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A legal way for savers to pick up 14%

By Stephen Womack

Hard-pressed savers were given no cheer last Thursday when the Bank of England base rate was kept at 0.5 per cent for the 15th successive month.

Continuing low interest rates are forcing savers to consider new ways to generate the income they need. And returns of up to 14 per cent have put purchased life annuities (PLAs) firmly on some savers' agenda.

A PLA involves handing over capital in exchange for a regular income. While the cash cannot be recovered, unlike a bank or building society savings account, the income is guaranteed for life.

Buyers also gain from the unique tax rules surrounding a PLA. Part of the regular payment is treated not as income, but as a return of the buyer's capital. This element is not taxed.



Picture perfect: Anne Williams uses income from her annuity to pay bills

Fiona Sharp, a chartered financial planner with financial adviser Almary Green in Cambridge, has arranged PLAs for several clients in recent months. 'It is something that has come on to my radar because of the poor returns on deposit accounts,' she says. 'The tax treatment makes the annuity an interesting option for those wanting security of income.'

Take the case of a man aged 70 who buys a £20,000 purchased life annuity. The gross annual income from this is £1,444. But £1,194 of this income is called the 'capital content', so the buyer is taxed only on the remaining £250. This means a net income for a 20 per cent taxpayer of £1,394. To earn the same after tax, he would need to find a savings account paying 8.7 per cent gross.

The equation improves with age. The same £20,000 earns a man aged 80 an income of £2,260 a year after basic-rate tax. Matching this requires an account paying an improbable 14.1 per cent gross.

Annuity rates are slightly lower for women because they have a longer average life expectancy. A woman aged 70 investing £20,000 would receive £1,376 a year and an 80-year-old would get £2,099.

Bob Bullivant, who runs specialist broker Annuity Direct, reports growing sales of PLAs and says: 'We're seeing a steady stream of people, mainly aged 70 or over, looking for security of income.'

Sharp adds: 'The annuity is a simple option for someone who wants guaranteed income to cover their bills. But it needs to be considered as part of a balanced income portfolio where the saver has access to capital invested elsewhere.'

Anne Williams is one of Sharp's clients. She is retiring this summer from her part-time job as a geology and geography lecturer at a further education college.

Anne, 66, was widowed in 2008 when her husband Philip died at the age of 64. After coming to terms with the initial shock of her bereavement, Anne realised that one of her financial priorities was securing her income as she headed towards retirement.

Philip, a former carpet retailer, had a pension that paid out a lump sum on his death. Sharp last month arranged for Anne to put a slice of this into a PLA with Aviva, paying the equivalent of six per cent a year on her money. She has retained other savings for emergencies, which will benefit from future rises in interest rates.

Anne, a keen artist from near Olney, Buckinghamshire, says: 'I have a State pension and will have a small teaching pension, but my purchased life annuity will help secure my income and pay some of my bills.'

Like other types of annuity, buyers of PLAs can choose to add a guarantee that the income will be paid for a minimum of five or ten years, guarding against their early death. They can also choose a lower income on day one, which then rises over time.

Bullivant says: 'Many of our clients are interested in taking an escalating income.'

Tim Whiting, a director of specialist broker Alexander Forbes Annuity Bureau, says: 'Those who are in poor health or have an existing medical condition may also be able to qualify for an enhanced annuity rate and a higher income.'

This is how care annuities - designed to cover the fees for nursing homes - work.

There are risks in going down the annuity route. Savers who hand over their capital will miss out on any future interest rate bounce.

The Organisation for Economic Cooperation and Development last month said British savings rates would need to rise to 3.5 per cent by the end of 2011 to head off the risk of higher inflation.

And hard-pressed savers could, of course, boost income themselves by running down capital rather than handing over a slice of savings to an annuity firm.

But such a strategy has risks. Take the case of £20,000 on deposit earning 2.5 per cent after tax. Our 70-year-old man who wants to match income from a PLA

would have to take £1,394 a year from savings - with the result that his money would be gone before his 87th birthday.

An 80-year-old man trying to match the income from a PLA would exhaust his capital before he reached 90.

Sharp says that a PLA can be far more tax-efficient than leaving money in the bank, especially for those paying tax at higher rates.