WHIreland®
WEALTH MANAGEMENT

Case Study

Drawdown pension vs. buy-to-let property

Matt is 61, he is married to Liz who is 58 and they have two adult children. Matt enjoys his consultancy work and while he's reducing his hours, has no plans to fully retire before he is 70. He has a personal pension fund valued at £250,000. He used an inheritance to buy a new build property for £165,000 early in 2013. He is renting it out at £695 a month, but would charge more to new tenants. He expects to receive net rental income of £7,500 a year, based on his experience so far of expenses and void periods.

He is suspicious of pensions and influenced by the 'no-one needs to buy an annuity any more' headlines. He confirmed his prejudices by checking an online calculator and concluding he would need an annuity with 3% escalation and a 50% widow's pension. On this basis, if Matt took 25% tax free cash of £62,500, the £187,500 balance of his pension fund would secure what he considers a disappointing initial income of £6,420 a year. His adviser agrees that an annuity is not right for someone in Matt's position. He does not need to secure a lifetime income, both he and Liz are relatively young, in good health and do not smoke - and their exclusive postcode is another disadvantage when it comes to annuity purchase.

While his adviser is keen to turn the discussion to drawdown, Matt's instinct is still to unlock his pension cash to purchase a second buy-to-let property to provide additional income both now and when he ceases paid work. He believes he would be able to buy a similar property for £180,000 plus legal expenses and stamp duty and rent it out for £795 per month. Based on his experience so far, he expects to get a net rental income of £8,590 a year but accepts it could be less than this. He sees significant advantages compared with an annuity. He would not only get a higher increasing income, but also the possibility of capital growth. If he predeceased Liz, she would inherit the property free of inheritance tax, along with the full income stream. His children could also inherit.

Matt explains his thinking on how he will finance the purchase. He plans to limit his consultancy earnings for 2018/19 to £30,000, and expects to get £7,500 net rental income from the existing buy to let and about £4,300 net over six months from the new property. His understanding is that provided he ensures his other income is within the basic rate band, he will be entitled to 25% tax free cash of £62,500 and will pay 20% tax on the £187,500 taxable portion of his lump sum leaving him with £212,500. His adviser explains that using his assumptions, he would actually end up with around £166,932 after paying tax of £83,068 on the £187,500 lump sum at an effective rate of just over 44%.

Taxable lump sum	£187,500
Earnings	£30,000
Net rental income (existing BTL)	£7,500
Net rental income (6 months new BTL)	£4,300
	£229,300

This would take his estimated total income over £100,000, so he would lose the £10,600 personal allowance and pay tax as follows (using the announced rates and bands for 2015/2016):

£34,500 x 20%	£6,900
£115,500 x 40%	£46,200
£79,300 x 45%	£35,685
	£88,785

Ignoring the taxable lump sum for the purposes of this example, he would have an income of £41,800 and would benefit from the personal allowance.

£11,850 x 0%	£0
£29,950 x 20%	£5,990
	£5,990

Therefore, the effective amount of tax on the lump sum of £187,500 is £88,785 + £5,990 = £92,725.

£92,725 / £187,500 x 100 = 49.5% effective rate of tax.

£250,000 - £92,725 = £157,275 available lump sum.

Having gone through that reality check, Matt's open to discussing other options and confirms that he had only planned on restricting his consultancy income to £30,000 based on his misunderstanding. He has no immediate need of additional income. His adviser suggests that initially, he could leave his substantial pension funds invested across a broad range of investment classes, including property funds, rather than using all his funds on a single buy-to-let property.

One of the key attractions of buy-to-let to Matt is the growth potential from property. He had not fully considered that not only would the net rental income be taxable, but he would have to sell a property to access the capital gains when he would be liable to capital gains tax. His adviser points out that in contrast, pension funds grow free of taxes on the income and capital gains from the underlying investments.

Matt's also interested in controlling the amount of his income and marginal tax rate. His adviser explains that when he wants to use his funds to provide a pension income, he could use phased flexi-access drawdown. For example, he might start by designating £30,000 of his funds to provide pension income. He could take 25% or £7,500 as tax free cash. For a basic rate taxpayer, that equates to £9,375 of additional gross taxable income. For a higher rate taxpayer, it equates to £12,500. He could draw down on the remaining £22,500 flexibly, taking as much or as little pension income taxable at his marginal rate as he needed. He could repeat the exercise over time. This would give him significantly more control over his income mix and marginal tax rate than rental income from a second buy-to-let property. Also, the undrawn funds would continue to benefit from a tax advantaged investment environment even after being designated to provide pension income.

He could also consider taking a flexible income via the new option of partial pension encashment (officially referred to as uncrystallised funds pension lump sums). 25% of each such withdrawal would be treated as tax free cash, while the balance would be taxed at his marginal rate of income tax.

Buy-to-let also drew Matt's attention because of his concerns about providing pension benefits for Liz and an inheritance for his children. His adviser reassures him that if he dies before 75, all his remaining uncrystallised and drawdown pension benefits can be paid out as a lump sum or as drawdown income to Liz and/or his children, ordinarily free from tax and outside his inheritance tax estate. If he dies after 75, any remaining funds can be paid via flexi-access drawdown or as a lump sum to Liz and/or his children. They will have to pay income tax at their own marginal rate on the funds they receive. (This assumes that Matt has sufficient lifetime allowance on death to cover the uncrystallised benefits – only applies on death before 75.)

Matt realises he had not considered the disadvantages of taking all his pension benefits as a lump sum and relying on buy-to-let properties to provide him w ith a retirement income.

He commits to deferring taking his benefits. He recognises that it should be possible to combine tax free cash, flexi-access drawdown and partial pension encashment to provide him with a more tax efficient retirement income when he needs it. He also realises this could offer inheritance tax planning advantages, particularly if it comes to making provision for his children.

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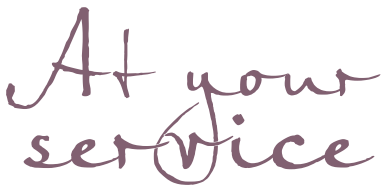

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