A. INTRODUCTION

1. The income drawdown rules are changing with effect from 6th April, 2011, removing the effective requirement to annuitise at age 75. A new form of flexible drawdown will be introduced, for individuals with a pension income of £20,000 or more, allowing unlimited drawdown.

2. These changes are being introduced as part of a policy of giving individuals greater flexibility over their pension arrangements, to suit their own particular circumstances.

B. POSITION BEFORE 6TH APRIL, 2011 – BACKGROUND

1. An income drawdown option was first introduced for defined contribution occupational pension schemes in 1999. However, in practice this was little used as:
   - schemes rarely permitted drawdown, and
   - the regulatory restrictions for drawdown from an occupational scheme were tighter than for personal pensions, so individuals tended to transfer to personal pensions to access drawdown for added flexibility.

2. The “A Day” tax simplification changes, which came into effect on 6th April, 2006, included a new drawdown regime. This applied to both occupational and personal pension arrangements in the same way.

3. Income drawdown was available as a form of unsecured pension before age 75. In addition, for the first time a limited form of drawdown was introduced for those aged over 75 – an alternatively secured pension (“ASP”).

4. The ASP option was originally introduced for people who had reached age 75 and had principled objections to mortality pooling (e.g. Plymouth Brethren). However, its use was not specifically limited to this group.

5. Following evidence that ASPs were being recommended as tax planning vehicles for passing on wealth on death, in 2007 the tax treatment of ASPs was tightened. Inheritance tax charges were introduced and other tax changes were made that could result in tax charges on death benefits from an ASP of up to 82%. Changes were also made to increase the minimum and maximum income that could be withdrawn from an ASP, to ensure that the funds were likely to be used in a member’s lifetime.

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1 The Finance (No. 3) Bill is currently at Committee Stage in the House of Commons. Further changes may be made to the Bill as part of the Parliamentary process. Royal Assent is expected in late June or early July.
6. The practical effect of these changes was that, unless an individual had a genuine objection to mortality pooling at age 75, annuitisation at age 75 was effectively compulsory, since the ASP was so unattractive.

7. Despite the 2006 changes, it was rare for defined contribution occupational schemes to change their rules to permit drawdown before age 75. Drawdown therefore remained largely the preserve of personal pension arrangements.

C. POSITION BEFORE 6TH APRIL, 2011 – CALCULATING THE INCOME LIMITS

1. The maximum and minimum level of annual income available under drawdown (for both unsecured pension and alternatively secured pension) was calculated as a percentage of a “basis rate”.

2. The basis rate was worked out using rate tables provided by the Government Actuary’s Department (“GAD”). These tables are designed to provide a measure of the annual amount of lifetime annuity income an unsecured pension fund can generate for the member at the point of calculation, assuming the annuity was purchased on a single life basis, with no inflation uplifts and no guarantee if the member died soon after purchase.

3. The rate was calculated as an income per £1,000 of the fund designated as income drawdown (net of any tax free lump sum taken) and was dependant on:
   – the member’s gender,
   – the member’s age, and
   – the gross redemption yield on 15 year UK gilts rounded down to the nearest ¼% (assuming this was not already an exact multiple).

4. The income drawdown available before and after age 75 was as follows:

<table>
<thead>
<tr>
<th>Type of drawdown</th>
<th>Maximum annual income (as % of basis rate)</th>
<th>Minimum annual income (as % of basis rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unsecured pension (before age 75)</td>
<td>120%</td>
<td>Zero</td>
</tr>
<tr>
<td>Alternatively secured pension (from age 75)</td>
<td>90%</td>
<td>55%</td>
</tr>
</tbody>
</table>

Comment: One consequence of the zero minimum income requirement on drawdown before age 75 was that members could drawdown a fund, leave it invested in the pension scheme and take a tax free lump sum out of it, without an income requirement.

5. The way the 2006 tables worked can be illustrated by the following examples.
6. **Example 1**²:

   - Barbara designates £100,000 of a money purchase arrangement to provide an unsecured pension from her 60th birthday (1st October, 2007).
   
   - The point of calculation is the ‘reference date’ of the calculation, that is, the date of designation, 1st October, 2007, when Barbara’s age is 60.
   
   - The relevant yield on UK gilts to use is 4.37%, which is rounded down to the next 0.25% at 4.25%.
   
   - Using the table for a woman aged 23 or over, the relevant figure, based on age 60 and yield 4.25% is £59.
   
   - Applying this to the unsecured pension fund, the basis amount is calculated as:
     
     \[
     \frac{\£100,000}{\£1,000} \times \£59
     \]
     
     \[
     = 100 \times \£59
     \]
     
     \[
     = \£5,900.00
     \]
   
   - The maximum income Barbara can take at age 60 is £6,840 (120% x £5,900), and the minimum is nil.

7. **Example 2**:

   - Catherine, aged 75, designates £100,000 of a money purchase arrangement to provide an alternatively secured pension from her 75th birthday (also 1st October, 2007).
   
   - Using the table for a woman aged 23 or over, the relevant figure, based on age 75 and yield 4.25%, is £87.
   
   - Applying this to the alternatively secured pension fund, the basis amount is calculated as:
     
     \[
     \frac{\£100,000}{\£1,000} \times \£87
     \]
     
     \[
     = 100 \times \£87
     \]
     
     \[
     = \£8,700.00
     \]
   
   - The maximum income Catherine can take at age 75 is £7,830 (90% x £8,700).
   
   - The minimum income Catherine can take at age 75 is £4,785 (55% x £8,700).

² This is a summary of an example given in the 2006 GAD tables.
D. SUMMARY OF CHANGES TO BE MADE BY FINANCE (NO. 3) BILL 2011

1. Reforms to the income drawdown rules have been developed as part of a policy of giving individuals greater flexibility over their pension arrangements, to suit their own particular circumstances. The effective requirement to buy an annuity from age 75 has been removed.

2. With effect from 6th April, 2011, both unsecured pension and alternatively secured pension will be replaced by a single new form of drawdown, “capped drawdown”, which will be available from age 55 for life:
   - new GAD tables are to be used for working out the maximum withdrawals in capped drawdown, with drawdown rates that are generally lower than under the 2006 tables.¹
   - the new annual maximum limit will be 100% of the basis amount and there will be no minimum limit.
   - drawdown limits will have to be reviewed at least every 3 years before age 75 (previously every 5 years) and annually thereafter.
   - pension commencement lump sums (tax free lump sums that can be paid on crystallising benefits) can be paid in relation to drawdowns after age 75.

3. In addition, there will be special unlimited drawdown arrangements (“flexible drawdown”) for individuals of any age who meet a minimum income requirement of £20,000, and whose schemes offer this facility – see Part E below.

   Comment: Both types of drawdown will also be available to overseas schemes which benefit from UK tax reliefs (either directly, for example migrant member relief, or due to a transfer from a UK registered scheme).

4. Where benefits are drawn down before death, and the remaining fund is paid out on death before age 75 in lump sum form, the tax charge is increased from 35% to 55%.

5. The same charge (55%) will apply where death occurs on or after age 75 and lump sums are paid to survivors, in place of previous total tax charges of up to 82%. There will not usually be any inheritance tax charges.

6. The following example illustrates the changes in the maximum income limit under the new rules.

7. Example 3:
   - The facts are the same as for Example 1 (at C.6 above) but Barbara’s 60th birthday is reached on 1st October, 2011 (rather than 2007).
   - Using the 2011 table for a woman aged 23 or over, the relevant figure, based on age 60 and yield 4.25% is £58.

¹ For an interim period up to 6th June, 2011 either set of tables can be used but with the 100% cap applying.
– Applying this to the unsecured pension fund, the basis amount is calculated as:

\[
\frac{100,000}{1,000} \times 58
\]

\[
= 100 \times 58
\]

\[
= \£5,800.00
\]

– The maximum income Barbara can take at age 60 is \£5,800 (compared to \£6,840 where it is assumed she reached 60 before 6th April, 2011).

8. There are transitional rules for individuals who are already in unsecured pension arrangements, so that the new rules only apply from the next review date.

9. As previously, the tax rules will permit schemes to offer capped and flexible drawdown, but will not require them to do so.

E. FLEXIBLE DRAWDOWN ARRANGEMENTS

1. Individuals who meet a minimum income requirement of \£20,000*, and whose schemes permit them to do so, will be able to apply for a special form of drawdown, with no limits on the amounts that can be taken as income from designated funds. This will be known as “flexible drawdown”.

2. The following pension income in payment counts towards the minimum income requirement:

– state pension,

– scheme pensions, lifetime annuities⁵ and dependants pensions/annuities paid under UK registered schemes,

– overseas pension scheme pensions/annuities which have the same features as a pension/annuity under a registered pension scheme, and

– payments under the UK financial assistance scheme.

3. Drawdown income cannot count towards the minimum income requirement, and scheme pensions paid by small schemes will also be excluded. Purchased life annuities (which are not under a registered pensions scheme) are also excluded.

4. To apply for flexible drawdown, there must not have been any contributions to defined contribution arrangements for that member in that tax year, and active membership of any other arrangements under registered pension schemes must have ceased.

* The minimum income requirement will be set by Treasury order at least every 5 years.

⁵ Where a lifetime annuity is index linked (so it can go down as well as up) only the minimum income payable each year is included.
5. The tax regime is designed to discourage new pension savings by individuals who opt for flexible drawdown. Once the flexible drawdown application has been accepted by the scheme administrator, any new pension savings for the individual under any registered pension scheme will be subject to the annual allowance charge.

6. There are rules to prevent the avoidance of tax by individuals becoming temporarily non-resident and taking flexible drawdown from either registered or overseas schemes. Income paid whilst non-resident will be treated as pension income arising in the year that residence in the UK is resumed.

F. CONCLUSIONS

1. The new tax rates applied where individuals who choose drawdown pass on unused funds to their heirs, combined with the adaptability of the flexible drawdown option may be attractive to wealthy individuals with large pension funds.

2. For the first time, we may see income drawdown becoming more widely available in occupational schemes. This is because there may be a community of interest for sponsors of defined benefit schemes and members with significant pension promises, in converting part of the promise to money purchase form. Individuals would then be able to access flexible drawdown, whilst sponsors manage future funding risk.

3. This could be achieved by transfers out to personal pensions, or alternatively, by permitting conversion within the sponsor’s scheme or internal transfers to another group pension scheme.

4. However, individuals should only make a decision of this kind after having taken their own advice from a suitably qualified professional.

This summary of the changes to the income drawdown rules is based on draft legislation (the Finance (No. 3) Bill, which is currently at Committee Stage in the House of Commons). Further changes may be made to the Bill as part of the Parliamentary process.