How do Conventional Annuities Work?

What is an annuity?

An annuity is a contractual agreement between an insurance company and the life assured to pay the life assured **an income for their lifetime** in exchange for a lump sum payment. This article explains how annuities purchased from pension funds work.

Under current legislation, benefits from pension schemes can be taken anytime from the age of 55. Annuity income is liable to income tax and for many individuals will remain a good choice for providing income in retirement from their pension funds.

Once an annuity is purchased you will no longer have access to the capital which was used to purchase it.

Pension Commencement Lump Sum (Tax-Free Cash)

You must decide before purchasing your annuity, how much of your pension commencement lump sum (tax-free cash) you wish to take. Once the annuity is purchased the tax-free cash option is no longer available. The maximum tax-free cash from a personal pension plan is restricted to 25% of the fund value. There is no right or wrong answer as to whether you take the tax-free cash it is down to your own personal circumstances and preferences.

The Open Market Option

In most cases your existing pension provider will offer you a default annuity option. Please be aware that this may not suit your circumstances and the rates offered could be considerably **less** than that available from other insurance companies.

Under current legislation your existing pension provider must allow you the open market option. This means that you have the right to use your pension fund and purchase an annuity from another annuity provider. **In many cases this is likely to mean a considerably larger pension income and therefore the open market option should always be explored.**

Before considering the open market option, you should check with your existing personal pension provider to see if any **guaranteed annuity rates** apply to your policy. **Guaranteed annuity rates can be extremely valuable** and could provide you with a much higher rate than currently available on the open market. Sometimes they may only be available if you purchase a certain type of annuity such as a single life annuity, this means the annuity is on the life of the person who owns the pension plan. Although some providers will provide alternative guaranteed rates if you wish to add a spouse's pension.

Options

There are several options available to you when deciding to take an annuity and because it is a one off decision, you should seriously consider taking independent financial advice.

Level

The income can be paid as a level income throughout your lifetime, this means that the income will never increase and if you were to live for a considerable time, the income would reduce in value in compared to inflation This income will obviously be higher initially than buying an index linked annuity.

Indexing an annuity

Alternatively, you could choose to index your pension annuity by either a fixed percentage, i.e. the level of income would increase each year by 3%/ 5% or by the retail price index, thereby keeping the real value of the pension income. This means that the level of income you would receive at the start of the contract will be lower than a level annuity.

Spouse's Benefits
An annuity will normally die with you meaning that the income would stop upon your death. Therefore, if you are married you may want to ensure that in the event of you pre-deceasing your spouse or civil partner that the income is paid to them. Spouses' pensions can be paid as a percentage of your annuity income such as 50%, 66% or even a 100% of your annuity.

If the annuitant dies before the age of 75, the spouse's income benefit payable, will be paid tax-free.

If the annuitant dies after the age of 75, the spouse's income benefit will be taxed at their marginal rate of tax.

Guarantee period
You may wish to ensure that the income is paid for a certain period, in the event of your premature death. Typically, terms of between 5 or 10 years are chosen, however the guarantee period can be for any period.

Therefore, if you chose a 10 year guarantee period and you died 3 years after purchasing the annuity, the income would continue to be paid for a further 7 years to your beneficiaries.

If you have also selected a spouse's pension, it will of course be paid for their lifetime. A guarantee is sometimes chosen by people that are not married, thereby meaning that in the event of their premature death, the pension will still pay for a certain period. Alternatively, where a married individual has chosen for example, a 50% spouses' pension with a 10 year guarantee, this would mean that if they died after 3 years, 100% of their pension would be paid for a further 7 years and then reduce to 50%, assuming the spouse is still alive.

If the annuitant dies before the age of 75, the remainder of the guaranteed income and any dependents/spouses pension will be paid tax-free to the recipient.

If the annuitant dies after the age of 75, the remainder of the guaranteed income and dependents/spouses' pension will be taxed at the marginal rate of tax of the recipient.

Capital Protection
If this option is selected, in the event of your death, the annuity provider will pay a lump sum to your beneficiaries.

The lump sum payment paid, is equal to the original investment, less the gross income payments that have been paid to you. This payment is paid tax-free if the annuitant dies before age 75.

If the annuitant dies after the age of 75, the payment is subject to 45% tax, for payments made between 6 April 2015 and 6 April 2016 and if they die after 6th April 2016, the payment will be taxed at the recipient's marginal rate of income tax.

Other types of annuities

Enhanced Annuities
Enhanced annuities offer higher rates (meaning a higher level of income is paid for the lump sum paid to the annuity provider) for individuals with medical conditions or lifestyles that may shorten their life expectancy, such as smokers, diabetes sufferers and the obese, to name but three. Ex-smokers could also qualify.

Impaired Life annuities
These annuities are offered to individuals with certain medical conditions, usually implying much higher mortality than applies to enhanced annuities. This may involve full underwriting, undergoing a medical examination and full medical history disclosure, this could result in an extremely higher annuity rate being offered.

It is estimated by the Association of British Insurers (ABI) that more than 40% of individuals may qualify for either an enhanced annuity or impaired life annuity therefore, even if you feel that you may not qualify for an enhanced/impaired life annuity you should always mention your medical history to your adviser. Historic medical conditions could qualify you for one of the above annuities.

Investment linked annuities.

Investment-linked annuities offer a variable income based on the investment performance of an underlying fund or funds. Like conventional annuities, the basic level of initial income is dependent on your age, size of funds and the options selected. Additionally, you are normally required to assume a future rate of growth for the underlying funds – the higher the selected rate, the higher your starting income will be and vice versa.

It is worth noting, however, that income levels under an investment-linked annuity will fluctuate with the underlying performance of the funds and they will only be suitable for those who can cope with an income that varies from year to year. Subject to the annuity provider's rules, you may change the assumed rate of future growth or switch to a conventional annuity at specified points in the future.

Advantages of Annuity Purchase

- Once agreed, you benefit from a level of income that is guaranteed throughout your lifetime and that of your spouse (if you have chosen a spouse's pension).
- Annuity rates may be lower in the future and therefore by purchasing an annuity now, you are securing benefits until death.
- You may wish to choose an annuity that increases by a fixed percentage or the retail price index each year, this allows you some comfort that the annuity is keeping pace with inflation.
- You can opt for an annuity that will guarantee the income for a certain period (maximum 10 years), therefore in the event of your death within the guarantee period, income would continue.
- You may also choose a capital guarantee that will provide the return of some of the fund if you were to die early.
- If you are or have been a smoker, have been or are in ill health, or you suffer from certain medical conditions (such as diabetes, high blood pressure) you may be entitled to receive enhanced annuity rates.
- Conventional annuities are not subject to investment risk and therefore irrespective of the performance of the markets you have a secure income for your lifetime.
- You can benefit from the open market option facility.

Disadvantages of Annuity Purchase

- Once an annuity has been purchased it is fixed and the decision cannot be reversed or changed.
- You cannot add spouse's benefits, increases, or guarantees once the annuity is in payment.
- Control of the pension fund is lost, and you can no longer access the capital.
- Where the pension fund is used to purchase a spouse's benefit and your spouse were to predecease you, this benefit is worthless.

*This information is a brief guide on Annuities and in no way constitutes a recommendation or any form of advice and was correct as of 27th May 2023 and is based on our current understanding of legislation. Please contact us for further details on 01372 371030. The information contained in this booklet is not to be used by any third parties without our express permission.