What is Income Drawdown?

This guide is just a very brief overview of how Income Drawdown works and the options available. If you are considering this option, you should take independent financial advice from a qualified specialist.

How does it work?

Income Drawdown differs very much from annuity purchase, because unlike annuity purchase you are not giving away your pension to a provider for a guaranteed income. Income Drawdown leaves the responsibility with you but in return, provides you with greater flexibility. This is not suitable for everyone and if you require a guaranteed income without any risk, annuity purchase should be seriously considered.

Firstly, although Income drawdown provides the most flexible way in drawing benefits you should look on a pension fund as income producing and not as bank account from where to take ad-hoc lump sums from as this could seriously affect your level of income in retirement, unless of course you have sufficient income from other sources to meet your income needs in retirement.

Taking benefits

There are two types of income drawdown available. These are as follows:

Flexi-Access Drawdown

Flexi-Access drawdown allows individuals access to their entire pension pot with flexibility as to how and when the individual takes their income/ tax free cash.

If you wish you could take some or all your tax-free cash, up to the maximum 25% of the fund value and leave the residual fund, to take income from immediately or later. Any income is, of course, taxed at your marginal rate of income tax.

The following example demonstrates how Flexi Access Drawdown could work:

John has a total pension fund of £300,000. He wishes to take a tax-free lump sum of £25,000 and an income of £5,000.

In this example he would have to use (crystallise) £100,000 of his pension fund to produce sufficient tax-free cash. This would provide £25,000 tax-free cash (i.e., 25% of £100,000) and the remaining £5,000 would be taxed at his marginal rate. This leaves him with a pension fund split into two elements.

- £200,000 remains untouched and is known as the uncrystalised pension. He also can still take up to 25% of this fund as tax-free cash at any time. He will also benefit from investment growth which would enhance the overall tax-free cash entitlement.

- He also has £70,000 in a crystalised fund, which is the remainder of the £100,000 part of the fund. Any withdrawals from this pot would be taxed at his marginal rate, irrespective of how well the fund grows.

If in the following year, he only requires taxable income, he can withdraw this from the crystallised fund of £70,000.

If, however, he needs further tax-free cash, then he would need to take this from the uncrystalised pot.

Uncrystallised Funds Pension Lump Sum

Under this arrangement you are crystalising an entire slice of your pension fund. The first 25% of the payment is treated as the tax-free cash element and the remaining 75% is taxed at your marginal rate of tax.

This leaves the remaining funds uncrystalised. As an example:

Mary has a pension fund of £200,000 and she requires £10,000 from her fund. The first £2,500 is considered as the tax-free cash element and paid free of tax. The remaining £7,500 is paid and taxed at her marginal rate of tax. Assuming she is a basic rate taxpayer this gives her a marginal rate of 15% on the overall income (based on 20% basic rate tax)

The remaining £190,000 of her fund will stay uncrystalised until she requests her next income payment, which will be treated in the same way.

Money Purchase Annual Allowance

If you have taken or decide to take flexible benefits which include income from your **personal pensions** this then restricts the amount you can contribute to personal pensions going forward. The maximum amount is restricted to £10,000 per year. (Income from annuities or final salary pensions are excluded).

This restriction only applies if you take income from your personal pension fund. Taking tax-free cash from the fund is excluded.

The money purchase annual allowance will only start to apply from the day after you have taken flexible benefits and affects no previous contributions made.

Capped Drawdown

This applies to individuals that entered Income Drawdown prior to 6th April 2015. This is no longer available for new people entering income drawdown. It works in the following way.

Capped Drawdown limits the amount of income that can be taken from your pension pot to specific limits set by the Government Actuary Department, these are known as GAD rates. The GAD rate is based on your age and sex and works out to be a percentage of the crystallised part of your pension fund. The maximum income that can be taken is 150% of the GAD rate and the minimum is 0. This means that you could just access the tax-free part of your pension fund and not take any income.

You can elect to transfer your capped drawdown pot to one of the new flexible drawdown pensions, but advice should be taken before proceeding.

Under these arrangements, an individual can still pay up to £60,000 in pension contributions per year.

Death benefits

The death benefits payable under income drawdown are as follows.

Before age 75
If death occurs to the policyholder prior to the age of 75 both the crystallised and uncrystalised funds are initially transferred in pension funds for the beneficiaries. The beneficiaries can access these funds at any age and any income or capital taken from those funds are paid tax-free under current legislation. No inheritance tax currently applies.

After age 75
If the policyholder dies after the age of 75, the nominated beneficiary will receive the fund, but any income payments made to the beneficiary are taxed at their marginal rate. Again, these withdrawals can be taken at any age.

Expression of Wish
An expression of wish is a request to the Trustees, to whom you would like the pension fund to be paid to on your death, therefore it is extremely important that you put a death nomination form in place. It should be completed listing all the potential beneficiaries that you may want to benefit from the pension fund.

Warning
Please remember that a pension fund is essentially a vehicle to provide for income in retirement and if used sensibly this will create more flexibility on how and when retirement benefits are taken. This option will not suit everyone and for some people buying an annuity, that will provide a guaranteed income, will still be the right choice.

Investors who initially choose the option of income drawdown can at any stage, transfer their funds to purchase an annuity.

Suitability
Income Drawdown will not suit everyone but may be suitable for the following.

- Individuals who wish to maintain control of their pension funds.
- People who consider that death benefits are very important to them.
- Investors that fully understand investment risk and are willing to take this risk.
- Individuals that wish to vary their income such as semi-retiree's.
- Individuals that want greater flexibility and choice
- People that want to phase in retirement income over several years.

Other Considerations for Income Drawdown

Investment risk
You and not an insurance company take the investment risk. The investment can be sensitive to market movements and whereas you will benefit if the fund performs well, if the fund value falls in value, it could affect your immediate and future income. You therefore have to be comfortable with taking investment risk.

Annuity rates & risk
You can purchase an annuity from your fund at any time or use part of your fund to purchase an annuity and continue in Income drawdown with the other part of the fund. Annuity rates do not always improve with age because they are based on a number of assumptions such as interest rates, GILT yields and longevity and in fact, rates could decline as you get older. This has been documented by the continual fall in annuity rates over the last 15 years.

Mortality drag.
Annuities are based on the principle of "mortality cross subsidy". Those who die before their normal life expectancy subsidise those who live longer than expected. If an annuity is deferred the investor is missing out on this subsidy. The extra return required to compensate for the absence of this subsidy is called mortality drag. Because of increasing longevity this has less effect the younger you are but more effect after the age of 70. Therefore, it is essential to consider the benefits of staying in Income Drawdown after the age of 70.

Critical Yield
The critical yield is the calculation used to show the investment returns required from the contract to match the income that could be provided by a conventional annuity at certain ages in the future. It is based on current assumptions of the cost of mortality drag, future annuity rates and the ongoing costs of the contract. Therefore, a high critical yield could mean that greater investment risk will need to be taken.

Income
The biggest challenge for plan holders will be to ensure that the pension fund is sufficient for their lifetime, therefore you need to carefully consider how much income is reasonable to take from your pension fund each year, taking too much could mean that the fund runs out before you. This could mean selling other assets such as your house to fund for later years.

Charges

Due to the type of contract, you need to factor in the cost of advice as regular reviews are required from a suitably qualified adviser along with the costs associated on the product. Therefore, ongoing costs need to be factored in when calculating the ongoing investment return required to meet your current and future income needs.

Advantages of Income drawdown

- You have full investment and income control in your retirement.
- You will benefit from any investment growth made within the fund.
- You can vary the level of income you require.
- After drawing the pension commencement lump sum, the remaining fund, less charges, will continue to be invested in a relatively tax free environment.
- You can purchase an annuity at any time with some or all the funds.
- If you die before an annuity has been purchased, the remaining fund can be pass across to your nominated beneficiaries.
- You do not need to take all your pension commencement lump sum at once. Income Drawdown pension allows you to phase this in, as required.

Disadvantages of Income Drawdown Pension

- Taking a high level of income maybe unsustainable during the period of pension fund withdrawal and could result in you, having to reduce your income and/or your pension fund running out of money.
- Taking withdrawals may erode the capital value of the fund especially if the investment returns are poor. This could result in a lower fund value being available if you wish to buy an annuity at a later date.
- Annuity rates may fall, whilst you are in income withdrawal and when or if an annuity is eventually purchased, it could be lower than the annuity income that could have been purchased at outset.
- Under the annuity option there is an element of cross-subsidy from annuitants who have died prematurely to those who remain alive. The cross-subsidy makes little difference if you take early retirement but is more noticeable after the age of 75, as the chance of mortality increases. This is known as ‘loss of mortality gain’. Those deferring annuity purchase, benefit less from cross subsidy.
- For the fund to maintain purchasing power, the investment performance, after charges must be greater than the interest rate, that would have been achieved to secure the annuity rate plus any mortality gain and expenses.
- The income drawdown contract will levy ongoing charges and if taking ongoing professional advice there will also be this cost to consider.
- There is no guarantee that the income you receive over the lifetime of the drawdown plan will be greater than that payable from an annuity or other income product.
- If income is taken from an income drawdown fund, you reduce your annual pension contribution allowance to just £10,000 per annum for all future years.

This information is a brief guide on Income Drawdown and is based on our current understanding of current legislation. This in no way constitutes a recommendation or any form of advice and was correct as of 30th May 2023. Please contact us for further details on 01372 371030.

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