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First Service Financial

Your retirement choices: How to **generate an income** in later life

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Retirement on your terms is likely to be one of the key elements of your financial plan.

So, as you approach or reach retirement, now is the time for you to start thinking about 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 all the things 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 in the years ahead.

If you haven't already done so, now is also the time to start thinking about your income in retirement, and how long it may have to last.

Data from the Office for National Statistics (ONS) shows that the average 60-year-old male will live to the age of 85, with a 1 in 10 chance of living until age 97. The average 60-year-old female will live until the age of 87, with a 1 in 10 chance of reaching 98.

A 60-year-old female has a 6.2% chance of living to age 100.

Source: ONS

Considering that your retirement could last 30 years or longer, it's important that you create a sustainable income that will enable you to maintain your lifestyle for many years to come.

Your income in retirement may 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 an index-linked 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 public or private sector for any period, you may have a final salary pension that will be paid to you by your current or former employer. These pensions are typically based on your salary and years of service and will often rise annually in line with the cost of living.
- **Investments -** You may have accumulated ISAs and other investments which you might 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 Benjamin Franklin said: *"If you fail to plan, you are planning to fail".*

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

A sensible way to start creating 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?**

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 for.

ONS data shows that, on average, a male currently aged 65 will live to age 85. The equivalent age for a female is 87.

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

If you are looking to pass on some of your wealth to your heirs when you die, then this will likely have an impact on the level of your income in retirement.

96% of high net worth individuals underestimate how much is needed for a comfortable retirement.

Source: *FTAdviser*

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 how much income you'll need to generate.

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

If you are married or in a civil partnership, or you have a partner, consider working together and building a plan that includes all your assets.

The benefits 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 leaving it to pass to your heirs – there are four main options:

- Buy an income for a fixed period or 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, sometimes 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 legislation has given retirees many more options when it comes to accessing pension savings. However, with greater choice comes greater complexity.

2024 research by Investec found that almost half of UK adults are concerned that their savings won't sustain them through retirement.

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 – especially if you're concerned that you will run out of money in later life.

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 a fixed period or for the rest of your life – however long that may be.

Advantages

- Buying an annuity provides you with a regular, guaranteed income for a fixed period or 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.
- The income is generally fixed, so there is usually no flexibility to take additional amounts as your needs change.
- 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

These work 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. So, annuity providers pay out more each year than standard annuities on the assumption that they won't last as long.

The types of conditions that make someone eligible for an enhanced annuity include diabetes, high blood pressure, and asthma.

If you decide to buy an annuity, you should shop around for the best rate available. Annuity rates vary from provider to provider, and shopping around could help you generate a higher income for your lump sum.

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 DC 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 (increasing to age 57 in 2028).

You can usually take 25% of your fund tax-free, up to a maximum of £268,275 in 2024/25 – either in a lump sum or at different times. You will then normally pay tax on the remainder at your marginal rate of Income Tax.

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

Advantages

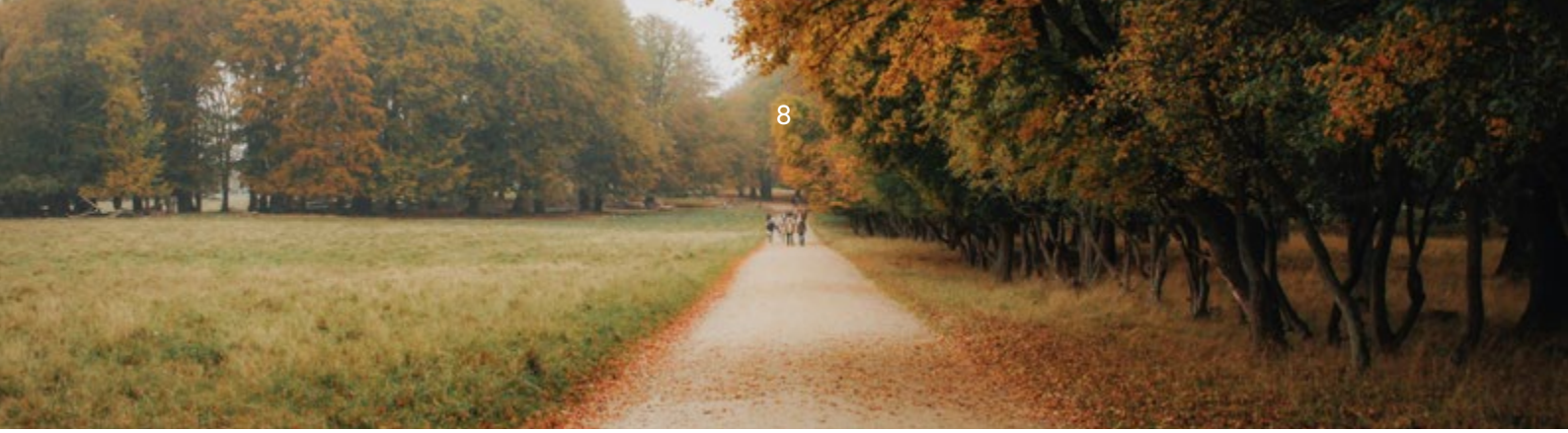
- As the name suggests, the big advantage of flexi-access drawdown is its flexibility. You can take as much or as little as you want, subject to how much there is in your fund.
- You can take regular income – monthly, half-yearly, or annually – and adjust this to match your needs.
- Any unused funds 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 beneficiary 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, any further pension contributions you may wish to make from earnings may be restricted to £10,000 without additional tax charges.

Consider only drawing money from 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.



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 legislation was the ability to take lump sums from your fund as and when you want to.

This 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 usually 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. Consequently, you could 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.

It can pay to seek professional advice before you take a lump sum otherwise you could end up with an unexpected and unwanted tax bill.

Do you really need the lump sum?

Just because you *can* take a lump sum from your pension doesn't mean you *should*.

For example, if you withdraw tax-free cash without a good use for it you will have to find an alternative home for it. The only way to shelter gains from tax is by using an ISA but annual contributions are limited to £20,000.

Money inside a pension is typically invested in a way that is suitable for your needs and any gains made are tax-free. Remember though that investments can fall in value too.

Moreover, money saved inside a pension is ultimately there to fund your retirement. Taking a lump sum away will reduce the potential for that money to generate an income in the future.

You can still put the lump sum to good use, depending on your wider financial circumstances, but it is important to understand the likely impact on your income in retirement, particularly if you are withdrawing tax-free cash some years before you plan to stop working.

Of the £83 billion taken in flexible payments since inception in 2015, nearly two-thirds (65%) has been taken by those aged under 65.

Source: *Professional Paraplanner*

Finally, money held in a pension does not usually form part of your estate for Inheritance Tax (IHT) purposes. This makes pensions a potentially valuable way to mitigate an IHT liability.

If you were to die before the age of 75 your pension can be passed to beneficiaries completely free of tax. If death happens after age 75 then the money is taxed at the recipient's marginal rate of Income Tax.

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 retirement plan.

Four crucial points to consider:

- Tax-free cash is a valuable benefit, especially if you pay Income 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. Remember that the value of your investments (and any income from them) can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance.
- As well as leaving the fund invested for potential investment growth, you should also bear in mind that annuity rates tend to 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.

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
- Taking lump sums.

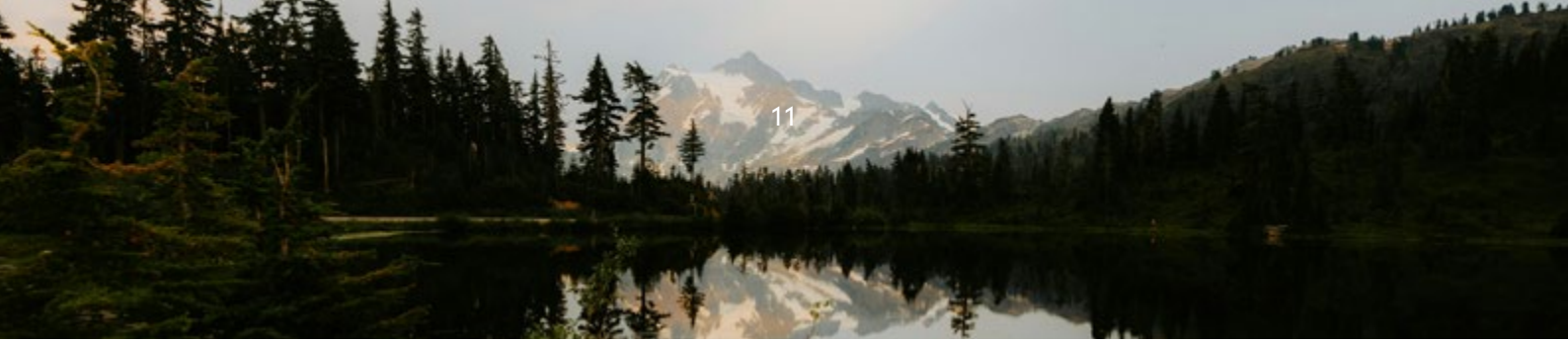
It's worth remembering that you're not limited to only using one particular option; Pension Freedoms legislation means you can mix and match for extra flexibility.

Here's an example:

- You decide to take some of your tax-free lump sum to pay for a big-ticket event such as home renovations or a major holiday.
- You then use a portion of your fund to buy an annuity, generating a guaranteed income that will cover your main expenses in retirement.
- You leave the remainder of your fund in drawdown, benefiting from potential investment gains with the ability to flexibly draw income as and when you need it.

If you retire in your late 50s or early 60s, you may also decide to flexibly draw more from your fund to meet your income needs, reducing this amount when you're eligible to claim your State Pension.

A financial planner will design an income strategy for you, making the most of your pensions and other income. They will ensure you draw your income as tax-efficiently as possible, helping you to maintain the lifestyle you want in retirement while also keeping one eye on any legacy you wish to leave.



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

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

Pension Freedoms legislation has given you more options, 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.

Between October 2022 and March 2023, 2 in 5 people entered into drawdown with no advice or guidance, while 2 in 3 annuities were sold with no advice or guidance.

Source: *FTAdviser*

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

We can also review your plans regularly and check they are still on track to meet your income requirements. We can then adjust them as and when your circumstances change.

If you're approaching, or at retirement, and you'd benefit from advice about how to generate an income from your savings, please get in touch.

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Please note: This guide is for general information only and does not constitute advice. The information is aimed at retail clients only.

Please do not act based on anything you might read in this article. All contents are based on our understanding of HMRC legislation, which is subject to change.

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.

Workplace pensions are regulated by The Pension Regulator.

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