AF7 Pension Transfers 2020/21
Part 2 Flexible Benefits

Once a transfer has been made the member has given up their right to a guaranteed income for life in exchange for a sum of money. It is now a Money Purchase arrangement and they face the same choices as someone who has a SIPP/PP or was a member of a money purchase scheme. They take on the investment risk as the fund must be managed to ensure it can provide a lifetime income.

At this point we are just considering what can be done rather than what should be done but advisers must understand the available options to an MP member at retirement Much of this should be familiar to many candidates and this part will help you revise your knowledge.

The milestones are to:

- Understand the principles of a Lifetime Annuity, FAD and UFPLS.
- Understand the death options from an uncrystallised and crystallised fund
- Be able to summarise the key differences between taking benefits from a DB scheme and through flexible benefits

What are the options?

Having transferred the member will have an uncrystallised money purchase fund in either a SIPP or PP. Option one is to do nothing which is the only option if the member is under 55.

If they are over 55 and want to take benefits they can use:

- A lifetime annuity
- Flexible access drawdown
- Uncrystallised Pension Lump Sum (UFPLS)

Lifetime annuity

A DB scheme pension and a lifetime annuity both offer a guaranteed lifetime income. Whilst this is an option, transferring from a DB scheme to buy a lifetime annuity would not seem to offer any benefits over remaining in the scheme particularly in the light of today's low annuity rates.

The one exception might be if the individual was in ill health and qualified for an impaired life annuity. The initial income might then be higher than the scheme pension.

Flexible Access Drawdown

The member usually takes 25% of the crystallised fund as a PCLS and the administrator will designate the remainder as a FAD fund. Any amount can then be withdrawn either on a regular or ad hoc basis. The member also retains the option of using any undrawn funds in the FAD to buy a lifetime annuity at some point in the future.

The withdrawals can be taken directly from the FAD, in effect using it as a bank account, or through buying short term annuities payable for a maximum of 5 years. You cannot take a PCLS from these as that can only taken when the FAD account was set up.

Further uncrystallised funds can be transferred into an existing FAD but no further input, that is new money can be placed into the FAD fund. Further input to other pension arrangements are permitted although these will be subject to the Money Purchase Annual Allowance.

All **withdrawals** from a FAD are subject to income tax at the member's non-savings rate. This is where care needs to be exercised since a large withdrawal could take someone into a higher tax rate band.

Andy has a fund of £200,000 and takes £50,000 as a PCLS designating £150,000 as a Flexi Access Drawdown fund. He is considering withdrawing all of this.

If his Income for the year before this event is £20,000 his tax for 19/20 before making a withdrawal would be:

Income	£20,000
Less PA	£12,500
	£7,500 @ 20%= £1,500

Taking all the FAD will increase his income to £170,000 so he will lose all his personal allowance.

His total tax liability will be:

£37,500 @ 20% =	£7,500
£112,500 @ 40% =	£45,000
£20,000 @ 45%	£9,000
	£61,500

The member does not need to crystallise all the fund which offers more flexibility.

Following a transfer Sarah has an uncrystallised fund of £800,000. She crystallises £500,000 and leaves £300,000 uncrystallised.

Once a fund has been designated as a FAD there is no obligation to make any withdrawals This means income can be varied and allows the PCLS to be released.

Jean is taking £15,000 a year from her FAD. She is offered a one year contract paying £40,000 so suspends her FAD withdrawals

George needs £25,000 as a lump sum but needs no income at this stage. He could crystallise £100,000 taking £25,000 as the PCLS and leaving £75,000 in the FAD account untouched.

A greater lump sum could be taken although part of it would be taxed. If George needed £50,000 he could take the additional £25,000 from the FAD. Assuming he is a higher rate tax payer he would have to withdraw £41,666.

UFPLS

A UFPLS is a withdrawal from an **uncrystallised fund** in which 25% of the amount taken is tax free and the remaining 75% taxable. The remaining fund remains uncrystallised. It is not possible to take a UFPLS from a FAD account as it is a crystallised fund.

David takes a £100,000 UFPLS from his fund therefore £25,000 will be tax free and the remaining £75,000 taxable.

The remainder of the fund remains uncrystallised, so David can continue to contribute and use it at any time to buy a lifetime annuity, put it into FAD or do another UFPLS. As it is uncrystallised it offers the prospect of taking a further 25% of the fund as a PCLS.

Having taken a UFPLS of £100,000 David has still got a £300,000 uncrystallised fund. If he designates that as a FAD at that point, he could take £75,000 as a PCLS. If he leaves it uncrystallised and it grows to £400,000, £100,000 could then be taken as a PCLS.

This is a key difference between UFPLS and FAD. With Flexi Access you crystallise all or part of the fund taking up to 25% as a PCLS and then withdrawing cash from the remainder as you wish. With UFPLS you simply take a withdrawal from the uncrystallised fund.

As we have seen 75% of a UPFLS is taxable and under HMRC rules unless the pension provider has the member's tax code they must apply what is known as a **month 1 basis.** This means that even though the withdrawal may be a one-off payment HMRC will treat it as the first of a series of regular monthly payments. This will result in an overpayment of tax that can be reclaimed but it may cause cash flow problems for the individual. This also applies to withdrawals from a Flexible Access Account where the administrator does not have a tax code for the member.

For a £60,000 UFPLS, £15,000 will be tax free and the remaining £45,000 is taxable. The administrator must make an immediate tax deduction of £18,531

1/12th of PA	£1,041	0%	0
1/12th of basic rate band	£3,125	20%	£625
1/12 of higher rate band	£9,375	40%	£3,750
Remainder	£31,459	45%	£14,156
Total			£18,531

The tax implications of taking a UFPLS, or indeed a capital withdrawal from a FAD, can be complicated as in the following example.

Mike's non-savings income is £9,000 below the higher rate threshold. He wishes to take a capital sum of £40,000 using UPFLS after any tax has been deducted. How much needs to be withdrawn?

Since he has £9,000 of the basic rate band left we first need to calculate how much needs to be crystallised to use this up.

As 25% of the UPFLS will be tax free then £12,000 (£9,000 x 4/3) needs to be crystallised.

In net terms, £3,000 is tax free and £9,000 taxed at 20% (£7,200) giving a net total of £10,200

This means he now needs a further £29,800 to hit is target. Each £1,000 of UPFLS produces £250 tax free and £750 taxed at 40% giving a net figure of £700.

£29,800/£700 x 1,000 = £42,751.

In total he needs to crystallise £12,000 + £42,751 = £54,751

A similar calculation can be carried out to calculate the net amount that needs to be withdrawn from a FAD with the difference that there is no tax free element since a PCLS would have been taken when the fund was designated a FAD. As in the previous example you must take account of how much of the basic or higher rate band the member has left.

Death benefits

Once a DB pension starts to be paid it can be passed on to spouse and/or dependant as defined by the scheme rules but must end on the death of that person. Similarly the income from a lifetime annuity will be passed on to the named person selected at the outset but it cannot be passed on when they die.

A wider range of options is available if deceased member had:

- An uncrystallised fund (no benefits have been taken)
- A Flexi Access Drawdown fund.

These funds are not normally part of the deceased's estate and cannot be passed on by a will or intestacy.

Who gets to decide?

Most plans will be written under trust so ultimately the scheme administrator can decide who will benefit from these funds. However, the member would normally have made a nomination naming the person or persons who get the right to choose what to do with these funds. This is not binding and the administrator has the power to override the nomination.

If the member wanted absolute certainty that the money would be paid to a specific person, then a binding instruction could be made but HMRC would then treat the funds as part of the deceased's estate.

The member can nominate anyone as there is no minimum age to receive the benefits but HMRC will class them either as:

- A dependant
- A nominee

A dependant is defined as a spouse/civil partner, a child under 23 at the date of the member's death or a child over 23 who is financially dependent on the member. Anyone else will be a nominee

The nominated person has three options:

- Take the fund as a cash payment
- Use the fund to buy a dependant's or nominee's lifetime annuity
- Designate the fund as a dependant's or nominees FAD

These are not either/or options and the fund could be split to take all three if required. If the deceased had nominated two individuals, each could select a different option.

The options in more detail

Cash lump sum

The nominated person takes all or part of the lump sum and can do whatever they like with it. The money is now outside the pension regime.

Lifetime annuity

This would be a **dependant's or nominee's lifetime annuity** and would cease on their death. There can be no other beneficiary and no guarantees. The rate would be calculated on the nominated person's age.

Designate the fund as a FAD

This would be described as a **dependant's/nominee's flexi access drawdown fund**. The nominee or dependant could take as much or as little as they wished from the FAD

The dependant or nominee can also nominate someone to receive any remaining fund on their death. That person is a successor and they will have the same options:

- A lump sum payment
- A successor FAD
- A successor annuity

Again, the lump sum payment will take the money outside the pension regime whereas the FAD means that it is still within it.

If the FAD option is chosen the successor can nominate a further successor who will have the same options.

Note that the member cannot nominate a successor which could raise issues with second marriages.

Alan and Suzanne are married and each have children from previous marriages. Suzanne would ultimately like her children to benefit from the drawdown fund. She dies and nominates Alan to receive the fund who can nominate his children to receive the benefits on his death. To avoid this Suzanne should nominate her children bypassing Alan. Alternatively, she could consider having the remaining fund placed into a trust on her death. This would take the money outside the pension regime

If no nomination was made the administrator has the power to nominate but on the **death of the member** this may be restricted. A dependant of the member can be given all three options but **if there is a living dependant,** non-dependant can only be offered the cash option **i**. This restriction doesn't apply where there are no living dependents.

When Kelly died, she was a widow and had two children Alan aged 26 and Peggy aged 22. She had made no nomination for her remaining fund. As Peggy is a dependant (under 23) the administrator can nominate Peggy to have an income or lump sum but Alan can only receive a lump sum.

However, if Alan and Peggy were over 23 when their mother died neither would be a dependent and could be offered both the income and lump sum options.

This restriction does not apply on the death of a beneficiary or successor.

Taxation of death benefits

All survivor benefits from a money purchase arrangement, whether income or capital are taxed in the same way:

For a death occurring after 5 April 2015 all benefits are tax free provided the deceased was under 75 when death occurred **and** the scheme/provider was notified within two years of death.

If the member was over 75 or under 75 but the scheme or provider wasn't notified within two years of death, then the benefits will be taxable as the recipient's non-savings income.

It is the age of the deceased person that is significant as illustrated in the following examples.

Alistair had designated his pension fund as a FAD and nominated his wife Hazel as his dependant. Alistair died age 74 when Hazel was 78 so whatever Hazel took would be tax free.

Hazel decided to take a dependant's FAD and nominated her son Donald as the successor. Hazel died aged 82 when Donald was 52. All benefits taken by Donald would be taxable.

From a purely tax efficient point of view Donald should designate a successor FAD rather than take a lump sum. Let's say the value of the fund was £100,000 taking this as a lump sum would mean that it would all be taxable in the tax year it was taken. By designating it a FAD Donald can control the amount of income that is taken each year.

Donald designates it as a FAD and takes no withdrawals. He dies aged 64 and his two children are the nominated successors. All benefits taken by them would be tax free

There will be a Benefit Crystallisation Event on the death of the member if they were under 75 and this could result in a Lifetime Allowance charge. Death after 75 is not a BCE. Neither is the death of a beneficiary or successor therefore no Lifetime Allowance charge will be made.

Paying death benefits into a trust

An individual can nominate a trust rather than an individual to receive the death benefits This will take the money out of the pension regime and has a potentially adverse tax effect.

If the deceased was over 75, the transfer will be taxed at 45% rather than at the recipient's personal tax rate. This is because a trust is not a person. If the trustees pay out the whole or part of this immediately to a beneficiary it will be paid with a 45% tax credit which can be reclaimed by the beneficiary.

Mary died aged 78 and she nominated a discretionary trust to receive her FAD fund of £100,000. This would be a subject to a tax charge of £45,000. The trustees decide to pay this to her granddaughter.

She receives £55,000 with a tax credit of £45,000. Assuming she is a higher rate tax payer she has a liability of £40,000 and can offset the tax credit so can claim a £5,000 refund.

If Mary had died under 75 there is no tax charge.

Charitable Lump Sum

There is a final option open to the member and dependant which is to use an uncrystallised fund or a Drawdown fund to make a gift to a charity lump sum. The rules for the member are:

- There must be no dependants of the member
- It is paid to a charity nominated by the member.

Antonia had a husband when she died. She could not make a charitable gift from either an uncrystallised or a drawdown fund.

For a dependant or successor, the rules are broadly the same but there must be no dependants of the original member. There are no age restrictions but benefits can only come from a drawdown fund.

Jeremy and Zoe were married at the time of his death and Zoe designated Jeremy's uncrystallised fund as a dependant's FAD. Jeremy had no children but Zoe had one child under 23 from a previous marriage

On Zoe's death a charitable lump sum can be made because Jeremy had no dependants even though Zoe does have a dependant

Zoe could select a charity of her choice but if Jeremy had made a nomination before he died then Zoe could not override this.

In the absence of any nomination the scheme administrator does not have the power to make a charitable donation.

Risks of taking benefits flexibly

The main differences between a DB pension and taking benefits flexibly can be summarised as follows:

DB pension

- Provides a known pension based on a formula
- Will have some indexation
- Will include a spouse's pension.
- Only decision the member has to take is how much PCLS to take
- No admin work for the member.

BUT

- Poor value if member dies early and has no spouse
- Spouse's pension is taxable
- No access to lump sums outside the PCLS.
- No possibility of passing capital on death apart from any lump sum guarantee
- All benefits ultimately rely on the sponsoring employer being able and willing to fund the scheme.

Flexible Benefits

- Ability to control what is taken from the fund and vary income.
- Any remaining capital on death can be passed on and will be outside the deceased's estate
- Beneficiaries' income could be tax free

BUT

- No guarantee that the fund will last for the individual's lifetime
- A lot of continuing admin and decision taking
- Will incur ongoing charges

That concludes this part so you should now:

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- Understand the death options from an uncrystallised and crystallised fund
- Be able to summarise the key differences between taking benefits from a DB scheme and through flexible benefits