

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 accumulated funds in order to provide for your retirement. The answer is that there are 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 anytime after age 55 with no upper age limit.

The main options at retirement under money purchase pension arrangements are:

- Lifetime Annuity
 - Traditional guaranteed annuity
 - Investment linked annuity
- Series of short term annuities
- Drawdown Pension
- Phased Retirement potentially incorporating;
 - Lifetime Annuities, and or,
 - Short Term Annuities, and or
 - Drawdown Pension

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 – PENSION COMMENCEMENT LUMP SUM

Most pension arrangements allow the retiring member to take a proportion of the accrued pension funds as a tax free lump sum, known as the Pension Commencement Lump Sum (PCLS). This is optional; that is to say if you take the PCLS option you will reduce the fund value and in turn the resulting income in retirement. PCLS 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. PCLS 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 annuity income to investment returns. Whilst it provides the prospect of higher income, there is also the risk that the income could go down. Investment-linked annuities can either be:

- **With-Profits** – these link income directly to the performance of the insurance company's With-Profits fund; or
- **Unit-Linked** – these link income to the funds you select.

There will usually be a choice of funds to select from.

SHORT-TERM ANNUITIES

With a short-term annuity, it is possible to use part of the pension fund to buy a fixed-term annuity for periods of greater than 3 years. Annuity options can be selected in much the same way as basic lifetime annuities. In the meantime, the proportion of the fund not used to purchase the fixed term annuity continues to be invested.

At the end of the annuity term another short-term annuity can be purchased. It is also possible to combine income from a short-term annuity with Drawdown Pension. Income payments from a short term annuity do not now need to cease by age 75.

CAPPED DRAWDOWN PENSION

Capped Drawdown Pension, also known as Pension Fund Withdrawal and Pension Fund Income Drawdown, is a very flexible post retirement pension plan allowing variable income and can be very tax efficient. It allows 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 that can be withdraw from the funds is based on, gender, age and prevailing annuity rates as determined by the Government Actuary's Department, known as the GAD relevant annuity rates. The minimum amount that can be withdrawn as income is 0% and the maximum 100% of the GAD rate. GAD rates are roughly equivalent to the level annuity a single male or female could purchase at the same age. Income levels are reviewed every 3 years.

Income Drawdown may continue beyond age 75 on the same basis, but is reviewed more frequently (annually). Beyond age 85 the reviews are based on prevailing rates for an 85 year old.

On death of the pension holder, a dependent can normally continue with the income withdrawal payments, purchase a lifetime annuity or receive the residual fund as a lump sum less a 55% tax charge. On death of the pension holder where there is no dependent the fund less the 55% tax charge returns to the estate/beneficiaries free from Inheritance Tax.

FLEXIBLE DRAWDOWN PENSION

Flexible Drawdown Pension is an extension of Capped Drawdown and allows individuals who are able to meet a Minimum Income Requirement (MIR) to take as much income as they like, realising of course it will all be subject to income tax. Flexible Drawdown will only be possible if the individual can declare that as well as meeting the MIR there won't be any future contributions to any pension arrangement.

The MIR is set initially at £20,000 p.a. and will be reviewed by Treasury Order at least every 5 years. The MIR is based on a secure income stream already in payment in the relevant tax year, comprising of State Pensions, Lifetime Annuities and Occupational Pensions.

PHASED RETIREMENT

Also known as Phased Drawdown as it works in a similar way to Income Drawdown but not all of the tax free cash (PCLS) is 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 PCLS element while the remainder of those encashed or vested segments is used to provide the income, either through Lifetime Annuity purchase or Drawdown Pension. 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 PCLS 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 PCLS, as well as the taxable annuity/income drawdown element.

Phased Retirement can be a useful financial planning tool, for example to ease back gradually on work and replace lost earnings with phased pension income. As part of the 'income' each year is tax free it can be very income tax efficient. It also provides more flexible options for survivors on death of the pensioner.

The unvested (un-crystallised) segments of the fund not yet converted to annuities or drawdown can provide a pension or be paid as an Inheritance Tax (IHT) free lump sum to surviving dependents.

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

ALTERNATIVES

There is also an emerging range of retirement products, known as Third Way arrangements. These 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 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. Pensioners may also receive an **Additional State Pension** if they 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
Deferred & Phased Vesting	Low - Medium	<ul style="list-style-type: none"> Deferred pension fund remains invested. Ongoing contributions can be made. Permits gradual annuity purchase. On death before vesting the un-crystallised fund value can be paid to beneficiaries free of Inheritance Tax (IHT). Unrestricted spouse's pension. 	<ul style="list-style-type: none"> Defers tax free cash. Ongoing investment risk.
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 if annuitant dies 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 unnecessary expense.
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 75. 	<ul style="list-style-type: none"> Death benefit subject to 55% 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.
'Third Way' Products	Medium	<ul style="list-style-type: none"> Flexibility to change with circumstances. Guarantees against market falls. 	<ul style="list-style-type: none"> Income is lower than annuities. Charges can be high. Ongoing investment risk.
Short Term Annuity	Medium	<ul style="list-style-type: none"> Defers Lifetime Annuity purchase decision. Leaves remaining funds invested. On death before vesting the un-crystallised fund value can be paid to beneficiaries free of IHT. 	<ul style="list-style-type: none"> Ongoing investment risk. Income cannot exceed 100% of GAD 'basis' amount.
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.
Phased Income Drawdown	Medium - High	<ul style="list-style-type: none"> Deferred pension fund remains invested. Permits greater control over income than phased vesting. Combines IHT advantages of phased vesting and Drawdown Pension.. 	<ul style="list-style-type: none"> Defers tax-free cash Ongoing investment risk. Death benefit on vested element subject to 55% tax if funds not applied to provide dependant's pension
Income Drawdown	Medium - High	<ul style="list-style-type: none"> Pension fund remains invested. Flexible income drawdown options. Flexible income or lump sum death benefit for beneficiaries. Could be used to deplete capital. 	<ul style="list-style-type: none"> Withdrawing high levels of income is likely to erode capital. Ongoing investment risk. Death benefit subject to 55% tax if funds not applied to provide dependant's pension.

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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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