# A Guide to Annuities

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# Contents

# 1. What is an Annuity?

Annuities allow individuals to exchange a sum of money for regular income payments, which can be chosen at the start of an annuity policy. The level of the income payments will depend on a number of factors which include the age, the health and the life expectancy of the individual ('the annuitant') plus the size of the lump sum.

## Are there different types of annuities?

There are a number of different types of annuity products which are typically provided by insurance companies ('insurers') and include:

- Purchased Life Annuities
  - Immediate needs annuities
- Pension annuities:
  - The scheme pension
  - The lifetime or fixed-term annuities

There are different types of annuity products; fixed income, escalating income, and unit-linked annuities, which include an investment element or a portfolio of funds.

## Is your client looking for income flexibility?

Not all annuity products are the same. One thing to consider, when selecting an annuity, is the level of income required now and whether this is likely to change in the future.

| | Policyholder has the option to increase the level of future annuity payments | Policyholder has the option to decrease the level of future annuity payments |
|---|---|---|
| Fixed Income | ✗ | ✗ |
| Escalating Income | ✗ | ✗ |
| Unit-Linked | ✓ | ✓ |

# 2. Purchased Life Annuity ('PLA')

## What is a traditional PLA?

A traditional PLA is an investment product which gives a guaranteed income payable throughout an individual's lifetime, in exchange for a single lump sum.

A PLA is purchased from an insurer. Its terms must include a life contingency.

Normally the annuity is payable for the individual's life, but it can be payable for a term ascertainable by reference to the individual's life, such as, the annuity can end on the earlier of the date of death, a fixed term, or another specified event.

Alternatively, the annuity could continue after the death for a specified term or according to some other specified condition.

## Are there restrictions on the funds that can be invested in a PLA?

There is no restriction on the amount that can be invested in a PLA.

However, a PLA can be purchased only with a cash lump sum.

A PLA cannot be purchased with funds that are intended to provide a pensions annuity, nor can it be purchased from the proceeds of a Will where the conditions of the Will require that an annuity must be purchased with the proceeds from the Will.

A simple lump sum left by a Will with no conditions attached can however be used to provide the funds for a PLA.

## How is a traditional PLA taxed?

**Income Tax**

A PLA is divided into two components, the capital element and the income element.

The capital element is simply a return of the purchaser's capital, and is not charged to UK Income Tax.

The income element is however taxed and is treated as taxable savings income, liable to UK Income Tax. This in effect is the interest content of the annuity as distinguished from the capital element.

UK tax legislation determines the amount of each annuity payment that is treated as exempt from Income Tax.

A PLA is attractive because unlike other annuities, only a proportion of the yearly sum paid under the annuity suffers UK Income Tax.

**Inheritance Tax**

The capital element of an annuity cannot be treated as normal expenditure out of income for the purpose of calculating UK Inheritance Tax liability.

## Can a company invest in a PLA?

Yes. Its taxation is however based on different principles to those that apply to an individual. A company is liable to UK Corporation Tax under loan relationship rules which specifically apply to companies.

# 3. Immediate Needs Annuity

## What is an Immediate Needs Annuity?

An immediate needs annuity is a type of insurance policy that provides a regular income in exchange for the payment of a single lump sum. An immediate needs annuity can be considered as a special form of purchased life annuity (PLA) but has a special and limited purpose.

The purpose of an immediate needs annuity is to cover the shortfall between a person's income and the costs of that person's care for the remainder of his or her life.

The price of the annuity will depend upon a combination of the following factors:

- Age
- Current annuity rates
- Level of income required
- State of health and life expectancy

An immediate needs annuity could be suitable for a person who is already in a care home, or is receiving care at home, and he or she wants the peace of mind to know that whatever happens, there will always be a regular income available for life.

It is unlikely to be suitable for a person who does not need to pay for care immediately, or who thinks that any care requirements are likely to be temporary only.

It is also not suitable for anyone who may want their money back (for example, as a lump sum payment).

An alternative is the deferred need care fee plan. This works in the same way as an immediate needs annuity but the first payment under the annuity is delayed for some months or perhaps years into the future, and is designed to begin making payments when the need for care fees is anticipated.

## Are there restrictions on the funds that can be invested in an Immediate Needs Annuity?

No. However, an immediate needs annuity can be purchased only with a cash lump sum.

## How is an Immediate Needs Annuity Taxed?

An immediate needs annuity enjoys the benefit of a special tax regime provided by Sections 725 and 726 Income Tax (Trading and Other Income) Act 2005.

This legislation ensures that, provided the following conditions apply, all payments under the annuity are entirely free of UK Income Tax:

- The policy is a purchased life annuity.
- When the policy was taken out:
  - One of the purposes of it was the provision of personal care or nursing care for the person protected under the policy; and
  - Care was needed because of physical or mental impairment, injury, sickness or other infirmity which was expected to be permanent.
- Payment is made directly to the care provider or local authority providing the care.

# 4. Pension Annuities

## What is a Pension Annuity?

A pension annuity can be bought only with money or funds held within a registered pension scheme. It cannot be purchased using other funds (for example, a lump sum or cash inheritance).

A pension annuity is simply a means of providing a regular income ('an income') and is typically acquired by persons who require an income after they have ceased working.

Pension annuities fall into two different types:

- The scheme pension
- The lifetime annuity

Both provide an income for life but are governed by different rules.

The scheme pension is considered first of all, but provides less flexibility than the lifetime annuity.

## What is a Scheme Pension?

The scheme pension is pension income payable either from the pension scheme itself or from an insurance company selected by the pension scheme.

Defined benefit schemes can only provide a pension income via a scheme pension. If an individual (member) wishes to access the flexibilities offered by a lifetime annuity, he or she must transfer the benefits in the pension scheme prior to crystallisation.

It is also possible for a money purchase (or defined contribution) scheme to provide a scheme pension, but a scheme pension may only be paid if the member had the opportunity to select a lifetime annuity instead.

A scheme pension must:

- be paid at least yearly
- not have a guaranteed period of more than 10 years
- not reduce unless specified circumstances apply (changes to income)
- be paid by the pension scheme administrator or by an insurance company selected by the administrator

### Variation of Annuity Income

With a scheme pension, it is possible to reduce or stop payment in one of the following circumstances:

- when the member recovers from ill health
- where all members are affected by a scheme wide reduction
- where it is a bridging pension and the member reaches state pension age
- when the scheme is being wound-up
- on forfeiture of entitlement
- on abatement, which applies to public service pension schemes
- when a scheme administration pays an amount of annual allowance charge

# 4. Pension Annuities (continued)

## What is a Lifetime Annuity?

A lifetime annuity is payable by an insurance company where the member has the right to choose the insurance company. It is the right of the member to select the insurance company that distinguishes the lifetime annuity from the scheme pension.

The basic rules that apply to a lifetime annuity from 6 April 2015 are as follows. Before 6 April 2015, similar rules also applied but were slightly more restrictive than the post 6 April 2015 rules.

From 6 April 2015 the following conditions must be satisfied:

- the lifetime annuity must be paid by an insurance company
- the member must be able to choose the insurance company
- the annuity must be paid at least yearly and for life
- if it has a minimum guaranteed period there is no limit to its duration
- annuities now have a wider definition of allowed decreases
- the potential survivor of a joint life annuity need not be a formal dependant of the member
- a lifetime annuity normally cannot create a lump sum on death
- a lifetime annuity cannot be surrendered or assigned, although this is possible via a Will, or scheme discretion, for guaranteed periods or to comply with a pensions sharing order

### Variation of Annuity Income from a Lifetime Annuity

The amount of a lifetime annuity may increase or decrease in line with any of the following, or with any combination of the following:

- retail price index
- consumer price index
- the value of 'freely marketable assets' (such as, shares, unit trusts, unit-linked pension funds, and open-ended investment companies ('OEICs'))
- an index of freely marketable assets (such as, FTSE100 index)
- with-profit funds

Conventional lifetime annuities purchased before 6 April 2015 generally do not decrease, or any falls in amount are determined by regulations made by the Board of Inland Revenue (now HM Revenue & Customs). From 6 April 2015, the scope for reducing (and increasing) annuities is significantly widened.

### Taxation of a Lifetime Annuity

Pension annuities are liable to UK Income Tax on the full amount of the pension income.

Unlike the purchased life annuity ('PLA'), there is no separation between a notional capital element (which is not taxed) and an income element (which is taxed). This is because the tax rules that govern the treatment of pension annuities are addressed in a different part of the UK tax legislation (part 9 of Income Tax (Earnings and Pensions Act) 2003 (ITEPA) whereas the rules that apply to purchased life annuities are to be found in Part 6 of Income Tax (Trading and Other Income) Act 2005 (ITTOIA).

# 5. Unit-Linked Annuity

## What is a Unit-Linked Annuity?

A unit-linked annuity is a plan taken out with an insurance company in exchange for a payment from a pension fund or any other lump sum.

A unit-linked annuity differs from most annuities, which are designed to provide a guaranteed income, because it offers no guarantee of a steady income level. The amount of income paid will depend upon how the underlying unit-linked investments perform.

With a unit-linked fund, units are purchased and these are usually priced daily. The value of the units held varies in accordance with how the price of the units moves. This is similar to having shares in an investment portfolio, but a unit-linked fund is typically made-up of a large number of investments so that the risk of investing in the fund is reduced.

Unit-linked funds work in one of two ways:

1 The first is to exercise the option to take out the plan on an assumed growth rate. This enables the rate of growth that the fund needs to achieve to receive the level of annuity income required. If the fund performs better than expected, the value of the annuity fund increases.

However, if the fund underperforms, the income is reduced.

2 The second alternative is to buy the annuity without an assumed growth rate. In such a case the income generated is directly dependent upon the performance that the fund achieves.

The unit-linked annuity carries a degree of risk and this should be taken into consideration by the investor.

### Taxation of a Unit-Linked Annuity

The taxation of unit-linked annuities depends upon the nature of the funds used to purchase the annuity.

For any unit-linked annuity, the way the income is taxed is different. Instead of the traditional capital/income approach a "tax exempt sum" is defined at the outset of the annuity. Any income payments, in excess of the tax exempt sum, in any year are taxable. If income payments in a year are less than the tax exempt sum then no tax is payable. Any unused tax exempt sums can be carried forward to future tax years.

If the annuity is purchased using funds from a pension scheme (apart from the tax-free lump sum), the entire annuity will be treated as pension income and taxed in the same manner as a pension annuity.

# 6. Need more information?

To find out more about annuities or to arrange a personalised illustration for one of your clients, get in touch with us.

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