Technical CONNECTION

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FINANCE ACT 2014

The Finance (No. 2) Bill 2014 received Royal Assent on Thursday 17 July. The Act is known as the Finance Act 2014.

STATE PENSION DEFERRAL RATES REDUCED

The Government has now confirmed in a written statement the rate at which the single tier state pension will increase in deferral.

Earlier this year the Government Actuary was asked to provide a report on the actuarially fair rate of increments for those reaching state pension age on or after 6 April 2016 and choosing to defer their state pension beyond state pension age.

The proposed new rate will be one-ninth of 1% for each week the state pension is not claimed. This means a 1% increase for every nine weeks of deferral or around a 5.8% increase for each full year. The current rate is 10.4%.

Draft regulations are expected to be published later in 2014 under the powers in the Pension Act 2014, which will set out the proposed rate.

FREEDOM & CHOICE IN PENSIONS CONSULTATION GOVERNMENT RESPONSE: SUMMARY

The Government has published its response to the Freedom & Choice in Pensions consultation. Its contents are summarised below.

The main points are:

- A statutory override will be introduced so that all DC schemes can offer the proposed flexibility.
- Increased transfer flexibility for DC members to transfer up to the date of retirement.
- Annuity rules to be relaxed to permit lump sum withdrawals and decreasing annuities.
- Minimum pensions age to increase from 55 to 57 in 2028.
- 55% drawdown lump sum death benefit tax charge likely to be reduced and be announced in the Autumn Statement.
- DB to DC transfers are to be permitted but with a new statutory requirement for professional independent transfer advice.
- Funded DB public service schemes will permit transfers to DC: unfunded public sector schemes will not permit transfers to DC.
- The Government will consult on extending the flexibility provisions to DB schemes.
- Guidance guarantee to be provided by The Pensions Advisory Service (TPAS) and the Money Advice Service (MAS) and others.
- Once 'flexible' drawdown is triggered from April 2015, tax-relievable contributions will be permitted up to a £10,000 pa cap. This new cap will not apply to existing capped drawdown clients who will remain subject to the current Annual Allowance (£40,000) until such time as the capped drawdown limit is exceeded when they too will be subject to the £10,000 limit.
- QROPS to be reviewed in light of the new flexibility provisions to ensure appropriateness of rules.

Next steps:

- A Pensions Tax Bill will introduce the flexibility provisions.
- Consultation on draft legislation to be published in August 2014.
- Draft legislation to be introduced to Parliament Autumn 2014.
- Pension Schemes Bill was introduced on 26 June 2014 detailing defined ambition pensions.

- The Pension Schemes Bill contains provisions to remove the option to transfer from an unfunded public service scheme to a DC scheme.

- The Pensions Schemes Bill will be amended to introduce the guidance guarantee provisions.

THE LAW COMMISSION PLANS TO REFORM THE LAW ON WILLS

The Law Commission (England and Wales) is planning to undertake a project to reform the law on wills with a view that the number of wills which are challenged will be reduced.

The existing law governing the validity and interpretation of wills is set out in the Wills Act 1837 - as amended by the Administration of Justice Act 1985 and other statutes. The law governing testamentary capacity, (the mental capacity to make a will), derives from case law - Banks v Goodfellow 1870 (5 QB 549).

The Commission's view is that the current law discourages some people from making a will, because it is not in line with social and medical developments, especially given the fact that people live longer so conditions affecting mental capacity are becoming more common. In addition, the rules as they stand can be complicated to understand and therefore may not always reflect an individual's intentions.

The project will consider whether the law can be reformed to encourage and facilitate will-making in the 21st century: for example, considering whether it can be updated to take account of developments in technology and medicine.

As part of the reforms, the following aspects will be looked at:

- Testamentary capacity
- Formalities required to make a valid will
- Mutual wills
- Ability to rectify will-drafting mistakes

The project will commence in 2015 and it is expected that final recommendations and a draft Bill will appear in 2018.

COMMENT

From a planning perspective, individuals should be encouraged to regularly review their will and this is especially important when circumstances change. If the reforms are introduced and do take account of social and medical developments it will be interesting to know how this may affect existing wills.

FREEDOM & CHOICE IN PENSIONS CONSULTATION GOVERNMENT RESPONSE – TRANSFERS FROM DB TO DC SCHEMES

(i) Guidance guarantee

The Government has confirmed that the guidance guarantee that it gave in connection with people using flexible pension access will be provided by independent organisations which will include the

Money Advice Service (MAS) and The Pensions Advisory Service (TPAS). Other organisations that may be involved in providing the guidance are AGE UK and Citizens Advice Bureau (CAB).

The Treasury has obtained approval from the Contingencies Fund for a fund of £10m to go towards the preparatory work in the development of the guidance process in advance of Parliamentary approval.

(ii) Statutory override

An override will be introduced to ensure that pension schemes are able to offer individuals flexible access to their savings.

(iii) Defined benefit (DB) transfers

DB transfers will continue to be permitted although Steve Webb, the Pensions Minister, reinforces the accepted view that for most DB members it is usually in their best financial interests to remain a member of the DB scheme.

People who are already receiving pensions from a DB scheme that are in payment will NOT be able to transfer to a defined contribution (DC) arrangement.

Transfers from unfunded public service schemes will be banned. Transfers from funded public service DB schemes will be permitted subject to new Transfer Safeguards which are shown below.

(iv) Transfer Safeguards

- ***Individuals***

For those members wishing to transfer out from a DB scheme, the receiving scheme will be subject to a statutory requirement that the individual has first obtained financial advice from a FCA authorised, professional independent financial adviser. The FCA have published a thematic report on enhanced transfer values with examples of what constitutes good and bad advice.

If the transfer is instigated by the employee/member of the DB scheme then the cost of the advice is to be borne by the member. However, if the employer is offering an incentivised transfer exercise, the cost of the independent advice will be the responsibility of the employer.

There is no requirement for financial advice if the pot is valued at less than £30,000 as the triviality commutation rules will then apply.

- ***Protecting pension schemes***

In order to avoid a rush of transfers that may threaten or destabilise a DB pension scheme, trustees have the power to ask the Pensions Regulator for a longer time frame to make a transfer payment or reduce the transfer amount if it's in the interest of the other scheme members. Guidance will be issued to trustees to remind them of the powers they currently have access to in order to maintain the sustainability of the pension scheme.

THE THIRD HMRC CONSULTATIVE DOCUMENT ON IHT AND DISCRETIONARY TRUSTS

The settlement nil rate band

The third HMRC Consultative Document of 6 June 2014 on IHT and discretionary trusts proposes, among other things, that an individual will be given a settlement nil rate band (SNRB) that they can apportion to any trusts created after 6 June 2014. This will be in addition to the individual's own nil rate band.

The percentage of the SNRB that is allocated to a particular trust can be changed at any time. The only restriction is that this allocated percentage cannot be reduced after the first payment point of the trust – normally this will be the first 10-year anniversary.

Most settlors will probably allocate a percentage of the SNRB to a trust when they create it. The percentage allocated will probably match their expectations of what the value of the trust is likely to be in 10 years' time. For example, if Jack establishes a trust for £100,000 now, it would not be unreasonable to allocate 35% of the SNRB to this - £113,750 in today's terms – and review the allocation in the run up to the 10-year anniversary date.

But, what about trusts that hold property with a low or nil value which could be valuable in the future? Well, in these cases it would be tempting to say that no SNRB should be allocated – and probably that would be the right approach – provided a review is made in the run up to the 10-year anniversary.

For example, Sally effects a term assurance for £500,000 subject to a discretionary trust. After 10 years, Sally is still alive and in good health and so no SNRB allocation is necessary. Indeed, on this basis no allocation of SNRB would be necessary in the next 10 years because any exits in the next 10 years would be charged to IHT at the effective rate that applied at the previous 10-year anniversary charge – in the case of Sally's trust this is nil.

However, what if Sally fell into serious ill heath in year 9? Well, in these circumstances, the policy could have a value in year 10 and an allocation of a part of the SNRB may be necessary. This would also be the case if Sally died just before the 10-year anniversary and there was insufficient time for the trustees to distribute the proceeds before the 10-year anniversary of the trust.

The position is slightly different with whole of life policies. Here the value of the policy will be the market value (normally the surrender value) or premiums paid if greater. This means that, unlike a term assurance, a whole of life policy will always have a value for IHT purposes – albeit normally a small value. This, in turn, means that some of the SNRB will have to be allocated to it at the 10-year anniversary to avoid an IHT charge at 6%. This would not necessarily be the case with a term assurance where market value is always used (not premiums paid).

Example:

Angela effects a whole of life policy for a sum assured of £250,000 subject to a discretionary trust. Premiums are £3,000 per annum – which fall within her annual IHT exemption. On the 10-year anniversary of the trust, the surrender value of the policy is £12,000. This is the market value for IHT purposes. The total premiums paid are £30,000 and so, as this exceeds market value, this is the value for IHT purposes.

This means that unless some of the SNRB has been allocated to the trust, an IHT charge of £1,800 will arise (£30,000 @ 6%). This is, of course, subject to any de minimis rule that may then apply.

To deal with this potential problem, Angela could have allocated a small percentage of her SNRB to the trust in the run up to the 10-year anniversary date.

If the new rules are implemented in the way proposed, this will mean that where polices – particularly protection policies - are held in a discretionary trust, it will be important for advisers to monitor trust values with a view to recommending how much of the SNRB would need to be allocated to an individual trust. Previously, because a trust would generally have qualified for its own nil rate band, the problem was not so acute.

The need to monitor the value of trust assets is particularly important where trusts of life policies exist and values can, quite quickly, dramatically change.

FREEDOM & CHOICE CONSULTATION IN PENSIONS GOVERNMENT RESPONSE: ANTI-AVOIDANCE

As a result of the pension flexibility proposals there is more scope for tax avoidance using registered pension schemes

The Government's response to the Freedom & Choice in Pensions consultation specifically addresses this issue

No sooner than the ink was dry on the Freedom & Choice in Pensions consultation paper, did a number of commentators come up with the idea that if you can withdraw any amount from your pension scheme aged 55 and over, (taking 25% as pension commencement lump sum (PCLS) and the remainder as a lump sum but subject to marginal rate income tax), then individuals aged 55 and over could effectively be remunerated by an employer making a pension contribution for their benefit. The saving is, of course, that there are no employee and employer NICs on the contribution and the individual is able to draw 25% of the contribution (less charges) tax free.

Remember, if an individual is currently taking capped income drawdown (irrespective of the amount drawn), the maximum input of further tax-relievable contributions is only restricted by relevant UK earnings and the Annual Allowance. On the other hand, for individuals who successfully elect for flexible drawdown there is NO ability to make further tax-relievable contributions.

In deciding how to deal with the position as regards the payment of future pension contributions by a person who intends to have flexible access to their pension, the Government has had to take into account a number of factors. For example, we now live in a world of Automatic Enrolment where the Government actively encourages people to save more for retirement. Conversely, the current rules for flexible drawdown do not permit further saving to a registered pension. Therefore, accessing pension funds at age 55, for example to repay debt or a mortgage, restricts the ability to carry on saving and secure a 'second pot' for a later and actual retirement.

The flexibility rules therefore need to balance the ability to make further contributions and prevent abuse by utilising tax avoidance loopholes.

The Government's flexibility proposals on anti-avoidance and the ability to continue to pay contributions are that for those who draw their PCLS post 5 April 2015 and take any further amount from the fund, they will be restricted to making tax-relievable contributions of up to £10,000 pa.

For individuals who are currently in a capped drawdown arrangement, provided the income that is drawn does not exceed the maximum capped drawdown amount for that individual, they will **not** be restricted to the new £10,000 pa contribution limit and will continue to be subject to the limits as described above. As soon as the income drawn from the drawdown arrangement exceeds the maximum capped income, the £10,000 pa limit will apply.

For individuals currently in flexible drawdown, from 6 April 2015 they will automatically have an annual limit of £10,000 pa per input year.

The £10,000 limit will not be activated if a person draws from a small pension pot valued at £10,000 or less as these pots can be accessed via the small pot rules. To help streamline events, the age at which funds can be accessed under the triviality and small pot rules is to be lowered to 55.

ENHANCED FLEXIBILITY FOR ANNUITY PRODUCTS UNDER THE NEW PENSION REGULATIONS

Increasing the flexibility with which people can take retirement benefits from DC schemes

The Government will be easing the tax rules to enable product providers to develop new retirement income products

As part of its intention to increase the flexibility with which people can draw retirement benefits, the Government is keen that the tax system should not restrict product providers in developing new products that are suitable for people drawing benefits in the new 2015 environment. It therefore believes that the pensions tax system should be modified to permit such products.

The current tax legislation recognises two broad categories of retirement income under registered pension plans:-

- *Lifetime annuities.* Here the tax rules governing lifetime annuities are prescriptive and relatively inflexible. As an example, payments made under a lifetime annuity are not permitted to decrease (except in specified circumstances) and lump sum benefits cannot be drawn.

- *Income drawdown (both capped and flexible).* The tax rules governing drawdown are significantly more flexible, particularly with regard to flexible drawdown which, subject to certain income safeguards being satisfied, permits complete withdrawal of the fund. Of course, complete flexibility of access to a pension fund (without income safeguards) will be available from 6 April 2015.

The Government takes the view that annuities will remain the right choice for many at some point during their retirement, and believes that many people will still value the security of an annuity. However, it believes that there is a clear demand for more flexibility to allow new products that meet and complement the changing nature of retirement.

Having consulted extensively on this issue, the Government believes that, in order to allow innovation, many of the restrictions in the tax rules and pensions legislation need to be removed. The Government understands that by relaxing the rules governing annuities product providers

would be able to develop a number of new and more flexible annuity products. The changes set out below will enable providers to create new types of annuity that more closely meet customer needs, as well as creating new products through the drawdown rules.

With this in mind, the Government intends to change the current tax rules in order to:

- **allow lifetime annuities to decrease.** This will provide significantly more flexibility in the design of the product. Providers will be able to offer products which meet individuals' needs more closely, for example by allowing annuity payments to reduce once an individual becomes eligible for the state pension

- **allow lump sums to be taken from lifetime annuities.** This would be subject to the condition that this is specified in the contract at the point of purchase. This will allow providers to structure much more flexible products that are capable of meeting specific circumstances, such as the need to meet the costs of care

- **remove the ten-year guarantee period for guaranteed annuities.** This will allow payments made to beneficiaries from guaranteed annuities to continue beyond the current ten-year maximum. It will also allow providers to create annuities that ensure more of an individual's fund is returned to their family in the event of their death

- **allow payments from guaranteed annuities to be made to beneficiaries as a lump sum, where the lump sum is under £30,000**. This will allow beneficiaries to receive pension payments as a lump sum if they wish, rather than having to spread these out over several years

Given that from 6 April 2015 more people will be able to access their pension funds, the Government expects that the retirement income industry will develop a number of new drawdown products which take into account the greater number of people seeking to buy them alongside the broader variety of fund sizes used to purchase them.

However, the Government wishes to protect consumers in the new innovative and flexible system. It will therefore work closely with the Financial Conduct Authority, the Prudential Regulatory Authority and the Pensions Regulator to ensure that the regulatory regime is sufficiently robust to protect the interests of consumers.

COMMENT

This is good news for product providers. There will inevitably still be a place for annuities in the new world of flexible pension withdrawal but some of the annuity rules considerably limit flexibility and appeal. These proposed changes will free up providers to offer annuity products that can truly meet the financial needs of customers in retirement in a flexible way.

INCOME WITHDRAWAL RATE FOR AUGUST 2014

The appropriate gilt yield, used to determine the 'relevant annuity rate' from HMRC's tables for an adult member commencing income withdrawals (or reaching an income withdrawal review date), in August 2014 is 3.0%.