

Financial Adviser, 24 February 2011

# Firing blanks

**The abolition of compulsory annuitisation never looked like it was going to affect a big portion of the next generation of pensioners, by Carl Lamb - MD of Almary Green Investments**

There has been much banging of drums and clashing of cymbals over the news that compulsory annuitisation - the rule that forces pensioners to take out an annuity by age 77 at the very latest - is to be abolished. It has been heralded as bringing greater choice and flexibility to the next generation of pensioners. But is this really the case?

The truth is that the changes will affect only a very small percentage of those approaching retirement. Government figures suggest that in 2009 alone over 450,000 annuities were purchased, with a value of nearly £11bn, and most of these would still have been purchased, even without compulsory annuitisation.

Annuities offer a secure regular income for life and continue to be the route most regularly advised for those with small to medium-sized pension funds. The vast majority of UK soon-to-be pensioners have less than £30,000 in their private pension pots, which is nowhere close to the amount that makes dispensing with an annuity an attractive proposition. For them the question is about where to find the best annuity products and rates in a difficult financial market, not whether or not to go down the annuity route.

However, there will be those who are in the fortunate position of having pension benefits far above the average. These will include those who have placed large sums into their private pension funds, perhaps through a Sipp arrangement. There will also be those in occupational schemes who have invested in their future through a parallel private pension scheme and have sufficient secure pension income from the defined benefit arrangement to allow them to take advantage of unsecured pension arrangements with their personal pension fund.

For these few, the abolition of compulsory annuitisation does offer new opportunities. There are three routes they can take: purchase an annuity, enter into one of two distinct versions of the unsecured pension path - capped drawdown or flexible drawdown - or, importantly, mix and match the solutions with a combination of annuity and drawdown, thus maximising the benefits of both routes.

A form of unsecured pension arrangement has been available post-age 75 for some years now. The alternatively secured pension was designed for those who have specific reasons for not taking out an annuity, such as religious beliefs. The ASP was introduced in 2006 and, at first, was seen as offering flexibility and estate planning opportunities, but once the tax framework around this type of arrangement was finalised, it was clear that it would only be suitable in a handful of cases. The current rules specify strict minimum and maximum income levels and any residue passed to non-dependent heirs attracts a huge tax charge of 82 percent.

Under the drawdown route, individuals are entitled to leave their pension savings in the appropriate pension investment vehicle, allowing it to continue to grow and build the pension pot, and for an income to be taken directly from segments of the fund, encashed as needed. The government is not keen, however, for pensioners to have the right to spend all of their

pension savings in a few heady years, falling back on the state for their support once the pot is empty. In order to prevent this, there are tight restrictions on how much of the pension fund can be spent through drawdown each year.

## **Alternatives**

In the case of capped drawdown, this amount is based on the annuity income that the fund could buy and is determined by the Government Actuary's Department. The new drawdown limits will be 100 per cent of the equivalent annuity figure. Of course, with every passing year in drawdown, the fund size is likely to decrease (although this should be at least partly offset by investment growth), the equivalent annuity figure will drop accordingly, and the opportunity to purchase an annuity at the original level will have been lost.

As an alternative to capped drawdown, the government has introduced flexible drawdown, with effect from April 2011. This will remove the maximum income limit provided the individual is able to prove that he can reach a guaranteed minimum income requirement. This requirement has been set at £20,000 a year from April 2011 and will be reviewed every five years.

The most important feature of the minimum income requirement rule is that qualifying income must be secure and guaranteed and cannot, therefore, take the form of investment income or other drawdown arrangements. Income from annuities, occupational schemes and the state pension are all qualifying income and if an individual has these in place, then a flexible drawdown arrangement could well be worth consideration. However, it would take a pension fund of about £250,000 to provide an annuity of £20,000 a year at today's rates. For the vast majority, there would be nothing left in the pot to take into a drawdown arrangement but for those who have funds in excess of this level, the opportunity is there for a more imaginative approach.

For those with very large pension funds, there is another fly in the ointment. From April 2012, the lifetime allowance for a pension fund will be £1.5m, with a 55 per cent tax charge levied on any funds in excess of this level. Where an individual has an existing pension fund of between £1.5m and £1.8m, it will be possible to protect it from the tax charge, but no further contributions to the fund will be allowed. Those with funds at this level who opt to follow the drawdown route in retirement – leaving the fund in investment - will need to make sure that growth does not take the fund over the lifetime allowance limit.

## **Benefits**

There are two clear benefits of a drawdown arrangement that will appeal to those with large funds. First, it may be useful to be able to retain specific investment vehicles into retirement. Business owners who have used their Sipp arrangements to finance their business premises, for example, may not wish to encash this investment, choosing to use the rental paid by the business back to the pension fund to finance their retirement income. Sipp arrangements may be particularly suitable for those keen to take advantage of the drawdown route, as they can hold a wide range of investments and can be adapted to meet encashment needs as they occur.

The second benefit of the drawdown route is the ability to pass on a portion of the residue of the pension fund to heirs on death. With an annuity contract, the value of the pension fund is lost to the pensioner's estate (although some protection against early death can be introduced into the contract).

It has always been possible to pass on the residue of a drawdown contract to one's spouse with a tax free lump-sum or income payable on death for pre-age 75 arrangements. Under current ASP rules, any residue of post-age 75 pension pots not used for dependents' benefits is subject to a punitive tax charge of 82 per cent. With drawdown now possible past the age of 75 for a wider range of individuals, some believe that a tax charge at this level will simply encourage pensioners, to spend, spend, spend in later years, risking the total depletion of the fund before death. Perhaps as a conscious effort to prevent this, under the new rules this tax charge has been reduced to 55 per cent on death, with no further inheritance tax payable.

Post-75 drawdown is an option that will bring more choice for a few specific future pensioners. However, the government is keen to ensure that such an arrangement is carefully controlled. Pre age 75, reviews of the drawdown arrangement must happen every three years, but once the pensioner reaches age 75, reviews must take place annually.

Despite the new flexibility in retirement income options, the big question for most future pensioners will be whether or not they can achieve their basic income requirements through an annuity. Those who have sufficient funds to take advantage of the abolition of compulsory annuitisation and go down the post-75 drawdown route will be those for whom affordability is less important than the ability to pass on at least some part of their pension savings to their heirs.

Not surprisingly, in the majority of cases where drawdown is an option for the individual, the advice is likely to be to combine both annuity and drawdown to build an income stream that has an acceptable level of security and flexibility so that retirement can be enjoyed to the full, however long life lasts.