Retirement Partnership

THE CASE FOR SCHEME PENSION

If you thought 'Scheme Pension' was a solution that should only be considered for the infirm rich, then you are wrong. This solution is now mainstream and should be being given a much greater profile in client discussions.

As the middle market for retirement solutions continues to grow, providers seek innovation from all sources. In 'The Case for Scheme Pension' we see that it is long established rules originating from final salary and SSAS schemes that now allow the retiree to obtain a bespoke retirement income rather than the off the peg annuity solution.

There are now three key providers in this space: *Hornbuckle Mitchell* have led the market, and we declare as our sponsors in this project. They are also joined by *Rowanmoor*, and more recently and perhaps more importantly by *AXA*. The arrival of one of the big companies has, and indeed should turn heads. This is a credible proposition that we predict will become more widely embraced, and discussed.

Scheme Pension is akin to a bespoke Saville Row suit. It is designed and established wholly on the personal profile of the client. However it is not something that should be regarded as being so exclusive. This option should be in the stable of those considered for the ordinary man, and well within the knowledge range of the professional retirement adviser.

Scheme Pension is in many ways the perfect retirement solution. Imagine a pension fund that maintains an income for you for the remainder of your days, and by design runs out of funds the day after you have died. None of your money is wasted. All of your money has been used exactly for what it was intended. Well this is the theory, and the practice may not be far short. There are risks though and these should as ever be well understood.

Overview of Scheme Pension

A scheme pension is simply where the pension scheme pays an income to the individual from the assets of the pension scheme rather than purchasing an annuity.

The Source regulation for Scheme Pension can be found in the HMRC manual for registered pension schemes – RPSM, and found at the following web address: *http://www.hmrc.gov.uk/manuals/rpsmmanual/rpsm09101200.htm*

They work in a similar way to final salary, or defined benefit, schemes. But those are usually for very large groups of people in a company scheme. There is nothing new about this concept because that is exactly how many SSAS schemes pay income to members. What is new is that the scheme pension option now applies to individual arrangements rather than just to group (company) arrangements.

Scheme Pension can be especially advantageous to individuals who are aged over 75 and in poor health, who do not want to purchase an annuity, and who understand the limitations of ASP. This has so far been the core market. However this will change, as it is clear that similar advantages are gained at younger ages *(see table on page 2)*:

The key to gaining an initial understanding of how scheme pensions work in practice is to understand the rules for income withdrawal and the rules for death benefits.

Income

The level of pension income is calculated by taking into account the individual's age, health and income options. At outset, the Actuary provides a range for Scheme

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Pension between an upper and lower level. This means that if the individual is in poor health and of advanced age, the amount of income payable will probably be higher than buying a lifetime annuity, and higher than the maximum limit under ASP. The level of income is reviewed at least every three years, and can be adjusted if there have been significant changes to life expectancy and/or the fund value at the time of the review.

The retiree will never be forced to reduce their level of income should, say, their life expectancy improve. They will merely be given the option to decrease for sustainability.

The pension can be paid for a predetermined term of 10 years, so if an individual dies during the period the income will continue to be paid to the nominated beneficiaries (usually their spouse), and taxed as income at their marginal rate. The remainder of the income payments must be paid as continued income and cannot be paid out as a lump sum. This typically means that the balance of any remaining fund would become payable.

The scheme pension income can be converted into a conventional annuity at any time by the trustees upon the request of the member. The annuity can be established on any structure, e.g. single or joint life; level or escalating; and can be set up with a guarantee period.

The following examples show typical income levels for different ages and options, based upon a GAD rate of 3.75%, correct at October 2009:

Male Example based on Fund Value of £ 500,000 and a GAD rate of 3.75%

Health	Age 55	65	74	75	85
Good	£36238	£40378	£50710	£52641	£90674
Fair	£36566	£41401	£53300	£55487	£96508
Poor	£37055	£42860	£56722	£59204	£103388
Very Poor	£41184	£52874	£75721	£78795	£130550
GAD*	£31800	£40800	£55800	£43650	£43650

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We must note here that the actuary will base the income at a reasonable level according to fund size and the personal circumstances of the client. This is different from USP/ASP as no account is taken of the GAD rates, and no age 75 limit applies.

The principle sees fund depletion as a factor. Ideally this will be near zero in the final days.

Death Benefits

After the death of the scheme member income will continue to be paid if the predetermined term option had been selected and the term had not expired. In addition there are two options:

- A dependant's Scheme Pension can be paid but it cannot be higher than the Scheme Pension the deceased received, otherwise an unauthorised payment charge will occur.
- A lifetime annuity can be purchased for any dependants but these will be single life and with no guarantee period.

A dependant's pension or dependant's annuity can be paid alongside any balance of the predetermined term (with overlap).

It is important to note that scheme pensions fall under the general principle that after age 75, all pension benefits, including those to dependants, must be paid as income and not as a lump sum. Any lump sum death benefits will be treated as an unauthorised payment and taxed at up to 82%.

The 82% is broken down as follows:
Unauthorised payment charge – 40%.
Unauthorised payment surcharge – 15%.
(This applies where the value of the unauthorised payment represents more than 25% of the fund value, so must apply here.) Scheme Sanction Charge: 15%

Therefore a total pension tax charge of 70% is applicable. In addition the remainder of the fund is likely to be subject to IHT (depending upon the size of the deceased estate) at 40%. The cumulative effect of the tax charges equals a charge of 82% on the residual fund.

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This is the same charge that would apply on death post 75 in ASP. Unlike ASP the fund cannot be paid to charity. The member could of course always draw a higher income in life to gift to charity if they so wished.

Summary of Advantages

- Income levels are set according to personal circumstances
- Income can be higher, particularly post 75
- Fund depletion is a factor of the assumptions
- Income can be paid for a predetermined 10 year period, and is reviewed every 3 years to ensure sustainability
- Spousal benefits can be paid up to previous income levels
- The client continues to remain invested and can benefit from excess returns

To gain a more advanced understanding we might like to consider the risks involved, and a range of scenarios for the use of Scheme Pension.

The Risks involved with Scheme Pension

The client must understand the risks involved with these arrangements and therefore the need for advice.

- Losing your money through bad investment returns. Investment risk is inevitable in this arrangement. The client should understand the interdependence of sustainable income with fund performance. This is just the same as the USP, and ASP environment.
- Living too long may cause problems. The actuary will base incomes on an assumption of life expectancy. As uncomfortable a subject as this is for most people, we have to highlight that living well beyond your years could see the fund depleted.
  The reality is that through regular and proper review the member and their adviser will be warned if it looks like the fund will not be able to sustain the income in the long term. This risk will therefore be managed.
- Taking too much income in the early years will create fund depletion and cause a strain in later years.

These risks may be inconsequential for the client who has considerable assets beyond their pensions, and the scheme may therefore be structured to the client's advantage, with a more aggressive strategy being adopted.

The client who has little else should proceed with great caution.

The need for advice

Clients will need the arrangement fully explained at the start. This should preferably take the appropriate amount of time, and allow the client to absorb and consider their opinions.

The set up process, although well supported by the providers, will inevitably be intensive, and require the adviser to spend time in liaison with the ceding schemes, and the new provider.

The case once established will need to be reviewed, and we recommend the investments are reviewed on a regular basis if not managed, and an annual review is conducted with the client, preferably face to face.

This will inevitably exclude certain clients if only through the cost of advice alone. These cases will be complex, although need not be complicated.

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Comparison with USP & ASP

Many people who do not want to buy an annuity at age 75 will consider investing in an Alternatively Secured Pension (ASP) but as we show below this option has severe limitations many of which can be avoided by investing in a scheme pension.

ASP is paid from the pension fund in much the same way as for drawdown before age 75 but the following rules apply.

- → The maximum income is 90% of relevant annuity for a person aged 75 and the investor must take a minimum income which is 55% of the relevant annuity. The income limits are reviewed every year. The income can be changed each year providing it does not exceed the maximum.

In comparison the Scheme Pension offers the client an income calculated according to the clients own age, health, and fund value. This offers the opportunity for an income in excess of ASP, and a planned depletion of the underlying fund.

Scheme pension income levels can therefore be increased if the client's health circumstances change and there is reasonable cause to suggest shorter life expectancy.

We also note that monies gifted from regular income are IHT exempt, so long as these are documented appropriately.

The death benefit options available when an investor dies whilst still invested in ASP will depend on the age of their dependant(s) at the date of death. When the dependant is below age 75, the following options apply:

- → The pension is treated as Unsecured Pension and income can be continued as per drawdown rules. When the dependant turns 75 this will be converted to ASP
- → On death of the dependant under age 75 the remaining fund can be paid as a lump sum less 35% tax but this might be subject to IHT
- → Annuity purchase – A single life annuity without a guarantee period or value protection.

When the dependant is aged over 75 the following options apply:

- → Continued income under ASP rules
- → Annuity purchase – A single life annuity without a guarantee period or value protection.

If there are no dependants the remaining funds can be paid as a charity lump sum death benefit without a tax charge. If a lump sum payment is made to anyone else it will be treated as an unauthorised payment resulting in a tax payment as high as 82%.

On death, in scheme pension, and the dependent is less than 75 years old the same rules apply as above with the Scheme Pension allowing an income to be paid under USP rules.

The balance of income from the predetermined term will be paid followed by a dependents pension at a level no greater than the previous income levels being paid. However we note that the basis of the income can be changed at the triennial review.

Finally we note that there is an area of contention in the regulation with some arguing that it is possible under Scheme Pension for the remaining assets to pass to other members of the scheme, and others saying that it is not. This works where a scheme pension has been set up with several members of the same family. Whatever your view this is clearly an area of contention, and the adviser should proceed with caution if building this in as a primary advice factor.

The suggestion is that by allowing other family members to join the scheme members' funds can pass down the generations, free of Inheritance tax. This would appear to be against the spirit of current legislation, and as such will be vulnerable to change, or indeed clarification. Some would indeed say that this is a case of 'Buyer beware!' We seek further clarification.

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The case for Scheme Pensions

For many the strongest case for investing in a scheme pension is to avoid purchasing an annuity and there are three reasons why investors, especially those at age 75 wish to avoid annuities:

- They want more income than annuities provide
- They want to continue to have control over their investments
- They want to see as much of their pension funds pass to benefit other family members on their death

More Income than an annuity?

The reality of Scheme Pension is that the income will last as long as the fund can provide. The risk of longevity is placed wholly with the client. In other words there is a risk that the client out lives their pension fund.

On the flip side the income from Scheme Pension can change with the health and circumstances of the client. This means that should the client's health turn and impairment develop, income can be increased.

We have already shown that the maximum income available under a scheme pension may be higher than under ASP post 75, and also higher than an annuity where the member is not in good health an actuarial calculation can justify a higher income.

It will also be possible to provide a higher income than an annuity over the longer term if at the 3 year review the scheme pension can be increased to reflect an increase in the value of the pension assets.

Most scheme pensions are calculated as single pensions which will provide a higher income than a joint life annuity. With a traditional annuity, the 'purchase' of dependents pension is made at the start, and income levels reduced accordingly. If the dependant predeceases the annuitant the benefit of the joint annuity is simply lost. Whereas a scheme pension can compensate for the lack of a joint benefit by providing the option of a dependant's pension and if the dependant does predecease the member there is no financial loss.

If a member's health deteriorates in the future there is an option to apply for an enhanced annuity that could provide a much higher income compared to annuity bought at an earlier date. This would be subject to a matching income rule, which may hinder the action, but it is worth pursuing. Alternatively the income paid from the scheme pension can be increased to meet the changing client circumstances.

Control over investments

A scheme pension can be invested in the same wide range of investments as other approved pensions such as SIPPs, drawdown or ASP.

One of the understandable reasons why investors may be reluctant to buy annuities is where the value of the pension fund has fallen in value as they approach age 75 because of volatile stock markets but where there is an expectations that equity prices will recover.

The use of scheme pension means that the underlying investments can remain unchanged. The investor keeps full control and if necessary an annuity can be purchased when markets recover.

The adviser and member should give ample consideration of the appropriate investment strategy, and as ever this will need to take into account an holistic view of the client's situation. Consultation with the scheme actuary would also be appropriate as assumptions should be consistent.

Benefiting other family members

In many situations (although not all), a scheme pension will allow a larger income to be taken than ASP or an annuity. This can be particularly useful for people with a shortened life expectancy, allowing them to take more money out of their fund whilst they are alive.

To maximise the benefits to other family members the net income from the scheme pension can be used to make 'Gifts out of Income'. (As long as HMRC rules for 'Gifts out of Income' are met, the gifted money is not liable for inheritance tax when the client dies i.e. the 7 year rule does not apply.)

The issue of funds passing down the generation has been discussed above, and should be handled with the appropriate level of care by the adviser.

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Simplify the transition

As many advisers who have worked with The Retirement Partnership will know, we advocate the benefits of long term planning, and a transition in to retirement.

The whole area of retirement advice has become complex, and for those with an established range of retirement benefits consideration of pre-retirement consolidation should be a priority. This allows for the smooth transition into retirement, with the phasing of benefits as other incomes decrease.

A number of providers now offer their retirement contracts within a package of solutions, and we encourage a review of these plans, and consideration of how they can bring advantage to the client.

Conclusions

Scheme Pension is a niche retirement solution today. It is in our opinion a proposition that requires a high level of advice and a continuing client relationship in retirement. It is not a proposition for those that do not wish to understand how their retirement funds are working, nor for those who do not understand the complexities.

However the market is far more sophisticated today and where the adviser can take time to educate the client in the advantages of Scheme Pension, and the client's circumstances fit the proposition this will provide the client with a range of unexpected benefits.

We commend this to the professional adviser.

Some technical stuff

→ *If an actuarial review provides a Scheme Pension increase of more than 5% each year, then a check against the Lifetime Allowance will need to occur (classed as BCE3).*

→ *A Health Questionnaire is required at the outset of taking Scheme Pension and for any actuarial reviews to take into account any changes in health. The Member confirms their level of health as being either Good, Fair, Poor or Very Poor.*

→ *There is an option available to take a Scheme Pension for a predetermined term of 10 years when this is first set up with 3 yearly reviews. If this option is taken, it cannot be removed.*

→ *Under the predetermined term, the Scheme Pension being taken can be reduced or increased in accordance with actuarial calculations, based on changes to life expectancy and the fund value at the time of the review.*

→ *If the Member dies with a predetermined pension term option, the remainder of the instalments can be paid out to anyone, but cannot be paid out as a lump sum.*

→ *A dependant's Scheme Pension is also available, although it cannot be higher than the Scheme Pension the deceased Member received, otherwise an unauthorised payment charge will occur.*

→ *The predetermined pension term instalments that are due for the remainder of the term and the dependant's Scheme Pension can be paid alongside each other if paid to the same person.*

→ *Death benefits from 6th April 2008 incur 82% tax charges if the fund is paid out after the dependant's pension is paid.*

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PO Box 570, Winchester, SO23 3HP
Tel: 01962 65 85 65

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