in a single year.

**Taxable Income**

Since 6 April 2016, those with a taxable income over £150,000 will have their annual allowance for that tax year restricted. This means that for every £2 of income they have over £150,000, their annual allowance is reduced by £1. The reduced annual allowance is rounded down to the nearest whole pound: this is the “Tapered Annual Allowance”.

The maximum reduction will, however, be £30,000. So, anyone with an income of £210,000 or more will have an annual allowance of £10,000. A person with high income, caught by the restriction, might then have to reduce the contributions paid by them and/or their employer otherwise an annual allowance charge will apply.

However, the tapered reduction does not apply to anyone with 'threshold income' of no more than £110,000. Definitions of adjusted income and threshold income are crucial to understanding whether someone is affected by the tapered reduction.

Both include all taxable income – so this is not only restricted to earnings. Investment income of all types and benefits in kind, such as medical insurance premiums paid by the employer, will also be included.

## Conclusion

In considering a withdrawal from a pension pot, it should be noted that any income withdrawals from a defined contribution pension, in addition to any tax-free cash already withdrawn, will also restrict contributions to only £4,000 per annum from a potential annual allowance of £40,000. Care should be taken where a person wants to pay into a pension and has either consciously or inadvertently withdrawn the taxable part of their pension as income, as they will be restricted as to the level of future contribution allowable.

There are a number of complex issues to be considered including:

- whether other assets should be used prior to accessing one’s pension;
- the beneficiaries one should nominate;
- the level of pension payments to be made to ensure limits are not exceeded,
- planning if the lifetime allowance is likely to be exceeded and
- for higher earners, if they have been caught by the tapered annual allowance.

Consequently, advice should be sought to review the options in all cases.

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