Budget 2014: Changes for Pensions and Savings

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Last month's Budget contained two proposals of particular interest to most people: namely their **pensions** and their **savings**.

The first part of this article covers my understanding of the **pension changes** which herald a new era for the way people fund their retirement and what happens to their pot of gold when they reach retirement age.

Pension Changes

From next year, millions of people reaching retirement age can spend their pension savings fund in any way they want – including (as has been widely reported) buying a Lamborghini. From April 2015 pensioners will still be able to take up to 25% of their pension pot (tax-free) from age 55 onwards. But, there will be no restriction on the amount of income they can take, and if they wish, the whole fund can be taken as a lump sum; this is a massive change, possibly the biggest in a generation.

HMRC explain that there are four types of pension arrangements, see below. You can be in any number of arrangements in the same scheme. An arrangement can only pay you one type of benefit, so if you're getting more than one type of benefit you must have more than one arrangement in the scheme.

The four different types of pension arrangements are:

- money purchase (or defined contribution arrangement)
- defined benefits
- cash balance
- hybrid

The two main scheme types

Most schemes are money purchase arrangements – the pension you get depends on how much the money you have paid in has grown to by the time you retire. This means the value of your pension will depend on how much pension your pension pot can 'buy'.

Defined benefits arrangements are the second most common type of scheme - you're promised a certain amount of pension at retirement. The amount of your pension is usually based on your pay and length of service. The announcement in the Budget, will remove the requirement on many people with defined contribution pensions to buy an annuity (usually from an insurance company) with a guarantee of either a fixed or escalating pension for the rest of their lives.

In future, retirees will have more flexibility to do what they want with their pension savings. The hope is that people can be trusted to manage their own finances. Some people take a lump sum to celebrate retirement with a holiday of a lifetime or, as the pensions minister admitted, even a Lamborghini sports car.

The time-bomb that exists for many people with an interest only mortgage, without any definite idea of how it will be repaid at the end of the term, could be defused by people extracting monies from their pension fund over say a 5 – 7 year period (to keep their tax rate low) and paying down their mortgage in full. The popularity of interest-only mortgages has waned in the last 30 years, as the reality of final value of endowment policies taken out to pay them off, has come home to roost. But now with access to pension monies to pay off home loans, maybe we will see interest-only mortgages becoming popular again. And of course, the actual monthly outgoing for an interest only borrower is quite a lot less than on a repayment mortgage – so houses will be easier to buy, the frenzy to buy will be increased and everything will be hunky dory as long as house prices don't go down.

Many retirees may choose to use the money to invest in buy-to-let property instead so that they receive a useful annual income. But the money available may not be enough to buy a property outright – currently, retirees will find it nearly impossible to borrow money on a rental property beyond age 70. On the other hand, maybe in future there will be a new mortgage market for the blue-rinse brigade – who knows?

In Australia, where people are already able to withdraw lump sums easily, recent evidence suggests that most retirees invest the money or use it to clear debts, but a few choose to buy holidays or cars. Similar changes were successfully introduced in Ireland in 1999 and the pensions system coped just fine. The Irish still save and there has been no crisis.

The new flat-rate state pension will provide just over £7,000 a year of income to fall back on but much lower than the vast majority of people are used to during their working life.

The schemes affected by the changes

The schemes affected by the changes are:

- Personal Pensions (including Group Personal Pensions)
- Stakeholder Pensions
- Self-Administered Schemes
- Defined Contribution Occupational Pensions (but not Defined Benefit or Final Salary schemes, such as those in which NHS employees or teachers are members)

Advantages or disadvantages of the changes

Advantages:

- There is greater flexibility in the

amount of income which can be taken from the pension savings.
- You can take ad hoc lump sums in whatever amount and whenever it suits you and use the money to repay debts or mortgages outstanding or buy a holiday home or buy-to-let property to generate additional income (although that will be taxable).
- There is no automatic requirement for people with small pension pots to buy a **Compulsory Annuity** all the income from which is taxable. Some people may choose to buy a **Purchased Annuity** which guarantees income for life but because each instalment is deemed to include an element of return of capital, the taxable element is smaller.
- People may retire earlier, by taking higher incomes from their pension fund, until the State Pension kicks in and then reducing the income from their pension pot.

Disadvantages:
- People who take lump sums either all at once or by instalments, could pay more tax on lump sums and earlier than it would have been on a pension drawn from their pension pot on an annual or monthly basis.
- Anyone who takes large lump sums, or indeed their entire pension pot as a one off payment, could be left with insufficient income to meet their living costs on a continuing basis for their later years.
- The income arising from investments made with lump sums taken from the pension pot will be taxable whereas if the money had been left in the pension pot, the income would have been tax-free.
- Depending on how lump sums are invested, any ongoing income is not guaranteed - unlike an Annuity, where the income is guaranteed for life.
- Anyone who rushes out to buy an Annuity before the new rules kick in on 6 April 2015 won't be able to take advantage of the changes.

Don't forget the tax impact

Taking all their saving out from their pension plans will mean that the taxman will want some of it. The money will be treated as income subject to income tax. There will also be inheritance tax consequences as, on death, estates may be larger than before.

At present, retirees don't have much flexibility if they want access to their defined contribution pension funds during their retirement – they have to pay 55% tax if they withdraw the whole pot (excluding the tax-free element, usually 25% of the total fund) and annual pension withdrawals are taxed as income. From April 2015, people aged 55 and over will only pay their marginal rate of income tax on anything they withdraw from their defined contribution pension – either 0%, 20%, 40% or 45%.

Tom McPhail, head of pensions' research at Hargreaves Lansdown, says (here) that people already retired and in drawdown (that is, not having bought an annuity but taking a pension out of their pension fund) may want to contact their drawdown provider to find out whether they are going to be able to adapt their systems to accommodate the new 150% income limit (up from 120%). This is a revalorisation of the maximum pension entitlement calculated from official annuity tables. Although you can request a review of your income limits on your policy anniversary, it is dependent on the drawdown provider being able to meet your request.

It seems that there is another beneficiary of the changes – namely HMRC itself:
- Currently, the taxman gets tax on the annual pension drawdown or annuity as it is taken. So it takes until the pot is exhausted for the HMRC to get its pound of flesh. And all the time there is money in the pension pot, the income is usually tax-free.
- In future, if retirees take all of their fund, HMRC will get an immediate income tax receipt at the marginal tax rate of from 20% to 45% rather than having to wait for it in annual instalments over the life of the pensioner. It gets better for HMRC too – any lump sums invested in assets such as buy-to-let property or stocks and shares or even left on deposit account at the bank, will produce taxable income.

Don't forget the care you may need later on

Paying for care in retirement will be another factor if funds are used to buy rental property or other investments – these may have to be sold if retirees need residential or nursing care in their final years. It could also have an impact on Local Authorities who would face extra bills to pay for social care if newly retired people have spent their money on holidays (or fast cars) etc rather than putting some aside for care costs in later life.

The new system is planned to be start fully in April 2015, but only for the 300,000 or more people who retire each year with a defined contribution pension fund. People who have invested in an annuity won't be able to access any funds as the capital will no longer be available. James Lloyd, of the Strategic Society Centre policy think-tank, says that people who opt to cash in their pension pots rather than purchase compulsory annuities are likely to have a lower income if and when they ask their councils for help with social care costs. It will also be easier to divest money from flexible pension pots before they require care putting them beyond the scope of means-testing.

How the current system works

Pension pot options

Currently, you can take up to 25% of your pension pot tax-free at retirement and you can spend it as you wish.

Other options:
- If you withdraw all your money then you are charged tax of 55%.
- If you are aged 60 and your overall pension savings are less than £18,000 you can take it all in one lump sum – this is called "trivial commutation".
- Regardless of your total pension wealth, if you are aged 60 or over, you can take any pot worth less than £2,000 as a lump sum, as this

classifies as a 'small pot'.

- A 'capped drawdown' pension allows you to take income from your pension, but there is a maximum amount you can withdraw each year (120% of an equivalent annuity).
- With 'flexible drawdown' there's no limit on the amount you can draw from your pot each year, but you must have a guaranteed income of more than £20,000 per year in retirement.

Interestingly, about 75% of people currently buy an annuity with their pension savings.

The new system

From 27 March 2014:

- The amount of overall pension wealth you can take as a lump sum is increased from £18,000 to £30,000.
- The maximum amount you can take out each year from a capped drawdown arrangement is increased from 120% to 150% of an equivalent annuity.
- The amount of guaranteed income needed in retirement to access flexible drawdown is reduced from £20,000 per year to £12,000 per year.
- The size of a small pension pot that you can take as a lump sum, regardless of your total pension wealth, is increased from £2,000 to £10,000.
- The number of personal pension pots you can take as a lump sum under the small pot rules, is increased from two to three.

From April 2015:

- From age 55, whatever the size of your defined contribution pension pot, you will be able to take it how you want, subject to paying your marginal rate of income tax in that year.
- There will be more flexibility. People who continue to want the security of an annuity will be able to purchase one and people who want greater control over their finances can draw down their pension as they see fit.
- To help people make the decision that best suits their needs, everyone with a defined contribution pension will be offered free and impartial face-to-face guidance on the range of options available to them at retirement (although the money set aside for this appears to be woefully inadequate).

The government has published a consultation on these changes alongside the Budget, so there may be final tweaks and amendments.

More information

There is more information from the government available here.

Savings Changes

This second part of my article covers my understanding of the **changes to savings** which seek to go some way to repair the damage done by the recession to the returns people get on the money they have put aside for a later or rainy day. I've written a separate article on the **pension changes** at the start of this publication.

Budget Proposals

Cutting the 10% tax rate on savings income

The government announced at Budget 2014 that from April 2015, it is abolishing the 10% 'starting-rate' of tax for savings income and replacing it with a new 0% rate, to provide further support for the lowest earners. It is also increasing the amount of savings income that the new 0% rate applies to, from £2,880 to £5,000.

What this means is that anyone with a total income of less than £15,500 will not pay any tax on their savings. From April 2015, if total income (things like wages, pension, benefits and savings income) is less than the personal allowance, plus £5,000, a taxpayer will be eligible to register for tax-free savings, with their bank or building society.

New Individual Savings Accounts (NISA), Junior ISA and Child Trust Fund (CTF): increasing flexibility for savers and investors

With effect from 1 July 2014, the annual subscription limit for cash and stocks and shares ISA will be equalised at £15,000, and restrictions on the transfer of funds between stocks and shares and cash ISAs will be removed altogether. Consequential changes will be made to the rules concerning the securities and other investments that can be held in an ISA, and Core Capital Deferred Shares issued by a Building Society will also be eligible for investment in an ISA and CTF.

With effect from 1 July 2014 the annual subscription limit for Junior ISA and CTF will be increased from £3,840 to £4,000.

Pensioner Bonds

The Chancellor announced the introduction of new pensioner bonds to help retired people who have suffered from low interest rates. Two fixed-rate "market leading" savings bonds will be launched to help people aged 65 and over who have seen their incomes cut by low interest rates over the last 5 years or so.

The new pensioner bonds, launched by the government's funding arm - National Savings and Investment (NS&I) - will be available from 1 January 2015 and be available to everyone aged over 65.

The exact rates will be set in autumn 2014 to ensure the best possible offer, but our assumption is 2.8% for a one-year bond and 4% on a three-year bond. *"That's much better than anything equivalent available in the market today,"* the Chancellor said.

The maximum deposit limit per person will be £10,000.

Premium Bonds

NS&I will allow Premium Bond purchases up to £40,000 – up by £10,000 on the current limit of £30,000 from 1 June 2014. The number of £1 million prizes will be increased to two from August 2014. *"Increasing savers' chances of winning the largest prize will allow people who want to save more through Premium Bonds to do so"* said the government. But, I think it isn't so much that people want to save more but rather win more!