

## RETIREMENT OPTIONS/BENEFITS

There has been much recent press about changes to pensions legislation and the way pension benefits can be used and drawn in the future. The Budget of 2014 was obviously significant in the way that retirement options can be drawn. This document has been updated to take into account the significant changes noted.

***The way you draw your pension benefits has become highly topical in recent times to ensure that you get real value from your pension benefits. This is why it is important that you consider the notes in this document carefully.***

These significant pension benefit changes came into force from 06 April 2015.

It should be clearly noted that the principle that a pension should provide you with income for the rest of your life does not change. Therefore, although these new changes are welcomed, the financial planning approach to any new changes should be balanced to take this longevity into account.

With this in mind, the 'headlines' that should be considered by each client before they make any important decisions are as follows:

- *Normally 25% of any unvested pension fund can be drawn as tax free cash.*
- *No restriction on income levels that you can draw from your plan.*
- *Income can be phased to meet your needs.*
- *Any income taken is still subject to income tax. You should be mindful of higher rate income tax charges if you take significant sums from your plan.*
- *Under the new legislation, there is now no tax charge on your pension fund on your death before the age of 75.*
- *Benefits available to estates for those over 75 will be taxed at the recipient's highest marginal income tax rate, whether taken as a lump sum or as a regular income.*

Under current rules, pension benefits can (normally) be taken at any time after the minimum age of 55. This is intended to increase to a minimum age of 57 from 2028 and subsequently to be held at a level of 10 years below State Pension age. In addition, you will no longer have to purchase an annuity following the legislation completed by the coalition Government in April 2011.

You will be able to draw your pension and carry on working. This allows individuals to take their benefits whilst continuing to work, for example part time, as they move more gradually to retirement. You may want to consider any effects on your income tax if this is the case as the combination of earned income and pension income may increase your overall tax liability.

There is no limit on the pension income in retirement that can be taken, although if you exceed specified levels as described later, there will be additional tax charges. The pension benefits that you will receive from your personal pension depend on the fund values finally available.

Under current legislation, the income provided by your pension fund in retirement is liable to taxation as earned income.

From an administration perspective, we are aware that some providers were not ready, willing or able to introduce this flexibility to their plans. This may mean that, if appropriate, changes to provider may be required if you do want to use the full flexibility available.



**Guildford (Registered Office):** Hadleigh House, 232 High Street, Guildford GU1 3JF  
Tel: 01483 578800 Fax: 01483 578864 email: [info@chaptersfinancial.com](mailto:info@chaptersfinancial.com)

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## YOUR RETIREMENT BENEFIT OPTIONS FROM APRIL 2016

You can choose the type of income/benefit you take. This could be:

- To draw tax free cash and take the balance of the fund as cash (or a proportion), subject to your highest marginal income tax rate.
- To draw the tax-free cash and leave the remaining fund unchanged.
- To purchase an annuity.
- To phase your retirement by purchasing annuities/taking income on a year by year basis with segments of the overall fund while leaving the remaining fund invested.
- To take income from the invested fund on a year by year or ad hoc basis ('Flexible Drawdown').
- Combination of the above.

I have provided some thoughts on these options below.

### ANNUITY PURCHASE

Historically, the most common way to take retirement benefits under pension plans was to take the maximum tax-free cash sum available and use the balance of your fund to buy an annuity. An annuity is a level or increasing income for the rest of your life and is taxed in the same way as salary.

An annuity gives you payments at stated intervals until your death. You give your pension fund either to the insurance company that you have built up your funds with or to another on the open market to purchase as large an income as possible for the rest of your life (Sometimes called the Open Market Option/ OMO). There are a number of types of annuity, which include Guaranteed, Unit Linked, With Profits, Value-protected and Impaired Life Annuities.

#### *Guarantees & Dependants' Pensions*

The cheapest annuity you can buy, i.e. one that will give you the highest starting income in return for your pension fund, is one that pays a level income for the rest of your life. However, when you die, no further income is payable even if you die after receiving only a few income payments.

At a cost, you can add extra benefits to your annuity at the outset, and these can include a guaranteed period of say five years, which will ensure income payments continue for the fixed period after you buy the annuity, even if you die before then. You are also able to purchase an escalating annuity which will mean that your income increases in payment and may help keep pace with price increases and the effects of inflation.

Where married or in a partnership (or with a financial dependant), you may decide to build into the annuity a spouse's pension that will continue to be paid in the event of your death. Typically, the pension will reduce by one half or one third in this event.

Guaranteed Annuities simply purchase an income based on the annuitant's age, normal life expectancy and the level of Gilt yields (on which annuity rates are based). These guaranteed annuities can be improved upon for 'impaired lives', which are subject to medical evidence, because of reduced life expectancy, and this is an area where there could be an improvement in the basic annuity rate available at the time.

## *Investment Linked Annuities*

Investment linked Annuities invest in unit linked equity-type funds or With Profits funds and the levels of income received are linked to how well the investments perform and with good investment conditions can produce an increasing level of income. If required, advice should be sought on these types of plan because of the investment risk involved.

### *Advantages of an Annuity*

- You have immediate access to all of your tax-free cash.
- You can choose between a level or increasing income for life with the rest of your fund.
- The income is guaranteed to be payable for at least the rest of your life (this does not apply to Investment Linked Annuities).
- Your pension income can be guaranteed for a certain period so that payments will continue for a fixed period after your death.
- Depending on how long you live you may get back more than you used to buy the annuity in the first place.
- They are relatively simple plans and usually do not involve on-going planning.

### *Disadvantages of an Annuity*

- Annuity rates may not be favourable when you buy your annuity.
- The levels of income and annuity features selected are fixed at the outset and cannot be changed even though your future income requirements, personal circumstances or health may change.
- It is possible that you may not get back the amount of money you used to buy the annuity if you die early.
- Options selected at outset, which come at a cost, may not be used in practice e.g. if you choose a spouse's pension option and your spouse predeceases you then the cost of this benefit has been lost.

## **PENSION INCOME DRAWDOWN FACILITY**

By using this type of facility, you can initially take the tax-free cash (again usually 25% of the fund) and the residual fund would be used to provide a taxable income, if you choose.

Income drawdown is suitable for some clients who already have income or capital from other sources and do not need to maximise the income from their pension funds.

Historically, when you started an income drawdown contract, the maximum level of income was calculated. This was based on 15-year gilt yields and used a formula given by the Government Actuaries Department (or GAD rate as it is known). Most also provided a 'critical yield' calculation (the amount of return required to compete with an annuity purchase). These calculations are still valuable in demonstrating the growth needed to show how long value may be provided.

From April 2015, this annual withdrawal limit has been removed for defined contribution (money purchase) pension schemes. There is now no limit on the amount of income you can draw. The new legislation allows defined benefit (final salary) schemes to give this increased flexibility to individuals. However, this is not binding on defined benefit schemes and therefore an individual may have to transfer to a new personal arrangement to take advantage of the new, more flexible, rules. The real value of a defined benefit scheme is usually greater than that of a personal arrangement and this is a complex area in which professional financial advice must be sought.

Usually, I would not recommend that the maximum income is taken, as one of the risks associated with income drawdown is that if the underlying fund does not perform well and the plan charges are high, the future income could be lower than if an annuity were purchased now. If no income or minimum income is taken, there is a far greater opportunity for the fund to grow and, if you opt for an annuity in the future, it is likely that it will be higher, however, you would have to bear in mind that you would not have enjoyed higher income in the previous years.

- For those remaining in capped drawdown plans (i.e. income drawdown plans established before 06 April 2015 which have not been converted to flexible drawdown) the maximum and minimum income levels are currently recalculated every three years (annually for those aged over 75 and every five years for plans set up before 6 April 2011 until their first review date after 6 April 2011, when they will move to three year reviews). Income can be varied within this period as long as the maximum and minimum figures are not exceeded.
- Any income provided will be taxed at your highest marginal income tax rate.

There are therefore risks involved in income drawdown.

- The fund may not grow as hoped and this could lead to an eventual shortfall in income in later years.
- Annuity rates may fall further in the future and if an annuity is eventually purchased it could be lower than if one were purchased now.
- If maximum income is required, this route may well not be the most appropriate as the growth needed to maintain this income level could prove difficult to achieve. Normally to allow for realistic growth rates, you should be considering income in the region of 4-5.0% pa of the fund.
- A potential benefit of purchasing an annuity versus using income drawdown is the cross-subsidy from those annuitants dying early to those that live longer. Mortality drag is the extra return that needs to be earned on investments within the drawdown contract to provide the same level of income as an annuity, as a result of this lack of cross subsidy.

### *Death Benefits*

One of the main attractions that income drawdown may have is the superior death benefits.

If you buy an annuity, then it is simply on your life/ joint lives and there would usually be no return at all to your estate on your death beyond the guaranteed period that might be written into the contract. With Income Drawdown, the residual fund is available.

If you die before the age of 75 whilst taking Income Drawdown, or if the fund is uncrystallised (all still invested), your dependants will be able to receive the value of the remaining fund tax free.

The person receiving the pension will pay no tax on the money they withdraw from that pension, whether it is taken as a single lump sum or accessed through Income Drawdown. If you die over the age of 75 whilst taking Income Drawdown, or with uncrystallised pension funds, the beneficiary will be able to access the pension funds flexibly, at any age, and pay tax at their marginal rate of income tax.

Pension drawdown therefore gives you and your dependants far more flexibility in making use of the pension funds. However, this is given at a price and the price is that you lose the guarantee that is provided by a conventional annuity.

If you chose this option, I would recommend that in the event of your death your fund should be nominated to financial dependants. This nomination can be updated if needed in the future.

## ***Inheritance Tax***

By concession, HMRC would not normally impose inheritance tax on any death.

### **HMRC / OCCURRENCE OF DEATH WITHIN 2 YEARS OF DRAWING PENSION BENEFITS/ POSSIBLE ADDITIONAL TAX CHARGES**

We are aware that HMRC currently maintain a policy of investigating any pension transfers/withdrawals that occur within 2 years prior to death. HMRC will seek to ensure that the implemented transaction was not arranged to avoid any tax on the pension benefits affected. If, in their view, the transaction was to avoid tax, they may seek to apply an inheritance tax charge to the benefits drawn at a level of a further 40%.

You should be aware of this current position before proceeding.

## **OTHER ISSUES**

### **LIFETIME ALLOWANCE**

There is a "Lifetime Allowance" (LTA) for the maximum amount of all your tax favoured pension savings. The pension Lifetime Allowance (LTA) is currently £1.055M (tax year 2019/2020). This limit has already dropped from £1.80M (tax year 2011/2012) and £1.5M (tax year 2013/14) and fell further to £1.25M in the tax year 2015/2016 and £1M in 2016/2017. These changes could affect those in Personal Pension and Occupational type schemes, including (as examples):

- Those in active or deferred Defined Benefit (Final Salary) schemes
- Those currently in Income Drawdown arrangements

Testing of the Lifetime Allowance will be carried out when you take your benefits. How benefits are secured will have an impact on how they are valued.

If benefits over the Lifetime Allowance are taken, a "Lifetime Allowance charge" will apply; i.e. you will have to pay tax on any excess over the £1.055M allowance. Any amount above the Lifetime Allowance can be paid as a pension benefit or lump sum cash benefit but will be subject to a tax charge, currently 25% if taken as pension income (plus the benefit will be charged at the individual's marginal rate of income tax) or 55% if taken as a lump sum.

If you are affected by these issues, you may want to seek individual financial advice on the benefits of HMRC's Individual Protection or Fixed Protection.

### **SUMMARY**

You can see from the above that planning to draw the benefits from your retirement plans can be a complicated subject. Therefore, this text should not be treated as individual advice. Individual advice is only available based on your personal circumstances.

The text above is based on our current understanding of legislation which can change. Please check that the rules detailed above are correct before making any financial decisions and seek individual advice in your circumstances. No individual advice is provided in this document.

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