Retirement Income Options

INDEPENDENT FINANCIAL ADVISERS
FAIREY ASSOCIATES LIMITED
Helping you make educated decisions.



A Clear and Simple Guide

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What is an annuity?

This option has been the traditional method of providing income in retirement. After firstly deciding the size of the tax free cash sum to be taken (if any at all), the remaining fund is used to purchase an annuity. In return for passing over your pension funds, an annuity provider would promise to pay you an income for the rest of your life.

You can buy an annuity if you have one of the following pensions:

Personal pension
Stakeholder pension
Most Additional Voluntary Contribution (AVC) scheme
Free-Standing Additional Voluntary Contribution (FSAVC) scheme
Retirement annuity contract (RAC)
Section 32 policy (buy-out bond)
Occupational money purchase scheme

The value of your annuity income will depend upon several factors including:-

Your age
Your health and lifestyle
Your occupation and where you live – in some circumstances
Current Interest Rates
The value of your Pension Fund
The type of Income you chose
The type of options and number of options you chose
The insurance company from whom you purchase your annuity

An annuity can be set up in various ways, and could include a guaranteed period, a spouse's pension and/or escalation. The inclusion of these additional benefits will result in the initial annuity income being reduced and the "shape" of the annuity cannot be altered once it has been commenced.

Benefits received from an annuity are taxed as earned income and you may have to pay some tax on the payment received from the annuity provider.

Within an annuity arrangement the insurance companies pool all of the money that is used to purchase annuities. They then set their annuity rates knowing that some annuitants would die before their average life expectancy and some will live beyond it. This means they can guarantee all annuitants an income for life because the unused fund of those who die earlier than expected help to pay the annuities of those who live longer than average. The process is called mortality gain or mortality cross-subsidy.

What types of annuity are there?

Single Life Annuity

An annuity just for you if either you do not have a spouse or partner or they have their own pension arrangements.

Joint Life Annuity

An annuity that will provide an income to you and then to your spouse or partner after your death.

Level Annuity

This pays out the same pension income throughout your life and will not increase in line with inflation.

Escalating Annuity

This will normally start at a lower rate than a level annuity and will gradually build up. With an escalating annuity you can chose from:-

- **Fixed Rate -** Your income will go up each year by an agreed fixed rate (for example 3% or 5%).
- **Index linked** - Your income is adjusted each year to reflect changes in the Retail Prices Index (RPI) or the Consumer Prices Index (CPI). The amount will vary from year to year to match inflation.

Whilst you may choose a fixed or escalating, there is no investment risk involved. Should the cost of living rise to a level that exceeds the rate of increase on your pension income you do run the risk of eroding the 'buying power' of that income.

You will usually have to pay tax on your pension income, just like your normal earned income.

The amount of your initial income will depend almost exclusively upon the annuity rates available at that time and the basis on which the annuity is set up. Generally speaking you will not be able to stop the annuity and buy another at a better rate, as it is "a once and for all" decision".

Impaired-Life Annuity

With age often comes the increased prospect of illness and injury. In recognition of this, companies have introduced annuity rates that reflect a reduced life expectancy, or alternatively a lifestyle, which could have an impact on life expectancy, such as smokers. Impaired-life annuities (also referred to as enhanced annuities) pay higher than normal income if you have certain health problems that threaten to reduce your lifespan. The usual options regarding the income basis are still available.

Lifestyle and "Postcode" Annuity

This is where a better rate is given to an individual should their specific occupation, lifestyle or their geographical location mean that they are more likely to die sooner.

The lifestyle annuity usually refers to smokers and/or those that may have a weight problem (but not significantly enough to warrant an impaired life annuity).

"Postcode" annuities refer to the geographical locations. Some insurance companies offer higher rates based on post codes.

Investment Linked Annuities

Investment linked annuities offer the prospect of a higher income in the future than you can get from level or increasing annuities – but only by taking on extra risk.

Investment linked annuities can either be:

- **With Profits** – these link your income directly to the performance of an insurance company's With Profits Fund, or

- **Unit Linked** – these link your income to the funds you invest in.

Both With Profits and Unit Linked Annuities operate in a similar way: your starting income is based on an assumed bonus rate or growth rate. If the fund grows at the assumed rate, your income stays the same. If growth exceeds the assumed growth rate, your income increases. If growth is less than the assumed rate, your income falls.

These types of annuities would appeal to individuals who are comfortable with exposing their pension funds to a degree of risk and are prepared to see fluctuations in the future levels of income payable to them by the annuity provider.

Short Term Annuity

This type of annuity allows an individual to utilise their pension funds to purchase a short-term annuity contract from an insurance company. The term of the annuity contract cannot be more than 5 years, and just like a conventional annuity, the level of income is guaranteed throughout the term of the arrangement.

A short term annuity contract option gives individuals the opportunity to re-assess their pension needs periodically and to choose alternative types of annuities as they go along.

Value Protection Annuities

Annuities have always provided the certainty of a secure income for life, irrespective of how long that may be. New pension legislation has now introduced Value Protection Annuities, in that they can also provide a return of capital in the event of death before the 75th birthday, subject to 55% tax.

Capital Protection can be added to an annuity to protect up to 100% of the value of the fund being used to purchase the annuity. By adding protection, the pension income will be reduced, but this

benefit alleviates the concern that many clients have in that they may not see the full value from their annuity if they were to die in the early years.

Investment Management

By buying an annuity, income will be guaranteed for life, irrespective of any subsequent movement in the investment markets. However, unless you purchase an investment linked annuity, there is no future potential to benefit from investment growth to improve your pension position.

Income Management

The rate of increase in your pension has to be chosen at the outset, as well as optional benefits such as a continued pension for your spouse on your earlier death. There is no opportunity to change these options at a later time to adapt to changed personal circumstances.

Annuity Purchase Management

The current annuity rate and therefore the timing of when you buy your annuity will have a great effect on the size of pension you will be able to receive. You are able to choose which Life Company to buy your annuity from and are therefore able to opt for the best rates possible. Aside from this there is no way of influencing the level of annuity rates. Annuity rates have been on a downward trend for some time and are likely to stay low for the foreseeable future.

What Happens When You Die?

When you die, your beneficiaries may continue to receive a pension or even the remainder of any guaranteed instalments as a lump sum. However, this depends on the options you choose when you purchase your annuity. These options are fixed from the outset, and cannot be changed to adapt to changes in your personal circumstances, such as widowhood or remarriage. In addition, your beneficiaries do not have the option to change their income payments to suit their requirements.

Advantages:

- Buying an annuity is straightforward, with minimum paperwork, and no ongoing reviews.
- You receive a fixed income for life, which cannot fall in value.
- You have no or limited exposure to investment risk.
- You can receive all of your tax-free cash lump sum at the start.

Disadvantages:

- Your pension options are fixed at the outset and cannot be altered to take account of changes in personal circumstances, such as widowhood.
- Your pension cannot be altered in value (except for standard increases) to take account of fluctuations in supplementary sources of income.
- This option may represent poor value for money should you die early.
- The pension you receive is dependent upon annuity rates at the time of purchase – which are currently low.
- You must make an immediate decision with regards to the amount (if any) of tax free cash lump sum that you take prior to purchasing an annuity.
- Unless you take an annuity which increases in line with inflation each year, the level of real income received will reduce due to inflation over time.

Flexi - access pension

This is an alternative to buying an annuity and allows you, from the age of 55 onwards, to leave your pension fund invested while drawing an income from the pension fund by using income withdrawals or by using a 'short-term annuity'.

You may consider this as a far more flexible income solution than a conventional annuity purchase, however, it is more complex and does come with greater risk and this should be carefully considered before entering into such an arrangement. One risk is the fact that if you decide to buy an annuity at a later date this could be lower than the annuity available at outset – this could be caused by poor investment performance, high levels of withdrawal from the fund or a combination of the two. It is riskier than an annuity as the income received is not guaranteed and will vary depending on the value and performance of underlying assets.

All withdrawals from drawdown funds will be subject to tax as pension income.

With flexi access drawdown there are no limits on the amount of income that can be taken from the pension fund. A pension commencement lump sum (or tax free cash) can be taken as 25% of the fund. Any income or lump sums received over and above of this will be taxed at the marginal rate of income tax that applies.

Investment Management

As the pension fund remains invested in a tax-efficient environment, the income you withdraw each year will be determined by the continued investment management of your funds. Careful attention therefore needs to be given to the investment management of your pension funds during drawdown to ensure that you do not run out of income during retirement.

Income Management

You are able to vary your income without limit. The level of income you choose to take will have implications for the performance of your invested fund, and will influence future possible levels of annuity you can buy. Withdrawals erode the value of your remaining fund, especially if investment returns are poor and income withdrawal is high.

Whilst in the short term it may be advantageous to draw the maximum income from your fund, in the medium to long term it is important that you balance your income requirements with the investment policy to ensure the annuity purchasing power of your pension fund is maintained. When maximum withdrawals are taken under flexible drawdown or the maximum short term annuity, these high levels of income may not be sustainable.

What Happens if You Die?

On the death of an individual who has been taking income withdrawals from a personal pension, the remaining fund becomes available to provide benefits for the member's spouse and/or dependants, or others, as nominated by the member or, if there is no such nomination, chosen by the scheme administrator.

The options are: -

- For the residual fund to be paid out as a lump sum, however there maybe tax payable:-
    - If the deceased is under 75, then no tax will be payable.
    - If the deceased is over 75, the rate of tax will be 45%, this will reduce to the beneficiaries marginal rate of tax from 6th April 2016.
- For the survivor to take income by means of income withdrawals
- For an annuity to be purchased to provide income to the survivor

With flexi- access drawdown not only can you receive an income but it also maintains the flexible financial protection for the residual fund which should allow for greater benefits to be passed on to your spouse or beneficiaries upon your death.

Advantages:

- You are able to take just the lump sum and no income if you want
- You can avoid buying an annuity completely
- You have control over when you commit your pension fund to purchase an annuity (if at all). If rates are low when you come to retire, annuity rates tend to improve in relation to age, so the older you are, the better your annuity rate could be
- You do not receive a set income but are able to vary it to suit your personal circumstances between set limits to supplement your other sources of income
- You may be able to mitigate your personal liability to income tax in certain years
- The fund stays in a favourable tax environment
- The fund remains invested so you have the potential to benefit from good investment performance in a tax-efficient environment and to exercise control over your own investment portfolio (by utilising a self investment personal pension plan)
- It gives you improved death benefit options compared with an annuity

Disadvantages:

- A careful investment portfolio needs to be drawn up which will involve some investment risk and reliance upon investment management
- The pension fund could fall in value
- The income is not guaranteed and could go down
- Withdrawing too much income may have an adverse effect on preserving your pension purchasing power or preserving the capital value of your fund
- Increased flexibility brings increased costs - costs are higher for flexi- access drawdown contracts rather than for annuities and there is the need to review arrangements on an on-going basis
- Annuity rates may have worsened by the time you eventually purchase an annuity and this could result in you receiving an income lower than what may have been available had an annuity been purchased at outset
- Large lump sum payments over and above the amount of ‘tax free cash’ that can be taken will be taxed at your marginal rate of tax.

Uncrystallised funds pension lump sum

This is a new concept whereby a lump sum can be drawn directly from uncrystallised money purchase pensions. 25% of the lump sum is still paid tax-free. The balance of the lump sum is taxed at the member's marginal rate of income tax.

Any remaining pension fund is invested until such time as the fund is exhausted.

Unlike flexi access drawdown it isn't possible to access available tax free amount in one go then take flexible income. There may also be some restrictions that would apply to members with primary protection, enhanced protection or lifetime allowance enhancement factors affecting tax free cash entitlement.

Money Purchase Annual Allowance

To prevent widespread abuse of the new flexibility, a new anti-avoidance measure will be introduced - the Money Purchase Annual Allowance (MPAA). This means that once income is taken from a UFPLS or a flexi access drawdown policy, the annual allowance for making tax relieved contributions will be £10,000.

The Money Purchase Annual Allowance applies:
• when income is taken from flexi-access drawdown (FAD),
• when income above GAD limits (150%) is taken post 5 April 2015 from a capped drawdown fund,
• when an uncrystallised funds pension lump sum (UFPLS) is received,
• when a payment from a reducible lifetime annuity (this is another new flexible option) is taken,
• from 6 April 2015 for those already in flexible drawdown, who currently have no annual allowance.

However it does not apply:
• where an individual commences FAD, but doesn't receive any income i.e. just takes tax-free cash,
• where an individual is in capped drawdown (ie pre 6 April 2015) and doesn't receive income above 150% GAD after 5 April 2015,
• when small pots are accessed.

Phased retirement

Phased retirement is not a product but a process which allows you to exert more control on your retirement fund and convert it gradually over a number of years to income, by using a combination of tax-free cash sums and annuities to provide a flexible income.

Under Phased Retirement, your pension funds are split into a cluster of many separate plans, sometimes called “segments or arrangements”. The arrangements can then be used to provide income at different times.

Each time an arrangement is converted to purchase an annuity, you can first take part of the arrangement as a tax-free cash payment with the balance of the arrangement being used to purchase an annuity which will provide a regular income (taxable under PAYE).

Converting arrangements regularly – for example, once a year – means you can effectively use the tax-free cash, as well as the annuity, to provide your income. The drawback is that if you stagger the conversion of arrangements into annuities, you will not be able to take all your tax-free cash from your total pension fund at once as a single lump sum.

Phased retirement can be a very useful financial planning tool, for example, if you want to ease back gradually on work and start to replace your earnings with pension income.

It also provides more flexible help for your survivors if you die. Arrangements that have not yet been converted to annuities (unvested) can be paid out as a lump sum, free of income tax or inheritance tax. Alternatively the remaining unvested fund can be used to provide your spouse or other beneficiaries with income.

Any annuities already purchased under phased retirement may also provide benefits upon death but the amount and nature of any payment would be dependent upon how the annuity was originally set up.

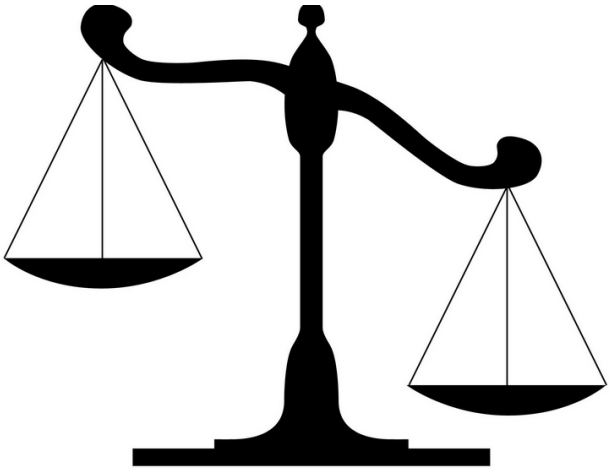
Phased retirement is generally suitable only if you have a fairly large pension fund, or you have other assets or income to live on. This is because the bulk of your pension savings remain invested which may be more risky than buying an annuity straight away.

Advantages:

- You choose when to buy your annuities and what types of annuity to buy.
- You can buy different types to suit your changing requirements.
- Annuities provide a guaranteed income for life. Once you have bought your annuity, the insurance company cannot change the rate, even if rates go down. You can shop around for the best annuity rate at the time of encashing the different segments. You might lower your marginal rate of income tax by buying your annuities in stages. This is because each time you cash in an arrangement, up to 25% is paid as tax-free cash.
- Income provided under a phased retirement plan can be generated in a very tax efficient manner as each time you cash in an arrangement(s), up to 25% is paid as a tax free lump sum.
- Any arrangements you haven't cashed in can normally be paid as a lump sum if you die.
- Any arrangements you haven't cashed in remain invested in tax efficient pension funds.
- You benefit from the "mortality cross-subsidy" if you live longer than average (see previous explanation).

Disadvantages:

- You cannot take all your tax-free cash sum in one go because it is split equally across all your arrangements.
- Annuity rates could get worse. The annuities you buy in future may be at a worse rate than you could get now.
- You could get poor investment returns on your uncashed arrangements.
- You will suffer charges on your uncashed arrangements.
- Once you have bought your annuity, you cannot change it, even if your circumstances change.
- Your annuity might not keep up with inflation and therefore its purchasing power may reduce.
- You do not benefit from the "mortality cross-subsidy" if you die soon after buying your annuity.



Phased drawdown

As the name would suggest, a Phased Drawdown arrangement combines the tax efficiency of phasing with the flexibility of flexi-access drawdown.

Once again, income can be provided in a tax efficient manner, utilising tax free lump sum withdrawals which are then supplemented by a series of flexi-access drawdowns (i.e. not from the purchase of different annuities). The overall concept of a Phased flexi-access drawdown arrangement is to maximise the tax efficiency of personal pensions whilst potentially improving upon the death benefits that would generally be available under an annuity or conventional Drawdown arrangement.

Advantages:

- Income is generated in a very tax efficient manner
- You can defer the purchase of an annuity
- The potential for a further tax free lump sum to be payable when the fund is utilised to purchase an annuity
- Potentially greater death benefits than an annuity or standard income drawdown arrangement.
- The potential to benefit from growth on your pension fund within a tax efficient environment

Disadvantages:

- You cannot take all your tax free cash sum in one go because it is split equally across all your arrangements.
- A careful investment portfolio needs to be drawn up which will involve some investment risk and reliance upon investment management.
- Withdrawing too much income in the early years may have an adverse affect on preserving your pension purchasing power or preserving the capital value of your fund.
- Increased flexibility brings increased costs and the need to review arrangements on an ongoing basis.
- Annuity rates may have worsened by the time you eventually purchase an annuity and this could result in you receiving an income lower than what may have been available had an annuity been purchased at outset.