



Unsecured Pension (Pension Drawdown)

Unsecured Pensions replaced pension drawdown when the new rules for pensions simplification came into force in April 2006. An Unsecured Pension allows you to make income withdrawals from your pension fund until age 75 instead of buying an annuity.

At the age of 75 you must buy an annuity or transfer to an Alternatively Secured Pension.

The Advantages

Unsecured Pension has many advantages compared to an annuity purchase but the most important are:

- ✓ **Income flexibility** - Each year the amount of income taken can be varied between the minimum and maximum limits. Income can also be taken monthly, quarterly, half yearly or annually.
- ✓ **Control over investments** - If drawdown is set up through a Self Invested Personal Pension there is a wide range of investment options available.
- ✓ **Choice of death benefits** - Unlike annuities where the only death benefits are available from a joint life annuity, drawdown offers a choice of death benefits.

The Disadvantages

When you buy an annuity you give up control of your pension fund in return for a secure income. With Unsecured Pension you maintain control of the pension fund but your income will not be secure and so it is a much more risky option than buying an annuity.

There are a number of risks involved when deferring an annuity purchase by investing in an income drawdown plan. Understanding and knowing how to manage these risks is very important.

Investment Risk – The value of investments can go down as well as up.

Mortality Drag - If you defer purchasing an annuity you will miss out on the mortality cross subsidy. The extra return required to compensate for the absence of this subsidy is called Mortality Drag.

Decrease in your annuity Purchasing Power – If annuity rates fall and the value of your pension fund does not increase sufficiently to compensate, an annuity purchased in later years will provide less income compared to purchasing an annuity now.

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Income Limits

The amount of income that can be paid from an Unsecured Pension fund is determined by reference to tables produced by the Government Actuary's Department (GAD). The maximum income in any one year is roughly equal to a single life annuity and there is no minimum income requirement.

To ensure that the income limits from drawdown are in line with annuities the limits are calculated by reference to current gilt yields. GAD produces a set of special tables based on a range of interest rates.

Income flexibility

Income can be varied each year so long as it is kept within the GAD limits.

Income withdrawals can be paid monthly, quarterly, half yearly or annually and can be in advance or arrears.

5 Yearly Reviews

There is a compulsory review every five years to ensure that the pension fund can sustain future income payments. At the review the minimum and maximum income limits are set for the next 5 years.

Short-term Annuity

Tax simplification introduced a new option whereby an individual may choose to secure part (or all) of their unsecured pension through the purchase of a short-term annuity contract from an insurance company. The term of that annuity contract cannot be more than five years, and the annual amount payable by the contract is bound by the same rules as income withdrawal payments paid direct from the scheme. The term of that annuity must not extend beyond the member's 75th birthday.

The short-term annuity contract option gives people the opportunity to reassess their pension needs periodically and to choose alternative types of annuities, so long as they secure an income for life by age 75.

Drawdown - Death Benefits

For many people, the more flexible death benefits are the most attractive feature of drawdown. Conversely, the most negative part of an annuity is the absence of any lump death benefit.

On the death of the policyholder there are three options:

Lump Sum Death Benefit - A surviving spouse or dependant may take the remaining pension fund as a capital sum, less a 35% tax charge.

The lump sum payment will be free of IHT, providing the correct trust has been set up.

Continued Drawdown - A surviving spouse or dependant may continue making income withdrawals

Annuity Purchase - A single life annuity can be purchased for the spouse or dependant.. This will be without a guarantee period or value protection.

Alternatively Secured Pension (ASP)

ASP is a new option that allows you to avoid purchasing an annuity at age of 75 by continuing with a limited form of drawdown.

For many years the Government and the Revenue resisted pressure to abolish the compulsion to buy annuities at age 75. They argued that pensions are designed to provide income in retirement and they are not to be used to allow individuals to pass their pension funds to their families. Therefore it was a welcome surprise when as part of Pensions Simplification in 2006, that the Government introduced this new option.

However the attractiveness of ASP was greatly reduced when in December 2006 the rules were changed so that the option to leave unused ASP funds to the family would attract an effective tax charge of over 82%

Income Limits

Alternatively Secured Pension ASP will be paid to an individual from their pension fund in much the same way as for drawdown before age 75. The maximum income will be 90% of relevant annuity (see income limits for drawdown) based on age 75. The minimum income will be 55% of the relevant annuity.

The income limits are reviewed every year. The income can be changed each year providing it does not exceed the maximum.

Death Benefits when the policyholder dies

Most people will probably consider ASP not to maximum income, but to maximise the death benefits for their family. However when you die the remaining fund must be used to provide benefits for your surviving dependants, normally spouse or partner.

With a dependant below the age of 75

There are two options for a dependant who is below the age of 75:

- ✓ Continued income withdrawals under Unsecured Pension rules
 - If the dependant dies before age 75 the fund may be paid as a lump sum death benefit less 35% tax and normally free of IHT
- ✓ Annuity purchase - A single life annuity without a guarantee period or value protection.

With a dependant above the age of 75

There are two options for a dependant who is above the age of 75:

- ✓ Continued income under ASP rules
 - When the dependant dies, unless they have a dependant themselves, the situation is as described below under the heading “Without a dependant”
- ✓ Annuity purchase where the annuity can have a guarantee period of up to 10 years.

Without a dependant

The remaining funds can be paid as a charity lump sum death (CLSDB) benefit without a tax charge.

If a lump sum payment is made from an ASP which is other than a CLSB it will be treated as an unauthorised payment resulting in a tax payment as high as 82%.

Generally speaking, unless there are special circumstances such as your wife being much younger, ASP is not advisable for the following reasons:

- ❖ The income is pegged at the limit for a 75 year old so you cannot take as much income as you could get from an annuity
- ❖ You may not wish to be exposed to investment risk at this age
- ❖ The death benefit situation is complex and if the dependant is over the age of 75 any lump sum payment other than a CLSB will be treated as an unauthorised payment resulting in a tax payment of more than 80%.

Phased Retirement

This is a very tax efficient way to pay your pension income. Your pension plan is set up with a number of different segments and year you convert a number of these segments into tax free cash and pension.

Each vested segment will provide tax-free cash (normally 25%) and an annuity purchase. The tax-free cash is added to the annuity and the two together provide income for that year. As a large part of the total annual income is comprised of tax-free cash it is clearly very tax efficient as income tax paid is only applied to the annuity.

In subsequent years further encashments are made to provide more tax-free cash and income in addition to the annuities already in payment. Therefore there will be a number of different annuities and each one may be on a different basis e.g. with profit, single or joint and level or escalating.

On death of the policyholder before age 75, any unvested pensions segments will be paid out free of tax. In addition there may be continued benefits from the annuities in payment. For instance the balance of any guaranteed period and or a spouse's pension.

Deciding between an Annuity and Unsecured Income

Deciding between an annuity and pension drawdown can be a very difficult decision because there are many different factors to take into consideration.

As you approach retirement it is important to set out your retirement objectives. As you do this you will realise that you probably have more than one objective and there is no one type of annuity or drawdown that will meet all of these objectives.

The table below sets out the some of the most important objectives with a comment about which product meets these objectives. Please put a tick in the final column to indicate your preference.

Objective	Comment	✓
Sustainable income for the rest of your life	Few people want a falling income and the only sure way to guarantee an income is with an annuity. Only annuities can insure against longevity because they are based on the concept of Mortality Cross Subsidy.	
	With Drawdown there is a significant risk that income levels may reduce in the future because there is no mortality cross subsidy and you might not achieve the required investment returns. However drawdown does provide the opportunity to outperform an annuity and there is more flexibility	
Keeping place	Inflation reduces the future value of income. Level	

with inflation	Annuities may be storing up trouble for the future if high inflation returns.	
	Only an Index Linked Annuity can guarantee to maintain its real value over time.	
	For those who believe that in the long run, equities are a good hedge against inflation, a With Profit Annuity could be considered instead of an index linked annuity.	
	A Drawdown plan with the appropriate investment strategy should be able to provide an income stream that at least keeps pace with inflation	
Flexibility	There is no flexibility with a Standard Annuity but the income is guaranteed	
	Flexible Annuities provide a certain amount of flexibility with income levels and control over investments	
	Drawdown provides flexible income options, investment control and choice of death benefits. However flexibility comes with a price, the risk of a lower income in the future	
Financial Security for family	Most annuities do not provide a lump sum death benefit but are normally set up with a spouse's pensions and a minimum guarantee period.	
	The Open Annuity provides a lump sum death benefit	
	Drawdown provides better death benefits by allowing a lump sum death benefit (less 35% tax) or continued income for spouse and or dependants.	
	Even better death benefits are available with Phased Retirement	
Not taking undue risk	The main risks to consider in retirement are; the risk of income falling, inflation risk, investment risk and the risk that your circumstances may change. No one policy can manage all these risks, which means that even an annuity is not risk free.	
	Understanding and managing risk is one the most important aspects of retirement planning and those who are risk adverse will probably be more comfortable with an annuity .	
	Whereas those prepared to take a certain amount of risk in return for the extra flexibility and control will be attracted to drawdown	
	For those who are not risk adverse but do want to take all the risks associated with pension drawdown, with profit annuities may be considered	