WEALTH MANAGEMENT ALERT

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LIGHTHOUSECARRWOOD

Using tax-free cash in drawdown to minimise income tax

With drawdown – taking regular amounts of money from a pension – increasingly popular, we look at how clients may be able to minimise the amount of income tax they pay by taking their 25% tax-free amount gradually, rather than as a lump sum.

Many people don't realize that they don't have to take their 25% tax-free cash as a lump sum when they access their pension. They can take it as part of their regular income payments, and for some people this might be more tax-effective.

One can understand the attraction of having a tax-free lump sum to spend as one wishes – whether for the holiday of a lifetime, a new car or, perhaps more sensibly, to pay off the mortgage and any other debt.

Some clients could be better off

However, some clients could ultimately be better off if, instead of taking the tax-free cash all at once, they take the first 25% of each income payment from their pension tax-free. This could be particularly beneficial for clients who have taxable income from other sources, for instance part-time work, when they have "retired".

The potential to increase the amount of tax-free cash

Clients still get the benefits of the tax-free cash, but spread over a longer period, with the advantage that more of their pension fund remains invested in the tax-sheltered pension, with the potential for additional growth for longer.

Not only does this enable some clients to minimise the income tax they pay over the longer term, but as the funds remain invested and have the potential to grow, it also gives the possibility of ultimately receiving more cash tax-free.

Valuable way of managing taxable income

Jon's example (right) demonstrates the perfect tax position. He gets the income he needs without paying any income tax, yet he makes minimum use of his tax-free cash. This way of managing tax can be a valuable tool for clients whatever their income needs, as we show in Kate's example (see next page).

It can be particularly useful when a client's needs change, for instance as they move gradually into retirement by reducing hours (like Kate) or if they stop work entirely before they receive their state pension.

One of the other key benefits of taking the tax free cash gradually is that a client will retain more of their pension fund in the uncrystallised part of their pension fund. The advantage of this is that they will potentially increase the total amount of tax-free cash that they receive from their pension fund. Of course, this needs to balance with the current income tax position of the client.

Continued on next page

Using the personal allowance

Jon decided to take early retirement when he turned 60. He receives a defined benefits pension of £2,850 a year. He also has defined contribution benefits worth £90,000. He needs to supplement his defined benefits income until he starts to receive his state pension. He hopes to work part time at some point, once he has had a bit of a break. He currently needs an income of just under £15,000 a year.

In the first year of his retirement Jon withdraws £12,000 from his defined contribution pension, made up of £3,000 tax-free cash and £9,000 taxable income. The £9,000 plus his defined benefit pension income of £2,850 comes within his £11,850 personal allowance (2018/19). As he is taking the balance as tax-free cash, he has no income tax to pay in this tax year.

If Jon had taken the full tax-free cash, or even just the £12,000 needed to make up his income, he would have 'wasted' his personal allowance and used up his tax-free cash unnecessarily.

If he had taken all the tax-free cash, placed it on deposit and taken the extra income directly from his pension, he would have paid £600 income tax unnecessarily (£3,000 X 20%).

Jon can continue to take money out of his pension each year and vary the amount he withdraws to take into account tax bands and any income he receives in due course from part-time work.

If a client's full pension is crystalised and they take all their tax-free cash in one payment, no further tax-free cash will become available (unless they make further contributions). In contrast, taking the tax-free cash gradually gives the uncrystallised part of the pension the potential to grow and generate an additional entitlement to tax-free cash.

When could a uncrystallised funds pension lump sum be appropriate?

A uncrystallised funds pension lump sum (UFPLS) can also be used to provide income through a combination of tax-free cash and taxable income. If the client wants to receive 25% tax-free cash and 75% income then UFPLS payments can achieve the same outcome as drawdown.

However, the UFPLS doesn't provide any flexibility and there is no option to take tax-free cash only or other combinations of tax-free cash and taxable income.

Remember to check against the Lifetime Allowance

The Lifetime Allowance (LTA) also needs to be considered for clients with substantial pension funds. The LTA is currently £1.03m (tax year 2018/19). Crystallising all or part of a pension fund means that the whole fund will be tested against the Lifetime Allowance and if value exceeds £1.03m, the excess will be taxed at 55%. Clients who are approaching or have already exceeded the Lifetime Allowance should take independent financial advice before accessing their pension.

We are experienced in helping individuals choose a suitable way of accessing their pension, in light of their current and likely future income needs, and their current and likely future tax position. We would be happy to work with you to advise your clients on accessing their pensions in the way that suits you best.

To refer clients to us or to discuss how we could work together, email Phil Mason, Business Development Director, LighthouseCarrwood Limited.
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Tax treatment depends on the individual circumstances of each client and may be subject to change in future. Tax advice which contains no investment element is not regulated by the Financial Conduct Authority. The value of your pension investments and income available can go down as well as up, so you could get back less than you invested. A pension is a long term investment and taking income or withdrawals in excess of fund growth may result in the fund running out quicker than expected. Inflation will reduce how much your income is worth over the years. Your eventual income may depend upon the size of the fund at retirement, future interest rates and tax legislation.

Optimising tax on larger pension pots

Kate is 57 and wants to work less. She is reducing her hours, which means that her £51,350 a year income will fall by £10,000. However, her expenditure will stay the same for the next few years whilst she supports her children through university. Fortunately she has a substantial defined contribution pension fund – its current value is £700,000. She wants to use this fund to provide the additional £10,000 a year income she now needs to find.

The £10,000 Kate is looking to replace actually gave her a net income payment to her of £7,000, once she had paid £3,000 income tax on it. With the higher rate band for 2018/19 at £46,350, £5,000 was taxed at 20% and £5,000 at 40%. She now has a number of options for taking the income she needs from her drawdown plan.

She could "crystalise" £28,000, of which she could then withdraw £7,000 (25%) tax-free, and leave the rest invested. Although this would be tax-efficient for the current tax year, Kate would be using her tax-free cash faster than necessary and would simply be deferring paying the income tax due on the remainder of the £28,000.

Another option would be to crystalise £8,580 a year, of which £2,145 would be tax-free cash and £6,435 subject to income tax. £5,000 of that would be taxed at 20% and £1,435 at 40%, giving a total of £1,574. This leaves Kate with £7,000 net, just over the amount she needs. Whilst this uses the least tax-free cash, it also means that she would pay higher rate tax on part of the withdrawals

Finally, she could crystallise £12,000, pay out £3,000 in tax-free cash and £5,000 in income and leave £4,000 invested in the crystallised fund. The £5,000 income would use up the rest of her basic rate band and would be taxed at 20%, netting her £4,000. This together with the £3,000 tax-free cash provides Kate with the net income of £7,000 she is seeking. This option balances the use of tax free cash whilst ensuring the taxable withdrawal remains within her basic rate band.

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