Pensions: income drawdown

Standard Note: SN 712

Last updated: 23 May 2014

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Section Business and Transport Section

Individuals with defined contribution (money purchase) pensions build up a pension fund using contributions, investment returns (if any) and tax relief. At present, most people (75%) with a DC pension use it to buy an annuity at retirement. The advantage is that an annuity provides a guaranteed income for life and the individual no longer bears any investment risk. Under current rules, the main exceptions to buying an annuity are that: some people with small amounts of pension saving or very small individual pots may have the option from age 60 to take all of it in the form of a lump sum. There is also the option of "income drawdown", which allows the individual to draw an income from their fund while leaving the rest of it invested.

The Labour Government's policy was to require people to turn their pension fund into an income stream by the age of 75 (sometimes known as the "requirement to annuitise"). This was on the basis that generous tax incentives to encourage people to save for an income in retirement made it reasonable to require people to turn their pension fund into an income stream by age 75. However, it introduced the option of an Alternatively Secured Pension from age 75, aimed at people with religious objection to the pooling of mortality risk.

The current Government legislated to end the "requirement to annuitise" at 75. Accordingly, sinceApril 2011, income drawdown has been an option throughout retirement. However, except for people with other pension income over a set amount, the amount that can be withdrawn each year is capped.

In Budget 2014, the Government announced reforms to take effect from 27 March 2014, including more flexibility for income drawdown arrangements. This was in advance of more radical proposals to allow people from April 2015, whatever the size of their defined contribution pension pot, to take it from age 55 "how they want, subject to their marginal rate of income tax in that year" – see HM Treasury, 'Freedom and choice in pensions'. These longer term changes are discussed in a separate note SN 6891 *Budget 2014 – flexibility for DC pension savers from April 2015.*

Contents

1 Retirement options

1.1 Overview

Money purchase schemes (such as occupational defined contribution (DC) pensions, group personal pensions, stakeholder pensions and individual personal pensions) build up a pension fund using contributions, investment returns (if any) and tax relief. The amount of a person's fund will depend upon the level of contributions paid and the investment income achieved.[1]

The minimum age at which an individual can generally draw a pension (other than on ill-health grounds) is generally 55. People generally have the option of taking up 25% of their pension fund as a tax-free lump sum, provided scheme rules allow. At the moment most people (75%) who reach retirement age with DC pension savings use them to purchase an annuity.[2] The advantage is that an annuity provides a guaranteed income for life and the individual no longer bears any investment risk.[3] The main exceptions to buying an annuity are:

- People with small amounts of pension saving may have the option from age 60 to take all of it in the form of a lump sum;[4]

- There is also the option of 'income drawdown', which allows the individual to draw an income from their fund while leaving the rest of it invested. However, except where the individual can show that they have other pension income over a set amount there is a cap on the amount they can draw down each year.

The rules changed in April 2011. Before that date, an individual had to purchase an annuity by the time they reached the age of 75.[5] Although the option of an alternatively secured pension was introduced in April 2006 as an alternative for people with principled objections to annuitisation, it was never intended be widely used (see section 2.2 below). While under the age of 75, individuals had the option of a lifetime annuity or "unsecured pension" (whereby they could draw income from their fund, up to a cap, by while leaving the rest of it invested).[6]

The current Government legislated to remove the "requirement to annuitise" with effect from April 2011. The unsecured pension and alternatively secured pension have been replaced by income drawdown, which is now an option throughout retirement. However, unless an individual can show they have other pension income of at least £12,000 (£20,000 until 27 March 2014), the amount they can draw down is capped. The cap was initially set at 100% of an equivalent annuity, but increased to 120% in April 2013 and to 150% pm 27 March 2014.

Recent studies have highlighted ways in which the annuities market does not work well for consumers. For example, eight out of ten consumers who purchase an annuity from their existing provider could get a better deal on the open market.[7]

In Budget 2014, the Government announced short-term changes, increasing the size of pension that could be taken as a lump sum and introducing more flexibility into the income drawdown arrangements – see HM Treasury, 'Freedom and choice in pensions'. This is discussed in section 5 below.

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[1] See, for example, HMRC, Registered Pension Schemes Manual, paragraph RPSM09202010

[2] HM Treasury, Freedom and choice in pensions, March 2014

[3] Ibid; HM Treasury, The Annuities Market, December 2006, p1

[4] Library Note SN 2181 Pension lump sums

[5] 77 for people over 75 on 22 June 2010

[6] Money made clear, Income withdrawal, June 2007

[7] FSCP, Annuities: Time for Regulatory Reform, December 2013; Financial Conduct Authority TR14/2 Thematic Review of Annuities

1.2 Income drawdown

People who do not want to purchase an annuity have the option of "income drawdown". This allows them to draw an income from their fund (in the form of a short-term annuity or income withdrawal) while leaving the rest of it invested.

The Money Advice Service explains that there are two kinds of income drawdown: capped drawdown and flexible drawdown:

> **What is an income drawdown plan?**
>
> Income drawdown is a type of retirement income product that lets you draw an income from your pension pot while leaving the remainder invested. This means you can continue to benefit from growth in the fund. By using income drawdown, you avoid or can delay having to turn your pension pot into an annuity.
>
> There are two kinds of income withdrawal: capped drawdown and flexible drawdown. In both cases, any income you take from your pension is taxed in the same way as other retirement income.
>
> The rules about how much income you can withdraw have been relaxed for both capped and flexible drawdown from 27 March 2014. And government proposals due to come into effect from April 2015 will offer complete flexibility about how you take your pension pot.
>
> - Find out more about the new rules for accessing pensions in our guide New rules about pensions from 27 March 2014.
>
> **Capped drawdown – interim rules from 27 March 2014**
>
> Capped drawdown limits how much you can withdraw and is the more common type of income drawdown. The amount you can take is now capped at 150% of the value of an equivalent annuity (up from 120%). There is no minimum level of income you must take.
>
> **Flexible drawdown – interim rules from 27 March 2014**
>
> Under flexible drawdown there are no limits on the income you can draw. However, you must be able to show you are already receiving other pension income of at least £12,000 a year (down from £20,000). This minimum income level includes state pension benefits, salary-related pensions, lifetime annuities and scheme pensions. [8]

Individuals considering their options should seek advice. The Money Advice Service has information on when and where to get pensions help and advice. The Pensions Advisory Service also has information on its website – see for example, its factsheet on Income Drawdown (March 2014).

A more detailed explanation of the rules can be found in HMRC's *Registered Pension Schemes Manual*. The rules from 6 April 2011 onwards are in RPSM09103500 - Technical Pages: Member benefits: Drawdown pension. The rules that applied to arrangements before that date are in Technical Pages: member benefits.

[8] Money Advice Service website – income drawdown

Issues with income drawdown

As explained above, income withdrawal is generally considered to carry more risk as the fund stays invested and, therefore, could either rise or fall in value. There is also a risk that an individual might exhaust their savings prematurely. The Pensions Policy Institute said in 2011 that many IFAs “recommend people need a pension pot of a minimum of between £100,000 and £250,000 as well as other income and assets in order to ensure people can bear the investment risk and longevity risk associated with drawdown.”[9]

The Money Advice Service says it is not generally used for pension pots smaller than £50,000 because of the increased charges and investment risk:

> **Is income drawdown suitable for you?**
>
> Many personal pensions and some workplace defined-contribution schemes offer income drawdown as an option. If you’re in a workplace pension scheme and want to use income drawdown, you might first need to transfer your pension pot from your workplace pension scheme to a personal pension.
>
> Because of the increased charges and investment risk associated with income drawdown, it is generally not used for pension pots smaller than £50,000. However, in view of the government’s proposed changes from April 2015 it may be a suitable option for you if you don’t want to take out an annuity and can’t afford to delay taking retirement income from your pension pot.
>
> We recommend that you get advice before deciding whether income drawdown would be suitable for you.[10]

In its “risk outlook” for 2012, the Financial Services Authority (FSA) identified income drawdown facilities as a potential risk to consumers:

> **3.12.3 Decumulation (potential concern)**
>
> The decumulation market in the UK is growing rapidly as more people with defined contribution type pension arrangements reach retirement age. Traditionally, consumers in the UK have purchased annuities at the point that they reach retirement. However, the government has now removed the requirement to annuitise pension savings by the age of 75. Furthermore, low current gilt yields mean lower annuity rates and Solvency II may further increase the cost of annuities and reduce their attractiveness.
>
> As such, there is increasing likelihood that alternative forms of decumulation products will become more popular. Indeed, the use of income drawdown has grown over the last five years, although there has been some moderation since 2009 (see figure 87). These products may pose additional and different risks for consumers (as opposed to traditional annuities). For instance, income withdrawal risk factors include:
>
> - the capital value of the fund may be eroded;
> - the investment returns may be less than those shown in the illustrations;
> - annuity or scheme pension rates may be worse in the future; and
> - high levels of income may not be sustainable when maximum withdrawals are taken, or a short-term annuity is purchased.

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[9] PPI, The implications of ending the effective requirement to annuitise by age 75, December 2011
[10] Money Advice Service website – income drawdown

> These factors increase the potential for mis-selling income drawdown products, as advisers are likely to need to consider other variables (capacity for loss, risk, higher costs, etc) that are not typically considered when an annuity is purchased.
>
> Consumers have the potential to suffer detriment if they are sold an income drawdown type product when an annuity would have been more appropriate to their circumstances. This risk has the potential to affect all those people entering retirement in the near future.[11]

In February 2014, its successor body, the Financial Conduct Authority, announced a competition market study into retirement income – annuities and income drawdown. It said this would allow it to assess how well competition works for consumers in those markets, "with a view to exploring whether any remedies were required to drive competition and improve consumer outcomes in this area."[12]

2 The Labour Government's position

The Labour Government's policy was to require people to turn their pension fund into an income stream by age 75 (often referred to as the 'requirement to annuitise"). The option of drawing down income while leaving the rest of the fund invested, was generally only available up to that age. The current Government has abolished the requirement to annuitise. Because drawdown arrangements can now continue throughout retirement, it changed some of the rules in order to reduce the risk of people exhausting their savings prematurely.

2.1 Background

The "mandatory annuitisation of pension funds" dates back to the *Finance Act 1921*.[13] A requirement to annuitise between the ages of 60 and 70 was introduced by the *Finance Act 1956*.[14] The upper age limit was increased to 75 by the *Finance Act 1976.*[15]

The Labour Government supported the continuation of this policy for a number of reasons:

> 15. Pension funds built up with the benefit of tax privileges must be turned into retirement income using annuities by the time people saving for pensions reach age 75. This is because:
>
> - tax relief on pension contributions is provided so people can save for an income in retirement, not for other purposes;
> - annuities pool people's risk, ensuring that they are the most financially efficient way of turning capital into an income stream; and
> - annuities make sure that people continue to receive an income from their savings no matter how long they survive, thus reducing their possible future need for income-related support from the Government.[16]

However, it emphasised that the rules had become more flexible over time:

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[11] FSA, Retail conduct risk outlook 2012

[12] Financial Conduct Authority, Thematic Review of Annuities, TR14/2 February 2014

[13] Mamta Murthi, J. Michael Orszag and Peter R. Orszag, *The Value for Money of Annuities in the UK: Theory, Experience and Policy* (1999)

[14] Section 22 (2)

[15] Section 30

[16] DWP and Inland Revenue, Modernising annuities. A consultation document. February 2002

29. Large occupational pension schemes do not need to use annuities to provide pensions. They can arrange to pay their pension liabilities to their members from their own resources. These funds are often large enough to be able to pool the risks for members of their schemes successfully and at reasonable cost. Most other pension schemes, including personal pensions, stakeholder pensions and additional voluntary contributions (AVCs), must turn pension funds into reliable income for pensioners by buying annuities for life from an insurance company. This is a long standing condition for obtaining tax approval for these kinds of pension schemes which then qualify for favourable tax treatment.

30. Successive Governments have provided these tax privileges for pensions to encourage people of working age to provide income for themselves in retirement. There are certain conditions associated with accepting the terms of pension contracts.

31. In common with other pensions, annuities in payment are taxed as income when pensioners receive them. So the role of tax relief for pensions has sometimes been described as postponing taxation of income until retirement. With the introduction of stakeholder pensions, to which non-earners can contribute with the benefit of tax relief, this concept is no longer quite accurate. But it remains true that tax relief in the savings phase of pensions is awarded to support saving for retirement - and not for any other purpose such as building up capital.

32. The tax rules about when and how annuities should be purchased have become more flexible over time. Originally people had to use all their pension funds at the point of retirement. They could take a quarter of their fund as a tax free lump sum and had then to annuitise the remainder. (The rules for AVCs are slightly different: they must all be used to buy annuities, since they supplement an occupational pension which can itself offer the option of a tax free lump sum.)

33. From 1979 small self-administered pension schemes (SSASs - most of which are defined contribution schemes like personal pensions) were able to postpone buying an annuity for five years after their members retired. Since 1995, both members of these schemes and retired people with personal pension funds have been able to postpone buying an annuity until the retired person reaches age 75 so long as they take a minimum income from the fund on retirement. Since 1999, (nearly) all defined contribution pension schemes have had the same flexibility.[17]

2.2 Introduction of Alternatively Secured Pensions (ASPs)

In December 2002 the Labour Government proposed a series of measures to simplify the tax treatment of pension saving. As part of this, it said it would retain the “age 75 rule” but would introduce more flexibility about the patterns of income people could draw:

> 5.45 The Government’s proposals retain the age 75 rule. That is, all pension funds build up with the benefit of tax relief must be drawn as benefits by that age. However, in line with the general principles about retirement benefits, there will be more flexibility about how people may determine the pattern of their income, including income in drawdown. These general benefit rules will take the place of existing limits on the amount of annual drawings. They will clearly need professional financial advice about how best to husband their pension savings, taking due account of other resources.[18]

This, it said, would allow different kinds of annuities to be developed, including:

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[17] Ibid, p9

[18] HM Treasury, ‘*Simplifying the taxation of pensions: increasing choice and flexibility for all’*, December 2002

- "limited period annuities". This would allow people to use part of their fund to provide an annuity for a predetermined period, perhaps three to five years. At the end of this period, they could buy another limited period annuity, or a lifetime annuity; and

- "value protected annuities" – which could make a residual payment on the death of the annuitant before age 75, equal to the difference between the amount paid for the annuity and the stream of payments made under the annuity before death.[19]

In December 2003, the Government proposed new rules to meet the needs of those who had principled objections to the pooling of mortality risk.[20] The Government proposed to allow pension income to be delivered after the age of 75 through "Alternatively Secured Income" (later called "Alternatively Secured Pensions"):

> **Age 75**
>
> 3.4 The previous chapter discussed the Government's proposal to move the minimum age for taking benefits to 55. The Government intends to retain the existing rules, which require all pension savings to be used to provide an income either to the member or, on death, to his or her survivors, by age 75. This reflects the fact that pension savings are intended to be used as income in retirement.
>
> 3.5 Conventional pensions and annuities are likely to remain the most popular and suitable means of securing benefits. However, some religious groups have principled objections to the pooling of mortality risk and need to be accommodated by the new rules. The Government, therefore, proposes to allow pension income to be delivered after age 75 through *Alternatively Secured Income (ASI)*.
>
> 3.6 The pension scheme must at all times remain responsible for delivering ASI. All income payments to the member must be paid via the scheme whether or not the administration and investment of the funds underlying the ASI have been placed with a financial institution. ASI will need to satisfy the general benefit rules but there will be additional controls in place to ensure that funds are used for their proper purpose. The maximum income that can be taken in any year will be 70 per cent of that which could be generated by applying to the fund an annuity rate for a person of the member's age and sex up to age 75. From 75, the annuity rate for a 75 year old will be used. The minimum income to be taken from the product in any year will be £1 or any greater DWP minimum income requirement. If at any point the scheme is to be wound up, the ASI funds standing to the member's credit must be used to purchase an annuity for the member.
>
> 3.7 The maximum income will have to be reviewed annually. On the member's death any remaining funds underlying the ASI must be used first to provide dependants' pensions. If there are no dependants, any remaining pension fund must revert to the scheme, where it may be re-allocated to provide pension benefits for other scheme members or possibly be paid to a registered charity. Otherwise, funds will revert to the employer.
>
> 3.8 ASI is likely to be an inferior choice for pension savers without dependents and who do not have a principled objection to the pooling of mortality risk. The product may

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[19] Ibid, para 5.51-55

[20] This is discussed in more detail in Library Standard Note SN/BT 4189, 'Alternatively secured pensions'

> be converted to a guaranteed pension for life or an annuity at any time at the member's discretion.[21]

The pension tax simplification proposals on which the Government had consulted in 2002 and 2003 were introduced by Part IV of the *Finance Act 2004.* The Explanatory Notes on the *Finance Bill 2003/04* summarised the provisions as follows:

> 57. An alternatively secured pension is a pension payable from age 75 which is an alternative to purchasing a lifetime annuity or paying a scheme pension. It was devised to meet the concerns of groups of people who have principle objections to the pooling of risk which is a feature of lifetime annuities. It is a pension payable as income withdrawals. As with income withdrawals for unsecured pension payable before the age of 75, the pension instalments are paid from underlying assets. But the maximum alternatively secured pension is 70% of a comparable annuity.

The Government argued that ASPs were "likely to be an inferior choice for pension savers without dependents and who do not have a principled objection to the pooling of mortality risk."[22] However, there was nothing in the legislation to say that people must have religious objections to pooling mortality risks in order to take an ASP.

Over time the Government did in fact become increasingly concerned that too wide a use was being made of ASPs. In a debate on Report Stage of the *Finance (No 2) Bill 2005/06*, on 4 July 2006, Ed Balls, the then Economic Secretary to the Treasury, restated the Government's original reason for introducing ASPs:

> As the hon. Member for Fareham reminded us, we have also introduced an alternatively secured pension—ASP—for pension scheme members who have not secured their pension benefits by age 75, where the member has a principled religious objection to the pooling of insurance and mortality risk. As the hon. Gentleman knows, and as the quotation from my right hon. Friend the Member for Bolton, West (Ruth Kelly) to which he referred makes clear, it was always our intention that the rules would apply in the specific and narrow case of individuals with such principled religious objections such as the Christian Brethren. It has always been our intention to replicate the secure lifelong income obtainable from an annuity through those measures, but not to allow that to become a way in which a small and wealthy minority could benefit substantially from tax advantages to the cost of taxpayers overall. We have always made it clear that we shall not allow those concessions to be taken up more broadly to get round the annuity rules. This is not a mainstream product and it must not become a tax avoidance measure. We shall not be going down that road.[23]

Changes to the rules were introduced by the *Finance Act 2007.* The Explanatory Notes to the *Finance Bill 2006-07* said:

> This clause and Schedule 19 introduce a requirement to pay a minimum income each year from a member's or dependant's alternatively secured pension (ASP) fund. It also removes from the authorised payment rules transfer lump sum death benefits, which means that, in future, such payments will be unauthorised. And consequential changes are being made to the inheritance tax rules largely to address the interaction of inheritance tax with the unauthorised payment charges on the same ASP funds.

21 HM Treasury and Inland Revenue, Simplifying the taxation of pensions: the Government's proposals, December 2003

22 HM Treasury and Inland Revenue, Simplifying the taxation of pensions: the Government's proposals, December 2003

23 HC Deb 4 July 2006, cc 728-729

Schedule 27 provides for repeals as a consequence of the changes made by Schedule 19.[24]

In May 2009, the then Economic Secretary to the Treasury, Ian Pearson said these rules meant there was now an alternative to annuitisation at 75:

> There is no requirement to annuitise at any age. Rather there is a requirement that an income be taken from pension savings by age 75. The Government have considered this requirement to secure an income from a pension fund at age 75 in light of recent conditions in financial markets but has no plans to change it. 95 per cent. of people take an income from their pension savings by the age of 70. The current rules already allow a considerable degree of flexibility. A pension income can currently commence at any time between the ages of 50 and 75, and can be taken from a pension fund without annuitising, through income drawdown. Even at 75, it is not compulsory to annuitise; alternatively secured pensions are available for those for whom they are suitable and who do not wish to buy an annuity.[25]

HM Treasury explained the options available to people above and below the age of 75 before April 2011, as follows:

> 2.5 Most members of Defined Contribution (DC) schemes secure a retirement income by purchasing an annuity. The existing options for members of DC schemes who do not wish to purchase an annuity are limited:
>
> - before age 75, individuals can enter an **unsecured pension arrangement (USP)**, which enables them to leave their pension fund invested while drawing down an income. The maximum amount that can be drawn down each year is 120% of the amount of an equivalent annuity;[6] and
>
> - after age 75, individuals can enter **an alternatively secured pension (ASP) arrangement**. ASP is similar to USP but has a lower maximum drawdown limit (90% of the amount of an equivalent annuity). There is also a minimum drawdown limit of 55%, to ensure that pension savings are used to secure a retirement income.
>
> 2.6 ASPs were introduced to provide an alternative to annuities for people who have principled objections to annuitisation, and were never intended to be widely used as an alternative to annuitisation. Consequently, the existing pensions tax rules effectively require most members of registered pension schemes to purchase an annuity by age 75.
>
> 2.7 Different tax charges currently apply before and after age 75 to different kinds of pension benefits, in particular death benefits:
>
> - **if an individual dies before age 75 and has not taken any income from their pension fund**, the entire fund can be paid out as a tax-free lump sum;
>
> - **if an individual dies before age 75 under a USP arrangement**, any unused funds can be paid out as a lump sum, taxed at 35%. Ordinarily there is no inheritance tax (IHT) charge; and
>
> - **if an individual dies after age 75 and is in an ASP arrangement**, any unused funds are subject to an unauthorised payment charge (up to 70%),

[24] HM Treasury (March 2007), *Finance Bill 2007: Explanatory Notes,* Clause 68: Pension schemes, para 1
[25] HC Deb, 15 May 2009 : Column 1105W; HM Treasury, *The Annuities Market*, December 2006, p2

unless they are used to provide a dependant's pension or donated to charity.[7] IHT may be chargeable on the remainder, resulting in a maximum total tax charge of 82%.[26]

The rules relating to the payment of pensions are in section 165 of the *Finance Act 2004.*

2.3 The Pensions Commission Report

In debate on the *Pensions Bill 2003-04,* the then Pensions Minister, Malcolm Wicks said the question of compulsory annuitisation would be considered, along with other issues, when the Pensions Commission reported:

> We set up the Pensions Commission under Adair Turner to review the regime for UK private pensions and long-term savings. Its first report, published last month, provides a mine of detailed and valuable information on the demographic challenges that we face. It is a singular fact that we are debating whether to preserve one of the few elements of compulsion in our pensions structure, but the Pensions Commission was set up specifically to look at the effectiveness of the voluntary approach to pensions and whether there is a case to move to greater compulsion. The commission is considering whether the level of compulsion within the UK pension system is appropriate. For people investing in a pension, the requirement to purchase an annuity at 75 with tax-privileged saving is a compulsory element in the existing system. **Once the commission has reported on the wider issues relating to compulsory saving, the Government will wish to consider key issues, including annuitisation at the age of 75, with particular care and urgency, and decide whether they remain fit for the purpose**.[27]

The Pensions Commission published its Second Report in December 2005. It was "not convinced by arguments that annuitisation requirements should be waived entirely" as it was reasonable to require tax relieved pension saving to be turned into a regular pension income at some time. However, it recommended that policies to encourage later annuitisation, particularly in the light of increasing life expectancy. It recommended, for example:

- The ages of first possible and last possible annuitisation should rise over time in line with life expectancy.

- Government should consider whether there is a case for a cash limit to the amount which individuals are required to annuitise at any age (with the benefits of tax relief recovered via the appropriate tax treatment of withdrawals during life or of balances remaining at time of death). [28]

In response, the Labour Government argued that there was no case for policy measures to encourage later annuitisation across the board (beyond wider changes to facilitate longer working lives) or increasing the upper age limit (although this would be kept under review.[29]

2.4 Criticisms of the policy

Private Members Bills - retirement income funds

In opposition, a number of Conservative backbenchers introduced Private Members Bills with the aim of providing for an alternative to annuitisation at 75. These included David Curry's

[26] HM Treasury, *Removing the requirement to annuitise by age 75*, July 2010

[27] HC Deb 16 November 2004, cc 1221-1223

[28] Pensions Commission, A New Pension Settlement for the Twenty-First Century; The Second Report of the Pensions Commission*,* November 2005, page 33

[29] HM Treasury, *The Annuities Market*, December 2006

Pension Annuities (Amendment) Bill 2001/02, Edward Garnier's *Retirement Income Reform Bill 2002/03* and Adrian Flook's *Retirement Income Reform Bill 2003/04*. These provided that people with pension funds large enough to buy an annuity providing a minimum retirement income above the level of means-tested support should be able to re-invest any residual funds in a "Retirement Income Fund" (RIF) which they could use as they liked.

None of these Bills was successful. David Curry's Bill (which was fifth in the list of Private Members' Ballot Bills in 2001/02) was talked out on Report;[30] Edward Garnier's Bill (which was fourth in the list of Private Members' Ballot Bills in 2002/03) was also talked out on Report;[31] and Adrian Flook withdrew his Bill (which was ninth in the list of Private Members' Ballot Bills in 2003/04) arguing that it "would better continue its parliamentary life as an amendment to the Pensions Bill."[32]

The then Conservative pensions spokesperson, Nigel Waterson, moved an amendment to the *Pensions Bill 2003-04.* He explained that:

> The Conservative party has felt strongly for some time, hence that string of private Members' Bills, that we badly need to bring more flexibility and fairness into the system…
>
> [The Treasury] does not want people to fall back unnecessarily on the state system when in their earlier years they have made provision for a pension fund. That is why the proposals, which I think have much cross-party support, are designed to allow people to have maximum flexibility in their choice of retirement income and to create a minimum retirement income—MRI—so that people need not fall back on state benefits if things go wrong. We say that the MRI level should be set each year by the Chancellor and it is intended to be at a level above pension credit. The sense of having it fixed each year is to allow the Chancellor at any given time to take into account changes to pension credit, to means-testing or to any other relevant factors, to ensure that it remains relevant and effective in carrying out its function. (…)
>
> The intention is that those retiring in future could purchase an increasing annuity that would provide sufficient income to maintain them above the level of state benefits. At the same time, the intention is to create a retirement income fund—an RIF. Individuals with pension funds in excess of those required to meet the MRI would be able to reinvest those savings in an RIF, and there would be no restrictions on when and how much income could be drawn.[33]

In response, the then Pensions Minister, Malcolm Wicks, explained that the Government provided tax relief on pension contributions to encourage people to secure an income for themselves in retirement:

> The debate is interesting and I am sure that the House will return to it, as has been promised—or threatened. However, the essential matter is that pension schemes are pension schemes. They are designed to give people a secure income to last the whole of their retirement. The annuity is, virtually by definition, such a guarantee to pay an income for life, no matter how long that life turns out to be. Over the decades, successive Governments have brought forward fiscal tax advantages for such

30 The Bill's provisions are described in Library Research Paper 01/118 and the Parliamentary debates are summarised in section II, C, 2 of Library Research paper 03/19

31 HC Deb 11 July 2003, cc 1566-1574. The Bill's provisions are described in Library Research Paper 03/19

32 HC Deb 26 March 2004, c 1192

33 SC Deb (B) 27 April 2004, cc 798-799

arrangements.

> What is being proposed is that over and above a certain level something intended to be a pension will become simply a capital sum for the individual to use as he or she likes. One can argue about the pros and cons of that, but I have no doubt that the fiscal arrangements would have to be rather different. I repeat that a pension is a pension, not a way of accumulating a large capital sum. There is a fundamental difference.[34]

Nigel Waterson withdrew the amendment explaining that there would be other opportunities to debate the issue.[35] Sir Malcolm Rifkind's *Rights of Savers Bill* in 2005 provided one such opportunity. This aimed to provide "much more flexibility in our pension system with reform of existing pension rules such as changes to annuity rules, but also a new savings vehicle."[36]

Conservative spokespersons tabled amendments aimed at introducing Retirement Income Funds to the *Pensions Bill 2006-07.*[37] An amendment was in fact successfully made to the Bill in the House of Lords, although it was subsequently overturned in the Commons. Conservative Peer, Lord Hunt explained how the provisions would work:

> Annuities can of course prevent pensioners spending their pension pots too quickly and being forced to fall back on benefits such as pension credit. Again, I should like to point out that these amendments do nothing to weaken that guarantee. Instead, they give pensioners a choice. Pensioners would be able to exercise choice over their pension funds with the single limitation that they must not recklessly spend them so that they end up becoming a burden to the long-suffering taxpayer.
>
> The largest amendment in the group, Amendment No. 66, allows for the establishment of a minimum retirement fund. In essence, this would be a savings scheme from which pensioners could draw down their retirement savings at a time of their choosing, as subsection (2) of the proposed new section makes clear. Subsections (3) and (4) of the new section ensure that a pensioner cannot draw out so much that the provider will no longer be able to guarantee a certain level of income for the rest of his or her life.[38]

He argued that international experience suggested there was demand for such a scheme:

> In Canada, a similar scheme is chosen by around 50 per cent of pensioners; indeed, it is the most popular savings vehicle in the country, and I reckon that the popularity of a scheme is not a bad criterion by which to judge it. On that basis, surely the fact that not one other country in the developed world has a compulsory annuitisation scheme akin to ours tells its own story.[39]

Lord Turner of Ecchinswell, formerly chair of the Pensions Commission, argued that it might be possible to overcome objections to a change in the rules:

> It is fairly clear that there are two arguments, but two arguments only, for compulsory annuitisation. One is that people should not fall back on the means-tested benefits of the state; the other, which is also a legitimate Treasury argument, is that tax relief is given to pension contributions as they go into the scheme, and it is therefore reasonable that as money comes out of the scheme, those are taxed moneys out. The

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34 SC Deb (B), 27 April 2004, c 805

35 Ibid, c813

36 Conservative Party press notice, "Flexible savings plan to boost retirement income", 24 October 2005; This is covered in more detail in Library Research Paper 05/69, The *Rights of Savers Bill*

37 Pensions Bill Deb, 6 February 2007, c388-398; HL Deb, 6 June 2007, c1131-4

38 HL Deb, 6 June 2007, c1137

39 Ibid, c1137

> total tax treatment is not more favourable than is intended, allowing for the fact that the most favourable element of the tax treatment is the tax-free lump sum that already exists. However, if we took those two principles, we might well end up with a rule establishing a minimum level of annuity that people had to buy, plus an appropriate set of rules as to the tax treatment if people, at any stage, either through inheritance or taking a lump sum, took the lump sum out. I have found it difficult over the years to understand what the arguments against that approach are.[40]

In response, the then Parliamentary Under Secretary of State, Lord McKenzie of Luton reiterated the principle behind the requirement to annuitise.[41] He said that there was no rationale for the taxpayer to subsidise bequests:

> In terms of bequests, more than half of a pension fund might consist of tax relief. There is no rationale for the taxpayer subsidising bequests. Individuals wishing to pass on assets at death have a number of non-pension vehicles to choose from.[42]

He outlined possible problems with the proposals under consideration. There appeared to be nothing to stop the minimum allowance being set at zero, so that "an individual might choose not to draw any pension income at all from the RIF in order to pass the fund on to heirs." Furthermore, "like previous amendments, this proposal is silent on how RIF withdrawals will be taxed and what will happen on a member's death".[43] He argued that anyone taking out an RIF would need significant alternative assets to be able to absorb simultaneously the investment and longevity risk:

> Anyone taking out a RIF would need to absorb simultaneously investment and longevity risk and it is likely that they would need alternative assets to do so. The ongoing charges of managing a RIF are likely to be significantly more than for conventional annuities. In many ways, the RIF resembles income drawdown—currently available up to age 75—whereby the pension fund remains invested and parts of it, within limits, can be withdrawn. It is likely to have a similar charge profile to the RIF's. We know, as this is documented in the Annuities Market publication, that income drawdown in its current form tends to be economic for funds of over £100,000—currently less than 5 per cent of pension funds. This is not a vehicle that will be of benefit or use to a whole range of pension savers.[44]

In conclusion, he considered that the RIF would be a "complex product aimed at the wealthy at the expense of the taxpayer."[45]

> Regarding the proposal to increase the upper age limit of compulsory annuitisation, he argued that people already had considerable latitude and only 5 per cent annuitised after age 70.[46] He also argued that the current regime already provided people with an element of choice – for example to take up to 25% of their fund as a tax-free lump sum.[47]

The amendment was pressed to a vote and accepted by 145 votes to 140.[48]

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40 Ibid, c1142
41 Ibid, c1148
42 Ibid
43 Ibid, c1149
44 Ibid, c1152
45 Ibid, c1152
46 Ibid, c1154
47 Ibid, c1155
48 Ibid, c1156

The *Explanatory Notes to the Lords Amendments to Pensions Bill,* published on 13 July 2007, said that the costs of the proposed Retirement Income Fund were difficult to quantify:

> **Retirement Income Fund**
>
> 63. Lords Amendments 12 to 14 would have significant increased cost implications, but it is difficult to quantify these because it is not clear how the minimum income requirement will work nor how RIF withdrawals and death benefits will be taxed.[49]

Lords' amendments 12-14 were rejected by the House of Commons on 17 July 2007.[50] The issue was debated again in the *Pensions Bill 2007-08.*[51]

Calls for temporary suspension of the rule

On 9 October, the then Shadow Work and Pensions Secretary, Chris Grayling, called for a suspension of the rules because of difficulties in the financial markets.[52]

In debate on the *Pensions Bill 2007-08,* the then Parliamentary Under Secretary of State, Lord McKenzie, argued that a temporary suspension "would only really benefit those who do not need to take any income from their pension savings and who may therefore wish to use them as a means of making bequests partly funded by the taxpayer."[53] He argued that it would lead to increased "uncertainty, complexity and cost" and was concerned about the message that would be sent out:

> …there is no guarantee that their assets will improve or even maintain their value. It is also possible that annuity rates could fall, potentially reducing the income available. In combination, a stagnation or fall in asset prices alongside a fall in annuity rates would have a severe impact on the income available from a person's pension savings. For anyone relying on their pension savings to support themselves in retirement, these are serious risks. It would be irresponsible for the Government to do anything which could lead people to delay taking their pension income and expose themselves to such risks without fully thinking through the consequences.[54]

He was disappointed that there was not a greater focus in the debate on who have to annuitise early because they need the income. Those people had "very real deadlines driven by their economic circumstances."[55]

3 Policy of the current Government

3.1 Commitment to end the requirement to annuitise by age 75

Before the 2010 General Election, both Conservative and Liberal Democrat parties had been arguing for a change in the rules. As explained in section 2.4 above, Conservative Members of Parliament had, on a number of occasions pressed for a system of "retirement income funds" as a way of introducing more flexibility into the system. Under this system, people would be required to purchase an annuity that would provide sufficient income to maintain them above the level of state pensions. The excess funds could be reinvested in a

[49] Pensions Bill, Explanatory Notes on Lords Amendments. Bill 146-EN
[50] HC Deb, 17 July 2007, c243; See also, HL Deb, 24 July 2007, c 699-704
[51] See Pensions Bill Deb, 19 February 2008, c527-34; and HL Deb, 14 July 2008, c1006-13
[52] Conservative Party Press Release,'*Grayling calls for emergency pension protection'*, 9 October 2008
[53] HL Deb, 27 October 2008, c1381
[54] Ibid, c1383
[55] Ibid, c1384

"retirement income fund" and there would be no restriction on when and how income could be drawn from this.[56]

In a pamphlet published in March 2010, the then Shadow Work and Pensions Secretary, Theresa May, argued that the issue of annuities should be addressed:

> If we want more flexibility before retirement then we must also give people more flexibility once they have retired. Conservatives naturally believe that individuals are best place to make decisions about their life and it is right to give people more control over their incomes in retirement, so we will end the effective obligation to buy an annuity at 75.[57]

The Liberal Democrats also said in its 2010 election manifesto that it would give "people control over their pension by scrapping the rule that compels you to buy an annuity when you reach age 75."[58]

The Conservative-Liberal Democrat Coalition's *Programme for Government* included a commitment to "end the rules requiring compulsory annuitisation at 75."[59]

3.2 Transitional measures

In Budget 2010 on 22 June, it was announced that the "existing rules that create an effective obligation to purchase an annuity by age 75 would end from April 2011."[60] Transitional arrangements were put in place in the *Finance Bill* to allow people reaching 75 after 22 June to defer a decision on what to do with their pension savings until the new rules were finalised:

> 5. For scheme members with money purchase arrangements who have not yet bought an annuity by age 75, the income withdrawals they may make become subject to strict minimum and maximum limits from age 75. Also, if such a member dies after reaching age 75 and any of the fund is not used to pay either pensions to dependants or a charitable donation, it is subject to tax charges up to 70 per cent. Specific IHT charges also apply to certain pension scheme members who die on or after their 75th birthday.
>
> 6. For scheme members with money purchase arrangements who have not yet bought an annuity and reach age 75 on or after 22 June 2010:
>
> - the strict minimum and maximum limits on income withdrawals will apply from their 77th instead of their 75th birthday;
> - immediately before their 75th birthday they will become entitled to income withdrawal and a tax free pension commencement lump sum in respect of those funds not previously made available for income withdrawal; and
> - in the interim period before the main changes have effect in 2011-12, there will be tax charges of 35 per cent on lump sum death benefits paid by the scheme if they die on or after 22 June 2010 and aged 75 or over. The specific IHT death charges on pension scheme members, who are in drawdown and are aged 75 or over when they die, will not apply in these circumstances. Previously there could have been tax charges up to 82 per cent of the value of the drawdown fund.

[56] See for example, SC Deb (B), 27 April 2004, cc798/9
[57] Theresa May, *Providing for Pensions. Principles and Practice for Success* , Politeia, 2010
[58] The Liberal Democrat Manifesto 2010
[59] *The Coalition: our programme for government*, 20 May 2010
[60] Para 2.60

> 7. These interim changes enable those reaching age 75 on or after 22 June 2010 to defer their decision on what to do with their pension savings until after the new rules are finalised next year. [61]

The transitional provisions were debated in Parliament on 15 July 2010. The then Economic Secretary to the Treasury, Justine Greening, was asked why there was no retrospective element to the provisions (to cover people who had reached their 75th birthday before Budget day on 22 June).[62] She explained that the Government "did not agree with making retrospective legislation except in the most egregious cases."[63]

The then Shadow Chief Secretary to the Treasury, Angela Eagle, tabled an amendment to the effect that schedule 3 should not take effect unless a report on the implications of ending compulsory annuitisation had been laid before the House of Commons.[64] She asked why only eight weeks was being allowed for consultation instead of the usual twelve. Some of the issues raised by the consultation document, such as how the "minimum income requirement" should be defined, would be difficult to decide. Furthermore, a relatively small number of people would benefit:

> When we look at the impact assessment, we see that the changes will affect a tiny minority at the very top-a mere 8,000 people on the Government's estimates, out of 445,000 people who annuitise every year. They will affect only those who can afford to live without touching their pension pot until fully 10 years after retiring. We know that two thirds of people take their annuity upon retirement and that only a much smaller number of people last beyond 70, so the flexibilities that the Government are looking for will be required by only a tiny number of very rich people. The Minister therefore needs to justify why this is a priority and why we need a rushed consultation of only eight weeks over the summer to bring it about.[65]

Her amendment was defeated on division by 313 votes to 187.[66]

Provision for the transitional arrangements was made in section 6 and schedule 3 of the *Finance (No 2) Act 2010*.[67]

3.3 Consultation

HM Treasury's consultation paper, *Removing the requirement to annuitise by age 75* was published on 15 July. This explained that the Government was "committed to re-invigorating pension saving by giving people more flexibility to choose retirement options that are best for them", provided they did not fall back on the state:

> 1.6 As longevity increases and people work for longer, the existing rules will be restrictive for an increasing number of people. The Government believes that people should have more choice over the use of their pension savings and has therefore committed to ending the effective requirement to purchase an annuity by the age of 75 from April 2011.
>
> 1.7 Annuities remain an effective way of insuring against the risk of exhausting savings prematurely and are good value in comparison with other similar products. Research

[61] Budget Note 22
[62] HC Deb, 15 July 2010, c1170-1173 [Stewart Hosie]
[63] Ibid, c1173
[64] Ibid, c1173
[65] Ibid, c1176
[66] Ibid, c1178
[67] *Finance Bill 2010 – Explanatory Notes*

shows that individuals often underestimate their own longevity and the risk of individuals running out of retirement savings increases as longevity continues to increase. Individuals who wish to benefit from greater flexibility will therefore be able to do so provided they do not fall back on the state.[68]

The Government explained that pension tax relief was available to encourage people to take responsibility for retirement planning. It proposed to reform the tax rules for retirement and death benefits in line with the following principles:

Box 2.A: Principles for a new tax framework for retirement

1 The purpose of tax-relieved pension saving is to provide an income in retirement.

2 Any changes to the pensions tax rules should not incur Exchequer cost and should not create any opportunities for tax avoidance.

3. Individuals should have the flexibility to decide when and how best to turn their pension savings into a retirement income, provided that they have sufficient income to avoid exhausting savings prematurely and fall back on the state.

4. In line with the EET model, pension benefits taken during an individual's lifetime should be taxed at income tax rates. The tax-free pension commencement lump sum will continue to be available.

5 On death, pension savings that have been accumulated with tax relief should be taxed at an appropriate rate to recover past relief given, unless they are used to provide a pension for a dependant.[69]

From April 2011, there would "no longer be a specific age by which people effectively have to annuitise." The option of income drawdown would be available throughout retirement, rather than just to age 75. There would be a cap on withdrawal to ensure that people did not exhaust savings prematurely. This would not apply to people who could show they had secured a sufficient minimum income to prevent them from "falling back on the state":

2.14 The Government will also create more flexibility for people who do not wish to buy an annuity. USP currently allows individuals to take a tax-free lump sum at the beginning of their retirement if they wish, keeping funds invested in a tax-exempt environment while drawing down an income from their remaining pension pot in line with their needs, subject to a prudent drawdown limit. The Government will allow capped drawdown - equivalent to USP extended beyond age 75 - for the whole of an individual's retirement. This means that individuals will be able to choose how much to draw down annually from their pension pot throughout their retirement (subject to a capped limit), or whether to draw any income at all.

2.15 The Government will go further than capped drawdown by creating additional flexibility for individuals who wish to draw down more than the capped annual limit. Under this flexible drawdown model, individuals will be able to draw down unlimited amounts from their pension pot, provided that they can demonstrate that they have secured a sufficient minimum income to prevent them from exhausting their savings prematurely and falling back on the state. The requirement to demonstrate a minimum income will apply at the point at which an individual wants to exceed the annual capped drawdown limit. The Government wants to ensure that the requirement to

[68] HM Treasury, *Removing the requirement to annuitise by age 75*, July 2010
[69] Ibid, page 8

secure a minimum income is transparent and fair and can be implemented without undue complexity or burdens on individuals or business. The design of this requirement is discussed in detail in Chapter 3. [70]

Because in future, income drawdown would be an option throughout retirement rather than just to age 75, the level of the existing cap on withdrawals would be reviewed:

> 2.16 Both capped and flexible drawdown will increase flexibility for private pension savers before and after age 75. This will make it unnecessary to continue to offer ASP as an option after age 75. ASP will therefore cease to exist when new rules come into effect. The new capped and flexible drawdown limits and rules will apply to existing members of ASP from April 2011.
>
> 2.17 The annual USP limit (120% of the value of an equivalent annuity) was set in the context of the existing rules. The risk of running out of funds during drawdown increases with advancing age. The Government therefore intends to review whether the existing annual limit remains appropriate.

To ensure that people did not use pension saving as a "tax-privileged means for passing on wealth,"[71] any unused funds remaining on death would be taxed at a rate designed to reflect the value of tax relief received (probably around 55%):

> 2.22 Consistent with the mainly tax-deferred nature of pension saving, it is important that pension benefits continue to be taxed at a rate which reflects the value of relief given and which ensures that the cost of providing tax relief remains sustainable. The Government intends that:
>
> - pension benefits drawn down under the new, more flexible arrangements will continue to be taxed at income tax rates. (The tax-free pension commencement lump sum will continue to be available);
> - any unused funds remaining upon death will be taxed at a rate designed to recover past relief given unless they are used to provide a dependant's pension. (In this case, the pension will be taxed as income of the dependant in the normal way). The Government expects that an appropriate recovery charge will be around 55%;
> - to make the new framework as simple as possible, the Government intends that the recovery charge should generally apply to all death benefits. However, death benefits for those who die before age 75 without having accessed their pension savings will remain tax-free; and
> - inheritance tax will not ordinarily apply to unused pension funds remaining after death in addition to the recovery charge. However, the Government does not intend pensions to become a vehicle for the accumulation of capital sums for the purposes of inheritance. The Government will therefore ensure that the tax rate on unused funds remaining on death does not leave open incentives for pension saving to be used to reduce inheritance tax liabilities. The Government will monitor this closely and will take further action if there is evidence of such activity.
>
> 2.23 Further detail on proposed tax charges will be published in draft legislation later in the year.[72]

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[70] Ibid, p9
[71] Ibid, para 2.9

The Impact Assessment explained that as key areas of the policy still needed to be determined, it was "difficult to quantify fully the potential costs, and some of the benefits are difficult to quantify by their nature." Initial estimates suggested that in the short term "around 3,000 people immediately approaching retirement and a further 5,000 aged between 55 and 75 will benefit from the new flexibility for pension savings." The intention was that the measure should "not incur Exchequer cost."[73]

3.4 Response to consultation

The Government published a response to its consultation in December 2010. It explained that under existing rules, annuitisation was effectively compulsory for almost all pension savers:

> 1.2 At present, individuals with tax-relieved pension savings are required to secure an income by age 75. Alternatively Secured Pensions (ASPs) exist for people reaching age 75 with principled objections to mortality pooling, but these are subject to strict income withdrawal limits and tax charges of up to 82%. In practice, annuitisation by age 75 is effectively compulsory for almost all pension savers.[74]

It intended to reform the rules to "create a fair and sustainable regime that gives individuals (as well as employers, providers and schemes) appropriate flexibility to make arrangements that suit their circumstances and preference":

> 1.6 Under the new proposals, an individual will be able to purchase an annuity with all or part of their pension savings from age 55 without restriction. The age 75 restrictions on value protection, trivial commutation and pension commencement lump sums will also be removed.
>
> 1.7 At present, Unsecured Pensions (USPs) and ASPs allow individuals to draw down income from invested pension savings before and after age 75 respectively. These products are subject to different recovery charges and annual withdrawal limits. The Government's proposals replace USPs and ASPs with a single product - capped drawdown - available from age 55 without restriction.
>
> 1.8 The proposals will also provide additional flexibility for individuals wishing to draw down more than the capped annual limit. Individuals demonstrating that they can satisfy a Minimum Income Requirement (MIR) will be able to draw down unlimited amounts from their pension pots in a flexible drawdown model, subject to income tax at their marginal rate. The purpose of the MIR is to ensure that an individual entering flexible drawdown has sufficient secured income to avoid subsequently falling back on the state.[75]

Many respondents to the consultation agreed that the cap applying to withdrawals should be lower than that which applied to unsecured pensions. The Government proposed setting a limit equivalent to 100% of the value of a comparable annuity. Investment reviews would take place every three years before age 75 and annually after that:

> 3.9 The Government believes that this strikes an appropriate balance between fairness and simplicity, while limiting the risk of individuals exhausting savings in later life. To

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[72] Ibid

[73] Ibid, Annex C – Impact Assessment, para

[74] HM Treasury, Removing the requirement to annuitise by age 75. A summary of the consultation responses and the Government's response. December 2010

[75] Ibid

> further mitigate this risk, the Government believes that reviews at least every three years before age 75 and annual reviews after age 75 are appropriate in capped drawdown. The Government Actuary's Department (GAD) will issue updated tables extended beyond age 75 as the basis for calculating the annual capped drawdown limit.
>
> 3.10 The Government recognises that some risk will remain that individuals in capped drawdown could exhaust their savings prematurely or achieve significantly worse outcomes than if they had bought an annuity. This risk is inherent in any drawdown arrangement where outcomes are dependent on investment returns and individuals cannot insure against longevity via mortality pooling (as with an annuity). It will therefore be important that individuals take appropriate advice before entering a capped drawdown arrangement.[76]

The Government proposed that any unused funds remaining upon death should be taxed at a rate designed to recover past relief given unless they are used to provide a dependant's pension (55%). This attracted particular criticism from many respondents who argued it was unfairly high, particularly for basic rate taxpayers and existing unsecured pension holders. However, the Government remained of the view that 55% was appropriate. It estimated that 75% of individuals currently in drawdown would have received most of their tax relief at the higher rate. It rejected calls for a lower charge (such as 35%) on the grounds that this "would not fully recover the relief provided for many people, and would create an incentive for some people to save into a pension in order to avoid [inheritance tax]."[77]

The consultation document had asked for views on what should constitute a "secure income" for the purpose of the Minimum Income Requirement. It proposed taking account of pension income that was: currently in payment; guaranteed for life and that took into account reasonable expectations of the cost of living. The sorts of pension income the Government proposed taking into account were the State Pension, index-linked occupational pensions and index-linked annuities.[78] Following the consultation, it decided level annuities should be permitted as well:

> 3.39 The Government believes that the MIR should be as flexible as possible and recognises that level annuities are by far the most common choice for providing a retirement income. The Government will therefore allow level annuity income to count towards the MIR. While such income does not „take into account reasonable expectations of the future cost of living", it is possible to compensate for this in the design of the MIR.[79]

Suggested levels for the MIR had ranged from £7,000 to £31,000 a year, with the majority believing an MIR of between £12,000 and £18,000 to be appropriate. The Government had decided that an appropriate level for the MIR is £20,000. This amount would be reviewed at least every five years. [80]

There was widespread concern among respondents that the new rules might increase the likelihood of individuals seeking to enter drawdown products without a full understanding of the risks involved:

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[76] Ibid
[77] Ibid, para 3.15-25
[78] HM Treasury, Removing the requirement to annuitise by age 75, July 2010, para 3.8-9
[79] HM Treasury, Removing the requirement to annuitise by age 75. A summary of the consultation responses and the Government's response. December 2010
[80] Ibid, para 3.44-54

3.68 The Government is committed to ensuring that consumers have access to financial advice to enable them to make appropriate choices. The rollout by the CFEB of the free and impartial national financial advice service will help consumers understand these choices and will signpost consumers in the direction of specialist advice where appropriate.

3.69 The Government recognises the concerns raised about individuals entering drawdown without a full understanding of the risks involved. It is right that individuals who wish to benefit from the flexibility offered by capped drawdown pensions are able to do so but this product inevitably carries exposure to investment risk that annuities do not. The associated risk of depleting funds prematurely cannot be entirely mitigated without imposing undesirably restrictive withdrawal limits that would undermine the flexibility that drawdown arrangements provide.[81]

The Government said it was difficult to give a precise estimate of the number who might be able to take advantage of flexible drawdown. However, of some 450,000 people who purchased annuities in 2009, it estimated that less than 1% had a pension fund large enough to do so:

All individuals with pension assets in DC schemes will benefit from greater choice over how to use their pension assets in retirement.

It is estimated that around 50,000 individuals currently in a drawdown arrangement could initially benefit from flexible drawdown, if they choose to demonstrate they have sufficient secured lifetime income. A broad estimate, based on existing trends, is that a further 12,000 individuals a year may be able to access flexible drawdown in a steady state. With up to 200,000 individuals currently in income drawdown arrangements, a considerably larger number of individuals could potentially benefit from not being required to purchase an annuity by the age of 75. These figures are based on Financial Services Authority data.

As well as those already in drawdown, the measure will also affect individuals who are not yet retired, or who have not yet applied all of their funds to providing a pension, and who may now choose not to buy an annuity. Around 450,000 annuities were purchased in 2009, therefore the number of individuals who could consider entering an income drawdown product instead of purchasing an annuity could be substantial in future years.

As stated above, it is difficult to make a precise estimate of the number of people who may be able to take advantage of flexible drawdown in future, as this depends on individual circumstances. Assuming full basic State Pension (bSP) entitlement, an individual would need to secure up to £15,000 per annum from private pension sources to meet the required income level, as well as having further pension savings which they wish to withdraw. Securing an annuity income of £15,000 would require a pension fund of over £200,000 at current rates. Less than 1 per cent of the annuities sold in 2009 were purchased with a fund of this size, though as more individuals save into a DC pension, fund sizes will become larger. An individual would also be able to meet the income requirement with a defined benefit (DB) pension income of £15,000 annually on top of the bSP. There is no firm data on the number of individuals with DB income of this level who also have additional DC savings that they could withdraw under flexible drawdown.

[81] Ibid

> Since this measure increases the options open to individuals in retirement, more individuals may opt to seek financial advice as a result. Such advice will incur a cost to the individual, although it is their choice, and many may have sought advice anyway.
>
> Individuals wishing to access flexible drawdown will need to provide evidence that they have a secured lifetime income of £20,000 a year. This adds a small burden on the individual in this circumstance, but again it is only *if* they wish to exercise this new choice.
>
> Individuals already in unsecured pension or ASP arrangements will be affected by the changes to income withdrawal limits and tax charges on lump sums left at death as outlined in the above revisions section.
>
> In relation to IHT, the proposed change will directly affect the 1,000 or so estates each year which currently get charged on their lump sum death benefit, as well as the pension providers and financial advisors who help people plan their pensions.[82]

The Government decided to proceed with implementation in April 2011:

> 3.32 The Government has considered representations from providers that the introduction of flexible drawdown pensions should be delayed to allow more time for providers to adapt to the changes. However, the Government believes that a delay would create further uncertainty which would make it more difficult for providers to plan for the new arrangements. The Government therefore intends to legislate for all aspects of the new tax framework, including flexible drawdown pensions, in *Finance Bill 2011*.[83]

Comment

An article in the *Financial Times* suggested that the change in the rules could lead to an increase in demand for Self-Invested Personal Pension Plans:

> Self-invested personal pensions (Sipps) were introduced in 1989 to give investors freedom to manage their investments within a tax-efficient pension wrapper. Sipps can be used for income drawdown , but this option, known as an alternatively secured pension (ASP), has been largely given a wide berth by retirees over 75 due to the hefty tax charges imposed on funds on death after this age. But from next April, pensions in drawdown will be taxed on death at just 55 per cent, down from 82 per cent currently in ASP. This, along with the introduction of a new uncapped flexible drawdown option, is expected to increase their appeal. "This is great news for the Sipp market," says John Lawson, head of pensions policy with Standard Life, the provider. He said people had shunned ASP because of the restrictions on how much income could be withdrawn as well as the hefty taxes. "Removing these restrictions and substantially reducing the tax charge will result in a big increase in the numbers of people opting for drawdown via Sipps."[84]

Another pointed out that those drawing down the maximum allowed under existing rules for people under age 75 could face a reduction in their retirement income:

> Pension savers considering moving into an income drawdown plan are being advised to act in March - or face a steep drop in their retirement income. This warning comes

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[82] HM Treasury, Consultation on draft legislation - removing the requirement to annuitise from age 75, December 2010

[83] HM Treasury, Removing the requirement to annuitise by age 75. A summary of the consultation responses and the Government's response. December 2010

[84] 'From strip bars to cricket grounds; Self-invested personal pension plans', *Financial Times,* 18 December 2010

> from pension analysts who believe that individuals should make the most of a small window of opportunity to lock into drawdown before regulatory and rate changes put a squeeze on income from April 6. One of the key factors that will cut income for investors going into drawdown in the new tax year is a reduction in the annual withdrawal limit (see table). Currently, investors aged below 75 can take out a maximum of 120 per cent of the rate offered for a comparable annuity. This rate is set by the Government Actuary's Department (GAD). But, from April 6, the GAD rate will drop to 100 per cent of a comparable annuity for these investors, as unsecured pensions (USP) are replaced by a "capped" drawdown arrangement." Depending on a number of factors, the maximum withdrawal level may reduce for the under-75s," says Nick Fletcher, chief executive of Saunderson House, a firm of independent financial advisers. "Those therefore drawing at or near the current maximum should prepare for a potentially lower withdrawal rate."
>
> However, the situation will improve for a minority of investors aged 75 or over currently in alternatively secured pensions, whose GAD rate will increase from 90 per cent to 100 per cent as they are absorbed into "capped" drawdown.
>
> The income squeeze facing most investors will be compounded by a second, and unrelated, change to the table used by insurers to determine retirement income levels. Advisers warn of a "double income dip" after new GAD tables released by HM Revenue & Customs last week had many rates that were lower than last published in 2006.[85]

A further article in the *Financial Times* suggested not all providers would offer the option in the first instance.[86]

In December 2011, the Pensions Policy Institute produced a briefing note analysing '*the implications of ending the effective requirement to annuitise by age 75".* Its conclusion was that:

> The Government has removed the effective requirement to annuitise and introduced new regulations which give people more flexibility to potentially grow their pension savings during retirement and to attempt to preserve some of their fund to leave as inheritance. For people with large savings and a high appetite for risk, the changes will be very welcome and could be beneficial.
>
> However, individuals deciding to use Capped and Flexible Drawdown may also be exposed to more risks to their retirement income. The Government will need to ensure that people have access to clear, appropriate and accessible advice and information to ensure that they understand both the potential upsides but also the inherent risks involved in accessing private DC pension savings more flexibly.[87]

3.5 Legislation

The *Finance (No 3) Bill 2011* was published on 31 March 2011. The relevant provisions are in clause 65 and schedule 16. Explanatory Notes were provided on the HM Treasury website and there was draft guidance and draft secondary legislation on the HMRC website.[88] Details of the progress of the Bill through Parliament can be found on the Parliament website.

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[85] Josephine Combo, Act fast to maximise income drawdown'. *Financial Times,* 26 February 2011

[86] Josephine Cumbo, Drawdown savers face transfer costs, *Financial Times, 19/20 February 2011*

[87] PPI, The implications of ending the effective requirement to annuitise by age 75, December 2011

[88] HMRC, Pensions: Draft Guidance on Changes to the Benefit Rules under Registered Pension Schemes, 31 March 2011; HM RC, Pensions: Removing the effective requirement to annuitise at age 75 (Draft regulations relating to flexible drawdown pensions). 31 March 2011

At the Bill's Public Bill Committee stage, the then Financial Secretary to the Treasury, Mark Hoban, explained that the overall policy intention was to allow savers more flexibility, while safeguarding the interests of taxpayers:

> I must say that I have had correspondence from a whole range of people—from the self-employed to high earners—who are keen about the proposal, because they believe that it will encourage them to save more for the future. They resent having to buy an annuity at 75. They want the flexibility that the measure brings to give them more control over their pensions and their savings. That is one of the themes that run through the Government's approach to reforming pensions and savings. We want to give people more flexibility not only in the way they accumulate their pension savings and their savings more generally, but also in the way they use the pension pots that they have built up when they have chosen to retire. This measure captures the right balance, ensuring that taxpayers' interests are safeguarded by clawing back the tax relief given. It also ensures that people have some choice and control over their savings. It will in the long term prove a further reason for people to build up savings.[89]

The then Shadow Economic Secretary to the Treasury, David Hanson, asked about the potential impact of the provisions on inheritance tax:

> Schedule 16 introduces a tax charge of 55% on lump sums left in pension pots at death by those over the age of 75. That is calculated to be the equivalent of the 40% inheritance tax charge, with an additional 15% to take account of the tax relief given on pension pot accumulations. However, the amount of tax relief can vary hugely, depending on people's circumstances. The 55% rate will therefore over-recover tax from some and under-recover tax from others. Will the Minister give his view on the impact of the clause on inheritance tax avoidance?[90]

The Minister explained the Government's position as follows:

> Simplicity underpins many of the key elements of the clause under debate today. [...] There will be a single recovery charge on unutilised funds remaining on death of 55%. As the right hon. Gentleman said, the recovery charge can be as high as 82% for those above the age of 75. Perhaps he should also have mentioned that lump sum death benefits relating to individuals who die before the age of 75 and before taking a pension are tax free. Lump sum death benefits relating to individuals who die before age 75 after taking a pension are liable to tax at 35%. That is under measures put forward by the right hon. Gentleman's Government when they were in office. Therefore, rather than having no tax, or having tax paid at 35% or up to a rate of 82% on an unutilised pot at death, we have moved to a single tax rate of 55%. I must say that I have received much correspondence from colleagues suggesting that the 55% rate should be reduced, and their constituents have written to them asking for lower rates to be introduced, but I believe that 55% achieves the right balance, and let me say why.
>
> By setting the charge at 55%, we have sought to recover the amount of relief received by a typical individual who may be subject to the charge. The governance modelling suggests that a 55% charge would ensure that there are no tax advantages for pension death benefits compared with other assets on which inheritance tax is payable. Accordingly, it is not appropriate to levy inheritance tax on top of the recovery charge. We recognise that most of the people who will take advantage of the measure will be those who paid the higher rate of tax, and a 55% rate is, therefore, applicable. That would lead to cases in which people received tax relief at the basic rate of an over-

[89] Finance Bill Deb, 7 June 2011, c476
[90] Finance Bill Deb, 7 June 2011, c472

> recovery, but it is better to have a single simple rate, rather than a variable rate that depends on the rate of tax someone may have paid at some point in their life as they built up their pension pot.
>
> The single rate is appropriate. It means a higher tax charge for those who die before the age of 75 and a slightly lower tax charge for those who die afterwards, but it ensures that the tax relief that the Government have given to encourage people to build up a pension pot is actually fully recovered at the point of death. That is the right way to do it. Of course, if the unutilised pot is used to provide a pension for a dependent, which may be a spouse or a minor, that will be tax-free, as is the case at the moment. That is the right level of protection to ensure that tax relief is recovered by the Government.[91]

The *Finance Act 2011* received Royal Assent on 19 July. The relevant provisions are in section 65.

4 Income drawdown in 2012

4.1 Factors affecting drawdown amounts

Except for those eligible for flexible drawdown, the Government sets a cap on the amount that can be drawn down each year.[92] In April 2013, the limit increased from 100 to 120 per cent of the "basis amount", the value of which is calculated in accordance with tables prepared by the Government Actuary's Department:

> The basis amount is the rate of income, which would be available if an individual of the same age as the drawdown pensioner were to use the whole of their drawdown pension fund to buy themselves a level single-life annuity without a guaranteed term. The basis amount is also commonly referred to as "the amount of either an 'equivalent annuity' or a 'comparable annuity'".
>
> The value of the basis amount is calculated in accordance with tables prepared by the Government Actuary's Department (GAD). Two tables prepared by GAD are used for this purpose: one for individuals aged under 23 and one for individuals aged 23 and over.[93]

A more detailed explanation can be found in HMRC's Registered Pension Schemes Manual.[94] The GAD tables applying from April 2011 are on the HMRC website.[95]

As explained in section 3.4 above, from April 2011, the total amount an individual in a capped drawdown arrangement can withdraw each year reduced from 120% of the value of an equivalent annuity to 100%. This was because, with the removal of the requirement to purchase an annuity at age 75, income drawdown is an option throughout retirement. The Government wished to reduce the risk of individuals prematurely exhausting their retirement savings. One way of doing this was to reduce the maximum amount that could be withdrawn each year. To further mitigate the risk, the maximum amount an individual could withdraw

[91] Ibid, c474-5

[92] RPSM09103540 - Technical Pages: Member benefits: Drawdown pension: Maximum amount of capped drawdown

[93] HMRC, Pensions – capped drawdown, January 2013

[94] RPSM09103540 - Technical Pages: Member benefits: Drawdown pension: Maximum amount of capped drawdown

[95] HMRC website, Drawdown pension tables

would now be reviewed every three years, rather than every five years as previously.[96] The Government estimated the impact of this decision on individuals as follows:

> The decision to reduce the maximum annual withdrawal limit for drawdown pensions from 120% to 100% of the value of a comparable annuity was taken by the Government following extensive public consultation on reforms to remove the effective requirement to purchase an annuity by age 75. The impact on people with income drawdown pension schemes is as follows:
>
> - if younger than 75, their maximum income withdrawal is around 17% lower than it would otherwise have been and
>
> - if aged 75 or over, their maximum income withdrawal is around 11% higher than it would otherwise have been.
>
> A Taxes Impact and Information Note for the measure was published on 9 December 2010 on the website of Her Majesty's Revenue and Customs.[97]

The then Financial Secretary to the Treasury, Mark Hoban, explained in March 2012 that a number of factors could influence the maximum annual income an individual could drawdown, including:

> The yield on UK 15 year gilts at the time of an individual's investment review—gilt yields are set by the market and are currently at a historic low,
>
> Investment returns, which may be depressed as a result of current economic conditions; and
>
> The individual's own withdrawals over the period since their last review, so leaving a reduced capital pot from which to draw down.[98]

An article in *Money Management* magazine in February 2012 said individuals were facing significant reductions in income when their arrangement came up for review.

> Challenging investment markets and the new less generous withdrawal rules are hard enough to deal with as it is. Now anyone taking income drawdown for their pension will need to face the fact that the amount of income that they will receive for the next three years will be in part determined by the wild swings in gilt yields caused by the eurozone crisis.[99]

In response to concerns from some drawdown providers, the Government argued that reductions in the amount people were able to draw down were only partly due to drawdown policy changes (other factors such as low gilt yields also being relevant). Although it appreciated that individuals were experiencing financial strain in the short-term, its reforms were based on longer-term considerations. It was confident that the reforms would "improve flexibility and income sustainability for savers for the future."[100]

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96 Ibid
97 HC Deb 18 Jan 2012 c834W
98 HC Deb 20 Mar 2012 c618W
99 Mary Stewart, 'Sad about GAD', Money Management, February 2012
100 A J Bell, 'Government says no' to AJ Bell on call for review of income drawdown rules, 3 October 2012; See letter from Economic Secretary to the Treasury, Sajid Javid, dated 25 September 2012

Low gilt yields

Strong demand for gilts following the financial crash in 2008 led to a general fall in gilt yields which had a significant impact on the major holders of such instruments like pension funds.

The Government issues gilts to borrow from the money markets. These have a rate of interest they pay (the coupon rate) and a date when they will be redeemed - which is when the government repays the investor the capital sum borrowed. Each security is issued at a unit value – normally £100. A typical gilt might therefore be called 4% Treasury Gilt 2016. The coupon indicates the cash payment per £100 nominal that the holder will receive per year. For example, an investor who holds £1,000 nominal of 4% Treasury Gilt 2016 will receive two coupon payments of £20 each on 7 March and 7 September. The coupon rate usually reflects the market interest rate at the time of the first issue of the gilt. Government borrowing is managed on a day-to-day basis by the Debt Management Office (DMO). The coupon rate set reflects the rates available in the market at any one time, reflecting how rates of borrowing have fluctuated in the past.

Gilts do not have to be held until redemption and are freely traded in the market. If there is strong demand for UK gilts, perhaps because the UK government is seen as being a 'safe haven' compared to other forms of investment, the price of openly traded gilts on the market is likely to rise. Because since the coupon interest rate does not alter, the price rise forces down the actual rate of interest paid on the investment. For example, a 4% coupon rate (£4) will be paid to the holder of the gilt regardless of whether they paid £100 for the security or £120. In this example, the market rate on gilts has fallen to 3.3%. When the next round of gilt sales is planned the DMO is likely to reduce the coupon rate since it knows that investors are prepared to accept a lower return.

4.2 Finance Act 2013

In the Autumn Statement on 5 December, the Chancellor announced that the capped drawdown limit would be increased back to 120% of a comparable annuity:

> I have also listened to concerns from pensioners about draw down limits. I am today announcing that the Government will raise the capped drawdown limit from 100% to 120%, giving pensioners with these arrangements the option of increasing their incomes.[101]

Draft legislation in clause 49 of the *Finance Bill 2012/13* was published on 17 January 2013.[102] This provides for the 20 per cent increase to apply for all drawdown pension years starting on or after 26 March 2013. Explanatory Notes were also produced.

The Government expected the change to affect around 500,000 drawdown pensioners during the period 2012-13 to 2016-17. They would be entitled to "receive pensions up to 20 per cent higher than would otherwise have been the case." The Exchequer impact was expected to be "negligible."[103] .

The legislation is now in section 50 of the *Finance Act 2013*.

The *Financial Times* reported that providers took different approaches to implementing the change:

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[101] HC Deb, 5 December 2012, c878; See also HM Treasury, Autumn Statement, Cm 8480. December 2012, para 2.58

[102] HMRC, Pensions – Capped Drawdown, 17 January 2013

[103] Ibid

> The majority of providers decided they would maintain the existing income level, for example a client taking 100 per cent of their income limit would continue to be paid 100 per cent, even though their new entitlement was increased to 120 per cent. However, a significant minority took the opposite view and faced some criticism in doing so. They took the decision to move any client taking maximum income under the lower limit onto the maximum income under the new, higher limit.[104]

In Budget 2013, the Government announced that it had asked GAD to review the pensions drawdown tables.[105] *Money Marketing* said this was in response to representations from the Association of British Insurers which wanted the GAD maximum used to set drawdown rates to be calculated using a mixture of long-term corporate bond yields and long-term gilt yields.[106]

5 Budget 2014

In Budget 2014, the Government announced changes to the income drawdown rules to take effect from 27 March 2014:

- The amount of guaranteed pension income people would need in retirement to access their savings flexibility would reduce from £20,000 to £12,000;
- The capped drawdown limit would increase from 120% to 150%.[107]

This was as part of a package of measures intended to allow people greater freedom and choice over how to access their defined contribution pension. The other measures related to the circumstances in which pension saving can be taken as a lump sum. The Budget document said:

> **1.164** As a first step towards this reform, the Budget introduces a number of immediate changes, to allow people greater freedom and choice now over how to access their defined contribution pension. From 27 March 2014 the government will:
>
> - reduce the amount of guaranteed pension income people need in retirement to access their savings flexibly, from £20,000 to £12,000
>
> - increase the capped drawdown limit from 120% to 150% to allow more flexibility to those who would otherwise buy an annuity
>
> - increase the size of a single pension pot that can be taken as a lump sum, from £2,000 to £10,000
>
> - increase the number of pension pots of below £10,000 that can be taken as a lump sum, from 2 to 3
>
> - increase the overall size of pension savings that can be taken as a lump sum, from £18,000 to £30,000.[108]

[104] Greg Kingston, Income drawdown changes: Drawdown on the up, *Financial Times,* 24 June 2013
[105] HM Treasury, Budget 2013, HC 1033, March 2013
[106] Michael Glennister, Boost for drawdown savers as GAD hits 3.25%, *MoneyMarketing,* 17 September 2013
[107] HM Treasury, Budget 2014, HC1104, 19 March 2014
[108] Ibid

Some days after the Budget, HMRC produced information to explain whether the unravelling of actions taken shortly before the Budget changes were announced, would give rise to a tax charge. The information was aimed at people who had:

- received a tax free lump sum after 27 March 2014
- received a tax-free lump sum on or before 27 March 2014, and either
  - cancelled an annuity contract within the cooling-off period on or after Budget day (19 March 2014) that was linked to that lump sum
  - not yet decided how to access the rest of their pension savings.[109]

The information related to the tax rules: the options available in an individual case would depend on what the pension scheme decided to allow.[110]

The change which took effect on 27 March 2014 are provided for in the *Finance (No.2) Bill 2013-14* (chapter 4, clauses 39-41)*.*

In debate in Public Bill Committee on 8 May 2014, Exchequer Secretary to the Treasury, David Gauke, said that:

> As a result of the changes, an extra 85,000 people are expected to be able to access their pension wealth as a lump sum this tax year, if they so wish. Some 400,000 existing draw-down pensioners will be given the option of receiving significantly greater withdrawals from their pension funds.[111]

Further information was provided in HMRC Tax Information and Impact Note – Increasing pension flexibility.

The changes taking effect from 27 March 2014 are short-term measures, in advance of more far-reaching reforms to be introduced from April 2015. The Budget document said:

> **1.165** Under the current tax system, people are charged 55% if they choose to withdraw all of their defined contribution pension savings at the point of retirement. This means the majority of people instead purchase an annuity and receive taxable income over the course of their retirement. Under the new system, an individual will be able to withdraw their savings at a time of their choosing subject to their marginal rate of income tax. The government anticipates that under these circumstances some people will choose to draw down their pension sooner in order to suit their personal situation. This will increase income tax revenue in the short to medium term. [112]

These longer term changes are discussed in a separate note – SN 6891 Budget 2014 – flexibility for DC pension savers from April 2015.

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[109] Budget changes – pension flexibility and changes to Finance Bill 2014
[110] Ibid
[111] PBC Deb 8 May 2014 c223
[112] Ibid