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TECHNICAL

BULLETIN

EXTENDED GUARANTEE PERIODS VS VALUE PROTECTION

An overview of where a guarantee period or value protection might be most appropriate.

Amongst the changes introduced by pension freedoms in 2015 was an overhaul of death benefits. Some restrictions were lifted and there were changes to the taxation of benefits. As a result, some annuity providers of guaranteed income for life solutions (GIfL) changed their products to incorporate extended guarantee periods. They also reinvigorated value protection.

This has added a layer of choice for advisers and retirees when considering which approach provides the best solution in terms of:

- cost against value; and
- suitability for the plan holder and their beneficiaries.

Therefore, the decision as to which option should be selected (if any) needs careful consideration. These options were originally designed to offer protection on different elements of buying a GIfL:

- A guarantee period aims to protect the income selected.
- Value protection (first introduced in April 2006) aims to protect the original capital.

However, this distinction in respect of guarantee periods has been somewhat blurred, as a result of the greater flexibility available since 6 April 2015.

For example, the GIfL provider can now offer the beneficiary the option to commute their guarantee period, in some scenarios. In other words, they're given the ability to exchange the income for a lump sum.

Extended guarantee periods for lifetime annuities:

There is now no limit on the maximum period a provider can offer a guarantee period for, with some providers offering up to 30 years.

If the plan holder dies before they're 75 the income from the guarantee is paid tax-free to the beneficiary.

If the plan holder dies after 75, the income guarantee is taxed at the beneficiary's marginal rate of income tax.

In addition, any remaining guarantee period can now be paid out as a trivial commutation lump-sum death benefit (TCLSDB), if the contract allows it and if:

- the amount valued and made available is less than £30,000; and
- it extinguishes the individual's entitlement under the GIfL contract.

It should also be noted that there's still no provision to attach a guarantee or term certain to a dependant's income (or indeed a nominee's or successor's GIfL).

Furthermore, short-term annuities (temporary annuities payable by an insurance company arising from an allocation of drawdown funds) can still only have a maximum guarantee of five years. Note that this differs from certain products marketed as 'fixed-term annuities' – these simply provide a guaranteed rate of income on a drawdown basis.

Value protection (technically referred to as an annuity protection lump sum)

This option is often discounted for a number of reasons. One such reason was the pre 6 April 2015 tax treatment of the death benefit. Due to the size (55%) of the special lump sum death benefit tax charge it meant there was a question around the value of this feature. With changes to the tax treatment this option has become viable once again.

If the plan holder dies, a value protection lump sum is returned, less all the gross income payments made since the GIfL went into payment.

If the plan holder dies before 75, the value protection lump sum is paid tax-free.

If they die after 75, currently any payment to an individual would be taxed under PAYE at their appropriate rate. However, if payment is to a 'non-qualifying person', the special lump-sum death-benefit rate of tax will continue to apply. For 2018/2019 this is set at 45%.

A non-qualifying person is defined as either:

- an entity other than an individual (such as a company); or
- an individual acting in the capacity of:
  - a trustee (other than a bare trustee);
  - a personal representative;
  - a director of a company; or
  - a partner in a firm or member of a limited liability partnership.

Depending on the features available within a particular GIfL contract, it's possible that value protection can be set up on the death of the first life, or on the death of the last survivor. This is if the GIfL features a built-in spouse's/dependant's income.

Considerations

The main difference between guarantee periods and value protection is how the benefits are provided to the beneficiaries. These are either as:

- a continuation of income in the case of guarantee periods (unless they're commuted); or
- as a lump sum, if provided through value protection.

Essentially, both these options can now provide a greater degree of insurance in the event of death. The aim isn't only to provide some form of benefit to beneficiaries – it could also reassure the plan holder that their GIfL capital isn't 'completely lost' to the provider.

Tax

- When establishing the most appropriate death benefit option, a key consideration is the tax position of the intended recipient(s). There's likely to be a different tax liability arising as a result of an additional income stream, when compared to a one-off lump sum. The tax due could be significant.
- For deaths over the age of 75 – most recipients will be taxed at their marginal rate. For example, the impact of £4,000 each year, received for a further 10 years, is likely to result in less tax payable by the recipient compared to the scenario where a lump sum's paid. However, an alternative single payment of, say, £40,000 in a particular tax year may be more attractive to some – even if the tax is greater.

The beneficiary's circumstances

- Another key consideration is whether a potentially sizable capital sum is appropriate for the intended beneficiary/ies.
- For minors (for example, grandchildren) it should be possible to pay either the lump sum or any income stream to a parent or legal guardian. However, those over the age of majority will be free to spend any death benefits as they wish. The financial position of the beneficiary and the impact on their estate may need to be evaluated. Factors that may be relevant include:
  - loss of any means-tested benefits;
  - potential bankruptcy;
  - possible divorce; and
  - the inheritance tax position.
- It may be possible to use a trust as a vehicle to receive the value protection lump sum. This can help manage the death benefits more closely, in line with the plan holder's wishes. However, the contrasting tax position between paying to a trust and paying directly to the beneficiary should also be considered.

Subsequent death before the end of the guarantee period

- In the case of guarantee periods, if the recipient dies whilst any remaining guarantee is outstanding, this can be passed on. However, where these payments are being paid at the discretion of the GIfL provider, they retain the discretion to appoint to a new beneficiary.

Cost vs value:

Deciding on which option to use very much depends on the individual needs of the retiree. One of the biggest factors may be the desire to receive back all of the capital used to buy the GIfL – either as income for the retiree or in combination with the gross death benefits payable.

Summary and next steps:

When restrictions were removed on guarantee periods and changes to taxation on death benefits, retirees were greatly impacted especially when considering the increasing longevity expectations.

The use of value protection, or an extended guarantee period, means that GIfLs are now able to provide money-back options. This goes a long way towards removing one of the most common objections to GIfLs – 'if you die, then the money dies with you'.

So, which option is better? The decision is very individual to each client's circumstances. It'll likely depend on planning considerations and some of the softer facts around the clients' wishes for their legacy planning.

A good question to ask could be: what are you most interested in protecting? If the preference is for income, this may suggest a guarantee period. Conversely, if a capital sum's more desirable, this might suggest value protection.

Further questions could include:

- Who should benefit?
- Do you have any concerns on how they could handle these monies?
- What is their tax position?

This'll help ensure any expression of wish form is completed correctly. It'll also show what the implications of any income payment or capital payment may have on the beneficiaries' financial position.

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