

## Introduction

Following the introduction of 'pension simplification' on 6 April 2006 you can now take your pension benefits in the following ways:

- Purchasing a 'secured pension', that is an **annuity** (ie an income for life). This can be level or increasing.
- Purchasing an 'unsecured pension', that is a **pension drawdown** product, subject to simplified rules, but not after age 75. This option is the subject of this Guide.
- Purchasing an 'alternatively secured pension'. This is available from age 75 and is designed for people with religious beliefs which would prevent them from buying an annuity at age 75.

## Unsecured Pension

Originally introduced in 1995 under the name of 'Pension Fund Withdrawal', an unsecured pension plan **allows you to take a pension commencement lump sum** (also referred to as 'tax free cash') **of up to 25%** and an income from your fund **whilst deferring the purchase of an annuity**.

Your **pension fund remains invested** and **you draw an income from it each year** if you want to. There is, in fact, no requirement for a minimum income to be drawn.

The maximum limit (referred to as the 'basis amount') is calculated by the Government Actuaries Department (GAD).

The basis amount is determined by your age and sex and is **120% of the yearly income which could be paid** if the pension fund were used to buy a level (ie non escalating) single life annuity.

### Example of Unsecured Pension Calculation (based on Gilt Index Yield at February 2008)

Investor's Sex:	Male
Marital Status:	Married
Investor's Age:	65
Total Pension Fund:	£400,000
Tax Free Lump Sum Taken:	£100,000
Unsecured Pension Fund:	£300,000
Current Gilt Index Yield:	4.25%
GAD Factor:	70
Maximum Annual Income:	£25,100
Maximum Monthly Income:	£2,100

The basis amount has to be formally **reviewed every 5 years**. At this time, you may have to change the level of the amounts being drawn down to fall within the new limit.

Importantly, the GAD factors vary according to long term interest rates, so if interest rates fall, GAD factors can fall too.

You have **considerable flexibility in setting the amount you draw** and can vary it (within the limits) from year to year to meet changing personal or financial circumstances. This system of drawing down income is **available until age 75**.

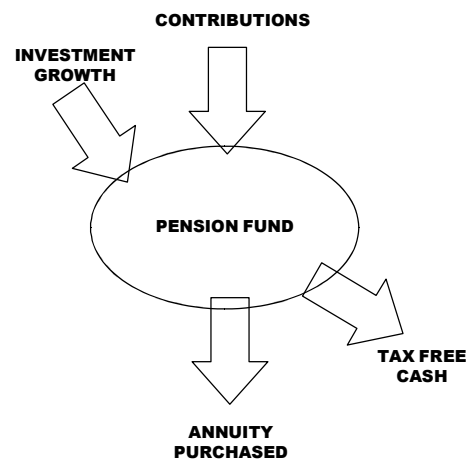
Because you do not buy an annuity at the outset, **you can keep your options open** on ancillary benefits and do not end up paying for benefits which might not be needed.

The **pension fund remains under your control**, so can be invested for growth or income, according to your objectives.

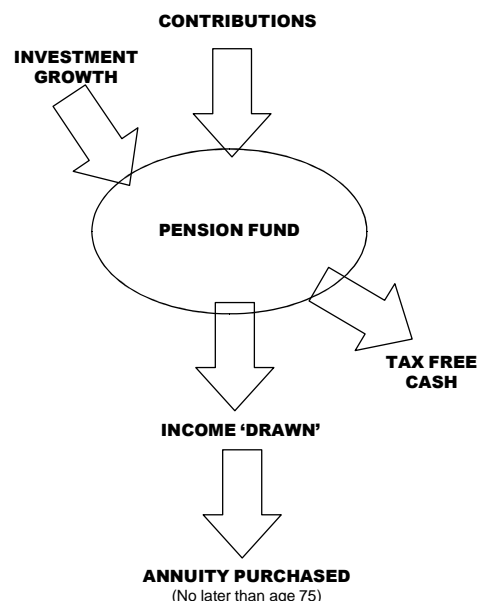
On death, the whole of your remaining pension fund, less a 35% tax charge, is **available to provide benefits to your family or beneficiaries**.

**Clients who are rather risk averse** and who need a high level of income in retirement **are unlikely to gain any benefit from an unsecured pension** and may end up with an inferior pension to that which they could have had simply by purchasing an annuity at the outset.

## The Conventional Approach



## The Unsecured Pension Approach



## Further Contributions

Once you have started a Pension Fund Withdrawal plan, **you cannot pay further contributions** into it.

## Transfers

Subject to certain rules, **you can transfer between the unsecured pension plans** of different product providers. You can choose to buy an annuity, with any provider, at any time.

## 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 a unsecured pension plan, 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'. **It is important that you continue to take this into account** when considering this type of plan both now and in the future.

## Critical Yield

The critical yield calculation is **an attempt to show the investment returns required from an unsecured pension plan** 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 pension fund withdrawal and, crucially, **assumes that throughout the period of withdrawal the underlying annuity interest rate and mortality basis will not change.** If annuity rates continue to fall the critical yield could seriously understate the growth required.

Clearly **the critical yield is an important consideration** in deciding whether or not an unsecured pension plan 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 pension fund withdrawal 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 an unsecured pension plan as opposed to an annuity.

## Additional Charges

There are **additional charges incurred under the unsecured pension plan** option, over and above those associated with the purchase of a conventional annuity.

These charges and the effect they have on your Plan are detailed in the Key Features Document which you would receive with any unsecured pension plan recommendation. Do please read this document carefully and ask any questions if anything is not clear.

## Death Benefits

If you **die during the fund withdrawal period**, the following options are available to your spouse or other dependants:

- **Continue to withdraw income** in the same way, until your spouse or dependant reaches the age of 75, or when the deceased would have reached 75, whichever is the earlier.  
  
Income tax is charged on the withdrawals as earnings in the usual way.
- The **maximum drawdown level** is calculated at the date of death using the rate from the GAD tables appropriate for the spouse or dependant. The maximum will not be allowed to exceed the maximum that could have been paid to the member on the day before death.
- **Buy an annuity**, which is taxable in the usual way. This may not exceed the maximum pension which would be payable to the member.
- **Take the remaining fund as a lump sum**, with liability to tax at 35%. This tax liability also applies where a non-spouse dependant inherits the lump sum.
- Where you have a spouse (including a civil partner), **any protected rights fund must be used to provide an income** (ie either income withdrawal or an annuity) for that person.
- A spouse who is under the age of 60 can **defer the purchase of an annuity until the age of 60.** If he or she chooses this option, the spouse cannot then take pension fund withdrawal.

## Protected Rights

If you have contracted out of the State Earnings Related pension Scheme (SERPS) or the State Second Pension (S2P) at any time, **you will have a fund consisting of what is called 'protected rights'.**

There are rules surrounding how protected rights benefits can be taken, but **you can still use an unsecured pension plan for your protected rights pension fund** provided that the particular product provider allows this. All protected rights benefits must be taken at the same time.

## The Tax Situation

The following is a summary of **the tax treatment of an unsecured pension plan:**

- Any growth in your unsecured pension fund will be **virtually free of UK income and capital gains tax.**
- Corporation **tax is paid on dividends** received from UK shares and cannot be reclaimed.
- Income withdrawal and annuity payments are treated as earned income and **taxed under the Pay-As-You-Earn (PAYE)** system.
- Any lump sum death benefits payable on death in an unsecured pension will be **taxed at 35%.**
- There **may be inheritance tax implications** on death in income withdrawal.

## Inheritance Tax

On your death the remaining pension fund (less the 35% tax charge) **could pass to your dependants free of inheritance tax**. There is, of course, no inheritance tax on death under an annuity but that is because the entire fund is lost (subject to the level of any initial guarantee).

**If the fund is to pass to a spouse**, there would be no inheritance tax under current legislation in any case. If the fund is to pass to another dependant a trust should be set up for them.

In correspondence with the Association of British Insurers (ABI), the Capital Taxes Office of HM Revenue & Customs has confirmed that, as a general rule, there will be no inheritance tax liability on a lump sum benefit paid under trust on the death of the member **where the decision to take pension fund withdrawal was made for 'commercial and retirement planning reasons'**, and the individual was in normal health and not aware of any ill-health when making the pension fund withdrawal decision and survives at least two years afterwards.

'Ill health' in this context means terminal illness or health such as to render the individual uninsurable.

## Tax Planning

As the timing and level of income can be tailored each year to suit your circumstances, an unsecured pension plan is **an extremely useful aid to your tax planning**:

- You want the flexibility to **vary the amount of pension income** you take. Maybe you need the cash lump sum but have little immediate need for income. Or perhaps you are retiring gradually and need **a flexible and increasing income**.
- You want to **leave your heirs the bulk of your pension fund** (though a tax charge would be deducted) if you died before reaching age 75.
- You are confident that **your pension fund can be invested for a better return** than you would have got from an annuity. This almost certainly means investing in share based investments and you must feel comfortable with the stock market risk.
- You want to **avoid being locked into current annuity rates**. But bear in mind that future annuity rates could fall.
- You might be expecting to make a large capital gain from, say, the sale of shares in a particular tax year. In this case you could reduce the amount of income you draw in that year so that **you might possibly be able to reduce the amount of capital gains tax** to be paid.

## Pensions Advice

Certain areas of pensions advice **require the use of a pension specialist**. In general terms all competent independent financial advisers (IFA) should be perfectly able to advise you on funding for your retirement.

However, when you get to the point **where you need to consider your retirement options** it is essential to involve a pensions specialist.

This is particularly important **where you have 'defined benefit'** (also known as 'final salary') **occupational pension scheme benefits** or **the total of your pension funds is in excess of £200,000**.

Such a specialist will have passed the Chartered Insurance Institute's **G60:Pensions** exam, or be an Associate or Fellow of the **Pensions Management Institute**.

We currently have two such pensions specialists in our team of advisers.

## Risk Factors

- The Key Features Document provides you with details of any risks and potential disadvantages associated with the contract recommended. An investment into an Unsecured Pension Plan is intended as a long-term investment.
- High income withdrawals may not be sustainable during the deferral period. By withdrawing larger amounts from the fund you will reduce the amount remaining in the fund and so reduce the potential for long term growth. This is especially true if investment returns are poor and a high level of income is being taken. This could result in a lower income when the annuity is eventually purchased.
- The investment returns may be at a worse level when annuity purchase takes place.
- Where past performance is mentioned please note that the past is not necessarily a guide to future performance. For example, the treatment of pension funds has changed with the removal of tax credit on UK equity investment. The value of units and the income from them may go down as well as up and your pension fund may be less than the amount you have invested. Tax rates depend on individual circumstances and tax rates and laws may change in the future.
- The illustration uses certain assumed rates of growth, as prescribed by the Financial Services Authority. These rates are not guaranteed and it would be prudent to review your contract on an ongoing basis.
- All statements concerning the tax treatment of products and their benefits are based on our understanding of current tax law and HM Revenue & Customs practice.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. The above summary is based on our current understanding of legislation and is not intended as a definitive listing of the rules governing unsecured pensions. If you are in any doubt as to whether you should use an unsecured pension then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

## Personal Advice

If you would like to discuss whether you should use an unsecured pension, please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**  
Email: **enquiries@arch-fp.co.uk**  
Online: **www.arch-fp.co.uk**

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## Unsecured Pension

### Advantages

An unsecured pension plan is especially attractive in the following situations:

- You want to secure a tax-free cash sum, but do not need all of the income which an annuity would provide.
- 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.
- The pension fund (less any income withdrawn and associated charges) will continue to be invested for you until you decide to purchase your annuity. Depending upon investment returns, which can fall as well as rise and are not guaranteed, this may provide the opportunity to achieve sufficient growth to improve your ultimate benefits when you decide the time is right to purchase an annuity.
- If you and/or spouse are relatively young, this makes annuity purchase relatively less attractive (because of the lower mortality factor), therefore you can take advantage of a longer timescale in which to take on the rewards and risks associated with equity-based investment.
- You are not entirely dependent on the income from the pension plan and can therefore afford to see fluctuations in its level. Preferably, income withdrawals should be kept as low as possible to avoid the possibility that poor investment performance will erode the value of the fund.
- If you believe that interest rates and therefore annuity rates are temporarily at low levels and might increase again.
- You need a flexible income that might be relatively low to start with, but might need to be higher after a few years have elapsed.
- It is possible to recycle the maximum level of pension fund withdrawal as fresh pension contributions. The result is tax neutral, improves lump sum death benefits and creates a future source of tax-free cash. In effect you can draw your cash in full and keep the balance of your pension funds fully invested.
- Potential death benefits may be greater than under the conventional annuity route.
- The remaining pension fund (ie policies not being used to provide income), can be returned to your beneficiaries, normally free of Inheritance Tax and the 35% tax charge.

## Unsecured Pension

### Disadvantages

It is important to be aware of the possible drawbacks as follows:

- There are often relatively high charges levied for the considerable amount of administration and advice involved in running an unsecured pension plan.
- By investing in safe investments like cash and fixed interest securities, you are bound to receive a lower lifetime income than is available from an annuity, which has the advantage of the mortality factor.
- Investing in assets that might provide the extra returns that could out-perform an annuity involves risk. The shorter the time-scale to age 75 and compulsory annuity purchase, the higher is the risk.
- There is no guarantee that your income will be as high as that offered under the conventional annuity route.
- There is no guarantee that annuity rates will improve in the future. They could be lower when you decide to purchase your annuity than they are currently. Your pension may be lower than if you bought a conventional annuity now.
- You have to purchase your annuity by the age of 75 (with one exception mentioned below), and will be subject to the annuity rates available at the time of purchase.
- The value of your pension fund may go down as well as up. Additionally, you may not have a sufficient fund available to purchase an annuity equivalent to the amount you would have received at the outset. This is because income payments are technically withdrawals of pension fund capital and these payments 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).
- Death benefits, which are not paid to your spouse or dependants, might be liable to Inheritance Tax.
- Death benefits payable as a lump sum under arrangements being used to provide income, are subject to tax at a special rate of 35%.
- You may feel the prospect of future higher income does not compensate for the guaranteed level of income available today, and for the rest of your life, that a conventional annuity provides.