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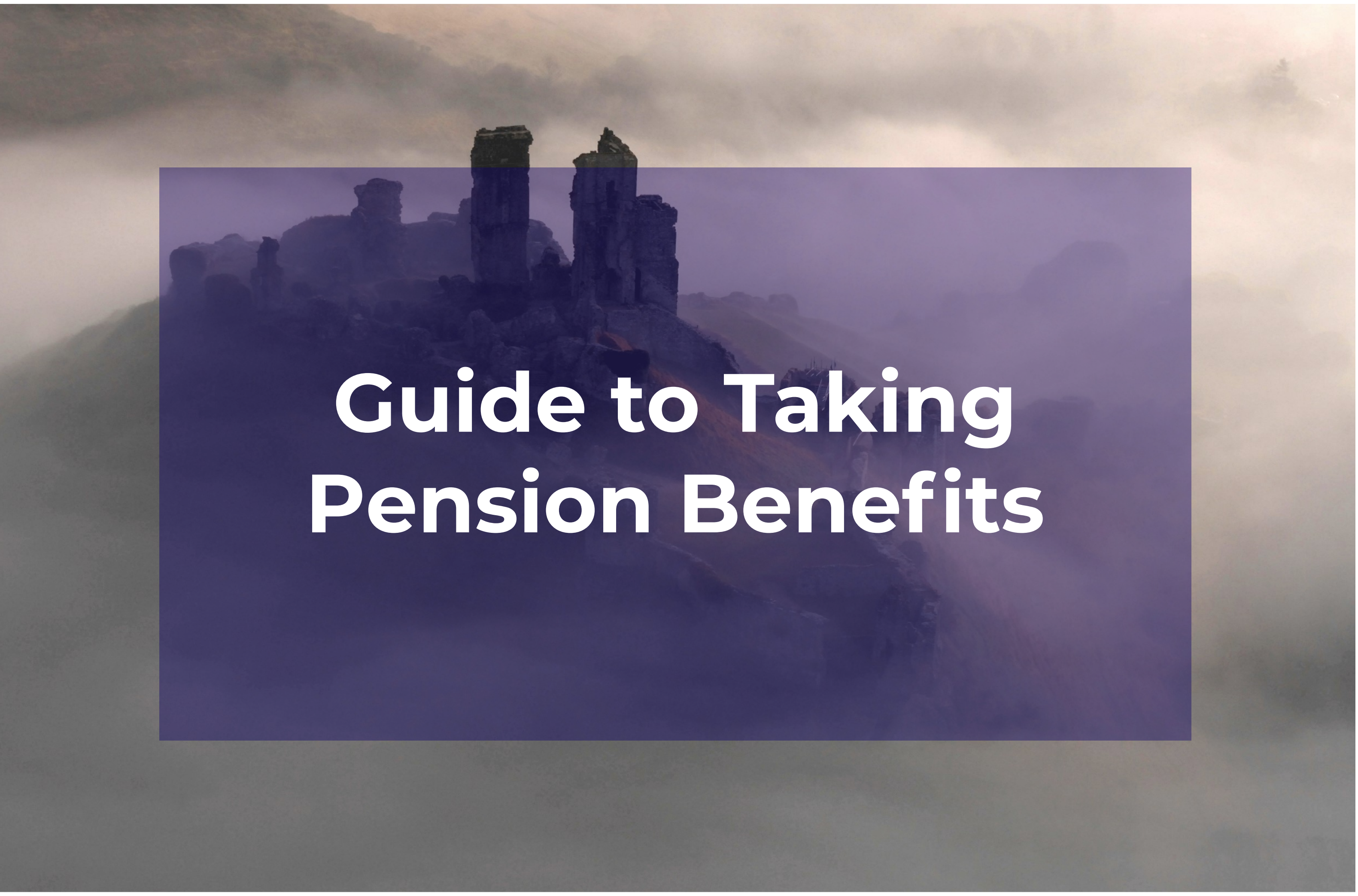
Investments • Pensions • Financial Planning



Guide to Taking Pension Benefits

Purpose of this guide

This guide gives an overview of the main options available for using an invested pension fund to provide retirement benefits.

The scope of this guide

It is important to stress that the Government has regularly changed the regulations applying to pension funds and might well do so again, so relying on current rules does, inevitably, involve some risk.

We refer here only to an invested pension fund sometimes knows as a “money purchase” or “defined contribution” plan. This guide is not relevant to a defined benefit (or salary based) pension, where the options are structured differently.

However, defined benefit pensions can sometimes be converted to a defined contribution plan by taking a transfer value and this guide could, therefore, still be of interest to those holding a salary-based pension arrangement and wanting to explore all alternatives available.

When can pension benefits be taken?

Pension benefits can normally be taken at any time after age 55, although some professions allow benefits to be taken earlier. The minimum age is increasing to 57 from 6th April 2028 and may change again in the future.

Once the minimum age is reached benefits can be taken at any time, whether or not you are retired.

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Can I delay taking benefits?

Yes. Even though schemes are usually set up with a planned retirement date, you do not have to take any benefits at that point, or at any point until you wish to.

It is usually best to delay taking pension benefits until you retire, or at least until your earned income no longer meets your needs. Additionally, it may be sensible to delay beyond your retirement, if the income isn't needed, as this could prove beneficial for your Inheritance Tax (IHT) planning if your estate is over the threshold for IHT.

It can also be beneficial in terms of tax planning if you are unfortunate enough to pass away before age 75, as that would normally make the pension fund or the income it can produce tax free to your beneficiaries.

The options available when you do take benefits

You have the option to take some of your pension fund as a tax-free lump sum, normally limited to 25% of the fund value. With any fund not taken as a tax-free lump sum at outset you have the following core choices, or a combination of them:

- Withdraw as a taxable lump sum
- Buy a lifetime annuity (guaranteed income)
- Keep the money invested and take income from the fund as needed

There are also other less conventional options, such as a fixed term annuity or a flexible annuity.

We look at each of these individually on the following pages.

Tax-Free Lump Sum Entitlement

This is referred to as a 'Pension Commencement Lump Sum' and is normally set at 25% of the fund value, subject to a maximum, which was originally created by the Lifetime Allowance (LTA) and now subject to the Lump Sum Allowance (LSA), which we look at later.

Some older plans can offer a higher figure than 25%, so it is important to check with the pension provider what tax-free lump entitlement is available.

In most cases it makes sense in terms of tax planning to take full advantage of the tax-free entitlement, either through lump sum withdrawal or, if you are keeping the fund invested rather than buying an annuity, through a structure where generally 25% of each income payment is tax free. We explain this below.

However, there can be reasons not to take the tax-free cash sum, such as where you have a plan with guaranteed annuity rates high enough so that, even after tax, the benefit could be more attractive than available if investing a lump sum after withdrawing it from the pension.

In addition, as a pension fund is exempt from Inheritance Tax, there can be a long-term Estate Planning advantage in leaving money in a pension fund rather than withdrawing it and moving it to your taxable estate.

Withdrawing as a taxable lump sum

If someone wishes, they are entitled to withdraw their full pension and do with the money as they wish.

If taking more than the 25% tax free entitlement or if applicable the Lump Sum Allowance of £268,275 has been exceeded, income tax will be deducted at source. Depending on the amount involved, this can create a high-rate tax liability which would not have arisen with other routes.

However, if there are unused personal tax allowances available, as is often the case on retirement before State Pension age, taking capital withdrawals from your pension fund to utilise the allowance can be very sensible tax planning.

In most situations, though, withdrawing a pension fund rather than using one of the other options is likely to represent poor tax planning over the longer term.

It is worth remembering that there may be charges each time a lump sum withdrawal is made and limits to how many withdrawals can be made each year.

Lifetime Annuity

This is where you use a pension fund, or part of it, to buy a guaranteed income from a life insurance company. The income is normally taxable and subject to tax deduction at source under the PAYE system.

There are various options to include or exclude as suited but, once established, the payments are guaranteed on the basis selected and, except in the case of a flexible annuity mentioned later in this guide, cannot subsequently be altered.

The rate available reflects the options selected as well as:

- Long term interest rates at the time
- Average life expectancy
- Personal health and lifestyle issues if these are expected to shorten life expectancy against the average

An annuity with an enhanced rate to reflect health conditions or lifestyle is normally called either an impaired life annuity or an enhanced annuity.

For someone who outlives the life expectancy used by the insurance company, the insurance company may lose, but this is compensated by the gain they make on those who pre-decease the life expectancy applied when setting the annuity rate.

An annuity involves taking a risk of capital loss if you die earlier than expected in exchange for security of income during your lifetime.

The nature and degree of this risk, and of other risks that an annuity can create, such as inflation risk, depend on the options selected at outset.

The main options available with an annuity are as follows on the following page:

Annuity Options	Explanation
Dependent's benefit	An annuity can continue paying an income to a spouse, civil partner, or other eligible dependent in the event of the plan holders' death, at a rate selected at outset, typically 50% or 100% but other options are available. The eligible dependent will be named in the application for the annuity as their age and health (if applicable) will be taken into account in the annuity rate offered. If a dependent's pension is needed to ensure their financial security, then it is unwise to omit it, even though it reduces the payments and would cause a relative loss if the partner dies first .
Escalation in payment	Normal options are a fixed percentage rate of, say, 3% or 5% per annum or a payment linked to inflation as measured by the Retail Price Index (RPI). It should be noted that with some inflation-linked pensions there is the facility for the pension to drop in the event of the RPI falling. Although escalation in payment substantially reduces the starting figure, if it is not selected the spending power of your income will fall each year. If the annuity you are buying is to provide required income rather than extra income for discretionary spending, failure to include full inflation linking creates a real risk to your long-term financial security .
Investment linking	These link income payments to the performance from one of the insurance company's investment funds. However, this means the payment can fall rather than rise so involves investment risk. Someone prepared and able to accept investment risk might be better suited to the drawdown option explained below, since this is far more flexible .
Guarantee period	This provides for the pension to continue in payment for a minimum period from commencement even if the annuitant dies. Normal guarantee periods are five years or ten years. This option is likely to appeal to someone who wants to mitigate the potential loss to their family created by buying an annuity rather than keeping the money invested, although the ability to do so is restricted due to the time limits .
Payment frequency	Pension payments are normally needed monthly, but they can be set up quarterly, six monthly or annually. They can also be "in arrears" or "in advance". With a yearly in arrears annuity, the first payment would not be received until 12 months after the annuity is purchased. With payments in arrears, there is an option to include a proportion arrangement so that, on death, any amount accrued since the last payment will be paid to the date of death .
Death value protection	In exchange for a reduction in the annuity it is possible to pre-select a percentage of the original purchase price (less annuity payments already received) to be paid out on death (or second death on joint life annuities). Any payment on death will be taxable in the hands of the recipient .

If you have a plan with guaranteed annuity rates above those available in the market, not all options will be available without losing the benefit of the higher rates. It is very important to obtain quotations on the open market and ensure any eligibility for enhanced or impaired life rates is explored before making a decision on which annuity to purchase

Keeping the money invested and taking income from the fund

With this option, instead of passing the money to an insurance company in exchange for a guaranteed income (annuity), you can keep it invested in your own name, within a pension plan, and use this to generate the income you need.

If you have already withdrawn your tax-free lump sum the pension is called a Flexible Access Drawdown (FAD), and all income is taxable, with tax deducted at source under the PAYE system.

If you have not withdrawn your tax-free lump sum the pension is a normal pension fund rather than a FAD account, and each withdrawal is 25% tax free and 75% taxable. This structure uses what is nattily called 'Uncrystallised Fund Pension Lump Sum' (UFPLS) withdrawals.

For convenience, we refer to either of these structures in the rest of this guide as simply "drawdown".

Drawdown may appeal to those who would like:

- Flexibility over the amount of income they receive each year
- To avoid or delay making an irrevocable decision on such difficult issues as inflation proofing and dependent's benefits
- To ensure some of the fund is available to their beneficiaries on death

A key point is often the last one listed above, since drawdown has the potential to avoid a significant loss of assets for the family, which can occur if an annuity has been purchased.

On death, the remaining fund is normally made available to your nominated beneficiary.

If death occurs before age 75 then the beneficiary can receive the lump sum, or withdrawals for life, with no tax payable. If death occurs after age 75, the beneficiary will pay tax at their marginal rate, unless all is withdrawn in a single payment, in which case the tax charge would be 45%.

However, the obvious potential downside of keeping the money invested rather than buying a guaranteed income is that you continue with investment risk.

The degree of risk depends on the way the money is invested, and the way income is being generated from those investments, but it is not possible to eliminate the risk altogether. This is exactly the same as applies with any investment being used for income generation, and not just pension accounts.

In essence, any investment driven approach to income generation carries the risk that the income produced will be less than you could have received if you had bought an annuity.

If you withdraw capital rather than just the net of costs income it generates, you are also facing a risk your future income reducing or of the money running out and the source of income expiring altogether.

Our general advice is to not withdraw more than the natural income available unless the pension fund is only for surplus spending and you could comfortably manage without it if you needed to, or the extra withdrawal is for a temporary period to bridge a gap until another source of income comes on stream.

It is important to note that drawdown involves continued investment and advice costs which are higher than those associated with annuity purchase, since no ongoing investment management and advice is required with an annuity.

Due to the lack of guarantees over future income, drawdown is less likely to be suitable where the income generated is part of your essential spending for financial security, although this depends on the amount of income needed as a percentage of the pension funds value, as it is that which determines the risk of the withdrawals not being sustainable.

At any point a drawdown plan can be discontinued with the balance of money in the plan used to purchase an annuity of any style preferred or with the money withdrawn entirely.

Less mainstream options

Fixed Term Annuities

These provide a fixed (or inflation linked) guaranteed income over a set period of time. At the end of that period, there can be a preset maturity value which can be used to buy another fixed term annuity, buy a lifetime annuity or be invested into a drawdown fund (see earlier).

The advantage can be flexibility. If, during the fixed term period, there is a change of circumstances such as death of a partner, decline in health or change in financial circumstances, then the annuitant can re-consider their options when the existing annuity ends.

However, there can be significant disadvantaged too:

- There is a risk that annuity rates at the end of the fixed term are lower than they were at outset, and the maturity value may not purchase as high an annuity income as could have been achieved with a lifetime annuity at outset
- It will be necessary to go through the decision-making process again at the end of the fixed term and there may be a cost involved with this
- There are few providers in the market so rates may not be attractive

Someone able and willing to accept the risks of a fixed tern annuity should also have the ability to accept the risks associated with keeping the money invested and using drawdown and should consider that as drawdown is far more flexible.

Flexible Annuities

These are a half-way house between annuity and drawdown.

They aim to provide a regular income for life, the flexibility to increase or decrease income levels as required, plus the potential for future income growth.

They are, though, investment linked so involve investment risk. The underlying investment must meet the performance targets set by the provider in order to maintain, or possibly increase, current income levels. If underlying investment performance does not meet the targets, then income will fall.

In an attempt to recreate the certainty of income that comes with a traditional annuity, providers of flexible annuities set a guaranteed minimum income level, which they say income will not fall below. This will normally be a lot lower than the guaranteed annuity available in the market at the time. The guarantee is given by the company, so its value depends on their financial strength.

Some other points to note

Tax free benefit caps

This guide looks generally at the way pension benefits can be taken, rather than in detail at various issues which can arise. However, it is important to note that there are caps on how much can be taken out tax free under either the 25% rule or the death before age 75 rule.

Lump Sum Allowance – The LSA is the limit on the total tax-free lump sums that can be paid before taxation applied. As it stands, the limit is £268,275, although it can be higher if former Lifetime Allowance protection is held.

Lump Sum and Death Benefit Allowance – The LSDBA is the limit on the maximum amount of tax-free lump sums that an individual and beneficiaries can receive from a pension. The LSDBA stands at £1,073,100 which is the same limit for those with Lifetime Allowance protection and includes serious ill-health lumps sums paid before age 75.

Overseas Transfer Allowance – This allowance limits the maximum tax-free amount that can be transferred out of the UK and is set at £1,073,100 for those without Lifetime Allowance protection.

Generating 'income' from invested an invested pension

Most investments, including funds linked to the stock markets, bond markets, infrastructure, and commercial property, generate natural income, the level of which varies significantly from one fund to another and, in some cases, is more or less zero, whilst in others is exceptionally high.

Where a portfolio is required to generate income, our normal approach is to recommend a structure which enables natural income to be distributed, thereby avoiding, or at least mitigating as much as is possible, the need to sell investments to generate 'income'.

However, there are many pension plans and investment arrangements operated by life insurance companies where this flexibility is not available and the only way to draw 'income' is by selling shares or units in the funds held. This significantly adds to the risks associated with a drawdown plan.

Atkins Bland has a separate short guide to this subject, entitled '*Generating Investment Income for Natural Yield*', which is available on request.

Triggering the "money purchase annual allowance"

Anyone taking pension benefits (beyond withdrawing their tax-free cash entitlement) flexibly, which is by drawdown or flexible annuity will trigger the "money purchase annual allowance".

This reduces the annual pension contribution allowance eligible for tax relief from the normal £40,000 down to just £4,000. If taking benefits before retirement, perhaps to bridge a gap in employment, this needs to be weighed up as the lost future tax planning can be significant.

"Small pots"

A 'small pot' is defined as a pension valued at up to £10,000 and, if withdrawn fully, this will not trigger the money purchase annual allowance restriction. Up to three small pot payments are allowed. Some providers, notably those operating modern portfolio pensions, are able to create small pots by separating a larger pension fund into two or more components.

Using the small pot facility could be a better option than FAD for someone who wants to be able to pay more than £4,000 p.a. into a pension.

Important notes

Any opinions expressed on the merits or disadvantages of any options are intended as a general comment only and not as specific advice to the reader.

This document is intended as a supplement to full independent advice and not as a replacement for it and should be read in conjunction with any personalised recommendations provided by Atkins Bland Ltd and with any product brochures supplied.

The value of investments will fall as well as rise, as can any income produced or generated. An investor may, therefore, get back less than invested.

Inflation can reduce the real value of capital and the income it generates.

Past investment performance is not a reliable guide to the future.

Any reference to taxation, regulation or legislation is based on our current understanding and details should be checked before any reliance is placed upon its accuracy.

The impact of taxation and tax planning depends on individual circumstances and may be subject to change, which can be retrospective.

Errors and omissions excepted.

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Atkins Bland