

# A Guide to Income Withdrawal



# A Guide to Income Withdrawal (Also known as Unsecured Pension)

Since 6th April 2006 ('A-Day'), income withdrawal is defined as a form of 'Unsecured Pension'.

On 6th April the existing rules were changed and two methods of Income withdrawal were introduced-Capped Drawdown and Flexible Drawdown.

## Capped Drawdown

Income withdrawal allows you to take part of your pension fund as a 'Pension Commencement Lump Sum' (the 'A-Day' phrase for tax-free cash) and defer the purchase of a lifetime annuity.

In the meantime, you can withdraw, or 'draw down', a (taxable) income from the remainder of your pension fund, which remains invested within a tax-advantageous environment.

As a lifetime annuity has not initially been purchased, this potentially allows you greater flexibility and control in the following areas;

- Greater control over the amount of your (taxable) income.
- Greater investment control over your pension fund.
- Greater choice over when to buy an annuity
- Greater flexibility for your dependants, in the event of your prior death.

As you must firstly transfer your accrued pension fund(s) into an income withdrawal plan, it is very important that you initially discuss the feasibility of the transfer(s) with us.

It is also important that the transfer(s) occur before you take any benefits from the transferring scheme(s). However, you are able to transfer pension funds held within an existing income withdrawal arrangement to an alternative income withdrawal provider.

## How Capped Drawdown works

- Once received, your transfer value(s) will be available for investment in the chosen income withdrawal provider's range of funds (which will probably also include funds operated by 'external' fund managers).
- If, however, the transfer is being made to a Self-Invested Personal Pension Plan (SIPP), it would be possible for you to invest part or all of your fund in a range of other 'permitted' investments, including OEICs and unit trusts, investment trusts, quoted stocks and shares and even commercial property.

- A Pension Commencement Lump Sum (PCLS) of (usually) up to 25% of the total income withdrawal fund can be paid at outset. Provision of a wholly tax-free PCLS will depend on the total value of your pension portfolio (excluding State pensions), as at the date of effecting income withdrawal, which will be tested against your Lifetime Allowance. However, the amount which can be taken as a PCLS may be restricted if any part of the income withdrawal fund originated from a 'pension sharing order', as a result of a divorce settlement.
- If required, an income can be paid to you from your income withdrawal fund, which is taxed as earned income on a pay-as-you-earn ('PAYE') basis. When opting for income withdrawal, you are able to select a specific level of annual income up to a maximum amount, which is calculated at outset and remains in place for the following three years until you reach age 75 when it is reviewed annually. However, there is no minimum income amount; you could decide to withdraw no income at all, if required.
- The Government Actuary's Department (GAD) calculates your maximum income amount as 100% of the notional annuity that you could secure with your pension fund, based on your age at the date of review and total fund value.
- You are able to vary (or cease) your income each year to suit a changing tax position, income requirements, or the actual performance of the underlying investment portfolio.

An example:

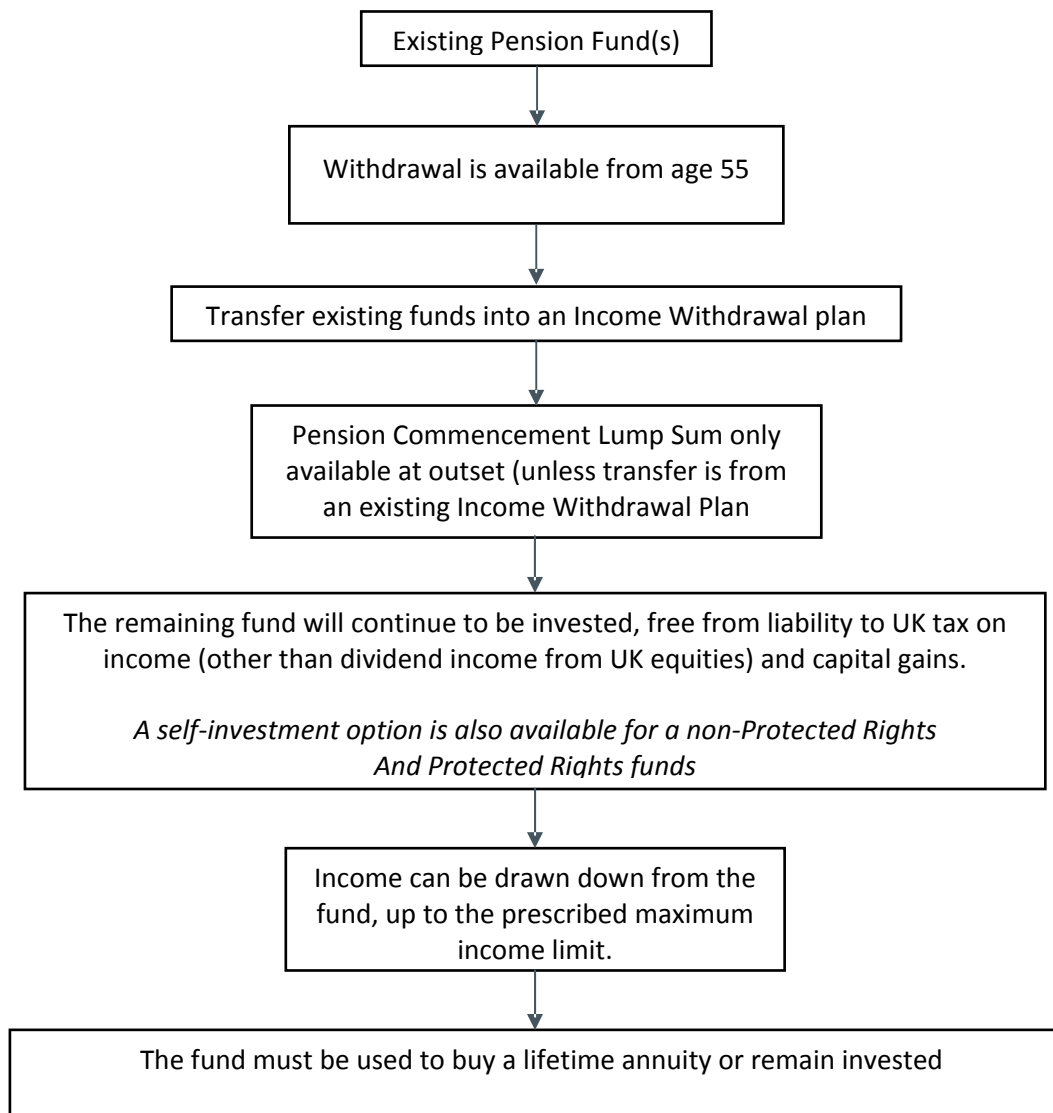
Ignoring charges, if you had a total income withdrawal fund of £133,333, you could (usually) take up to £33,333 as a one-off PCLS, immediately at outset.

That leaves £100,000 from which you can draw an income, if required.

If we assume, for example, that £100,000 could secure a gross annual income of £9,600 – on the basis prescribed by GAD (that is, by using a GAD factor of 80 per £1,000) – this would be the maximum amount of income that you could 'draw down' from your fund annually. The income amount you take could be ceased or varied up or down each year, provided that it does not go above the maximum limit. The maximum income amount would then be recalculated every three years until you reach the age of 75 and then annually thereafter and may go up or down however, you can request that your maximum income level is re-calculated earlier than the scheduled review date (for example, on each anniversary of the plan).

You retain control over how your income withdrawal fund is invested. Your invested fund is free of all UK taxes on investment income (other than dividend income from UK equities) and capital gains, until you decide to use your remaining withdrawal fund to purchase an annuity.

### A flow-chart to show how income withdrawal works



### What happens on death during Capped Drawdown

- Unlike a lifetime annuity, if you die whilst receiving payments from a Capped Drawdown Fund, the value of your withdrawal fund on death will generally be available for payment to one or more beneficiaries
- If you leave a spouse or anyone who was financially dependent on you, they could elect to use the remaining fund to provide them with an income. This may be done by either;
  - Purchasing a lifetime annuity (which can be deferred to age 60, if required)
  - By continuing in Capped Drawdown themselves
  - If they are aged over 75, as at your date of death, effecting an Alternatively Secured Pension
- Alternatively, the remaining Non-Protected Rights fund could be paid as a lump sum, subject to a 'one-off' tax charge of 55%. Any remaining Protected Rights funds must be used to provide a widow's pension if married at the date of death, if not married the funds can be paid as a lump sum less 55% tax charge.

## **Advantages of Capped Drawdown**

- Because you can choose when to purchase an annuity, you are not necessarily forced into purchasing an annuity when annuity rates are relatively low, which would affect the amount of income you receive for the rest of your life.
- Under a Capped Drawdown plan, not only can you choose when to buy a lifetime annuity, you can normally also choose which provider to buy a lifetime annuity from, through use of the 'open market option' facility.
- Capped Drawdown allows you continued control over your investments. Being able to continually monitor and amend your investment portfolio (with our ongoing help and advice) allows the potential to maximise returns through the careful selection of investments, which are tailored to meet your objectives and risk profile.
- Overall, there is greater flexibility in providing for your dependants, in the event of your prior death. The extra options in how income withdrawal death benefits can be paid and to whom they may be paid, allows you added flexibility when planning for your beneficiaries.

## **Disadvantages of Capped Drawdown**

- The relative merits of transferring your existing pension fund(s) into a Capped Drawdown plan should be considered carefully. There is no guarantee that the benefits provided under Drawdown will be as good as, or better than, those that you are giving up, by transferring.
- Annuity rates are not guaranteed and may get worse over time, rather than improve. This is particularly important if annuity purchase is delayed
- The value of your income withdrawal fund is not guaranteed and may go down as well as up, over time. In particular, the value of the income withdrawal fund may not grow sufficiently to provide you with an ongoing income, which matches the income you would have received, had you purchased a lifetime annuity with the available fund at outset.
- Drawing an income at, or near to, the maximum amount possible is likely to be unsustainable over the longer term. If you withdraw high levels of income from your withdrawal fund, this may erode the capital value of the fund, especially if the investment returns achieved on the underlying portfolio are poor. This restricts the potential for the longer-term growth of your investments and could, therefore, result in a lower income when (and if) an annuity is eventually purchased. It could also affect the long-term financial security of your surviving spouse and/or dependants in the future.
- The prevailing GAD maximum limit for your Capped Drawdown arrangement may be lower than your desired level of income.
- Setting up a Capped Drawdown arrangement also involves the construction of an underlying investment portfolio. The risk profile of the underlying portfolio may need to be higher than your prevailing attitude to investment risk, in order to realistically aim to achieve the ongoing 'critical yield' for the arrangement. In addition, achieving the critical yield is no guarantee in itself of maintaining the annuity purchasing power of your income withdrawal fund over time.
- Capped Drawdown policyholders do not benefit from the 'cross subsidy' arising out of mortality, which those who purchase an annuity may enjoy. The potential impact of this loss of cross-subsidy increases over time and is sometimes referred to as "mortality drag".

- The charging structure of Capped Drawdown contracts is more expensive than, for example, the cost of purchasing a lifetime annuity. It may also include the costs associated with reviewing such arrangements on, for example, an annual basis.

### **Flexible Drawdown**

Individuals who can demonstrate that they can satisfy a minimum income requirement (MIR) will be able to draw down unlimited amounts from their pension pots. This type of arrangement is known as Flexible Drawdown.

Any amount drawn will be taxed as income at their marginal rate in that tax year

The MIR is to be set at £20,000 and reviewed by the Treasury every 5 years.

Only pension income will be included for the purposes of MIR. This income can include the state pension, income from a final salary pension and annuities. It does not include income from investments or from other Drawdown arrangements

If the MIR is met the rest of the pension fund can be taken as “flexible drawdown” with no upper limit.

- The provision of flexible drawdown will be down to the provider.
- No tax relief will be granted on any pension contributions made once in flexible drawdown
- Protected Rights benefits will not be allowed under flexible drawdown until April 2012.

### **Death Benefits**

- Should you die whilst the Income Drawdown policy is still in force, your surviving spouse or dependants would have up to four options as to how they could take the benefits;
- Take the fund remaining on death as a cash lump sum less a one-off 55% tax Charge. This is only applicable to the Non-Protected Rights element. Any Protected Rights element must be used to provide a spouse’s pension if you are married or in a civil partnership, otherwise it can be paid as a lump sum less the 55% tax charge
- Use the fund remaining on death to purchase a lifetime annuity or,
- Continue in Income Drawdown, with the maximum income allowance based on their age and sex
- If applicable, defer the purchase of a lifetime annuity until they reach age 60.

No Inheritance Tax (IHT) will typically apply to lump sum death benefits either before or after age 75. Where there is no dependent it will be possible to pay the lump sum death benefit tax free to charity.

### **Advantages**

- You are able to take all of your tax-free cash lump sum entitlement at outset.
- You do not receive a set income but are able to vary to suit your personal circumstances to supplement other sources of income.
- You have the potential to benefit from good investment performance in a tax efficient environment and to exercise control over your own investment portfolio

### **Disadvantages**

- If you are in Flexible Drawdown you will not receive tax relief on any future pension contributions
- The amount of capital drawn from the fund is liable to tax at your highest marginal rate
- If the MIR increases and your pension income is less than this then you will have to move into Capped Drawdown
- Tax rules may change in the future

## **Short Term Annuities**

Short-term annuities are available within an unsecured pension contract instead of, or in addition to, 'drawing down' an income, as detailed previously. They will allow an unsecured pension member, or their surviving dependant(s), to purchase a temporary annuity, or a series of temporary annuities (on the open annuity market, if required) with all, or part of, their total pension fund. Each annuity term cannot be more than 5 years in duration, or up to age 75, if earlier.

Under both options, an income can continue to be taken until the surviving dependant reaches age 75, after which an income must be secured, either by the purchase of a lifetime annuity, or by effecting an Alternatively Secured Pension contract. The maximum income allowable is the same as for Income Withdrawal and must be re-calculated at least once every five years.

Should the dependant die whilst in Income Withdrawal, any remaining fund not used to provide income could be paid out as a cash lump sum, subject to a one-off 35% tax charge. A short-term annuity can be set up with a dependant's pension, if required.

## **Suitability**

Income withdrawal is most likely to be suitable for a fairly sophisticated investor, who fully understands and accepts the potential disadvantages and inherent risks involved.

However, income withdrawal can still constitute an efficient tax-planning tool, a means of accessing the available Pension Commencement Lump Sum without having to extract any taxable income and as a way of providing an individual (and in particular, their surviving dependants) with a greater range of death benefit options than compared with, for example, lifetime annuity purchase.

MonetarySolutions is an appointed representative of Burns-Anderson Ltd.

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