Adrian Walker considers the merits of designation in phased retirement planning.

careful steps to phased retirement

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Since the introduction of the new pension regime over two years ago, advisers with clients considering a 'phased approach' to their retirement planning have had to consider various possibilities as to how that planning would operate.

HM Revenue & Customs (HMRC) has introduced the concept of designation of funds, where clients gradually move their registered pension scheme from an accumulation to a decumulation phase.

Provided that all of the client's uncrystallised funds are held within a scheme arrangement, funds moving to income withdrawal can be treated under the designation rules.

This approach can be adopted under the Skandia Personal Pension Scheme and the Selestia Personal Pension Scheme insofar as legislation permits.

how does designation work?

Where a client has uncrystallised funds moving into income withdrawal, or wishes to add further contributions/transfer payments into an arrangement holding post A-Day income withdrawal for designation, the client's overall maximum annual income entitlement is recalculated at the point of the additional designation. The client will retain the possible benefits of:

a. the scheme income year established when income withdrawal was first created post A-Day

b. the same five-year income review date established when post A-Day income from that arrangement was created.

The effect of this recalculation will be to change the overall maximum annual income entitlement in the scheme income years remaining before the five-year income review.

The revised maximum derives from the income withdrawal fund then available, applied to the relevant income factor in the month that the additional designation takes place.

where does designation not apply?

There are three situations where movement of uncrystallised funds into income withdrawal cannot use the designation rules. These are:

a. Adding to pre A-Day income withdrawal funds

HMRC requires the arrangements holding these funds to be ring-fenced for all purposes, and stipulates that the arrangements cannot be added to by further contributions or transfer payments.

Any movement of uncrystallised funds into income withdrawal after A-Day must establish a separate unsecured pension facility with a scheme income year and five-year review date separate from that of any pre A-Day income withdrawal facilities.

These restrictions will apply even where there is a transfer of pre A-Day unsecured income to a new registered scheme.

b. Transfer of post A-Day income withdrawal funds

HMRC requires the transfer of unsecured pension funds, whether pre or post A-Day, to an arrangement in which no other funds are currently held.

As these funds must be held in a separate arrangement from arrangements already holding uncrystallised funds, it is not possible to designate those uncrystallised funds into the same post A-Day income withdrawal arrangement at a later date.

Where clients require designation and are transferring a mixture of post A-Day uncrystallised and crystallised funds, the unsecured pension transfer must be established first. This will create the arrangement into which further uncrystallised funds can then be transferred.

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c. Uncrystalised funds held separately

Uncrystallised funds in arrangements separate from those created by a post A-Day income withdrawal facility do not form part of the same arrangement. Unless the scheme permits restructuring of its arrangements, on future crystallisation those funds will create a separate slice of income withdrawal, having an independent annual and five-year review period from all other income withdrawal arrangements.

summary

Understanding how designation operates will ensure that advisers take account of its potential risks and advantages for clients' future retirement planning. The effect on future income instalments will have an impact on both the future investment strategies of existing income withdrawal funds and the continuing monitoring of underlying gilt yield future income slices.

care issues

There are a number of issues applying to the application of designation.

Creation of lower annual scheme income

In the current climate of falling investment markets, at the time of the additional designation the income factor applied to the fund value may actually reduce the annual income entitlement available. This revised annual income will then apply until the end of the five-year review period.

If the designation takes place late in a scheme income year, clients who have been taking maximum income according to the previously calculated limit may have received income above the recalculated maximum.

Unless the client repays the excess income promptly, the excess will be treated as an unauthorised payment and suffer an unauthorised member payment charge of 40%.

Also, the scheme administrator will be liable for a separate tax charge of 15% which will often be deducted from the income drawdown fund. This tax charge will, however, be reduced by the amount of income tax already paid on the excess income. Where the client was a higher rate taxpayer, the two will cancel out.

Continuity

Designation enables continuity for both the client and the adviser of retaining the existing scheme income year and five-year review date. Income variations will, therefore, only apply within those review periods and will not extend the five-year review period beyond the point at which any increased entitlement becomes available.

Flexibility

The ability to make additional designations at any time enables advantage to be taken of good investment performance to produce higher income or reduce the amount of uncrystallised funds needed to meet the client's ongoing target income.

Planning

It may be difficult to definitively formulate this structure before an intended planning date. However, gilt yields for a calendar month do become available from the 15th of the preceding month. This will provide some guidance on whether designation would be more beneficial in the current or following month. In some cases, the delay in designation by a month or so could allow the client's birthday to pass and therefore generate increased income to the existing arrangements.