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FINANCIAL PLANNING

Your retirement choices: how to generate an income in later life

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You've reached retirement or are approaching it. Now is the time for you to start thinking about taking your foot off the gas and enjoying a comfortable life when you stop working.

Many people see retirement as the start of their "second life" – the time when you have the chance to do what you want to do. You may have been planning this moment for many decades and have grand plans for what you might like to do with the years ahead.

If you haven't already done so, now is the time to start thinking about your income in retirement.

If Office for National Statistics (ONS) data is to be believed, it's not beyond the realms of possibility that your retirement could last thirty years or longer. So, it's going to be important that you create a sustainable income that will enable you to maintain your lifestyle for many years to come.

Of course, it's quite possible that your income in retirement will come from a range of sources. These might include:

Earnings – Many people choose to keep working in retirement, perhaps on a part-time or consultancy basis. You may even want to set up your own business, focusing on a passion or hobby.

State Pension – The State Pension is the bedrock of your retirement. While it may not be sufficient to maintain the lifestyle you want, from age 66 – or later if you're retiring in the future – you'll receive a State Pension based on your National Insurance contribution record.

Money purchase (defined contribution) pension – These are pensions you (and perhaps your employer) will have been contributing to. They might include workplace or personal pensions.

Final salary (defined benefit) pension – If you've worked in the corporate world for any period, you may have a final salary pension that will be paid to you by your former employer. These pensions are typically based on your years of service and will often rise annually by the rate of inflation.

Investments – You may have accumulated ISAs and other investments which you may want to use to generate a retirement income.

For the purposes of this guide, the focus will be on how you generate an income from any defined contribution (DC) pensions – sometimes called "money purchase" pensions – that you've contributed to during your working life.

You may even have several of these pensions, including personal pensions you have set up yourself and workplace pensions you may have contributed to.

Essentially, with this type of pension, you have an accumulated "pot" of savings that you will use at retirement to generate an income.

Firstly, it's important that you have a retirement plan in place

As with achieving success in most things, you need a plan.

It only needs to be an outline at this stage. It's likely your circumstances could change and, therefore, so will your plans. However, it's much easier to amend a plan that's already there, rather than having to start from scratch each time.

A good way to start your plan is to consider three questions:

1. What do you want to do once you have retired?

This will give you a good idea of the income you will need during your retirement. Regular overseas travel, while you are active and healthy, will necessitate a higher income than if you're just planning to spend more time with your family and enjoy some inexpensive hobbies.

2. How long will you live?

Clearly, it's impossible to answer this question accurately – no one has a crystal ball! However, it's worth being aware of how long you might need an income to help your planning process.

Recent ONS data shows that, on average, a man currently aged 65 will live to age 84. The equivalent age for a woman is 86.

3. What legacy do you want to leave for your family?

If you are looking to pass on much of your wealth to your heirs when you die, then this will clearly have an impact on your income planning.

The answers to these questions will help you put your plan together. They will give you an idea of what you want to do in retirement, how much it will cost, and therefore how much income you'll need to generate.

Once you've established what income you need in retirement, it's time to think about the ways in which your pension savings can generate this income.

If you are married or in a civil partnership, then your planning process should include all your assets. Create a joint plan that considers the plans you both have once you retire.

The impact of Pension Freedoms

The laws surrounding how you can take your pension changed in April 2015. Since then, you have far more flexibility and a wider choice of options when it comes to accessing your retirement savings.

Aside from taking all your fund in one go, or not taking it at all – and therefore leaving it to pass to your heirs – there are four main options:

- Buy an income for life, known as an "**annuity**".
- Take an adjustable income, known as "**flexi-access drawdown**" (or sometimes just "drawdown").
- Take **lump sums** from your pension fund, known as "uncrystallised funds pension lump sums" (UFPLS).
- **Mix and match** different options.

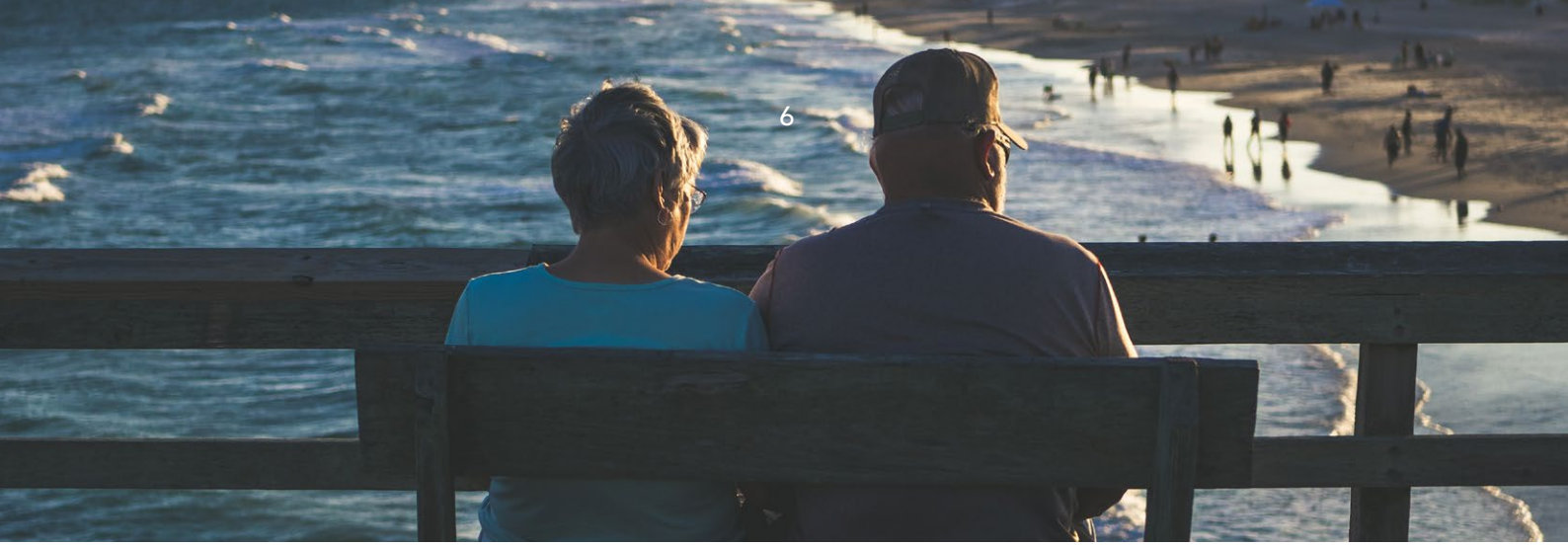
The next four steps will consider these in turn.

With great freedom comes great responsibility

Pension Freedoms have given retirees many more options when it comes to accessing pension savings. However, with greater choice comes greater complexity.

2019 research by Moneyfacts found that clients who did not take advice before drawing down their pension savings were three times more likely to run out of money compared with those who took advice.

Your pension savings may have to last you for many years, so it can really pay to take professional advice when the time comes to retire.



1. An income for life: Buying an annuity

Buying an annuity means you use some, or all, of your pension fund to provide a regular income for the rest of your life.

Essentially, you use a lump sum from your pension fund to "buy" an income from an insurance company. The insurer will then provide you with a guaranteed income for the rest of your life – however long that may be.

Advantages

- Buying an annuity provides you with a regular, guaranteed income for the rest of your life.
- It's possible to link the income to inflation so it increases each year.
- A percentage of your annuity income can be paid to your spouse or partner on your death.

Disadvantages

- Once you've taken it out, you can't typically change your mind.
- On your death, or the death of your spouse or partner if they receive an annuity after you die, the annuity stops, and no funds are returned.

As well as conventional annuities, there are also annuities for people in poor health or with an underlying health condition. These are known as "impaired life" or "enhanced" annuities.

Enhanced annuities

This works in the same way as a standard annuity in that you're paid a guaranteed income for life.

Enhanced annuities work on the basis that, if you have a serious medical condition, you will have a shorter life expectancy than someone in a better state of health. Annuity providers therefore pay out more each year than standard annuities on the assumption that they won't last as long.

The type of conditions that can mean someone is eligible for an enhanced annuity include diabetes, high blood pressure, and asthma.

It's been estimated that 60% of people could qualify for an enhanced annuity, so it's worth checking to see if you're eligible when you start planning your retirement income.

If you decide to buy an annuity, you should shop around for best rate available. It's a one-time-only decision that can't be reversed, so you should ensure you're getting the best available income.

2. Drawing down income: Flexi-access drawdown

Flexi-access drawdown allows you to withdraw as much or as little from your pension fund as you wish. You can take lump sums or regular income – it's entirely up to you.

You can start taking money when you reach age 55, though this could potentially increase to age 57 in 2028.

You can take 25% of your fund tax-free – either in a lump sum or at different times. You will pay tax on the remainder at your marginal rate.

Any money you don't take remains invested in your pension fund.

Advantages

- As the name suggests, the big advantage of flexi-access drawdown is its flexibility. You can take as much or as little as you want, subject to how much there is in your fund.
- You can take regular income – monthly, half yearly, or annually – and adjust this to match your needs.
- Any unused funds remain invested, so you will benefit from any investment growth in a tax-efficient environment.
- If you die before you've taken all your funds, you can nominate a relative to receive the remaining money.

Disadvantages

- The value of investments can fall as well as rise. So, as your fund remains invested, the value of your fund has the potential to fall.
- Once you have taken any money out of your fund above your 25% tax-free cash entitlement, you can only then make further pension contributions of £4,000 a year and benefit from tax relief.

Expert view

"Drawdown has many appealing qualities for those seeking to maximise flexibility in their retirement planning but one of the key trade-offs is that individuals have to take on longevity risk for themselves.

"The fact that those individuals going it alone with their drawdown strategies are almost three times more likely to have depleted their fund compared with those taking professional advice should be a red flag moment."

Richard Eagling, Moneyfacts head of pensions.

You should only take the money out of your pension fund that you need. Money remaining in the fund is subject to potential investment growth, so only taking what you need could improve your investment returns.

Taking your tax-free cash

You don't have to take all your tax-free cash at once. How you take it should form a key part of your income planning.

Four key points to consider:

- Tax-free cash is a valuable benefit, especially if you pay tax at 40% or 45%. You could gain from using tax-free cash tactically to minimise the amount of tax you pay.
- Once you take money out of your pension fund, it is no longer subject to investment growth. So, unless you need it, it can be worth leaving it invested.
- As well as leaving the fund invested for potential investment growth, you should also bear in mind that annuity rates increase as you get older. This means you could benefit from a higher guaranteed income later.
- Some pension providers allow you to take tax-free cash as part of regular flexi-access income withdrawal, so you can take it as income rather than as lump sums.

3. Take lump sums from your pension fund

Rather than use flexi-access drawdown to take regular income, one of the biggest changes to retirement income that came with Pension Freedoms was the ability to take lump sums from your fund as and when you want to.

This obviously means that you're able to take all your fund in one go. If the value of your fund is less than £10,000, you may be able to use the "small pot" rules to take the whole sum in one go with no tax implications.

However, if you have a larger pot, then taking it all at once could leave you with a sizeable tax bill.

For example, if your pension fund is worth £100,000, you could take up to 25% – £25,000 – as a tax-free lump sum. The remaining £75,000 would then be added to your income in that tax year, potentially pushing you into a higher tax bracket; you could therefore lose up to 45% of your lump sum as tax.

This could substantially reduce the size of your pension fund, potentially leaving you short of income in later life.

Seek professional advice before you take a lump sum – otherwise you could end up with an unexpected and unwanted tax bill.

Remember: apart from the tax-free cash element, you'll typically pay Income Tax on other amounts you withdraw from your pot. You should be aware of this if you take lump sums, especially if a lump sum pushes you into a higher Income Tax bracket.

4. Mix and match

You've now seen three different ways you can take money from your pension pot: buying an annuity, using flexi-access drawdown, and taking lump sums.

It's worth remembering that you're not limited to only using one particular option; Pension Freedoms mean you can mix and match for extra flexibility.

For example, if both you and your partner have pension pots, you could consider buying an annuity with one of them and leaving the other invested.

This would give you a guaranteed income stream for life, alongside your respective State Pensions. You could then use the other fund flexibly for lump sums as and when you needed them.

A financial planner will design an income strategy for you, making the most of your pensions and other income. They will ensure your income is taken as tax-efficiently as possible, helping you to maintain the lifestyle you want in retirement.

Pension Freedoms provide great flexibility when it comes to taking income from your pension pot. If you both have pension funds, you get even greater flexibility to mix and match options.

Financial advice can help you make the most of your pension savings

As you will have realised from reading this guide, income in retirement is not straightforward.

Pension Freedoms have made the process more flexible, but this flexibility goes hand in hand with increased responsibility for managing your own income and investment. This means that the decisions you make could have a big impact on your pension fund and mistakes can prove costly.

Working with a financial planner can add value. They can help you with all the points you've seen in this guide – from building your retirement income plan to helping you manage the amount you take from your pension fund as tax-efficiently as possible.

They will also review your plans regularly, to check they are still on track to meet your income requirements and to adjust them as and when your circumstances change.

A 2019 report from the Pensions Policy Institute (PPI) found that over-65s were less likely to take financial advice than younger age groups.

Despite the complexities of Pension Freedoms, just 15.4% of over-65s had sought professional financial advice.

The report stated: "Given the complexity of retirement decisions, many people will find it difficult to make choices that will best meet their needs over the course of later life.

"Advice and guidance play an important role in supporting people while making these choices."

If you're approaching or at retirement and you'd benefit from advice about how to structure your income tax-efficiently, please get in touch.

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Please note: A pension is a long-term investment not normally accessible until 55 (57 from April 2028). The value of your investment (and any income from them) can go down as well as up which would have an impact on the level of pension benefits available.

Your pension income could also be affected by the interest rates at the time you take your benefits. The tax implications of pension withdrawals will be based on your individual circumstances. Levels, bases of and reliefs from taxation may change in subsequent Finance Acts.

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