

Department of Work and Pensions
Q&As relating to Protected Rights and Income drawdown
7th October 2008

Please note that the advice given below is only the Department's view on how the legislation works, and should not be taken as a definitive statement of the law. A final and definitive judgement as to what the law is ultimately is for the Court. You should rely only on advice from your professional advisers.

1. Question – Can income drawdown be taken in stages from protected rights (as per HMRC rules for non protected rights)?

DWP advice - Our legislation allows protected rights to be given effect to during an "interim period" by making payments under an "interim payment" ie income withdrawal. Regulations prescribe various conditions that must be met for this to go ahead - but having to give effect to **all** the protected rights is not included. Therefore I can confirm that it is possible to take income withdrawal from protected rights in staggered intervals as for non protected rights. The relevant legislation is s28(1A) of the Pension Schemes Act 1993 and reg 6 of the Occupational and Personal Pension Schemes (Protected Rights) Regulations 1996.

The member would not therefore need to give effect to all his protected rights at the same time.

2. Question - What is intended by paragraph 3A of s28A of the PSA:

(3A)The proportion of the aggregate payment which gives effect to a person's protected rights must not be greater than the proportion of the value of the rights to money purchase benefits under the scheme that is attributable to the protected rights.

DWP advice - the policy intention is that protected rights should not be "eroded" disproportionately to the rest of the fund. So, whatever percentage of the drawdown available from his fund a person decides to take, the proportion taken from his PR fund must not be greater than the proportion from non PR fund. E.g: if he takes 50% of the drawdown available from the non PR fund he can only take a max of 50% of that available from the PR fund.

3. Question – subsequent to question 2 - If the individual only designates say half of his PR fund as income withdrawal, what affect does this have? In the example you give, if he takes 50 per cent of the draw-down available from the non-PR fund, can he only take a maximum of 50 per cent of the draw-down available from that smaller PR fund?

Alternatively, is the proportion of draw-down available from the PR fund based on the proportion the total PR fund bears to the total money purchase benefits - whether designated for income withdrawal or not.

DWP advice - On the first point: Yes, if he decides to take drawdown from half his fund, some PR some NPR - the same rules apply. The PR must not be

eroded disproportionately. So in this example he could only take a maximum of 50% of the drawdown income available from the PR put into drawdown. I agree that the wording of section 3A may be ambiguous but I can confirm that this is the policy intention.

As an example: say the fund is £100,000 of which £25,000 are PR. The income drawdown available from the whole fund is £5,000pa. 25% of this, ie £1250, could be drawdown from the PR and the rest from the NPR. If the member decided to only drawdown £2,500 pa then, again, only 25% of this could be taken from the PR fund.

4. Question – subsequent to questions 1 and 2 - could you please confirm that

(1) a member with protected rights of £25,000 could

- designate £5,000 as income withdrawal in 2007,
- designate a further £5,000 in 2008 and
- buy an annuity in 2009 and

(2) that it is only in 2009 (when an annuity is bought) that all protected rights must applied, either as annuity or income withdrawal e.g the remaining £15,000 might be applied £10,000 annuity and £5,000 income withdrawal.

On the 1st point could you please confirm how s28A(3A) it is intended to work where a member only designates protected rights as income withdrawal. i.e. non-protected rights are not designated as income withdrawal.

DWP advice - The overriding policy intention here is that the protected rights should not be "eroded" disproportionately to the rest of the fund. Therefore it is not possible to put only the protected rights into drawdown and leave the rest of the fund untouched. s29(3A) means that if PR make up 50% of the fund then, of the amount drawdown, a maximum of 50% can be derived from the protected rights.

The protected rights regulations allow people to use these rights in stages for income drawdown purposes if they wish. However when an annuity is purchased all protected rights must be used for that annuity purchase. So in your example (2) is incorrect. All of the PR must be used to purchase an annuity rather than some being diverted for drawdown.

5. Question - Do survivor's benefits have to be provided if a member marries or forms a civil partnership after the interim arrangement has started but dies during the interim period?

DWP advice – Section 28A of Pension Schemes Act 1993 sets out the requirements for interim payments (or drawdown) and says that drawdown can continue to a member's widow etc if he dies while taking drawdown. It wouldn't matter that the member wasn't married at the start of the arrangement, just that he was married when he died.

When that drawdown arrangement ceases the widow would have the same options as normal i.e: continuing in drawdown (USP or ASP), buying an annuity/pension, or taking a lump sum if that was appropriate (say trivial commutation).

6. Question - I have follow on queries relating to this subject. It is probably simplest to give you a couple of examples to illustrate the queries.

Example 1

SIPP contains crystallised benefits of £100,000 which were transferred in from one APP.

£50,000 of the benefits are Protected Rights (PR) and £50,000 are non-Protected Rights (NPR) The maximum annual income from the fund is £10,000 The member has elected to draw and annual income of £8,000

Based on the answer you have provided and our interpretation of the legislation we believe that the member cannot draw more than £4,000 of his annual income from the PR fund. This is because his benefits are split on a 50/50 basis and therefore the maximum he can draw from his PR fund is 50%.

Question 6a - is this correct?

DWP advice – correct.

Following on from this we do not believe there is a restriction on the member choosing to draw more than 50% of the £8,000 from the NPR i.e. he could draw £5,000 from the NPR and £3,000 from the PR.

Question 6b - is this correct?

DWP advice – correct - this is within the overall 25% max so OK.

Following on again, it could be argued that there is a notional maximum income of £5,000 which applies to both the NPR and the PR (this on the basis that the total maximum income from the fund is £10,000). However, our reading of the legislation is that this notional maximum is not a legal maximum (the only legal maximum is that which applies to the scheme) and therefore, in the above example, the client could theoretically choose to draw the full £8,000 from the NPR funds and nothing from the PR.

Question 6c - is this correct?

DWP advice – correct. Fine from a protected rights point of view and don't think there is anything in the tax rules that would prevent this.

Finally, in relation to Example 1, we have a question about how the proportionate limit works on an ongoing basis. If we say that the member chose to draw £5,000 from the NPR and £3,000 from the PR in year 1 and we assume an investment growth rate of 0% then at the start of year 2 the member has NPR of £45,000 and PR of £47,000 (approx a 51%/49% split). For year 2 is the proportionate limit based on the 50/50 split that existed when the benefits were crystallised, or does the proportionate limit change to the 51/49 split that existed at the end of the first year? Our view is that the only practical way that this can

work is for the split to be established at the point of crystallisation or benefits review (five yearly USP, annually ASP) and for this to be the proportionate limit that applies until the next benefits review.

Question 6d - is this correct?

DWP advice – correct. We are more concerned with the principle of this rule rather than very exact calculations.

Example 2

SIPP contains crystallised benefits of £100,000.
£50,000 of these are NPR and were transferred in from scheme A. £50,000 of them are PR and were transferred in from scheme B.

The maximum annual income is £10,000 and this is split £5,000 in relation to NPR and £5,000 in relation to PR (as these benefits were transferred in from separate schemes it is a legislative requirement that they must be held in separate ringfenced 'arrangements' each with their own benefit limits and review dates).

The member has elected to draw an income of £8,000.

The question in this example is really whether the proportionate limit works in a different way because the NPR and PR are held in separate ringfenced arrangements i.e. in this example the member can elect to draw £5,000 from the PR and £3,000 from the NPR? Our view of the legislation is that this must be the case because of the legal separation (in the same way that it would be possible if the benefits were still held in separate schemes pre-transfer to the SIPP).

Question 6e - Is this correct?

DWP advice – DWP legislation does not recognise the term "arrangement" which is an HMRC expression used in tax law. Our rules on proportionality apply to the funds held in "a scheme" and so apply to the total funds in the two arrangements in the same way as if they were held in one arrangement. I.e. same rules as for example 1 would apply.

7. Further advice from DWP in relation to the proportion of protected rights that can be used when income drawdown is taken:

In response to your query regarding the change in legislation with effect from the 1st October that will allow protected rights to be held in certain Self Invested Personal Pension (SIPP) Schemes (provided they meet the HMRC requirements), it would perhaps be beneficial if I explained how income drawdown in an Appropriate Personal Pension (APP) Scheme currently works and the policy that underpins this.

The current policy intention is that protected rights are broadly a replacement for additional State Pension, and as a result of this they carry a certain set of responsibilities. Section 28A(3A) of the Pensions Schemes Act 1993 is a measure that was introduced with the intention to stop the protected rights fund from being eroded disproportionately to the rest of the fund. It attempts to

ensure that the member can take no more of the protected rights than that which equates to a proportionate amount of the total value of the APP scheme. Therefore, it is not possible to put only the protected rights into drawdown and leave the rest of the fund untouched. Section 28(3A) means that if, for example, protected rights make up 50% of the scheme then, of the amount taken as drawdown, a maximum of 50% can be derived from the protected rights.

Example - if an APP scheme contained £50,000 of benefits from a Protected Rights (PR) fund and £50,000 from a non-Protected Rights (NPR) fund and the estimated maximum annual income from the fund is £10,000 (the maximum annual income that can be drawn is 120% of a comparable annuity for a single person at a given age as determined by the Governments Actuaries Department. See the following website for further details <http://www.hmrc.gov.uk/pensionschemes/gad-tables-instructions.pdf>) the member may elect to drawdown up to this amount. If he decided to draw an annual income of £8,000, he could not draw more than £4,000 of his annual income from the PR fund. This is because his benefits are split on a 50/50 basis and therefore the maximum he could draw from his PR fund would be 50%. Alternatively, the member could decide to draw the full £8,000 from the NPR funds and nothing from the PR, as there are no such restrictions on the NPR.

We do not have any plans to amend these rules ahead of the Government's proposals to abolish contracting-out on a defined contribution basis – the planned date for this is 2012. However, once these changes are introduced, they will also apply to past rights and there will no longer be separate rules for protected rights once this legislation comes into effect. As a result of this, these requirements will fall when contracting-out on a defined contribution basis is abolished.

The legislation that defines the rules for income drawdown from a pension fund can be found in Section 165 of the Finance Act 2004. These rules along with Section 28A(3A) of the Pensions Schemes Act 1993 will continue to apply with effect from the 1st October when protected rights will be permitted to be held in a SIPP.