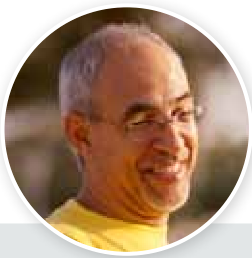
Case study

Multiple tax wrappers in retirement income planning



This client could reduce his annual tax bill by as much as £10,000, and leave an increased legacy, just by making simple tweaks to the way he spends his retirement savings.

The client

John is aged 60 and divorced. He has two adult children who are both married and have young families. John is planning to retire very soon. He has the following savings, totalling £1.05m:

- A **SIPP** worth £500,000.
- An **ISA** worth £70,000.
- A portfolio of **unit trusts** worth £160,000, with capital gains of £80,000. The portfolio generates a net dividend of 1% (£1,600) per year, which is reinvested.
- An **offshore bond** (1,000 segments) purchased 10 years ago for £200,000, which is currently valued at £320,000 (no withdrawals taken).

John also owns the family home, which is worth £700,000.

John's objective

John estimates that he will need income in the region of £60,000 a year (after tax) to maintain his lifestyle and help out with his grandchildren. He would like to preserve as much of his wealth as possible so that it can be passed on efficiently to the family. He is concerned about inheritance tax, but feels that it is too soon to consider giving away assets.

There are many ways in which John can achieve his main objective of a retirement income of £60,000 a year. Some will be clearly more tax-efficient than others, and the less tax John has to pay the less he will have to withdraw to give him his target income. This means that his funds could last longer in retirement.

To do this, John needs to use the tax allowances that are available, and avoid higher rates of tax whenever possible.

Option 1: old world retirement

Annual income after tax: £60,000

Annual tax bill: £10,461

Traditionally, retirement income has come from pension savings. To achieve the target disposable income of £60,000, John would need to withdraw £68,861 from his SIPP every year, on top of the dividends he already receives. Of the money he takes from the SIPP, £17,215 would be tax-free.

If John topped up with dividend income, this would all be subject to higher rate tax, as the SIPP income is 'earned income' and is taxed before dividend income.

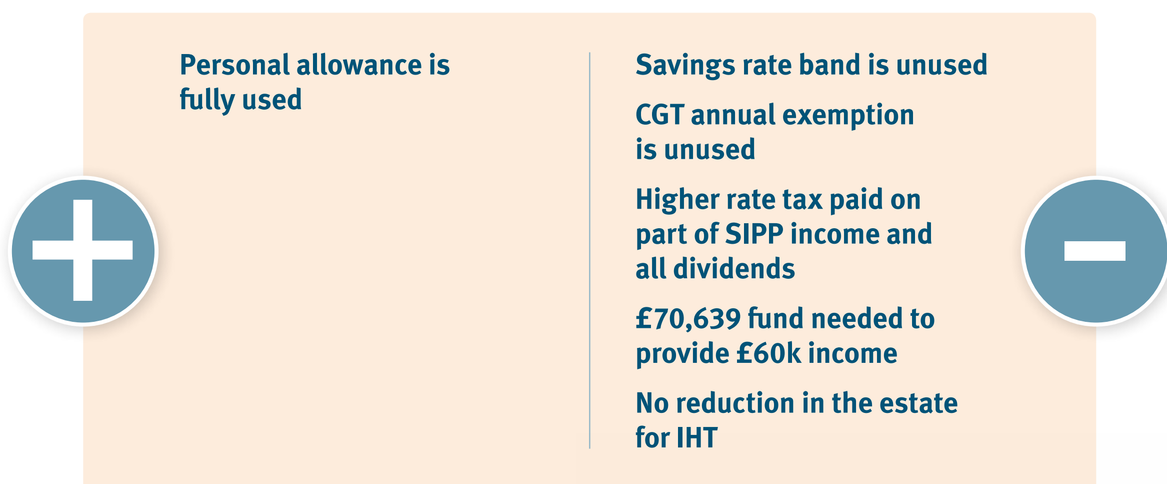
In this option, John uses his personal allowance fully, but he is taking too much pension income to use his savings rate band. He doesn't use his CGT allowance at all.

Legacy

If John died in the first year of retirement, his legacy (excluding the family home) would be £761,139.

All the non-pension assets above the available nil rate band would be subject to IHT at 40%, meaning only 60% of the actual value will be inherited by the family.

John's SIPP is not included in his estate for IHT. If John died before the age of 75, his SIPP would be available for his beneficiaries tax-free. But by taking income from his SIPP, he is reducing the amount that can be passed on in this way.



Option 2: new world retirement

Annual income after tax: £60,000.

Annual tax bill: £0.

At age 60, John is in control. If he considers all his savings when deciding how to support his future needs in retirement then he can take advantage of considerable tax-free allowances.

John could crystallise gains within his offshore bond. Taking £40,000 (by surrendering 125 segments) would give a chargeable gain of £15,000. While John is potentially a non-taxpayer (as he is not yet entitled to his state pension and does not have to draw an income from his SIPP), he could take full advantage of the fact that bond gains are treated as savings income. The gain would fall nicely within the new extended tax-free savings rate band.

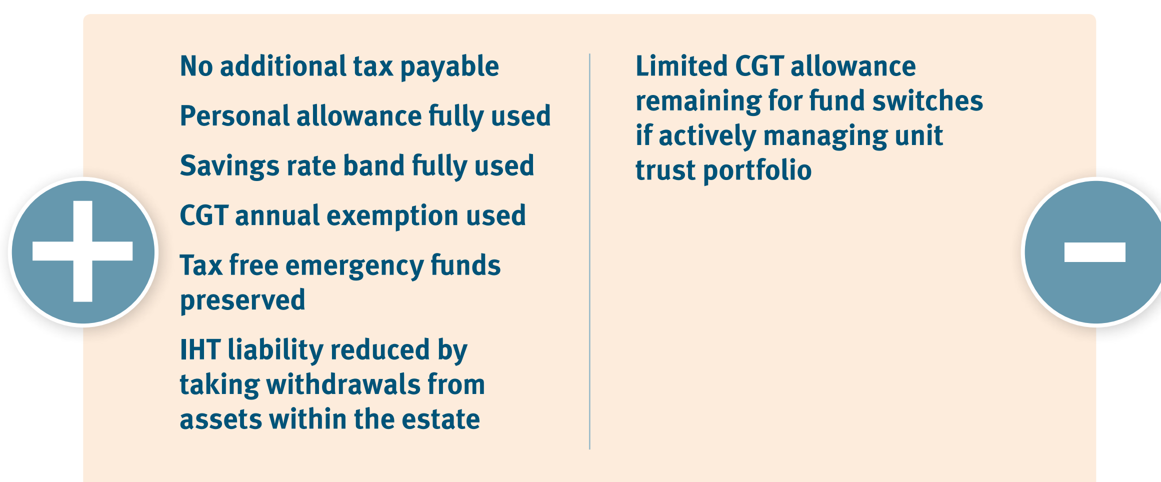
That leaves John wanting another £20,000 of income each year. This could be made up of dividends and a disposal of some of his unit trust portfolio. Assuming the gains are distributed evenly across the portfolio, he could sell units for £18,586 and the capital gain of £9,293 would be within his £11,100 annual exemption and free of tax. And, of course, there will be no further tax to pay on the net dividend received of £1,414 (reduced by the units sold), as the 10% non-reclaimable tax credit that comes with it will satisfy his liability.

In this way, John has achieved the £60,000 he requires per year without paying any more tax. He has also preserved the tax-free funds in his ISA. Taking withdrawals from the bond and the portfolio of unit trusts reduces the amount exposed to IHT and also leaves the SIPP intact, which can be paid out tax free should he die before age 75.

Legacy

If John died in the first year of retirement, his legacy (excluding the family home) would be £794, 848.

The SIPP fund remains tax-free before age 75. The proportion of his estate that is subject to IHT is reduced, as his income needs are met from capital.



Option 3: tax-free income - at a cost

Annual income after tax: £60,000.

Annual tax bill: £0.

John could draw his income from his tax-free cash and ISA for at least 3 years. He pays no income tax at all while he has funds left in tax-free cash and his ISA. However, this wastes his £10,600 personal allowance, his £5,000 savings rate band and his £11,100 CGT annual exemption.

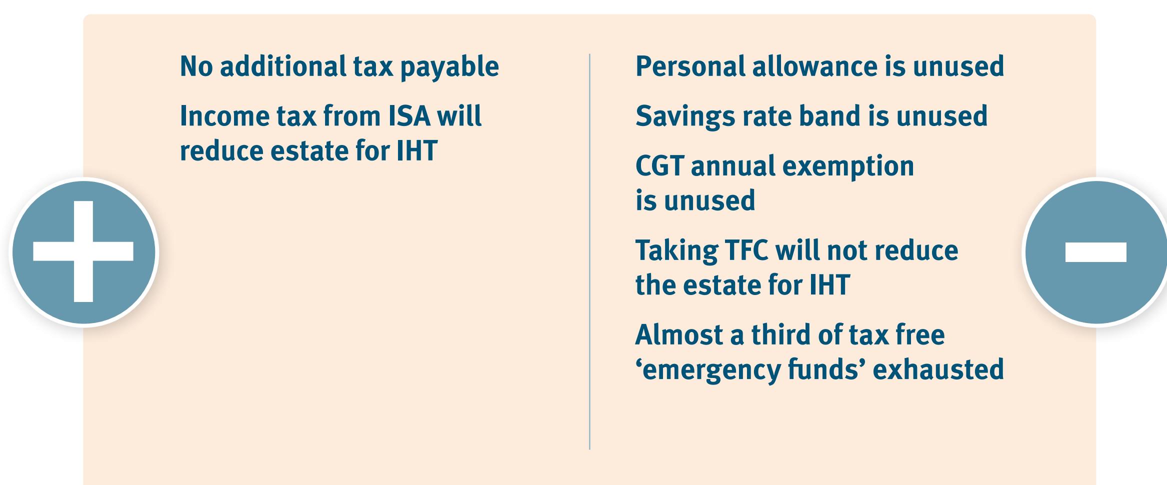
In each year that he took income in this way, he would only be using around a third of his total tax-free sources. He would also be reducing his tax-efficient 'emergency' funds.

Legacy

If John died in the first year of retirement, his legacy (excluding the family home) would be £771,200 (assuming he took all additional income from SIPP tax-free cash).

Taking and spending tax-free withdrawals from his ISA would reduce the proportion of his estate that was subject to IHT at 40%.

John's SIPP is not included in his estate for IHT. If he died before age 75, his remaining SIPP funds will be available tax-free for his beneficiaries. So if he takes cash from his SIPP, he is potentially reducing what can be passed on to family members tax-free.



Summary

It should be clear to John that, by using his tax allowances and carefully choosing where to take his income from, he can take any profits from his taxable savings without paying any tax at all. This potentially increases the longevity of his total savings. And could leave more for his family too.