A guide to drawdown

AJBell
Youinvest

Contents

The value of your investments can go down as well as up and you may get back less than you originally invested.

We don't offer advice, so it's important you understand the risks, if you're unsure please consult a suitably qualified financial adviser. It can be a good idea to shop around to find the provider that offers the best pension for you. If you need help shopping around, the Money Advice Service website (moneyadviceservice.org.uk) provides some useful information.

Tax treatment depends on your individual circumstances and rules may change. The information in this guide is based on tax rules as at 6 April 2020. If you are a resident in Scotland, different rates of tax apply and figures and examples in this guide may vary.

Introduction

Pension rules, over recent years, have grown more relaxed. Long gone are the days when you'd be shovelled into an inflexible annuity for life. Now – thanks largely to 2015's pension freedoms – you have plenty of options when you come to retire. Want to take out your money in one go? You can. Want to withdraw lump sums as and when you need them? No problem. Want to leave most of your pension pot invested and buy an annuity with the rest? That's easily done too.

But the most popular way of accessing your pension, particularly in the wake of the 2015 reforms, is through income drawdown. So how does it work? Just as when you buy an annuity, drawdown lets you initially take tax-free cash of up to 25%. But unlike an annuity, the other 75% remains invested – and you draw an income directly from it.

There are certainly advantages to this approach. Not only does your money remain invested – with the potential of further growth – but you also have control of when, and how much, you withdraw. This can make it easier for you to stay within a lower tax bracket, and give you the flexibility to make big one-off withdrawals should you need to. Compared to an annuity, it can also be easier to pass your remaining pension wealth onto your loved ones when you die. So it isn't difficult (especially given the marked slump in annuity rates in recent years) to see why drawdown has become the default for retirees with above-average sized pension pots.

But it isn't difficult, either, to see the potential risks. Unlike an annuity, which guarantees you a fixed income for as long as you live, a pension pot in drawdown can run out. So before you do anything else, you need to ask yourself some important questions. How much money do you need in retirement? What are your priorities? How much investment risk are you willing to take? Challenging yourself in this way can help you create a retirement plan that ensures your hard-earned pot lasts as long as you do.

Seeking guidance? Try Pension Wise

To help you understand the options you have at retirement and make the right choice for you, we recommend you take advantage of the government's Pension Wise service – which offers free, impartial guidance.

You can contact Pension Wise online at pensionwise.gov.uk, in person at the Citizens Advice Bureau or by telephone via The Pensions Advisory Service on 0800 280 8880.

It can also be a good idea, before you move into drawdown, to seek advice from a suitably qualified financial adviser. This is especially true if you're transferring a pension from an existing scheme (which may not always work to your benefit).

How does drawdown work?

To enter drawdown, you need to:

- ✓ be aged 55 or over.
- ✓ have a 'defined contribution', or 'money purchase', pension – that's a pension fund built up by your own and (if it's a workplace scheme) your employer's contributions, rather than a pension that gives you a percentage of your salary at retirement, which is known as 'defined benefit'.

You can transfer a defined benefit pension to a defined contribution pension, but you should weigh this decision carefully: it may leave you worse off. And if the value of your pension benefits is £30,000 or more, you'll need to take advice from a regulated financial adviser. Also, keep in mind that not every defined contribution pension offers a drawdown account. You may need to transfer to a personal pension, such as a SIPP.

To get started with drawdown, you need to be with a provider that offers it. Drawdown is offered by a number of providers, including AJ Bell Youinvest. To find the right one for your needs and circumstances, it can be a good idea to shop around. If you need any help, the Money Advice Service website (moneyadviceservice.org.uk) provides some useful information. Once you've confirmed you want to enter drawdown, you can normally take up to 25% as a tax-free lump sum, while the other 75% remains invested. What you invest in is up to you, and you should take into account your income objectives, including how much money you want to take and when, and how long you need the fund to last.

Apart from the 25% tax-free lump sum, any money you take from your pension pot via drawdown will count as part of your income for the year, and will be taxed accordingly. That means large withdrawals could push you into a higher tax band – something to consider when you're planning your retirement income strategy.

Of course, moving into drawdown (rather than buying an annuity) exposes you to continued investment risk. Market downturns could reduce your retirement income, and withdrawing too much, too soon, could mean you run out of money. So deciding how much income to take and the best place to invest your money necessitates some careful planning. (And once in drawdown, it's sensible to review your portfolio regularly: to make any necessary adjustments to your investments and income.)

But the flipside of that coin is added flexibility. Drawdown can give you more options. Once you've got your tax-free lump sum, you can start taking an income straight away, or wait until later. You can also choose to move your pension pot into drawdown gradually, taking a quarter of each amount tax-free rather than taking your full tax-free chunk all at once (this approach can be more tax-efficient). And at any time, you can use all or some of the money you have in drawdown to buy an annuity should you want to.

Case study

Joanne Harris, 63, is approaching retirement and considering drawdown.

Joanne has a SIPP worth £500,000 and no other retirement savings. Before she retires, she's keen to pay off the final £50,000 of her mortgage.

She decides to access £200,000 of her fund now: by taking £50,000 as a tax-free lump sum and putting £150,000 into drawdown. This allows her to pay off her mortgage. Once she retires, she'll start taking income from the drawdown fund as and when she needs it. The remaining £300,000 of her fund is untouched, meaning she can draw a further tax free lump sum in the future. Both her drawdown funds and the rest of her funds remain invested in her SIPP.

Drawdown popularity and pension rules

Since the pension freedoms, the popularity of drawdown has boomed. More than twice as many pension pots are moved into drawdown than into annuities (compared with 90% of pots moving into annuities and only 5% into drawdown before the pension freedoms). What's more, accessing pots early has become the new normal: 72% of pots since the pension freedoms have been accessed by consumers younger than 65.

But it's worth remembering that pension rules are decided by governments, and governments – and rules – can change. Just because a rule applies now doesn't mean it will apply in decades to come.

Pros and cons of drawdown

Pros	Cons
Flexibility: You can take as much retirement income as you like when you need it, be it regularly, in large lump sums or even no income at all	**Investment risk:** Your investments could go south, affecting your retirement income. And money lost in retirement can be especially difficult to get back
Potential growth: Your money stays invested, giving you the opportunity to keep growing your pension pot and protect it from inflation	**High stakes:** Your pension pot could run out, leaving you insufficient money to live off
Control: You make the decisions about your pension savings and choose where it's invested	**Planning needed:** You need to work out your income objectives, and how long you'll need the fund to last
Tax choices: You decide how much income you take, letting you manage withdrawals to minimise your tax bill	**Time consuming:** You need to review your investments and income strategy regularly, to ensure they remain appropriate
Options: You don't have to move all your pension pot into drawdown in one go. And at any time, you can use some, or all, of your money to buy an annuity	**Complicated compared to annuities:** Annuities are more straightforward. In drawdown, you, not the annuity company, shoulders the risk that your money will have to cover a longer-than-anticipated period
Death benefits: You can pass your pension fund onto loved ones after death (tax-free in some circumstances)	**MPAA:** Once you start to draw a flexible income from your pension fund, the MPAA (money purchase annual allowance) reduces the amount you can continue paying into your pension with tax relief from £40,000 to £4,000 per year
Low annuity rates: Drawdown can offer higher income than buying an annuity, though it isn't guaranteed	**May be temporarily over-taxed:** When you take a one-off taxable payment for the first time, income is likely to be taxed on a 'Month 1' basis, potentially leaving you out of pocket until you complete a tax return

Drawdown alternatives

Thanks to the pension freedoms, retirement now brings plenty of options. If you need help deciding what's best for you, we recommend the government's Pension Wise service – which offers free, impartial guidance – or that you contact a regulated financial adviser.

Annuities

When you buy an annuity, you're exchanging money in your pension pot for a guaranteed income that lasts the rest of your life. But in recent years, annuity rates have slumped – and their popularity levels with it.

Also, level annuities offer no protection from inflation, which can swiftly become a problem: a 5% inflation rate could halve your income's spending power in 14 years. And single-life annuities don't let you pass on any wealth to your inheritors unless they include a guarantee period. When you die, even if you've only received one payment, that's it.

But despite that, annuities can certainly be an option worth considering. You've many types of annuities to choose from, including escalating annuities (which can rise in line with inflation) and joint life annuities (which can continue to pay the same, or a reduced, amount to your partner after you die). But above all, annuities may be best for retirees who don't feel comfortable with the investment risk of drawdown, and crave the security of a guaranteed income.

Lump sums, or UFPLS

Taking ad-hoc withdrawals from your pension is a bit like using your pension as a bank account. You take out lump sums as and when you need them, and the rest of the fund stays where it is.

Like drawdown, withdrawing lump sums gives you flexibility. You can withdraw as much, or as little, as you like, and 25% of what you withdraw each time is tax-free. But unlike drawdown (where the remaining 75% remains invested), you take out the whole lump sum, with the remaining 75% taxed as income. The somewhat intimidating term for this is 'uncrystallised funds pension lump sums', or UFPLS. Put simply, the lump sums are 'uncrystallised' because you haven't moved the money into drawdown.

So what are the advantages? There are two main ones. You can take as much money as you like in one go. Or by staggering your withdrawals, you can spread the 25% tax-free benefit over a period of time.

But there are also disadvantages. Like drawdown, your pension pot could simply run out. And depending on your pension provider, there may be charges involved (just as with drawdown). You also might be restricted to a certain number of withdrawals a year. Also, if you've placed part of your pension pot in drawdown, you can only take UFPLS from another, non-crystallised part. Additionally, once you've taken a UFPLS payment, however small, the amount you can contribute to your pension with tax relief falls from £40,000 to £4,000 a year (see the 'Drawdown and tax' section).

Taking no income

To begin with, it's likely you'll want to leave your pension pot untouched. Yes, you can start taking your pension from age 55, but the majority of people won't just yet. They'll intend to work longer and keep on saving for retirement.

But even when you do come to retire, you can opt to not take money from your pension beyond all, or some of, your 25% tax-free lump sum. That way, not only can the rest of your pension continue to grow, but you can continue to contribute up to £40,000 to your pension each year. As soon as you take an income, this amount falls to only £4,000 per year.

Of course, this approach only works as long as you can live off your pension's tax-free cash. And it's really just a holding position until you're ready to take an income from the rest of your pot.

Drawdown decisions: annuities, risks and where to invest

With flexibility comes responsibility. Drawdown gives you plenty of choice – but also means plenty of decisions. Decisions such as: whether to buy an annuity, and if so, how much of your pension pot to put towards it. For example, do you want to buy a large annuity, or a smaller one that covers your essential living costs while the rest goes into drawdown giving you a flexible income?

Deciding where to invest your money when retired is important too. It's arguably more important than when you're working, because money lost in retirement – when your income is more limited – can be extremely difficult to get back again. When in drawdown, your fund will also need to work hard to keep up with inflation, charges and any withdrawals you make. Renowned financial adviser William Bengen advocated taking 4% of your portfolio every year from age 65 for sustainability (the 'Bengen rule'), but this is a rough guide and won't apply to everyone. For that reason, it's always important to monitor your portfolio and what you're withdrawing.

When investing before retirement, accumulation units (Acc) often prove a popular portfolio choice, because any dividends you receive are reinvested for you, helping to grow your pot more quickly. But when in drawdown, you might prefer to choose income units (Inc), which automatically pay out any income, saving you the hassle and cost of doing it yourself.

Equity income funds are often popular with dividend hunters, because they typically hold shares in businesses that are predicted to grow their dividends over time. Funds more generally (such as unit trusts or investment trusts) give you access to a whole portfolio of shares, bonds or both through a single investment. As ever with investing, diversification is key. It's essential you don't leave yourself overexposed in any one area – for instance, when chasing dividends.

Investing your drawdown pot: two strategies

When you move your pension into drawdown, you've the freedom to invest where you like. But broadly speaking, there are two main investment approaches you can choose between: natural yield and total return. (If you're not an experienced investor, keep in mind it may be a good idea to seek advice from a regulated financial adviser.)

Natural yield

What is it? Taking only the income generated by investments (e.g. dividends on shares, coupons on bonds, interest on cash) without selling the underlying investments themselves.

What are the advantages? By only withdrawing the yield on the investments and not the investments themselves, your pension pot can continue – potentially – to grow. You're giving yourself the best possible chance it will last throughout retirement. You also won't run the risk of 'pound-cost ravaging' – where withdrawals made after markets have fallen make it more difficult for the pension pot to recover, and greatly increase the chances your money could run out.

And the disadvantages? Natural yield can be a great strategy – providing you can make it work. You'll need a certain amount of income for your everyday necessities (and luxuries), and the yield from dividends may not always cover it. That's been especially true in recent years, when bond coupons have plumbed new depths and reliable dividends have grown tricky to come by. Worse, in the chase for yield, you might be tempted to up the risk in your portfolio – with the obvious danger that performance could go the other way.

Total return

What is it? Taking income from dividends and coupons, while also selling some investments along the way. A more flexible approach than natural yield, designed to maximise retirement income while remaining sustainable.

What are the advantages? You're less straitjacketed than when sticking to natural yield. By selling investments, you're able to supplement your income from dividends and coupons – ensuring you've enough money to live off. And your portfolio is likely to be more diversified. By focusing entirely on generating an income (as in natural yield), your overall returns may be lower or more volatile.

And the disadvantages? Unlike natural yield, you'll be dipping into your capital, which means your pension pot could eventually run out. And you need to be careful about selling investments during falling markets – which can irreparably reduce your portfolio's value (the 'pound-cost ravaging' mentioned earlier). Some financial advisers say dipping into between 4% and 5% of your pension pot each year from age 65 gives you a good chance of making your savings last as long as you need them to, though obviously this isn't guaranteed.

Drawdown and tax

Income tax

Drawdown lets you choose how much income you take, and as a result, how much tax you pay. Everything you withdraw (after taking your tax-free lump sum) is taxed as income for the tax year. So by limiting the amount of income you take, you can stay within a lower tax bracket.

What's more, you don't have to move your whole pension pot into drawdown at once. You can choose to stagger the process, converting chunks of your pension over time. This can be even more tax-efficient, since each time you can withdraw 25% tax-free cash.

Remember that different income tax rates may apply based on whether you live in Scotland or the rest of the UK.

Lifetime allowance

The lifetime allowance is a limit on the amount you can withdraw from your pension without triggering extra tax charges. The allowance is set at £1,073,100 and applies to the total of all your pensions.

Whenever you access your pension (such as through drawdown or an annuity), the amount you take is compared against your remaining lifetime allowance. If you go over it, you'll need to pay additional tax. A lifetime allowance check will also be carried out when you hit 75 if your pension still has drawdown funds or unused funds.

Tax relief and the money purchase annual allowance

When paying into a defined contribution or money purchase pension, you can normally get tax relief on up to £40,000 of your annual contributions, or 100% of your taxable salary (whichever is lower).

But once you start flexibly accessing your pension (e.g. by taking drawdown income), the amount you can continue to pay in with tax relief each year drops – to £4,000. This is known as the Money Purchase Annual Allowance (MPAA). It's to discourage people from putting their salary into their pension to get tax relief, then immediately withdrawing it, with 25% being tax free.

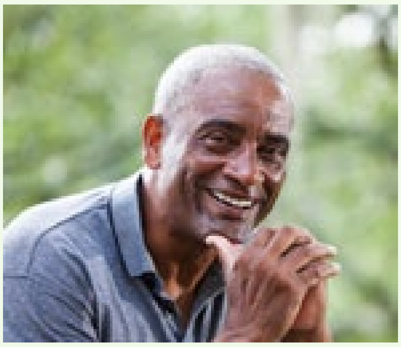
The MPAA is only triggered when you access your pension savings flexibly, so you won't trigger it just by taking your 25% tax-free lump sum, or by buying an annuity.

'Month 1' tax

When you make a single flexible withdrawal in a tax year, it's likely to be taxed on a 'Month 1' basis. In other words, you'll be taxed as if you're withdrawing the same amount each month. So taking out a big chunk could mean handing over a hefty amount in tax.

If you take a one-off payment and don't intend to make any further withdrawals in the same tax year, you can reclaim any tax you overpay by completing HMRC's P55 form[4]. Alternatively, you can wait until the end of the tax year for it to be settled, although you might be left out of pocket in the meantime.

Case study



James Williams is 65 and looking to take income from his SIPP.

James has already taken his tax-free cash, and having retired, is looking to draw an income from his SIPP for the first time. He wants to take an income of £24,000 a year, and is considering whether he should take this as an annual payment or to spread the payments monthly.

If he takes the annual payment, it's likely to be overtaxed by over £6,800. He can reclaim this from HMRC by completing a P55 form, or by waiting until the end of the tax year. Alternatively, if he takes monthly payments any slight overpayment in the first month should be corrected automatically within the following monthly payments.

	Annual payment		Monthly payments	
Personal allowance available	£1,042		£12,500	
Amount liable to 20% tax	£3,125		£11,500	
20% tax charge		£625		£2,300
Amount liable to 40% tax	£8,333			
40% tax charge		£3,333		
Amount liable to 45% tax	£11,500			
45% tax charge		£5,175		
Total tax payable		**£9,133**		**£2,300**

Note: Calculations do not take into account any state pension that may also be payable.

[4] If you've withdrawn your whole pension fund, you'll need HMRC's P50Z or P53Z form

What happens when you die?

April 2015's pension freedoms brought sweeping changes – not just to the rules that apply when you're alive, but to the rules that apply when you die. Gone are the days when, if you had a defined contribution pension, you had to worry about your pension savings being taxed at 55% when you died.

Now – unlike a simple annuity, where payments stop after death – drawdown brings flexible death benefits. One important change is that your pension can now be left to anyone you choose. It no longer has to be a dependant (such as your spouse). So it's essential you fill in your provider's 'expression of wish' form, declaring who you want to inherit your pension pot.

Also, any pension funds left when you die can be passed on to your beneficiaries for them to take as a one-off lump sum, or gradually as income. How much tax will they have to pay? That depends on the age at which you die, as you can see:

Under the age of 75

If you die under the age of 75, your entire pension fund can be passed on tax-free[5]. Your beneficiary can choose to take the funds either as a lump sum, or as income drawdown.

Age 75 or over

If you die at or over the age of 75, the inheritors of your pension will pay income tax at their marginal rate whether they choose to take the fund as a lump sum or withdraw it as income drawdown.

Since pensions are typically held in trust outside your estate, they continue to be free of inheritance tax in most cases.

[5] Your fund can be passed on tax free up to your available lifetime allowance, provided it's passed on within two years.

Flexible. Affordable. Award-winning

Why AJ Bell Youinvest is best for drawdown

At AJ Bell Youinvest, we know there are multiple reasons you'd want to move your pension into drawdown. Not just for the greater control – and choice – it gives you. But also for the chance to make your retirement money work harder.

That's why we make sure our SIPP ticks every box. Low charges to save you money, an easy-to-use website and mobile app so you can manage your account anywhere, and investment ideas from our specialists so you're never short of portfolio inspiration – whether you're a master investor, or more of a beginner.

But don't just take our word for it. In 2017, we won 'Best SIPP for Income Drawdown' at the Moneywise awards, and that's just one of the many awards we've won for our SIPP down the years. Here's what makes our service stand out:

- **Low costs.** You can deal from just £1.50 and won't pay more than £9.95 per online deal
- **Control and choice.** You make the decisions about your pension, and can choose from a market-leading range of investments, including 2,000 funds, shares from 24 markets, bonds, investment trusts and ETFs
- **Easy to manage.** You can access your account 24/7 and deal on the go with our mobile app
- **Inspired investment ideas.** You'll never be short of possible portfolio picks, whether it's our AJ Bell funds (where all you need to do is choose between income and growth funds, and pick your risk-level), or our AJ Bell Favourite funds list (an expert-picked list of the lowest-cost and highest-quality funds out there)
- **Full drawdown flexibility.** Our SIPP gives you the choice of full or partial drawdown, lets you take an income monthly, quarterly, half-yearly or annually – or as one-off amounts – and lets you easily nominate beneficiaries so you can pass on your pension wealth in the event of death
- **Easy to transfer your pension.** And even better, we'll cover up to £500 of your transfer costs

If you'd like advice about your pension, and the options you have (including drawdown), we recommend you speak to a regulated financial adviser. If you need help finding a financial adviser in your local area, try unbiased.co.uk or directory.moneyadviceservice.org.uk.

You can also get free and impartial guidance on your options for a defined contribution pension by using the government's free Pension Wise service: pensionwise.gov.uk

To open a SIPP today, just visit youinvest.co.uk/sipp

If you have a SIPP with us and are thinking about starting to access it, it's important you find out more by reading 'SIPP – a guide to accessing your pension' on our Free guides page.

Then if you decide you want to go ahead, you can get started by logging in to your account online and selecting 'Access my pension' from the 'My account' menu.

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