AWFM Fact File

"Pension Options At Retirement"

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The way in which you are able to draw on your pension benefits is in the process of being completely overhauled. What you may have once thought was a simple choice between a fixed income and a variable income has now altered.

Therefore, if you are approaching retirement it is important for you to understand that there are several different options available to you with your pension fund. If you speak with an Independent Financial Adviser about your retirement options, you will soon learn that in fact there are almost too many options to count. The options set out in this sheet primarily cover Money Purchase Pensions (investment based pensions which you and maybe your Employer have been contributing to). These Money Purchase Pensions have a capital value rather than promising a level of income as Defined Benefit (Final Salary or Career Average) pensions do. It should be noted that it is still possible to transfer out of Defined Benefit pension schemes and select one or some of the options listed below, but you must receive advice from a registered Financial Adviser in order to do so (unless the transfer value is less than £30,000).

As from April 2011 it is no longer necessary for anyone to purchase an Annuity. Restrictive rules regarding "Protected Rights" have also been removed. There is therefore a lot more flexibility regarding pension retirement options than there ever used to be. The only outstanding issue is whether the older pension providers will be able to offer all of the latest options. As ever financial advice will be paramount to making the right choices.

Tax-Free Cash

For a Personal Pension Plan, the tax-free cash is usually 25% of the pension fund value at retirement. This will not always be the case, as older pensions (pre 1988) had a different calculation of tax-free cash. If it is a Retirement Annuity (Section 226 policy), which was a pre-1988 Personal Pension, the tax-free cash will be 3 times the maximum Annuity figure. If your plan is an Executive Pension Plan it will be different again as the maximum tax free cash will be linked to your Final Salary and the number of years service you have completed with your Employer. Broadly however, 25% tax free cash is a reasonable figure to assume at first until it is possible to clarify the type of scheme. It should be noted however that sometimes the tax free cash can be significantly less than 25% with older plans.

Should I take the Tax Free Cash?

In general, as the tax-free cash is indeed tax-free and the cash can be used in any way you desire, it is unusual not to take the full tax-free cash sum. If you do not *need* your tax-free cash straightaway however, there is an excellent facility to provide income in the early years of retirement in a very tax efficient manner from your pension. This is known as Phased Retirement and is described in more detail later in this fact file. It is also possible to take the tax free cash from the pension and establish a Purchased Life Annuity with the proceeds, securing a guaranteed income for life with the same options and stipulations as a normal Pension Annuity. The tax treatment is more favourable however, as a portion of the income is treated as returned capital and so is tax free.

Pension Options

With either the whole of your pension fund or the remainder after taking the tax free cash (with the exception of option 1 which isn't available after tax free cash has been taken), you have the following options in retirement:

1. **Uncrystallised Funds Pension Lump Sum**
   This option, newly available from April 2015, essentially allows you take out anything from a small amount up to the maximum value of your pension fund as a lump sum, with 25% being tax free and the remaining 75% taxed at your marginal rate of income tax. This option is currently only available to those with pension pots worth less than £30,000 (with a few other stipulations) and is known as a "Triviality Pension Lump Sum". This new "Uncrystallised Funds Pension Lump Sum" (just rolls off the tongue!) option does away with any of these "Triviality" requirements. The option is therefore available to pension pots of all sizes, subject only to them being currently "Uncrystallised" (no tax free cash taken yet). Care needs to be taken if a large lump sum is being taken as many could find themselves giving up large amounts of the pension income by paying 40% or even 45% income tax.

If this option is selected and if less than the full value of the pension plan is taken, the amount left undrawn is still "Uncrystallised" and would remain invested. Therefore, in terms of risk this option would be similar to "Income Drawdown" (see below) and is in fact a sub-option within Income Drawdown. However, with "Flexi-Access Drawdown" (see next page) offering the same lump sums option but with greater flexibility over how much can be drawn as tax free cash and how much as taxable income, we can see little benefit in this option for people looking to take their pension in more than just one lump sum.

2. In-House Annuity

An "Annuity" involves handing over the capital value of your pension fund to an Annuity provider in return for a guaranteed income for life. Your pension company will almost certainly provide you with some Annuity quotes based on taking the Annuity with themselves. It is very rare for this Annuity to be the most competitive in the market-place. To counteract this, the existing provider is contractually obliged to offer you the Open Market Option transfer value. In some cases pension funds had an Annuity income conversion rate built into the policy at the outset. This is generically known as a Guaranteed Annuity Rate. A Guaranteed Annuity Rate may provide a far better income to capital value ratio than any prevailing Annuity rate. It should therefore be established whether such a guarantee applies to your plan first, before transferring away.

3. Open Market Option (Annuity)

This facility allows you to approach other Annuity providers at retirement to obtain the best Annuity deal currently on the open market. In most cases the open market Annuity will be better than the in-house Annuity as there is more competition in the market.

More on Annuity Purchase issues

With an Annuity, either in-house or on the open market, you are effectively using the whole or the residual fund to provide yourself with an income for the rest of your life. Annuity rates quoted are usually based on a single life pension paid with no increases and no guarantees. The rate given will depend on the individual's age and health unless a Guaranteed Annuity Rate exists. It is important at this stage to note that if you are married and your spouse is in anyway dependent on you financially, that rather than purchasing a single life Annuity, you should ensure that your spouse is protected by way of a joint life Annuity.

In the case of a joint life Annuity the annual payments would be made initially to the person who accrued the pension fund, but on their death would be payable to the spouse for the rest of their life. A Spouse's Pension could be a half of what was paid to the policyholder, two thirds or an exactly the same amount. By building in a Spouse's Pension, the income produced would be lower. If an increasing pension were chosen in order to keep pace with inflation, the initial Annuity rate would be decreased still further.

One of the big downsides with Annuity Purchase is early death of the annuitant and/or their spouse. If death occurs shortly after the Annuity has been set up, the pension fund will be lost to the Annuity Provider.

It is possible to build in a 5 or 10 year guarantee (and for some providers even up to a 30 year guarantee!), ensuring that payments are made to the surviving spouse or Estate of the annuitant for the remainder of the guarantee period. This option can help protect against the risk of losing the capital value of the pension fund on death. Generally the smaller guarantee periods aren't too costly and are therefore usually included.

Another option, which is only offered by some Annuity providers, is "Value Protection". This option ensures the return of a pre-agreed portion of the pension fund on death of the annuitant (e.g. 75% or 50%), less any income payments that have been made. However, this option significantly reduces the income offered by the Annuity and so for many is not a viable or attractive option.

When purchasing an Annuity you must decide on what benefits you want to include. In summary, the main decisions that need to be made are as follows:

- Single life or Joint life? – Joint life would include a Spouse's Pension of anything between 50% to 100%.
- Increasing or Level? – Level produces the maximum income initially but will gradually lose pace with inflation.
- Guarantee or No Guarantee? – You can build a 5 or 10 year guarantee to the Annuity payments (or up to 30 years with some providers).

- Value Protection – included?

It is possible to mix & match these options but the more options you build in, the less the initial income will be. There are other options and benefits you can build into an Annuity. These options are described in more detail in our Fact file "Annuity Purchase Options V 2.1". In the end decision will be based on many aspects of your personal and financial situation, and is where quality advice is absolutely necessary.

4. Income Drawdown

If Annuity Purchase is at the low end of the risk spectrum then Income Drawdown is towards the other end. Income Drawdown has several sub options nowadays, described in more detail in our fact file "Revised Income Drawdown – January 2015". However, in summary this option allows you to take your tax free cash but rather than purchase an Annuity, to draw an income from your pension fund whilst keeping it invested. The main sub options of Income Drawdown from are as follows:

Capped Drawdown – this is Income Drawdown but with a cap as to how much income can be drawn each year. The cap is dependent on the amount of tax free cash that has or is being drawn, the yield on the FTSE 15 Year Gilt Index and the Government Actuaries Department (GAD) rates at the time.

Flexi-Access Drawdown – this is the government's new idea, available from April 2015. This option essentially allows you draw as much as you like from the pension fund whenever you like providing the holder is aged 55 or over (set to increase to age 57 in the future). The money can be drawn as taxable income or tax free cash (up to 25% of the fund value) subject to taking some tax free cash to establish a "crystallised" pot to draw the income from. If the fund were drawn in one go then a large income tax bill would be applied. Clearly this option is for those with enough discipline not to use up the pot too soon! This option is available currently to those with a guaranteed income in retirement of over £12,000. This is currently known as "Flexible Drawdown". Flexi-Access Drawdown will not have the £12,000 guaranteed income requirement.

Capped Drawdown with Phased Retirement - This option is most appropriate for people who have gathered savings together over their lifetime, so that when they retire do not actually need a tax free cash lump sum, but do need a pension income. With this option, instead of taking your tax free lump sum in one go, you take it gradually over the first few years of retirement. Every payment made to you would be part tax free cash and part taxable pension income. In this way you can provide yourself an income in the first few years whilst paying very little tax. By leaving as much tax free cash in your fund for as long as possible, you give it the opportunity to grow the tax free cash without impacting on your initial pension income levels.

Flexi-Access Drawdown with Phased Retirement – this option is identical to that described above but with the difference being you can choose how much of the "income" payment you want to be tax free cash and how much you want to be taxable income. This is similar to the Uncrystallised Funds Pension Lump Sum option but with Flexi-Access Drawdown you have more choice as to how much of your income is tax free cash and how much is taxable income, subject of course to the 25% tax free cash limit.

One of the main advantages of Income Drawdown is that the fund in its entirety can then be passed onto a surviving spouse to either purchase an Annuity or continue with Income Drawdown, or even be passed onto non-dependent children.

From April 2015 a pension fund can now actually pass to whoever the pension fund holder nominates, whether dependent or not. However, preference will always be given to a surviving spouse and in most cases the pension trustees (the pension scheme administrator) would offer the full benefits to a surviving spouse as a first port of call. The taxation of these death benefits has changed from April 2015. Under the new rules, if death of the pension member occurs before age 75, and the administration of the death benefits are dealt with within 2 years of death, any payments from either the pension fund or an Annuity established with the pension fund will be tax free. If the pension member dies after the age of 75 (or if the administration of the death benefits exceeds the 2 years from death) then any payments made from the pension fund, or an Annuity established with the fund, will be subject to the beneficiaries' marginal rates of tax. For institutions, including Trusts, this will be 45%. In some circumstances where the pension fund provider does not offer Flexi-Access Drawdown for the beneficiary, then the lump sum option would be subject to 45% also. This is changing from April 2016 to align the taxation of the death benefits with the marginal rate of tax regime described above.

The downside to the Income Drawdown option is that as the fund remains invested, it is also susceptible to market downturns and the risk that the investment returns won't meet the withdrawals being taken, potentially causing the fund to run out. With Annuity purchase the Annuity provider takes on board this investment risk for the annuitant and guarantees an income for life.

5. **Phased Retirement With Annuity Purchase**
   It should be noted that it is possible to use Phased Retirement with Annuity Purchase. This basically involves taking tax free cash in stages and at each stage purchasing an Annuity with three times the amount of tax free cash taken. The benefits of this option are most felt if Annuity rates increase or if you continue working and purchasing an Annuity with the whole fund takes you into higher rate tax. However, the downside is that the cost of advice can erode the potential benefits as for most IFAs, charges would be levied each time an Annuity is purchased, rather than just a one-off cost.

6. **Hybrid Options**
   As shown so far, the two main options with Money Purchase pension funds at retirement are Annuity Purchase or Income Drawdown, however, there are some hybrids of these two options. These can involve purchasing an Annuity with some of the funds and running Income Drawdown or something similar with the remaining funds. It could also involve purchasing short term Annuities, say every five years, a bit like renewing your fixed term mortgage. You would only want to undertake this option if you felt confident that Annuity rates are going to increase, as otherwise the advice costs of this option are unlikely to outweigh the benefits. The most common hybrid option however is a With Profits or Investment Annuity.

7. **With Profits or Investment Annuity**
   With Profits or Investment Annuities were introduced to try to give some exposure to investment markets in the hope of achieving an increasing income, whilst balancing this with the desire of the Annuity purchaser to have a low risk income. With this type of Annuity you have to select at outset an annual bonus rate that you expect the Annuity Provider to produce. This will be anything between 0% and 5%. If you select the 5%, you will receive the highest initial Annuity payment. If you select 0%, and the following year the Annuity Provider declare a 3% bonus rate for example, your Annuity will increase in value. If for example you selected a 5% annual bonus rate and the Annuity Provider only achieved 4%, your Annuity would reduce. This option can only really be assessed with some quotations. It should also be noted that this option usually comes with a minimum Annuity level, meaning that if investment returns are poor, your Annuity income will never drop below a pre-agreed level. This hybrid option can also include all of the Annuity benefits and options described above and also suffers the same fate of an effectively lost pension fund on early death of the annuitant or the Annuitant's spouse.

Summary

We hope that this document is useful in summarising the many options available to Money Purchase pension fund holders at retirement. With a variety of options available to individuals at retirement, and some of these being complicated with various tax implications to take into account too, we believe it is vital that those looking to draw on their pension funds seek Independent Financial Advice. It cannot be taken as a given that your current pension provider will offer either the best Annuity rate for you or even the new flexible pension benefits the current government is bringing in from April 2015. At the very least you should ensure that you are getting the best Annuity, at best, it may be that another retirement product is more appropriate to your situation.

If you have any questions or need an independent review of your pension arrangements,
please contact us to discuss your situation further.
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If you wish to have an assessment of your own situation, you should contact the office for advice.

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