J05 Pension Income Options 2020/2021
Part 5: Flexible Benefits

This part will deal with alternative ways of taking pension benefits.

The milestones for this part are to understand:

- The difference between drawdown and annuities.
- The principles of flexi access drawdown
- How UPFLS works
- The options with pre April 2015 drawdown arrangements
- How benefits can be taken under small pots rule

Whilst an annuity guarantees a fixed level of income for life the package cannot be renegotiated. If rates rise the annuitant can't benefit from these. If a joint life annuity has been purchased and the second life dies first no one else can benefit. Even if the second life outlives the purchaser the pension cannot be passed on. There is also a real possibility that you may receive less in income than the purchase price.

The alternative is to draw money directly from the fund and two methods are available for benefits crystallised after April 6 2015:

- Flexi Access Drawdown (FAD)
- Uncrystallised Fund Pension Lump Sum or UFPLS.

Both offer more flexibility than an annuity but cannot provide a guaranteed lifetime income.

Note that whilst individuals with a PP or SIPP can take the benefits as they choose (subject to HMRC rules) members of an occupational money purchase scheme may be prohibited from using either of these methods. They would have to transfer the fund in the OPS to a PP/SIPP to take benefits flexibly.

Flexible Access Drawdown

Once an uncrystallised fund has been designated as a FAD the member can withdraw any amount they wish. Withdrawals can be regular or made on an ad hoc basis and each payment can be for a different amount. The member also has the option of using any undrawn funds in the FAD to buy a lifetime annuity at some point in the future.

The withdrawals can be taken directly from the FAD, in effect using it as a bank account, or through buying short term annuities payable for a maximum of 5 years. You cannot take a PCLS from these as that was taken when the FAD account was set up.

Further uncrystallised funds can be transferred into an existing FAD but no further input, that is new money can be placed into the FAD fund. Further input to other pension arrangements are permitted although these will be subject to the MPAA. This limits all future input into a money purchase arrangement to £4,000 with no ability to carry forward any unused allowances

All withdrawals from a FAD are subject to income tax at the member's non-savings rate. This is where care needs to be exercised since a large withdrawal could take someone into a higher tax rate band. If a basic rate tax payer took £200,000 from a FAD part of it would be taxed at 45% and they would lose all their personal allowance for that tax year.

Andy has a fund of £200,000 and takes £50,000 as a PCLS and puts £150,000 into Flexi Access. He then withdraws all of this.

If his Income for the year before this event is £20,000 his tax for 20/21 would be:

Income	£20,000
Less PA	£12,500
	£7,500 @ 20%= £1,500

Taking all the FAD will increase his income to £170,000 so he will lose all his personal allowance.

His total tax liability will be:

£37,500 @ 20% =	£7,500
£112,500 @ 40% =	£45,000
£20,000 @ 45%	£9,000
	£61,500

FAD gives far more flexibility over how benefits are taken compared to an annuity. This can be useful to someone who carries on working on a self-employed basis and whose earnings fluctuate.

Helen sets up a consultancy business after leaving full time employment. In 18/19 she earned £50,000 and takes nothing from her FAD

In 19/20 she decides to take on less work and withdraws £30,000 from the FAD

A FAD can also be used to release the PCLS

George needs £25,000 as a lump sum but wants no additional income at this stage. He could crystallise £100,000 taking £25,000 as the PCLS and leaving £75,000 in the FAD account untouched.

A greater lump sum could be taken although part of it would be taxed. If George needed £50,000 he could take the additional £25,000 from the FAD. Assuming he is a higher rate tax payer he would have to withdraw £41,666.

UFPLS

A UFPLS is a withdrawal from an uncrystallised fund in which 25% of the amount taken is tax free and the remaining 75% taxable. The remaining fund remains uncrystallised. It is not possible to take a UFPLS from a FAD account.

David takes a £100,000 UFPLS from his fund out so £25,000 will be tax free and the remaining £75,000 taxable.

The remainder of the fund remains uncrystallised so David can continue to contribute and use it at any time to buy a lifetime annuity, put it into FAD or do another UFPLS. As it is uncrystallised it offers the prospect of taking a further 25% of the fund as a PCLS.

Having taken a UFPLS of £100,000 David has still got a £300,000 uncrystallised fund. If he puts that into a FAD at that point he could take £75,000 as a PCLS. If he leaves it uncrystallised and it increases to £400,000 he could then take £100,000.

This is a key difference between UFPLS and FAD. With Flexi Access you crystallise all or part of the fund taking up to 25% as a PCLS and then withdrawing cash from this as you wish. With UFPLS you simply take a withdrawal from the uncrystallised fund.

As we have seen 75% of a UPFLS is taxable but unless the pension provider has the member's tax code they must apply what is known as a month 1 basis. This means that even though the withdrawal may be a one-off payment HMRC will treat it as the first of a series of regular monthly payments. This will result in an overpayment of tax which can be reclaimed but it may cause cash flow problems for the individual. This also applies to withdrawals from a Flexible Access Account.

For a £60,000 UFPLS, £15,000 will be tax free and the remaining £45,000 is taxable. The administrator must make an immediate tax deduction of £18,605

1/12th of PA	£1,042	0%	0
1/12th of basic rate band	£3,125	20%	£625
1/12 of higher rate band	£9,375	40%	£3,750
Remainder	£31,458	45%	£14,156
Total			£18,531

The tax implications of taking a UFPLS, or indeed a capital withdrawal from a FAD, can be complicated as in the following example.

Mike’s non-savings income is £9,000 below the higher rate threshold. He wishes to take a capital sum of £40,000 using UPFLS after any tax has been deducted. How much needs to be withdrawn?

Since he has £9,000 of the basic rate band left we first need to calculate how much needs to be crystallised to use this up.

As 25% of the UPFLS will be tax free then £12,000 (£9,000 x 4/3) needs to be crystallised.

In net terms, £3,000 is tax free and £9,000 taxed at 20% (£7,200) giving a net total of £10,200

This means he now needs a further £29,800 to hit is target. Each £1,000 of UPFLS produces £250 tax free and £750 taxed at 40% giving a net figure of £700.

£29,800/£700 x 1,000 = £42,751.

In total he needs to crystallise £12,000 + £42,751 = £54,751

A similar calculation can be carried out to calculate the net amount that needs to be withdrawn from a FAD with the difference that there is no tax free element since a PCLS would have been taken when the fund was designated a FAD. As in the previous example you must take account of how much of the basic or higher rate band the member has left.

Managing flexible income

Assuming that the member wants to ensure the fund will produce a lifetime income then the performance of the fund must be constantly monitored and adjusted. This contrasts with a lifetime annuity where once it is purchased the income will arrive every month in the member’s bank account and no further work is required.

The main risk in moving into FAD (or using UFPLS) is that the fund could be exhausted whilst the individual is alive. In simple terms the investment growth should be sufficient to replace the income withdrawn. This will be dealt with in detail in the next part.

Pre-April 2015 drawdown

Some form of Drawdown has been available since 1995. Immediately prior to April 2015 there were two methods:

- Capped Drawdown
- Flexi Drawdown.

Both ceased to be available for new arrangements after 5 April 2015. What happened to any existing cases can be summarised as follows:

- Flexible Drawdown arrangements automatically became FADs on April 6 2015.

- Capped Drawdown arrangements could continue and it's possible to transfer new uncrystallised funds into an existing arrangement provided the new provider allows this. The member can also elect to convert it to a FAD and this will occur automatically if more than the maximum amount is withdrawn.

The mechanics of capped drawdown

Capped Drawdown limits the maximum that can be taken in a plan year. This is calculated using the Government's Actuary's Department or GAD rate. The GAD table is a grid with the vertical axis showing the individual's age and the horizontal axis medium term Gilt Yields

The cross-over point shows the income for a £1,000 lump sum. For a 60 year old and 2.5% yield the rate would be £49 per £1,000. If the amount going into CD was £200,000 this would produce £9,800. However, the maximum is 150% of the GAD rate so in this case it would be £14,700.

The administrator calculates and informs the member of the maximum amount. The member is then free to take any amount between nothing and the maximum. The administrator has to recalculate the maximum amount every three years up to age 75 and then annually.

As mentioned earlier a member in Capped Drawdown arrangement can transfer further uncrystallised funds into it. This will trigger an immediate review which will usually increase the maximum amount. This can be taken immediately but the date of the next three year review will stay the same.

Tim set up a capped drawdown on July 1 2013 with a maximum income of £20,000

Reviews took place in July 2016 and July 2019 when the maximum withdrawal was set at £25,000

In October 2020 he transferred more uncrystallised funds into it and the maximum income increased to £26,000.

This can be taken immediately and the next review will be on July 1 2022

If part of the fund was used to buy a lifetime annuity or is subject to a pension sharing order this will also trigger an immediate review. As funds have been withdrawn the maximum withdrawal will reduce but this will only take place at the next plan anniversary date. The date of the next three year review will remain the same.

Someone in CD who wishes to convert to Flex Access has to complete an application form and this must contain a warning that by doing this the Money Purchase Annual Allowance will apply.

It's also possible to transfer a CD arrangement and FAD arrangement to another provider. This must meet several conditions.

- It must be to a new arrangement which must have no funds or assets in it. This may be difficult with a CD since the proposed receiving provider may not be prepared to set up a new CD arrangement.
- It must be on a like to like basis so a flexi access drawdown fund must be transferred to a flexi access drawdown, a capped drawdown to a capped drawdown
- If it is transferred into a capped drawdown fund, whether it is for the member or a dependant the same maximum withdrawal limit and the same three year review cycle remains.
- If the drawdown funds being transferred represented an arrangement that started before April 6 2006 these must be kept in a separate arrangement from other scheme funds and cannot be merged with other drawdown funds.

Small Pots

There is one final way of taking benefits and that is under the small pots rule. This is designed to allow those with small uncrystallised funds to access all their benefits without using FAD or UFPLS.

For a non-occupational scheme the maximum amount to qualify for this is £10,000 and this can be done on three separate occasions. This means that someone with a Personal Pension with a fund of up to £30,000 could split this into three separate plans and take it all as cash. The first 25% is tax free and the remainder will be taxed as non-savings income.

For occupational schemes the limit is again £10,000 and there is no limit on the number of times this can be done. The tax rules are the same.

Prior to the 15/16 tax year trivial commutation could also be used if the total value of all benefits was less than £30,000. This has been superseded by UPFLS so if someone had a fund of £24,000 and could not use the small pots rule, this could all be withdrawn using UPFLS.

That concludes this chapter so you should now know:

- The difference between drawdown and annuities.
- The principles of flexi access drawdown
- How UPFLS works
- The options with pre April 2015 drawdown arrangements
- How benefits can be taken under small pots rule