

Gibbs Denley Preferred Your Retirement Options Explained

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I. Quick Guide

The following pages contain a substantial amount of technical information. The following summary will hopefully be of assistance.

LIFETIME ANNUITY	Regular and secure income For life.	A tax free cash sum may be provided at outset and your remaining capital used to purchase an income paid for life	Your annuity income is paid at least annually and can increase or remain level in payment.	Additional options can be selected at outset such as annual or one off increases, spouse's benefits or guarantees. Buying some of these options will reduce your own income, or the initial income available.	Once you have bought your annuity, you usually cannot change your mind or change the benefits. On death there may also be the option of a lump sum if selected at outset, subject to certain tax charges.
WITH PROFIT ANNUITIES	An income that has a minimum level in retirement normally, with the potential to have an enhanced income from with profit bonuses.	A tax free cash sum may be provided at outset. The remaining capital buys an income in two parts. Firstly a minimum level, usually for life, and then an additional income based on the bonuses provided by the underlying with profit fund.	Your annuity income is paid at least annually with a proportion fluctuating depending on the with profit fund performance.	Additional options can be selected at outset such as annual or one off increases, spouse's benefits or guarantees. Buying some of these options will reduce your own income, or the initial income available.	Once you have bought your annuity, you usually cannot change your mind or change the benefits. On death there may also be the option of a lump sum if selected at outset, subject to certain tax charges.
UNIT LINKED ANNUITIES	An income that is completely linked to the performance of a managed fund.	A tax free cash sum may be provided at outset. The remaining capital invests in a managed fund or funds, with the income rising and falling on the performance of the funds.	Your annuity income is paid at least annually and can potentially rise or fall	Additional options can be selected at outset such as annual or one off increases, spouse's benefits or guarantees. Buying some of these options will reduce your own income, or the initial income available.	Once you have bought your annuity, you usually cannot change your mind or change the benefits. On death there may also be the option of a lump sum if selected at outset, subject to certain tax charges.
VARIABLE ANNUITIES	An income supported by the underlying assets that can rise and fall depending upon health and investment performance.	A tax free cash sum may be provided at outset. The remaining capital invests in a range of funds which you may select yourself. It is underwritten on a regular basis to determine what income may be received.	Your annuity income is paid at least annually and can potentially rise or fall.	Additional options can be selected at outset such as spouse's benefits or guarantees. Buying some of these options will reduce your own income.	In practice, unlike other annuities, with a variable annuity, it is possible to transfer it to a Lifetime Annuity should you wish to do so. On death there may also be the option of a lump sum if selected at outset, subject to tax charges.
CAPPED INCOME DRAWDOWN	Tax free cash lump sum paid at outset and fund remains invested. Income can also be elected if required.	The balance of the fund not used for income remains invested with a view to providing potentially higher future benefits.	You can choose the income you want, and when you want it, between nil and 100% of the limit set by the Government's Actuary Department (broadly equivalent to a single life annuity).	If investments do well, you may benefit from higher future income payments, and vice versa.	On death, the remaining fund is available to pay benefits to your family or dependants.
FLEXIBLE INCOME DRAWDOWN	Enhanced form of Income Drawdown available to those with other secured incomes (State Pension / Lifetime Annuities / Scheme Pensions) above £20,000 per year.	After receiving the maximum tax free cash sum, further unlimited withdrawals may be taken (albeit taxable, as income) until the plan's value is exhausted.	Provides an added dimension of flexibility. Careful planning may even avoid Higher / Additional Rate Tax charges.	Each year you decide Any further pension contributions will be subject to the Annual Allowance Tax Charge; likely to be 40% - 50% depending upon circumstances.	On death, any remaining fund is available to pay benefits to your family or dependants.
PHASED RETIREMENT	Part of your fund and part of your tax free cash are used in segments when required to provide an overall income.	The balance of the fund not used for income / tax free cash remains invested with a view to providing potentially higher future benefits.	Your starting income is smaller, but is supplemented by a portion of your tax-free cash sum.	Each year you decide how much fund to use for annuity purchase / income drawdown and how much tax free cash is used to supplement your income.	Because you don't commit all your funds to Income Drawdown or buying an annuity immediately, you keep your options open.

2.1 Lifetime Annuity

Overview

An annuity is simply a series of payments made at selected intervals in return for a pension fund. The level of payment is dependent upon age, sex, annuity rate, size of fund and options selected. Annuity rates tend to mirror interest rates since they are related to the returns earned on Fixed Interest Gilt Edge Securities. There are many different types of Annuities and these are covered later on in this section.

Tax Free Cash

Most types of pension plan have the option of taking a tax-free cash lump sum before exchanging the residual fund for a series of payments. This is often referred to as the Pension Commencement Lump Sum and the decision of whether to access the cash or not effectively needs to be made at the outset.

Income

Annuity payments are taxed at source under the PAYE system. Provided a P45 is presented the annuity will be paid net of your marginal rate of tax and there will be no further tax liability. Payments can be made monthly, quarterly, half yearly or yearly and can be in advance or arrears. Payments can remain level or can increase in payment.

Death Benefits

The option of what type of death benefits to include must be made at outset. The options available are as follows:-

- A spouse's or dependents pension up to 100% of the pension you had received
- A guaranteed period of up to 10 years which will ensure that on death within the first 10 years, the remaining payments you would have received continue to be paid to your estate.
- Commonly known as Capital Protection, this option can be included to ensure that on death the original fund value, less the gross income payments already made, can be paid out less a flat rate tax charge of 55%.

Key Points & Risks

- You will receive a guaranteed income for life, and you can elect for your spouse/beneficiaries to receive a guaranteed income or potentially a lump sum less tax upon your death.
- Whilst interest rates may fall in the market, your income will remain unaffected.
- Tax-free cash is available at outset.
- There are no additional charges applied to the contract once in force. All charges are taken at outset and are reflected in the annuity rate offered.
- The contract is simple to understand, there is no need to review the contract and there is minimal paperwork needed to start the payment of benefits.
- Those who purchase an annuity and live for a long time in retirement benefit from 'mortality gain', which is the cross subsidisation of those who live a long time in retirement by those who die early in retirement.
- The selected income level is fixed and cannot be varied in response to changing personal financial circumstances (excluding potential future increases).
- There is no opportunity of participating in future investment returns.
- Any options to provide benefits on death must be selected at outset and will result in a lower initial pension payment. These selected benefits cannot be altered in the future.
- If you die in the early years, you may not have received an income over the period equivalent to the capital that you invested.

Suitability

Lifetime Annuities are most likely to suit individuals who want an absolute guarantee on their pension payments and/or for their spouse/partner. They therefore suit individuals with low (cautious) attitudes to risk and requiring a high level of security. They also suit individuals who have relatively small pension funds and who will be heavily reliant on their pension income.

2.2 With Profit Annuity

Overview

A with profit annuity is similar to a Lifetime Annuity in that it is simply a series of payments made at selected intervals in return for a pension fund. The level of payment is also dependent upon age, sex, annuity rate, size of fund and options selected. The main difference is that the initial pension level and future income levels are also dependent on the performance of the underlying with profits fund.

An assumed future bonus rate (ABR) is selected at outset by the investor. The higher the ABR the greater the initial income, however if the actual bonus rate of the with profit fund does not equal the ABR then the amount of pension payable will decrease. Most with profit annuities offer a minimum guaranteed level of pension.

Tax Free Cash

Tax free cash, otherwise referred to as the Pension Commencement Lump Sum must be withdrawn at outset then the residual fund is exchanged for a series of payments. Once an annuity has been purchased there is no further entitlement to tax-free cash, as per Lifetime Annuities.

Income

Annuity payments are taxed in the same way as described under 'Lifetime Annuity'. Income will increase or decrease in payment depending on fund performance relative to the ABR.

Death Benefits

The option of what type of death benefits to include must be made at outset. The options available are the same as under the Lifetime Annuity.

Key Points & Risks

- You will receive an income for life, and you can elect for your spouse/partner to receive an income or lump sum less tax upon your death.
- Tax-free cash is available at outset.
- Charges are taken at outset and are reflected in the annuity rate offered. The with profit fund deducts charges before bonuses are declared.
- The contract is simple to understand and there is minimal paperwork needed to start the payment of benefits.
- The selected income level is not guaranteed and is subject to future investment returns.
- Any options to provide benefits on death must be selected at outset and will result in a lower initial pension payment. These selected benefits cannot be altered in the future.

Suitability

With Profit annuities are most likely to suit individuals who want some guarantee on their pension payments but also want the potential to benefit from future investment return. They therefore suit individuals with a medium attitude to risk and security. It should be noted however, that where a high level of expectation is placed on the assumed growth, then this will raise the risks involved to a medium/high level.

2.3 Unit Linked Annuity

Overview

A unit linked annuity is very similar to a with profit annuity in that it has all the same options and features but is invested in unit linked funds rather than a with profits fund. The initial pension and future income levels are also dependent on the performance of the underlying unit linked funds.

Often the investor is allowed to assume a future rate of growth. The higher this assumed rate the greater the initial income, however if the actual growth does not match this rate then the amount of pension payable will decrease. Some contracts offer a minimum income level so that at least some income may be payable, but this is unlikely to meet the needs of the investor.

Tax Free Cash

Tax free cash, otherwise referred to as the Pension Commencement Lump Sum must be withdrawn at outset then the residual fund is exchanged for a series of payments. Once an annuity has been purchased there is no further entitlement to tax-free cash, as per Lifetime Annuities.

Income

Annuity payments are taxed in the same way as described under 'Lifetime Annuity'. Income will increase or decrease in payment depending on fund performance relative to the assumed growth rate.

Death Benefits

The option of what type of death benefits to include must be made at outset. The options available are the same as under the Lifetime Annuity.

Key Points & Risks

- You will receive an income for life, and you can elect for your spouse/partner to receive an income or lump sum less tax upon your death.
- Tax-free cash is available at outset.
- The contract is simple to understand and there is minimal paperwork needed to start the payment of benefits.
- The selected income level is not guaranteed and is subject to future investment returns.
- Charges will be higher than under a Lifetime Annuity.
- Any options to provide benefits on death must be selected at outset and will result in a lower initial pension payment. These selected benefits cannot be altered in the future.

Suitability

Unit Linked annuities are most likely to suit individuals who want some guarantee on their pension payments but also want the potential to benefit from future investment return. They are based on two aspects, that of the fund selected, and the assumed growth rate. They therefore suit individuals with at least a medium/high to high attitude to risk and security.

2.4 Vocational, Enhanced and Impaired Life Annuities

Overview

Individuals in poor health (or those with a known medical condition, i.e. diabetes) may apply for higher annuity rates due to their shorter life expectancy – this is often subject to a medical report/examination. Some individuals may be offered enhanced rates due to their lifestyle or physical condition, i.e. smokers or clinically obese. The rates involved can increase the income available significantly.

More recent developments have seen the introduction of Vocational or 'Post Code' Annuities, which can be based on occupation and postcode. For example a bricklayer in Yorkshire will be given a higher rate than a stockbroker in Surrey.

In all other respects, these annuities are the same as a Lifetime Annuity.

Suitability

These annuities are most likely to suit individuals who want an absolute guarantee on their pension payments and are eligible for the higher rates. They therefore suit individuals with low attitudes to risk requiring the security of a guaranteed lifetime income, but may also be suitable for individuals with high attitude to risk but are in ill health.

3. Income Drawdown

Overview

Under the option of Income Drawdown (or pension fund withdrawal) you can choose to immediately take a tax-free cash lump sum and then, instead of buying an annuity, leave the remainder of the fund invested in a tax-efficient environment.

An income can then be drawn from the invested pension fund, if required. This income may vary between limits, set by the Government Actuary's Department (GAD). The maximum limit, which is reviewed every 3 years, is derived from tables published by GAD and is based on your fund size, age, sex and the gilt yield at that time. This maximum limit is currently broadly equal to a single life annuity that you could have purchased at that point. There is no minimum limit.

Tax Free Cash

Most types of pension plan have the option of taking a tax-free cash lump sum before exchanging the residual fund for a series of payments. Normally 25% of the fund can be taken at outset, with no further entitlement. Sometimes, it may be possible to preserve a higher entitlement if benefits arise from an occupational pension scheme and the scheme administrator is willing to pay out tax-free cash before payment of the residual fund, however this is a less common scenario and in most cases, transferring from an occupational pension scheme will cap tax free cash at 25% of the fund.

Income

A pension income does not have to be taken but if this is required, it cannot exceed 100% of the maximum GAD rate. This income is taxed as earned income under the PAYE system.

Death Benefits

If you die whilst in an Income Drawdown contract your surviving spouse/dependant has a number of different options available to them:-

- 1 Take the fund as a cash lump sum (with a tax charge of 55%), or
- 2 Buy a Lifetime Annuity with the fund, or
- 3 Continue taking Income Drawdown themselves.

Key Points & Risks

- You are able to take all of your tax-free cash lump sum entitlement at the outset.
- You do not receive a set income but are able to vary it to suit your personal circumstances, up to a maximum limit, to supplement other sources of income.
- With careful planning you are able to mitigate your liability to personal income tax in certain years.
- You have the potential to benefit from the performance of the invested fund, which remains in a tax-efficient environment, and to exercise control over your own investment strategy.

- High levels of income withdrawals are unlikely to be sustainable over the long term.
- 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 when (or if) an annuity is eventually purchased and could also affect the long-term financial security of your spouse/partner.
- The investment returns may be less than those shown in the illustrations.
- Annuity rates may be at a worse level when annuity purchase takes place. Although annuity rates generally increase with age, they have fallen dramatically during the past 15 years. This trend may continue.
- A careful investment portfolio needs to be constructed which will involve some investment risk. This means the fund value could fall which could affect your future income levels.
- Withdrawing too much income in the early years may have an adverse effect on preserving your pension (annuity) purchasing power or preserving the capital value of your fund.
- Increased flexibility brings increased costs and the need to review arrangements on an ongoing basis.
- There is no guarantee that your future income will be as high as that offered by an annuity purchased today.
- You may feel the prospect of the future higher income does not compensate for the known income available from an annuity now and for the rest of your life.
- You may be prevented from withdrawing your chosen level of income due to the action of the GAD limits.
- Income Drawdown involves an element of mortality risk. If you purchase an annuity, you may benefit from a cross subsidy from those annuitants that die relatively early. This cross subsidy is not present with Income Drawdown and so to provide a comparable income, a higher investment return will be required. The impact of mortality can be expressed as an annual percentage rate by which the net investment performance of the remaining personal pension fund would have to exceed the interest rate implicit in an annuity in order to break even. This effect has become known as the 'mortality drag'.
- The charges are explicit whereas under an annuity they are inherent in the annuity rate offered.
- Potential IHT issues where benefits are not taken from the plan.

Inheritance Tax Issues

If it is unclear that there were not sound retirement planning reasons for undertaking Income Drawdown and death occurs, the use of the contract may be deemed as an attempt to circumvent the payment of inheritance tax (IHT). Furthermore, if you are in ill health and decrease the level of withdrawals with the intention of keeping the funds in your plan, thus outside of your estate, this may also be seen as a deliberate attempt to avoid IHT.

In both cases, the Capital Taxes Office could issue a claim and it is therefore vital that should your circumstances or personal health alter, that you seek professional advice on this very complex issue before reducing your withdrawals.

Critical Yield

Critical yields are illustrated by product providers using a common prescribed basis. There are two types (A and B).

Type A – the growth rate needed on the Income Drawdown arrangement sufficient to provide and maintain an income equal to that obtainable under an equivalent immediate annuity.

Type B – the growth rates necessary to provide and maintain a selected level of income.

The higher the rate involved, the more difficult it will be for your pension fund to provide similar benefits to you than would otherwise be available

Suitability

Income Drawdown is generally suited to the relatively sophisticated investor, who is capable of fully understanding the risks. The contract can be used as a useful tax planning tool and a means of accessing pension fund tax free cash without having to take the full taxable income. It will usually require a fund of significant size in order for the fund to be able to bear the increased costs associated with this type of retirement planning. Where an income is actually being drawn, the investor will typically require a medium/high attitude to risk in order to achieve the outperformance that this strategy requires from its investments.

Flexible Drawdown

Individuals with a 'lifetime income' (essentially a guaranteed income from their State Pension, other annuities and/or defined benefit pension schemes) of at least £20,000 gross per annum may take unlimited withdrawals from their Income Drawdown plans, if the scheme provider offers this option. This is known as 'Flexible Drawdown'. It is worth remembering that such withdrawals will be subject to income tax (as per any other Income Withdrawals taken) at your highest marginal rate.

It should also be noted that once an individual has chosen Flexible Drawdown, they will be liable to the annual allowance tax charge on any new pension contributions - the normal annual allowance of £50,000 doesn't apply. The annual allowance tax charge is calculated by adding the excess contributions onto income and taxing it accordingly - so the tax will be somewhere between 40% and 50%.

Investment Footnote

It is important to note that the manner in which the investment funds supporting Income Drawdown are allocated to investments is an ongoing process. There will need to be a mixture of short, medium and long term assets, with the combination varying depending upon the level of income you require, the frequency and your attitude to risk too.

Traditionally, it is accepted practice to hold between 18 months and 2 years worth of income in cash or deposit based assets so that there is sufficient money available to pay out your income without having to sell more medium or long term assets at a point where it is potentially not cost effective to do so.

4. Phased Retirement

Overview

Phased retirement allows you to control your retirement fund and convert it gradually over a number of years into income. This control is achieved by 'crystallising' part of your retirement fund each year to provide you with your desired level of income. The overall income will be made up of part tax-free cash and part annuity or Income Drawdown.

The balance of your pension fund (i.e. the portion not cashed in or 'crystallised' to provide you with a given level of income) continues to be invested, thus providing you with the possibility of higher future income and a potentially increased death benefit – although this cannot be guaranteed. This will depend mainly on how much income you take out of the pension fund (especially in the early years), the investment returns achieved and future annuity rates.

Tax Free Cash

Maximum tax-free cash is not taken at outset; instead, it is phased-in each year to provide part of your overall income. Typically, you may take 25% of the part of the fund that is being crystallised i.e. used to provide the retirement income.

Note that if uncrystallised funds still exist at age 75 a Benefit Crystallisation Event still occurs on the unused funds. This was introduced from 6 April 2011. Funds in a money purchase scheme no longer have to be designated for income drawdown or annuity purchase at age 75, but can be left as 'unused funds'. However, these funds are tested against the lifetime allowance at 75 and, even though benefits aren't coming into payment, a lifetime allowance charge could be incurred.

Income

Because the income is made up of annuity payments (or Income Drawdown payments) and a portion of tax-free cash, your overall liability to Income Tax can be reduced. Payments from the annuity or Income Drawdown can usually be made monthly, quarterly, half yearly or yearly, in advance or arrears as per the relevant sections on these products elsewhere in this Guide.

Death Benefits

For annuity purchases, the option of what type of death benefits to include is made at outset.

For funds that are in Income Drawdown, the spouse/dependant has the following options:

- Receive the value of the plan less a 55% tax charge.
- Continue with Income Drawdown.
- Should the spouse/dependant continue with Income Drawdown and then die themselves, the full fund value less 55% tax could be paid to any nominated person(s).
- Purchase an annuity immediately.

The uncrystallised part of the fund can be paid, upon death, as a tax free lump sum to your spouse/dependant or any other nominated beneficiary provided this is prior to you reaching age 75.

Key Points & Risks

- You retain investment control of the segments of your pension fund not yet used to purchase an annuity.
- You can choose to purchase an annuity at any time.
- As you get older there is the prospect of annuity rates rising and providing you with a higher income. It is cheaper for insurance companies to purchase an annuity to provide a given level of income for someone age 70 than for someone age 60 (assuming the returns provided by medium to long-term gilt yields remain the same).
- You will be able to change the shape of your retirement income to reflect your personal circumstances in the future, although once you have purchased an annuity, this income payment will continue unchanged for the rest of your life.
- The remaining pension fund (i.e. the uncrystallised portion) can be returned to your beneficiaries, normally free from Inheritance Tax, in the event of your death before age 75.
- Under certain circumstances, lower sums of money obtain a better annuity rate than larger sum of money, this being because history has tended to show that the more wealth someone has accrued, the longer they tend to live, or be able to afford access to better health care.

- There is no guarantee that your income will be as high as that offered under the Lifetime Annuity route referred to earlier.
- Deferring the purchase of the annuity does not guarantee a higher level of future income, as annuity rates can go down as well as up and the value of the continued investment of your pension fund may go down as well as up.
- The final level of income may not be better than which could have been secured with the whole retirement fund at outset via a Lifetime Annuity. This is because the amounts withdrawn (including charges for the ongoing administration of the plan) may erode the value of your pension fund if investment returns are not sufficient to make up the balance.
- You may feel that the prospect of future higher income does not compensate you for not being able to enjoy a guaranteed and secure level of income today and for the rest of your life.
- You will not receive all of your tax-free cash as a lump sum at the outset, because you are using this cash to supplement your income.
- Counter to the point mentioned earlier, it is also possible with some providers to achieve a greater annuity rate with a larger fund value; therefore it is also entirely possible that by approaching this route, you can lose out on the overall annuity rate that could have been achieved.

Suitability

Phased Retirement is most likely to suit individuals who want to gradually retire, i.e. the self-employed, or those individuals who are likely to be higher rate taxpayers. They also suit individuals with a medium or higher risk/reward rationale because there is a greater element of risk involved, both with the part of the pension fund remaining invested and the potential for annuity rates to decrease in the future.

Those persons that have accrued a sizeable pension fund and need an income, but wish to provide as much of a lump sum death benefit as possible, whilst supporting themselves, may also be suitable for this approach.

4. Triviality

Overview

Where an individual is aged over 60 and their total pension funds from all occupational and personal pension plans is less than £18,000 the entire fund can be paid out as a lump sum.

Commutation of all pension plans must take place within the same 12 month period.

If there is already a plan in payment which commenced prior to 6th April 2006 the notional value of this is calculated by multiplying the annual gross income as at 5 April 2006 by 25. This figure is then adjusted by the rise in the Lifetime Allowance (LTA) from 6 April 2006 to the nominated commutation date.

Pensions in payment after 5 April 2006 will have used up a percentage of the LTA, as confirmed by the scheme administrator at the benefit crystallisation event (BCE) date.

Tax Free Cash

Tax free cash can still be drawn and this will usually be a maximum of 25% of the fund value.

Taxation

The remaining fund after the tax free cash has been paid will be added to earned income and taxed accordingly.

Occupational Scheme Members

Where an individual has benefits in an employers pension scheme that is closing (known as winding up) they could be entitled to commute their benefits under triviality rules before age 60 as long as:-

The employer is not contributing to any other scheme for the individual

The employer will not make any contributions for this member for at least a year

However there are many complications around this and these usually require guidance from an experienced specialist adviser.

Gibbs Denley can offer guidance on all aspects of retirement planning from our team of highly experienced, advanced-qualified advisers. For more information concerning details contained in this guide, please speak with a member of the team.



The information in this guide is intended to provide an overview of the options available and does not constitute specific advice. Past performance should not be taken as a guide to future returns. The value of investments and the income from them may fall as well as rise and you may not get back the full amount invested.