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WEALTH MANAGEMENT

Case Study
Accessing Pension Funds for Mortgage Repayment

Roger has an interest only mortgage which he is due to repay in the near future. There is a shortfall in the ISA funds he has earmarked for this purpose. He plans to keep working for several years, although he is hoping to reduce his hours once he turns 60. He is divorced with a clean break settlement, so his ex-spouse has no claims on his pension fund or other assets. He has three adult children and his first grandchild will be born shortly.

In more detail;

- Roger has a £150,000 interest only mortgage on a property valued at £420,000.
- His mortgage payments are £500 a month.
- The mortgage is due to be repaid in September 2018, when he will be 59.
- He expects to earn £80,000 in 2018/19, but less in later years as he plans to reduce his hours.
- He has £100,000 in ISAs earmarked for mortgage repayment.
- He is rebuilding his cash funds after covering property maintenance costs.
- He has a £700,000 personal pension fund. He has not previously crystallised any funds and does not have primary or enhanced protection, so the standard £1.03 million lifetime allowance (LTA) is available.
- He makes ad hoc pension contributions. He has not made any contributions for the 2018/19 tax year. He contributed between £15,000 and £18,000 gross in each of the previous five tax years.
- He has made a non-binding nomination for his three adult children to receive any pension lump sum death benefits.
- He is in good health and has a normal life expectancy for his age.

Option 1
Repay mortgage with pension tax free cash

Roger is finding it difficult to re-mortgage on an interest only basis even if he repays £100,000 from his ISAs. Moving to a more expensive repayment basis does not fit with his plans to work fewer hours once he turns 60, as he is hoping to reduce his outgoings in line with the prospect of earning less. He is willing to use his ISA funds for mortgage repayment, but does not want to touch his remaining cash funds. Roger wants to understand the main options for releasing sufficient funds from his pension to repay his mortgage. He is not planning to start taking a regular pension income for several years, so an annuity is not under consideration.

Crystallised pension fund		£600,000	
Mortgage repaid from: Tax free cash		£150,000	
Income tax payable		£0	
LTA used		58%	
Remaining funds	Crystallised pension	£450,000	
	Uncrystallised pension	£100,000	
	ISA	£100,000	
	Total	**£650,000**	
Annual allowance provided takes no drawdown income		£40,000 (+ carry forward)	
Death benefit free from IHT/taxes on death before 75. IHT free but subject to inheritor's marginal rate of income tax on death post 75.		£550,000	£550,000
ISA potentially liable to 40% IHT on death		£100,000	£100,000
Potential net death benefits		**£610,000**	

Option 2
Repay mortgage with Pension tax free cash and ISA

Alternatively, Roger could crystallise £200,000 of his fund by designating it for flexi-access drawdown. He could then take £50,000 (25%) as tax free cash and add this to the £100,000 ISA funds to repay the mortgage.

Mortgage repaid from tax free cash	Pension tax free cash	£50,000	
	ISA	£100,000	
	Total	**£150,000**	
Income tax payable		£0	
LTA used		19.4%	
Remaining funds	Crystallised pension	£150,000	
	Uncrystallised pension	£500,000	
	Total	**£650,000**	
Annual allowance provided takes no drawdown income		£40,000 (+ carry forward)	
Death benefit free from IHT/taxes on death before 75. IHT free but subject to inheritor's marginal rate of income tax on death post 75.		£650,000	£650,000

Option 3
Repay mortgage with partial pension encashment

Roger also has the option of using partial pension encashment (PPE), officially referred to as taking an uncrystallised funds pension lump sum (UFPLS). This enables him to access funds without first having to designate them for flexi-access drawdown. The first 25% of the PPE is paid as tax free cash, and the balance is taxed at his marginal rate of income tax. This is treated as a benefit crystallisation event for LTA purposes.

He could use this option to repay the full mortgage. In Roger's case, the amount of the PPE required means he loses his £11,850 personal allowance for 2018/19. Compared with not taking the PPE, this reduces his after tax earned income by £4,740 (£11,850 x 40%). Therefore he needs a post-tax PPE of £154,740 to cover this income shortfall as well as repaying the £150,000 mortgage. After allowing for his £80,000 taxable earned income, £70,000 of the 40% income tax band remains available to set against the taxable element of the PPE, with the balance taxed at 45%. That means taking £227,472 via PPE to provide sufficient funds.

PPE/crystallised pension fund	£228,287
£57,072 tax free cash x 0%	£0
£70,000 x 40%	-£28,000
£101,215 x 45%	-£45,547
After tax PPE	£154,740

Where PPE is not an available option, an individual could instead crystallise £228,287 of their pension fund by designating it for flexi-access drawdown. They could take 25% (£57,072) as tax free cash and the balance as a taxable income withdrawal. The overall consequences would be the same as taking a PPE.

Mortgage repaid from tax free cash	Pension tax-free cash	£57,072
	Pension after tax sum	£92,928
	Total	**£150,000**
After tax sum used to cover shortfall		£4,740
Income tax payable	at 40%	£28,000
	at 45%	£45,547
PPE/Crystallised pension fund		£228,287
LTA used		22.16%
Remaining funds	ISA	£100,000
	Uncrystallised pension	£471,713
	Total	**£571,713**
Annual allowance		£4,000
Death benefit free from IHT/ taxes on death before 75. IHT free but subject to inheritor's marginal rate of income tax on death post 75.	£472,528	£471,713
ISA potentially liable to 40% IHT of death	£100,000	£60,000
Potential net death benefits		£531,713

Option 4
Repay Mortgage With Partial Pension Encashment & ISA

Even if Roger uses his ISA funds as well as PPE to repay his mortgage, he will still lose his £11,850 personal allowance. Therefore, he needs to realise £54,740 after tax via PPE. That means taking £78,200 providing 25% tax free cash of £19,550 and an after tax amount of £35,190.

PPE/crystallised pension fund	£78,200
£19,550 tax free cash x 0%	£0
£58,650 x 40%	-£23,460
After tax PPE	£54,740

As before, the alternative is crystallising £78,200 by designating it for flexi-access drawdown, taking 25% as tax free cash and the balance as a taxable lump sum.

Mortgage repaid from tax free cash	Pension tax-free cash	£19,550
	Pension after tax sum	£30,450
	ISA	£100,000
	Total	**£150,000**
After tax sum used to cover shortfall		£4,740
Income tax payable	at 40%	£23,460
PPE/Crystallised pension fund		£78,200
LTA used		7.59%
Remaining funds	Uncrystallised pension	£621,800
Annual allowance		£40,000
Death benefit free from IHT/taxes on death before 75. IHT free but subject to inheritor's marginal rate of income tax on death post 75.		£621,800

Weighing up the Options

Roger is relatively young and in good health but moving into the retirement phase of life. He rightly views his pension fund primarily as a source of retirement income. However, as a divorced man with no dependants, the treatment of lump sum death benefits is also a factor.

Options 3 and 4 are easy to dismiss for Roger. Both result in an avoidable income tax liability if he uses this approach to repay his mortgage. In normal circumstances, he is never likely to be an additional rate taxpayer. Once he stops working, he may be able to access pension income at a marginal rate below 40%. He has to take additional funds over and above that needed to repay his mortgage, or suffer the consequences of a £4,740 reduction in his after tax earned income. In addition, the reduction in his annual allowance under both options to £40,000 a year limits his ability to rebuild his pension funds after repaying his mortgage.

In many ways, the choice between options 1 and 2 has neutral consequences. ISA funds, crystallised pension funds and uncrystallised pension funds all provide a tax efficient investment environment. When it comes to taking a tax efficient retirement income, there are also no significant differences resulting from having £100,000 in ISAs or the ability to withdraw 25% tax free cash from £400,000 of uncrystallised pension funds. The 'freedom and choice in pensions' agenda has removed any significant restrictions on Roger accessing his pension funds.

In addition, both options 1 and 2 allow Roger to keep a £40,000 annual allowance and the possibility of using carry forward, giving him the same scope to rebuild his pension funds. Of course, he will have to consider the anti-tax free cash recycling provisions if he wants to significantly increase his contributions in the two tax years after taking tax free cash.

Both options allow him to contribute to ISAs in future, up to the relevant annual limits.

However, option 2 offers potentially better lump sum death benefits. ISA funds are part of Roger's IHT estate whenever he dies.

However, uncrystallised and drawdown pension funds can be paid as a lump sum or income on death before 75, free from both IHT and other taxes. If Roger dies after 75, his nominated inheritors can draw down any remaining funds flexibly, subject to their own marginal rate of income tax. Roger might nominate grandchildren to receive funds, to take advantage of their personal allowances.

Therefore maximising the use of ISA funds (option 2) for mortgage repayment has no adverse consequences compared with option 1 when it comes to Roger's main priority of providing a retirement income. In addition, option 2 offers potential advantages in respect of the net amount of death benefits available for Roger's inheritors.

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