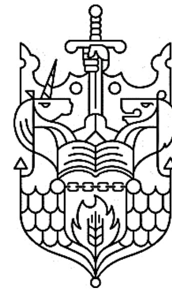

AF8-RETIREMENT INCOME PLANNING

ASSIGNMENT 3 COURSEWORK EXEMPLAR

The purpose of this assignment is to make recommendations for a suitable tax-efficient investment strategy for Patrick and Jane to enable them to generate a sustainable income from their pension plans and other assets from the date of Patrick's retirement. The information used for the assessment was provided at a meeting with Patrick and Jane and summarised in Assignment 1.

BACKGROUND

Patrick has recently been diagnosed with a heart condition which will require ongoing treatment. As such, Patrick has decided to retire in a few months' time so that he and Jane can spend time travelling to include visiting family, over the next few years. They estimate that the travel costs will be £70,000 in total over three years. Jane's employer is willing to provide continuing employment on a flexible basis to cater for the travel and her salary will reduce to £10,000 p.a. to take into account the reduced working hours.

Patrick and Jane currently have their home on the market and are planning to purchase a new property for approximately £400,000. Their aim is to release funds of £200,000 after moving costs, to provide additional income in retirement.

Objectives

Patrick and Jane's immediate objectives are to ensure that they have sufficient capital for the next few years to cover their travel plans. Over the longer term, they want to ensure that they are able to generate a joint gross income of £45,000 per annum, in today's terms throughout retirement, from their existing investments, pension plans and the £200,000 from the sale of their home.

IMMEDIATE REQUIREMENTS

There is an immediate requirement to ensure capital of £70,000 is available for travel costs over the next 3 years. Once Patrick retires the only income for 3 years is Jane's reduced annual salary of £10,000 plus investment income. From age 65, Patrick will receive the income from the deferred annuity and from age 66, his State Pension. Jane's State Pension will be payable 2 years later when she retires. As a result, there is also an immediate need for additional monies to meet their income requirement of £45,000.

Until now, Patrick has been a Higher Rate taxpayer whilst Jane paid Basic Rate tax. The income from the current portfolios has not attracted any additional Income Tax as the savings income was within the Personal Savings Allowance of £1,000 for Jane and £500 for Patrick, the dividends were below the Dividend Tax Allowance of £2,000 and the balance of income was from ISAs which is tax free.

The onshore Investment Bond is technically a single premium life insurance policy and as such, the life company pays the equivalent of Basic Rate Tax on the funds' income and profits. Income

accumulates within the fund and for tax purposes, is treated as belonging to the life company hence no further tax was payable by Patrick and Jane. As Patrick and Jane could well be non-taxpayers from 2021, the investment in the Bond does not allow them to use the Capital Gains Tax exemption against any gains or claim back any tax deducted within the fund if their total income does not fully utilise their Personal Allowance.

The Managed fund in which the investment is currently held has 40% in UK equities and 40% in global equities. The investment Bond has been held since June 2013 during which time the FTSE All Share Index has risen approximately 12% and the MSCI International World Index has increased by 79%. This compares to the Investment Bond's increase of 13% over the same period.

Considering their other investments in the light of Patrick and Jane's new tax position, the unit trusts allow Patrick and Jane to utilise their Capital Gains Tax Annual Exemption of £12,300 against realised gains and the ISAs provide tax free capital gain. In addition, the ISA provider can recover tax deducted on income from certain types of investments such as Fixed Interest and commercial property. The Investment Bond does not allow the use of these tax benefits and together with the apparent under- performance, I recommend encashing the Investment Bond to fund the travel costs. In order to calculate any potential tax payable, the gain of £30,000 is divided by the number of years held i.e., 7. This slice of £4,285 is divided equally between Patrick and Jane and added to their respective incomes for the current tax year. As this will result in both Jane and Patrick remaining as Basic Rate taxpayers, there will be no further tax payable on the gain.

INCOME REQUIREMENTS

Patrick and Jane require a gross income of £45,000 from the time that Patrick retires which I have assumed to be at the end of this year. The £200,000 has been released from the sale of their property and this is to be used to generate income. The following is the capital and pension funds available to meet their income objective after deducting their travel costs from the proceeds of the investment bond.

Description	Patrick	Jane	Joint
Savings account			£35,000
OEIC/Unit Trust holdings- UK Recovery funds			£42,000
OEIC/Unit Trust holdings - Emerging Markets Growth			£33,000
Stocks & Shares ISAs - US Equity Tracker fund	£30,000		
Stocks & Shares ISAs - UK FTSE 100 Tracker fund		£30,000	
Released from sale of property			£200,000
Balance of proceeds from Bond			£15,000
Pension Plans	£162,000	£33,000	
Total	**£192,000**	**£63,000**	**£325,000**

Tax position

Assuming Patrick retires at the end of 2020, his salary in 2020/21 tax year will be £36,000. This will mean that he will be a Basic Rate taxpayer for the current tax year even after including investment

income. From April 2021 he will no longer have a salary and therefore will not have any income to set against his Personal Allowance.

Assuming Jane also moves to her new flexible working arrangement from January 2021, her salary for 2020/21 tax year will be £13,500. This will mean she will fully use her Personal Allowance and remain a Basic Rate taxpayer. From April 2021, her reduced salary of £10,000 will not be sufficient to fully utilise her Personal Allowance.

Pensions

Although Patrick will no longer have a salary, pension income is treated as earned income for tax purposes and can therefore be set off against his Personal Allowance. As it is unlikely that Patrick's existing pension scheme will offer the new style withdrawal flexibility due to the age of the scheme, Patrick should transfer his Group Personal Pension to a new arrangement. This will allow him to withdraw monies from the fund on a flexible basis which allows the amount to be tailored to Patrick's circumstances. This should be investigated with his existing provider before recommending any changes to the existing plan.

The new plan will be segmented so that withdrawals can be made by encashing segments of which 25% of the amount will be Tax-Free cash and the balance treated as income. Alternatively, the Tax-Free cash from all or a number of segments can be taken, leaving the balance of the monies invested from which withdrawals can be taken in the future. These withdrawals will be treated as income for tax purposes.

The option I recommend is to encash sufficient segments of Patrick's pension fund each year using UFPLS so that the income from these segments, after taking Tax-Free cash, equates to his unused Personal Allowance. Based on the earlier explanation, this will amount to a withdrawal of £16,666 consisting of £4,166 Tax-Free cash and £12,500 income in the first year. In the second and third year the amount can be increased to take into account any changes in the Personal Allowance and in the subsequent years decreased to take into account the additional pension income from the annuity when Patrick reaches 65 and his State Pension from age 66.

The new plan has the facility to withdraw additional Tax-Free cash up to 25% of the "uncrystallised" pension fund as well as additional income. This allows the income to be tailored each year to meet Patrick's requirements and take into account his tax position.

The total withdrawal in the first 3 years is projected to be £49,998 (see income table later). Ignoring any growth on the pension fund, this will leave a fund at age at age 66 of £112,002 from which he will make ongoing withdrawals of approximately £4,600 which is just over 4% of the fund. This is a realistic withdrawal rate when taking into account their attitude to risk and may provide for some increase and/or ad hoc withdrawals if required.

With Jane's pension, a similar strategy can be used from her retirement at age 66. She can encash sufficient segments of her pension fund each year, using UFPLS so that the income from these segments, after deducting Tax-Free cash, equates to her unused Personal Allowance Assuming the Personal Allowance and State Pension increase by 2.5% p.a., this will amount to a withdrawal of approximately £3,589 in 2023. This amount consists of Tax-Free cash of £897 and £2,691 income rising the following year to take into account the cessation of salary and a full year's State Pension.

Over the next 5 years, the pension contributions will continue to be paid by herself and her employer. This will amount to at least £4,000 assuming her salary remains unchanged over this timeframe. If we assume that with some growth on the pension fund the total fund at age 66 is £40,000, the suggested annual withdrawals could not be sustained over the longer term. I therefore

recommend that Jane makes additional contributions into her pension plan from their savings account of £24,000 spread over the next 4 years.

The maximum additional contribution on which Jane can receive tax relief is equal to her salary minus the gross contributions being made by Jane and her employer. Jane's contributions are made net of Basic Rate tax. For example, if Jane pays an additional contribution of £6,000 p.a., this is net of Basic Rate tax which means the amount credited to her pension plan is £7,500. Over 4 years, this will bring the fund up to approximately £70,000. Increased withdrawals from the ISA portfolio could be taken after 2029 when all of the Non-ISA funds have been switched into the ISA portfolio, using the annual Bed & ISA transactions which were recommended earlier. The ISA withdrawals would then replace the pension withdrawals. This would remain tax-efficient for Jane and leave residual funds in the pension to draw on in later years, if further income was required. Based on the proposed withdrawals from the pension, this would have a residual value, assuming no growth was achieved by 2029 of approximately £41,000. As the withdrawals have been made by UFPLS, there would be residual tax-free lump sum available of £10,250 which could grow further in future.

Assuming Jane makes pension fund withdrawals during retirement within her unused Personal Allowance, then no tax will be payable and Jane has benefited from a tax free increase of 25% on her initial contributions.

Existing Investments

As detailed in assignment 2, the existing unit trusts are invested in higher risk funds and in order to align the portfolio with Patrick and Jane's more cautious risk profile I recommended:

- Encashing the Emerging Markets unit trust
- Encashing the U.K. Recovery unit trust
- Switching the U.S. Equity fund within the existing ISA.

The unit trust investments made a reasonable return over the years with the U.K. Recovery fund increasing by £24,000 and the Emerging Markets fund increasing by £18,000. On encashment the gain would be subject to Capital Gains Tax. During the tax year of disposal, an individual can realise an amount of gain from all disposals without incurring Capital Gains Tax. This amount is called the Annual Exemption and for 2020/21 the amount is £12,300. Any gains over this amount will be subject to Capital Gains Tax at 10% for Basic Rate taxpayers and 20% for those paying higher rates of tax. As the investments are held in joint names, the gain would be divided by two and both Patrick and Jane could then use their individual Capital Gains Tax Annual Exemption and then pay tax at the appropriate rate on the balance. As detailed in assignment Two, both Patrick and Jane will be Basic Rate taxpayers for the current tax year and each would therefore have a Capital Gains Tax liability of £870. This liability can be eliminated if the encashment takes place over two tax years enabling Patrick and Jane to each use two Annual Exemptions, i.e., £24,600, which is greater than their share of the overall gain and hence would not attract any tax.

As Patrick and Jane have not used the ISA allowance for the current year it would make sense to use the proceeds from the unit trusts to invest into ISAs. This will mean that future growth and income from the investments will be within the ISA and will not incur any Capital Gains Tax on profits or additional tax on income.

I recommend the following encashment of unit trusts for the 2017/18 tax year.

Existing Fund	%	Proceeds	Estimated Capital Gain
Emerging Markets	100.0 0	£33,000	£18,000
U.K. Recovery	16.67	£7,000	£4,000
		£40,000	**£22,000**

The maximum contribution into ISAs for 2020/21 is £20,000 which means that the above will release sufficient monies for Patrick and Jane to each fully utilise their current ISA allowance. The estimated capital gain when divided equally between Patrick and Jane is within their Capital Gains Tax Annual Exemption and hence no tax is payable.

The remaining monies in the Recovery fund can be similarly encashed and invested in ISAs next year. Based on the current fund value the gain will be within the Annual Exemption for Patrick and Jane in the 2021/22 tax year and the proceeds would use £25,000 of their ISA allowances leaving scope for a further £15,000 contribution in that tax year. This additional £15,000 contribution can be made from the balance of the proceeds of the Investment Bond. It should be borne in mind that tax rates and allowances may change across two tax years and also the value of the portion of investment left for the second tax year could fall.

In addition to moving the unit trusts and cash into ISAs, the existing funds already within the ISA should be switched as detailed in assignment 2 to reflect Patrick and Jane's new risk profile.

Once the monies are in the ISAs, income can be distributed without incurring any tax and will not use up any tax allowances. It is difficult to estimate the exact level of income as it will fluctuate and be dependent on the funds chosen, the economic climate and charges. As a guide, balanced mixed asset funds tend to hold between 20% and 60% of equities at any one time, and at present are generating an income of up to 5% p.a. but generally are in the region 4%. A more cautious fund with lower levels of equities up to a maximum of 35% of the fund, tend to have income levels closer to 3%. If we assume a yield of 3.5% on the ISAs, then the income generated will be £4,900 p.a.

New Investment

Continuing the strategy of maximising the contributions into ISAs, I recommend using the £200,000 to purchase unit trusts in funds to reflect Patrick and Jane's attitude to risk. Each year, unit trusts can be sold to provide the maximum ISA contributions assuming that the gain is within their Capital Gains Tax Annual Exemption. This transaction, often called a "Bed and ISA", can normally be completed at little or no cost if the unit trusts and ISAs are held on a platform with the "transfer" going into the same ISA funds as those held in the unit trust.

The moving of the investments into ISAs is likely to take at least 6 years assuming current levels of allowances. During that time, the majority of the dividends generated from the unit trusts should fall within the Dividend Allowance of, currently, £2,000 each so only a small tax liability will be incurred. If the different asset classes within Patrick and Jane's risk profile are purchased as separate unit trusts. i.e., not Managed funds, then the higher yielding funds can be transferred to the ISA first to reduce the level of yield from the remaining unit trusts as quickly as possible. This will provide some defence against the Dividend Allowance being reduced in the future.

I recommend that the unit trusts are held in individual's names rather than joint names. It means that if either Patrick's or Jane's tax position changes in the future, there is greater flexibility in

tailoring which funds to encash each year. In addition, it helps to make the Bed & ISA easier as it is moving unit trusts held in one name into an ISA for the same person.

Using the same income assumption as detailed earlier, the income generated from the £200,000 will be £7,000 p.a. Based on the current dividend allowance, £4,000 of this will be tax-free with the remainder subject to tax at 7.5%, so a tax liability of approximately £112 for each of them. This will reduce each year as the funds are moved into ISAs.

Income in Retirement

Having taken into account the preceding recommendations, the table on the next page seeks to illustrate their likely income and shortfall during retirement. I have assumed Jane will retire at age 66. The table assumes that:

- *Patrick will retire at the end of this year and at the same time, Jane will move onto a reduced salary.*
- *Patrick's deferred annuity does not contain any GMP and hence will not affect his State pension.*
- *The State pension will be payable from the 1st of the month of their 66th birthday.*
- *The income from their current portfolio will rise by inflation although in reality, it will fluctuate and may fall.*
- *The income recommendation for the year 2029 will continue* ***unchanged*** *apart from inflation increases throughout their retirement. This is based on the growth rates already stated for each investment.*

Patrick and Jane Income in Retirement

Source	06/04/2021	06/04/2022	06/04/2023	06/04/2024	06/04/2025	06/04/2026	06/04/2027	06/04/2028	06/04/2029 onwards
Personal Allowance	£12,500	£12,813	£13,133	£13,461	£13,798	£14,143	£14,496	£14,859	£15,230
Patrick									
State Pension	-	-	£1,595	£9,810	£10,055	£10,307	£10,564	£10,828	£11,099
Deferred Annuity	-	-	£4,700	£4,818	£4,938	£5,061	£5,188	£5,318	£5,451
Personal Pension	£16,666	£17,083	£9,064						
ISA Income	£2,450	£3,082	£3,721	£4,329	£4,977	£5,629	£5,815	£5,770	£5,713
Investment Income	£3,500	£2,870	£2,227	£1,572	£903	£221	£0	£0	£0
Tax due on dividend income	-£113	-£65	-£17	£0	£0	£0	£0	£0	£0
Tax due on pension	£0	£0	£0	-£233	-£239	-£245	-£251	-£257	-£264
Sub Total	**£22,503**	**£22,970**	**£21,291**	**£20,295**	**£20,634**	**£20,973**	**£21,317**	**£21,659**	**£21,998**
Jane									
Salary	£10,000	£10,250	£10,506	£10,769	£11,038				
State Pension						£10,307	£10,564	£10,828	£11,099
Personal Pension				£3,589	£3,679	£5,114	£5,242	£5,373	£5,507
ISA Income	£2,450	£3,082	£3,721	£4,329	£4,977	£5,629	£5,815	£5,770	£5,713
Investment Income	£3,500	£2,870	£2,227	£1,572	£903	£221	£0	£0	£0
Tax due on dividend income	-£113	-£65	-£17	£0	£0	£0	£0	£0	£0
Tax due on pension				£0	£0	£0	£0	£0	£0
Sub Total	**£15,837**	**£16,137**	**£16,438**	**£20,258**	**£20,597**	**£21,271**	**£21,621**	**£21,971**	**£22,319**
Total Income	£38,340	£39,108	£37,729	£40,554	£41,231	£42,244	£42,938	£43,630	£44,317
Required Income	£45,000	£46,125	£47,278	£48,460	£49,672	£50,913	£52,186	£53,491	£54,828
Surplus/Shortfall	-£6,660	-£7,017	-£9,549	-£7,907	-£8,440	-£8,669	-£9,248	-£9,861	-£10,511
ISA withdrawal	£6,660	£7,017	£9,549	£7,907	£8,440	£8,669	£9,248	£9,861	£10,511
Tax on Pension Income	£0	£0							

- Assumptions: Inflation/RPI: 2.5% p.a. on State Pension/Deferred Annuity/Jane's Salary
- Shortfall drawn each year from ISA capital: tax-free
- Personal Pension withdrawals via UFPLS within Personal Allowance (including PCLS)
- ISA and Investment Income is 3.5%
- ISA's and Investments grow 2% p.a.
- ISA allowances used every year
- ISA allowance remains unchanged at £20,000
- Dividend Allowance remains at £2,000
- Dividend Tax remains at 7.5%
- Personal Allowance increases each year by 2.5%

The table shows a net income of just under £39,000 increasing each year which will be topped up with tax-free capital withdrawals from their ISA portfolio. Their requirement was £45,000 gross annual income which if all was generated from a pension could suffer tax of up to £6,700; the net result being lower than the projected income above. If it transpires that Patrick and Jane need additional income, this could be taken each year depending on their requirements and investment performance. For instance, if growth has been good, additional monies could be taken for the unit trusts within their Annual CGT Exemption, tax-free from the ISAs or via Tax-Free cash from their pension plans.

All of their Unit Trust and OEIC holdings should be held in the ISA wrappers within 6 years. This will provide additional tax-free income and capital withdrawals. Based on estimated annual capital growth of 2% per annum along with the income yield of 3.5% which will be paid out to Patrick and Jane to supplement their retirement income, their ISA portfolios should allow them to continue to withdraw the required shortfall as a capital sum each year for the remainder of their lives. This is based on an assumption for linear growth of 2% per annum with no adverse market events. Further assumptions are set out in the enclosed Appendix.

In the event of adverse market conditions, Patrick and Jane can draw additional lump sums from their pension plans, either as tax-free cash or as additional taxable income should the tax-free element be exhausted in later years.

In the event of death, the ISAs are effectively transferred to the survivor and the balance of the pension fund is also available to the survivor either as a lump sum (tax free on death before age 75) or via a flexi-access scheme. There would be a reduction in income as the deceased's State Pension would cease and in the event of Patrick's death, his annuity would reduce by 50%. The survivor's expenditure is likely to reduce but there is room to top up any income requirements from the ISAs or pensions.

Summary

In summary, I have sought to provide a tax efficient income from investments and pensions by using the various tax allowances. The strategy has a high degree of flexibility to cater for their needs particularly as they settle into their new home which may result in lower outgoings. They need to maintain some savings to act as a reserve in the case of emergencies.

Appendix

	2021/22		2022/23		2023/24		2024/25		2025/26		2026/27		2027/28		2028/29		2029/30
ISA	£140,000	£136,140	£176,140	£172,645	£212,645	£207,349	£247,349	£244,389	£284,389	£281,637	£321,637	£319,400	£332,308	£329,706	£329,706	£326,439	£326,439
UT's/OEIC's	£200,000	£204,000	£164,000	£167,280	£127,280	£129,826	£89,826	£91,622	£51,622	£52,655	£12,655	£12,908					
ISA Income @ 3.5%	£4,900		£6,165		£7,443		£8,657		£9,954		£11,257		£11,631		£11,540		£11,425
	£2,450		£3,082		£3,721		£4,329		£4,977		£5,629		£5,815		£5,770		£5,713
UT's/OEIC's @ 3.5%	£7,000		£5,740		£4,455		£3,144		£1,807		£443		£0		£0		
	£3,500		£2,870		£2,227		£1,572		£903		£221						
Income Total	£11,900		£11,905		£11,897		£11,801		£11,760		£11,700		£11,631		£11,540		£11,425
Income each	£5,950		£5,952		£5,949		£5,901		£5,880		£5,850		£5,815		£5,770		£5,713

Assumptions

- UT/OEIC transfers £40K to ISA each tax year
- Proceeds of house sale invested in UT/OEIC
- Growth: 2% per annum
- Dividend Income: 3.5% per annum
- Based on growth of 2% per annum, assets will be sustainable to age 92 for Patrick

Examiner Comments

The assignment requires you to provide a detailed recommendation to explain how you would propose to generate the required level of income for the clients in a tax-efficient and suitable manner.

This particular assignment is focused on the recommendation process and requires you to demonstrate that you are able to provide a coherent strategy that will meet the client retirement income needs.

The mark given to this assignment is **55**.

Areas where the assignment scored highly include the following:

- There is a clear strategy which takes into consideration all assets available to Patrick and Jane and includes consideration of the guaranteed income sources that will come into payment during their retirement.
- Detailed consideration is given to the income shortfalls, taking into consideration their plans to travel and other objectives.
- Consideration has been given to tax-efficiency and the use of various tax allowances including the Personal Allowance.
- Consideration has been giving to improving the future tax-efficiency of their portfolio by making switches into ISAs and drawing from a range of assets in the most tax-efficient manner possible.

Areas for further improvement include the following:

- More detailed exploration of the sustainability of the proposed strategy could have been included to identify any potential risks to the strategy posed by adverse market events or greater income requirements in later life.
- Structure could have been enhanced using tables and more detailed calculations.
- References or suitable examples should have been included to demonstrate wider reading and research e.g., HMRC guidance and regulations on Tax Allowances.
- Greater explanation of the tax-efficiency of the proposed strategy could have been included. Although this was indicated in the income model, more detail and explanation would have been of benefit.