

Annuity Options



INTRODUCTION - What is an annuity?

An annuity is a product that enables you to exchange a lump sum of money (either from a pension fund or other form of savings) for a regular income, typically for life, but it could be for set terms. How much income you receive depends on a range of factors including the amount invested, your sex, age, state of health, lifestyle, whether you want a single or joint annuity, level or increasing income, as well as economic factors such as interest rates and inflation.

The person who receives the annuity payment is known as the Annuitant. However, they may not necessarily be the person who purchases the annuity. Annuities are normally provided by insurance companies who operate huge pools of annuity money, which are predominately invested in Government borrowing (Gilts). Gilts provide a stable income which helps to meet the guarantees for all of their annuity customers.

There are two groups of annuity products depending on the source of the purchase funds. The difference between them determines their tax status:

- 1) **Compulsory Purchase Annuities.** These are annuities that are purchased from the proceeds of either a pension arrangement, trust fund or Court Order. For tax purposes the annuity income is treated as if it were earned income. Please see our **Pensions Options At Retirement** Fact Sheet for additional information on the alternative options available when considering your pension income.
- 2) **Purchased Life Annuities.** These are annuities that are purchased from savings other than pensions. They benefit from a portion of the income being tax-free, the amount of which depends on the age and life expectancy of the annuitant. The tax-free part is called the Capital Element and is not taxed as it is deemed to be a return of the original capital invested. The rest of the income is subject to income tax.

In the main, the amount of annuity income is calculated using life expectancy statistics for the general population. However, a number of providers use postcode or regional life expectancy statistics. There are also a limited number of providers who specialise in providing annuities for people who have suffered or are suffering from illness or have lifestyle considerations. These are known as impaired life or enhanced annuities.

Annuities are generally designed to pay the income throughout the remainder of an annuitant's lifetime. However, they can also be established for a specified period. If death should occur earlier than anticipated the annuitant may not receive an income equal to the amount of capital originally invested. Conversely, the longer the annuitant lives the greater the likelihood of receiving far more income than the Capital originally invested.

Clearly there is a trade-off between having the peace of mind of receiving a guaranteed income for life against the possibility of premature death. Annuities are essentially a 'pooled risk' product where there are cross subsidies between those who live for a shorter period than anticipated and those who live longer.

There are numerous options available when constructing an annuity and these can be configured in a variety of ways to meet with your specific needs. The critical point to bear in mind is that once established it is not possible to alter the terms of an annuity, so you have to be sure, at outset, that it is the most appropriate solution to your current and future requirements.

Annuity rates vary from provider to provider, therefore, it is important to search the market for the best terms. Shopping around for pension annuities is called the exercising the **Open Market Option**. An independent financial adviser is best placed to source the most competitive deals.

LIFETIME ANNUITES

This is the traditional product which effectively 'spends' the capital invested to purchase the guaranteed income for life. The annuity income can be payable:

- On a single life basis, i.e. with no spouse's income on death of the annuitant.
- On joint lives with a reduction on the annuitant's death typically of nil, 33% or 50%.
- Level throughout life or increasing each year in payment.
- Guaranteed payable for an initial period, usually the first 5 years.
- With a guarantee to return the purchase price less income paid out on death in the first 10 years.
- At an enhanced rate for 'impaired' lives, typically for smokers, the overweight and those with specific health conditions.

Additionally a Purchased Life Annuity can offer a **Capital Protection** facility, whereby the original purchase money is guaranteed to be repaid either by way of income, or if premature death should occur, by a lump sum payment being the balance of the purchase price less income payments already received.

INVESTMENT LINKED ANNUITIES

These are generally only available to Compulsory Purchase Annuities and provide the ability to link the amount of your annuity income to investment returns. Whilst it provides the prospect of higher income, there is also the risk that your income could go down. Investment-linked annuities can either be:

- **With-Profits** – these link your income directly to the performance of the insurance company's With-Profits fund; or
- **Unit-Linked** – these link your income to the performance of the funds you select. There will usually be a choice of funds for you to select from.

SHORT-TERM ANNUITIES

With a short-term annuity, you can use the capital to buy a fixed-term annuity lasting (typically) five years. You can choose your annuity options in much the same way as basic lifetime annuities, e.g. to single, joint, level or indexed.

Comparison of Pension Annuity Options

Option	Risk	Pros	Cons
Lifetime Annuity	Low - Medium	<ul style="list-style-type: none"> • Income for life – guaranteed. 	<ul style="list-style-type: none"> • Capital value is lost to the estate. • Expensive optional benefits may prove to have been unnecessary.
Lifetime Annuity with Guarantee	Low - Medium	<ul style="list-style-type: none"> • Income for life – guaranteed. • Income paid for guaranteed 5 or 10 year period should annuitant die earlier. 	<ul style="list-style-type: none"> • Capital value is lost to the estate when the guarantee expires. • Guarantee may prove to have been an expensive unnecessary option.
Capital Protected Annuity	Low - Medium	<ul style="list-style-type: none"> • Income for life – guaranteed. • Return of purchase price less income paid out on death pre age 75. 	<ul style="list-style-type: none"> • Death benefit subject to 35% tax. • No return of value after age 75.
Impaired Life Annuity	Low - Medium	<ul style="list-style-type: none"> • Income for life – guaranteed. • Enhanced annuity rate, i.e. increased pension. 	<ul style="list-style-type: none"> • Only available if annuitant suffers from certain medical conditions or is a smoker.
Short Term Annuity	Medium	<ul style="list-style-type: none"> • Defers Lifetime Annuity purchase decision. • Leaves remaining funds invested. 	<ul style="list-style-type: none"> • Maximum term 5 years. • Income cannot exceed 120% of GAD 'basis' amount. • Not available after age 75.
Investment Linked Annuity	Medium - High	<ul style="list-style-type: none"> • Potential for longer-term income growth. • Income is investment related. 	<ul style="list-style-type: none"> • May have lower initial income. • Investment related income risk. • Income may fluctuate. • Income may reduce.

NB. This is only a summary of the main options available to those thinking of purchasing an annuity. Individual advice is essential prior to taking any action as this area is complicated and requires personalised advice. Investors should be aware that traditional annuities provide a guaranteed income whereas the alternative products provide an income which can vary depending on the value and performance of underlying assets. Unlike lifetime guaranteed annuities they are complicated and based to varying degrees upon investment risk and should not be entertained by those with a low risk tolerance, who do not understand the consequences and who rely entirely on their pension funds for their retirement income. Investment related plans should be reviewed regularly to check on progress and be adjusted according to your changing circumstances.

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No responsibility can be accepted for the accuracy of the information in this fact sheet and no action should be taken in reliance on it without advice. Please remember that past performance is not necessarily a guide to future returns.

The value of units and the income from them may fall, as well as rise. Investors may not get back the amount originally invested

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