Capped Drawdown

Introduction

Capped drawdown allows individuals to take an income and tax-free cash (Pension Commencement Lump Sum (PCLS)) from their money purchase pension arrangement while it remains invested.

If an individual chose to take capped drawdown pension, they can still buy an annuity at any time.

The withdrawals under capped drawdown are subject to a maximum income level, but there is no minimum income that must be taken.

Note – no new capped drawdown arrangements can be created from 6 April 2015, although an existing capped drawdown arrangement can be topped up where allowed by a scheme.

Pre-6 April 2015 Capped Drawdown Arrangements

For pre-6 April 2015 capped drawdown arrangements, the existing capped drawdown rules will continue to apply unless:

- an election to convert to flexi-access drawdown takes effect on or after 6 April 2015, or
- the capped drawdown limit is exceeded, in which case the capped drawdown arrangement is automatically converted to flexi-access drawdown to avoid the unauthorised payment rules applying.

Income

The maximum income limit is 150% of the basis amount, which is determined by a set of annuity tables produced for HMRC by the Government Actuary's Department (referred to as the GAD tables).

These rates are based on 15 year gilt yields (unless the withdrawal is for a dependant aged under 23, in which case 5 year gilt yields are used) and a notional annuity which is level in payment, single life, payable monthly in arrears and has no guarantee.

A calculation, based on the GAD tables, must be undertaken when income withdrawals first commence and at each review date thereafter until an annuity is purchased or the individual dies. The maximum income level will normally apply until the next review date.

To determine the maximum income withdrawal in respect of the individual's/adult dependant's capped drawdown arrangement used to provide income withdrawals the following steps are undertaken:

1. Calculate the attained age in complete years of the individual at the date the capped drawdown withdrawal commences or, where appropriate, at the review date (the 'reference date').
2. Obtain the gross redemption yield on UK gilts (15 years) for the 15th of the month preceding the month in which the capped drawdown becomes effective.
3. If the yield is not an exact multiple of 0.25%, round it down to the next 0.25. No rounding is necessary for exact multiples.
4. Using the attained age from step 1 left and the rounded yield from step 3 above, look up the maximum withdrawal rate in the appropriate GAD table.
5. To determine the maximum withdrawal, apply this rate to the fund net of PCLS and multiply by 150%. The result of the calculation should be rounded to the nearest whole penny.

The minimum income is zero, so an individual may choose to take their PCLS and take no income at all. The income taken can be varied between £0 and 150% of the GAD income at any time during the pension year.

If an individual takes less than the maximum GAD income in a pension year they are not able to carry the unused amount forward to the next year.

Tax
Income payments are taxed through the PAYE system at the individual's marginal rates for earned income and the tax is deducted from the payment before it's paid to the individual.

Reviews
A drawdown pension year is the 12-month period starting from the date that the drawdown first began and each subsequent 12-month period after that. Drawdown pension years will not alter.

There is a regulatory requirement to review the income limits. The income limit has to be reviewed every three years before age 75 and every year from age 75. This period is referred to as the reference period.

At the review stage (the reference date) the drawdown provider will re-set the GAD limits based on the appropriate GAD tables using the individual's age and taking into account then current gilt yields. As the individual will now be older, this will normally mean an increase in the rate used to calculate the maximum income.

There are other events which trigger a review which will result in a change to the GAD limits and/or the reference period. These are described below:

1. Request of the individual (member nominated reviews) with the agreement of the scheme administrator
2. Where an annuity is purchased or a scheme pension provided with all or part of the fund
3. When the drawdown arrangement is reduced as a result of a pension sharing order (i.e. a pension debit against the individual's fund)
4. When an additional fund designation occurs (i.e. a further amount of uncrystallised monies moved into the drawdown arrangement).

In the case of 1 above, the reference period will change. This means future reviews will take place every three years (yearly from age 75) from the new date. However, it should be noted that these requests can only take place from a future anniversary of the review date.

In the case of 2, 3 and 4 above, the GAD limit will be recalculated but the reference date at which the reviews take place will continue as before.

Another point to bear in mind is that, in certain circumstances, a scheme administrator may make the GAD calculation up to 60 days before the review date. The date chosen is actually referred to in legislation as the 'nominated date'. The review date itself does not change, only the date of the calculation. The purpose of using this 60-day window is to allow effective communications – particularly before a fall in the maximum limit – before the income payable changes.

This option is NOT open to scheme administrators in the case of points 2, 3 and 4 (or when drawdown is first selected).

Death Benefits
If an individual dies before age 75 with remaining capped drawdown funds:

- any income payments to beneficiaries will be paid free of tax, and

- any lump sums payable will be paid free of tax up to their available Lump Sum and Death Benefit Allowance (LSDBA).

Note: Any funds placed into drawdown before 6 April 2024 won't be tested against the LSDBA on death on the basis that they will have already been previously tested under the former Lifetime Allowance.

If an individual dies on or after age 75 with remaining capped drawdown funds, both income payments and any lump sums made to beneficiaries will be taxed as pension income under PAYE at the recipient's marginal rates.

Transfers

A capped drawdown arrangement can be transferred to a new ring-fenced arrangement (containing no other funds already held under the arrangement) with another registered pension scheme. This can be either a capped drawdown arrangement or a flexi access drawdown arrangement.

A capped drawdown to capped drawdown transfer must be on a like for like basis so the current maximum income limit and reference period will carry over to the new arrangement.

A capped drawdown arrangement can also transfer to a flexi-access drawdown arrangement subject to the new provider permitting this.

Further Pension Contributions

Individuals in capped drawdown may continue to make contributions, however, if for example they take income above the maximum income limit they will be subject to a reduced annual allowance – the Money Purchase Annual Allowance (MPAA).

The MPAA, which was increased to £10,000 from 6 April 2023, will apply only to money purchase contributions. The individual may in addition accrue benefits in a defined benefit scheme up to the value of £60,000 a year, less any money purchase contributions within the MPAA, before an annual allowance charge applies.

Carry forward is not available in conjunction with the MPAA.

Key Point summary

Capped drawdown is not available for funds newly placed in drawdown from 6 April 2015.

If an individual with an existing capped drawdown arrangement exceeds the maximum GAD, they will trigger the MPAA. Anyone who needs to contribute more than this annually will have limited options, thereby compromising their long-term savings plans and restricting future access to long-term income.

Capped drawdown can convert to flexi-access drawdown at any time subject to the provider permitting it.

This represents Zurich's understanding of HMRC regulations governing capped drawdown. This is subject to change and Zurich does not accept responsibility for any action taken or refrained from, by any person relying on this information.

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