

BRIEFING NOTE

Income Drawdown

Annuity – regular income payments from an insurance company in return for a single up front payment.

An Income Drawdown plan – provides flexibility as regards income, date of retirement and asset selection but (in its basic form) with no guarantees.

This paper has been prepared by the Actuarial Profession to explain how income drawdown works. It defines income drawdown, compares it with annuities and examines in some detail the risks associated with this type of plan.

Introduction

Many people save into a personal pension or company-sponsored money purchase plan throughout their working lives to provide an income when they retire. The money they receive in retirement is paid to them from these savings either by use of an annuity (*insert link to Briefing Note on annuities*)¹ or an income drawdown plan.

An annuity provides regular income payments from an insurance company in return for a single up front payment. This allows the pensioner to continue to enjoy a guaranteed income from their accumulated pension savings without the risk of running out of capital in old age.

An income drawdown plan comprises an investment fund from which pension payments are drawn. This provides greater flexibility as regards income; date of retirement and asset selection but with no guarantees in respect of pensions benefits.

This note focuses on the basic form of income drawdown²

¹ In April 2007 the Actuarial Profession issued a Briefing Note on annuities it can be accessed at http://www.actuaries.org.uk/_data/assets/pdf_file/0010/27397/annuities_briefnote.pdf

² It is now possible to obtain some form of guarantee with some income drawdown plans for an additional, explicit charge however this is not within the scope of this paper.

How an income drawdown plan works

At retirement, as an alternative to purchasing a conventional annuity, the accumulated pension plan's assets are invested in an income drawdown fund which is set up under trust or deed poll insurance policy. The pensioner then may draw an income from the fund subject to a maximum amount in each year which is laid down in statute and currently set at 120% of the annuity that could be purchased based on tables produced by the Government Actuary, which are linked to current interest rates.

Every five years, the maximum income must be re-calculated to reflect the amount remaining in the fund and the latest tables from the Government Actuary.

The pensioner is liable to income tax on each payment of income. This reflects the fact that the pension fund was originally built up with contributions that received full relief from income tax. The insurance company administering the drawdown will usually deduct tax at source, in the same way as an employer deducts tax from income under the PAYE scheme.

No later than on attainment of age 75, the remaining fund must be used to purchase an annuity unless an Alternatively Secured Pension is set up (see below).

On death before 75, the fund can be used to provide an income to a dependant either by purchase of an annuity or a continuation of an income drawdown plan to the dependant. If income is not taken in this way, there is a 35% tax charge on the pension fund with the balance then available being outside of the deceased's estate.

Alternatively Secured Pensions (ASP)

An ASP operates in a similar way to an income drawdown plan and allows income between 55% and 90% of the income payable by a standard level annuity for a 75 year old to be taken. These limits must be recalculated every year, but continue to be based by reference to an annuity at age 75.

On death, benefits must continue to dependants where there are any. In the absence of dependants, the remaining fund can be passed tax free to a charity of the pensioner's or the scheme administrator's choice. The final option, in the absence of either dependants or a charitable direction, is for the remaining fund to be passed directly to beneficiaries of the deceased, but in this case the payment will be considered as unauthorised and subject to

inheritance tax as the top slice of the deceased's estate, bearing a combined rate of tax totalling up to 82%.

This exceptionally high rate of taxation comes about because the remaining fund that passes to the beneficiaries on death has firstly to pay three tax charges under pensions legislation, comprising an unauthorised payment charge of 40%, an unauthorised payment surcharge of 15% and a scheme sanction charge of 15%. These charges together total 70% of the payment on death. Secondly the payment net of these charges will be subject to inheritance tax, assessed as the top slice of the deceased's estate. If all the deceased's nil rate band has already been used up elsewhere in the estate, then inheritance tax at 40% is payable, leaving just 18% of the residual fund on death available for the beneficiaries, a combined tax rate of 82%.

The combination of tight restrictions on the level of income which can be taken and the high tax charges on the fund remaining at death are designed to restrict the attractiveness of the ASP to those with a genuine religious objection to the purchase of an annuity. This was the stated Government intention behind the introduction of the ASP.

Factors to be considered with an income drawdown plan

Before deciding on taking an income drawdown plan people should consider whether their pension plan is likely to be the primary source of income and the overall level of resources that they will have in retirement.

People with substantial resources, or whose pension plan is less material to their overall level of income in retirement, are more likely to be attracted by the additional investment freedom available under income drawdown as they will be in a better position to bear any associated risks.

Before deciding whether to opt for an income drawdown plan or an alternative (e.g. annuity) the pensioner will need to judge the rate at which income is taken from the fund having regard to how long they might live, the likely investment performance of the fund and the ongoing charges levied by the product provider. The product provider will make a charge for the investment of the funds and for the administration of the fund in accordance with the terms and conditions. The pensioner may also need to pay separately for advice in relation to how much income should be taken from the fund and the appropriate investment mix.

If, prior to the purchase of any annuity, assets remain on the pensioner's death, these would be for the benefit of their dependants. It is possible that the fund may be exhausted before the pensioner dies.

Therefore the key risks inherent in an income drawdown plan are:-

Investment

While one objective of an income drawdown plan is the investment freedom and opportunities afforded, there is the risk that investments in stocks and shares may not perform as well as expected and that the fund will be eroded with the consequent reduction in future income. Under conventional annuities, investment risk is taken by the insurance company; liabilities are supported by long dated fixed interest bonds where the asset proceeds are effectively fixed to match closely the annuity payments. This may result, on average, in lower investment returns than from a basket of shares but the individual is protected from falls in the stock market. Where the intention is to purchase an annuity at some future date, the income drawdown plan is also exposed to the risk of bond yields falling at the time of the desired annuity purchase. Such a fall would affect the annuity rate available at the relevant time.

Longevity

The lifespan of an individual is not predictable. If he/she dies early, the fund's assets will be available to provide dependant's benefits. If, conversely he or she lives to an old age, then income may need to be reduced to avoid the risk that the fund could be exhausted. Added to this individual-specific risk is the increasing longevity of the population which could mean an increased risk of annuity rates falling by the time an annuity is eventually purchased. Where an annuity is purchased at outset, the insurance company/annuity provider takes on this risk.

Tax

With a conventional annuity, the normal income tax rules apply. In the case of an income drawdown plan, HMRC has tried to apply equivalent rules, but there are additional tax anti-avoidance provisions that could have unexpected consequences if not carefully planned.

Annuity purchase at 75 (or earlier)

The terms available for the purchase of an annuity at some future date are unpredictable and therefore the amount that could be purchased may be higher or lower than the pension that could have been purchased at retirement. Those surviving to purchase an annuity will also have lost the cross-subsidy benefit available under an annuity from those dying before that age and will need to have achieved a higher investment return to compensate for this. This phenomenon is commonly referred to as “mortality drag”; its impact increases gradually for each year that the purchase of an annuity is postponed.

The requirement to re-calculate the maximum income every five years is intended to reduce the risk of the fund running out due to either poor investment performance or greater than expected longevity.

Summary

An income drawdown plan enables a pensioner to avoid locking their pension fund into annuity rates when investment conditions may appear unfavourable. However, they are exposed to the risks of both longevity of life and unfavourable financial conditions. These risks are partially controlled through certain restrictions on the maximum amount of income that may be withdrawn from the fund each year.

Comparison of relative value for money between income drawdown plans and conventional annuities is difficult and requires expert advice. Income drawdown plans may be particularly suitable where an individual need only take a restricted income for a period following retirement, perhaps because of the receipt of income from other sources.