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DRAWDOWN OPTIONS

When can I take some benefits from my SIPP?

At any time after you have reached age 55. Special rules apply to Protected Rights – these are explained at the end of this leaflet.

Is there an age by which I must start to take benefits

No

Can I take any benefits tax free??

Yes. You can take up to 25% of the value of your fund as a tax free cash sum. So if your SIPP has a total value of £200,000, you can take up to £50,000 as a tax free lump sum.

What about the rest of my fund?

The balance of your fund is used to provide you with income over the remainder of your lifetime. This can be done in one of two ways:

- a) an annuity can be purchased for you, or
- b) you can keep your SIPP going, investing the assets accordingly, and take your income each year out of the SIPP assets.

An annuity can be purchased at any time – so this means that you can start to take benefits via income drawdown and then an annuity can be purchased at a later date. But note that once an annuity has been bought for you, you cannot “unbuy” it – it is a one way option.

We set out below the basic principles, advantages and disadvantages of each of these options. However, you **must** take advice from your IFA as to which option is best for you. We cannot give you that advice.

How does an annuity work?

In essence, the whole of your SIPP fund is passed to an insurance company and in return they will pay you an annual income for the remainder of your life.

What’s the annuity process?

Your IFA is key to this. Your IFA will discuss with you your income needs.

You have to receive income each year, but you can usually choose to receive it monthly, quarterly, half-yearly or yearly and it can be “in advance” i.e. it is paid to you at the start of the month, quarter or year etc, or “in arrear” i.e. you receive it at the end of the month, quarter or year.

Your IFA will also discuss whether you want an income that is fixed i.e. it is the same level each year until you die, or an income that increases each year, say in line with price inflation.

Finally, they will discuss the “death” situation with you. When you die, do you want the income to continue to any surviving spouse or dependant children, and if so, at what level? Do you want there to be guaranteed annuity income payments for say 5 years, or perhaps even 10 years (but if you opt to have the annuity payments guaranteed for more than 5 years, you cannot also opt to have the provision for a spouse’s pension after you die).

Obviously, the more “benefits” you build in eg inflation protection or spouse’s benefits after your death, the lower will be your initial income level.

Your IFA will then obtain quotations from the insurance market to see which insurance company offers the most competitive deal, given your circumstances and requirements.

Is the income payable under an annuity taxed?

Yes, the income you receive from your annuity will be subject to income tax.

What are the advantages of an annuity purchase?

Certainty - that your chosen income stream will be paid to you for the remainder of your life. None of us know how long we will live. It is well documented that life expectancy is increasing rapidly. As part of the annuity contract, the insurance company undertakes to pay the income for the remainder of your life (and if you opt for a continuation of income to your spouse after your death, they will continue to pay out income until he/she also dies).

What are the possible downsides of an annuity purchase?

Many people dislike the fact that they are handing over the whole capital to an insurance company which then benefits from the residual capital when you die. However, there are ways of mitigating that, as we explained above. Secondly, insurance companies typically base their annuity calculations on the yields underlying long-term gilts. Many people believe that these are punitive and that they can get better investment returns themselves by continuing to actively manage the funds within their SIPP (with advice from their IFA).

Is there an alternative to an annuity with an insurance company?

Yes, you can take what is called a “drawdown pension”. This is colloquially known as “income drawdown”. With this, you keep your SIPP going and keep it invested (taking advice from your IFA), and take income each year out of the assets of your SIPP. This means that you retain total control of your SIPP fund.

There are some major advantages – you retain control of the investments and you can choose within a wide range the level of your income each year and you also retain some control of capital on your death.

There are some disadvantages:

- a. your SIPP assets may not be able to provide you with an adequate income level if you live a long time. In other words, you may not have enough capital to provide your desired income level.
- b. if the value of investments within your SIPP falls in value, this may erode the fund and affect the amount of income the fund can generate.
- c. You will also have the regular ongoing administration costs of your SIPP.

Again the advice is – consult your IFA.

How does “drawdown” work?

There are two types of drawdown – “capped drawdown” and “flexible drawdown”. Once you have reached 55 you can take income each year from your SIPP. The amount you can take each year is chosen by you.

Capped drawdown

You choose the level of income each year within the following ranges:

- a. nothing i.e. no income at all, and
- b. 100% of the income you would receive if the whole of your SIPP fund was applied to what are called GAD rates. These are published by the Government Actuary’s Department (GAD) and are broadly the rates that would apply if you were to use your SIPP fund to buy an annuity. They depend on your sex, age and 15 year gilt rates.

So if you take a tax free cash sum and are living off that, you may decide to take zero income for a few years.

The maximum amount you can take i.e. the 100% of GAD amount, must be reviewed at least once every 3 year (annually after age 75)

Flexible drawdown

If you have guaranteed pension income (effectively either from the State and/or an annuity) of at least £20,000 per annum, you can take as much pension via drawdown as you like in any year.

Is the income I receive taxed?

Yes, the income you receive under “drawdown” is subject to income tax. So if you opt for flexible drawdown the additional income will be taxed at your marginal income tax rate i.e. up to potentially 50%.

Do I only have one chance to take a tax free cash lump sum?

No. If your SIPP had a value of say £200,000, you could choose to vest say half of it i.e. £100,000 and take £25,000 as a tax free lump sum. The other £75,000 would then be used for income drawdown and the residual £100,000 would be “unvested”.

After another year or two, the remaining £100,000 might have risen, with investment returns, to say £120,000. You could then “vest” this £120,000 and take a further £30,000 tax free cash i.e. 25%, with the residual £90,000 being used for income drawdown.

This is called “phased” drawdown and can be a useful tool to take income tax efficiently – your IFA will advise you fully on this. But it is more costly as we as the SIPP administrator have more work to do!

What happens when I die in “drawdown”

There are three choices:

- a) the full amount of your remaining SIPP fund can be used to provide drawdown, in the same way, for your spouse and any other financial dependants, or
- b) 45% of your remaining SIPP fund can be paid out to your dependants or any other party as a lump sum. The other 55% is paid out as a tax charge.
- c) The whole of your remaining SIPP fund can be paid out to a pre-nominated charity.

Special rules apply to any Protected Rights, however – see later in this leaflet.

If I opt for “drawdown”, can I or my surviving spouse at a later date change my mind and buy an annuity?

Yes. It is quite common for someone to initially take benefits via income drawdown and, at a later age, use the remaining SIPP fund to then buy an annuity. A common reason for this is that, as time goes by, more and more of the capital will be used for income and there comes a time when it might be more cost effective to buy an annuity (rather than pay ongoing SIPP fees) and/or the security of an annuity might appeal.

Similarly an annuity purchase option is available to your spouse after your death.

As we said above, the reverse is not true however – having bought an annuity you cannot later “unbuy” it and move into income drawdown. Annuity purchase is one way

What about HMRC limits?

When you start to take benefits (which can be just taking a tax free lump sum) it is classed as a Benefit Crystallisation Event, which means that your total pension assets at the time are checked against your Lifetime Allowance. If they exceed your Lifetime Allowance, there is a penal tax applied to the excess. Your IFA will be able to fully advise you on HMRC limits and how they might affect you.

What about Protected Rights?

When you start to draw benefits, you can take 25% of your Protected Rights as a tax free cash sum. As with non-Protected Rights, the remaining 75% must be used for income, either via an annuity purchase or income drawdown

If an annuity is purchased, the Protected Rights monies must be used to purchase an annuity that provides for a 50% contingent pension to your legal spouse or civil partner on your death. If you elect to take your pension via income drawdown, then on your death your remaining Protected Rights fund must be used to provide an income to your surviving legal spouse or civil partner.

These special rules for Protected Rights will cease to apply from 6th April 2012.

Which option is right for me?

We cannot give you this advice. You need to consult with your IFA and go through the pros and cons of annuity purchase and income drawdown with them.

Please note there are significant risks associated with this decision and this can affect the value of your future income. This document is for information only and should not be construed as advice

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