



What are my options at retirement?

This is a question that we are regularly asked by our clients. With these notes we hope to be able to explain some of the most common options available to you as you approach retirement and which need to be considered before you take your retirement benefits. The notes do not apply to you if you are in a “final salary” pension scheme.

TAX FREE CASH

Generally speaking, if you are looking for maximum income it is better to take the maximum tax free cash from a money purchase pension plan and to take no tax free cash from a final salary pension fund. However, what you decide to do will depend upon both your individual circumstances and the plan arrangements. You need to consider these along with your personal and family goals in retirement.

These notes refer just to money purchase pension plans which fall into two types:

- **Personal Pensions including Self Invested Personal Pensions (SIPPs)**
Usually a personal pension fund carries the option to commute 25% of the fund as a tax free lump sum. Personal pension buy out plans ("section 32 policies") and draw down schemes from company pension arrangements will usually follow the rules of their original company pension schemes although they may well generate 25% tax free cash if this is more generous than the original rules permitted.
- **Company Pension Plans**
Again tax free cash will usually be 25% of the value of your pension plan. Some people will benefit from a greater percentage of protected tax free cash and this is because they may have been in their company pension scheme before the rules were last changed.

SCHEME PENSIONS

These are pensions provided by a final salary itself or by an insurance company nominated by the scheme administrator and are like a traditional pension annuity mentioned below.

LIFETIME ANNUITIES

With a traditional annuity the annuitant (person receiving the pension) gives cash to an insurance company in exchange for a guaranteed income for the rest of their life. Once the annuitant dies, the income ceases and the insurance company keeps the balance of the initial investment.

The problem with annuities is that in the recent past the rates offered have been dropping. This is due in part to the poor investment returns received by providers and also to the increase in life expectancy as a result of healthier living and improved medical outcomes.

The main types of annuity are

- **Single Life**
This type of pension is paid for the annuitant's life alone. If the annuitant dies one month after starting the pension, the annuity ceases and the insurance company pockets the cash. On the other hand, if the annuitant lives to well over 100 the insurance company will keep paying until the annuitant dies.
- **Joint Life**
This is a pension paid to a couple (e.g. husband and wife, civil partners or an unmarried couple) throughout their joint lives and until the last one of them dies.
- **Reversionary Annuity**
This is often referred to as a "joint life/last survivor" annuity. With a reversionary annuity the pension is payable in full for the lifetime of the annuitant and then on their death a reduced pension will be payable to their dependant. Typically the annuity reduces by 1/3 or 1/2 on the annuitant's death and will be paid for the remainder of the dependant's life.

Some special terms can be applied to all annuities, but they come at a cost. The most common are:

Guarantee Period

A guarantee period can be established with an annuity (typically five or ten years). For example, with a five year guarantee, if the annuitant dies after 12 months' payments have been made, their estate receives the value of a further 48 payments. At the end of the guarantee period no further payments are made.

Level

This type of annuity provides the highest annuity rate, but the income remains level (fixed) for the rest of the annuitant's life. Whilst it provides a high initial income, the value in real terms will be eroded by inflation.

Fixed Escalation

Escalation can be built into an annuity, typically at 3% or 5% pa.

RPI Escalation

As the name suggests, the pension increases each year in line with RPI. It is not currently possible to obtain escalation by the Average Earnings Index (AEI) which is, of course, the real level necessary to maintain the earning power of a pension.

LPI Escalation

LPI stands for Limited Prices Increase. This is an increase in the pension by RPI, but with a cap of (usually) 5% pa maximum. In this way the insurers know that their risks are reduced if high inflation returns.

With Profit or Equity Escalation

With this type of escalation the basic principle is that the annuity will increase if the insurance company's investments outperform agreed parameters. If the pension funds grow at more than the agreed rate in any year then the annuitant will get a higher pension. If the funds grow at less than the agreed rate then the pension may fall.

OPEN MARKET OPTION (OMO)

When you are approaching retirement, your pension provider will write to you with details about your pension fund, its value and how you can use it to buy an annuity. In the past annuities were purchased from the pension provider, but more recently it has become possible to shop around and approach other annuity providers to get the best deal, known as the Open Market Option.

The majority of people still don't use the OMO because they don't know they can or don't realise the benefits of doing so. Those who don't use the OMO and settle for the deal offered by their pension provider may be missing out on up to 40% more income from one offered by another annuity provider. One of the main reasons that people can get more from an annuity, if they shop around, is that they may qualify for what is known as an Enhanced Annuity (sometimes known as an Impaired Life Annuity) which pays a higher income to people who smoke and people who suffer from a range of health conditions - anything from asthma to a serious heart condition. Some companies offer higher rates to people who have followed certain occupations or people who live in certain parts of the country.

It is especially important to undertake this research before purchasing an annuity as you cannot change your annuity once it has been purchased.

INCOME DRAWDOWN (IDD) OR UNSECURED PENSION

As an alternative to using your accumulated pension fund to purchase a conventional annuity, it is possible to purchase an 'unsecured pension' (previously known as 'drawdown'). This income can continue until age 75 at which time you can either purchase an annuity or maintain your income in the form of an Alternatively Secured Pension (ASP). Unsecured income must cease by the age of 75 and the level can be set between zero and a maximum which is the equivalent of 120% of the Government Actuary's rate for a person age 75 years. Unsecured pensions must be actuarially reviewed every five years when the income payable will also be reviewed.

The sum that is drawn down is taxed in the same way as an annuity, i.e. as income. The balance of the fund remains invested in a tax efficient environment and will ultimately be available to your dependants should you die before 75. The fund can be used to provide an income to a dependant either by purchase of an annuity or by continuation of an income drawdown plan. If income is not taken in this way, there is a 35% tax charge on the pension fund with the balance then being transferred to your beneficiaries, but outside of your estate.

The expenses associated with a draw down scheme will be higher, because of ongoing management and monitoring, and it is a generally held view that under normal circumstances they are best suited to pension funds of £100k or more. Unlike a purchased annuity where the future income level is certain, there is no guarantee that the fund remaining will grow sufficiently in the future to maintain the level of income required.

ATHIRD WAY?

In recent times a 'third option' has been developed, positioned between annuities and drawdown pensions, and sometimes called variable annuities. They are becoming more widely available and are offered by pension providers as unit-linked pension products with a guaranteed minimum income for life. They look like a traditional annuity but, with the guarantee, the level of income you can receive increases in line with the performance of the underlying investment fund. Although they look like an annuity they are technically classed under the pension rules affecting Unsecured Pensions ("Drawdown") and this is attractive because it means that there is a fund still available to pass to your dependants or beneficiaries in the event of your early death.

Like IDD, a third way pension is reviewed every five years and at age 75 you would need to purchase a conventional annuity or set up an alternatively secured pension.

ALTERNATIVELY SECURED PENSION (ASP)

If you choose to enter into this sort of arrangement at 75 then you must take between 55% and 90% of the Government Actuary's rate for a 75 year old. The limits are reviewed every year but always relate to a 75 year old person no matter what age you might be. On your death, benefits will continue to be paid to any dependants that you might have and in the event of you having no dependants then the remaining fund can be passed to a charity of your choice completely free of tax. If you have made no charity nomination then the fund will pass to the beneficiaries of your estate after the deduction of taxes. If inheritance tax is payable on your estate then these combined charges could be as high as 82%.

And finally some other points to note.

Trivial Benefits

If the value of all your pension benefits is less than 1% of the Lifetime Allowance (LTA), £1,800,000 in 2010/11, the benefits can be commuted for a lump sum. 25% of the lump sum will be tax free and, 75% will be taxed as earned income.

Protected Rights

Protected rights funds can also choose from all the new alternative pension options including commutation for cash, and they can also be placed into a Self Invested Pension Plan.

June 2010 Budget

The Government has recently announced that it intends to introduce new legislation to abolish the requirement to purchase an annuity at age 75 and that this is likely to be introduced from 2011-12. In the meantime, to help those approaching their 75th birthday, the age at which an annuity must be purchased has been increased from 75 to 77 with immediate effect. It is hoped that the taxes and charges when transferring pension benefits will also be reviewed.

Please be aware that whilst every effort has been made to ensure that the information contained within these notes is correct, they are necessarily brief and of a generalised nature. Sense Financial Solutions is happy to provide you with specific personalised advice prior to you finalising any arrangements.