



Unsecured pension

In this section you will learn, in detail, about the unsecured pension option available to age 75.

1 Income withdrawal using unsecured pension (USP)

2 The lifetime allowance & benefit crystallisation

3 Income limits

4 Income reviews

5 Transitional rules for pre A-Day drawdown

6 Transfers

7 Death benefits

8 Inheritance tax

9 USP – investment risk & mortality drag

10 Short-term annuities

11 USP - advantages

12 USP - disadvantages

13 USP CASE STUDY for subscribers to

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1 Income withdrawal using unsecured pension (USP)

Income withdrawal, or pension fund withdrawal as it is also known, allows members (or dependants) to draw a pension income directly from their pension fund rather than using the fund to buy an annuity. The pension commencement lump sum is paid in the usual way when the benefits are crystallised, but the remaining fund continues to be invested.

Unsecured pension (USP) is the name for the type of income withdrawal allowed for those under age 75. It is only available for money purchase benefits. Pensions paid under USP are subject to income tax in the usual way.

2 The lifetime allowance & benefit crystallisation

When USP first starts, this is a benefit crystallisation event and the crystallised value of the USP fund and any pension commencement lump sum paid must be tested against the member's available lifetime allowance.

There is also a second benefit crystallisation event when a USP fund is used to buy an annuity or provide alternatively secured pension. The crystallised value at this event is calculated as the current fund value minus the fund originally moved into USP.

3 Income limits

There is a maximum limit on the amount of pension that can be paid under USP, but no minimum. The maximum yearly income allowed is 120% of the basis amount from the tables produced by the Government Actuary's Department (GAD).

The basis amount for each £1,000 of USP fund is found in the GAD table based on:

- The member's gender and age (in complete years) on the reference date for the calculation.

- The gilt yield in force on the reference date. For members over age 23, this is the gross redemption yield on 15 year UK gilts from the FTSE Actuaries Government Securities Yield Indices for the 15th of the month before the month in which the reference date falls. For those aged 23 or less, the 5 year yield should be used. Unless the published yield is an exact multiple of 0.25%, the calculation should be based on the published yield rounded-down to the nearest 0.25%.

4 Income reviews

When USP first starts, this sets the first pension year and the first 5 yearly reference date. The maximum income limit must be reviewed and recalculated on each reference date at the end of each 5 yearly reference period.

Following changes introduced in the Finance Act 2007, interim income reviews can be requested at the start of any pension year. These reviews reset the 5 yearly reference dates.

For administrative convenience, the calculations can be done on any nominated date up to 60 days before the actual reference date, based on the fund value on the nominated date but using the member's age on the reference date itself.

If the member uses part of their USP fund to buy a lifetime annuity, designates more fund into USP as part of a phased retirement strategy or gives up some of their USP fund as part of a pension share on divorce, this also triggers an income review.

5 Transitional rules for pre A-Day drawdown

Any existing income drawdown in place before A-Day (6 April 2006) automatically became subject to the USP regime on A-Day. However, as an administrative concession, the maximum income did not need to be reviewed until the earlier of:

- 6 April 2008, or
- a date set by the scheme administrator, or
- any other date on which a recalculation of the income limit is required (for example, on annuity purchase or pension share).

Income could be reduced to zero immediately from A-Day without conducting an income review, but no increase could be made without a review first taking place.

Note that existing pre A-Day income withdrawal funds never face a benefit crystallisation test.

6 Transfers

USP funds can be transferred to another pension scheme after income withdrawal has started. The funds must be held in a separate arrangement from any other funds the member has under the receiving scheme.

The USP pension year, maximum income limit and reference dates for the transferred USP fund remain unchanged under the receiving scheme.

7 Death benefits

On a member's death in USP, the residual fund can be used to provide lump sum death benefits taxed at 35% or dependants' pensions taxable as income.

Dependants' pensions can be provided by continued income withdrawal, under either the USP or alternatively secured pension rules depending on the dependant's age, scheme pension or annuity. The income limit for a dependant's USP pension is calculated based on the dependant's age. Only dependants' pensions paid by USP can provide further benefits on the dependant's death (by way of a lump sum taxed at 35%).

8 Inheritance tax

Section 3(3) of the IHT Act 1984 brings pension death benefits into account for inheritance tax (IHT) purposes where an individual's "omission to act" results in their estate being reduced.

However, there is a general exemption under section 10 of the IHT Act 1984 unless there was gratuitous intent in the omission.

In general, this means that death benefits from a USP fund should normally be exempt from IHT. The kind of rare circumstance where this exemption might not apply is, for example, where someone in poor health suddenly reduced their USP income knowing that they did not have long to live.

The only situation where a USP fund will always be assessed for IHT is where it was inherited by a dependant following a member's death after 75 in alternatively secured pension. In these circumstances, it will be assessed for IHT on the dependant's death.

9 USP – investment risk & mortality drag

Because USP funds remain actively invested, this exposes the member to investment risk that generally does not exist with lifetime annuities or scheme pensions. Investments can go up or down, which will affect the income available from a USP fund.

If investments do well, this can mean that USP income is higher than the income that could have been provided by buying an annuity. But adverse investment performance will reduce the maximum income allowed following the next income review, which might mean that buying an annuity would have been a better bet.

To compound this risk, the cost of any annuity is based on the average life expectancy of the annuitants. This means that those annuitants who die earlier than expected subsidise those who live longer than expected. USP does not benefit from the mortality subsidy inherent in annuity products. The effect of this lost mortality subsidy for each year in USP is known as mortality drag.

10 Short-term annuities

A member can use part of their USP fund to buy a temporary annuity known as a short-term annuity. The annuity has a maximum term of 5 years (or age 75, if earlier) and must be paid at least yearly. It can be guaranteed, but cannot include an annuity protection lump sum.

A short-term annuity purchase does not affect the USP reference dates or maximum income limit, but the income from the short-term annuity counts towards the maximum income allowed from the USP fund.

As with other annuities, a short-term annuity must be provided by an insurance company and the member must be given a choice of provider (the open market option).

Short-term annuities allow those using income withdrawal to secure a guaranteed level of pension income for a fixed short-term period, without the need to commit all their fund to annuity purchase. It thus combines some of the security of annuity purchase with some of the flexibility of income withdrawal.

11 USP - advantages

The main attractions of USP are:

- It gives immediate access to a pension commencement lump sum without the need to take full income.
- It provides flexible income, which can be varied as needed to meet income needs or maximise tax advantages.
- An annuity can be bought at a time of the member's choosing, allowing the member to benefit from improvements in annuity rates.
- The fund remains invested, giving more scope for real investment growth. This is particularly attractive to more sophisticated investors.
- Death benefits are usually higher, and more flexible, than under secured pension alternatives such as annuities.

12 USP - disadvantages

The main risks associated with USP, which mean it has restricted suitability, are:

- As the fund remains invested, the member carries the investment risk.
- As the member gets older, they will increasingly suffer the effects of mortality drag.
- Pension income is not guaranteed and can go down.
- Annuity rates may worsen during the period in USP.
- Charges tend to be relatively high.

13 USP CASE STUDY

Those subscribing to http://www.wizardlearning.com/monthly_CPD.html can take the online USP case study incorporating 10 multiple-choice questions.