

What are the options for flexible retirement after A-Day?

This survival guide looks at the added flexibility for taking benefits at retirement provided by the Finance Act 2004, particularly opportunities for flexible or 'phased' retirement and alternatives to buying annuities.

What will change at A-day?

Amongst the Government's stated aims in introducing the legislation is to encourage older members of the work force to continue working for longer and companies to provide more workplace flexibility for those nearer retirement.

Under the current legislation, you are not able to take a pension from an occupational pension scheme and continue to work for the same employer unless you rejoin the company in a new employment role. Furthermore, most pension schemes require members to stop accruing benefits at the scheme's normal retirement age and many force the member to retire at this date.

From A-Day, the government will introduce new rules allowing employees to take some pension benefits while continuing to work for the same employer. Examples of flexible retirement include:

- Individuals could retire early, take the whole of their retirement pension and continue to work for the same employer whilst also accruing further pension benefits under the same pension scheme;
- As above, but the individual could decide to take only part of their accrued pension from the scheme (HM Revenue and Customs refer to this as 'phased' retirement);
- Alternatively, rather than continuing to build up pension benefits in the same scheme, the member could accrue further pension benefits in a different scheme of the same employer, such as a defined contribution scheme or a stakeholder arrangement.

A key point to note is that the legislation does not force employers and trustees to provide flexible retirement options as this could increase administration costs. Many employers and trustees will therefore take the least cost option and only provide minimal, if any, options relating to flexible retirement.

Important note

It should be noted that this guide is provided for general information only and should not be relied upon to take action nor should it be seen as attempting to provide you with any advice. The issues covered are most likely to be of interest to employers, trustees and individuals interested in flexible retirement options after A-Day. A-Day will present a large number of complicated opportunities and you will need to seek advice specific to your individual circumstances, needs and objectives.

It is important to note that the provisions of the 2004 Finance Act have not yet come into force, and may be amended before A-Day.

The views and opinions expressed here are those of PSFM Ltd and Punter Southall & Co Ltd given our understanding of the issues at the time of publication.

What are the issues for employers?

On the face of it, the new legislation provides an opportunity for an employer to use pensions as a way of encouraging older employees to work for longer by giving them more flexibility relating to retirement. Valued employees will no longer have to leave employment in order to start drawing their pension. Flexible retirement could allow employees to reduce their hours, and at the same time maintain their total income by starting to draw part, or all, of their pension.

In practice there are reasons why employers may not provide as much flexibility as their employees and the government might like:

- Administrative burden – if the employer provided full flexibility including future accrual on a part-time basis, the potential extra administration could be significant. In most pension schemes, this additional expense will fall on the employer.
- Future accrual issues – with the majority of defined benefit schemes closed to new entrants, the employer may prefer members opting for flexible retirement to leave the defined benefit scheme and join an alternative (defined contribution) scheme for future service. Other employees may also view this as being fairer.
- Life insurance issues – many life insurers have rules about not providing cover for members over normal retirement age.

- Age discrimination – forthcoming legislation is not expected to prevent pension schemes from keeping a normal pension age. However, it is not clear whether employers would be able to restrict access to the pension scheme to members under normal pension age where they want employees to continue working past that age.

What are the issues for trustees?

Although changes to occupational pension schemes are often driven by the sponsoring employer, the trustees are ultimately responsible for the application of the funds and in many cases must give consent for changes to the scheme rules. Trustees, therefore, have a key role in any changes and also have a duty to look after the interests of all members, including those who use the flexible retirement flexibility. Trustees may be more resistant to changing their scheme due to the additional administrative burden and the fact that recruitment and retention are not relevant to them.

Trustees may also be concerned that allowing members to rejoin defined contribution pension schemes for a short period after taking retirement may result in small pension pots for which it is difficult to obtain an annuity on competitive terms (if at all). Similarly, allowing members to rejoin final salary schemes for post-retirement accrual could result in small pensions that cannot be trivially commuted.

Trustees may decide that they only want to provide a simplified version of flexible retirement to minimise administration costs, such as requiring all existing benefits to be taken at the same time with members rejoining the same scheme (or a different scheme) for future service.

What are the issues for individuals?

Any additional retirement flexibility should be welcomed by members. If the employer and trustees allow it, individuals may be able to take some of their benefits and combine this with a move to part-time hours, thus keeping their income relatively stable. The rest of their pension benefits can be taken when they retire completely from the pension scheme. The individual may also be able to accrue further pension benefits as they continue working.

Where a member takes phased retirement from a final salary scheme, they will only be able to take cash equal to 25% of the value of the pension that comes into payment. Therefore, there is no scope to take a large cash lump sum early and defer taking any pension. Some high earners in final salary schemes may choose to transfer their benefits up to date of early retirement into a personal pension or stakeholder arrangement to obtain the flexibility this may provide (as described further below) and start accruing benefits in the company pension scheme again from scratch as they continue working (if permitted by scheme rules).

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What are the alternatives to buying an annuity for members of defined contribution schemes?

As an alternative to lifetime annuities, members of defined contribution (money purchase) schemes may also be entitled to take benefits through an unsecured or alternatively secured pension (depending on scheme rules). There are three types of such pension available after A-day:

- Short-term annuities;
- Income withdrawal (or income drawdown);
- Alternatively secured pension.

Short term annuities payable for up to 5 years are only available to members under age 75 and may be attractive where members want a guaranteed income for a few years of part-time working before they cease employment entirely.

Income withdrawal is also only available to members under age 75. The member can designate all or part of his fund for drawdown, take 25% of the funds designated as cash and then draw some pension if desired. An annual pension can be drawn of up to a maximum of 120% of an annuity rate calculated by the Government Actuary's Department (GAD).

At age 75, the member must use all remaining funds to purchase a lifetime annuity or a scheme pension unless they opt for 'alternatively secured pension'. This is similar to income withdrawal, but the maximum pension is restricted to 70% of the GAD annuity rates to make sure that the pension fund will last at least until the member's death. Under this option, members may be able to pass on any funds remaining on death to other members of the scheme or to a charity. This option was originally seen as very attractive as a means of intergenerational transfer of assets within a family SIPP (self-invested personal pension), but HM Revenue and Customs have now indicated that there is likely to be a charge to inheritance tax in such cases.

Where can I get further information?

Punter Southall Financial Management are leading independent financial advisers and part of the Punter Southall group, providing financial planning, pensions advice and asset management for individuals, companies and trustees. Call 0870 850 3019 or your usual consultant.

Punter Southall & Co provides pensions consultancy advice to trustees and employers. Call 020 7839 8600 or speak to your usual consultant.

Email aday@puntersouthall.com or visit our website at www.puntersouthall.com