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Taking pension benefits: a guide to your options

Introduction

This guide outlines the different options available when you want to access your pension benefits. You have the option to access part, or all, of your pension benefits at any time from age 55 (or your State Pension Age, less 10 years, if this is later, subject to future legislation). This is irrespective of whether you have stopped working.

Pension rules introduced in April 2015 changed the way in which pension benefits can be taken. These changes give you a number of options as to how you take benefits and it is really important that the implications of these options are fully understood and accepted before you make any decisions.

The route for most people from age 55 involves taking up to 25% of their pension fund as a tax-free lump sum (subject to the Lump Sum Allowance). The residual fund is then withdrawn as taxable income via one of (or a combination of) the following options:

- annuity purchase;
- flexi-access drawdown;
- phased retirement; or,
- uncrystallised funds pension lump sum.

Apart from the tax-free cash element of the pension fund (usually 25%), funds withdrawn will be added to your taxable income in the year it is received and taxed accordingly depending on which Income Tax bands the income falls within.

This tax rate could be 20%, 40% or 45% or a combination of these rates depending on the amount withdrawn, together with your other taxable income received in the tax year of making the income withdrawal.

The government will not prescribe a particular product which you will need to purchase or invest in to access your pension savings. It will be up to you to decide how you want to access your pension benefits.

The four major risks

Appropriately taking benefits from your pension involves careful analysis of the following four areas::

- longevity;
- investment returns and volatility;
- inflation; and,
- later-life care costs;

If you do not properly plan for these issues, you risk running out of money.

Consequently, you could end up having to return to work, selling valuable assets, or decreasing the inheritance you wish to leave to loved ones

Longevity

Estimating life expectancy is very difficult. Nonetheless, you need to consider how long you might reasonably live when planning for your retirement and how much capital and/or income you will need. Many people underestimate how long they will live.

Making sensible assumptions will be critical to ensuring that you do not withdraw an unsustainable level of income and exhaust the fund, leaving you with inadequate income.

The idea that we are living longer is supported by data from the Office of National Statistics (ONS). They suggest that the number of people aged 90-94 will increase from 472,000 to 685,000 in the next 10 years, with a 74% chance that at least one person in a partnership will survive beyond age 90.

Currently, a 65-year-old male buying an annuity is expected to live on average 20 years, to age 85. For a 65-year-old female life expectancy is 22 years, to age 87. In reality, however, 50% of both males and females will live longer than their respective average life expectancies.

An annuity is currently the cornerstone of many people's retirement income, and the only product that guarantees to provide a defined income for life, however long that may be.

When deciding whether to purchase an annuity or withdraw income directly from your pension fund, you will need to consider very carefully whether you can accept the risk that you live longer than you expect (or have planned for) and your money runs out

Investment returns and volatility

If you do not buy an annuity, but instead withdraw income directly from your fund under pension flexibility rules, you will be exposed to ongoing investment risk and value fluctuations.

To deliver long term returns that protect against the effects of inflation, your pension will need to be invested across a diversified range of assets. Therefore, it will remain exposed to investment risk.

This ongoing risk can result in fluctuations of the underlying asset values. It is important that you understand how volatility, combined with making regular income withdrawals, can affect the value of your fund when deciding where and how to take income.

Making income withdrawals from your fund when the value of the assets is depressed can have a significant impact on the fund's ability to recover value over the longer term.

Inflation

One of the biggest risks facing retirees is inflation, which even at very low levels (compared to levels experienced, even in the recent past) can have a devastating effect on living standards over time.

Over 20 years, the impact of rising prices on a fixed income (such as a level annuity) is as follows:

- 2% inflation reduces real incomes by 1/3;
- 3.5% inflation reduces real income by 1/2; and
- 5.0% inflation reduces real income by 2/3.

The effect of compounding means that the problem gets worse the longer people live. A person who took out an annuity paying £10,000 at age 60 and who is now 85 would have found their inflation-adjusted purchasing power had fallen as follows:

Average inflation	Inflation-adjusted purchasing power
2.00%	£6,000
3.50%	£4,100
5.00%	£2,800

In addition, pensioner inflation can be higher than the usual Consumer Prices Index (CPI) measure as they typically spend proportionately much more of their income on items such as food, council tax, fuel and utility bills.

Later-life care costs

Finally, when deciding how to fund your retirement, you should carefully consider the potential of increased income needs in much later life to fund expensive eldercare.

Whilst the State will make some provision for meeting care costs, the danger of running out of money whilst in later life could mean real financial hardship if you need long-term care.

The State Pension

The State Pension is intended to ensure that everyone has a basic amount of income to support them in their old age. Since April 2016 the State Pension has been a single tier or flat rate system providing a maximum pension in the region of £221 per week.

As mentioned, when discussing later-life care, it would not be prudent to rely on the government supporting you through financial hardship. Compared to the cost of living, the State Pension is becoming less and less of a secure stream of income.

The amount you will receive is based on your National Insurance (NI) record. To qualify for the new State Pension, you need at least 10 qualifying years of NI contributions and at least 35 years to get the full State Pension - a proportionate amount will be paid for qualifying years between these levels.

Deferring your State Pension

You can put off claiming your state pension when you reach state pension age if you wish to. This will allow you to build up additional benefits which you can take in the form of extra State Pension

Voluntary National Insurance (NI) contributions

You must be eligible to pay voluntary NI for the time that the contributions cover.

You can usually only pay for gaps in your NI record from the past 6 years, depending on your age. Therefore, if relevant, class 2 or 3 NI contributions can be made to increase State Pension entitlement.

Your options for taking your pension

Annuity purchase

Many people have historically purchased a lifetime annuity with their pension funds. This remains a popular option for those who require certainty over their pension income or do not feel comfortable taking any investment risk with their pension fund in retirement.

Purchasing a conventional annuity will ensure that you receive a guaranteed income for life, including provision for your dependent(s) where this option is selected.

Lifetime annuity

You could take benefits through your current provider, this typically involves taking a tax-free lump sum of 25% of the fund and purchasing a conventional annuity with the balance of the fund based on the annuity rates they are offering. You need to be aware that your existing provider may not offer you the best annuity rates.

Open market option

You could transfer the whole value of your pension fund to another provider who offers the best rate for the type of lifetime annuity you want.

Enhanced/impaired annuity

Higher annuity rates are available from certain providers based on health and lifestyle. You may be able to access this option from your existing provider or you may have to take an open market option.

With profits/unit-linked annuity

You can use the whole of your pension (after any tax free cash has been paid) to purchase a lifetime annuity on a 'with- profits' or unit linked basis.

These annuities provide a level of income linked to ongoing investment performance but also expose you to ongoing risk.

Third way/ variable annuity

You may transfer your pension fund to a provider offering a lifetime annuity on a flexible basis (often called variable or third way annuities). These types of annuity look to combine the certainty of a lifetime annuity with ongoing investment as seen with Flexi-access drawdown.

Fixed-term annuity

You may transfer your pension fund to a provider offering a fixed term annuity.

You will select the required term at outset and the required income amount. Some providers will offer a guaranteed maturity value, which you can choose to take as a final income payment, subject to tax and whilst in payment a fixed (level) or increasing regular income. There are also various death benefit options.

Factors to consider

Have you thought about dependents benefit options? These include choosing a joint life annuity, and/or guaranteed period and/or value protection.

You may also wish to factor in future inflation and the impact this will have on the purchasing power of your annuity income in the future. You can therefore choose to protect your annuity income by choosing an income which increases each year.

Both of these options are more expensive and will reduce your starting income but over time could pay out more overall.

Flexi-access drawdown

This option was introduced in April 2015 to give you total flexibility as to how and when you access your pension benefits. You can transfer the whole value of your pension fund into a Flexi-access drawdown plan which allows you to vary future capital and income levels to fit in with your needs and overall financial plan.

The remaining fund will continue to be invested and under your control. There are no minimum or maximum income limits dictating how much you can take out at any given time; and if you wish you can just access the tax-free cash initially and defer taking any income until a later date. This will then be subject to Income Tax at your highest rate.

Flexi-access drawdown is considered high risk when compared to a lifetime annuity as the income is not secure and could run out if not managed correctly.

If the fund performs well relative to the level of income withdrawn, it may be possible to increase the level of income you withdraw over the years. Adopting a flexible income approach could therefore provide a degree of protection against inflation if the level of income is managed sensibly.

However, if performance is poor and/or the amount of income taken from the fund cannot be supported by the net investment returns, both the fund value and future income will be reduced, potentially to zero, in extreme circumstances.

Note that, once you are in Flexi-access drawdown, you can still purchase an annuity at any time.

Uncrystallised funds pension lump sum

Also introduced in April 2015, this allows you to withdraw a single (or series of) lump sums from your existing pension without the need to move the funds into a drawdown plan first.

The nature of the payments you receive under this feature is that 25% of the fund (or 25% of each payment if less than the total fund is withdrawn) will be tax free; and the balance taxed at your marginal rate(s) of Income Tax.

Not all pension arrangements will offer the flexibility to withdraw benefits as a series of lump sums; therefore in some circumstances it will be necessary to transfer the pension fund to a more flexible arrangement before this method of drawing benefits can be accessed.

Phased or partial retirement

You can convert your retirement fund into income in stages over a number of years (often referred to as staggered vesting or phased retirement), using either annuity or drawdown. This may be available with your current pension arrangement or you may need to transfer your existing pension funds into a new arrangement.

Each time you need to access some money you can take up to 25% tax free cash plus a taxable income. It can be tax efficient if you control your tax-free cash and income to take advantage of your personal tax allowance.

You can also use your pension fund to utilise a combination of these options.

Tax considerations

After payment of the maximum tax-free cash, any income you receive from your plan will be taxable and will be added to any other taxable income you receive to arrive at your marginal rate of Income Tax.

Pension providers are legally obligated to operate PAYE, so they may be obliged to use an emergency tax code and may therefore deduct a higher rate of tax at source from your income payments than you would ordinarily be liable to pay.

Depending on your other taxable income, the application of the emergency code can also mean that too little Income Tax is deducted at source. Either way, you will need to contact HMRC to rectify any under or over payments.

Benefits considerations

You should also be aware of the potential impact that taking your pension could have on any income related DWP benefits.

This could include:

- employment and support allowance;
- housing benefit;
- income support;
- jobseekers allowance;
- pension credit; and,
- universal credit.

How your pension is treated will depend on whether you or your partner have reached the qualifying age for pension credit. You can find out your qualifying age for pension credit by using the GOV.UK State Pension Calculator at www.gov.uk/calculate-state-pension.

The way in which you use flexible pension options could affect your future entitlement to benefits. If you or your partner take money out of your pension before you have reached the qualifying age for pension credit, it will be treated as either income or capital.

This depends on how frequently you withdraw it. If you do not take any money out of your pension, it will not be taken into account when your benefit entitlement is calculated. Once you reach the qualifying age for pension credit you are expected to use your pension to support yourself.

If you choose not to buy an annuity after reaching the qualifying age for pension credit, an amount of notional income will be taken into account when your benefits are worked out. Notional income is essentially an amount equivalent to the income you would have received if you had bought an annuity.

Deprivation of assets

If you spend, transfer, or give away any money that you take from your pension, DWP will investigate whether you have deliberately deprived yourself of that money to secure or increase your entitlement to benefits.

If it is decided that you have deliberately deprived yourself, you will be treated as still having that money and it will be taken into account as income or capital when your benefit entitlement is worked out.

If you are in receipt of any of the above benefits, we will consider the likely impact your chosen income strategy will have on those benefits in preparing our advice.

Funding limits whilst accessing pension benefits

The pensions money purchase annual allowance (MPAA) is £10,000 per year. The MPAA was introduced to prevent savers abusing pension rules by taking money out of their pension and then reinvesting it in the same year to benefit from extra tax relief.

The general rule is that you can contribute the lower of your annual earned income or £60,000 per year into a pension arrangement.

However, this allowance is reduced if you withdraw any taxable income from a defined contribution pension pot under pension flexibility rules (being in capped drawdown, which was only available prior to 6 April 2015, or purchasing a traditional annuity, does not trigger the MPAA).

It is this limit that is referred to as the money purchase annual allowance (MPAA).

The application of the MPAA rule can hold potential tax consequences where you have accessed benefits flexibly from a defined contribution pension pot and have also been automatically enrolled into a workplace pension scheme with contributions exceeding £10,000 per annum.

Individual consideration may therefore need to be given to retaining scheme membership and suffering the annual allowance charge where contributions exceed £10,000 per year or opting-out of the auto-enrolment scheme.

What happens upon your death?

For those who are under the age of 75 at the time of death, it will be possible to leave the whole of the remaining pension fund that sits inside the remaining Lump Sum Death Benefit Allowance (LSDBA) to any beneficiary of their choice, tax free (with any amount above the LSDBA potentially being taxable).

This can then be taken in the form of a lump sum or series of income payments. The LSDBA does not apply if your nominated beneficiary decides to receive their benefits as an income.

For those who are 75 and over at the time of death, irrespective of whether the remaining fund is taken as a lump sum or a series of income payments, death benefits will be subject to Income Tax at the beneficiary's marginal rate.

Inheritance Tax planning

Death benefits from a pension are available to any named beneficiary, not just your spouse or financial dependent.

However, in the government's Autumn Budget in October 2024 they confirmed plans to make pension death benefits subject to Inheritance Tax (IHT) from 6 April 2027 if they are left to beneficiaries other than your spouse or civil partner.

This will be done by adding the remaining value to the rest of your estate. Any IHT payable on the pension benefits will be deducted from the inherited pension fund before it is received by your beneficiaries. The pension provider will be required to make the IHT payment.

In conclusion

The rules give you freedom and choice as to when and how you access your pension benefits. However, you could face a significant tax bill if you cash in your entire pension at once, rather than in stages making use of available tax rates and allowances. Your beneficiaries also could be faced with an Inheritance Tax death bill on your death.

In addition, a pension is to provide funds for your retirement. State Pension benefits are unlikely to provide you with a sufficient income to enjoy a comfortable retirement so it would be unwise to take all your pension savings early and then rely solely on the State Pension in the future.

How we can help you

Whether you are about to retire or have only just started saving towards your pension, we can help you.

Pensions can be a complicated area with frequent legislative change. Working with a financial planner gives you the peace of mind that you are always on track to achieve your ideal retirement.

Our expert team will guide you with suitable and sustainable retirement planning to help you meet your financial objectives.

If you would like further information on how we can help you, contact your Lucas Fettes Financial Planning adviser. You can also email **info@lffp.co.uk**, call us on **01603 706 820,** or visit our website at **www.lffinancialplanning.co.uk**

The contents of this guide do not constitute financial advice. The impact of taxation (and any tax relief) depends on individual circumstances. This has been prepared based on our current understanding of UK Law, Taxation and HMRC practice, all of which could be subject to change in future. The value of investments can fall as well as rise and it may not always be possible to receive back the sum initially invested. Past performance is not necessarily a guide to future investment returns.

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