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Pensions

Six things you should know about pensions flexibilities from April 2015

Briefing

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Most scheme members are aware that it is possible to take their scheme benefits as cash following the Chancellor's 'freedom and choice' reforms which were implemented mainly under the Pension Schemes Act 2015. This briefing sets out the reforms in terms of the questions a member may ask – the concept is relatively straightforward, but there is obviously a great deal more detail which we cannot include here. Words in italics are defined at the end of the briefing.

01 | Can anyone take all their scheme benefits as cash at any time?

An active or deferred member who is aged 55[1] or over may generally take scheme benefits as cash. For members who want to take defined benefits as cash, or whose scheme rules do not allow defined contribution accounts to be taken as cash, it can be a complicated process. Members should also be aware of any income tax payable (see 5 below).

A member may take defined contribution benefits as cash, if scheme rules allow. Most schemes will not allow members to take their defined benefits as cash, although part of them can (as before) be taken as a tax free pension commencement lump sum, or a scheme may allow (or require) a member who has trivial benefits to take them as cash.

It is also possible to drawdown cash from a defined contribution account as and when the member needs it, if scheme rules allow, although many schemes have chosen not to offer this particular flexibility (see below).

02 | What if a scheme does not allow cash to be paid other than the usual pension commencement lump sum or trivial benefits?

An active or deferred member generally has a right (or may be permitted by scheme rules) to transfer a defined contribution account to another scheme which allows benefits to be taken as cash either as an UFPLS or by drawdown. If a member wishes to take defined benefits as cash he will normally have to transfer them to another scheme which does allow them to be taken as cash.

There is a difference between what rights a member has under legislation, and wider options which a scheme may allow. Legislation only allows a member to transfer all his defined benefits and/or all his defined contribution benefits. If for example, a member wished to transfer his defined contribution account but leave his AVCs in the scheme, this is not a right under legislation, but may be allowed by scheme rules. If a member has defined benefits, he only has a right under legislation to transfer them out up to 12 months before his normal retirement date. Scheme rules however may allow an option or discretion to transfer at any time. If the member still has a right to accrue either defined benefits or defined contributions, then he does not have a right under legislation to transfer those benefits, but scheme rules may allow this.

Even if a scheme's rules have not been changed to offer the new flexible options, a member can always ask the trustees to allow him to take cash. Many trustees did not feel they had sufficient time to implement processes and procedures before April 2015, but now that some time has passed, and if they receive sufficient pressure from members, they may change their policy. The legislation allows trustees to implement the new flexibilities even if their rules have not yet been changed to allow all the options. The new transfer out provisions also override more restrictive scheme rules.

03 | What are the advice requirements for taking scheme benefits as cash?

A member who is taking defined contribution benefits must be advised shortly before retirement by scheme trustees to contact the Pension Wise service, for impartial information and advice. Pension Wise is a free service established by the Government, funded by the financial services industry. A member who is transferring defined benefits worth more than £30,000 to another scheme, intending to convert them to cash, must have taken appropriate independent financial advice before the scheme trustees are allowed to make the transfer, and the trustees must check that advice has been received. Appropriate independent financial advice has to be paid for by the member. His employer is not allowed to contribute directly to the cost, as this would be considered an encouragement to the member to transfer out.

04 | What will it cost a member to take benefits in cash?

Most schemes can make an administration charge in order to process paying a defined contribution account as a cash sum (either an UFPLS or drawdown). If a member has to transfer to another scheme before receiving cash, there may also be further administration charges. A member should ensure before transferring, and before taking cash, that he knows what the charges will be. A transferring member should choose a provider whose charges will fit his withdrawal pattern. Insurance companies and other providers may have very different charging structures.

In addition, the cash sum for a member who has defined benefits will be calculated by the paying scheme to be equivalent to the value of those benefits. This cash sum may or may not equal what a member would have received as a pension, depending on how long the member lives, what increases are payable, and how the cash sum could be invested.

05 | How is a cash sum taxed?

If cash is taken as an UFPLS from a defined contribution scheme, 25 per cent will be tax free, and the balance is taxed at the member's marginal rate. Currently HMRC is applying an emergency code to one off UFPLS cash payments from pension schemes, so the member will have to arrange any tax rebate with HMRC separately.

If the member is drawing down cash from the scheme, that cash can be used to pay a pension commencement lump sum, so effectively 25 per cent of each cash sum drawn down is tax-free, and the balance drawn down is taxed at the member's marginal rate.

Trivial benefits are taxed in the same way, that is 25 per cent tax free, and the balance taxed at the member's marginal rate.

06 | If a member has started to receive a scheme pension, can he still convert it to cash?

No. If a pension has started, either from the scheme or from an insurance company annuity, then it cannot currently be converted to cash, or transferred to a scheme which pays cash. However, the Government has not ruled out creating a secondary annuity market in future, which would allow a member who has already purchased an annuity to sell in on to a third party for a cash sum. If a member has only taken a pension commencement lump sum, he can still transfer out the balance of benefits whether they are defined benefit or defined contribution. A defined benefit transfer will require appropriate independent financial advice as explained above.

Definitions

An active member is a person who is currently contributing to or accruing benefit in a pension scheme, a deferred member means a member who is not currently contributing to or accruing benefit in a pension scheme, but is entitled to benefit from the scheme at a future date.

Defined contribution and defined contribution account means a member's pot which builds up from his own and his employer's contributions (if any), plus investment returns and tax relief on contributions. There is no promise to the member of the value of his benefits when he starts to receive them.

Defined benefit scheme is one that promises the member a certain level of benefit on death or retirement. Employers' contributions must then be determined from time to time so as to cover the cost of the promised benefits when added to member contributions (if any). Most defined benefit schemes provide a pension based on the member's earnings close to retirement.

Drawdown allows a member to designate some or all of his defined contribution account for withdrawal in several payments over time. He can drawdown cash whenever he wishes, subject to any scheme rules. Each time he draws down cash, 25% will be tax free, and the balance will be taxed at the member's marginal rate.

Trivial benefits are benefits (either defined benefits or defined contribution account) which are worth less than either £30,000 from all schemes to which a member belongs, or £10,000 from each scheme a member belongs to (up to a maximum of three schemes).

Pension commencement lump sum is a tax free cash sum paid to a member by a scheme when their pension comes into payment, in exchange for a reduced pension. For most members it is 25% of the value of their benefits, but some members who were members before 6 April 2006 have a right to a higher lump sum.

UFPLS means an uncrystallised funds pension lump sum, which is held in a defined contribution scheme or arrangement, and has not yet been used to provide benefits. Any number of UFPLSs can be paid from a scheme, with 25% of each payment being tax free.

AVCs are additional voluntary contributions which members of both defined benefit and defined contribution schemes may make. AVCs go into an individual account for the member, which can be used to increase pension, or (since April 2015) can be taken as a cash sum. Legislation now allows transfer of AVCs from a defined benefit scheme separately from pension benefits.

It is possible to take benefits earlier than age 55 due to serious ill-health which prevents a member from working, provided Finance Act requirements are met and scheme rules allow. Some members also have a protected pension age lower than age 55. It is also possible to postpone taking benefits, but most schemes require members to take their benefits by age 75.

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