

TO DRAW OR NOT TO DRAW - TAKING PENSION BENEFITS

Given that the means for drawing benefits with Alternatively Secured Pension ("ASP") are now clear, the question on many investors' minds is whether or not to take benefits – to draw (vest) or not (remain unvested). The decision is a strategic financial planning one and therefore should be considered in the context of your overall financial circumstances once appropriate professional advice has been sought. The main options available for drawing benefits from a personal pension at different ages are summarised in the matrix below. The death benefits for each circumstance are set out overleaf.

Pre age 75

Post age 75

Unvested

It is possible for a pension (or part thereof, if segmented) to remain unvested until age 75. In this scenario, growth and income within the pension scheme is virtually tax free, subject to not exceeding the lifetime allowance (where relevant).

All pension policies must be vested at least the day before age 75. Remaining **unvested after age 75 is therefore not an option.**

Vested

There are two main options for drawing from a pension before age 75, as follows:

(a) Unsecured Pension ("USP")

When a pension is vested, **up to 25%** of the fund can be taken tax free as a Pension Commencement Lump Sum ("PCLS") with the **option** to then draw "income" (which is taxable as earned income) from the residual fund, at a **rate of 0-120%** of the specified Government Actuary's Department ("GAD") rate per annum. The current GAD rate for a male aged 60 is 6.4% and for a female is 6.0%.

If the rate of withdrawal under USP exceeds the rate of pension fund growth, the capital value of the residual fund will be eroded over time. Under USP, the residual fund can continue to benefit from virtually tax free income and growth.

(b) Secured Pension (via annuity)

The annuity (which is irrevocable) must be paid at least annually, in advance or arrears and can be level or escalate in payment (as specified at outset). The annuity can be purchased with a **guarantee (of up to 10 years)** and may provide for a continuing annuity for a surviving spouse, civil partner or financial dependant.

There are two main options for drawing from a pension after age 75, as follows:

(c) Alternatively Secured Pension ("ASP")

"Income" (which is taxable as earned income) **must** be drawn from the residual fund at a **rate of 55-90%** per annum of the specified GAD rate at age 75. The fund, and therefore the level of income drawn, is reviewed annually.

As with USP, if the rate of withdrawal exceeds the rate of pension fund growth, the capital value of the residual fund will be eroded.

If ASP is entered into, there is no requirement to purchase an annuity (though an annuity can be purchased at any time using the ASP fund).

(d) Secured Pension

The annuity (which is irrevocable) must be paid at least annually, in advance or arrears and can be level or escalate in payment (as specified at outset). The annuity can be purchased with a **guarantee (of up to 10 years)** - and may provide for a continuing annuity for a surviving spouse, civil partner or financial dependant. An annuity purchased by a dependant from inherited USP or ASP funds cannot include a guarantee.

If you would like our advice on any of the matters in this bulletin, please contact Nick Fletcher, Managing Director, at nick.fletcher@saunderson-house.co.uk or on 0207 315 6504 (direct), who will either help you personally or guide you to an appropriate adviser.

When choosing to draw from a pension, it is important to consider the death benefits associated with each of the options, summarised as follows (all references to a spouse include civil partners):

(i) Unvested

Upon the death of the pension scheme member, the entire value of the unvested fund can be passed to beneficiaries with no tax charge (subject to not exceeding the lifetime allowance, where applicable).

In addition, inheritance tax will not normally apply to the death benefits when the funds are written into the appropriate trust (as the James Hay SIPP is).

(iii) ASP

A surviving spouse can continue to draw an “income” from the ASP funds, either as continued withdrawal or through the purchase of an annuity.

On the spouse’s subsequent death, or where no surviving spouse or dependent beneficiary exists, the funds are passed to charity. Payments to a beneficiary’s pension fund, if made, would be classified as unauthorised payments and subject to tax in excess of 80%.

(ii) USP

The surviving spouse or other beneficiary can receive the funds as a lump sum after a 35% tax charge (the funds then form part of the spouse’s/beneficiary’s estate).

Alternatively a spouse or financial dependant until age 23 (or later if disabled) can continue to draw “income” from the pension fund. If the recipient then dies before age 75, the funds can be passed to a beneficiary after a 35% tax charge and inheritance tax.

If the spouse survives to 75, either an annuity or an ASP must be purchased, the death benefits from which are described in (iii) and (iv).

(iv) Annuity

Other than any guarantee period or spouse’s pension purchased at the outset, there are no death benefits paid and the residual “funds” will be retained by the provider.

A guaranteed period can reduce the risk of “capital loss” in the event of the policy holder’s death.

Advantages of vesting

- It secures the PCLS outside of the restrictive pension environment. Some investors have expressed concern that the tax free PCLS facility may be removed.
- The PCLS and any income drawn from the pension can be gifted to beneficiaries, reducing the value of the investor’s estate and potentially the Inheritance Tax (“IHT”) liability. Any gifts made out of surplus income may be exempt from IHT under the normal expenditure out of income exemption.
- Drawing benefits before age 75 reduces the amount of pension fund remaining at age 75 that must be applied to either annuity purchase or ASP. Many investors consider annuity purchase unattractive, while the death benefits for funds in ASP are now more restrictive following the changes announced in the December 2006 Pre Budget Report.

Disadvantages of vesting

- Future income/growth on the PCLS and any income drawn from the pension may be subject to income/capital gains tax, though there are a number of tax efficient methods of investing outside of pensions.
- When the PCLS and income are drawn, if not gifted, they will form part of the investor’s estate for IHT purposes. If not vested, IHT will not normally apply on death before 75 if the pension is written under the correct trust or left to a surviving spouse.
- The residue of the vested fund is subject to a 35% tax charge if paid out as a lump sum on death before age 75 (though a surviving spouse or financial dependant does not have to receive the residue of the vested fund as a lump sum).

It is important to note that the value of many investments and the income derived can fall as well as rise. Few investments are guaranteed and you may not get back the amount you originally invested. Past performance is not a guide to the future. All taxation is based on our current understanding of the law, which may be subject to change in the future. For Unsecured or Alternatively Secured Pension policies you should note the following: High income withdrawals may not be sustainable during the (annuity) deferral period. Taking withdrawals may erode the capital value of the fund, especially if investment returns are poor and a high level of income is being taken. This could result in a lower income if and when an annuity is eventually purchased. Annuity rates may be at a worse level if and when the annuity purchase takes place than are available now or indicated in any illustration. A certain investment return is required simply to “keep pace” with an annuity, because an Unsecured/Alternatively Secured Pension withdrawal fund does not receive a benefit from the early death of other pensioners, as does an annuity. This lack of subsidy possibly requires a return of 1-2% per annum above that which could be obtained from the medium-long dated gilt investments on which annuity rates are based. This effect is known as mortality drag. Even if investment returns are strong, there is a possibility of the future income reducing if there is a significant decline in the factors affecting the GAD rate. These factors are the yield on medium-long dated gilts and mortality rates. If the purpose of the Unsecured or Alternatively Secured Pension is to “beat the annuity rate” (attempt to purchase an annuity when rates are higher whilst also maintaining the overall level of income that could have been provided through annuity purchase), investment in (more risky) equities is necessary in order to simply overcome the effect of mortality drag; City forecasts are for equities to outperform gilt investments by only 2-3% per annum over the next few years, so the chances of “beating the annuity rate” are remote if this forecast is correct. If an annuity has not been purchased by age 75, the maximum income from an Alternatively Secured Pension after age 75 is significantly less than the maximum that applied before age 75 under an Unsecured Pension.