

## **CASE STUDY NUMBER 4: INCOME DRAWDOWN PLANNER OF THE YEAR.**

**Bob and Jean COLLEY.**

**Dated: 6<sup>th</sup> July 2009.**

### **Introduction:**

This report addresses the issues arising from your wish to know how best to meet your future income requirements commensurate to your attitude to investment risk and your concerns about becoming a burden on your family. The purpose of the report is to help you plan, and thus achieve and maintain, your lifestyle within agreed times and budgets. As I do not have full details of all your arrangements, such as your ISA holdings and capital gains tax position, this report is in outline only. Confirmation of facts, details and agreement concerning assumptions about your finances and future growth and returns, are required before the report's recommendations can be actioned.

The main assumptions regarding future investment growth (returns and yields) and inflation used to produce a "life time cash flow" calculation (not shown due to the requirement for brevity) are very important and need regular updating. Once actioned, the plan will need updating, reviewing and adjustments following regular (no less than yearly) reviews.

### **Current Situation:**

You are both aged 63. Jean has already reached her state pension age and Bob will do so within the next 2 years. Having bought your "dream" home and joined the local golf and country club, you now wish and expect a long retirement during which you fully intend to spend your savings playing golf, travelling and generally enjoying the lifestyle you plan without financial worries.

### **Aims, Objectives, Issues and Problems:**

Objectives are defined as future intentions, capable of being "quantified" and "qualified" i.e. a set amount of money over a given period. A "lifetime cash flow" calculation will show how such objectives may (or may not) be met. "Aims" are less specific intentions and greatly help in deciding and refining potential options as to what to do. It is therefore important to establish the aims and objectives as well as the issues and problems in setting out a recommended plan of action. Thus:

- You presently spend £60,000 per year and wish to be able to afford to continue to do so in "real" terms for the rest of your life. You may take less holidays later in life but may also require greater help (for example with the garden) but the assumption for the present is to plan to secure £60,000 spendable "income" per year for life.
- While you do not specifically aim to assist your children or grandchildren further financial, you have made gifts to your children in the past that are now clear of your estate for inheritance tax purposes. Additionally, your grandchildren stand as the beneficiaries of your wills. However, I assume that if your arrangements can be made so as to cost effectively reduce your inheritance tax liability then you will wish to do so preferring to benefit your family (or charity) rather than HM Treasury.
- You are concerned not to be a burden to your family in the future; I assume by this you mean a "financial" burden but other areas – such as making decisions as to your welfare later in life – may be included.
- You dislike the idea of buying an annuity but have not stated why. You also have concerns regarding Alternative Secured Pensions (ASP, called "drawdown") because of the tax impact on death after age 75.

**Your "Net Worth", Income Tax and Income and Expenditure Situation:**

- You have a life assurance policy that provides £600,000 on "second" death to a trust for the grandchildren. I comment about this life assurance policy further on in this report.
- Bob's pensions are valued at £720,000; Jean's are worth £370,000. These plans are currently invested in gilts (75%) with the balance in cash. Part of the fund is designated "protected rights."
- You jointly hold £200,000 on deposit earning 2% gross at present.
- You each have £20,000 in premium bonds. I assume any winnings are added to these holdings and are not utilised as income. Your premium bonds can be taken as forming an emergency reserve fund of £40,000.
- Bob has unit trusts held in UK gilt funds (£150,000), worldwide gilts (£75,000) and cash (£25,000) – a total of £250,000.
- Jean has unit trusts of £255,000 split between 4 UK gilt funds.

**Main Assumptions:**

- You are/will take your full state pension as entitled.
- You are relatively experienced investors and are successful in actively managing your portfolios. Although you switched your unit trust holdings in 2007 it is not possible for me

to calculate past or current Capital Gains liability – an important potential liability to establish before executing any recommendations. I assume the unit trusts are not all held in ISA's as the original sums invested would have exceed the ISA contribution allowances, although it would be unusual for experienced investors such as yourselves not to have used any ISA allowances.

- I assume you will continue to manage your investments as successfully as you have in the past and will utilise ISA for income and have a bias towards capital growth outside the ISA, thus being effective and use both income and capital gains tax personal allowances. You will continue to manage these assets and your present cash holding (presently high because of the property purchase) will reflect your "risk" tolerance. This means that if 55% is held in shares, of a total of £705,000 (Bob's £250,000, Jean's £255,000 and cash of £200,000) £387,750 will be held equally (i.e. **£193,875 each**) between you in unit trusts.
- I assume a yield/growth of 4% above inflation on your unit trusts and 1% "real" return on the balance of gilt and deposit funds (**£158,625 each**). These figures give an income of **£7,755** (on the unit trusts) plus **£1,586.25** (from gilt and deposits) that may be taken by each of you, free of tax through the ISA and the CGT personal allowance, from your non pension holdings without reducing their real (inflation proofed) values. This represents a "real" combined overall net return of about 2.2% - a figure that matches your risk profile, protects the value of your non pension investments and permits a significant reserve on deposit that could be used should there be a period of poor equity investment return. Rebalancing of the portfolio at the regular reviews or possibly more frequently is important.
- You were both employed and your pension schemes were, in the main, contracted out of SERPS – now held as "protected rights." Jean already receives the basic state pension and Bob has this to look forward to and probably some additional Graduated Pension, SERPS and Second State Pension but I am assuming that your pension from the state will be £152.30 per week for Bob (as a married man) and £95.25 for Jean. These figures should be confirmed with Bob obtaining a state pension forecast.

#### **Annuity Purchase Option:**

Whilst you do not wish to use your funds to purchase an annuity, it is worthwhile considering this option if only to establish a "benchmark". If a widows/ers pension were to be purchased, providing a 3% yearly increase in income, then Bob's fund would provide a gross income of about **£31,032** (£34,704 with no widows pension) and Jean's **£15,355** (£16,391 with no widowers benefit.) Net of basic rate tax this would produce more than sufficient to meet the shortfall in income given the assumed "income" from your combined unit trust holdings (£7,755 x 2), state pensions

(Bob £7920 in 18 months time and Jean currently £4,953) **and** your target of £60,000 net **but:**

- You would lose control of the capital
- Your tax free cash option would not be utilised
- You would lose your personal tax age allowance
- If the widow/ers option were used then one of you would certainly not obtain value from this!

I therefore concur that the annuity option is inefficient (which possibly explains your dislike of this option) but annuity purchase does offer you income security. You are not risk averse but should measure decisions against *your* security and *your* goals – my recommendations retain flexibility and efficiency in providing your target income but these advantages, plus other gains such as inheritance tax planning, come at a cost of some small risk to your own security. Therefore, if you do not purchase an annuity now you are, by default, accepting some risk to your income security. The presumption is that you do so because of the potential gains in flexibility, tax efficiency and the inheritance tax advantages for the family i.e. there should be a reward or reason for the risk taken and such income tax and/or inheritance tax savings against your continued financial security are matters for consideration at each future review.

### **Inheritance Tax:**

You have already taken steps to both mitigate and provide for inheritance tax. Allowing £100,000 for personal possessions (jewellery, the new cars etc) your present inheritance tax liability is approximately £400,000. This leaves a net estate of some £1,247,000 plus the value of the pensions if “unvested” (not yet drawn upon) where the pension policy is subject to a suitable instruction to the insurance company (a “form of nomination.”)

Had you both died yesterday, your grandchildren would have inherited the net estate of £1,247,000, plus the pensions of £1,090,000 plus the life policy of £600,000 – a total of **£2,937,000**. Clearly, funds used to purchase an annuity are lost to the family immediately. “Phased drawdown” (see below) is more inheritance tax efficient than annuity purchase, although this reduces both before and (more significantly) after age 75. These significant tax-planning advantages may be fully explained in a lengthier report.

The premium for the life assurance policy is reviewed at regular intervals, possibly every 10 years or more frequently. I expect the premiums to increase substantially from £400 monthly (or the cover to reduce equally significantly) at every future review. Without specific policy details it would be wrong to put a figure on this but I recommend you cancel the life policy (after

a proper enquiry of the detail) as the policy proceeds are not required.

Instead, the premium could fund personal pensions for your grandchildren. A contribution from you of £100 per month to a pension plan for each grandchild is "grossed up" by a basic rate tax rebate to £125. The child cannot obtain these funds until age 55 (as rules stand at present) but could possibly use the projected eventual tax-free cash as a way of repaying debt (such as a mortgage). Such a scheme may be beneficial in educating/encouraging the children to think ahead and save, as you have clearly done, but would also immediately fall outside your estates as "regular expenditure." I will provide further details and specific recommendations later if you wish to pursue this.

#### **Pension Options and Recommendations for Phased Drawdown:**

This now brings me to the main purpose of this report – how best to extract the required level of income from your private pensions to meet the gap between state pension income plus investment income and your joint target of £60,000 net.

I reconfirm that you do not require the tax-free cash available from the pension funds (25% of the fund) for any capital purpose. I have calculated that the maximum income you are permitted to draw upon (120% of what is known as the Government Actuary Departments Rate) is in the region of over **£54,000** for Bob and **£26,000** for Jean. Not only is such a figure in excess of your requirement and tax inefficient but it would dangerously erode your funds and long term pension income and future financial security. Avoid this extreme.

However, you are, permitted to "phase" the taking of your pensions using the tax-free cash element to reduce income tax liability. Again, based on the financial assumptions we should discuss fully and agree, I have calculated that your pensions need to provide **£14,222** each net per year once Bob is in full receipt of his state pension at 65. The additional funding in the next few months until then is not a problem given the other resources you have.

Such a "phased" approach uses "income" taken from a combination of tax-free cash and taxable income "drawdown" from the fund. Your right at age 75, under present rules, to continue to draw the tax-free income would cease when you would take the final balance of remaining tax-free cash and possibly purchase an annuity or continue to "drawdown" under slightly different "unsecured income" rules. It is possible that the rules will change by then.

Although the projected figures for such a strategy are complex, the rate of withdrawal is less than the assumed investment return given your risk profile and intention to hold 55% of the funds in equities even though the need for regular reviews adds to costs. One advantage of this approach is that, even with £60,000 of net income from all sources between you, neither of you lose your age allowance from age 65. Furthermore, there are considerable inheritance tax advantages as much of your pension fund, split into vested and unvested segments, would fall outside of your estate if you died before the age 75.

To demonstrate how the scheme works an overall income for Bob of £14,222 in the first year may come from "segments" of pension funds of £45,694 being "vested." £11,575 (25%) is taken as spendable tax-free cash. The remaining 75% is drawn upon at the maximum GAD rate (almost certainly eroding this element) or can be used to by an annuity but will, in one way or another, produce £2,646 after tax. In this way, the required income of £14,222 attracts an income tax liability of less than £700. This is a highly efficient, albeit complex, arrangement and meets your requirements. Additionally, there may yet be major reform of the present penal tax of 82% after age 75.

#### **Recommendations and Actions:**

- We need to:
  - discuss this report, agree the assumptions and generic recommendations and arrange pensions accordingly.
  - Review and probably cancel the life assurance policy – I require written authority from you to approach the life company for details
  - we can discuss pension plans for the grandchildren if appropriate.
- I will provide
  - Bob with form BR19 to obtain a state pension forecast.
  - "forms of nomination" for your pensions when "drawdown" arrangements are completed.
  - Yearly reminders to arrange the regular reviews.
- You need to confirm details of your ISA holdings and CGT liability to me.
- It is essential you continue to rebalance portfolios regularly.

#### **Other Issues:**

In meeting your financial objectives comfortably, other issues to consider include:

- Charitable gifting of capital, reflecting your financial security; possibly setting up your own charity.
- Review wills.
- Arranging "Lasting Powers of Attorney" to cover welfare as well as financial issues.
- The Protected Rights element of your pensions present some complications but these will be accommodated within my recommendations.

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