

Introduction

It used to be the case that the only option at retirement for those who were not members of final salary schemes was to buy a fixed annuity with their accumulated pension fund.

Since 1995 the options have broadened considerably, as new types of annuity have appeared and HM Revenue and Customs (HMRC) has allowed different ways in which income can be drawn from pension funds. The new simplified pension tax regime introduced on 6 April 2006 (A Day) further increased the choices available, although the Chancellor has already started to cut back on some of the options.

Anyone with a money purchase pension arrangement, such as personal pension (PP), retirement annuity contract (RAC), small self-administered scheme (SSAS – now called investment regulated occupational pension scheme) or executive pension plan (EPP), now has a range of choices when they reach retirement.

These include:

- *Traditional annuities*, with either level or increasing payments.
- *Scheme pensions*, which are very similar to annuities but operated directly by the pension scheme. For money purchase arrangements scheme annuities are rare, but for final salary schemes they are the only option.
- *Investment-linked annuities*, under which payments depend on the performance of the underlying unit-linked or with profit fund.
- *Income drawdown*, which, as the name implies, involves withdrawals being made direct from the pension fund.
- *Short-term temporary annuities*, under which income is provided by systematically purchasing temporary annuities with terms of up to five years, the balance of the pension fund remaining invested.
- *Phased retirement*, which uses a mixture of tax-free cash and annuity payments or pension fund withdrawals to provide a tax-efficient income.
- *Alternatively secured pension*, which is a restricted form of income drawdown only available at age 75.

Each of these options has its advantages and disadvantages, which are examined in more detail below. There is invariably a trade-off between risk and return and between the level of income and death benefits. It is particularly important to make the choice on a holistic basis, ie to take account of the individual's complete financial and personal circumstances. For example, someone whose money purchase pension fund is to be their sole source of retirement income is much less able to accept investment risk than the person who has other sources of income, eg from earlier membership of a final salary pension scheme.

The complexities of this area of retirement planning are such that expert independent financial advice is virtually essential. In many instances it will be difficult for the layperson to obtain a full understanding of all their options now and in the future without the help of an independent financial adviser. The right retirement income decision is vital: if someone makes the wrong choice, they could end up regretting it for the next 30 years or more.

Tax-free cash

The first decision at retirement, before consideration of how income is to be taken, is whether to take tax-free cash (now referred to as the pension commencement lump sum by HMRC). Cash

can only be taken when income starts to be drawn (in whatever form) from a pension policy, even if the income level is nil. For anyone with a money purchase pension arrangement, the general principle is to draw the maximum tax-free cash. The simple logic behind this is that at the margin the income will normally be taxed, whereas the cash will be tax-free.

Cash does not disappear on death and, unlike pension income, it can be transferred between spouses as part of a tax-planning exercise. As a consequence, the cash can end up producing more net income than it would if it had been dealt with as part of the pension arrangement.

There are three main exceptions to the general principle of always drawing cash:

- If the individual will be a non-taxpayer in retirement, the tax freedom of cash will count for nothing, and maximising income is likely to be the most important factor.
- If the pension policy has guaranteed annuity rates (as many RAC policies issued before 1988 did), it may be better value to select a taxed annuity rather than the tax-free lump sum.
- Where phased retirement is chosen, the drawing of the tax-free cash takes place in stages and the cash is effectively used as income.

Traditional annuities

The traditional annuity is based on an investment in fixed interest securities, usually corporate bonds rather than gilts. Annuities can be level throughout life, rise at a fixed percentage each year or rise in line with the retail prices index (RPI). They can be used to provide income for just the pension fund owner or for the owner and their dependants.

Despite the other options now available, annuities remain the most popular way of converting a pension fund into retirement income. One reason for their continued primacy is that many pension funds are too small for the other options to be viable. The average annuity purchase price has been increasing recently because of new triviality rules introduced as part of pensions simplification. Nevertheless, the average remains under £30,000 and many annuity purchases are below £20,000. At these levels, maximising immediate income is usually vital, a role best suited to traditional annuities.

Annuity features

Traditional annuities come with a range of payment options, all of which generally have to be selected at outset. Under pensions tax simplification, the transfer of annuities in payment is now possible, subject to certain constraints. In practice a transfer is unlikely to be worthwhile because of the costs incurred, so the initial choice of annuity features and provider remains important.

The main annuity options are:

- **Frequency** – Annuities can be paid monthly, quarterly, half-yearly or yearly. Payments can start as soon as the annuity begins (in advance) or at the end of the frequency period (in arrear). For any given frequency, payments in advance mean a lower rate than payments in arrear. Most people opt for monthly annuity payments, as the pattern most closely follows earnings and outgoings. However, it can sometimes be worth considering different frequencies. For example, the closing year rules for the self-employed will often lead to a large income tax liability for the tax year when work ceases. If annuity payments are received during that year, they may all be taxed at a higher rate. It could therefore be wise to choose an in-arrear frequency that limits – or avoids any – payments in the final tax year of self-employment.
- **Increases in payment** – Some 80% of annuities are on a level basis, ie the gross income stays at the same amount throughout life. While level annuities maximise the initial income, their purchasing power is inevitably eroded by inflation. Even at an annual inflation

rate of 2.5%, purchasing power is reduced by a quarter every 12 years. An alternative is to arrange an annuity that increases, either at a predetermined rate or in line with inflation. Final salary occupational pension schemes must provide limited price indexation (LPI) pensions in respect of service since 6 April 1997. LPI pensions rise in line with inflation, up to a maximum of 5% each year for benefits accrued between 6 April 1997 and 5 April 2005 and 2.5% for benefits accrued thereafter. The LPI requirement was scrapped completely for money purchase occupational benefits, including EPPs, which started on or after 6 April 2005.

Similarly, contributions in respect of contracting out of the State Second Pension (S2P) and its predecessor, the State Earnings Related Pension Scheme (SERPS), under PPs and money purchase occupational schemes are no longer required to be applied to the purchase of escalating annuities but can fund level annuities instead. However, widow(er)'s benefits must still be bought by a married person. There are now no HMRC upper limits on escalation rates for pensions or annuities, although cost will normally mean that fixed increases above 5% are rare.

The main drawback to buying any form of increasing annuity is the initial reduction of income that has to be accepted. It can take many years before the rising income reaches what the level annuity would have provided (see example below).

Example – The cost of inflation protection

Anne is reaching retirement at age 60. After drawing her tax-free cash, she has £100,000 under her personal pension to spend on an annuity.

On the one hand she would like the maximum income, but on the other she has been told she will probably live for almost 30 years according to the actuarial statistics.

She is therefore uncertain whether to buy a level annuity or an inflation-linked annuity.

Her choice is between:

- Level pension £6,012 a year.
- RPI-linked pension £3,516 a year.

If inflation averages 2.5% a year:

- It will not be until her 88th birthday that the RPI-linked pension starts to exceed the level pension.
- She will have to survive almost another 18 years – until her 106th birthday – before the total payments under the RPI-linked annuity equal those of the level annuity.

Like many others before her, Anne may decide to buy the level annuity with the intention of saving some of the extra income it will initially provide. However, intentions do not always become realities!

Annuity Rates: Source FSA Comparative Tables, April 2009

- **Guarantees** – Annuity payments may be guaranteed to be payable, regardless of whether the pensioner is alive, for a period of up to ten years. If death occurs during the guarantee period, payments must continue to the nominated beneficiaries: there is now no option to commute payments under a new annuity for a lump sum. The cost of a guarantee – in

terms of a reduced annuity rate – rises with age and length of guarantee. However, in most cases it is relatively small. For example, for a man aged 65, adding a five-year guarantee reduces income by about 0.4%.

- **Annuity protection** – As an alternative to a pension guarantee, since A Day newly purchased annuities may incorporate annuity protection. Under this option, if death occurs before age 75 a lump sum is paid to the member’s estate equal to the difference (if any) between the annuity purchase price and the gross annuity instalments paid to the date of death. This lump sum is subject to a flat 35% tax charge.

Example – Annuity protection

Three months after his 69th birthday, Sid uses his £400,000 pension fund to buy a lifetime annuity with annuity protection. This provides him with a gross income of £34,000, payable yearly in advance. Two months before his 75th birthday, Sid dies. Under annuity protection, the lump sum payment will be:

Purchase price of annuity	£400,000
Less total gross income received	(£204,000)
Gross lump sum death benefit	£196,000
Less tax at 35%	(£68,600)
Net lump sum	£127,400

If Sid had died three months later, after his 75th birthday, no lump sum would have been due.

- **Dependants’ pensions** – It will normally be possible to purchase an annuity for a financial dependant at the same time as the annuity for the pension policyholder. As a general rule, there is no limit on the size of dependants’ pensions. There is no need for the dependant to be married to, or be a civil partner of, the member. However, for unmarried or same sex couples, there must be some element of financial dependency.

Annuity rates

The actuaries at life insurance companies are responsible for the calculation of annuity rates. They take account of the yields available on long-term fixed interest securities and anticipated life expectancy, as well as payment frequency and guarantees. At any one time, the annuity market tends to be dominated by about half a dozen companies that compete fiercely for business. Many other companies quote annuity rates simply because they are obliged to do so for existing policyholders (see page 5, “Open market option”). The competing companies keep their annuity rates under constant review, with the result that ‘league tables’ for annuity rates can and do change from day to day in response to small changes in interest rates.

Since the start of the 1990s, annuity rates have fallen dramatically, as long-term interest rates have declined and life expectancy has improved. In 1991, a man aged 65 could expect to receive an annuity rate of about 13.3% if he chose a level monthly pension. As at March 2009, the corresponding figure was 7.1%. The dramatic fall in rates has prompted many journalists and some politicians to say that annuities are now poor value for money. At the least, such criticism is simplistic.

Annuity rates reflect their underlying components, so if interest rates fall and pensioners live longer, it is inevitable that rates will be lower. The high interest rates of the 1980s and early 1990s were the result of much higher rates of inflation than now. So while the old annuity started at a

higher level, its purchasing power fell rapidly. For example, between January 1980 and January 1990 the buying power of a fixed annuity fell by 48%.

While the leaders in the annuity market are limited in number, there is generally no consistency between them. A company that is quoting the best level annuity rate for a man aged 65 May not even be in the top five for index-linked annuities payable to women of the same age.

Specimen annuity rates – April 2009

Age	Men		Women	
	Level	Inflation-linked	Level	Inflation-linked
	%	%	%	%
55	5.84	3.29	5.61	3.06
60	6.34	3.86	6.02	3.53
65	7.07	4.61	6.62	4.16
70	8.10	5.66	7.46	5.02

Source: FSA Comparative Tables, April 2009

Open market option

Virtually all money purchase pension plans give the policyholder the right to buy an annuity from any authorised insurance company. This feature, known as the open market option, is valuable because many companies that provide pension plans do not compete in the annuity market. Insurance companies are obliged to quote a pension annuity if they offer a pension contract, even though they may not be interested in the business. According to the Association of British Insurers (ABI), about two-thirds of policyholders buy the annuity their pension provider offers, but two in three also seek advice before deciding what to buy.

Since September 2002, the Financial Services Authority (FSA) has required insurers to bring the open market option to the personal pension and retirement annuity policyholder's attention. They are now also required to give details of annuity options (eg escalation) for money purchase occupational schemes. The difference the open market option can make is significant. For example, for a woman aged 65, the most competitive company in April 2009 was quoting an annuity rate more than 28% higher than the eighth most competitive – and there would be many companies with lower league positions. Industry figures suggest that using the open market option could increase income by up to 30%.

Enhanced/impaired life annuities

Until the late 1990s, it was rare for insurance companies to consider the health of the annuity buyer when setting rates. Annuities contain an inherent cross-subsidy between those who die earlier than average and those who outlive the norm, and little was done to disturb this. The problem was – and is – that if those in poor health were given better annuity rates to reflect their shorter lifespan, annuity rates for the remainder would have to fall correspondingly, as an element of cross-subsidy would be lost.

Nevertheless, competition has encouraged a growing number of insurance companies to offer enhanced annuity rates for people with reduced life expectancies. For example, some companies offer smokers more attractive rates, while one insurer gives better rates to blue collar workers. A handful of companies will provide individually underwritten impaired life annuities for individuals with serious health problems, potentially doubling the amount of income payable.

About 25% of annuities are now written on impaired or enhanced rates. However, enhanced and impaired life annuities do not always produce the highest income: a company at the top of the

league tables may offer a better standard annuity rate than an enhanced/impaired life rate from a less competitive company.

The increased availability and take-up of enhanced/impaired annuities has two important consequences:

- It puts downward pressure on annuity rates for 'healthy' lives.
- It increases the attractiveness of using strategies such as income withdrawal, which defer the purchase of an annuity, possibly until a point at which enhanced/impaired annuities are available.

Investment-linked annuities

In the 1990s, falling annuity rates encouraged the development of investment-linked annuities. These have similar features to the traditional annuity in terms of payment frequency and guarantee, but the way in which the income is provided is fundamentally different.

Investment-linked annuities fall into two basic types: with profit and unit-linked. With profit initially proved by far the more popular, although much of the innovation has been on the unit-linked front.

With profit annuities

At one time, with profit annuities seemed to be the answer to declining conventional annuity rates, and in 2000, 20% of the annuity market was with profit. However, the popularity of with profit annuities has dropped significantly because of the Equitable Life debacle and the effect that three years of negative stock market returns from 2000 onwards had on bonus rates.

Most with profit annuities operate on the same principle:

- At outset, the annuity purchaser has to decide on how much future bonuses are to be anticipated in setting their initial annuity rate. The upper limit, set by legislation, is 5%. At 5%, the with profit annuity rate is currently about 20% higher than the traditional level annuity rate for a male aged 65. The lower limit is 0%, ie no bonus at all is anticipated. The higher the assumed bonus rate (ABR), the greater the initial annuity payment. An ABR of about 3% will match current annuity rates. The flip side is that the more return that is anticipated, the less scope there is for future increases in the annuity payment. A high ABR also increases the risk that payments will fall because actual bonus rates are less than assumed, as recent years have shown.
- Each year, the annuity provider declares a bonus. This will usually be in two components: an annual bonus, which is reflected in all future payments, and an additional or terminal bonus, which applies only for that year. The additional bonus will normally be based on the duration of the policy, so the longer a policy is in force, the greater the bonus declared in any one year.
- There may be a guarantee that the annuity payment cannot fall below a certain level, which is typically what would have been payable at outset with an ABR of 0%. However, guarantees are not universal, and some providers do no more than promise that income cannot fall by more than a maximum amount in any one year.
- Most of these annuity policies have options that allow the ABR to be varied or the annuity to be switched from a with profit basis to a traditional conventional annuity. This flexibility can be useful, because the appetite for investment risk generally falls with age. The switch to a fixed annuity may, for example, take place when the dependant's pension begins.

Example – With profit annuities in practice

In March 2008, James chose a with profit annuity with an ABR of 5%. His basic annuity income in the first year was fixed at £10,000.

At the end of the policy's first year, the insurer declared an annual bonus of 4% and an additional bonus of 2%. His second year's income is calculated as:

$$\text{Basic annuity} \times ((1 + \text{annual bonus}) \times (1 + \text{additional bonus})) / (1 + \text{assumed bonus})$$
$$= £10,000 \times ((1 + .04) \times (1 + .02)) / (1 + .05) = £10,103.$$

If the same bonus rates are declared at the end of the second year, the calculation will become:

$$£10,000 \times (1.040 \times 1.040 \times 1.02) / (1.05 \times 1.05) = £10,007.$$

The income will have fallen, even though the total bonus rate was 6%, because the additional bonus declared at the end of the first year was a one-off payment and did not increase the basic annuity on which bonuses were declared in the following year.

Unit-linked annuities

Unit-linked annuities operate on a similar principle to with profit annuities. Instead of an ABR, the annuity purchaser makes an assumption about the future rate of investment return – up to a maximum of 5%. Again, the higher the assumption, the less scope for increased income and the greater the risk of a fall.

Once the investment return is assumed, this sets the number of units in the chosen funds to be cashed in future to provide income. There will normally be a wide choice of funds. One company even allows annuity purchasers to operate a self-managed fund until they reach the age of 75. Unless the fund is guaranteed (which will limit performance), there is a risk that the unit price will fall, with the inevitable consequence for income. For example, people who started their unit-linked annuity with an investment in a UK equity fund at the turn of the millennium would now have income around 35% below the 2000 level, even if they had assumed a nil investment return. Initially they would have experienced a sharp decline in income, which began to reverse when the UK market started to recover in 2003, only to fall again as the credit crunch took hold in 2008.

The quid pro quo for the downside risk is that strong investment performance could boost income dramatically. There is no limit on the amount that can be paid, thanks to changes introduced by pensions simplification.

Unit-linked annuities have not proved popular because of that downside risk to income. In theory, a with profit annuity reduces that risk by smoothing returns, although as some people have discovered over recent years, the risk is still there.

Income drawdown

Income drawdown, or pension fund withdrawal as it is sometimes called, first came to the fore in 1995 when it was introduced as an option for PPs. Since then it has become widely available, to the point where it now accounts for about a fifth of the funds invested at retirement.

In theory the income drawdown facility is available for all money purchase occupational schemes, including EPPs, deferred annuity plans (formerly section 32 buy out bonds) and investment regulated occupational pension schemes (formerly known as SSASs). In practice very few occupational schemes other than SSASs and some recent deferred annuity plans offer income

drawdown. Anyone with benefits under occupational schemes wanting to use drawdown will often be advised to transfer to a personal pension, provided that the transfer does not result in an unacceptable reduction in any tax-free cash rights that are subject to transitional protection.

SSAs are more commonly used for income drawdown because the approach can avoid the forced sale of illiquid investments (eg property).

Personal pension drawdown in operation

As its name suggests, income drawdown involves withdrawing income directly from the pension fund. Usually the income drawdown plan is a self-invested personal pension (SIPP) to which the value of all the individual's existing policies is transferred at retirement. Some insurance company plans without a self-invested framework do permit income withdrawal, but most advisers favour the SIPP approach to give maximum future investment flexibility without the need to change plan providers (or the cost of doing so).

Tax-free cash can be drawn from each part of the plan used to provide benefits, but only when the withdrawal process starts for that part. The old process by which plans were segmented into 10,000 identical arrangements is no longer common following pensions simplification. Strictly speaking it is not possible to take cash and defer withdrawals, but since A Day there has been no minimum withdrawal, so the same result can be achieved. This feature could be particularly useful for someone who wishes to draw cash from their pension fund to clear debts (eg a mortgage) but does not require any immediate income.

The maximum tax-free cash is 25% of the value of the arrangement. The maximum initial level of income is determined from tables produced for HMRC by the Government Actuaries Department (GAD). The rates in the tables are based on the age (minimum 50, maximum 75) and sex of the individual, and the yield on 15-year government securities. Once set, for each of the following five years income can be drawn at any level up to a maximum of 120% of the HMRC rate (see example). Thereafter the process is repeated every five years, with a quinquennial review using the then current fund value, age and interest rate to establish the maximum withdrawal. However, legislation in the Finance Act 2007 now allows pension planholders to initiate interim reviews, subject to the consent of their scheme administrators.

If further parts of a plan are drawn upon, an annuity is purchased or a pension sharing order is made, the level of maximum withdrawal is recalculated for the balance of the five-year review period. Drawing upon further parts of the plan does not automatically mean the maximum withdrawal will increase – it depends on fund values and prevailing interest rates.

When age 75 is reached, an annuity must be purchased, or drawdown can continue in the form of alternatively secured pension (see page 12, "Alternatively secured pension"). There is nothing to prevent an annuity being bought earlier than age 75.

Example – Income withdrawal limit

After drawing his tax-free cash, Matthew has a £250,000 fund. He is aged 58 and the prevailing 15-year gilt yield is 3.75%. The notional annuity rate from the HMRC tables is 5.6%. For the next five years, he can draw a maximum income each year of:

$£250,000 @ 5.6\% \times 120\% = £16,800.$

There is no minimum level of withdrawal – Matthew need take no income after drawing his cash.

The maximum income withdrawal level is generally about 20% higher than the income available from a league-topping monthly annuity. It is normally not advisable to draw the maximum amount and if this is necessary from an income viewpoint, then in most instances an annuity would be more suitable.

Unlike an annuity, under income withdrawal there is no cross-subsidy between survivors (who continue to receive annuity payments) and the dead, who receive no death benefit.

Two consequences stem from this:

- Death benefits are superior under income withdrawal.
- The investment return achieved by the income withdrawal funds must be enough to make up for the loss of the mortality subsidy (which increases with age).

Investment returns also have to support higher costs than apply to an annuity, so overall the rate of return to match an annuity may be 2%–3% more than the performance of the fixed interest securities underlying an annuity. To achieve this higher return it will normally be necessary to invest in real assets, eg equities or property. Clearly this implies risk.

The experience to date of income withdrawals has underlined the risk in this approach. Because interest rates fell rapidly between 1995 and 1998, in the first three years of drawdown investments underpinning income withdrawal plans had to achieve a return of about 19% a year to give the same results as buying an annuity. Very few plans did this, not least because many were linked to with profit funds, which could not grow fast enough.

As a result, many of those taking withdrawals at or close to the maximum level suffered a reduction in income when their plans were first reviewed in 1998. In the following three years poor equity market performance caused problems, again leaving many people with a reduction in income. Although stock market performance picked up from the 2003 lows, it was a similar story when the following reviews took place in July 2004. Things were better in 2007, thanks to better market conditions.

A small number of providers are now offering income drawdown plans that incorporate some form of income guarantee. This typically used to be set at around 5% of the fund value when withdrawals begin. However, following the turbulence in investment markets, the typical guarantee is now around 3.5%. These plans offer an interesting halfway house between the conventional annuity and the traditional drawdown structure, but the charges for the guarantee are relatively high.

Death benefits

One of the major factors in favour of income withdrawals is the death benefits available before (at the latest) age 75. All of the fund remaining at death can be used to provide:

- Further income withdrawals for dependants until their 75th birthday.
- Dependants' annuities.
- A dependant's alternatively secured pension if the dependant is aged 75 or over.
- A lump sum, subject to a tax charge of 35%.

These options can be combined, so a dependant could choose a mix of taxed lump sum and taxable income. As a general rule, it is possible to arrange at outset for the lump sum on death to be paid via a trust, which will normally be free of inheritance tax (IHT).

Occupational income drawdown

Income drawdown from occupational pension plans, such as EPPs, deferred annuity plans and investment regulated occupational pension schemes, now operates in the same way as personal pensions. However, before pensions simplification a different, less advantageous set of rules applied to occupational scheme drawdown. As a result, many schemes did not and still do not incorporate the feature.

Income drawdown practicalities

Income withdrawal is not for the unsophisticated.

Most advisers would agree that income withdrawal:

- Is not worthwhile where less than £100,000 remains after tax-free cash is drawn. Some advisers put this figure at £250,000. The average drawdown investment is around £100,000 according to the ABI.
- Is not suitable for those who will be largely or wholly dependent on withdrawals for their retirement income. Even if one of the guaranteed drawdown versions is chosen, an annuity would provide a higher initial income. The experience since 1995 underlines the need for other sources of income that can be accessed if necessary where no guarantees are incorporated in the drawdown plan.
- Is normally inappropriate where the maximum level of income is taken. Unless death benefits are particularly important – eg because of poor health – there is too great a risk that future income might have to be reduced at review.
- Is unsuitable for cautious investors and those who do not like investment risk. An income withdrawal plan based on ‘safe’ investments, such as cash funds, is most unlikely to produce the necessary returns to match an annuity.
- Should not be run to the maximum age (ie 75) unless there is a definite intention to subsequently opt for an alternatively secured pension. The mortality cross-subsidy in annuities rises with age, so the closer to 75, the greater must be the investment fund performance under income withdrawal. However, this point is less crucial where there would be a dependant’s income payable.
- Needs to be subject to annual reviews once it is set up.

While in theory income drawdown can be used for contracted-out benefits, in practice this is less common.

Short-term temporary annuities

Pensions simplification introduced an alternative to income drawdown, based on a series of temporary annuities. The structure echoed a plan that had been offered for a number of years by one – and only one – insurance company.

At outset, once tax-free cash has been drawn, part of the remaining fund is used to buy a temporary annuity, with a maximum term of five years. The annuity income cannot exceed the income withdrawal limit, ie 120% of the relevant HMRC rate. When the annuity expires, the process is repeated, although no annuity can be purchased that runs beyond age 75. The death benefits on the residual fund are the same as for income withdrawal, while the temporary annuity may be guaranteed for the whole of its term.

Phased retirement

The concept of phased retirement pre-dates income withdrawals and is similar in some ways. Like income drawdown, phased retirement normally involves a transfer to a SIPP at outset, although it is possible for any money purchase scheme to provide the benefit.

Phased retirement in operation

The concept of phased retirement is relatively simple. In the first year, part of the pension arrangement is 'crystallised', ie used to provide net 'income'. This consists of a combination of:

- Tax-free cash (25% of the crystallised fund), plus
- Net income from an annuity purchased with the balance of the fund.

In subsequent years (up until a maximum of age 75) the process is repeated after allowing for the income in payment from the previously purchased annuities. So, over time the proportion of net income represented by annuity payments increases, and the tax-free cash element reduces (see example below).

Phased retirement provides a tax-efficient way of funding retirement income, because at least in the early years the bulk of the 'income' is tax-free cash. However, as the example shows, the income taxable element increases over time. This also highlights a drawback of phased retirement: tax-free cash is not available as a single lump sum. Many of those reaching retirement look to the tax-free cash to fund a cruise, replace the company car or simply clear outstanding debt as earnings cease.

It is possible to vary income under phased retirement simply by altering the amount crystallised each year. The annuities already purchased will continue, regardless of the new amount crystallised. Like income withdrawal, phased retirement involves investment risk, as the bulk of the fund remains invested outside of the annuities. While the annuities that have been purchased benefit from the mortality subsidy, the portion of the fund that remains invested does not.

Example – Phased retirement

Jeremy is 65, a basic rate taxpayer and has a fund of £200,000. He wants to receive a net income of £7,500 a year using phased retirement.

On current annuity rates, he could achieve this in the following way:

Age	Fund vested	Net annuity	Tax-free cash	Cumulative net annuity
	£	£	£	£
65	25,564	1,109	6,391	1,109
66	21,885	920	5,471	2,029
67	18,580	826	4,645	2,855
68	15,712	717	3,928	3,572
69	13,235	619	3,309	4,191
70	11,083	538	2,771	4,729
71	9,226	464	2,307	5,193
72	7,636	463	1,909	5,591
73	6,271	341	1,568	5,932
74	5,121	288	1,280	6,220

In the first year, £25,564 worth of the fund is crystallised, of which £19,173 is used to buy an annuity of £1,386 gross, equal to £1,109 net of 20% tax.

The balance of £6,391 is drawn as tax-free cash.

The total net receipts are therefore £7,500. In the second year, £21,885 worth of the fund is crystallised. This provides tax-free cash (£5,471), with the balance (£16,414) used to buy an annuity of £1,150 gross, equal to £920 net of 20% tax.

As there is already £1,109 net from the annuity bought in year one, the total receipts are again £7,500.

At the age of 75, Jeremy will have a remaining fund of around £155,000, based on a 7% return before charges, which could buy him a final annuity of around £16,000 gross, £12,800 net (assuming basic rate tax of 20%) to add to his existing net annuity income of £6,220.

Death benefits

The death benefits under a phased retirement scheme for the non-protected rights element fall into two parts:

- For the arrangements that have not been crystallised, the full value of the fund is available to provide benefits. This can be paid as a lump sum with no 35% tax charge and, if an appropriate trust is established at outset, usually free of IHT.
- The death benefits under the annuities will depend upon the terms of the annuities, eg whether any guarantees or dependants' annuities were included.

The absence of a 35% tax charge will usually mean that phased retirement initially offers a higher lump sum death benefit than income drawdown. However, the advantage is gradually eroded as annuities are purchased, and in later years income drawdown might offer a larger lump sum despite the tax charge.

One way to obtain the best of both worlds is to use income drawdown as part of a phased retirement plan rather than annuity purchase. If this phased income withdrawal approach is used, death benefits are available from both the crystallised and uncrystallised parts of the pension plan. For the crystallised elements, the death benefits are as for alternatively secured pension, described on page 13, "Death benefits". However, phased income withdrawal adds a further layer of complexity to the operation of the scheme and removes any element of mortality cross-subsidy.

Phased retirement practicalities

Many of the same considerations regarding risk, minimum investment and regular reviews that apply to income drawdown also apply to phased retirement. However, there is a further point to note. The purchase of annuities needs to allow for any dependants' benefits. There is a danger otherwise that insufficient funds will be left unvested to purchase a widow(er)'s pension if death occurs after the phasing has been running for a long period.

Alternatively secured pension

Before the introduction of pensions simplification, an annuity had to be purchased by age 75 if a money purchase contract was being used for income drawdown or had not been crystallised. Simplification introduced a new option at age 75, the alternatively secured pension (ASP). The ASP was introduced because certain religious groups object to annuities on moral grounds. The Treasury made it clear that it did not see ASP as a means of estate planning for the pension rich.

In the Finance Act 2007, it introduced changes that significantly reduce the use of ASP in estate planning.

ASP is a form of income withdrawal under which:

- The maximum income is 90% of the appropriate HMRC rate, based on an age of 75.
- The minimum withdrawal is 55% of the appropriate HMRC rate, based on an age of 75.
- Reviews to set the maximum and minimum withdrawal levels must be undertaken yearly, but the HMRC rate used continues to be based on an age of 75, not the member's actual age.
- The income is taxable under PAYE on the recipient.

These restrictions aim to limit the possibility of exhausting a member's pension funds before death. In practice they could mean that the fund declines only slowly if relatively modest investment returns are achieved. For example, at the HMRC income drawdown interest rate for May 2009 (3.75%), the maximum ASP income is 8.55% of the fund for a man and 7.47% for a woman.

Death benefits

The death benefit regime that applied when ASP was introduced on A Day has been replaced by new, harsher rules in the Finance Act 2007. The death benefits under ASP are contingent upon whether the deceased member (who is, by definition, aged over 75) has any surviving dependants.

- If there are dependants, then the remaining fund must be used to provide dependants' pension benefits. No lump sum is payable. The dependants' benefits can take any of the usual forms. If a dependant's ASP is chosen then, on the dependant's death, the test is again whether there are any dependants of the member. If there are, then again pension benefits must be provided.
- If there are no dependants, there are currently two options provided for in legislation:
 - The transfer of alternatively secured rights, and/or
 - The charity lump sum death benefit.

The same two options apply to the remaining fund under ASP payable to a dependant if, when that dependant dies, there are no other dependants of the deceased member.

The transfer of alternatively secured rights

This transfer represents a transfer of the remaining ASP funds to a member (or members) of another pension arrangement (or other arrangements) within the deceased member's registered pension scheme. These would normally be other money purchase arrangements, but could in theory be defined benefit arrangements. There is no option to transfer monies to another scheme.

The recipient(s) can be nominated by the member or, if the member has made no nomination, a dependant in receipt of a dependant's ASP.

- If the nominated member is under age 75, then the transferred sum normally becomes uncrystallised funds for a money purchase arrangement.
- If the nominated member is over 75, then normally the transferred sum is immediately designated to provide ASP.
- In either case, the transfer is regarded as an unauthorised member payment and is liable to tax penalties totalling 70%, the bulk of which have to be met by the recipient from their

own resources, not the transferred fund. The tax penalty is levied in addition to an IHT charge.

Inheritance tax

The value of the alternatively secured rights transferred is treated as the top part of the deceased member's estate for IHT purposes, whether the transfer payment is made on the member's death or on the subsequent death of a dependant in receipt of an ASP dependant's pension. A special adjustment is made where, unusually, there is remaining nil-rate band of the member to set against the ASP fund either on the member's death or the subsequent death of a dependant.

The IHT calculations are made on the basis of the rates applying at the time the transfer occurs. The Finance Act 2007 deals with the interaction between the IHT tax charge and the tax penalties, the net result of which is that in most cases the overall tax chargeable will be 82% of the fund transferred. The IHT liability is met by the scheme administrator as a deduction from the amount transferred.

The overall tax treatment of ASP transfers is now very unattractive, as the example below shows. Alternative methods of estate planning may well be preferable, eg buying an annuity with the pension fund monies and using the income generated to fund a life policy placed under trust.

Example – Inheritance tax charge and unauthorised payment charges on transfer of alternatively secured rights

Bill dies in August 2009 with an estate of £600,000, an unused nil-rate band of £325,000 and remaining ASP funds of £200,000. He has no dependants and the ASP funds pass as a transfer of alternatively secured rights to Bill's nominated beneficiary, his niece June.

As Bill has a non-pensions estate exceeding his nil-rate band, the ASP fund is fully liable to 40% IHT. Assuming that the IHT charge is payable first, the tax paid by June and the scheme administrator is as shown below:

	£
ASP fund	200,000
IHT scheme (40%)	(80,000)
Net of IHT fund	120,000
Unauthorised payment charges:	
June (55%)	(66,000)
Scheme (15%)	(18,000)
Net fund transferred	102,000

- The total tax charge is £164,000, ie 82% of the £200,000 available for transfer.
- Of this, June has to find £66,000 personally.
- If June is a high earner, she could be worse off than if she paid a gross personal contribution to a pension of £66,000 and received 40% tax relief.

The charity lump sum death benefit

The scheme administrator can also nominate a charity, but only if:

- The member has not nominated a charity, and
- Any dependant in receipt of a dependant's ASP has not nominated a charity in respect of their fund.

As charitable gifts are generally exempt from IHT, payment of the charity lump sum death benefit does not give rise to an IHT liability. ASP therefore remains a useful option if the aim is to pass the remaining pension fund to a charity on death.

Conclusion

How to deal with accumulated pension funds at retirement is a complex issue. The choices involve many difficult and sometimes conflicting options. However, with life expectancies continuing to increase, the decision is an important one that rewards careful examination. In this instance, accepting the first offer – the annuity from your pension plan provider – will almost always be the wrong thing to do.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2009, which are subject to change.