



**Defined Benefit Transfers  
& Triage  
A Client Guide**

# **Defined Benefit Transfers & Triage – A Client Guide**

## **Introduction**

The purpose of this document is to give you general information about defined benefit pension schemes (also known as final salary schemes) and flexible benefits offered within an individual pension and drawdown plan. This has been written with the intention of highlighting whether or not you may benefit from seeking regulated advice in relation to your personal situation from a pension transfer specialist.

## **The starting assumption**

The general rule of thumb is that defined benefit schemes offer very valuable guarantees, so it is usually not appropriate to transfer these unless you have valid reasons for doing so. This is the reason why the Financial Conduct Authority have made the initial assumption that “It is unlikely to be suitable to transfer safeguarded benefits offered through an occupational pension scheme in favour of flexible benefits”.

## **A balanced view**

Below we present a balanced view of some of the key advantages and disadvantages of each scheme. This is aimed at helping you decide the factors, which are important to you and to educate you so you can make an informed decision about whether to seek advice.

## **Defined Benefit schemes**

The benefits you receive from a defined benefit scheme are determined by the number of years that you were a member of the scheme and your salary at the date you left, rather than by how much you paid in and by how well the investments have performed. This means that even if investments perform poorly or there is a stock-market crash (such as in 2008), you will not suffer a loss of the benefits you receive from your pension.

The schemes are usually set up and partially funded by an employer; and managed by a group of trustees and actuaries, whose collective responsibility is to ensure that the scheme is run effectively and can meet its liabilities. If there is a shortfall and the scheme cannot meet its liabilities (i.e. the payments of benefits to the scheme’s members), the company who set the scheme up must fund it instead.

This means that you are not responsible for providing your own income from the scheme and that the company with whom you worked is legally bound to support you throughout your retirement.

If the scheme and company is unable to meet its obligations to you, the scheme will then be wound up and entered in to the Pension Protection Fund (PPF); recent examples are Toys R Us, Carillion and Mothercare. The PPF is a government backed safety net for failing pension schemes and although you may receive less income (particularly from any tax free cash lump sums) than in the original scheme, it will be guaranteed for life.

Despite the hefty advantages, Final Salary Schemes do not suit everyone. Whilst defined benefit schemes provide huge amounts of guarantees, they do not allow for any flexibility.

Once in payment, you cannot reverse or change anything about the pension you are receiving. Even in ill health, the trustees have no obligation to change the details of your pension.

Each scheme has a 'Normal Retirement Date', usually 65. If you retire before this date, the benefits you would have received will be reduced to accommodate the fact that you are accessing them earlier and therefore, in theory, should be receiving the income for longer.

You are unable to take a tax free cash lump sum from a defined benefit scheme without also taking the accompanying income. This means that you cannot use the lump sum to pay off debts, for example, and defer the income until you actually retire.

Most defined benefit schemes pay 50% of your income to your surviving spouse on death. This would mean that your spouse may receive a healthy amount of income in the future after you had passed away. So if your spouse was to predecease you or if you weren't married when you passed away, your pension would die with you.

This is also the case if, for example, you and your spouse both passed away at the same time or very close together. Ordinarily, there are no provisions for the money to be passed on to your children or grandchildren.

Some schemes also offer a dependant's pension. A dependant can be one of the following:

- the member's widow(er) or civil partner at the time of the member's death.
- a child of the member who is under the age 23 at the time of the member's death.
- a child of the member who, in the opinion of the scheme administrator is dependent on the member because of physical or mental impairment at the date of the member's death.
- a person who wasn't married or in a civil partnership and is not a child of the member, who in the opinion of the scheme administrator is, at the date of the member's death: financially dependent on the member, in a financial relationship of mutual dependency with the member; or dependent on the member due to mental or physical impairment.

Any income you receive from a defined benefit scheme is taxable at your highest marginal rate of income tax.

## **Potential advantages of defined benefit schemes**

- You will receive a secured guaranteed income for life, which is likely to rise each year in line with inflation, your spouse/partner or other dependant may receive an income (subject to income tax) upon your death.
- There is minimal paperwork needed to start the payment of benefits and no ongoing monitoring of the scheme is required once the first payment has been made.
- At retirement you also have the option of sacrificing some of your income in favour of receiving a tax-free cash lump sum.
- Defined benefit schemes will place no personal investment risk on you.
- Most defined benefit schemes have a legal duty to provide a pension for a surviving widow/widower or dependant in the event of your death.
- If the defined benefit scheme cannot meet its obligations to you, it can apply to be entered in to the pension protection fund where most (not all) of your benefits will be protected.

## **Potential disadvantages of defined benefit schemes**

- A defined benefit scheme is rigid in its structure, you will get a set amount of money each month until you die therefore it cannot adapt if your needs change throughout retirement.
- The payments of your scheme pension must be selected before taking any benefits and cannot be changed, at a later date.
- Many defined benefit schemes have a pre-selected retirement age and taking benefits early can result in reduced pension benefits.
- Any income you receive from a defined benefit scheme will be subject to income tax at your highest marginal rate.
- Any income you receive from a defined benefit scheme may affect your entitlement to means tested state benefits.
- Only your spouse/partner and children under the age of 23 (unless legally defined as a dependant if older) will usually be entitled to a reduced pension on your death. This will mean you will not be able to leave your pension benefits on death to any other party.
- Any options (if offered by your scheme) to provide benefits on death must be selected at outset and will result in a lower initial pension payment.

## **Defined Contribution (Money Purchase) schemes**

A defined contribution pension such a personal pension scheme is almost the 'polar opposite' to a defined benefit pension in that the benefits you receive from the plan are decided entirely by how much you pay into the pension and how well your investments perform. Your retirement benefits are therefore derived from a finite sum of money which is used to either purchase an annuity (a guaranteed income similar to that of a defined benefit or final salary scheme) or provide an entirely flexible income which runs the risk of running out.

At retirement in a defined contribution scheme, you have the option to take up to 25% of the value of your pension as a tax free cash lump sum. This can be taken in stages or as a single lump sum and you are not obliged to take an income immediately after doing so.

If you opt not to take full advantage of your tax free cash, any income derived from the sums not taken would become taxable.

Once you have taken your tax free cash, you have two options with regards to generating an income from the remaining pension fund:

### **1. Annuity**

An annuity is similar to a defined benefit scheme in that you pay the entirety (or part of) your pension to an insurance company who, in return, will provide you with a guaranteed income for life.

Once the annuity has begun, you are no longer responsible for the income you receive. The annuity company must, in all circumstances, pay the agreed amounts until you pass away, the contract then ceases.

Annuities are 100% covered by the Financial Services Compensation Scheme with no limits to the compensation you could receive. So if your annuity company went bust, you could receive 100% of the money you paid in to the annuity less any income that you had received as a lump sum.

Despite the guaranteed nature of Annuities, they have become increasingly unpopular over the last 10 years.

The standard annuity will pay the highest level of income, but it will not increase at all on an annual basis and will cease entirely on your death.

You can add certain options such as annual increases in payments, spouse's pensions and guarantee periods which ensure that the income is paid for a minimum period of time regardless of whether you survive that period or not (at the end of the minimum period no further payments will be made and the contract ceases); but each addition will reduce the level of income you are paid on an annual basis.

As an example, having your annuity income increase in line with the retail price index each year and asking for a 50% spouse's pension would reduce your starting income by around 40% in current markets.

You could also be entitled to an enhanced annuity (higher income than a standard annuity) depending on your state of health and whether you smoke or not.

Annuity incomes are at historic lows at the moment. This is due to the fact that we are all living a lot longer than we used to, meaning that the annuity companies have to make their cash flows last a lot longer; and the fact that we are in a very low interest rate environment.

Annuities cannot be passed on to your children, only to your spouse.

Any income you receive from an annuity is taxable at your highest marginal rate of income tax.

## **2. Drawdown**

A drawdown pension works in a similar way to a cash savings account in that you can take any sum of money from it at any time, but it will be taxable and will take a couple of weeks to reach your bank account.

After you have taken your tax free cash from your pension, the pension remains invested and can be used at any time. You have complete control over your income levels and can change them at anytime. You can take: regular monthly income, six monthly income or annual income; and have the option of taking ad-hoc lump sums as well.

On death, the value of your remaining funds can be passed to whomever you choose, regardless of their relation to you; and have the choice of how they receive it. There are three options in this regard;

1. they can receive it as a lump sum (which may be taxable),
2. a guaranteed income (an annuity)
3. a drawdown account which can then carry on to whomever they decide on their death and so on.

If you pass away before the age of 75, this can be done entirely tax free (although any guaranteed incomes would be taxable) and if you die after the age of 75, the monies received are taxable at the recipients' marginal tax rate and only when they access it i.e. they could leave the funds in a drawdown account and no tax would be applied.

## **Despite the obvious benefits of flexibility, Drawdown does carry its own risks**

A drawdown income is reliant on an unpredictable investment market and is derived from a finite lump sum. This means that poor investment performance or a particularly aggressive income strategy could mean that you run out of income from your drawdown Pensions.

It is imperative that any drawdown account is well managed to ensure that this does not happen; or that if it does, it is pre-meditated and will not cause any long term damage to your overall financial wellbeing.

Any income you receive from a drawdown scheme over and above the tax free cash is taxable at your highest marginal rate of income tax.

## **Potential advantages of an individual pension or drawdown plan**

- The tax-free pension commencement lump sum (usually referred to as Tax Free Cash) of an individual pension or drawdown plan can be greater than from a defined benefit scheme.
- You can choose how and when your benefits are taken. This offers greater flexibility and choice.
- When taking benefits there are no restrictions on the amount of money you can withdraw at any one time.
- On your death, your nominated beneficiaries will receive the remainder of your pension fund. There is no restriction on who you choose to receive these benefits.
- Benefits can be taken in the following:-
  1. Draw up to 25% tax free cash and leave the remainder invested
  2. Draw up to 25% tax free cash and draw a regular income from the amount still invested
  3. Draw up to 25% tax free cash and draw amounts as and when needed
  4. A combination of 1 and 2
  5. Draw the entire fund as one lump sum; 25% of which would be tax free and the remainder taxable
  6. Draw up to 25% tax free cash and purchase an annuity with some or all of the remainder (commonly known as hybrid schemes)

## Potential disadvantages of an individual pension or drawdown plan

- The benefits taken from a drawdown plan will need to be carefully managed to ensure it does not run out.
- There is the possibility if you need regular income the investment fund may not be sustainable throughout your lifetime. This could potentially mean you are not able to meet core income requirements in later life.
- The funds you invest in will be subject to fluctuation and this can result in the value of the fund reducing even when income is not being taken. Where income is being taken this will deplete the fund to a greater degree.
- The only way to obtain a secure income through an individual pension is with the purchase of an annuity. It is unlikely you would be able to replicate the same level of income payments paid by the defined benefits pension scheme.
- Any income/lump sum payments you receive from the non-tax free element of a pension fund will be subject to income tax at your highest marginal rate.
- By taking far higher levels of income (when compared to a defined benefit scheme), this may push you into a higher tax band.
- Any income/lump sum payments you receive from a pension fund may affect your entitlement to means tested state benefits.
- There will be ongoing annual charges and administration charges to pay. You will also need to monitor where the fund is invested to ensure it meets your attitude to risk and investment objectives.

## Examples of where a transfer may be beneficial or harmful

- **Circumstances where a transfer may be harmful**

An individual would need to rely on the income from their pension to provide their core income requirements throughout retirement.

- **Circumstances where a transfer may be beneficial**

An individual that would not rely on their pension to provide their income throughout retirement and would like individuals to benefit on their death but who are not defined as a dependant.



## **The advice process**

There is no requirement or expectation that you proceed from triage to advice. If you do decide to proceed with advice, you may be offered abridged advice and/or full advice.

Abridged advice is a shortened form of advice and includes an initial assessment of your circumstances. Where you receive abridged advice, it is to ensure you do not pay for full services when it would be clear, earlier in the process, that it is in your best interest to remain in your existing scheme. You will receive a recommendation to remain in your existing or where the initial assessment does not produce a clear outcome, at this stage in the process it will be for you to confirm if you want to proceed to full advice.

Full advice involves a complete assessment of the merits of whether or not to transfer your existing scheme with the most suitable alternative from the available market.

## **Additional information**

Further information on DB transfers can be accessed through the The Pensions Advisory Service (TPAS) within the Money and Pension Service (MaPS)

**Please sign and return the declaration on the next page.**

This document provides you with information on generic advantages and disadvantages of a defined benefit scheme and an individual pension or drawdown plan.

This document is not providing any advice on your personal circumstances or your actual defined benefit scheme.

If you are unsure as to the most suitable option for your individual circumstances you should seek independent financial advice.

All references to tax free and non-tax free elements of pensions only apply to UK residents.

**Declaration**

I have read the entire document and understand the main differences between a defined benefit pension scheme and the benefits offered with an individual pension and drawdown plan.

**Name:** .....

**Signature:** .....

**Date:** .....