Fact Sheet – PENSION ANNUITIES

A pension annuity is one of the choices available when deciding upon how to access benefits within your Registered Pension Scheme. They are purchased with money / funds held within the scheme.

Pension Annuities generally fall into two types – lifetime annuities and scheme pensions. Both provide an income for life, but they follow different rules.

Scheme Pensions

A Scheme Pension is a pension income payable either from the scheme itself or from an insurance company selected by the scheme.

Defined Benefit schemes can only provide pension income via a scheme pension, which do not offer the flexibilities available under lifetime annuities. It is possible for a money purchase/defined contribution pension scheme to provide a scheme pension under certain conditions.

Scheme pensions must:

- be paid at least annually, and
- not have a guaranteed period of more than 10 years
- not reduce unless in specified circumstances (changes to income), and
- be paid by the scheme administrator, or an insurance company selected by them

The rules governing scheme pensions are generally more restrictive than those for lifetime annuities. There is little room for variation of Scheme Pensions, unlike Lifetime Annuities.

Lifetime Annuities

Lifetime Annuities are payable by an insurance company where the member has the right to choose the insurance company, this is a key difference to Scheme Pensions.

A lifetime annuity is more flexible than a Scheme Pension with various different forms and options.

A lifetime annuity set up now may increase or decrease in line with any one or a combination of the following:

- retail prices index/consumer prices index
- the value of an underlying investment strategy
- With-Profits funds
- After allowance for any contractual charges

<u>1 - Inflation Linked Annuities</u>

As the name suggests, Inflation-linked annuities vary according to the rate of inflation. This is usually the retail prices index (RPI) but could also be the consumer prices index (CPI).

The starting level of an inflation-linked annuity will depend to some extent on the provider's view of future inflation. The initial income amount may start higher or lower than a fixed escalating annuity depending on the rate of fixed escalation chosen. For example, an annuity increasing by 5% pa might have a lower starting income than an inflation-linked annuity, but one with a 2% pa fixed escalation may have a higher starting income. This outcome will vary as conditions / views change.

<u>2 - Investment-Linked Annuities</u>

Investment-linked annuities are those where the level of the annuity will vary dependent upon the returns of an underlying investment. The most common are unit-linked annuities and with-profits annuities.

While investment-linked annuities can, and do, use different underlying investments to determine the amount of annuity payable, they all operate using the same general principles:

- a starting level of income is chosen, usually by the individual from a range set by the annuity provider
- the starting level will equate to a certain rate of growth each year – sometimes referred to as the anticipated growth rate
- the actual rate of growth each year is determined by the growth on the underlying investments chosen - e.g. with-profits fund, unit linked funds
- if the actual rate of growth each year is the same as the anticipated growth rate the annuity will remain level
- if the actual rate of growth each year is lower than the anticipated growth rate the annuity will reduce
- if the actual rate of growth each year is higher than the anticipated growth rate the annuity will increase

The starting level of an investment-linked annuity will vary depending on the anticipated growth rate (AGR) chosen at the start. For a fund of £100,000 the starting annuity will be higher if an AGR of 6% is chosen as compared to an AGR of 2%. As a general rule, as the chosen AGR gets higher the starting annuity will become closer to the annuity provided through a fixed level annuity. It is usually possible to select an AGR that will provide a starting annuity of the same amount as a fixed level annuity.

Investment-linked annuities do carry investment risk which neither fixed nor inflation-linked annuities have. This investment risk may help combat the effects of inflation, whilst also providing the opportunity for the fund to still be linked with investment performance. Income will vary in accordance with investment performance.

<u>3 - Variable Annuities</u>

Variable annuities offer an alternative 'middle ground' between conventional (fixed/inflation-linked) annuities and income drawdown.

In a similar manner to investment-linked annuities they offer the ability for a continued link between the annuity income and investment performance.

However, they go one step further than investment-linked annuities in that they can provide wider income limits, have greater income variability and allow for income reviews to be undertaken, all of which are similar in nature to the old rules that were applicable to income drawdown.

Variable annuities are not, however, able to replicate all of the death benefits permitted under income drawdown; in particular, they are not able to return a lump sum on death as income drawdown can.

The income from a variable annuity can be chosen from within a set range which is 50% - 120% of the amount of level annuity the fund could purchase with the variable annuity provider or the average of 3 current market annuity rates on offer.

You may choose an income at any point between these limits and can vary the amount of income at any time agreed with the annuity provider, as long as it stays within the above limits.

The minimum and maximum income range/limits must themselves be reviewed by the annuity provider at least once every 3 years. That review will set the minimum and maximum for the period until the next review date.

At the outset the fund used to calculate the income limits will be an actual pension fund but at future reviews it will be a notional fund.

When the amount of annuity has been chosen the same basic approach to investment returns, as that for investment-linked annuities, can be applied.
The notional fund is linked to underlying investments, such as a with-profits fund or unit-linked funds, and the value of that notional fund will go up or down in line with their investment performance. The annuity is paid from that notional fund and so will also impact its value.

Variable annuities can be seen as higher risk than investment lined annuities as the notional fund value is able to fall. They do however provide a solution to the lack of flexibility in being able to alter income, which is associated with other annuities. However, they are not able to offer the same range of death benefits as Drawdown.

4 – Fixed Term Annuities

A fixed-term annuity provides a regular retirement income for a number of years – often five or 10 – as well as a 'maturity amount' at the end of the specified period. You can then use the maturity amount to invest in another retirement income product, such as another fixed-term annuity or a lifetime annuity or you can take money out of your pension.

You don't have to buy an annuity to generate an income from your pension.
When buying a fixed-term annuity, you choose:

- The term, which is usually between three and 20 years.
- Annuity options, such as single or joint, fixed or increasing income – much the same way as when buying a lifetime annuity.
- Whether you want the annuity to deliver a guaranteed or an investment-linked income.

With a fixed-term annuity paying a guaranteed income, you can also choose the level of the income and the maturity amount you'll need to invest at the end of the term. The higher the income you choose, the lower the maturity amount will be.

5 – Conventional Annuities

A conventional annuity pays you a guaranteed annuity income for the rest of your life, regardless of what happens to interest rates or investment markets in the future.

Your chosen annuity provider takes on the future risk of providing you with a guaranteed annuity income in return for the money you saved into your pension fund. The annuity rate you receive reflects the current market conditions when you take out your annuity. A conventional annuity assumes you have no particular health or lifestyle conditions.

In respect to conventional annuities issued prior to 6 April 2015, they fall into one of two basic varieties:

- those that remain **level** throughout the time they are paid; or
- those that increase by a **fixed** amount/rate at set intervals.

A level annuity will pay the same amount throughout the period it is paid.
A level annuity will generally provide the highest starting amount of income as compared to most other annuities (variable annuities being a notable exception).

The risk of the amount of a conventional annuity reducing is very low - that would only potentially happen if the provider paying the annuity became insolvent. Even in that scenario the protection afforded by the Financial Services Compensation Scheme is 100% of the claim.

The only other risk is that the income will not keep pace with inflation.

6 - Protected Rights Annuities

Annuities paid from 'protected rights' pension funds are subject to some specific legislation.

These are:

- the annuity must be calculated based on unisex rates (i.e. the annuity rate used must be the same for a man and woman of the same age)
- if the member is married the annuity must include a survivor's annuity
- where a guaranteed period is included it cannot be more than 5 years.

7 - Enhanced and Impaired Life Annuities

Enhanced Annuities are annuities that provide higher income amounts than a 'normal' annuity because of the individual having a lower than 'normal' life expectancy.

It is important that we have details with regards to any lifestyle of medical information that may qualify you for enhanced rates.

Taxation of income

A pension annuity is treated as income, as it had been earned, and taxed as such. It will be added to any other income you have and the rate of tax that will be deducted will be dependent on your personal circumstances.

Death Benefits

The decision with regards to which, if any, death benefits to include needs to be made at the time of purchasing the annuity. The more death benefits that are included, the lower the starting annuity will be.

Where no annuity death benefits are built in to the annuity at the point of purchase, all payments cease on death, and there is no lump sum or return of capital.

Annuity death benefits that can be included in an annuity fall into a number of main categories:

- Guaranteed periods
- Joint life annuity
- Nominee annuity
- Value protection

It is possible to provide both dependant / joint life annuities and guaranteed periods under the same lifetime annuity at the point of purchase.

<u>Guaranteed periods</u>

A guaranteed period is a minimum period of time for which an annuity will be paid, irrespective of how long the individual lives. For example, if you purchased a 10 year guaranteed and dies in year 2, the guarantee will provide for a further 8 years' payments.

<u>Joint life annuities</u>

From 6 April 2015 legislation allows new joint life annuities to be passed on to any beneficiary. However, this will impact on the annuity purchase rate and requires the annuity provider to agree to offer this (so allowed for in the annuity terms). Not all providers offer this as an option.

On the death of the annuitant, a joint life annuity will continue to be paid to the survivor for the rest of the survivor's lifetime – and the survivor doesn't need to be a dependant. However, the annuity provider may restrict this, say to a named beneficiary. Should you choose a joint life annuity with, say, a grandchild, the annuity payments are likely to be paid for much longer than if the joint annuitant is in the same age group as the annuitant. So the initial starting annuity would be much lower.

A joint annuity can be paid at any rate up to 100% of the annuity being paid. The level that would be paid to the survivor will be set out in the annuity policy terms and, again, is reflected in the cost of buying the annuity.

However, there are a couple of exceptions:

- investment-linked annuities payable to a survivor can subsequently increase, because of investment performance, to an amount higher than was payable to the annuitant.
- If there is "overlap" which is detailed below.

With overlap / without overlap - Where the annuity doesn't include "with overlap", the survivor's annuity won't start until the end of the guaranteed period if the annuitant dies during the guaranteed period.

Where the annuity includes "with overlap", the survivor's annuity will start immediately on the annuitant's death, even where the annuitant dies during the guaranteed period meaning that:

- payments of the deceased's annuity continue to the end of the guarantee period and
- the survivor's annuity is paid in addition until the end of the guarantee period (and continues thereafter, until the survivor's death).

Nominee annuities

The terms of the nominee annuity are also agreed at the point the annuity is purchased. You are able to nominate anyone (not limited to a dependant) to receive an ongoing annuity on death (although this would be subject to agreement by the provider). The difference from joint annuities is that the nominee's annuity isn't a continuation of the annuity, but a stand-alone annuity with its own terms and conditions, payable on death.

Value protection

Value protection allows a lump sum (after tax if applicable) to be paid on the death. Value protection is available both for scheme pensions and lifetime annuities. The maximum amount (before tax) that can be paid under value protection is:

Annuity purchase price minus the total amount of the annuity payments to date of death (ignoring any tax deducted on the annuity payments).

The payment is tax free where death occurs before age 75 or taxed at the recipients' marginal rate of tax where death occurs from age 75 onwards.

Successor's annuities

In addition to the joint and nominee's annuities detailed above, there is a third form of annuity which can be paid after the death of the initial beneficiary. This is called a successor's annuity. A successor's annuity is purchased from the crystallised funds within a drawdown pension dependant's capped/flexi-access drawdown fund.

Taxation of Death Benefits

Continued regular annuity payments to a joint annuitant or nominee and payments for the remainder of a guaranteed term, are taxed in line with the tax treatment for drawdown contracts.

What this means is, from April 2016, the death benefits on annuities are taxed as follows:

Payment type	Age of the annuitant at death	Tax
Lump sum – Annuity protection / capital protected annuity	Death before age 75	Tax-free
	Death from age 75 onwards	taxable at marginal income tax rate of the recipient
Income – income from guaranteed payments or joint life / nominee's / successor's annuities.	Death before age 75	Tax Free**
	Death from age 75 onwards	Taxable at marginal income tax rate of the recipient

**Income death benefits from pre-age 75 unused uncrystallised funds must be settled (ie used to buy annuity or designated to drawdown) within two years or they become subject to income tax.
Where instalments continue under a guaranteed period on the death of the annuitant:

- Annuitant dies before age 75 –paid tax-free to the deceased person's estate, from which it is distributed to beneficiaries as per deceased persons will / intestacy etc.
- Annuitant dies post age 75 - A guaranteed annuity is paid to the estate of the annuitant. Prior to distribution to the beneficiaries under the deceased's will/the laws of intestacy, income tax is deducted at the personal representatives' rate of tax, which is basic rate. When the annuity is subsequently paid to the beneficiary, it will be classed as "basic rate of tax paid" and will only be liable to further income tax if the beneficiary is a higher or additional rate tax-payer.

If the capital value of the joint annuity is under £30,000, under trivial commutation lump sum death benefits rules, the benefits can be paid as a lump sum. All triviality payments are taxable in the hands of the recipient. The annuitant's age at death is irrelevant. The payment of a trivial commutation lump sum death benefit doesn't have any entitlement to a tax-free element, unlike a trivial commutation benefit paid to a member.

Inheritance tax

This is only payable in one instance under a lifetime annuity.

If a guaranteed period is specified, any outstanding instalments become payable on death and form part of your estate for IHT purposes. The person(s) entitled to the money will be determined in accordance with your will or the laws of intestacy (whichever is appropriate). This means that the value of those instalments is potentially liable to IHT.

If the payments go to your surviving spouse / civil partner, then no IHT will actually be payable as these transfers are exempt from IHT.

The value of a guaranteed annuity for IHT is not simply the amount of the outstanding instalments. It is the current open market value of those instalments – in effect, what someone would pay now for the income stream up to the end of the remaining guaranteed period.