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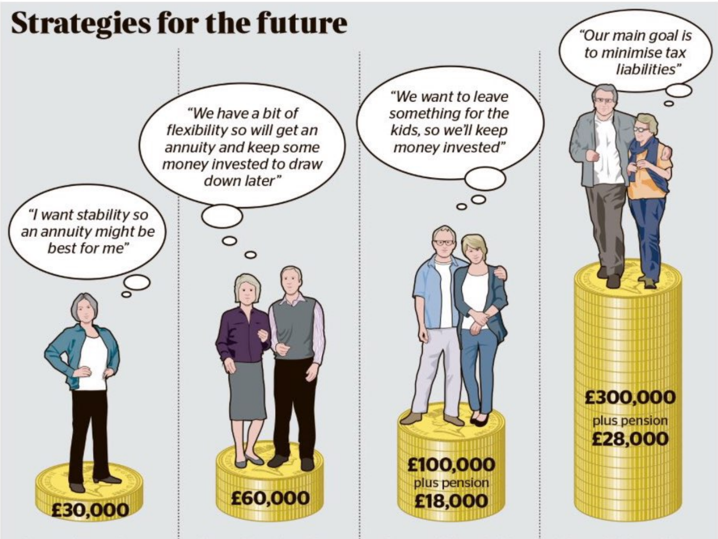
How you can be part of the pension revolution

If you want to make the most of the reforms, start assessing your options now, says Francesca Steele



Gemma is a smoker so she can get an enhanced annuity rate

Jim and Jennie opt for a small annuity, leaving some of the fund invested

Gerry and Mary decide to take some money out to buy property

John and Helen withdraw lump sums, carefully checking their tax position

The autumn statement next month will be part of the Tory campaign to reconnect with older voters. At the centre of this fightback will be the wide-ranging pension reforms unveiled in the budget which allow retirees an unprecedented level of freedom in the investment of their pension pots.

There will no longer be a requirement to use a pension fund to buy an annuity which pays a guaranteed income for life; people aged 55 and over will also be entitled to use their pension fund as a cash machine, withdrawing amounts at will, while leaving the rest invested. However, this new regime has caused some confusion among imminent retirees who are unsure about the alternatives to annuities which have fallen out of favour as a consequence of a low rates that they offer.

So what should you do with your pension pot if you want to become part of the pensions revolution? Wealth at Work, a financial adviser, has put together some fictional examples of people retiring after April next year and the choices they face.

Jonathan Watts-Lay, the director of Wealth at Work, says: "Which decision to take is down to each individual's unique circumstances, everything from health, to where they live, to whether they want to leave anything for their children."

Individual with average pension pot

Gemma is 65, single and doesn't have any children. She is retiring with a pension pot of £30,000 and no other assets. However she is a smoker and has diabetes, which means she could qualify for an enhanced annuity rate of about 7 per cent, rather than a more typical rate of 5 per cent. The Wealth at Work research suggests that the best option for Gemma may be to take her 25 per cent tax free lump sum if she needs it — £7,500 — for holidays or pressing concerns and then secure an annuity of about £1,600 a year on the balance of £22,500. Combined with her state pension and pension credit, which Gemma qualifies for because of her low income, this would give her £9,314 a year. This is tax-free because it falls below the personal allowance threshold of £10,500.

People aged 55 and over will be able to withdraw pension funds at will
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Couple with average pension pot

Jim, 65, and Jennie, 62, do not have children and each has a pension pot of £30,000 to add to their state pension of £5,881 per year. "The important thing here is that they plan as a couple, not as individuals," Mr Watts-Lay says. They can each take 25 per cent of their £30,000 as a tax-free lump sum (so £15,000 in total) and one could consider taking an annuity of about 5 per cent from the remaining £22,500, yielding about £1,125 a year.

Combined with their state income, this would give one of them £7,006 and the other £5,881 in reliable tax free income each year — £12,887 in total — and also leave them £22,500 invested to draw down on at a later date. "They could take the whole lot in one go after April. However, for most people with just £60,000, the risk is probably too high."

Couple with defined benefit pension and decent defined contribution pot

Gerry and Mary are 65 and have two adult children. Gerry's defined benefit pension — also known as a "final salary" scheme — will pay him £18,000 a year, plus a tax-free lump sum of £27,000. He also has a pension pot which he has built up from another workplace worth £100,000. Mary has no pension of her own, but if Gerry died she would receive half his defined benefit scheme. The couple are concerned about leaving something for their children. "The key here is that they get to keep control so that they have something to pass on to beneficiaries," Mr Watts-Lay says. The "death tax" on pension beneficiaries is to be scrapped, meaning that if the pension saver dies before the age of 75 it can be passed on tax free even if it has been dipped into. This means that Gerry and Mary can put money aside for the kids and still draw from it occasionally. Wealth at Work suggests that because they do not need immediate additional income they could leave his pension invested in a cautious portfolio (a mix of bonds, cash and equities), with the chance to buy an annuity later, for example if his health were to deteriorate. If they die after 75 their children can draw an income from the pension pot, on which they will pay marginal rates of income tax. They could also consider buying property for their children.

Couple with defined benefit pension and big defined contribution pot

John and Helen are in their early 60s and in good health. John has a generous defined benefit scheme which will provide £28,000 a year and a tax free lump sum of £42,000. Helen has a defined contribution scheme worth £300,000. They both have other savings and investments and no mortgage. Because they have other assets, Mr Watts-Lay says the key thing is to manage the different savings to minimise tax liabilities. Tax-free schemes such as Isas, as well as pensions, should be maximised. Since John is self-sufficient, Helen could take £75,000 tax-free as a lump sum and use the remainder of her fund (£225,000) to buy a life annuity yielding about £12,240 a year at a rate of 5.4 per cent. She could leave her savings invested in funds of varying risk, or, given the new tax rules, she could take lump sums taxed at her marginal income tax rate. ■