What is Income Drawdown

This guide is just a very brief overview of how Income Drawdown works and the options available. If you are considering this option, you should take independent financial advice from a qualified specialist.

How it works

Income Drawdown differs very much from annuity purchase, because unlike annuity purchase you are not giving away your pension to a provider for a guaranteed income. Income Drawdown leaves the responsibility with you but in return, provides you with greater flexibility. This is not suitable for everyone and if you require a guaranteed income without any risk, annuity purchase should be seriously considered.

Taking benefits

There are two types of income drawdown available. These are as follows;

Flexi-Access Drawdown

Flexi-Access drawdown allows individuals access to their entire pension pot in the following way;

It provides you flexibility on how and when you take income or the tax-free cash. If you wish you could take some or all of your tax-free cash, up to the maximum 25% and leave the residual fund, to take income from immediately or at a later date. Any income would of course be taxed at your marginal rate of income tax. The following is an example, to demonstrate how Flexi Drawdown could work;

John has a total pension fund of £300,000. He wishes to take a tax-free lump sum of £25,000 and an income of £5,000.

In this example he would have to crystallise £100,000 of his pension fund to produce sufficient tax-free cash. This would provide £25,000 tax-free cash (i.e. 25% of £100,000) and the remaining £5,000 would be taxed at his marginal rate. So in total he has taken £30,000 from a crystallised pot of £100,000. This would leave him with a crystallised fund of £70,000 from which no further tax-free cash can be taken. Any withdrawals from this pot would be taxed at his marginal rate.

The remaining £200,000 would is known as an uncrystallised fund, from which he can take 25% tax-free cash in the future.

If in the following year, he only requires income, then he would withdraw this from the crystallised fund of £70,000.

If however he needs further tax-free cash, then he would need to take this from the uncrystallised pot.

Uncrystallised Funds Pension Lump Sum

Under this arrangement you are crystalising an entire slice of your pension fund. The first 25% of the payment is treated as the tax-free cash element and the remaining 75% is taxed at your marginal rate of tax.

This leaves the remaining slice of the fund uncrystallised.

As an example; Mary has a pension fund of £200,000 and she requires £10,000 from her fund. The first £2,500 is considered as the tax-free cash element and paid free of tax. The remaining £7,500 is paid and taxed at her marginal rate of tax.

The remaining £190,000 of her fund will stay uncrystallised until she requests her next income payment, which will be treated in the same way.

Under this arrangement and to avoid abuse of taking a tax-free lump sum and then recycling this back as a pension contribution, to benefit from tax relief. Individuals that still wish to pay into their pensions are then restricted to a maximum contribution of £10,000 per year.

Money Purchase Annual Allowance

If you have taken or decide to take flexible benefits which include **income,** such as an 'Uncrystallised Funds Pension Lump Sum (UFPLS)' or flexi-access drawdown with income, and you want to continue paying contributions to a defined contribution pension scheme, the annual amount which you can contribute to pensions is severely restricted to £4,000 per year and applies for all future years.

This restriction only applies if you take income from your pension fund. If you only take tax-free cash, the normal annual allowance applies/.

The money purchase annual allowance will only start to apply from the day after you have taken flexible benefits and so any previous savings are not affected

Capped Drawdown

This applies to individuals that entered Income Drawdown prior to 6th April 2015. This is no longer available for new people entering income drawdown. It works in the following way.

Capped Drawdown limits the amount of income that can be taken from your pension pot to specific limits set by the Government Actuary Department, these are known as GAD rates. The GAD rate is based on your age and sex and works out to be a percentage of the crystallised part of your pension fund. The maximum income that can be taken is 150% of the GAD rate and the minimum is 0. This means that you could just access the tax-free part of your pension fund and not take any income.

You can elect to transfer your capped drawdown pot to one of the new flexible drawdown pensions but advice should be taken before proceeding.

Under these arrangements, an individual can still pay up to £40,000 in pension contributions per year.

Death benefits

The death benefits payable under income drawdown are as follows;

Before age 75

If death occurs to the policyholder prior to the age of 75 both the crystallised and uncrystallised funds can be paid out to the nominated beneficiaries tax-free as either a lump sum or as regular withdrawals (income), which will also be tax-free.

After age 75

If the policyholder dies after the age of 75, the nominated beneficiary will receive the fund but any income payments made to the beneficiary are taxed at their marginal rate.

A death nomination is a request to the Trustees, to whom you would like the pension fund to be paid to on your death, therefore it is extremely important that you put a death nomination form in place.

Warning

Please remember that a pension fund is essentially a vehicle to provide for income in retirement and if used sensibly this will create more flexibility on how and when retirement benefits are taken. This option will not suit everyone and for some people buying an annuity, that will provide a guaranteed income, will still be the right choice.

Investors who initially choose the option of income drawdown can at any stage, transfer their funds to purchase an annuity

Suitability

These are some examples where Income Drawdown maybe suitable for anyone that fits in the following list.

- Individuals who do not want to lose control of their pension funds
- People who consider that death benefits are very important to them
- Investors that fully understand investment risk and are willing to take this risk
- Individuals that wish to vary their income such as semi-retiree’s
- Individuals that want greater flexibility and choice

Other Considerations for Income Drawdown

Investment risk

You and not an insurance company take the investment risk. This means that Income Drawdown is not normally recommended for a cautious investor and a diversified portfolio needs to be considered, which will include equity and other asset based investments. The investment therefore is very sensitive to market movements and you will benefit if the fund performs well but likewise your fund value and income could suffer if the fund falls in value.

Annuity rates & risk

You can purchase an annuity from your entire drawdown fund at anytime or just use part of your fund to purchase an annuity and continue in Income drawdown with the other part of the fund. Many people believe that as you get older annuity rates improve, however this is not always the case. Annuity rates are based on a number of assumptions such as interest rates, GILT yields and longevity and in fact could decline as you get older. This has been documented by the continual fall in annuity rates over the last 15 years.

Mortality drag

Annuities are based on the principle of "mortality cross subsidy". Those who die before their normal life expectancy subsidise those who live longer than expected. If an annuity is deferred the investor is missing out on this subsidy. The extra return required to compensate for the absence of this subsidy is called mortality drag. Because of increasing longevity this has less effect the younger you are but more effect after the age of 70. Therefore it is essential to carefully consider the benefits of staying in Income Drawdown after the age of 70.

Critical Yield

The critical yield is the calculation used to show the investment returns required from the contract to match the income that could be provided by a conventional annuity at certain ages in the future. It is based on current assumptions of the cost of mortality drag, future annuity rates and the ongoing costs of the contract. Therefore a high critical yield could mean that greater investment risk will need to be taken.

Income

The biggest challenge for plan holders will be to ensure that the pension fund is sufficient for their lifetime, therefore you need to carefully consider how much income is reasonable to take from your pension fund each year, taking too much could mean that the fund runs out before you. This could mean selling other assets such as your house to fund for later years. Under the state pension rules applicable from 2016, when the state pension becomes flat rate, there will no longer be means tested benefits to top up your pension provision.

Charges

Due to the type of contract, you need to factor in the cost of advice as regular reviews are required from a suitably qualified adviser long with the costs associated on the product. Therefore ongoing costs need to be factored in when calculating the ongoing investment return required to meet your current and future income needs.

Advantages of Income drawdown

- You have full investment and income control in your retirement
- You will benefit from any investment growth made within the fund
- You are able to vary the level of income
- After drawing the pension commencement lump sum, the remaining fund, less charges, will continue to be invested in a relatively tax free environment.
- You can purchase an annuity at any time with some or all of the fund.
- If you die before an annuity has been purchased the remaining fund can be pass across to your nominated beneficiaries.
- You do not need to take all of your pension commencement lump sum at once. Income Drawdown pension allows you to phase this in, as required.

Disadvantages of Income Drawdown Pension

- Taking a high level of income maybe unsustainable during the period of pension fund withdrawal and could result in you, having to reduce your income and/or your pension fund running out of money.
- Taking withdrawals may erode the capital value of the fund especially if the investment returns are poor. This could result in a lower fund value being available if at a later date you wish to secure an annuity.
- Annuity rates may fall, whilst you are in income withdrawal and when or if an annuity is eventually purchased, it could be lower than the annuity income that could have been purchased at outset.
- Under the annuity option there is an element of cross-subsidy from annuitants who have died prematurely to those who remain alive. The cross-subsidy makes little difference if you take early retirement but is more noticeable after the age of 75, as the chance of mortality increases. This is known as 'loss of mortality gain'. Those deferring annuity purchase, benefit less from cross subsidy.
- For the fund to maintain purchasing power, the investment performance, after charges must be greater than the interest rate, that would have been achieved to secure the annuity rate plus any mortality gain and expenses.
- The income drawdown contact will levy ongoing charges and if taking ongoing professional advice there will also be this cost to consider.
- There is no guarantee that the income you receive over the lifetime of the drawdown plan will be greater than that payable from an annuity or other income product.
- If income is taken, you reduce your annual pension allowance to just £4,000 per annum for all future years

*This information is a brief guide on Income Drawdown and is based on our current understanding of current legislation. This in no way constitutes a recommendation or any form of advice and was correct as at 6th April 2017. Please contact us for further details on 01372 464940.