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## **Baker Davies Product Guide**

# Phased retirement

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## 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 will increase to 57 from 2028 with further increases expected 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, this will change to 57 from 2028 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, this will change to 57 from 2028 or, if younger, meet ill-health conditions
- The payment must be payable from your uncrystallised rights held in a money purchase pension
- There's no maximum age to take an UFPLS and there's no need to have any lump sum allowance or lump sum and death benefit allowance available in order to take an UFPLS but the amount of the tax free element of the UFPLS payment is determined by the amount of available allowances (and can't be more than 25% of the UFPLS payment)
- An UFPLS can't be taken if primary or enhanced protection with protected tax free cash is in place, if a person has a lifetime allowance enhancement factor but the lump sum allowance is less than 25%, if a person has enhanced protection and has taken a serious ill-health lump sum and an UFPLS can't be paid from a disqualifying pension credit
- 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

<p>Changes from 6 April 2024</p>	<p>If you have accessed a pension plan of any type before 6 April 2024 and might benefit from increasing your tax free lump sum entitlement through obtaining a Transitional Tax-Free Amount Certificate (TTFAC), then if you take a Pension Commencement Lump Sum (PCLS or tax free cash sum) or Uncrystallised Funds Pension Lump Sum (UFPLS) on or after 6 April 2024 before obtaining a TTFAC you will have lost the chance to do so. This may mean a lower entitlement to tax free lump sums during your lifetime or for your beneficiaries if you should die before age 75 than might have been the case if you had obtained a TTFAC</p>
<p>Age and health</p>	<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 are 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 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>
<p>Investment risk</p>	<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>

Investment risk	<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>
Other risks	<p>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.</p> <p>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.</p> <p>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).</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>
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 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 (i.e. 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>

Taxation	<p>With regard to the taxation of an UFPLS, 25% of the UFPLS payment may be taken tax free within available lump sum allowance and lump sum and death benefit allowance limits, with the balance taxed as pension income at your marginal rate(s) of income tax. From 2024/25 it is possible to take an UFPLS payment even if over 75 and whether or not the UFPLS has a tax free element, i.e. an UFPLS can still be taken if all allowances have been fully used up but all of the payment would then be subject to income tax.</p> <p>When funds are being used to purchase an annuity or to be placed in drawdown, 25% of the funds can usually be taken as a tax free lump sum within allowable limits. 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. 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>
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, free from income tax if you died before age 75 (in the case of lump sums paid from funds crystallised after 5 April 2024, as long as they are within your available Lump Sum and Death Benefit Allowance). 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> <p>Most pensions are currently free from inheritance tax. For deaths after 5 April 2027 the government intends that most pension death benefits will form part of the deceased's estate.</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

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 efficient contributions to money purchase pensions will be limited to the £10,000 money purchase annual allowance rather than the standard annual allowance of £60,000.

If your health/circumstances change, you may change the way/amount of income you are drawing and or/purchase an annuity.



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