Briefing

Options for drawing benefits from a self-invested pension

You spend a long time building up a pension fund that is big enough to support you throughout your years in retirement. The choices you make about how and when you draw benefits from your pension fund will determine how much value you get out of it. This briefing note provides you with an overview of the ways in which benefits can currently be accessed from your pension fund.

Money can be withdrawn from your self-invested pension, usually from age 55 onwards, either as a cash lump sum, which may or may not be tax-free, or as taxable income. We would always recommend that you seek advice from a financial adviser before drawing any benefits, as most of the options are irrevocable and some of them will limit what you can pay in later, should you need to.

Option 1:
Do nothing!

Nowadays, there is no compulsion to ever draw any benefits from your pension fund. Instead, you could leave your fund fully invested to be distributed to your surviving beneficiaries on your death. Further information about this can be found in our "Taxation of pension death benefits" briefing note here.

Alternatively, you should consider whether you need to take out all of the benefits from your pension fund now, and if not, then either take them at a later date, or draw your benefits out in stages.

Most pension schemes allow you to defer taking benefits, including the State Pension and, depending on your circumstances, it may be a great way to make your pension fund last longer. It could also mean that your cash lump sum and/or income is higher than would be the case today, (although this is not guaranteed), as the fund would stay invested for longer within a tax-efficient environment and annuity rates typically increase with age.

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However, there are potential downsides to deferment, as well. For example, you would lose out on the income that you would otherwise have received during the deferment period, and annuity rates could fall as they are affected by gilt yields and improvements in longevity, which may cancel out any benefit for age.

If you decide that you do want or need to withdraw benefits now – either fully or partially – the following options set out the different ways of doing that.

Option 2:
Draw a tax-free lump sum

This is now known as a 'pension commencement lump sum' (PCLS) and, although it is not compulsory to draw a PCLS from your pension fund, it is a very popular option because it is tax-free 'cash in hand' and can be spent on whatever you like.

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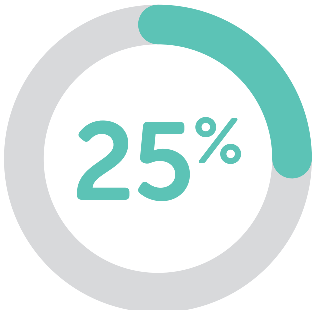
You will usually be able to take up to 25% of your fund, (or 25% of your available Lifetime Allowance (LTA), if lower), as a PCLS. Although some or all of a PCLS can be re-invested into other savings vehicles, please note there may be a tax charge levied by HM Revenue & Customs (HMRC) if you 'recycle' this lump sum to increase your normal pension contributions. An alternative to reinvestment, however, is to retain the PCLS within your pension fund, until required.

If you have registered with HMRC for Enhanced, Primary, Fixed or Individual Protection, or have a scheme-specific protected lump sum, then different rules apply on the amount of your PCLS and you should seek confirmation from your usual self-invested pension client manager. For example, if you have Enhanced Protection, you may be limited to a lower percentage of your pension fund as a PCLS, or you may be subject to the standard rule of no more than 25% of the LTA.

In addition, current pension rules mean that you can draw a PCLS only (including in tranches) from your fund, and leave the rest fully invested – there is no compulsion to draw a taxable income at the same time. Depending on your circumstances – for instance, if you are still working and perhaps paying higher rate tax – it can be a very tax-efficient way of drawing your benefits.



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If you do want to draw an income from a pension fund, however, there are currently three main ways of achieving this.

Option 3:
Purchase an annuity

An annuity is a contract with an insurance company, where you exchange your pension fund for a regular income. It guarantees to pay you an income for life, no matter how long you live. The insurance company takes on the risk that you will live a long time, rather than you taking the risk of running out of money.

Your chosen annuity provider will pay you a regular income taxed in the same way as earnings.

The amount of income payable is dependent on your age and health, the size of your self-invested pension fund, economic factors, the type of annuity you purchase, and the structural options that you select (see below). You should also be aware that once you have purchased an annuity, you cannot cash it in, or make changes to your selected options.

Structural options that can be selected - to create the 'shape' of your annuity - include the following;

1) An 'escalating' guaranteed income increases over time to keep up with the increasing cost of goods and services, known as inflation. Your ncome will start at a lower level and will then increase by your chosen percentage each year.

2) A 'level' guaranteed income will remain fixed. Your income will start at a higher level than an 'escalating' guaranteed income, but as you get older, inflation may increase; meaning, therefore, you would buy less with the same income.

3) A guaranteed minimum payment term can be incorporated, even if you do not survive to the end of that term.

4) A guaranteed income based on your medical history and lifestyle factors, (for example, if you smoke, have high blood pressure, are on prescribed medication, or have a medical condition). You may be eligible for an 'enhanced' guaranteed income (also known as 'impaired', lifestyle' or 'underwritten' annuity). These tend to pay a higher income.

5) A guaranteed income that provides an income just for you is known as a 'single life annuity'. By contrast, annuities that provide an ongoing income for a nominated beneficiary, should you die before them are known as 'joint life annuities' and provide a slightly lower income initially, but payments will continue to your nominated beneficiary after you die, or for a guaranteed period (see (3) opposite).

6) You could also protect your annuity payments through 'value protection'. Value protection is an option that, if you die without having received the full value of your self-invested pension fund as income, returns a lump sum to a beneficiary (minus total gross payments made, and tax). As a result, value protection gives the ability to protect up to 100% of the original amount used to purchase the annuity.

7) Finally, there are other specialised lifetime annuities, including with-profits and unit-linked annuities, which include different features. You should seek specialist advice on these if they may be of interest to you

The most important decisions surrounding purchasing an annuity are when you buy it, and the shape of your annuity. As a rule of thumb, annuities arguably become more cost-effective once you get into your seventies. It is also important to 'shop around' to find the best annuity deal for you, as you would with any other purchase, as the annuity rates offered by the various annuity providers can vary significantly.

Option 4:
Go into flexi-access drawdown

Whereas an annuity provides security over the payment of a known income amount for the remainder of your life, the main advantage of 'drawdown' over a lifetime annuity is flexibility. From 6 April 2015, the method of providing drawdown income for those not already in drawdown is from a 'Flexi-Access Drawdown' (FAD) fund.

FAD allows you to draw pension income without limit, and funds designated as available for FAD will remain invested in your pension and withdrawals can be made with the payments being taxed as income. Tax will normally be deducted at source under Pay-As-You-Earn (PAYE).

There is no limit, therefore - other than the availability of monies - on how much can be drawn out of your FAD fund each year, which includes the possibility of drawing out the entire FAD fund in one taxable instalment, if required.

If this is the intention when funds are first accessed, then an 'Uncrystallised Funds Pension Lump Sum' (UFPLS) may represent a more appropriate method of accessing funds (see option 5 below).

Because there is no annual income limit, (as there was with earlier forms of drawdown like 'capped drawdown'), there is also no concept of a 'pension year', or a need to undertake three-yearly, or annual, maximum income recalculations.

There is also no requirement to purchase an annuity with your FAD fund at any stage, although this remains an option, (see our briefing note "How long should I stay in drawdown?") By contrast, it is not possible to go into FAD, once you have used your pension fund to purchase an annuity.

You should regularly review your chosen level of income if you intend for your fund to provide you with a sustainable pension in the future, (see our briefing note "How long does my drawdown fund need to last?").

Finally, drawing a taxable income from a FAD fund triggers the Money Purchase Annual Allowance (MPAA), which restricts what you can pay in. The MPAA is explained further in this briefing note after option 5.

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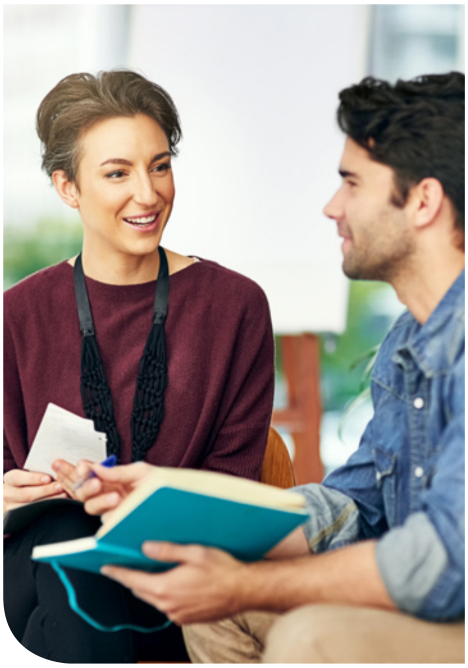

Option 5:
Draw an uncrystallised funds pension lump sum

This is an alternative way of drawing out - in one go - all of the funds being accessed. In effect, it is the same as receiving a PCLS and, at the same time, asking for the whole of a FAD fund to be withdrawn.

The tax-free cash element of an Uncrystallised Funds Pension Lump Sum (UFPLS) is usually 25%. The remainder is taxed as income. In addition, the payment of an UFPLS will trigger the MPAA (if this has not already been triggered).

An UFPLS is not available from funds that:

- Are already in drawdown
- Would trigger an LTA 'excess tax charge' (which is explained opposite)
- Are designated as being 'disqualifying pension credits' (funds received from an ex-spouse on divorce)
- Relate to a member with 'lump sum protection'

The lump sum protection that is relevant here is the protection of lump sum rights of more than £375,000 for members with either enhanced protection and/or primary protection.

Can I mix my benefit options?

Yes.

You can choose a combination of the benefit options above over time, or over your total self-invested pension fund, whichever suits your needs. For example, you could take 25% of your fund as a PCLS, use 50% to buy a guaranteed income for life (an annuity), and take the remaining quarter as flexible income, via FAD.

When choosing your options, you need to consider how much income you require now, and for the rest of your life. You also need to consider how important it is to you that this income is guaranteed.

In terms of the maximum amount of benefits that you can have from your pension fund, if the total value of all your registered pension schemes exceeds the standard LTA, then a tax charge will usually apply on the excess amount above the LTA. If you have a form of LTA protection, (for example, enhanced protection), this may serve to reduce or eliminate any LTA excess tax charge that would otherwise be payable.

The LTA is, therefore, the total monetary amount you can save into pensions in your lifetime while still getting tax relief. The standard LTA is £1.03 million for the 2018/19 tax year. Your fund will be assessed against the relevant LTA when you take benefits, and again when you reach age 75. Each time you take new benefits a portion of your LTA is used up.

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What is the Money Purchase Annual Allowance (MPAA)?

If you receive income from a FAD fund or take an UFPLS, (as the jargon defines it, 'flexibly access your pension'), you will be subject to more restrictive rules on how much you can save tax-efficiently within a 'money purchase' pension fund for the rest of your life. (A money purchase pension fund is one into which money is paid and invested, and the benefits available from it are based on its fund size).

The restriction was brought in with the new pension freedoms to prevent salary being paid into a pension plan and then drawn out, more or less immediately, with a view to saving income tax.

The standard Annual Allowance (AA) is currently £40,000 gross per tax year, and you can also 'carry forward' up to three previous tax years of unused contributions, where available.

Where you flexibly access your pension, a reduced AA - known as the MPAA - then applies to subsequent contributions to a money purchase pension arrangement.

The MPAA is currently £4,000 gross per tax year, and furthermore, the ability to carry forward any unused contributions is lost. However, self-invested pension members who also have 'defined benefit' pension arrangements, (for example, a 'final salary' occupational pension scheme), will still be able to accrue up to a further £36,000 gross worth of benefits in those arrangements per tax year, on top of the £4,000 gross MPAA.

Please note that it is the first payment of income, rather than the establishment of a FAD fund, that triggers the application of the MPAA.

This means that the PCLS can be paid in isolation, and a FAD fund set up, without causing a reduction in the AA – if and until such time as income is drawn from the FAD fund. This could be a sensible precaution, to make it easier to cope with the unexpected in the future (for example, involuntary redundancy).

If you exceed the MPAA a tax charge is made, which claws back any tax relief that was given on your pension contribution.

When choosing your options, you need to consider how much income you require now, and for the rest of your life. You also need to consider how important it is to you that this income is guaranteed.

Can Barnett Waddingham give me advice on what options to take?

No. Our client managers will be able to provide further information about the various benefit options available to you, including how to access them, but they will not be able to advise which option, or combination of options, is the best for your personal circumstances.

We are happy to work with your existing advisers to implement any decisions you have made.

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Where can I seek help?

Three government bodies provide free and impartial guidance about your benefit options:

Pension Wise

www. pensionwise.gov.uk
(0300 330 1001)

The Pensions Advisory Service

www.pensionsadvisoryservice.org.uk
(0300 123 1047)

Money Advice Service

www. moneyadviceservice.org.uk
(0800 138 7777)

Please note that Pension Wise, The Pensions Advisory Service and Money Advice Service are all due to be replaced by a (as yet un-named) 'Single Financial Guidance Body', with effect from winter 2018, following Royal Assent of the Financial Guidance and Claims Act in May 2018. We will update this briefing note in due course, once full details about the new Body and its launch date become known.

Conclusion

The aim of this briefing note is to outline the key options that you need to consider, as you approach the point where you might need to start drawing benefits.

You will get the most value out of the pension fund that you have spent a long time saving for, by making good decisions on when you take money out, in what form or forms, and over what period of time. A financial adviser is best placed to help you to make those decisions.

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Please contact your Barnett Waddingham client manager if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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