Cambrian

Capped drawdown

What is it?

Capped drawdown is a type of income drawdown which allows you to withdraw income, within limits from your pension fund without purchasing a lifetime annuity.

Prior to 6th April 2015 it was possible to purchase a capped drawdown plan. Any capped drawdown arrangements in existence didn't automatically become flexi-access drawdown arrangements on 6 April 2015 and can remain as capped drawdown if required. Alternatively a capped drawdown plan can be converted to a flexi-access drawdown plan (with no restrictions on withdrawals) at the plan holder's request.

No new capped drawdown arrangements can be created, however it is still possible to transfer from one capped arrangement to another and, in some cases, for additional pension funds to be added to the capped drawdown plan.

The following rules for capped drawdown arrangements continue to apply from 6 April 2015 onwards for those who wish to remain in capped drawdown:

The maximum amount of income that can be drawn is 150% of a comparable lifetime annuity based on tables published by the Government Actuary's Department. It is not however necessary for any income to be taken. Any amount of income from zero income through to the 150% maximum can be selected.

The plan and maximum income will be reviewed every 3 years up to the anniversary of entering drawdown until the 75th birthday and annually thereafter.

Anyone who has a capped drawdown plan in place before 6th April 2015 can choose, after that date, to continue with the plan as capped drawdown and remain subject to the current rules. As long as the income withdrawn remains within the maximum limit, as calculated at the most recent review, you will continue to have a full Annual Allowance in relation to future tax relievable pension funding (£40,000 in 2020 / 21). If your income exceeds £200,000 pa you may be subject to a tapered annual allowance.

As soon as you withdraw any amount from the flexi-access drawdown fund (or exceed the maximum income withdrawal from your capped drawdown fund) a reduced Annual Allowance of £4,000 will apply to you in relation to future pension funding (the reduced figure doesn't apply to the funding of any final salary pension scheme of which you may be a member).

Aims of drawdown pension

The main purposes of drawdown pension can be summarised as follows:

- Deferral of annuity purchase, thus avoiding being locked into low annuity rates which may apply at the time of retirement.
- The drawdown pension option enables the policy holder to buy an annuity at a time that is best suited to them and hopefully when annuity rates are more favorable or provides an opportunity to avoid purchasing an annuity altogether where appropriate.
- The option enables investors to retain control over their pension investments and allows them to continue to be invested in the markets.
- It postpones the decision of deciding which type of annuity to lock into, for example. providing a contingent pension for a wife or husband and selecting a level or increasing pension.

- Income can be varied within allowable limits (see below) which gives flexibility. This can be useful for tax planning or where other sources of income are available.

Eligibility

It is no longer possible to open up a new capped drawdown plan, but it may be possible for additional funds to be added to your existing plan. It is also possible to transfer from one capped drawdown plan to another.

Critical yield

The critical yield calculation is an attempt to show the investment returns required from a drawdown arrangement to match the income that could be provided by a traditional annuity. The critical yield takes into account mortality drag and the additional costs involved with a drawdown pension and, crucially, assumes that throughout the period of withdrawal the underlying annuity interest rate and mortality basis will not change.

The critical yield is an important consideration in deciding whether or not drawdown pension is an appropriate investment vehicle or not. Once established it is then necessary to decide how the funds will be invested to achieve the critical yield. Generally, if long term income is the requirement, the drawdown pension route will only prove to be more effective in total income terms if the investment return generated is sufficient to cover:

- The investment return on current annuity rates, plus
- Mortality drag, plus
- The additional costs involved in a drawdown pension arrangement as opposed to an annuity.

Mortality Drag

Annuity providers know that not all annuitants will live as long as expected. The providers use this 'mortality gain' to subsidise current annuity rates. Therefore those clients who die earlier than expected subsidise the remaining annuitants. If you choose an alternative to annuity purchase, such as drawdown pension, then you do not benefit from this cross subsidy and effectively take on the 'mortality risk' yourself. The longer you delay annuity purchase, the less you will benefit from the cross subsidy when you eventually buy an annuity. This is known as 'mortality drag'.

Main Features of Capped Drawdown Pension

Age and health	The amount of income you can withdraw under a capped drawdown plan is based on the Government Actuary's Department (GAD) tables which are based on age but do not take health into account. For flexi-access drawdown you can choose how much income you want to withdraw without reference to any rates or limits other than the size of your pension fund. If you or your spouse is relatively young, a secured pension (lifetime annuity or scheme pension) would be less attractive due to the lower mortality factor and, in addition, there is a longer timescale to take advantage of the potential investment rewards and risks of Drawdown Pension. You can delay purchasing a Lifetime Annuity if you think annuity rates will improve.

Investment risk	Investing in relatively safe areas such as cash and gilts is unlikely to enable a higher lifetime income to be achieved than with a secured pension therefore investing in the type of assets that might achieve the extra returns necessary will involve risk. The shorter the term to the intended date of purchasing a secured pension, the greater the risk. The value of your pension fund may go down as well as up and investment returns may be less than those shown in the illustrations. The levels of income provided may not be sustainable, so in other words your pension fund may run out. Taking withdrawals may erode the capital value of the fund, especially if investment returns are poor and a high level of income is being taken. This could result in a lower income if / when an annuity is eventually purchased. If investment returns do not at least match the critical yield (in simple terms, the value of growth required to provide an equivalent income at the age you intend to purchase an annuity) your eventual income is likely to be less than that which could have been available via the annuity route. Please be aware that there may be occasions when an individual fund or funds may have a higher risk rating than your overall stated attitude to risk. If this is the case, then the overall risk rating applied to all of the combined funds being recommended is still designed to meet your stated tolerance.
Other risks	Annuity rates may be at a lower level if / when annuity purchase takes place and there is no guarantee that your income will be as high as that offered under the other options referred to earlier. There is no guarantee that annuity rates will improve in the future. They could be lower if / when you decide to purchase an annuity than they are currently. Your pension may be lower than if you bought a lifetime annuity now. High levels of drawdown pension may not be sustainable in the longer term. If you intend to invest some or all of your pension fund there may be charges involved with the new investment. If you withdraw large amounts of capital from your drawdown fund these may impact on any means tested benefits you are in receipt of.
Flexibility	You can take your tax free cash lump sum immediately to spend or invest as you wish without the need to take any income at all if this suits your circumstances. Subject to limits imposed by legislation (with capped drawdown), you will be able to plan in advance the level of income that you wish to take each year, so that you can take into account any other sources of income which may become available to you. There are products available which offer a level of guaranteed income which is paid regardless of the performance of the investments in your pension fund thereby removing some of the risk involved with Drawdown Pension (albeit at a price and subject to specified conditions being met). If the Drawdown Pension product is set up within a Self Invested Personal Pension (SIPP) wrapper, this will permit access to a wide range of investments and enable the investments to be rearranged easily if required (and usually more cost effectively than switching between product providers).

Taxation	You can usually take up to 25% of your pension fund as a tax free lump sum. The provider of your pension plan will deduct tax from any withdrawals you take through the PAYE system and you should be aware that if they do not hold your correct tax code, an emergency code will be used and you may need to reclaim or pay additional tax through your self-assessment tax return or by way of a separate claim. The income you draw will be taxed as earned / pension income, with tax deducted at source in the tax year in which it is withdrawn. This could mean income tax of up to 45% (46% in Scotland) depending on your circumstances. You can structure your income to mitigate liability to personal income tax. By reducing your income in some years you may be able to avoid a higher rate tax liability. If in flexi-access drawdown you may withdraw an unlimited amount from your pension fund, although all amounts withdrawn will be taxed as income at your marginal income tax rate(s). All statements concerning the tax treatment of products and their benefits are based on our understanding of current tax law and HM Revenue and Customs' practice. Levels and bases of tax relief are subject to change.
Transfers & withdrawals	It is possible to transfer your drawdown plan from one provider to another. If your existing drawdown fund is still within the five year reference period applicable under the old unsecured pension rules your new plan will continue under the old rules until the end of the current five year reference period, from the start of your next pension year, the new government maximum income rules of 150% will apply. The maximum amount of income that can be drawn is 150% of a comparable lifetime annuity based on tables published by the Government Actuary's Department. It is not however necessary for any income to be taken. Any amount of income from zero income through to the 150% maximum can be selected. The plan and maximum income will be reviewed every 3 years up to the anniversary of entering drawdown after the 75th birthday and annually thereafter. Whether the maximum income level rises or falls will depend on general interest rates and your pension fund size at the time of review, which in turn is dependent upon investment performance and withdrawal levels. You will be able to convert your capped drawdown pension to a flexi-access drawdown fund at any time, which will allow you to withdraw unlimited amounts, but as soon as a withdrawal is made from the flexi-access drawdown plan the money purchase annual allowance will be triggered. This means that you will only receive tax relief on money purchase pension contributions up to £4,000 a year. If you do not convert your fund and take a withdrawal or you remain in capped drawdown and withdraw no more than the maximum income limit calculated at your most recent review, the capped drawdown rules will continue to apply and you will be able to make tax relievable pension contributions up to £40,000 a year (assuming you aren't subject to the tapered annual allowance rules). Tax relief on personal contributions is limited to 100% of your earnings in the tax year (or £3,600 if greater).

	You can make ad hoc withdrawals instead of, or in addition to, taking a regular income from your fund.
Availability	There are many drawdown providers in the market and you should ensure you consider costs, service standards and investment choice before selecting a provider.
Long term care	Your income payments will be taken into consideration should you require long term care in the future. If greater than the actual income being taken, an income in line with that available from an annuity based on your age at that time will be taken into account.
Treatment after death	Your beneficiaries can continue to take withdrawals from any remaining drawdown fund on your death (annuity purchase is also an option) or take the remaining fund as a lump sum. If you die before age 75 any income or lump sums taken by your beneficiaries will be tax free . If you die after age 75, any income or lump sums taken by your beneficiaries will be taxed at the recipient’s marginal income tax rate(s).
Type of charges	Drawdown Pension products tend to have higher charges than Secured Pension products due to the greater amount of administration and advisory input they involve.
Future planning issues	If you decide to move abroad after retirement, you can arrange to have your pension paid to an overseas bank account if you wish to. If your health / circumstances change, you may change the amount of income you are drawing and or / purchase an annuity. Further tax-relievable pension contributions may be made before age 75. If you are taking income from capped drawdown you still have the full £40,000 annual allowance (unless subject to the tapered annual allowance rules), and you are also able to carry forward any unused allowance from the previous three years. Please note that if you have also used flexi-access drawdown or withdrawn an Uncrystallised Funds Pension Lump Sum under a different arrangement you will be subject to the £4,000 money purchase annual allowance (MPAA) instead.