PENSION DRAWDOWN

APRIL 2025

Pension drawdown is a popular and **flexible** way of accessing your **money purchase pension** fund, whilst leaving the undrawn funds invested.

A pension drawdown contract enables tax free cash to be taken at outset, and additional income withdrawals to be taken **as and when required**, but **without the irrevocable commitment of annuity purchase**.

Deciding when and how to take pension income can be complex, and we look in depth here at who drawdown might suit. As importantly, we also look at the factors which need careful consideration before going into drawdown, and the potential pitfalls to look out for.

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SUMMARY

In drawdown, the **pension fund remains invested** and **withdrawals can be made at any time**, if required, with **no minimum or maximum** amounts. Up to **25% tax-free cash** lump sum can also usually be taken on entering drawdown, subject to your remaining available Lump Sum Allowance (£268,275 for most people unless protection applies). Drawdown (technically 'Flexi-Access Drawdown') is one of several options open to individuals for accessing their pension fund at retirement. Please see our Planning Research Note on Pension Withdrawals for an overview.

A drawdown contract can be entered into at **any age from 55 (age 57 from April 2028)** and can be run throughout the individual's lifetime. The drawdown pension fund **can still be wholly/partly used to buy an annuity at a later age** if required.

Those who have taken **income** from a drawdown contract (except for old Capped Drawdown contracts) have a **reduced Money Purchase Annual Allowance of £10,000** applying to new money purchase pension contributions. This does not apply if you have only taken the tax-free cash sum and no income.

If it is anticipated that an annuity will eventually be purchased from the drawdown pension fund, then, to overcome **mortality drag**, assets generally need to be invested mainly in **higher risk** (higher expected return) classes such as equities or property. This route is therefore only suitable for those with a good tolerance of investment risk, and who are prepared for the administration, complexity and potential additional cost involved.

WHEN MIGHT YOU CONSIDER DRAWDOWN?

A drawdown pension may be the preferred route for an investor who wants to take some income or capital from their pension, but doesn't want to be locked into annuity rates and wishes to remain invested in potentially higher-return asset classes. Within drawdown contracts, temporary annuities are also available, which may be more suitable for those requiring a higher level of income certainty - at a cost.

The contract may be taken out with the existing pension provider, or by transfer to a new provider. Once pension withdrawals have started, it is possible to transfer to another provider or designate additional funds into the drawdown contract (subject to provider rules). However, the costs and disruption involved mean that the SIPP (self-invested personal pension) structure remains popular as a flexible home for drawdown funds. Please see our separate Planning Research Note on Types of Pension for further details of SIPPs.

Unlike traditional annuities, the money can remain invested and the individual can draw a variable income from age 55 (rising to age 57 from April 2028).

TYPES OF DRAWDOWN

FLEXI-ACCESS DRAWDOWN

All new drawdown contracts from April 2015 are Flexi-Access Drawdown contracts, with no minimum or maximum withdrawal amounts, and no access requirements (subject to the specific terms of individual pension providers).

Please note that all withdrawals in excess of the tax-free cash lump sum will be subject to income tax at the appropriate marginal rate, as for any other pension income. A withdrawal of the entire fund in one tax year could therefore lead to a higher income tax burden than for a gradual withdrawal. If an overseas individual goes into drawdown, then any tax liability will be deferred to the year in which they become UK resident again, if they have been non-resident for less than five complete tax years.

A reduced Money Purchase Annual Allowance of £10,000 applies once any income has been withdrawn from the FAD contract (or for any individuals who previously held a Flexible Drawdown contract).

Those who were already in drawdown at April 2015 may have been in one of two types of contract:

CAPPED DRAWDOWN

This type of contract can continue to be run, provided the maximum income withdrawals are not exceeded. The maximum income that can be withdrawn is dependent upon the size of the pension fund and the maximum income rate calculated by the Government Actuary's Department (GAD). This maximum is set at 150% of the relevant GAD limit, and must be reviewed every three years until the end of the drawdown pension year in which the individual reaches age 75, and every year thereafter. There is no minimum income amount. The benefit of continuing this type of contract is that the full £60,000 Annual Allowance remains available should additional new pension contributions be desired.

FLEXIBLE DRAWDOWN

This type of contract automatically became Flexi-Access Drawdown on 6 April 2015.

DEATH BENEFITS

The choices on death whilst within a drawdown pension contract are as follows (although the particular scheme rules should be checked to make sure all options are available):

- Lump sum payment: the pension fund can be paid out as a lump sum to your specified beneficiaries.
- Pension benefits: payable as a lifetime annuity or drawdown pension to your specified beneficiaries.
- Payment of a lump sum to charity if there are no dependants.

TAX

Drawdown income, during lifetime, is taxed as earned income at the marginal rate of income tax.

The income tax treatment of death benefits depends on the age at which you die, as below. However, it is also proposed that, for deaths from 6 April 2027, Inheritance Tax applies to all pension death benefits. Further details are awaited.

For death benefits where an individual dies before age 75: any remaining pension fund used to provide an income (e.g. via drawdown or annuity for the beneficiary) is paid free from income tax. Any lump sum within the available Lump Sum and Death Benefits Allowance (LSDBA) is also paid free from income tax. The LSDBA is £1,073,100 for most people (unless pension protection applies). The available LSDBA is, broadly, the LSDBA reduced by any previous tax-free pension lump sums paid. Any lump sum paid in excess of this is taxed to income tax at the beneficiary's marginal rate of income tax.

For death benefits where an individual dies after age 75: all lump sum and income payments will be taxed at the **beneficiary's marginal income tax rate**. If funds are inherited as **Beneficiary Drawdown**, the nominated beneficiary will be able to **retain the benefit** of the tax favoured drawdown pension wrapper around the funds until they need to be withdrawn. If any funds remain unused on their own death, these can be passed on to their own beneficiaries under the same rules. The tax treatment applying at this second death depends upon the beneficiary's own age at death.

Individual scheme rules may restrict the above options, particularly for older schemes, and so should be checked to ensure that the desired flexibilities are allowed. In particular, the advantages of Beneficiaries Drawdown may not be able to be offered unless the beneficiary is either a dependant (e.g. a spouse or minor child), or is specifically named as a nominee on the **expression of wish/nomination of beneficiaries form**. It is therefore extremely important that the expression of wish is completed and kept up to date.

POTENTIAL RISKS OF FLEXI-ACCESS DRAWDOWN

MORTALITY DRAG

In general, annuity rates will increase the older the potential annuitant is at the start of the contract, assuming underlying factors remain the same (gilt yields, average life expectancy, market competition etc.). This merely reflects the fact that the insurance company, on average, has to pay out the annuity for a shorter period of time.

However, statistically, as you grow older, you are also expected to reach an older age than average. For example, a 50 year old might be expected on average to reach age 80, however, a 70 year old might be expected to reach age 85. When the 50 year old buys his annuity, the rate is subsidised by those other 50 year olds who die before the expected age of 80. The rate for the 70 year old is also subsidised by those of his group who die before the expected age of 85. However, the amount of this mortality subsidy is greater at age 50 than at age 70, as there is a larger pool of people generating the subsidy. This is referred to as **mortality gain**.

Thus in **absolute terms, the rate you receive as you grow older, becomes worse** – this is known as ‘mortality drag’, which is the opposite of mortality gain. If you are deciding to take your annuity at a later date, your pension fund will therefore have to increase in value in real terms in order to “beat” mortality drag. The extent of the extra growth needed increases with age: the Chartered Insurance Institute estimates that, at age 50, it is under 0.50% p.a., at age 60 it is around 1% p.a. and by age 70 it is close to 3% p.a., in addition to the return required to match the annuity income (although this clearly depends upon the type of annuity used for comparison, and if you compare to a capital protected annuity, then the mortality difference is clearly much reduced).

The only way to try to “beat” mortality drag is make investments that will give you the potential for real growth, i.e. a return over those from gilts (government bonds). Most investors use equities to aim to achieve these higher returns, although this strategy in itself comes with investment risk and should be considered carefully to ensure that the individual can tolerate the risk involved.

POTENTIAL RISKS OF FLEXI-ACCESS DRAWDOWN

INVESTMENT RISKS

The value of your income is not guaranteed and will depend partly on future investment performance. The value of your fund can go down as well as up and past performance of your chosen fund is not necessarily a guide to future performance. With a conventional annuity your income would be 'guaranteed' and not be dependent on future investment returns.

Clearly, lower risk investments could be chosen, but these investments have not historically produced sufficient returns to make drawdown pension worthwhile if comparing to an annuity outcome over an average lifetime. To beat mortality drag, and compensate for the charges suffered, the investor is mathematically encouraged to consider higher risk profile investments.

In addition, the investor should be alert to the possibility that a high level of income withdrawals may deplete the fund too quickly, unless sufficient investment returns are achieved. A fixed and inflexible requirement for income withdrawals may further compound this risk, by requiring a higher proportion of the overall fund to be withdrawn when markets are low. The preference is usually to set the income withdrawal as low as possible, with different pots (inside or outside the drawdown pension fund) allocated to support income withdrawals depending on the timescale to anticipated withdrawal.

REDUCING ANNUITY RATES

If it is anticipated that an annuity will eventually be purchased, annuity rates may fall over the period of income withdrawal. For example, if the world economy moves into a deflationary cycle, gilt yields could fall further, so depressing annuity rates. Of course, an inflationary cycle, as experienced recently, has seen the opposite, with gilt yields (and corresponding annuity conversion rates) increasing.

CHARGES

The level of administration and advice required, and hence the costs of setting up and maintaining drawdown pension contracts, can be high, and add to the investment return that needs to be achieved simply to achieve the same level of income as from a traditional annuity.

CRITICAL YIELD

The critical yield calculation will be shown on drawdown pension illustrations. This shows the minimum annual return that needs to be achieved on the fund to prevent the 'annuity purchasing value' of the fund from decreasing, assuming that the specified level of income is being taken from the funds. This includes the additional yield required to compensate for the annual management charges assumed on the underlying funds, ongoing product and advice charges, and the effects of mortality drag. Please note that, should the annuity not be purchased at the age shown, or should annuity rates be different (as they invariably will be) from the rate used, then the growth rate required will also be different.

Based on long term historic trends, an investment in equities is likely to give you the best possibility of achieving this return. However, this illustrates the inherent risk with drawdown pension, that if you were to be forced to purchase an annuity with the remaining funds whilst the markets are depressed, or the funds did not provide the required return, or annuity rates fell in the interim, then you may not be able to achieve the annuity income expected.

CONCLUSION

The combination of mortality drag and charges can make the drawdown pension policy the "worst deal" in comparison with a conventional annuity, if you have a cautious attitude to investments. Therefore, you might have to incur additional risks by investing in equities, to aim for the higher returns necessary just to match the traditional annuity. On the other hand there are other, unquantifiable, characteristics e.g. flexibility and potentially enhanced death benefits, making it difficult to objectively compare the different options.

In general, drawdown pension may be more suitable for a younger investor with a large fund who requires the tax-free cash sum, but only requires a minimal (or zero) level of income. The timescale for investment would therefore be long enough to justify investing in higher risk asset classes, however, the investor would still need to have an appetite for investment risks, and the risk of annuity rate falls. The investor would also ideally have other, sufficient, sources of retirement income that were invested in a more traditional manner. Situations where a flexible income is required, or the investor or their spouse is in poor health, may also lead to drawdown pension being suitable.

In all situations, the investor needs to understand the nature of investment risk and the relative complexity of the drawdown pension arrangement versus the annuity alternative.

Important Information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested. This document is provided for information only and does not constitute advice. You should not act on any of the information without seeking professional advice.