DC pensions flexibility: legislation laid before Parliament

In the 2014 Budget, the Government announced what it called "the most fundamental reform to the way people access their pensions in almost a century". The most significant change announced was that, from April 2015, members with defined contribution (**"DC"**) benefits, meaning money purchase or cash balance rights, would be able to draw down all their benefits as cash from age 55. The Government has now laid the Taxation of Pensions Bill (the **"Bill"**) before Parliament. The Bill will put in place the tax-related aspects of the changes. Occupational schemes can offer these flexibilities to their DC members, and members with defined benefit rights may want to transfer or convert them to DC so as to access their benefits in new ways.

Background: the 2014 Budget announcements

The 2014 Budget announced that the restrictions on drawdown of pension benefits would be removed, so as to let DC members draw down all their benefits as cash from age 55 and effectively removing the requirement to annuitise. The current tax-free cash would continue to be available and members would pay tax on amounts drawn down above the tax-free cash limit as extra income, even where they withdrew all their benefits. (Currently a 55% tax charge applies if a member does this.)

Ways of taking DC benefits from April 2015

The Bill introduces two new ways for DC members to take their benefits at age 55 from 6 April 2015:

- Schemes will be able to pay a new type of authorised lump sum, called an uncrystallised funds pension lump sum, which is effectively a cash lump sum comprising all or part of a DC member's uncrystallised benefits. 25% of this sum will be tax-free and the remainder will be taxed at the member's marginal rate. There is no limit on the number of such lump sums which can be paid to a member provided that they are paid from a member's uncrystallised benefits.
- DC members will be able to designate their benefits as flexi-access drawdown funds, which will allow them to make as many uncapped withdrawals as they wish from those funds. (The member can still later use those funds to purchase an annuity.) At the time that the member designates benefits as flexi-access drawdown funds, the member will also be able to take a tax-free pension commencement lump sum. No additional tax-free cash will be payable if the member later uses some of the flexi-access drawdown funds to purchase an annuity.

DC members will still be able to use their funds to purchase an annuity, to take a scheme pension and to exchange their benefits for a lump sum under the small lump sum rules. However, it will no longer be possible for a DC member to exchange benefits for a trivial commutation lump sum, presumably because HMRC expects these members to be able to access their DC benefits under the new flexibilities instead.

Statutory override

The Bill makes changes to the way in which DC benefits can be accessed under the tax rules – what DC members can do in practice with their benefits will depend on what their scheme rules provide. Trustees and managers of schemes will have a statutory power to make certain payments in connection with the new flexibilities without needing to amend their scheme rules, including payments from flexi-access drawdown funds, pension commencement lump sums in connection with a designation of flexi-access drawdown funds, and uncrystallised funds pension lump sums. The statutory power contains no requirement for employer consent to be obtained, nor does it include any power for the trustees or scheme manager to recharge any additional administration costs to the member. It is not clear how trustees are expected to approach exercising this power if they come under significant member pressure to allow additional flexibility.

Treatment of existing drawdown arrangements

The existing rules about capped drawdown and the minimum income requirement for flexible drawdown will not apply to benefits designated for flexi-access drawdown on and after 6 April 2015. DC members who took capped drawdown before 6 April 2015 will be able to re-designate their funds as flexi-access drawdown funds with the scheme administrator's consent. In addition, if a DC member who has taken capped drawdown makes a withdrawal which breaches the capped drawdown limit, the member's drawdown funds will be converted automatically into flexi-access drawdown funds. Funds held by DC members who took flexible drawdown before 6 April 2015 will be converted automatically into flexi-access drawdown funds.

Changes to the annuity rules

The current rule which says that an annuity generally cannot decrease while in payment will not apply to new annuities from April 2015. In addition, the requirement that the member must have been offered the opportunity to select the insurer in order for the purchase of an annuity to be an authorised payment will not apply to new annuities from April 2015. Lifetime annuities with a guarantee period of more than 10 years will also be possible. Annuities must still be purchased from an insurance company and (in the case of a lifetime annuity) must be payable for life.

Changes to the trivial commutation and small lump sum rules

The age from which small defined benefit (**"DB"**) or DC pensions can be exchanged for cash under the small lump sum rules will be lowered from 60 to 55, as will the age at which DB pensions can be commuted for a trivial commutation lump sum. In addition, the maximum amount of benefits which can be exchanged for a trivial commutation lump sum death benefit will be increased to £30,000 from 6 April 2015 to mirror the change made to the trivial commutation lump sum limit earlier this year.

Changes to the annual allowance regime

The annual allowance for future DC pension saving will reduce to £10,000 (the **"DCAA"**) where a DC member:

- takes an uncrystallised funds pension lump sum;
- accesses funds under flexi-access drawdown (the DCAA will not be triggered by a DC member designating funds as flexi-access drawdown funds or taking a pension commencement lump sum unless accompanied by a withdrawal of flexi-access drawdown funds); or
- buys a lifetime annuity other than in prescribed circumstances (as yet, the Government has not confirmed what the prescribed circumstances will be).

(The DCAA is triggered in certain other circumstances which are unlikely to affect the majority of DC members.) There are complicated rules on how the DCAA will interact with DB savings and the standard annual allowance of £40,000, and on how it will apply to savings under hybrid arrangements set up from 14 October 2014.

The Bill imposes a wide range of new information provision obligations on scheme administrators with respect to the new DCAA.

Changes to tax charges on death

The Bill amends the tax charges payable where a member dies with unused drawdown and DC funds with effect from 6 April 2015. Members will be able to nominate one or more beneficiaries to whom those funds will be passed on their death.

- Where the member dies before age 75, the beneficiary will not pay tax on the funds whether the funds are taken as a single lump sum or via drawdown.
- Where the member dies after age 75, the beneficiary

can take the funds via drawdown, in which case the beneficiary will pay tax on the funds at the beneficiary's marginal rate. Alternatively, the beneficiary can take the funds as a single lump sum in which case the beneficiary will pay tax at 45% on the funds (the Government intends to reduce this to the beneficiary's marginal rate of tax from the 2016/2017 tax year).

Comment

Schemes will need to consider the extent to which they wish to offer the new flexibilities to DC members. The permissive statutory override does not allow schemes to recover any additional costs of offering the flexibilities from DC members, nor does it require schemes to obtain employer consent, despite the fact that trustees will be able to offer options that might have material administrative costs.

Whether or not schemes intend to offer the new flexibilities, they will need to start planning well ahead of April 2015 what changes they will need to make to scheme processes and administration in light of the reforms – for example to reflect the new DCAA information provision requirements.

The Pension Schemes Bill that is currently before Parliament is in the process of being amended to implement other aspects of the April 2015 reforms, such as changes to the transfer rules for DC members and DB members and the "guidance guarantee" whereby DC members will have a right to receive free guidance at retirement.

If you have any questions about this update, please get in touch with your usual Mayer Brown contact or:

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