In Depth
April 2014

Pot luck?
Budget proposes significant changes to the taxation of retirement savings
In a nutshell

The 2014 Budget included proposals to provide significantly more choice for those with defined contribution (DC) and cash balance funds, from April 2015. The same flexibility is not proposed for defined benefit (DB) pensions. To address a possible increase in transfers from DB to DC, transfers from public sector schemes would be prohibited, except in limited circumstances, and there may be restrictions on transfers from other DB schemes.

In the meantime, this year’s Finance Act will introduce changes with effect from 27 March 2014 to allow more limited additional flexibility for drawdown and small pots/benefits.

It is also proposed that Normal Minimum Pension Age would increase to 57 in 2028 and then be linked to increases in State Pension Age.

A consultation, covering the proposals outlined for 2015, closes on 11 June.

In this edition of In Depth, we summarise the proposed changes and outline the actions which should be considered by trustees and employers.
**Proposals for 2015**

**DC flexibility**

From April 2015, the government proposes to allow full access to DC (and cash balance) pots as cash lump sums or unrestricted drawdown. The option to take up to 25% of the funds as a tax-free pension commencement lump sum will be retained – with the remaining payments being subject to the individual’s marginal rate of income tax.\(^1\)

Scheme rules could allow individuals to decide how they access their retirement savings:

- a single lump sum could be paid;
- part could be taken as a lump sum with an annuity purchased with the remainder at retirement, or at a later stage; or
- savings could continue to be invested and accessed over time using a drawdown product but with no limits and no minimum income requirements.

People with significant pensions savings, or very small pots, already have flexibility. These proposals will extend the flexibility to all individuals with DC funds. Those who are currently in drawdown should also be able to benefit from the reforms.

**Decisions, decisions**

The government proposes to guarantee that everyone with a DC pension will be offered free and impartial face-to-face guidance on their financial choices when they retire. This should cover the individual’s range of options to help them make sound decisions and equip them to take action, whether that is seeking further advice or purchasing a product.

Pension providers and trust based schemes would therefore be obliged to offer each of their DC members guidance at the point of retirement. The government seeks views on the most appropriate way to implement this duty, and whether differing approaches should be taken for contract-based and trust-based schemes. Views are also requested on whether guidance can be delivered by providers themselves without compromising impartiality, or whether this needs to be provided by a third party.

The Financial Conduct Authority (working closely with the Pensions Regulator and the DWP in relation to standards for trust-based pension schemes) has been asked to make sure the guidance meets robust standards designed to ensure that it “focuses on helping consumers understand the choices open to them, how to engage with products and providers confidently and knowledgeably, and how to access professional independent financial advice where it is appropriate for them to do so”. A £20 million development fund will be made available to get the initiative up and running.

Advice at retirement is considered a critical first step. Further assistance and advice may be required. The government will consider ways to ensure that individuals are equipped with the skills and information to choose the adviser, broker or comparison site that suits their needs and understand the advice given. Some members will want regulated advice, and the government will work with the FCA to explore the extent to which this can be made more affordable, such as through the development of online delivery channels.

The more flexible options mean some people will need continuing access to advice later in their retirement. The government seeks views on what may be needed to improve access to the right guidance throughout retirement.

\(^1\) Additional charges are expected to apply (as at present) if the crystallised benefits exceed the lifetime allowance.
Proposals for 2015

The tax rules that apply to pension funds on death will be reviewed to ensure that they are appropriate under the new system. In particular, a flat 55% rate on funds allocated for drawdown but yet to be paid at the time of death may be too high in many cases once everyone with DC funds is able to enter into drawdown. The government will consider how to review these rules.

It is not clear from the consultation whether individuals opting to draw down funds or take a single lump sum would have their subsequent annual allowance reduced to nil, as is the case under the existing flexible drawdown provisions.

Scheme rules may need to be amended to make allowance for the new flexibilities. The consultation asks whether a statutory override should be put in place to ensure that pension scheme rules do not prevent individuals from taking advantage of increased flexibility.

The government expects the new flexibility to stimulate innovation and new competition in the retirement market. It suggests that this would include the development of new products which meet people’s social care needs and is interested in views on how the new rules could be designed to allow this.

Hybrid schemes

The government will consider how the new flexibilities should apply to hybrid schemes. Schemes which provide members with benefits that are the higher of a DB and a DC amount will need special consideration. However, we can see no reason why the DC flexibilities should not apply to members with pure DC benefits within a hybrid scheme, even if the member also has DB benefits within the scheme (for example where the DC benefits relate to AVCs).

DB transfers

The new flexibility will not apply to DB pension arrangements. DB members could transfer to DC arrangements to take advantage of the changes, but the government is concerned at the risks for members and the economy.

For public sector schemes (whether funded or unfunded), the government intends to legislate to remove the option to transfer to a DC arrangement, except in very limited circumstances. It does not intend to change the rules affecting transfers from public sector schemes to other DB schemes.

For private sector schemes, in principle the government would like to find a way to extend the DC freedoms. However the decision is finely balanced and it is consulting on the issues and risks. The options for transfers to DC arrangements are outlined as:

- removing the option, except in very limited circumstances;
- requiring transfers to be ring-fenced and subject to the existing tax framework for DC (thus removing the incentive to transfer) although this may introduce additional complexity and burdens on scheme sponsors and HMRC;
- capping the amount that can be transferred to DC each year (it is not clear how such a cap might work);
- allowing only transfers that have been approved by the trustees;
- allowing full transfer flexibility, but only if it is clear that this would not create significant risks for the UK economy.

The government is willing to consider other options.
NMPA proposals

The consultation proposes to raise the normal minimum pension age from 55 to 57 in 2028 (when the State Pension Age increases to 67) and thereafter to retain it at 10 years below SPA. Views are requested on whether the minimum age should rise further, for example to five years below SPA. The new minimum pension age would apply to all pension schemes which qualify for tax relief (so this would include DB schemes) although the government seeks views on this. Those who already have a protected pension age below 55 will be exempt from this rise.

Changes for 2014

The following amendments to existing options will be made with effect from 27 March 2014, once the Finance Act 2014 is in force. The Act is expected to receive Royal Assent in July.

**De minimis** rules will be changed so that individual pension benefits of up to £10,000 can be commuted or taken as cash, irrespective of the individual's total pension wealth. Previously a £2,000 limit applied. The number of personal pension pots that can be taken in this way will also increase from two to three.

**Trivial commutation lump sum** rules will be changed so that pension benefits can be commuted or taken as cash in cases where total pension wealth is up to £30,000 (previously £18,000).²

**Capped drawdown** thresholds will be relaxed. The limit on income that can be taken this way in any ‘drawdown year’ will be increased to 150% of an equivalent annuity (previously 120%), for drawdown years beginning from 27 March 2014.

**Flexible drawdown** thresholds will also be relaxed. The annual income required to apply for flexible drawdown, in the tax year in which the election is made, will reduce to £12,000 (previously £20,000). (Note that another important condition remains, that no contributions have been paid in the tax year in which the election is made.)

The changes to trivial commutation lump sum and de minimis rules apply to both DB and DC arrangements. It is not clear whether the de minimis rule change will continue to apply to DB after April 2015 (when full flexibility is expected to apply for DC), although the consultation document makes clear that the trivial commutation facility will remain.

Scheme rules may need to be amended to reflect the additional flexibility allowed under legislation. Particular care should be taken if it is proposed to make a payment reflecting the new thresholds before the Finance Act receives Royal Assent.

² Increase in the overall triviality limit from £18,000 to £30,000 applies only to trivial commutation lump sums - not to trivial commutation lump sum death benefits, or to winding-up lump sums/winding-up lump sum death benefits.
A call to action

Immediate actions

On DC, trustees and employers should consider communications with members.

A segmented approach is likely to be appropriate. A different message is likely to be required for:

- those at retirement – including those that have already received their retirement options;
- those expected to retire over the next year – who might prefer to defer;
- those who could retire in the near future; and
- those further away from retirement.

Scheme rules and retirement processes should be reviewed to allow for the 27 March changes.

On DB, trustees should consider whether it is appropriate to issue a communication to members, setting out the proposals – including the prospect of a possible ban on transfers to DC arrangements in the near future. Such a communication might be general in nature or could be more specific (even including details of the transfer value available). Achieving an appropriate balance will be important, and the timing may need to be chosen carefully, given the possibility of a ban on transfers in the near future. Trustees should also consider whether their transfer value basis remains appropriate, given the likely increase in demand for transfers.

Employers are likely to be interested in the approach proposed by the trustees. In particular, in cases where employers are in the process of considering an enhanced transfer value exercise, the possibility of a ban on all transfers in the near future is likely to focus attention on the timing of the exercise.

Again, scheme rules and retirement processes should also be reviewed to allow for the 27 March changes. In addition, trustees should consider commissioning a one-off exercise to meet smaller benefits by applying the increased limits for de minimis and trivial commutation to members, and may need to review the factors used for such exercises to ensure they are appropriate.
Medium term actions

On DC, trustees and employers should consider their members’ preferences and whether the scheme rules should, in principle, be amended to allow full flexibility within the scheme. They should also discuss the implications of proposed changes with their administrators.

Trustees will need to decide how to implement the requirement to offer face-to-face guidance at retirement once further details are available.

Trustees should also consider the implications for default investment strategies, particularly now that schemes need to communicate to members on lifestyling strategies. A default investment strategy which matches annuity prices for part of the funds as members near retirement may no longer be appropriate. Members might be expecting to take cash or drawdown at or during retirement:
DB trustees and employers will want to complete existing or planned transfer exercises, and may want to consider the timing of trivial commutation exercises. It is conceivable that a ban on transfers could be implemented before the summer recess, when the government response to the consultation is expected. There is also some uncertainty over whether the higher de minimis threshold will be retained after April 2015.

For both DB and DC, general communications (booklets etc as well as benefit statements) will need to be examined to ensure that they are not misleading and that they set out the full choices available.

### Longer term actions

Employers should review their overall benefit design to reflect both these changes and the end of contracting-out in 2016.

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<tr>
<td>General communication</td>
<td>General communications on</td>
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<td>Specific communication for</td>
<td>changes</td>
</tr>
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<td>retirees</td>
<td>Consider opportunities</td>
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<td>Review retirement process</td>
<td>– DB transfer exercise</td>
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<td>– Trivial commutation</td>
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<td>contracting-out changes</td>
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<thead>
<tr>
<th>Short term</th>
<th>Medium term</th>
<th>Longer term</th>
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<tbody>
<tr>
<td>April/May</td>
<td>2014</td>
<td>April 2015 onwards</td>
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