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News letter
1-6-2013

Flexible Drawdown Pensions

Introduction

Drawdown has been an alternative to annuity purchase since 1995 when it was introduced for personal pensions. In 1999 the facility was permitted under defined contribution occupational schemes however in practice only a relatively small number of schemes offered this and individuals still tended to transfer to personal pensions for added flexibility.
Where drawdown was provided at this time, there were different rules for personal and occupational schemes which continued until they were harmonised from 6 April 2006 (also know as A day or pension simplification). Pensions simplification brought with it one set of rules for drawdown for all defined contribution schemes. However there were two different forms of drawdown:

1. unsecured pensions (USP) for individuals up to the age of 75 and
2. alternatively secured pension (ASP) from age 75 onwards.

These rules didn’t stay with us for very long and were replaced on 6 April 2011 by drawdown pensions. Again two different forms of drawdown were introduced:

1. capped drawdown and
2. flexible drawdown.

Then in March 2013 the rules changed again, albeit in a relatively small way.

What is drawdown?

Drawdown occurs where the individual’s pension fund remains invested and they draw income from it, as and when required. It’s an alternative to purchasing a lifetime annuity whereby the pension fund, and therefore control of it, is given to an annuity provider in exchange for a regular, usually fixed, income for life. There are various forms of lifetime annuity and increasingly a range of products that operate under the drawdown pension rules but combine features of both drawdown and annuities.

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<u>What is a capped drawdown pension?</u>

A capped drawdown pension is a way for an individual to take benefits from their pension fund while it remains invested. To take a drawdown pension, an individual must usually have reached the normal minimum pension age, currently 55, though drawdown pensions can also be provided to dependants from any age and can be paid to those who are permitted to retire before the normal minimum pension age. This could be on the grounds of ill health for example or where an individual has a protected pension age. <u>There is no upper age limit for capped drawdown pensions.</u>

There is a limit on the amount of income that can be taken from a capped drawdown pension fund each year. This limit is set by HM Revenue & Customs (HMRC). The maximum is currently 120% of the basis amount and there is no minimum amount that must be taken. Before 26 March 2013 the maximum was 100% of the basis amount, which brought the income available from drawdown pensions and lifetime annuities to a similar level (based on single life, level annuities). However prior to 6 April 2011 the maximum had been 120% and many individuals found themselves facing significant drops in their income at their income review due to falling gilt yields and poor investment returns prompting the Government to move the maximum back up to 120%.

The maximum income must be recalculated at least every three years before the age of 75 and every year after that.

<u>How is a drawdown pension measured against the lifetime allowance?</u>

When benefits are crystallised or ódesignatedô into drawdown this is a benefit crystallisation event (BCE). At this point the value of the benefits being taken must be tested against the memberôs available lifetime allowance. This is a simple calculation using the amount being crystallised. Any pension commencement lump sum (PCLS) is also tested against the lifetime allowance. As an example, if £300,000 is crystallised providing a PCLS of £75,000 and a pension drawdown fund of £225,000 this would use up 20% of the standard lifetime allowance of £1,500,000 (2012/13 and 2013/14). The lifetime allowance is reducing to £1,250,000 in 2014/15.

Note that benefits have to be tested again where the funds in drawdown are used to purchase an annuity or at age 75 whichever is sooner.

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How are the limits worked out for capped drawdown?

HMRC sets the limit on the amount of income that can be drawn and when the limits must be recalculated; the idea being that the fund does not become exhausted too quickly. As mentioned earlier there is no minimum amount of income that must be taken and this has proved popular as many people like the idea of taking a lump sum early in retirement but donǫt necessarily have need for an income.

The maximum amount is 120% of the basis amount. The basis amount is worked out by dividing the drawdown pension fund by £1,000 and then multiplying the result by the appropriate rate per thousand from the appropriate GAD table (there are tables for those 23 and over and those under the age of 23). The rate takes into account the individualǫs age and gilt yield from the 15th day of the previous month (or earlier working day) rounded down to the next 0.25%.

Example

Iain is age 60 and has decided to use his pension fund of £400,000 for drawdown. After taking the maximum PCLS he is left with £300,000 to provide him with income.

Based on his age and assuming the gilt yield is 3.0% the basis amount from the GAD tables is £53 for each £1,000 of fund. This means the basis amount for Iainǫs £300,000 is £15,900 [(£300,000/£1,000) x £53] and a maximum income of £19,080 [£15,900 x 1.2].

Drawdown terminology What are pension years and reference periods?

The maximum level of income that can be drawn from a drawdown pension fund applies for a 12 month period starting from the date the fund is designated for drawdown. The same maximum applies in subsequent 12 month periods until a review is required.

Each 12 month period is called a ópension yearô - pension years donǫt change (apart from one exception for those at age 75 with multiple review dates within their scheme).

Each series of three pension years is called a óreference periodô ï reference periods only change where the member requests an earlier review.

Peter designates £200,000 for drawdown on 3 October 2012
His first reference period comprises of:
ää3 October 2012 to 2 October 2013 (the first pension year)
ää3 October 2013 to 2 October 2014 (the second pension year)
ää3 October 2014 to 2 October 2015 (the third pension year)
His second reference period is:
ää3 October 2015 to 2 October 2016 (the fourth pension year)
ää3 October 2016 to 2 October 2017 (the fifth pension year

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Drawdown terminology What are reference dates and nominated dates?
The three-yearly review can be carried out on the óreference dateô ï that is the first day of the first pension year in each reference period or on a ónominated dateô. The nominated date can be any date within the 60 days running up to the reference date. The drawdown pension fund will be valued on this date and the memberös age on this date will be used to calculate the maximum income, which will then apply from the next pension year.

Returning to the above example, Peterös first three yearly review is due on 3 October 2015 ï this is the reference date. However, the scheme administrator can take advantage of the 60 day window and carry out the calculation on any date between 4 August and 3 October. They could value the drawdown fund on 9 September for example (this would then be the nominated date) and recalculate the maximum income which will then apply from 3 October 2015.

Drawdown terminology What can trigger a review of the maximum income limit?
There are a number of events that trigger a review of the HMRC limits. These are summarised in the table below:

What is the event?	When does the new limit get calculated?	When does the new limit apply from?	Is there any impact on the reference period?
A scheduled review ï for example a three yearly review	On the reference date or on a nominated date	The start of the new reference period	No
The member requests an earlier review	On the first day of the next pension year (new reference date) or on a nominated date	The start of the next pension year	Yes ï a new three year reference period will commence
Phased drawdown ï there is a further designation of funds to drawdown (in the same arrangement)	Immediately after the additional fund designation occurs	Immediately ï the new maximum will apply in the current year if higher and in the remaining years in that reference period	No
The drawdown fund is reduced due to partial lifetime annuity / scheme pension purchase	Immediately after purchase occurs unless in final year of reference period	The next pension year	No
The drawdown fund is reduced due to a pension sharing order	Immediately after the pension sharing order comes into effect unless in final year of reference period	The next pension year	No

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What happens to the income limit when a drawdown pension fund is transferred?

If an individual wants to transfer funds already in drawdown to another scheme, then the full amount under the existing arrangement must be transferred and on receipt the receiving scheme must place the amount into a new arrangement (ring-fenced from any other funds that are held). The transfer does not trigger a recalculation of the income limit; the maximum income that applied in the transferring scheme will continue under the new scheme and the pension years and reference periods will remain the same. Prior to 26 March 2013 there were transitional rules for those with a five year reference period which resulted in a GAD review at the end of the current pension year where they transferred. These reviews no longer have to be done where the pension year ends on or after 25 March 2013.

Drawdown death benefits

What death benefits can be paid from a drawdown pension fund?

One of the main attractions of drawdown, when comparing to a lifetime annuity, is the ability to provide a death benefit where there is a remaining fund.

On death, the remaining drawdown pension fund can be used to provide benefits in a number of ways (these can be combined):

1. Paid as a lump sum less 55% tax
2. Used to purchase an annuity for a dependant
3. Used to provide a dependantôs drawdown pension

Who is classed as a dependant for death benefit purposes?

HMRC define a dependant as follows:

1. A person who was married to, or in a civil partnership with, the member at the date of the memberôs death (or, scheme rules permit, at the time the member first became entitled to a pension).
2. A child of the member under the age of 23, or 23 or over where they were dependent on the member because of physical or mental impairment.
3. A person that was financially dependent on the member, or had a financial relationship with the member of mutual dependence, or was dependent on the member because of physical or mental impairment.

Scheme rules may be more restrictive than this.

If there are no dependants then a lump sum can be paid tax-free to a charity nominated by the member, or dependant in the case of a dependantôs drawdown pension.

Are death benefits subject to Inheritance Tax (IHT)?

Prior to 6 April 2011, there were some rare occasions where Inheritance Tax would apply, such as where a member ómitted to actô (for example where they neglected to take benefits in order to increase the death benefit available to someone else). Since 6 April 2011, HMRC states that Inheritance Tax will not normally apply on death benefits payable from pension schemes; the trustee or scheme administrator will be able to distribute death benefits at their discretion.

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Flexible drawdown

What is flexible drawdown?
The Finance Act 2011 introduced a completely new form of drawdown called flexible drawdown. Flexible drawdown has no limits, allowing an individual to draw as much of the pension fund as required subject to income tax. However this flexibility is only available to a small number of people: those that meet the Minimum Income Requirement (MIR) in the tax year that flexible drawdown commences.

Schemes do not have to offer flexible drawdown.

What is the minimum income requirement (MIR)?
The minimum income requirement is met where an individual is in receipt of at least £20,000 of secure lifetime pension income. The aim of the MIR is to prevent a member from exhausting their drawdown pension funds and falling back on the state.
The £20,000 applies to every individual regardless of their age or gender. The Treasury will review the level of the MIR at least every five years, though any change will only affect those commencing flexible drawdown after the change as the declaration is made once.

Only certain types of pension income are included for this purpose:

1. Scheme pensions - only those provided by a scheme that is providing scheme pensions for at least 20 members are included.
2. Lifetime annuities - if the annuity is with-profits or unit-linked then only the minimum amount guaranteed by the annuity can be included.
3. State pensions - including UK and overseas State pensions.
4. Pensions from overseas schemes paying the equivalent of a UK scheme pension or lifetime annuity.

Drawdown pensions are excluded because the income is not secure for life.
To be included the pensions must be in payment.

What does an individual have to do to start flexible drawdown?
Where an individual believes they satisfy the MIR they can make a declaration to a flexible drawdown provider; the MIR only has to be satisfied once. If the provider accepts the declaration they will provide flexible drawdown which allows the individual to draw as much as they like from their drawdown arrangement without limit, but subject to tax at their highest rate.
In the year of commencing flexible drawdown, no contributions can be made to a defined contribution scheme and the individual cannot be an active member of any defined benefit scheme. In addition, once flexible drawdown has commenced, any further pension contributions will be subject to the annual allowance charge so flexible drawdown should only be used when an individual is sure they have made all the pension contributions they want to.

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What are the advantages of drawdown?

Drawdown can offer a number of advantages over a lifetime annuity:

1. It allows an individual to take their pension commencement lump sum (PCLS) without taking an income.
2. It allows for tax efficient retirement planning because the amount of PCLS and income drawn can be controlled. Being able to vary the income, albeit within limits with capped drawdown, passes control to the individual.
3. The annuity decision can be deferred indefinitely or until the individual is older or in ill health with the hope that rates are better at that time.
4. Death benefits are usually more attractive than those provided by an annuity and more flexible in that the beneficiaries often have a choice about how to use the remaining fund.
5. The fund remains invested and the individual retains control; those with SIPPs can continue to invest in their chosen assets and seek growth for their retirement funds.

What are the disadvantages of drawdown?

There is investment risk with conventional drawdown plans as the income available will depend on the performance of the underlying funds. Asset allocation has to be considered; as there is likely to be a need to generate a specific level of return in the fund a significant investment in equities may be required to meet the critical yield which may not be in line with the investorҳ attitude to risk.

It is also important to consider the construction of the portfolio including where income should be drawn from: from cash (which can hamper performance), from income producing assets (where requirements are modest) or on a basis driven by performance.

It should be recognised that if investments donөt perform as expected, this will have a severe effect on future income; and poor performance will be compounded by the client drawing high levels of income.

There is some longevity risk as there is a danger that the funds could become exhausted or at least severely depleted in the later years leading to a decline in income.

Another disadvantage of drawdown is ӭortality dragԭ this is the extra return required to compensate for the loss of the mortality cross-subsidy inherent in annuities. Mortality drag worsens as the client gets older and after 75 this can be particularly harsh.

Charges are also a concern on drawdown pension both from a product and an advice perspective. An annuity purchase is relatively simple and there is often just one advice point; with drawdown there is the need for ongoing advice and the FSA expects reviews to be undertaken at least annually.

At Seven Financial we are here to help.
Please contact the team.