GUIDE

Is income drawdown right for you?

This document contains important information and you should read it carefully and keep it safe for future reference.



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IMPORTANT INFORMATION

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Investments carry risk. The value of your investments (and income from them) can go down as well as up, and you may get back less than you invested. Past performance is not a reliable indicator of future results. Investments should be considered over the longer term and should fit in with your overall attitude to risk and financial circumstances.

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Introduction

Reaching retirement is one of the most significant financial milestones in your life. Thanks to pension freedoms you now have greater flexibility than ever before when deciding how and when to access your pension savings.

However, with greater flexibility comes greater responsibility and the decisions that you make could have a lasting impact on your financial security, tax position and the legacy that you leave to your loved ones.

The importance of making the right decision has increased further following changes announced by the Government that will bring most unused pension funds and death benefits into the scope of inheritance tax (IHT) when calculating the value of an estate from 6 April 2027. As a result, decisions about whether to leave pension funds invested, draw income, gift assets or use other retirement income solutions must be considered carefully as part of a wider financial plan. What may appear to be the most tax-efficient approach today may not necessarily be the most suitable strategy over the long term.

A financial adviser can help you to understand your options, assess the benefits and risks of each approach and create a retirement strategy that is aligned with your personal circumstances, objectives and family needs.

The following guide is for people who have a defined contribution pension and will focus on income drawdown and will outline some of the key factors that you should consider before discussing with your adviser whether income drawdown is the right option for you.

How does income drawdown work?

A popular way to withdraw money from your pension is via income drawdown.

Accessible once you reach the age of 55, rising to 57 from 2028, income drawdown allows you take up to 25% of your pension fund as a tax-free lump sum (up to a value of £268,275), and then the remainder of your pension fund remains invested giving you the flexibility to 'draw', or take, income from the remaining pot when you need it. Unlike some other pension withdrawal options, such as purchasing an annuity, income drawdown does not provide guaranteed income for life and requires careful planning and ongoing review.

When using your drawdown plan for regular income withdrawals, it is essential to consider your overall income from all sources, including the state pension if you are state pension age, any other pension pots and investments as this could affect your tax liability.



Why income drawdown is appealing to many retirees

Before deciding if income drawdown is the right move for you, you should consider the advantages and disadvantages. Income drawdown offers several potential benefits including:



Flexibility

With income drawdown you can choose how much income to withdraw, allowing your retirement income to adapt to changing circumstances. For example, you may wish to take a higher income in the early years of retirement if you still have a mortgage to pay off, you are planning to travel or engage in hobbies and then reduce withdrawals when expenditure falls in your later retirement years.



Continued investment growth potential

As your pension fund reminds invested, there is an opportunity for your fund to continue to grow during retirement. This can help to support future income needs and potentially combat the effects of inflation.



Investment choice

You decide how your pension pot is invested. This makes it particularly inviting to those who have invested throughout their working life and feel confident in choosing their own investments.

Investments carry risk. The value of your investments and any income from them can go down as well as up which may impact the level of income you receive. Past performance is not a reliable indicator of future performance.



Death benefit flexibility

Any remaining pension funds may be available to nominated beneficiaries on your death, although the tax treatment will depend on legislation at the time of death. It is therefore important to keep your expression of wish (nomination of beneficiary) form up to date so that pension scheme trustees understand who you would like to receive your pension benefits.

Current rules state that if you die before the age of 75 with all or some of your pension fund still invested, it will pass to your beneficiaries' tax free.

If you're over the age of 75 when you die, your beneficiaries can either draw money from the pension as an income, or take the fund as a lump sum, both options of which will be taxed.

It is also important to be aware that the rules surrounding pensions and IHT are changing. From April 2027, under current legislation, most unused pension funds are expected to be included within a person's estate for IHT purposes.

This represents a significant change from the current position and may affect how pensions are used as part of estate planning. As pension and tax rules can change, regular reviews are essential to ensure your arrangements continue to meet your objectives.

The Financial Conduct Authority does not regulate estate planning.

Key considerations to take into account

Whilst income drawdown offers flexibility, it also introduces a number of risks and challenges that should be carefully considered.

Expense:

Income drawdown can be an expensive option. There will be ongoing costs associated with managing your investments. You will need to be certain that the investments will grow enough to cover the extra costs.

Longevity risk:

Many people will underestimate how retirement spending changes over time. Retirement can last 20 – 40 years or even more. A withdrawal strategy that appears sustainable initially may not remain appropriate over the long-term. Taking too much income too early can significantly reduce the longevity of your pension fund.

Investment risk:

When choosing income drawdown, your pension remains invested. This means that the value of your fund can rise and fall depending on market conditions, which can be heavily impacted by interest rate changes, political events and global market sentiment. Periods of market volatility are inevitable and should be expected.

However, if your investment returns are lower than anticipated, your fund may not grow sufficiently to support future withdrawals. Understanding your attitude to risk and capacity for loss is therefore critical.

Sequencing risk:

Sequencing risk is often overlooked but is one of the biggest drawdown risks. This risk arises when poor investment returns occur during the early years of retirement whilst withdrawals are being taken from the pension. Two retirees may achieve the exact same average investment return over twenty years. However, if one experiences market falls at the beginning of retirement and the other experiences them later, the outcomes can be drastically different.

When withdrawals are taken during market downturns, investments may need to be sold at depressed values meaning that less capital remains invested to participate in future recoveries resulting in the pension fund becoming depleted quickly.

Managing sequencing risk often requires careful investment planning, appropriate withdrawal strategies and maintaining sufficient reserves for periods of market volatility.

Inflation risk:

Inflation gradually reduces the purchasing power of money. Even relatively modest inflation can significantly erode spending power over a long retirement. The cost of a weekly food shop may cost £60 now but in twenty years it may be substantially more. Failing to account for inflation can result in a significant reduction in living standards later in retirement.

Overall tax considerations

The way that you access your pension can have important tax implications. Whilst 25% of your pension will be available tax free up to a value of £268,275, withdrawals after that are generally subject to income tax at your marginal rate.

Therefore, large withdrawals have the risk of pushing you into a higher tax band which increases your overall tax liability and remember, all of your income is taken into consideration. So, if you are of state pension age or have income from other areas, pension withdrawals will increase your overall income. This can affect your entitlement to certain allowances or benefits and can create unnecessary tax charges. .

Careful withdrawal planning can help to improve tax efficiency and preserve more of your retirement savings.

Pensions and estate planning

Pensions play an important role in estate planning as unused pension funds are excluded from an individual's estate for IHT purposes making pensions an attractive vehicle for passing wealth to future generations. However, proposed changes due to take effect from 6 April 2027 are expected to bring most unused pension funds and death benefits within the scope of IHT.

This means that retirement income decisions should no longer be viewed solely through the lens of income planning. The types of questions to consider include:



Should pension assets be preserved or spent first?



How will pension assets fit in with wider estate planning?



What impact could future tax liabilities have on beneficiaries?

The interaction between retirement planning and estate planning is becoming increasingly important, making professional advice even more valuable.

The Financial Conduct Authority does not regulate tax advice and estate planning. Levels, bases of and reliefs from taxation may be subject to change and their value depends on the individual circumstances of the investor.

Why seeking financial advice is essential

Income drawdown offers flexibility and control, but it also places many important decisions in your hands. Unlike an annuity, where your income is guaranteed, drawdown requires ongoing management to help to ensure that your pension savings continue to meet your needs throughout retirement.

The decisions that you make when entering drawdown can have long-term consequences. Taking too much income too soon, investing too cautiously, taking excessive investment risk or failing to plan for changing circumstances could all affect the sustainability of your retirement income.

Income drawdown is generally most suitable for individuals who have a high understanding of investment risk, are comfortable with fluctuations in the value of their pension and have sufficient resources to withstand periods of poor investment performance.

Income drawdown is not a one-time decision; it is an ongoing retirement strategy. Professional advice helps to ensure that your drawdown strategy remains appropriate as your circumstances evolve. Retirement is rarely static. Your income requirements, health, family circumstances, investment markets and tax rules may all change over time. Regular reviews with an adviser allow adjustments to be made where necessary, helping you to keep your retirement plans on track and ensuring your pension continues to work as efficiently as possible.

Next steps

Retirement income planning is one of the most important financial decisions you will make.



If you would like to discuss whether income drawdown is suitable for your circumstances or explore the other options available to you, please contact us to arrange a consultation with one of our financial advisers.

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