Briefing

How long should I stay in drawdown?

Pension rules now allow individuals to remain in drawdown for life. However, as you get older, or if your circumstances change, it is important to look at whether drawdown is still right for you.

In addition, pension rules make age 75 a key moment, which may also affect your decisions. We highlight below some of the questions and issues that you should consider, we strongly suggest with an adviser, when deciding how long to stay in drawdown.

Drawdown for life?

The rules on drawing benefits from a pension fund have been through numerous iterations over the years. Prior to the so-called 'pension freedoms' being introduced in 2015, some fundamental changes took place in 2011.

What made the 2011 changes so important was how they began a break with how drawdown had always worked until then. People with defined contribution pension funds had had to take benefits from the fund by age 75 at the latest. The most common way to achieve this was to use the fund to purchase a lifetime annuity. The short-lived 'Alternatively Secured Pension' had provided another way, but this had been subject to strict conditions including a fairly tight range of income which could be withdrawn and the level of death benefits that could be paid.

The pension freedoms of 2015 saw the replacement of Capped and Flexible Drawdown with 'Flexi-Access Drawdown' and retained the ability for an individual to leave their pension fund uncrystallised indefinitely, as well as choosing to go into drawdown either before or after age 75.

The opportunities to pass on a drawdown fund on death have also expanded since April 2015, whereby non-dependants of a deceased member can now receive drawdown pension income for the rest of their life and, if there are still funds remaining, pass it on again when they die.

Now, whether you first go into drawdown before, after, or at age 75, the decision as to how long to stay in drawdown is influenced by a number of variables.

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beyond the expected

What happens at age 75?

Your decision may be affected by a number of important changes in pension rules that take place at age 75 in respect of:

- Contributions;
- Lifetime Allowance (LTA); and
- Taxation of death benefits.

Personal contributions to a pension after age 75 no longer attract income tax relief. However, employers can continue to make contributions on behalf of an individual who has attained age 75, and these will benefit from Corporation Tax relief, provided that the contribution meets the 'wholly and exclusively' test. Our blog - Employer contributions: what does 'wholly and exclusively' actually mean? explains how this test works.

> An individual's pension benefits will normally be tested against their available LTA at age 75, whether they are wholly or partly in drawdown at that point, or have yet to crystallise any of their fund.

For the former category, this represents a second test against their LTA, capturing any positive investment growth on their fund since first going into drawdown, whilst for the latter category, their fund will not have been tested before. In both scenarios, the possibility of a LTA excess tax charge may lead the member to withdraw their fund in full or in part, or purchase an annuity with their remaining drawdown fund, before age 75 to avoid the 'age 75 test'. (Those who fully crystallised their pension fund into drawdown before 6 April 2006 will not have their drawdown fund tested at age 75.)

Lastly, the taxation of death benefits from a money purchase pension fund changes at age 75. Prior to that age, death benefits can usually be paid free of income tax. However, on death from age 75 onwards, both lump sums and pensions will be taxable as pension income in the hands of the recipient, which could have significant consequences, depending upon their marginal tax rate.

Further information can be found in our Taxation of Pension Death Benefits briefing note.

How long should I stay out of the annuity pool?

When someone uses their pension fund to buy an annuity, they join a 'pool' of other people doing the same thing. Annuity providers understand that some of these people will not live as long as others. The savings they make from not having to pay an income to those people who die 'before their time', is used to meet the cost of paying those who live longer than expected. In effect, therefore, the annuity provider prices their annuities according to the average life expectancy of their annuity pool.

> When you opt for drawdown over annuity purchase, you choose not to join the annuity pool. The longer you delay purchasing an annuity, the more of that cross-subsidy within the pool will be lost.

This means that your drawdown fund will need to achieve a progressively-higher investment return over time to compensate, and research indicates that this required return can start to increase significantly after age 70.

How someone views the annuity pool will depend on a range of financial and personal circumstances. It may also change over time. Someone with a life expectancy of another 30 years might be more worried about the risk of dying far sooner (although statistically this is unlikely). Years later, when the anticipated span ahead is much shorter, the risk of living much longer than that may be more of a concern.

This is all academic, if you have no plans to ever purchase an annuity with your drawdown fund. However, for those who either intend - or need - to buy an annuity, it is important to keep a close watch on the fund size needed to buy the level of annuity income that you want. Crudely speaking, that fund size will depend on your age, health and interest rates.

What if my health deteriorates?

The main advantage of drawdown over a lifetime annuity is flexibility. Binding decisions are made at the point of purchase on the 'shape' of an annuity, which cannot normally be changed afterwards. Please refer to our briefing note - Choosing the right benefit options - for more information.

By contrast, remaining in drawdown maintains personal control over the fund and how much, or how little, is drawn as income, which can alter in response to changes in your circumstances over time. As people age, significant changes to their circumstances – such as a deterioration in health and/or mental capacity, or the death of a spouse – are increasingly likely to happen.

Where an individual in drawdown decides to purchase an annuity with some or all of their fund and they have experienced a deterioration in their health, it is important to be aware that 'enhanced' annuities are now available. These pay a higher income for those with medical and/or 'lifestyle' conditions likely to reduce their life expectancy.

Likewise, if an individual's mental capacity begins to deteriorate, it is vital that important decisions regarding the ongoing form and amount of retirement benefits are made before mental incapacity renders this task unachievable. Effecting a 'lasting power of attorney', whilst mental capacity allows, would enable other trusted people to then carry out the decision-making on behalf of the individual, as and when required.

> Bear in mind though, that an annuity offers more value for money the longer that it is in existence. Therefore, if you are in ill-health and your family has a history of early mortality, a lifetime annuity purchase may not be as appropriate as remaining in drawdown, particularly if the annuity ends on your death.

Should I take financial advice?

If you intend to stay in drawdown for as long as possible, it is important to maintain a watchful eye on the size of the fund and how long that fund is going to last. The fund size is but one of a diverse range of factors and circumstances, specific to each individual, that will influence how long they remain in drawdown. For this reason, we would strongly suggest that you seek financial advice, which will consider this question as part of a holistic financial assessment. As circumstances change over time, so do the requirements from your pension arrangements. Therefore, it is also important to undertake regular reviews of your drawdown, which an adviser is ideally suited to assist you with.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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