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Removal of age 75 rule for retirement benefits

In brief

- Since 6 April 2011, HMRC rules no longer require pension and lump sums to be taken by age 75.
- New income drawdown rules have replaced the previous USP and ASP rules.
- 'Flexible drawdown' is now available for those who meet a new 'minimum income requirement'.
- Tax-free cash is available after age 75.
- Death benefit rules, and aspects of their tax treatment, have changed.

Next steps

- Trustees and sponsors should review what options to offer members retiring in the future.
- Trustees may wish to consider permitting the payment of tax-free cash and death benefits to members over age 75.

On 6 April 2011, major changes came into effect regarding the way in which pension funds can be used to provide retirement benefits. Removing the requirement to purchase an annuity by age 75 means that, subject to scheme rules, members with defined contribution (DC) funds can now defer taking their benefits indefinitely. Funds can now be withdrawn on either a 'capped' basis or on an unlimited basis, so long as a 'minimum income' has been secured. Under HMRC rules, tax-free cash can now be paid after age 75, and lump sum death benefits can be paid on death after age 75 (subject to a tax charge).

Whilst these changes undoubtedly herald greater flexibility in how income in retirement may be taken, how will they affect members, and what do trustees and sponsoring employers need to consider?

Background

In the Emergency Budget on 22 June 2010, the Government announced it would remove the effective requirement for members with DC funds to purchase an annuity by age 75. A period of consultation followed, and the relevant legislation was incorporated into the Finance Bill, published on 31 March 2011. The changes came into effect from 6 April 2011.

Options under the previous legislation

Before age 75

For members with DC funds not wanting to purchase a lifetime annuity or scheme pension before age 75, the alternative was either to leave the fund uncrystallised or to enter into income drawdown in the form of unsecured pension (USP). This option allowed members to leave their funds invested whilst drawing an income directly from the fund of up to 120% of a notional annuity derived from tables published by the Government Actuary's Department (GAD). The amount withdrawn was reviewed every five years. Any funds remaining on the member's death could be paid as a lump sum, subject to a 35% tax charge.

At age 75

Before 6 April 2011, members with DC funds reaching age 75 had two options: to use their fund either to purchase a secured income (i.e. a lifetime annuity or scheme pension) or to provide an alternatively secured pension (ASP). Funds could not be left uncrystallised.

ASP was introduced from April 2006 for members who reached age 75 but objected to the mortality pooling associated with buying an annuity. The income paid under ASP had to be between 55% and 90% of a notional annuity derived from GAD tables. The right to take tax-free cash was lost at age 75 and, on death, tax charges of up to 70% applied unless the fund was used to provide a dependant's pension or paid to charity. Inheritance tax could also be levied on the balance, resulting in a total tax charge of 82%.

What has changed?

From 6 April 2011, members with DC funds no longer have to purchase an annuity by age 75. Instead, subject to scheme rules, they can defer securing an income or purchasing an annuity indefinitely.

The previous income drawdown options under USP and ASP have been replaced by two variants: 'flexible drawdown' and 'capped drawdown'. Both are available from age 55 (or earlier for those with a protected pension age), with no upper age limit. Transitional provisions apply for members with existing income drawdown under USP or ASP.

Capped drawdown

The capped drawdown basis is similar to USP in that no minimum income has to be drawn each year. The maximum amount is limited to 100% (previously 120%) of a notional annuity derived from GAD tables; this must be reviewed every three years prior to age 75, and annually thereafter.

Flexible drawdown and the MIR

Under flexible drawdown, unlimited amounts of income can be withdrawn by members who can demonstrate they have secured a minimum income level of at least £20,000 per year. This is known as the 'minimum income requirement' (MIR) and must be satisfied in the tax year in which the member opts for flexible drawdown. Income from state pensions, lifetime annuities, scheme pensions (from schemes with at least 20 pensioner members) and Financial Assistance Scheme payments can count towards the MIR; drawdown income cannot.

If members wish to use flexible drawdown, they must make a declaration that they are not making pension savings to any registered pension scheme. This means ceasing active membership of any defined benefit (DB) scheme and ensuring no contributions (by the member or employer) are paid to a DC arrangement in the tax year in which flexible drawdown is taken. Any pension savings made after flexible drawdown is taken will be subject to the annual allowance charge, without benefiting from the £50,000 annual allowance.

Tax-free lump sums

One of the knock-on effects of abolishing compulsory annuitisation at age 75 is that tax-free cash can now be taken after age 75 where the trustees permit this. Similarly, there is no upper age limit for paying lump sums on trivial commutation, winding-up or serious ill-health (but a 55% tax charge applies to the last of these if paid after age 75).

Death benefits and inheritance tax

From 6 April 2011, funds can still be passed on tax-free after death at any age to provide a dependant's pension. Lump sums

can also now be paid on death at any age, but the tax treatment will vary depending on the type of lump sum and the age of the member at death:

- Lump sum death benefits paid from uncrystallised funds or DB schemes remain tax-free (up to the member's lifetime allowance) where the member dies before age 75, with a 55% tax charge after age 75.
- Lump sum death benefits paid from funds in drawdown will be taxed at 55%, regardless of the age of the member at death.
- Where there are no dependants, funds in drawdown can be paid tax-free to a charity on death before or after age 75, provided the member has nominated the charity before their death.

In most cases, there will now be no inheritance tax charge in respect of unused pension funds remaining after death.

Continuing significance of age 75?

Despite the removal of the age 75 rule, tax relief is still only available on personal contributions paid before age 75. Furthermore, drawdown and uncrystallised funds must still be tested against the member's available lifetime allowance by age 75.

What should trustees & sponsors consider?

Removal of the age 75 rule potentially provides greater flexibility as to how and when DC members take their benefits. Trustees and sponsors of DC schemes are not required to adopt the new rules, but may wish to review the options they offer to members 'retiring' in the future. In reality, the changes are only likely to affect relatively wealthy members who can plan how and when they take their benefits in the most tax-efficient way.

The removal of the age 75 rule largely applies to DC pension schemes; however, trustees of DB schemes may also wish to consider permitting the payment of tax-free cash and death benefits to members over age 75 (although members would need to be aware of the tax implications where payment occurs after age 75). In addition, they should be aware that some members with large pension benefits may ask for a transfer of some or all of their benefits at retirement in order to benefit from the increased flexibility available in DC schemes. Some sponsors with DB schemes may wish to consider providing a DC option at retirement to allow their employees to take advantage of flexible drawdown.

Where can I get further information?

For further information, please get in touch with Nick Frankland on 0131 624 8834 or by email to nick.frankland@puntersouthall.com. Alternatively, speak to your usual Punter Southall contact.

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