BUCKINGHAM GATE

7 TIPS TO MAXIMISING INCOME IN RETIREMENT

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INTRODUCTION

The days of an individual retiring at 65 with 40 years service in a Defined Benefit scheme, and this being their primary source of income in retirement, are long gone for the vast majority of people.

Nowadays, it is much more common for those in retirement to be receiving income from a variety of sources including pensions, savings and investments and have a lot more flexibility as to how and when they take benefits in retirement.

The introduction of pension freedom from April 2015 has broadened the options even further, and many struggle with the bewildering array of choices available to support them in retirement. This guide will help you understand these options and help you make informed decisions as to the best way for you to retire in comfort.

PENSIONS

While the 2014 Budget introduced a number of changes to pension legislation, many of the rules regarding the way that pension benefits are taken remain fundamentally the same.

A pension can normally be accessed after the age of 55, and the majority of people will be able to take 25% of any pot as a tax free lump sum, with the remaining 75% used to provide an income which is taxable. This income can be provided in one of three ways, lifetime annuity, flexi-access drawdown and uncrystallised funds pension lump sum.

LIFETIME ANNUITY

(The remaining fund after any tax free cash has been paid is used to provide a fixed income which is guaranteed for life).

While the popularity of annuities has plummeted since the pension freedom rules were announced, they remain one of the only ways in which income can be guaranteed for the whole of your life.

Research by MGM Advantage suggests that up to 70% of retirees would qualify for enhanced annuities which look to boost income available by taking into account factors such as health and lifestyle. Contrary to popular belief, you do not have to be seriously ill to qualify for an enhanced annuity – a smoker with high cholesterol and blood pressure could get a whopping 47% boost to their retirement income.
(Source Hargreaves).

- ✓ Ensures certainty of income throughout your lifetime.
- ✓ Stockmarket volatility has no impact on income received.
- ✗ Inability to vary income to suit personal circumstances.
- ✗ Unable to pass on lump sum benefits to family on death, unless a specific option is purchased at extra cost.

TIP NUMBER 1

If you feel that an annuity is the right choice for you, it is vitally important that you shop around for the best deals. You are under no obligation to buy an annuity from the provider that your pension is invested with, and it is likely that you can get much more income from an alternative provider.

In the FCA's Thematic Review of Annuities published in 2014, it estimated that only 40% of annuitants shop around for the best rates despite the fact that 4 out of every 5 annuitants could get a better deal from an alternative provider.

A comparison of annuity rates from providers shows the gap between the best and the worst annuities available on the open market. Using current annuity rates for a 65 year old man with £100,000, the best income available was £5,929.56 per annum, almost 20% more than the worst which was £4,946.64 per annum. (Source Assureweb: fund after tax free cash paid, single life, level, payable monthly in advance without proportion, 5 year guarantee).

If this individual were to live until 85, the best rate would provide almost £20,000 more income in total compared to the worst rate.

FLEXI-ACCESS DRAWDOWN

(Funds remain invested and income taken as required).

While the option of income drawdown as an alternative to annuity purchase has been available for a number of years, the recent rule changes removed the upper limit on the amount that could be taken on an annual basis. This allows much more flexibility as to how and when income can be taken, and how income can be varied to fit around circumstances.

The big disadvantage of drawdown is ensuring that income withdrawals can be maintained for the lifetime of the recipient. One of the most important objectives for planners involved in retirement is to arrive at a level of income for a client that meets a client's needs but is also sustainable.

If large withdrawals are taken from the outset, then there is a real possibility that the fund will be depleted during lifetime. In countries such as Australia and the USA, that have had pension income flexibility for a number of years, this has proved a real issue and there have been calls to introduce more safeguards to prevent people from running out of money.

- ✓ Complete choice as to how income can be taken.
- ✓ Able to pass on remainder of fund to beneficiaries.
- ✗ Income is not guaranteed and can run out during lifetime.

EXAMPLE

Dave is 56 and requires £15,000 per annum to meet his living expenses. He decides to work part time and receives an annual salary of £5,000, and takes £10,000 per annum from his pension via flexi-access drawdown.

At 60, he decides to give up work entirely and so increases his annual withdrawals to £15,000 to meet his living expenses, but at 65 he is entitled to a state pension of £8,000 per annum and so reduces his pension income to £7,000 per annum.

TIP NUMBER 2

For those that do not need their tax free lump sum all in one go, this can be taken on a piecemeal basis over a period of time. For example, let's say we are starting with a pension pot of £100,000. You could take the full 25% tax free cash (£25,000) all in one go, however that would be the end of the available tax free cash.

On the other hand, you could choose to collect £5,000 of tax free cash and leave the remaining fund invested to grow. If the remaining pot were to grow by 25% over the coming years, the amount of tax free cash that could be taken would be £25,000 again! This process can be repeated many times over.

UNCRYSTALLISED FUNDS PENSION LUMP SUM

(Entire fund taken as a single lump sum or series of lump sums).

This is the only truly new option available to people to take their pension benefits, but it is also the most extreme. It allows the entire pension fund to be taken as a lump sum – 25% of the payment is tax free, but the remainder of the fund is treated as earned income, and when added to other income in the same tax year can result in significant tax charges.

While there are circumstances where the payment of a single lump sum can be beneficial, it is almost certainly the case that payments spread over a number of tax years will increase the amount received after tax.

Many people who choose this option are looking to reinvest the proceeds to generate a better perceived return than what they are getting from their pension. However, unless the new investment has the same or better tax advantages as a pension, it is unlikely to achieve a higher return after taking into account charges and tax.

The current Government are looking to make more properties available for first time buyers and have announced a number of measures to make buy to let properties less attractive to landlords. The 2015 Budget limited the amount of tax relief on mortgage interest payments to 20% from April 2017, which impacted higher rate taxpayers with relatively large mortgages on their buy to let properties.

The recent Autumn Statement announced that buy to let residential properties would incur an additional 3% Stamp Duty Land Tax (SDLT) on top of the existing rates, and from April 2019 any payment of Capital Gains Tax on the disposal of buy to let residential property will need to be made within 30 days (currently anything between 10 and 22 months).

✓ Ability to take the entire fund as a lump sum or possibly as a series of lump sums.

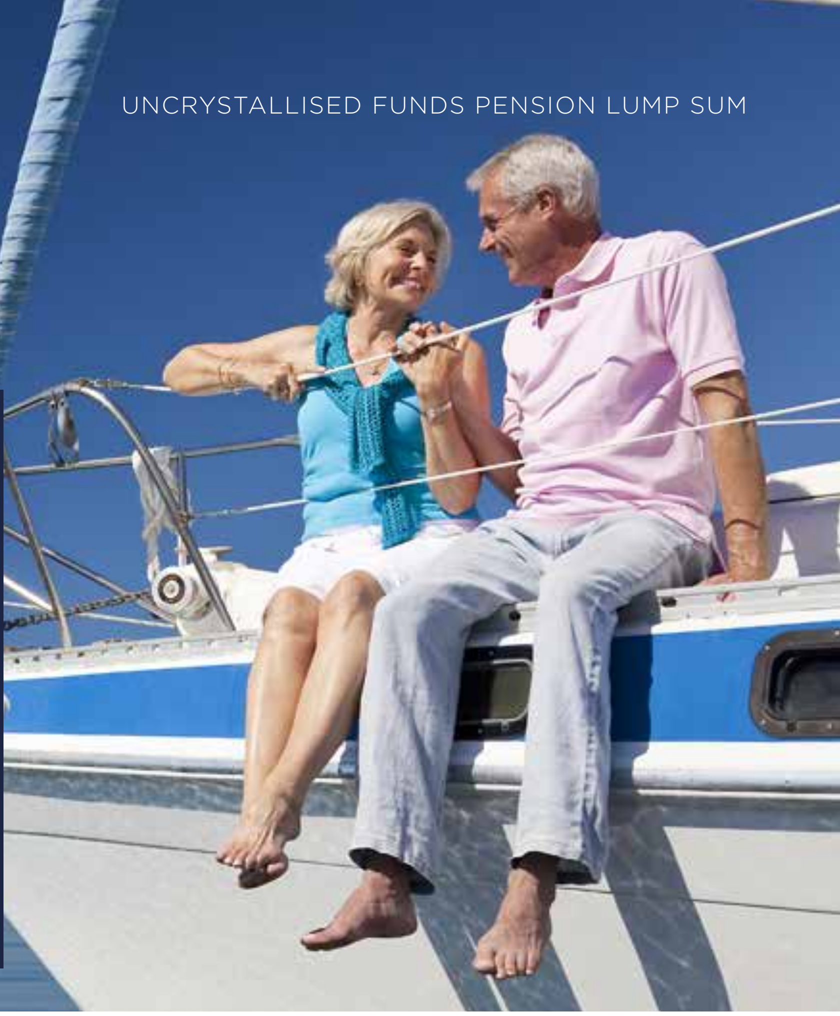
✗ Can generate an unexpected tax charge for the unwary.

✗ Pension cannot provide an income in retirement.

✗ If the fund is reinvested, it may increase liability to Income Tax, Capital Gains Tax and Inheritance Tax in the future.

TIP NUMBER 3

One of the rules of successful investing is to avoid selling assets when their market value is depressed, and during periods of stockmarket volatility the payment of large income amounts can severely damage the ability of the pot to provide income for life. It is highly recommended that anybody using flexi-access drawdown retains sufficient cash within the pension pot to fund at least 12 months of withdrawals in order to prevent the sale of assets at inopportune times.



EXAMPLE

Ronald and Robert are twin brothers who both have pension funds of £200,000 and no other income. Both take the maximum tax free lump sum and Robert elects to take an annual income that is below the income tax personal allowance.

Ronald decides to use his pension fund to purchase a buy to let property and withdraws the whole fund at once. The below table illustrates some of the potential differences between the tax treatments of both options.

	RONALD	ROBERT
Tax on withdrawals	Tiered up to 45%	No tax as income taken below personal allowance
Tax on asset purchase	Stamp Duty Land Tax of between 0-12%. Additional 3% charge from April 2016	No tax on asset purchases within a pension plan
Tax on income stream	Rental income taxed at marginal rate of between 0–45%	No tax on income received in a pension plan
Tax on pension fund / property growth	Capital Gains Tax at 18% or 28%, £12,300 annual exemption to be set against gains	No tax on fund growth within the pension plan
Tax position at death	Buy to let property will form part of the estate and be charged Inheritance Tax of up to 40%	No tax if pension scheme member passes away before age 75. Beneficiary will pay marginal rate if death occurs over age 75

DON'T FORGET THE STATE PENSION

The state pension has undergone a number of seismic changes over the last twenty years or so, and it is unsurprising that the majority of people have little idea of the pension they will receive from the Government.

The basic state pension currently for a single person is £137.60 per week and is dependent on national insurance contributions made during an individual's working life. For those who have been employed (as opposed to self employed), they may be entitled to an additional state pension which is determined by the amount of national insurance contributions paid.

To remove the complexity of the current system, the basic and additional state pensions will be replaced by a single flat rate pension scheme for those reaching state pension age from 6th April 2016, and this is currently £179.60 per week. However, this is reliant on an individual making full rate national insurance contributions for at least 35 years and having never contracted out of the additional state pension during their lifetime. According to a freedom of information request by Hargreaves Lansdown, less than half of the 3.5 million retirees between 2016 to 2020 should expect to receive the full flat rate pension.

Many regard the state pension as an irrelevance, but a look at the numbers highlights just how valuable a benefit the state pension can be. For those who will receive the full flat rate pension in 2016, this will provide them with an income of approximatley £8,296 per annum. This income is payable for life and will increase each year by the higher of the increase in earnings, the increase in inflation or 2.5%.

Finally, one point about the state pension that is often overlooked is that while it will always be paid gross, it is still regarded as taxable income. This means that the payment of the state pension can increase the tax payable on other sources of income.

TIP NUMBER 4

To put this into context, a 65 year old man would need a fund of £246,500, after the payment of tax free cash, to provide a single life annuity of £7,873.32 per annum with RPI escalation using standard annuity rates. (Source : Assureweb).

EXAMPLE

Bert is receiving a state pension of £7,600 per annum plus a private pension of £8,000, giving him a total taxable income of £15,600. As a basic rate taxpayer, he will have to pay £1,000 tax on this income which will be deducted entirely from his private pension (if the income was from two private pensions, the tax would be divided between the two in proportion).

OTHER INVESTMENTS

While pensions have traditionally been the primary source of income for those in retirement, it is becoming more and more common for other sources of income to be used to supplement retirement income.

ISAs have been with us in one guise or another for over twenty years, and research from The Telegraph in March 2015 suggests that there could be up to 200 investors in the UK who have £1 million or more in ISAs. The advantage of using an ISA for income needs is that this will be tax free compared to pension income which is taxable – for a basic, higher or additional rate taxpayer, this could be a significant boost to their available income.

Other sources of tax free income include dividends from Venture Capital Trusts (VCTs) and National Savings & Investment Certificates (not currently available for new investors).

Income from investments such as buy to let properties, dividends for direct shareholdings and savings are all potentially subject to tax. It is important that an investor is aware of the way that income from different sources is taxed to ensure that tax is not paid unnecessarily.

- ✓ Some investments can receive tax free income.
- ✓ Could benefit from better income tax treatment than earned/pension income.
- ✗ May have less favourable tax treatment than pensions for Capital Gains and Inheritance Tax.

TIP NUMBER 5

While it has normally been the case that pension funds are accessed as soon as an individual retires, for those with other investments it may be worth using these first before touching the pension funds. Any gains made within a pension fund are free from Capital Gains Tax, and pensions are almost always exempt from Inheritance Tax.

By comparison, an ISA doesn't generate any taxable gains during lifetime but they are part of a person's estate on death and could be subject to 40% tax. Therefore, for those with ISAs and pensions who are concerned about Inheritance Tax, it may well be more beneficial to spend their ISA investments before accessing their pensions.

"IT'S ABOUT THE MEANING, NOT THE MONEY. IF MY INVESTING IS NOT REALLY DEEPLY TIED TO WHAT I THINK IS MOST IMPORTANT IN MY LIFE THEN THE ASSET ALLOCATION, THE ESTATE PLAN, THE RETIREMENT PLAN MIGHT AS WELL BE THROWN OUT THE WINDOW."

GEORGE KINDER

THE RISKS OF LIVING TOO LONG

Perhaps the greatest risk with planning for income in retirement is that the majority of people underestimate how long they will need income for.

On average, male life expectancy has increased by three years for every decade since 1911, and while there is evidence that this rate is slowing down, it is clear that people approaching retirement will almost certainly live longer than their parents.

According to the Office of National Statistics, a 65 year old man retiring today can expect to live to 87 on average. However, he has a 1 in 4 chance of living until 94, and a 1 in 10 chance of making it until 99.

(Source: ONS – How long will my pension last?)

BEWARE THE TAXMAN – UNDERSTANDING HOW INCOME IS TAXED

A good understanding as to how income is taxed is critical to ensure that you retain as much of the income you receive as possible.

Taxable income from earnings, pensions, savings and investments are subject to income tax and the tax bands for the 2021/22 tax year are as follows:

- First £12,570 of income is payable tax free (personal allowance)
- Next £37,700 subject to basic rate tax (20% for earned and savings income)
- Income between £50,270 and £150,000 subject to higher rate tax (40% for earned and savings income)
- Any income in excess of £150,000 is liable to additional rate tax (45% for most income types)

There are a number of ploys to avoid this trap such as replacing taxed income with income from other sources such as ISAs which are tax free, or by using "tax reducers" such as pension contributions and Gift Aid payments. For those who are married or in a Civil Partnership, transferring income producing assets to a non-taxpaying spouse can save your personal allowance and use theirs more effectively.

TIP NUMBER 6

This clearly highlights the need to take a conservative approach to drawing income in the early years of retirement. Historically, many people have relied on the '4% rule' (where you only draw out 4% of your pension fund each year) to help them manage withdrawals. However, recent research has suggested that even a 4% withdrawal may not be sustainable for many people and that, in the UK, a figure closer to 3% might be more sensible. What is clear is that a personalised approach will need to be taken to income withdrawals, rather than trying to apply a 'one-size-fits-all' rule.

TIP NUMBER 7

An important "trap" to avoid is where income exceeds £100,000 per annum – above this limit, the amount of income that can be received tax free is reduced by £1 for every £2 above this figure. This means that if income is in excess of £125,140 per annum, the personal allowance is lost entirely.

This can also be an effective strategy for those who are higher rate taxpayers and have a spouse who is a basic rate taxpayer (the amount of tax paid on the transferred income can be halved in many cases) - for a married couple who live together, there is no Capital Gains Tax liability on this transfer of assets.

When considering any transfer of assets between spouses, it is important to consider the order in which income is taxed – income from earnings, pensions and rental income is always taxed first, followed by savings income and finally dividend income. For an individual who receives income from multiple sources and which crosses the tax band thresholds, the dividend income will generally incur the highest level of tax.

From April 2021, the first £5,000 of savings income is taxable at 0% but only if income from other sources was not in excess of £17,570 i.e. the personal allowance plus £5,000. April 2016 saw a further benefit with the introduction of a personal savings allowance where the first £1,000 of savings income was tax free (reduced to £500 for higher rate taxpayers and £0 for additional rate taxpayers).

This means that banks and building societies will no longer deduct basic rate tax at source from any savings income received, and those who receive savings income in excess of the allowance will need to complete a self-assessment and pay tax on the excess.

Again, the reallocation of savings income between spouses could result in a significant tax saving – a higher rate taxpayer would only have an allowance of £500, but if income was reallocated between two people, they could both benefit from an allowance of £1,000.

During the 21/22 tax year, there is a £2,000 dividend allowance, meaning the first £2,000 of dividend income is tax free.

This potentially means that £2,000 of dividend income can be received with no tax liability on top of the aforementioned allowances.

Again, the proposed changes highlight the importance of receiving income from multiple sources, and the tax savings that can be made if investments are arranged correctly.

EXAMPLE

Jane receives an annual pension of £21,000 in the 2021/22 tax year and will pay £1,686 (20% on the balance over the personal allowance of £12,570) tax on this.
Hilary receives the same level of income but has £12,570 as a pension, £5,000 as savings income and £2,000 as dividend income on which she pays no tax. She also has £1,430 of dividend income on top of this on which she pays only 7.5% tax of £107.25.

INCOME EROSION

Given that retirement for many will last 20 or 30 years, it is important to ensure that the purchasing power of income over a number of years is not weakened due to inflation.

Taking into account the Government's inflation target of 2% per annum, the purchasing power of a fixed income will be reduced by a third in twenty years time – or to put it another way, a fixed income of £1,000 per annum would only be able to buy approximately £650 worth of goods in 20 years time.

One of the benefits of the state pension is that it is guaranteed to increase in line with inflation at the very least. It is possible to use a pension fund to buy an annuity that increases in line with inflation, but this can severely impact the amount of initial income received. For example, using the same parameters as those in our annuity example earlier, a £100,000 fund (after tax free cash has been paid) for a 65 year male with an annuity that increases by the Retail Prices Index would only receive £3,285 (Source: Assureweb) (45% less than the initial income received on a level basis).

The merits of an index linked annuity compared to a level annuity can be quite difficult to quantify as the future date of death of the annuitant is unknown. However, using an assumed rate of 2.5% per annum for RPI, it would take 25 years for the income from an index linked annuity to match the level annuity.

In a time of historically low interest rates, the returns on deposit based investments have been well below inflation for a number of years, and while these are considered to be secure compared to equities, investors should not be blinded to the fact that the value of their cash deposits are being reduced in real terms if they are not receiving returns after tax and charges that match or exceed inflation.

THE MODERN APPROACH TO RETIREMENT INCOME TODAY

The announcement of the pension freedom legislation in March 2014 took everyone by surprise (even advisers), but several years into the new regime, a consensus approach is beginning to emerge as to the best way to structure income in retirement.

As we have seen, the new rules allow full flexibility with pension benefits but the big disadvantage is that the fund could be depleted during lifetime. It can be useful to conduct a cashflow modelling analysis to quantify what level of income is required to meet your expenditure requirements in retirement and structure your income as follows:

- A combination of state pensions, defined benefit payments or an annuity of some description to ensure that basic living expenses are covered by income from guaranteed sources.
- A cash holding to cover non-essential expenditure for a minimum of 12 months – this can take the form of a deposit account or cash held within an investment. This allows other investments time to grow and prevents them from being encashed when market values are low.
- The use of pension and non-pension investments to replenish the cash holdings when appropriate to maintain income for future withdrawals.

CONCLUSION

Decisions made at retirement can have a massive impact on the level of income that is received, and as some of these decisions are irreversible, it is very important that retirees fully consider all of the many options available to them before committing to a course of action.

FREE RETIREMENT AND INHERITANCE TAX PLANNING SEMINARS

Buckingham Gate Chartered Financial Planners hold regular Inheritance Tax Planning seminars in Central London. The seminars are **FREE** to attend, but places are limited.

If you would like to reserve places please email us at **events@buckinghamgate.co.uk** or call us on **020 3478 2160**

THE SEMINARS WILL COVER:

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- What level of income can you expect in retirement?
- Ways to reduce the inheritance tax liability on your estate.
- How to update your will to save thousands in inheritance tax.
- How to protect your assets for your loved ones.

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