A GUIDE TO PENSION WITHDRAWAL

TAKING BENEFITS UNDER NEW PENSION FREEDOM RULES

YOUR PERSONAL CFO
NAVIGATOR FINANCIAL PLANNING

OPTIONS AND CONSIDERATIONS FOR ACCESSING PENSION BENEFITS

The aim of this guide is to provide a basic overview of the options available for withdrawing benefits from pension funds. The decisions regarding retirement benefits can be complex, particularly where larger amounts are involved, and it is important to seek appropriate advice where required. This guide is further to our **'Guide to Pension Funding'**, which deals with pre-retirement pension accumulation. As per that guide it is 'Defined Contributions' schemes, such as personal pensions, to which the majority of this guide will be devoted.

Naturally (but not necessarily) the move from pension accumulation to pension withdrawal occurs around retirement. But once amounts have been accumulated in pension schemes, how are amounts withdrawn and used to fund retirement?

There are two main methods of withdrawing funds from a pension; Drawdown and Annuities. An Annuity is the traditional method of withdrawal associated with pensions: the pension pot is used to purchase an income stream from an insurance company. Annuities have received a lot of negative coverage over recent times due to a perceived lack of value and transparency (although the former has far more to do with monetary policy than anything else). Contrary to media coverage it has been possible to draw funds directly from a pension for a number of years now and either option can be appropriate based on an individual's circumstances.

The method of pension withdrawal used needs to be viewed in the context of a wider Financial Plan, of which it is one component. It is not a subject that can be discussed in isolation and needs to be integrated with investment, tax and estate planning.

Taking Pension Benefits

Under current legislation it is not possible to draw funds from a pension until age 55, except in some rare circumstances. At present 25% of a pension fund can be taken as a Pension Commencement Lump Sum (PCLS), which is tax free. Any withdrawals from the remaining 75% of the fund will be taxable. Due to this, the PCLS is virtually always taken.

The total 25% lump sum entitlement does not need to be taken at once. Benefits can be taken from pensions as and when they are required. For every £1 of PCLS taken another £3 are deemed to have been 'crystallised' and have no further tax free cash entitlement.

This guide is based on legislation for the 2015/16 tax year, as of the 6th April 2015. Levels, bases of, and relief from, taxation are subject to change. Such changes could be retrospective. The tax treatment described is based on current legislation, practice and interpretation

Pension Drawdown

With pension drawdown benefits are simply drawn directly from pension funds. The amounts can remain invested and lump sum and income payments can be withdrawn, as with other investments (although tax considerations need to be taken into account).

As of the 6th April a new type of pension drawdown was introduced, called '**Flexi-Access Drawdown'**. Any new pension drawdown scheme will be Flexi-Access. Under this new scheme there are no limits on how much can be withdrawn from a pension and when (provided the member is over 55). This has given every pension owner the ability to draw their full pension as cash whenever they want – leading the media to discuss vast quantities of Lamborghini sales.

Prior to this tax year there had been two main types of drawdown in operation. There was 'Flexible Drawdown' which permitted anybody with a minimum secure pension income (£12,000 p.a., previously £20,000 p.a.) to access sums as they wished. All old 'Flexible Drawdown' schemes have been converted to 'Flexi-Access' as of the 6th April 2015.

The second type is called **'Capped Drawdown'**. No new Capped Drawdown scheme can be opened but existing ones can continue as they are or convert to new Flexi-Access Drawdown. Capped Drawdown schemes are different as they limited how much income could be drawn in a tax year. This limit is called the Government Actuary Department (GAD) limit - broadly similar to the income available from a single life annuity. Over the last few years the maximum income from Capped Drawdown has increased from 100% to 150% of this limit.

> *For those already in Capped Drawdown, there is one potential benefit of remaining with it. When an individual uses Flexi-Access Drawdown the amount of tax relieved pension contributions an individual can make in a tax year is limited by the 'Money Purchase Annual Allowance' (MPAA) - set at £10,000. For those who remain in Capped Drawdown the standard Annual Allowance of £40,000 will continue to apply. This provides greater scope to accrue further pension benefits if required. This won't affect the majority of people, however there are scenarios where this could apply.*

There are important tax considerations to keep in mind with pension drawdown. Drawing large sums in one year could cause a higher marginal rate of tax to be suffered on the income, compared to gradually taking the amount over time. This could either be through falling into a higher rate of tax (higher compared to basic, or additional compared to higher) or through the loss of the personal allowance when income exceeds £100,000.

The main disadvantage of pension drawdown is that retirement funds remain exposed to investment risk. Fund values can fall, whereby current and future incomes will correspondingly fall. It is possible investment returns will help sustain a higher income, however they are subject to risk like investments. Pension drawdown also generally entails higher charges, for the administration, investment management (fund costs) and ongoing advice. These charges often mean it is not worth investing in low risk/return portfolios as returns could be largely consumed by charges. Pension drawdown is generally more appropriate for those who are willing and able to take some risk with their pension investments and income.

The removal of withdrawal limits also poses a financial planning risk to those depending on their pension income to fund their retirement. With an annuity a secure lifetime income is usually provided for life and can only be reduced by the effects of inflation. With income drawdown schemes there is no provision of a lifetime income and taking too much income in the early years could have drastic consequences later in life. As such the importance of careful financial planning will be increased where income drawdown is used as the primary source of retirement income.

Uncrystallised Funds Pension Lump Sums (UFPLS)

This is a new form of pension withdrawal introduced on 6th April 2015. It is for all purposes a form of pension drawdown, which allows those over the age of 55 to freely access sums within their pensions. It was introduced so existing pension schemes could offer a withdrawal option within their existing structure – allowing individuals to draw amounts from pensions without having to transfer to a new Flexi-Access Drawdown pension.

With UFPLS 25% of any withdrawal is tax free and the remaining 75% is taxable. For example someone with a £100,000 pension could withdraw £20,000. Of this £5,000 wold be tax free and £15,000 would be taxable income. In many cases flexi-access drawdown may be more useful as 25% of the whole pension (as opposed to the amount withdrawn) can be taken as a tax free lump sum (PCLS) - in our example £25,000 PCLS is available, so the £20,000 could be taken tax free.

Death Benefits

There has been a major change to the death benefits available from pensions over the last year. The impact of these changes has been to provide greater flexibility in how benefits can be passed onto future generations and the removal of a tax charge on doing so.

Under current rules, prior to age 75, a pension can be left as a 100% tax free lump sum. Pension benefits can left to whoever the member nominates – usually a spouse, children or a trust. This is will apply to pensions in accrual (such as personal pensions) or pensions from which benefits have been taken (i.e. Flexi-Access or Capped Drawdown). This is a significant benefit of pensions – contributions can be made into a pension without any tax incurred and paid out to beneficiaries in the event of death without incurring any tax.

Post age 75 pensions can still be nominated to beneficiaries, however benefits cannot be taken tax free. Instead the nominated beneficiaries will be able to take over the pension (or their nominated proportion of it) and continue it in their name. They are able to withdraw amounts subject to their own marginal rate of income tax.

Crucially pensions do not form part of an individual’s taxable estate for Inheritance Tax (IHT) purposes. Consequently these new rule changes have opened up the possibility of using pensions within estate planning – allowing funds to tax efficiently pass down through generations.

Annuities

With an annuity a pension fund is used to purchase an income stream. All access to pension capital is lost and there is little future flexibility, but a secure income is gained. Annuities provide a certainty of what future pension income will be and removes any risk of it falling or of funds running out.

Annuities can either be level, where income will remain constant throughout life, or indexed to increase over time. A level annuity will lose its value in real terms as it is eroded by inflation, whereas an indexed annuity can either part or fully protect the purchasing power of the income (although initial income will be lower to reflect this).

The main benefit of an annuity, aside from the security, is mortality pooling. An insurance company will have many annuitants who pay for a lifetime income stream, however long that is. Those who die earlier will still have paid the same amount, but for a shorter income period. The excess is retained by the insurance company in the pool of funds that pays all their annuities. This effectively spreads risks and allows an insurance company to pay a higher income to individuals than it would do in isolation. This doesn't happen with income drawdown plans where there is a risk of exhausting funds if you live longer than expected. With an annuity the effects of the 'mortality cross subsidy' insures against this risk, the effect of which gets greater with age.

The benefit of mortality pooling will be reduced as the amount of annuitants reduces, as more people take advantage of new pension freedoms. Mortality pooling is also being reduced by increasing segregation within the annuity market (see enhanced and flexible annuities below).

The flip-side of mortality pooling is that death benefits are more restricted than with pension drawdown. Annuitants can select a spouse's pension as a proportion of their own (at 50%, 66% or 100%) and a guaranteed period of up to ten years, whereby their estate is guaranteed to receive the income for that period irrespective of longevity. The higher the death benefits selected, the lower the initial income.

More recently annuities have been launched with value protection. This guarantees the estate will receive the sum used to purchase the annuity, minus the income payments received during the annuitant's lifetime. This provides protection in that the family does not risk losing the majority of the pension pot once an annuity is purchased. However value protection will greatly reduce the benefit of mortality pooling – as sums will not remain in the annuity pool. It is a trade-off between the two.

Enhancement

Individuals in poor health or who smoke are able to apply for 'enhanced annuities'. These are annuities with higher incomes, based on an individual's medical circumstances and life expectancy. In terms of income, enhanced annuities can be attractive to those in poor health as they will provide a higher income which is guaranteed for life. However it is worth carefully considering the death benefits required and the trade-off against the annuity income.

Flexible Annuities

Flexible annuities aim to combine some of the features of conventional annuities (security and mortality cross-subsidy) with some of the flexibility and investment options of pension drawdown. There are two main types of flexible annuity;

Temporary annuities

The purpose of a temporary annuity is to allow access to a pension income without committing to a lifetime annuity, or accepting investment risk. Temporary annuities typically last for 5 – 10 years and provide a fixed income with a fixed (or investment linked) end value. They are typically used by those who wish to delay purchasing a lifetime annuity, potentially because they expect annuity rates to rise in the future.

The short term and low risk nature of the products usually means investment returns are low. Unless annuity rates rise, using a temporary annuity will likely result in a lower total income than a conventional annuity alone. Furthermore annuity rates rising is far from certain. Markets price in all publically known information - annuity rates will only rise if interest/inflation rates rise more than markets expect.

Investment Linked Annuities

Investment linked annuities are designed to pay a lifetime income which is tied to the value of specific investments. Funds are not directly drawn from funds, but the annuity income will fluctuate in line with underlying investments. They provide an income between a minimum and a maximum level, which is based on the conventional annuity the provider would offer - typically 50% and 120% of this amount. The remaining fund is invested, giving a trade-off between initial and future income.

Specific growth rates are required on investments to maintain levels of income. If returns are less than those required income falls and if returns are higher than income rises. Unlike pension drawdown income can never be completely depleted, as there is a guaranteed minimum income. This guaranteed rate is typically quite low, so there is still the risk of a heavily curtailed income. Other aspects are more similar to conventional annuities. The death benefits are the same and mortality cross-subsidy exists within the pool of investment linked annuitants.

Lifetime Allowance (LTA)

There is a limit on the total amount of tax advantaged pension benefits that can be accrued, called the Lifetime Allowance (LTA). Benefits accrued in excess of this will suffer a penal tax charge. For the 2015/16 tax year the LTA is £1.25m. This is scheduled to fall to £1m in 2016/17 before increasing with inflation from April 2019.

Pension sums are measured against this limit when benefits are taken 'crystallised'. When benefits are taken they consume a proportional amount of the allowance e.g. £625,000 of pension benefits taken in 2015/16 will use 50% of the allowance. The remaining 50% would be left available for other pension benefits[1].

LTA is also consumed by any increase in pension funds between taking benefits and reaching age 75, or on purchasing an annuity if sooner). This is the case where any investment growth is enjoyed on pension drawdown schemes. For example if someone took their cash lump sum at age 65, leaving

[1] Salary related schemes also consume Lifetime Allowance; every £1 of annual pension uses £20 of allowance (£25 where the pension was in payment before 6th April 2006), with lump sums consuming allowance on a 1:1 basis (pre 6th April 2006 lump sums are not counted. For example a post April 2006 £20,000 p.a. final salary pension with a £60,000 lump sum would use £460,000 of Lifetime Allowance (20x£20,000 plus £60,000).

£500,000 in drawdown which grew to £650,000 by age 75, this increase would consume a further £150,000 of allowance.

For all benefits in excess of the Lifetime Allowance, a tax charge is levied. There is a choice of taking the excess benefits as a lump sum or an income. If a lump sum is taken, a 55% charge is applied. If the excess is taken as income, a 25% tax charge applies before income tax is levied in the usual way[2]. Various protection regimes may have been claimed by those who accumulated larger sums under old rules.

Protection

The Lifetime Allowance was introduced in 2006 and has twice been reduced in recent years. Each change in legislation has resulted in the introduction of protection schemes to protect those who accrued benefits under the old rules and would be made worse off. As such there are several types of pension protection an individual with large pension benefits could have claimed (and often more than one).

The subject of the Lifetime Allowance, and particularly the forms of protection are very complex. We are unable to cover the details and nuances of this subject within this guide. **We would always advise individuals with large pension benefits to seek professional advice before acting to help ensure the most appropriate courses of action are taken.**

Retirement Choices

Retirement planning should be considered within an individual's wider financial planning circumstances. A pension should be viewed alongside all other assets in deciding how to fund retirement. The decision over how and when funds are withdrawn from pensions should also factor in tax and estate planning considerations where applicable.

Generally where a pension will be the sole or main source of income throughout retirement an annuity will be more appropriate – providing financial security through a guaranteed income. Where there are other substantial assets or multiple sources of income, pension drawdown will become more attractive. Similarly where death benefits and estate planning are of greater importance pension drawdown will be more likely to be used.

The decision is not simple, particularly where larger pension funds are concerned or financial circumstances are more complex – there's only so much that can be cover in a guide. It is often worth obtaining specialist financial planning to help pull together these different and potentially conflicting factors into a retirement strategy. Furthermore a good financial planner will be able to combine your retirement strategy into a coherent financial plan to maximise the use of all your resources and help you achieve your financial goals.

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[2] *For a higher rate tax payer the total effective rate of tax on the lump sum and income options will be the same. An additional rate payer will pay less tax through the lump sum option. A basic rate payer will pay less tax through the income option.*

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