

Phased retirement

What is it?

Phased retirement refers to the process whereby, instead of all pension funds being accessed (or crystallised) at the same time, they are accessed in stages over time. Each time a part of the pension fund is required in order to provide a lump sum and/or an income it can be used in a number of ways – to purchase an annuity, placed in drawdown, or taken as a lump sum straight from the existing pension fund (known as an Uncrystallised Funds Pension Lump Sum or UFPLS).

Annuity purchase involves using some of your pension fund to purchase a lifetime income stream, normally of a guaranteed amount.

Drawdown Pension is a method of withdrawing benefits from your pension fund without purchasing a lifetime annuity. This type of plan is aimed at the more financially aware investor and tends to attract the larger pension funds. The minimum amount that can be invested varies from company to company and benefits are currently available from age 55 onwards. The minimum pension age is expected to increase to 57 from 2028 with further increases as State Pension Age goes up.

Compared to a conventional annuity, where the basis of income is fixed at outset and is unable to be amended, taking a series of withdrawals allows more flexibility with income being varied according to changing needs.

With phased drawdown plans, typically all pension funds are brought together into one personal pension to provide either a single fund or a number of separate but identical segments, which can be drawn on as required. In the first year of retirement you decide on the level of income that you require and the provider calculates the proportion of fund value/ number of segments needed to provide for the chosen level. Normally up to 25% of each segment can be taken as a tax free cash sum with the remaining balance securing an annuity at the then available annuity rates/or drawdown pension. The remaining fund value/segments not needed to produce an income are left invested until required. In the second year you decide how much income is needed after taking into account the income already being received from the annuity/drawdown pension in the first year. Again income consists of a tax free cash sum and an annuity/drawdown pension. It is possible to vary the type of annuity/drawdown pension selected on each occasion and it need not be on the same basis as the first or subsequent years. In each subsequent year the same process is repeated allowing you to take account of changing personal and family circumstances. This process can be continued indefinitely subject to there being sufficient funds remaining. The income you draw will generally be taxed as earned income, with tax deducted at source.

The remainder of your fund not being used to provide drawdown pension is invested for an indefinite time period (which could be until your death or until such time as you choose to purchase an annuity or take further drawdown pension (and tax free cash)). However, some phased retirement products may require that benefits commence no later than age 75.

Eligibility

In order to purchase an annuity or place pension funds in drawdown you must be aged 55 or over or, if younger, meet ill-health conditions.

In order to take advantage of UFPLS there are a number of conditions that need to be met:

- You must be aged 55 or over or, if younger, meet ill-health conditions

- The payment must be payable from your uncrystallised rights held in a money purchase pension
- If you are aged under 75, you must have more lifetime allowance remaining than the lump sum required
- If aged over 75, you must have some lifetime allowance remaining
- If you have primary or enhanced protection with protected tax free cash or a lifetime allowance enhancement factor but the lump sum allowance is less than 25% you can't take your benefits as a UFPLS
- Where scheme specific lump sum protection exists, the right to the higher TFC would have to be given up in order to use UFPLS

Critical yield (for drawdown pension)

The critical yield calculation is an attempt to show the investment returns required from a Drawdown Pension 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 in a Drawdown Pension and, crucially, assumes that throughout the period of withdrawal the underlying annuity interest rate and mortality basis will not change.

Clearly 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 Phased Retirement

Age and health	<p>Flexi-access drawdown allows you to choose how much income you want to withdraw without reference to any rates or limits other than the size of your pension fund.</p> <p>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.</p> <p>As you get older there is the prospect of annuity rates rising and providing you with higher income. This is because life expectancy is shorter for someone older and it therefore costs less to provide</p>
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	<p>them with the same given level of income than for a younger person, assuming all other things being equal.</p> <p>You can delay purchasing a Lifetime Annuity if you think annuity rates will improve.</p>
Investment risk	<p>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.</p> <p>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.</p> <p>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.</p> <p>This could result in a lower income if/when an annuity is eventually purchased.</p> <p>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.</p> <p>Deferring the purchase of the annuity does not guarantee a higher level of future income and the value of your remaining pension fund, when aggregated with any income you have taken, may not achieve the required level of growth to maintain income levels at the same level as could be achieved through the purchase of a conventional Lifetime Annuity with the entire pension fund (excluding tax free cash) at outset. This is because withdrawals of tax free cash and income withdrawals may erode the value of your pension fund if investment returns are not sufficient to make up the balance (including charges for the ongoing administration of the plan).</p>
Other risks	<p>Annuity rates may be at a lower level 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.</p> <p>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.</p> <p>There is no guarantee that your income will be as high as the income available under the Lifetime Annuity routes referred to earlier.</p> <p>You may feel that the possibility of future higher income does not compensate you for being unable to enjoy a guaranteed and secure level of income today and for the rest of your life.</p>
Flexibility	<p>Your uncrystallised pension funds and any drawdown pension fund not being withdrawn as income continue to be invested, thus providing you with the possibility of higher future income. This depends largely on how much income you take out of the pension</p>

	<p>fund (especially in the early years) and future investment returns achieved on the residual pension fund.</p> <p>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).</p> <p>You will be able to change the shape of your retirement income to reflect your personal circumstances in the future. Should your health deteriorate, it may be possible to achieve a better annuity rate (ie. higher income) in future. It is also possible to postpone the choice of whether to include any survivor's pensions until a lifetime annuity is purchased – this could be valuable for someone whose spouse is in poor health.</p>
Taxation	<p>You will not receive all of your tax free cash as a lump sum at outset, because you are accessing your pension fund gradually over time and using the cash to supplement your income.</p> <p>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.</p> <p>With regard to the taxation of a UFPLS, only 75% of the lump sum will be taxable (as earned/pension income at your marginal rate(s) of tax). The other 25% will be paid tax free.</p> <p>When funds are being used to purchase an annuity or to be placed in drawdown, 25% of the funds can be taken as a tax free lump sum. The annuity or drawdown income is taxed as earned/pension income.</p> <p>The provider of your pension plan will make your payment 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.</p> <p>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.</p>
Transfers & withdrawals	<p>It is possible to transfer your drawdown plan from one provider to another.</p> <p>You will be taxed on any income withdrawn at your marginal rate(s).</p> <p>You can make ad hoc withdrawals instead or in addition to taking a regular income from your fund.</p> <p>From 6 April 2015 the option to take UFPLS was introduced alongside the alternatives of annuity purchase and flexi-access drawdown.</p> <p>UFPLS means withdrawing a lump sum directly from your money purchase pension fund without first having to move the funds into drawdown. UFPLS could potentially be used as part of a phased retirement strategy (alongside the other alternatives of annuity</p>

	<p>purchase and flexi-access drawdown as required), for example in the first year of retirement or drawing benefits you decide on the level of income that you require and ask the pension provider to make payment of that amount to you as a lump sum. 25% of each UFPLS is tax free with the balance taxable as earned income. The remaining pension fund is left invested until required. In the second year (or when required) you decide how much income is needed and withdraw another UFPLS from your uncrystallised pension plan – 25% tax free and the balance taxable. In each subsequent year (or on an ad-hoc basis) the same process is repeated allowing you to take account of changing personal and family circumstances. This process can be continued indefinitely subject to there being sufficient funds remaining.</p>
Availability	<p>There are many drawdown providers in the market and you should ensure you consider costs, service standards and investment choice before selecting a provider.</p>
Long term care	<p>Your income payments will be taken into consideration should you require long term care in the future. If greater than the actual level of income you are taking, an annuity based on your age at that time will be taken into account.</p>
Treatment after death	<p>Whether uncrystallised or in drawdown pension, any remaining pension fund on death can be paid to your beneficiaries as a lump sum or as income payments, tax free if you died before age 75. On death after 75, if death benefits are taken as income (drawdown or annuity) or as a lump sum they will be taxed on the recipient at their marginal tax rate(s).</p> <p>Death benefits on any annuities that have been purchased will depend on the options selected at outset and could include survivors' annuities, continuing annuity payments for the remainder of a guarantee period and/or a lump sum representing the purchase price not yet received as income payments. Payments are taxed as described above for income and lump sums.</p>
Type of charges	<p>Drawdown Pension products tend to have higher charges than Secured Pension products due to the greater amount of administration and advisory input they involve.</p>
Future planning issues	<p>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. Further tax-relievable pension contributions may be made before age 75. Where drawdown income or UFPLS is being taken, tax relievable contributions to money purchase pensions will be limited to the £4,000 money purchase annual allowance rather than the standard annual allowance of £40,000.</p> <p>If your health/circumstances change, you may change the way/amount of income you are drawing and or/purchase an annuity.</p>