

# Pension Options at Retirement Fact Sheet



## INTRODUCTION

Having spent your working life building a portfolio of pension arrangements, the question at retirement is what to best do with the funds in order to provide for your retirement. The answer is a myriad of options of which one or more should suit you.

In addition to the State Pensions, there are two main types of pension arrangement:

- A **Defined Benefit** (pension) also known as a final salary arrangement whereby the pension receivable is determined amongst other things by the scheme rules, your length of service and your final salary and
- A **Money Purchase** arrangement, which we are referring to in the rest of this document. Put simply; the pension you receive in retirement is determined not by your final salary but mainly by the value of your pension funds, your age and interest rates at the time you take your benefits.

Whilst State Pensions cannot be taken before State Pension Age, Money Purchase pension benefits can currently be drawn between the ages of 55 and 75.

The main options under money purchase pension arrangements are:

- Lifetime Annuity
  - Traditional guaranteed annuity
  - Investment linked annuity
- Unsecured Pension (USP)
  - Pension fund withdrawal
  - Series of short term annuities
- Phased Retirement
- Alternatively Secured Pension (ASP) for those aged 75 or over

Whichever option is chosen the income from annuities and/or income drawdown is taxable in the same way as earnings were prior to retirement.

## TAX FREE CASH LUMP SUM

Most pension arrangements allow the retiring member to take a proportion of the accrued pension funds as a tax free lump sum. This is optional; that is to say if you take the tax free cash option you will reduce the fund value and in turn the resulting income in retirement. Tax free cash is often taken to repay outstanding debt such as a mortgage, spend on planned items, gifts for Inheritance Tax planning purposes and/or to invest in an alternative manner. Tax free cash is usually 25% of the accrued fund value.

## LIFETIME ANNUITY

The traditional approach is to use the pension funds to purchase a lifetime annuity. This effectively 'spends' the accrued funds to purchase the guaranteed income for life. The annuity income can be payable:

- On a single life basis, i.e. with no spouse's pension.
- On joint lives with a reduction on the annuitants 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 specific health conditions.

Pension income annuity rates vary from company to company and it is often advantageous to search the market for a better annuity rate. This is called the **Open Market Option**.

## INVESTMENT LINKED ANNUITIES

An alternative is 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 funds you select.

There will usually be a choice of funds for you to choose from.

## UNSECURED PENSION (USP)

An Unsecured Pension is an alternative to buying a lifetime annuity. Having taken the tax free cash lump sum it allows the customer to draw an income from their remaining pension fund while leaving the fund invested. A customer under 75 can take out an Unsecured Pension and either draw an income by using **Income Withdrawal**, or by using a '**Short-term Annuity**'. An Unsecured Pension will stop at age 75. By that time, customers must secure an income from their remaining funds, which generally means buying a **Lifetime Guaranteed Annuity** or in certain circumstances an **Alternatively Secured Pension**.

## SHORT-TERM ANNUITIES

With a short-term annuity, you can use part of your pension fund to buy a fixed-term annuity lasting up to five years. You can choose your annuity options in much the same way as basic lifetime annuities. In the meantime, the remainder of your fund continues to be invested.

At the end of the term of the annuity you can buy another short-term annuity. You can also combine income from a short-term annuity with income withdrawal. However, you must take a secured income from your remaining pension fund from your 75th birthday. Generally this is in the form of a lifetime annuity.

## INCOME WITHDRAWAL

Income Withdrawal, also known as Pension Fund Withdrawal and Pension Income Drawdown, is a very flexible post retirement pension plan allowing variable income and can be very tax efficient. It requires the policyholder to take their Tax Free Cash and leave the remainder of the pension funds invested, drawing their income from the invested pension funds. The level of income you can withdraw from the funds is based on your age and prevailing annuity rates as determined by the Government Actuary's Department, known as the GAD relevant annuity rates. The minimum amount you can withdraw as income is 0% and the maximum 120% of the GAD rate. The GAD rates are roughly equivalent to the level annuity a single male could purchase at the same age.

An Unsecured Pension (Income Withdrawal) will stop at age 75. By that time you must secure an income from your remaining pension funds, which generally means buying a lifetime annuity. The option to purchase a lifetime annuity with the remaining fund can be exercised at any time prior to age 75.

On death of the pension holder a dependent, who has not attained age 75 themselves, can normally continue with the income withdrawal payments, purchase a lifetime annuity or receive the residual fund as a lump sum less a 35% tax charge.

## PHASED RETIREMENT

Also known as Phased Drawdown as it works in a similar way to Income Withdrawal but the Tax Free Cash is not taken at outset, instead it is deferred and spread over subsequent years forming part of the 'income', whilst the pension funds remain invested.

Phased retirement splits the fund into multiple segments and uses one or more segments each year to provide income. From the value of the segments utilised each year, 25% is taken as the tax free cash element whilst the remainder of those encashed or vested segments is used to provide the income, either through lifetime annuity purchase or income drawdown. The unvested segments remaining invested for future use. Each year the member repeats this exercise with the appropriate number of segments being encashed or vested to provide that year's desired income and tax free cash combination. Converting portions of the fund regularly, for example once a year, means the member can provide a flexible and tax efficient income through the planned use of the tax free cash, as well as the taxable annuity/income drawdown elements.

Phased Retirement can be a useful financial planning tool, for example if you want to ease back gradually on work and replace your earnings with a pension income. As part of the 'income' each year is tax free cash it can be very income tax efficient. It also provides more flexible help for your survivors if you die.

The invested segments of the fund you haven't converted to annuities or drawdown can provide a pension or be paid as a tax free lump sum for your surviving dependents .

At any stage the member can draw the remaining tax free cash entitlement and purchase a lifetime annuity with the remaining fund.

### **ALTERNATIVELY SECURED PENSION (ASP)**

Alternatively Secured Pensions work in a similar way to USP (above) but have different rules. They are available to certain categories of people reaching age 75 who do not want to buy a lifetime annuity with their remaining pension fund.

A minimum income level must be drawn from the invested funds, being 55% of the 'basis amount'. The basis amount is the fund multiplied by the lifetime annuity rate for a 75 year old, obtained from the GAD table. The maximum ASP that a member can withdraw is 90% of the basis amount. This amount withdrawn must be reviewed and recalculated each year.

If the member dies while in ASP the only option is to provide an income for dependants or, if no dependents, the payment of a charity lump sum death benefit as nominated by the member.

Any other lump sum payment is treated as an unauthorised payment with potential unauthorised payment tax charges of up to 70% and potentially also subject to 40% Inheritance Tax, resulting in a potential total tax charge of 82%.

At any stage the member can purchase a lifetime annuity with the remaining fund.

There is also an emerging range of retirement products, known as Third Way, which aim to offer a combination of the longer term guarantees of an annuity with the potential for growth of an investment based product. They tend to be variations on those options discussed above.

**NB. This is only a summary of the main options available to those taking their retirement benefits from accrued pension funds. Individual advice is essential prior to taking any action as this area is very complicated and requires highly 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.**

### **ADDITIONAL NOTE ON STATE PENSIONS**

The **Basic State Pension** is based on your National Insurance Contribution history and can be deferred subject to certain rules. You may also receive an **Additional State Pension** if you are or have been in employment since 1978. State Pension Forecasts are available from The Pension Service:

<http://www.thepensionservice.gov.uk/state-pension/forecast/home.asp>

Your State Pension Forecast will confirm your State Pension Age. If you would like to know what this is currently go to:

<http://www.pensionsadvisoryservice.org.uk/state-pensions/state-pension-age-calculator>

For more information on the various retirement options please arrange an appointment and/or see the Financial Services Authority (FSA) consumer guides:

<http://www.moneymadeclear.fsa.gov.uk/tools/publications/publications.html>

## Comparison of Pension Options at Retirement:

Option	Risk	Pros	Cons
<b>Deferred &amp; Phased Vesting</b>	Low - Medium	<ul style="list-style-type: none"> <li>Deferred pension fund remains invested.</li> <li>Ongoing contributions can be made.</li> <li>Permits gradual annuity purchase.</li> <li>On death before vesting the uncrystallised fund value can be paid to beneficiaries free of Inheritance Tax (IHT).</li> <li>Unrestricted spouse's pension.</li> </ul>	<ul style="list-style-type: none"> <li>Defers tax free cash.</li> <li>Ongoing investment risk.</li> </ul>
<b>Lifetime Annuity</b>	Low - Medium	<ul style="list-style-type: none"> <li>Income for life – guaranteed.</li> </ul>	<ul style="list-style-type: none"> <li>Capital value is lost to the estate.</li> <li>Expensive optional benefits may prove to have been unnecessary.</li> </ul>
<b>Lifetime Annuity with Guarantee</b>	Low - Medium	<ul style="list-style-type: none"> <li>Income for life – guaranteed.</li> <li>Income paid for guaranteed 5 or 10 year period if annuitant dies earlier.</li> </ul>	<ul style="list-style-type: none"> <li>Capital value is lost to the estate when the guarantee expires.</li> <li>Guarantee may prove to have been an unnecessary expense.</li> </ul>
<b>Capital Protected Annuity</b>	Low - Medium	<ul style="list-style-type: none"> <li>Income for life – guaranteed.</li> <li>Return of purchase price less income paid out on death pre 75.</li> </ul>	<ul style="list-style-type: none"> <li>Death benefit subject to 35% tax.</li> <li>No return of value after age 75.</li> </ul>
<b>Impaired Life Annuity</b>	Low - Medium	<ul style="list-style-type: none"> <li>Income for life – guaranteed.</li> <li>Enhanced annuity rate, i.e. increased pension.</li> </ul>	<ul style="list-style-type: none"> <li>Only available if annuitant suffers from certain medical conditions or is a smoker.</li> </ul>
<b>'Third Way' Products</b>	Medium	<ul style="list-style-type: none"> <li>Flexibility to change with circumstances.</li> <li>Guarantees against market falls.</li> </ul>	<ul style="list-style-type: none"> <li>Income is lower than annuities.</li> <li>Charges can be high.</li> <li>Ongoing investment risk.</li> </ul>
<b>Short Term Annuity</b>	Medium	<ul style="list-style-type: none"> <li>Defers Lifetime Annuity purchase decision.</li> <li>Leaves remaining funds invested.</li> <li>On death before vesting the uncrystallised fund value can be paid to beneficiaries free of IHT.</li> </ul>	<ul style="list-style-type: none"> <li>Ongoing investment risk.</li> <li>Maximum term 5 years.</li> <li>Income cannot exceed 120% of GAD 'basis' amount.</li> <li>Not available after age 75.</li> </ul>
<b>Investment Linked Annuity</b>	Medium - High	<ul style="list-style-type: none"> <li>Potential for longer-term income growth.</li> <li>Income is investment related.</li> </ul>	<ul style="list-style-type: none"> <li>May have lower initial income.</li> <li>Investment related income risk.</li> <li>Income may fluctuate.</li> </ul>
<b>Phased USP</b>	Medium - High	<ul style="list-style-type: none"> <li>Deferred pension fund remains invested.</li> <li>Permits greater control over income than phased vesting.</li> <li>Combines IHT advantages of phased vesting and USP.</li> </ul>	<ul style="list-style-type: none"> <li>Defers tax-free cash.</li> <li>Ongoing investment risk.</li> <li>Death benefit on vested element subject to 35% tax if funds not applied to provide a dependants' pension</li> <li>Must opt for annuity or ASP at 75.</li> </ul>
<b>Unsecured Pension (USP)</b>	Medium - High	<ul style="list-style-type: none"> <li>Pension fund remains invested.</li> <li>Flexible income drawdown options.</li> <li>Flexible income or lump sum death benefit for beneficiaries.</li> <li>Could be used to deplete capital.</li> </ul>	<ul style="list-style-type: none"> <li>Withdrawing high levels of income is likely to erode capital.</li> <li>Ongoing investment risk.</li> <li>Death benefit subject to 35% tax if funds not applied to provide a dependants' pension.</li> <li>Must opt for annuity or ASP at 75.</li> </ul>
<b>Alternatively Secured Pension</b>	Medium - High	<ul style="list-style-type: none"> <li>Pension fund remains invested.</li> <li>Ongoing income drawdown options.</li> <li>Ongoing income for dependents.</li> <li>Could be used to deplete capital.</li> </ul>	<ul style="list-style-type: none"> <li>Withdrawing high levels of income is likely to erode capital.</li> <li>Income limited to max 90% GAD 'basis' amount for a 75 year old.</li> <li>Ongoing investment risk.</li> <li>No lump sum death benefit, except to a nominated charity.</li> </ul>

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No responsibility can be accepted for the accuracy of the information in this facts 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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