

Article placed in Moneyfacts ILP

The Great Divide

April 2011

Kenny Dalglish is famous for handling press conference questions with the response “maybees aye, maybees naw”. For those not fluent in the west of Scotland tongue I can of course translate and confirm that it simply means maybe yes, maybe no. It seems that this saying could also be used in conjunction with questions surrounding the introduction of flexible drawdown from 6 April 2011.

A clear split has appeared between those providers who will not be offering flexible drawdown from outset, if at all, and those who will have their products open for business from 6 April. As April approaches it is worth asking the providers you favour if they plan to sit in the “maybees aye” or the “maybees naw” camp and to probe a little on the reasons why.

Maybees naw

The people on the no side of the fence are casting doubts as to how appropriate flexible drawdown will be for many pension savers. There have been calls for FSA guidance before the option is offered to clients. Suggestions have also been made that insufficient time has been given to allow providers to develop these new flexible drawdown products.

I have to admit that in reading these stories I have wondered whether the reasons for delay provided tell us more about the business appetite to develop flexible drawdown than anything that is related to client and adviser need.

The business model of many traditional providers is based around charges applied as a percentage of the funds under management. In that scenario it is perhaps understandable that some will have concerns about the viability of these products from a profitability point of view. Flexible drawdown may accelerate the withdrawal of funds under their control, or even see whole pension funds withdrawn in one fell swoop. In a percentage based scenario this is not good news for the underlying revenue stream that you expect to make.

Maybees aye

Are firms from the yes camp taking a more pragmatic view? There is no doubt that it would have been good to have more time. Sure, we need to make calls on how we deal with satisfying the minimum income requirements. However, these are not the most sophisticated challenges we have had to deal with in recent times. As a colleague put to me recently “flexible drawdown is just a drawdown pension without a lid”. Also, from a financial perspective it is easier to be more optimistic about this market when charges are applied on a monetary basis as is the case with the majority of SIPPs.

Client need

Putting all of this aside, the most important factor is that there is a clear case for these products on the basis of client needs. Based on our discussions with advisers we believe that fears of masses of clients running down their funds will be unfounded. Rather than seeing a significant acceleration in withdrawal for all using flexible drawdown, we believe it will instead develop into a useful option for savers to reduce the marginal rate of tax on income drawn from pensions, whilst at the same time reducing the effect of the 55% tax charge on lump sum death benefits.

Looking at a case study allows us to put a little detail on this theory.

Michael has a secure annuity income of exactly £20,000 and so satisfies the Minimum Income Requirement which qualifies him for flexible drawdown.

His SIPP fund is worth £600,000 which he has yet to vest or crystallise.

Michael could immediately take a lump sum of £150,000 and withdraw the whole fund. The obvious downside to this is that he will pay 50% tax on the majority of the income and will place the funds into a non tax relieved environment and one where the funds are potentially subject to IHT on his death.

Alternatively Michael could take a lump sum of £150,000 and withdraw an income of £22,475 a year from the SIPP, making full use of the 20% tax band. This is likely to be significantly more tax efficient than the first option as ongoing income is drawn at 20% and the bulk of the funds remain free from IHT. The problem with this option is that, on death, the residual fund paid as a lump sum death benefit will be subject to a tax charge of 55%.

Many clients will favour the use of flexible drawdown where you crystallise a small part of your core fund each year and immediately withdraw the entire fund balance but only on the amount you have vested. For example, Michael could crystallise £29,966 in 2011/12 receiving £7,491 as a tax free lump sum and withdrawing the crystallised fund as a single taxable pension payment.

Taking the tax free lump sum and taxable pension together, Michael will only be paying 15% tax on the combined income. On top of this, because the fund that is left in the pension each year remains fully uncrystallised, any lump sum death benefits paid from the fund will not be subject to a tax charge.

With this in mind, it is understandable that there has been much discussion within advisers about the opportunities this new option introduces. It goes without saying that I view flexible drawdown as a very positive planning option for those clients who qualify for it. As time goes by and we see it being put to use in real scenarios I am willing to bet that the “maybees aye” camp will grow.

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