ADVISER GUIDE

Taking income in retirement

Over their working lives, clients will typically build up an array of different types of savings and assets. These could include pension plans, ISAs, investment funds and shares, cash savings, investment bonds and property.

Once they get to retirement, clients need to decide how to access these assets, to release an income to support them in their later life.

The order in which they access their savings can be very important. They will want to pay the least amount of tax on their income, but may also want to pass any unused assets to their loved ones, either in life or on death. Their income retirement strategy should reflect all these needs and objectives.

The increase in pension wealth held by UK households, together with the introduction of pension freedoms and new rules for pension death benefits, has meant challenging any accepted wisdom on the order to take assets where pensions are accessed first, and instead devising new orders to make the most of the flexibility offered on pensions.

! Tax treatment depends on the individual circumstances of each client and may be subject to change in the future.

Allowances and zero rates of tax

It's important to understand the tax position on both income taken from assets that are taxed, and on assets that are gifted in life or passed on death. This will help to prioritise which savings are used up first and devise robust financial retirement strategies.

	Level (2020/21)	Detail
Personal allowance	£12,500	• Amount of income people can receive before paying tax. • Married couples can transfer 10% of rate to each other if neither are higher or additional rate taxpayer. • Cut by £1 for every £2 of adjusted net income over £100,000, until it is completely lost for incomes of £125,000 or more.
Savings starting rate of 0%	£5,000	• Includes interest (such as from deposit accounts, gilts, corporate bonds and fixed-interest mutual funds) and offshore bond gains. • Cannot be used for dividends. • Lost on a £1-for-£1 basis if non-savings income exceeds the personal allowance. Completely lost if non-savings income is £17,500 or more.
Personal savings allowance	£1,000, £500 or zero	• Level depends on whether individual is a basic rate taxpayer (£1,000) or a higher rate taxpayer (£500). Lost for an additional rate taxpayer. • Includes interest and offshore bond gains, but not dividend income.
Dividend tax-free allowance	£2,000	• First £2,000 of dividend income is tax free. • The remainder is taxed at 7.5% (basic rate); 32.5% (higher rate); and 38.1% (additional rate).
Capital gains tax-free allowance	£12,300	• Level of gains that are tax free. • Remainder are taxed as capital gains.

By making full use of these allowances and zero rates of tax, individuals can minimise the tax they pay on income.

Order of taxation

The order in which income is taxed is significant as it can affect the availability of certain tax-free allowances and the rates of tax payable.

1. Non-savings income – salary, self-employed profits, pension income, rent, trust income
2. Savings income, excluding dividends – interest from deposits, gilts, corporate bonds, fixed-interest mutual funds and purchased life annuities (PLAs), offshore bond gains
3. Dividend income
4. Onshore life policy gains

Taxation of assets

Pensions income

Up to 25% of the pension pot can be taken as tax-free cash and the remainder is taxed as income.

People can crystallise the full pension pot, taking the full tax-free cash, and moving the remainder to drawdown to take gradually. When deciding how much taxable income to take, they need to be aware that too large an amount may push them into a higher tax bracket, meaning more tax will be due.

Instead of crystallising in full and taking all available tax-free cash, people can choose to phase in their pension and take portions at a time: 25% of each portion is tax free; the rest taxed as income.

This gives people massive flexibility to set the right level of income to take from their pension – tax-free and/or taxable – to fit in with the allowances they have available and so minimise the tax they pay.

State pension is taxable income but is paid gross. If an individual's total taxable income – including state pension – is greater than their allowances, then they will have to pay tax on the income that exceeds their allowances.

Pensions death benefits

Any pension fund left when the member dies can be passed to beneficiaries. Members can nominate who they want to receive the pension money, however the scheme administrator decides who the beneficiary is.

If the member is younger than 75 when they die, then the beneficiary will not pay Income Tax on any pension funds they take, either as a lump sum or as an income. If the member was over age 75 – and the majority of people are over 75 at death – then the beneficiary will have to pay Income Tax on the pension funds they receive.

Inheritance Tax (IHT) is not usually charged on pension assets unless specific circumstances apply. For example, in some schemes the member could direct who receives the money on death (rather than the nomination ultimately being at the scheme trustees' discretion). A transfer to a new pension plan within two years of death where the member knows they are in ill health could also be treated as a lifetime transfer for the purposes of calculating IHT.

Because of this flexibility, it's worth considering not using pensions to provide income immediately, but instead using them for inheritance purposes. But this depends upon the client's circumstances, whether they need the income, and their available allowances.

ISAs

People can take money from ISAs at any time and it will be tax free. The exception is withdrawals from a Lifetime ISA before age 60, which will incur a penalty unless the money is put towards the purchase of a first house or the individual is terminally ill.

However, because the withdrawal will be tax free, and therefore not making full use of the individual's allowances, it's probably not tax efficient to use only ISAs to provide income. Instead, it may be advisable to combine with other incomes that use the allowances, and the ISA income can provide a top-up if so required.

It's also worth remembering ISA income, like pension income, is being removed from an environment where investment growth is tax free. People need to decide whether it is better to take income out of ISA wrappers, or instead use other assets – which may not be as tax-efficient as ISAs at building wealth – to provide an income. ISAs may, therefore, be pushed down the order of assets from which to take income. This will depend upon individual circumstances.

If the ISA is not spent, it will be left within the estate. If it is passed to a spouse or civil partner on death, it will not be considered for IHT. Anything left on second death will be tested against available nil-rate bands.

The spouse or civil partner can also claim an ISA additional permitted subscription (APS) – equal to the value of the ISA at death or when the estate is wound up. This can boost their own personal ISA subscription level, and therefore shield more of their 'family wealth' from Income Tax and CGT. They can claim the APS regardless of whether or not they were left the ISA money from the estate.

The individual could take out the ISA funds and place them in a suitable trust to shield against IHT, or gift in life out of IHT allowances.

If the individual invests in AIM shares that qualify for Business Property Relief within ISAs, then the capital will fall out of estate for IHT if held for more than two years. However, this is a high-risk strategy and will not be suitable for all.

In addition, the Office of Tax Simplification (OTS) flagged in its report on IHT that these schemes are an area the Treasury may wish to curtail in the future.

Collectives

Gains are subject to Capital Gains Tax (CGT). Individuals can plan to minimise CGT on disposal by using their capital gains tax-free allowance.

They are also able to reduce the amount of tax paid on dividend income by using their dividend tax-free allowance of £2,000.

People could choose to place collectives in an appropriate trust to shield against IHT.

It may be advisable for people to realise the value of taxable portfolios of investments first, ahead of other – more tax-efficient – assets.

Investment bonds

People can minimise tax on chargeable gains. Each year they are entitled to withdraw up to 5% of the amount invested without incurring an immediate tax charge. This 5% tax-deferred withdrawal can be rolled forward to count against future chargeable gains if not required.

Gains from onshore bonds are taxed as the top part of income (see above). They receive a non-reclaimable 20% tax credit, which meets the liability for non-taxpayers and basic rate taxpayers. Further tax is only payable if the gain, when added to all other income in the tax year, falls in the higher rate band and above.

Offshore bond gains are added to all other savings income and taxed after earned income (see above). Gains are taxed at 20%, 40% or 45%. Gains can be set against the personal allowance, starting rate for savings and the personal savings allowance.

Top-slicing relief may also be available. This mitigates a higher rate or additional rate Income Tax liability (which has arisen because a chargeable event gain has been added to the individual's total income).

An investment bond can be placed in a trust to shield against IHT.

Investment bonds can be assigned to someone else without triggering a chargeable event, as long as cash doesn't change hands. This means that a higher or additional rate taxpayer can assign the bond to a spouse or partner without triggering a tax charge. This is especially useful if they're a basic rate taxpayer or a non-earner.

Any withdrawals are paid to the policy owner.

Property

Property – either residential or buy-to-let – can be sold to realise income. However, it's worth noting that, whilst the home property isn't subject to CGT, gains on buy-to-let property are subject to higher rates of CGT of 18% or 28%.

Equity release could also be an option as it provides a tax-free income and may be useful if the individual has used up other allowances. The two main types of equity release scheme are lifetime mortgages and home reversion plans. Individuals need to consider their options carefully as equity release is not suitable for everyone, and the features and risks of such schemes can be complicated to understand.

Which order to take income in?

Deciding how to take income in retirement can be complex, requiring you to think through individuals' needs, priorities and objectives.

Things to consider include the following.

- How much income does the client need; how can this be set up; and should it last a lifetime or a specific period?
- Do they want to use up all their income or is passing some onto their family now or later an important consideration?
- What risks do they have and how do they want to manage them?
- What tax-efficient ways can the income be paid using all the allowances the individual has?
- How does the income vary in retirement; do they want to fund for long-term care and how do they do that?
- Do they want to sell their home by downsizing; would they consider equity release?

The answers to these questions will vary for each client and their different circumstances.

A possible order to take income in is:

1. unwrapped investment portfolios (including shares, funds and buy-to-let property) – these can be taken gradually using the individual's capital gains tax-free allowance;
2. ISAs, except those invested in AIM shares that qualify for Business Property Relief; then
3. drawdown pension pots.

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