

**Income from Annuities**

**The Pensioners' Incomes Series  
Methodological Paper No. 8**

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## **Executive summary**

Previous methodological papers have identified the need to examine how income from an annuity bought with a private pension lump sum should be treated in the Pensioners' Incomes Series (PI). In particular, there is debate as to which components should be treated as occupational or personal 'pension income' and which should be treated as 'investment income'.

This paper considers income from all types of pensions and annuities. These are traced from the original source of the income, through how the pension fund / capital is used, and how pension lump sums are used, to how the income might be classified in PI. The treatment of most types of annuity income is reasonably clear, with both the source of capital and the method of income delivery consistent with either a 'pension motive' or an 'investment motive'. However, the arguments are less clear when classifying income from annuities bought with a private pension lump sum.

The paper argues that the post-retirement decision on how to derive an income from a private pension lump sum tell us more about whether an income should be treated as pension income than the pre-retirement decision to save in a pension. Annuities bought with a private pension lump sum are based on a pension savings vehicle and deliver a steady income consistent with a 'pension motive'. Therefore, it is recommended that private pension categories in PI should be changed so that such income is treated as pension income in PI. This means that only income where *both* the original savings vehicle and the method of income delivery are consistent with a 'pensions motive' would be defined as pension income.

Such a change may result in estimates being affected by misreporting in the Family Resources Survey (FRS). Some individuals may not correctly report where the lump sum they used to buy their annuity came from. On the other hand, it may reduce misreporting where those with compulsorily purchased private pension annuities report these as an annuity purchased with a private pension lump sum, rather than as a direct pension income. There is no evidence to suggest that one type of misreporting is more common than the other.

Since the impact on results is currently small, it is recommended that the change to the classification of this type of income should be made at a time that causes minimum disruption to the PI Series (e.g. at the same time as the introduction of a separate personal pension category).

## **Comments**

Any comments on this paper would be gratefully received:

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## 1. Introduction

In the Pensioners' Incomes Series (PI), annuity income bought with a lump sum from an occupational pension is currently included as part of investment income rather than occupational pension income. This is because, historically, it was not possible to identify this income separately from other annuity income. However, the Family Resources Survey (FRS) now enables us to identify whether the annuity was purchased using a lump sum from an occupational pension, a personal pension or neither of these.

[‘The Pensioners’ Incomes Series Methodological Paper No. 4’](#) briefly looked at this issue whilst examining personal pension income. The purpose of this paper is to follow the last recommendation of this paper, which was to revisit how annuity income bought through lump sums from occupational and personal pension plans should be classified in PI Series.

The issue is approached by looking at how incomes from all types of pensions and annuities are treated in PI, and in particular whether they should be treated as pension income or investment income. The paper considers the conceptual arguments for treating these incomes in different ways, as well as practical considerations concerning data quality.

## 2. Types of annuities

There are two basic main types of annuities. The first of these is a **compulsory purchase annuity**, which is bought using capital accumulated in either a personal or occupational pension fund. The ‘compulsory’ part of the title comes from the fact that funds accumulated in a personal pension or ‘money purchase’<sup>1</sup> occupational pension must be used to buy an annuity (apart from a proportion of the fund that can be taken as a lump sum). The holder of the pension can opt to defer annuitisation until a later date (although it must be annuitised before the policy-holder reaches age 75), and leave the fund intact, or in the meantime draw an income from the capital which remains invested in the fund. The latter process is known as ‘income drawdown’ or ‘income withdrawal’. Another option available to those people with ‘money purchase’ occupational pensions or personal pensions is phased retirement. This involves dividing the fund into separate segments that are managed separately. These are treated as separate funds and can be annuitised at the member’s discretion, but all must be annuitised by the time the individual reaches age 75.

The second main type of annuity, a **purchased life annuity**, is one which is bought *voluntarily* from an individual’s own capital. The Association of British Insurers (ABI) figures show that there were around 11,000 new annuities of this type bought in 1999, and a total of 335,000 in payment. Evidence from the Family Resources Survey suggests that in some cases, individuals voluntarily annuitise a lump sum from their

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<sup>1</sup> A money purchase scheme is one where employees and their employers contribute to an individual pension fund over that employee’s work life. Upon retirement the individual usually annuitises the fund to provide an income throughout retirement. Another type of occupational pension is a final salary scheme. This is where the individual receives a defined amount per year in real terms (for example, half their final salary). This type of occupational pension is usually financed from a communal fund, rather than an individual fund, or in some public sector cases from general taxation.

personal or occupational pension funds in a purchased life annuity. The 1999/00 FRS estimates that there are 234,000 individuals in receipt of income from an annuity bought with a lump sum. [This is some 100,000 lower than the ABI estimate, at least partly because it excludes people in long-term care, who may be particularly likely to hold a purchased life annuity if they have sold their house]. Of these 234,000, around 70,000 obtained the lump sum from an occupational pension and around 80,000 got it from a personal pension. A lump sum from an occupational pension can come from either a ‘money purchase’ type occupational pension or a final salary pension.

A summary of the choices available to individuals concerning annuities, ignoring income drawdown and phased retirement, is shown in Annex A. Income drawdown and phased retirement are comparatively rare events. For 1999 the ABI recorded that there were 232,000 new pension annuities bought, compared with the 18,000 new people who made use of the income drawdown option.

### 3. The current situation in the PI Series

This section ignores, for the moment, any concerns over FRS respondents’ ability to report different types of income under the “correct” category (see Section 5), and explains in conjunction with Annex A how selected types of income are treated in the PI Series.

The current situation, in terms of how **occupational pension** annuities are treated in PI, is outlined below. Any income from a compulsorily purchased annuity from a ‘money purchase’ occupational pension is treated as *occupational pension income* in PI. Any income stream that comes directly from a final salary occupational pension is also included as occupational pension income, as is the income that is being ‘drawn-down’ from an occupational pension. As stated above, there were 18,000 new people who made use of the income drawdown option in 1999 (although some of these may have been drawing down a personal pension). This type of income is fairly easy for the individual to identify, as they had to make a conscious decision to drawdown, and as such misreporting on this should be negligible, although there are no specific questions about income drawdown in the FRS. If lump sums from either ‘money purchase’ or final salary occupational pensions are annuitised through a purchased life annuity or put in some other investment vehicle, then any income that results from this is included in the *investment income* category in PI.

At the moment, all incomes from **personal pension** funds are included as investment income, whether they are obtained through a compulsory or voluntary annuity, or through some other investment vehicle. However this may change if a new ‘personal pension income’ category is introduced to the PI Series in the medium term (see [‘The Pensioners’ Incomes Series Methodological Paper No.4’](#) for more details). This paper assumes that in the short term personal pension income will continue to be treated as investment income in PI. In the medium term, if sample sizes are large enough to allow separate analysis of personal pension income, then that category will include income from the compulsory purchase annuity part of the personal pension fund. Furthermore, it *could* include income obtained from a voluntary annuity bought with a lump sum from a personal pension, depending on the recommendations.

If a lump sum is **not annuitised** then it is excluded from all income categories, as it is not considered a current transfer due to the fact that it is one-off in nature and unlikely

to be spent immediately upon receipt. However, any interest or other income earned by investing this capital is treated as investment income. The treatment of current and capital transfers in the FRS is looked at in more depth in the consultation paper “*Treatment of lump sums in the FRS/HBAI – current or capital transfers?*” as part of the [HBAI / PI National Statistics Quality Review](#).

#### 4. Conceptual issues

There can be little debate about the treatment of compulsory purchase annuity income: This should be included as occupational pension income if bought through an occupational pension or personal pension income (currently under investment income) if bought with a personal pension. If an annuity is bought with an individual’s own capital, then this should also be included in investment income. There is slightly less certainty about income from private pension lump sums not invested in annuities. It is very difficult to draw a line between capital invested to maintain or increase its value and capital invested explicitly to provide a steady income in retirement. There is less certainty of receiving a steady income in retirement if capital is not annuitised. So, in the absence of clear evidence of a pension motive, income from private pension lump sums not invested in annuities is included as investment income in PI.

The main area of debate relates to annuities bought with lump sums from private pensions. Historically, the source data for the PI Series did not enable us to identify how the voluntary annuity was purchased, so currently all purchased life annuity income is counted as part of investment income. However, the FRS now asks each benefit unit with a purchased life annuity whether that annuity was purchased with a lump sum from either an occupational pension, a personal pension or neither of those. Therefore, it is now theoretically possible to allocate this annuity to the source by which it was purchased. This would mean, for example, that income from an annuity purchased through an occupational pension lump sum could be counted as part of occupational pension income. Therefore, there are two options:

- (1) to keep all income from voluntarily purchased annuities as investment income
- (2) to split this type of income according to the source of the lump sum

The point to consider is whether income from an annuity bought through a lump sum from a private pension is better classified as pension income or some other investment income. Individuals’ main **motivations for contributing** to an occupational or personal pension are to provide a steady income for their retirement (‘pension motive’) and save in a tax-efficient manner for the future (‘investment motive’). Therefore decisions made before retirement do not tell us much about how this income should be classified. However, decisions made after retirement, such as the decision to annuitise the lump sum to provide a steady stream of income, are more in keeping with the ‘pension motive’ than the ‘investment motive’. If a similar lump sum was used to buy stocks, shares or other investments which deliver income (and may provide a higher return), then that type of income would be treated in a different way to an annuitised lump sum, despite the fact that it comes from the same original source. This could be justified on the grounds that the nature of delivery of the income from annuities and other investments is different. Income from an annuity is to some extent guaranteed, whereas income from other investments such as share dividends is more uncertain. The individual’s decision to annuitise seems to suggest that income

from an annuity bought through a lump sum from a private pension should be treated as pension income rather than investment income.

Another consideration for whether it would be suitable to group together income from voluntary and compulsory annuities by source is to look at how they are treated in terms of the tax system. Contributions made to private pensions are not taxed, but any income resulting from a compulsory annuitisation of the pension is taxed. Conversely, if an annuity is purchased voluntarily then the income on this is only partially taxed. The tax is levied on the implicit profit from the fund, so that only the part of the income that results from the *real increase* in value of the fund after annuitisation is taxed. The fact that income from voluntary and compulsory annuities is treated differently by the tax authorities could suggest that they should be treated differently in PI. However, leaving the income from voluntarily purchased annuities in the investment income category will also mean that incomes with different tax treatments are contained in the same category. Income from share dividends, for example, is treated in the same way as income from a compulsorily purchased annuity. Therefore, tax treatment should not be a major consideration when deciding how to classify annuity income.

An important feature of the Pensioners' Incomes Series is that it tries to show how important each source of income is to pensioners. Annuities bought with a private pension lump sum are based on a pension savings vehicle, and use an annuity to deliver a steady income consistent with a 'pension motive'. Therefore, it would seem reasonable that this income is 'credited' to the occupational or personal pension income category respectively, if the practicalities allow it. In summary, only income where *both* the original savings vehicle and the method of income delivery are consistent with a 'pensions motive' should be included as pension income.

## **5. Practical considerations**

One disadvantage of redefining the categories is that it may mean estimates of some income categories will have to be revised for previous years. An earlier methodological paper found that the changes would be small (see ['The Pensioners' Incomes Series Methodological Paper No.4'](#)). The latest figures for 1999/00 are given below. The conclusion, that making the change would only lead to small changes in estimates, remains the same. However, this issue should not be overlooked because it will get larger over time as personal and money purchase occupational pensions become more prevalent.

**Table 1:** Occupational pension and investment income with and without annuity split, 1999/00 (July 1999 prices)

		Mean income of those in receipt (£pw)	
		Income without split Option 1	Income with split Option 2
Occupational pension income	Total	102	103
	Pensioner couples	134	136
	Single pensioners	73	74
Investment income	Total	43	42
	Pensioner couples	66	64
	Single pensioners	26	26

There may also be a potential problem of benefit units misreporting where they got the lump sum from to purchase the annuity. The FRS asks whether an individual receives income from an annuity. If the answer is “yes”, they are asked how the annuity was bought:

- with a lump sum from an employee pension;
- or a lump sum from a personal pension;
- or neither of these.

The second of these questions could be subject to misreporting if respondents don't consider, or recall, that the annuity was bought with a pension lump sum (especially if they bought it some years after retirement). If all voluntary annuity income is left in the investment income category this would not pose a problem. However, if the proposed changes are made to the categories and respondents answer the second question incorrectly, we will face a situation of increased misreporting of occupational pension income.

If the changes are made (i.e. allocating annuities according to the source of the lump sum), it is possible that a different form of misreporting of occupational pension income could be reduced. This could arise from pensioners believing their income from a compulsory purchase annuity from a money purchase pension was from a voluntary purchase annuity funded by an occupational pension lump sum (the questions do not refer to ‘compulsory’ and ‘voluntary’ lump sums). This could be due to the ‘open market option’, where individuals reaching retirement can choose a company from which to purchase their annuity. This type of misreporting will lead to income that should be counted as occupational pension income, being incorrectly included as investment income. If the proposed changes were made, then this type of misreporting would be eliminated.

The FRS estimates that there are 70,000 individuals receiving income from an annuity bought with a lump sum from an occupational pension and 80,000 receiving the same type of income from a personal pension. However, there is a lack of alternative sources to compare these estimates to. Therefore, it is not possible to measure any over-reporting. It is worth pointing out that we might expect this form of investment to be rare, because a higher rate of return could usually be obtained by investing the lump sum in a different investment vehicle (although this has not always been the case, since annuity rates were higher in the past). Therefore it is thought that there

may be significant numbers of FRS respondents included in this category because they are misreporting compulsory purchase pension annuity income

There appears to be limited scope for improving the questions in the Family Resources Survey to reduce misreporting around this issue. This is because the vital distinction between a compulsory purchase annuity and a voluntary purchase annuity may not appear obvious to some respondents, particularly if the annuitisation took place a long time ago. If the questions made a direct distinction between the two, this might increase the risk of some pension income not being reported in the survey at all.

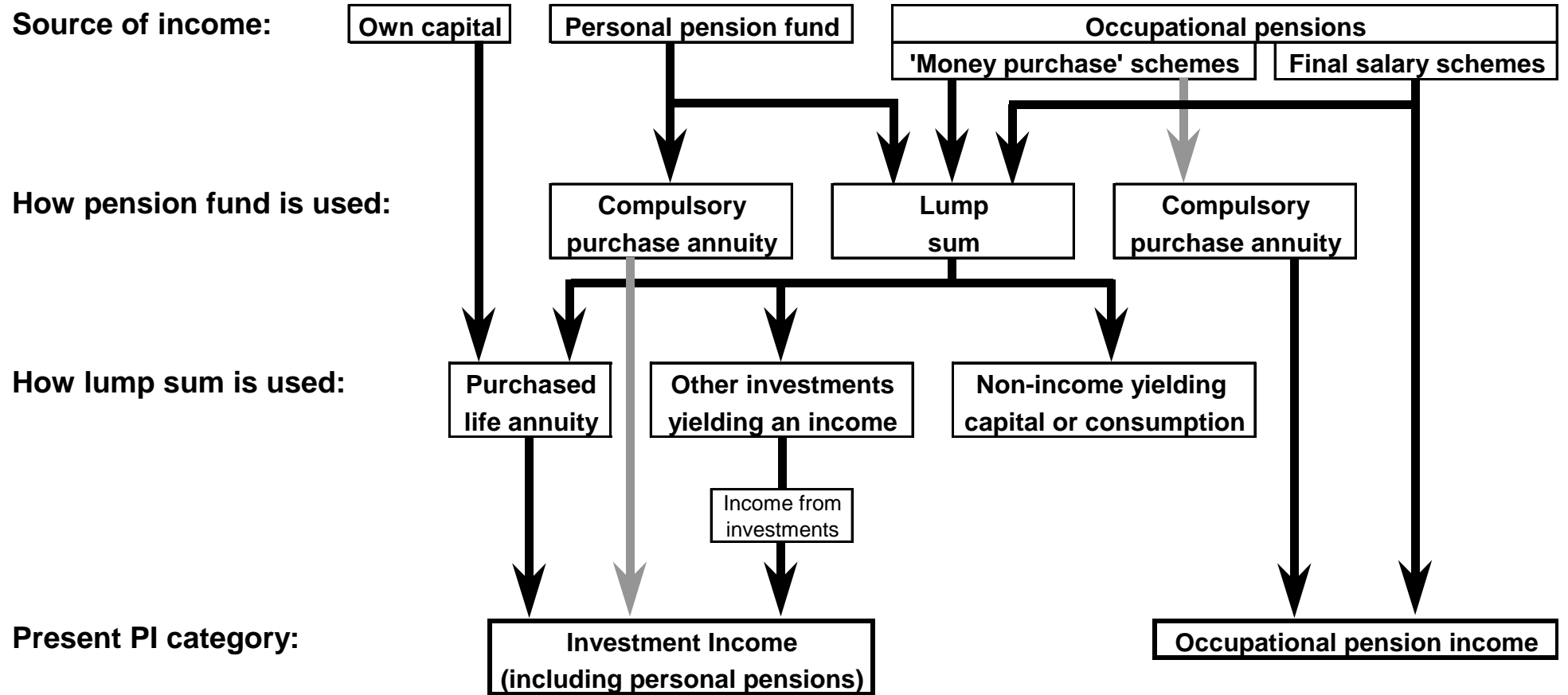
Overall, the practical implications of making the changes outlined in option two above, do not seem to rule out re-allocating income from an annuity bought through a lump sum from a private pension to the appropriate category. Indeed, this may even reduce some forms of misreporting.

## **6. Recommendations**

In summary, it is recommended that income should be included as private pension income if *both* the savings vehicle *and* the method of income delivery are consistent with a ‘pension motive’ (i.e. money accumulated through pension saving that is subsequently annuitised, regardless of whether the annuitisation was voluntary or compulsory). This recommended treatment is set out in Annex B. In particular it means that:

- Income from voluntary purchased life annuities should continue to be treated as investment income, as should income from private pension lump sums that are not invested in an annuity.
- Income from compulsorily purchased annuities based on pension lump sums should continue to be classified as (either occupational or personal) pension income.
- Income from annuities purchased through a lump sum from an occupational pension should be included as occupational pension income (as shown in Annex B) rather than investment income.
- Income from annuities purchased through a lump sum from a personal pension should be included as personal pension income rather than investment income. However, personal pension income will remain part of investment income until sample sizes are large enough to allow this source to be estimated as a separate category (see [‘The Pensioners’ Incomes Series Methodological Paper No.4’](#) for further details).
- Since the effects are currently small, these changes should be made at a time that will cause minimum disruption to the PI Series (e.g. at the same time as the introduction of a separate personal pension category).

**Annex A: present treatment of annuities in the PI Series**



**Annex B: possible future treatment of annuities in the PI Series**

