

Case study: Making designation work for your clients

Personal details

Phil Smythe is aged 55 and married to Sue. He's in full-time employment and earns £45,000 a year, paying higher rate tax on his top slice of income.

Phil and Sue have two children: Stephanie is aged 23 and getting married soon, and Lucas is aged 18 and about to start out at university. Phil owns a construction business and his son Lucas is studying to become an engineer as he wants to follow in his father's footsteps.

Phil's four key requirements:

1. Gradually reduce the amount of time he works and slowly pass his business over to his son, over the next 10 years.
2. Maintain a gross salary and income of £45,000 per year.
3. Avoid paying higher rate tax (we assume the HRT threshold is £40,000 a year after allowing for the taxable benefits in kind Phil receives through his company).
4. He also needs an immediate cash sum of £30,000 to help meet the cost of Stephanie's wedding.



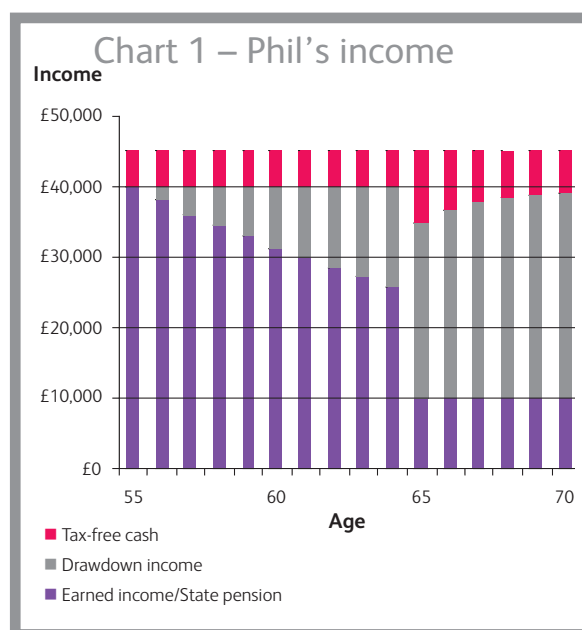
Current pension arrangements

Phil has a Scottish Widows Retirement Account which is currently worth £500,000. Just over £100,000 is held in cash in the Control Account, with the remainder invested in a wide range of mutual funds and collectives within the Fund Supermarket. As he wants to gradually reduce working, he has recently stopped paying ongoing contributions to his Retirement Account.

The solution

The chart below shows how Phil's income needs can be met through multiple designations.

An initial designation of £140,000 provides a £35,000 tax-free lump sum. Phil can use £30,000 of this for his daughter's wedding, while the other £5,000 can supplement his income in the current year.



Source: Scottish Widows internal. Amounts are in today's money and assume 7% p.a. investment return, 2.5% p.a. inflation and 1.5% p.a. charges. Figures are provided for illustrative purposes only.

In each subsequent year, Phil designates an amount of £20,000, providing a tax-free lump sum of £5,000 each year.

He also draws a taxable income from the Retirement Income part of his Account up to the higher rate threshold until he fully retires at 65.

By doing so, Phil has managed to remove his liability to higher rate tax.

At age 65, Phil retires and his State pension kicks in. However, his total income now no longer meets his £40,000 target for taxable income, so he needs to designate a larger amount in each subsequent year, which means that more of his income comes from tax-free cash.

By designating amounts each year, we've successfully met Phil's income requirements, and he should have sufficient funds left to maintain his total income when he eventually buys an annuity.

Further tax benefits can be achieved through making additional pension contributions from earned income and replacing these in part or in whole with pension income.

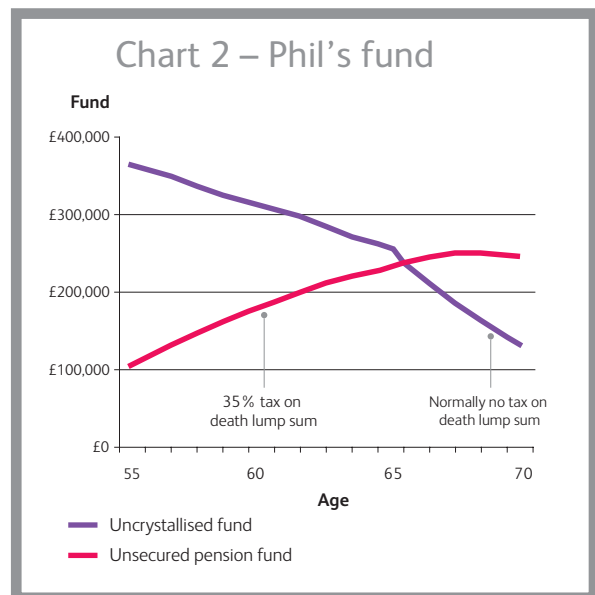
By doing so, a client can increase the value of the Retirement Planning part of their Account, while taking a pension income from the Retirement Income part.

Inheritance planning

An additional benefit of using multiple designations to provide income is that it can help maximise inheritance while minimising tax payable.

Whether funds are in the Retirement Planning part or have been designated to Retirement Income, there should normally be no inheritance tax liability on death. However, if a lump sum is paid on death from a Retirement Income part, a 35% tax charge will apply.

This means there are benefits on death from making multiple designations. Chart 2 shows the distribution of Phil's funds at various times.



Source: Scottish Widows internal. Amounts are in today's money and assume 7% p.a. investment return, 2.5% p.a. inflation and 1.5% p.a. charges.

Managing the transition to retirement in this way is therefore tax-efficient, whether Phil survives to buy an annuity, or dies at a relatively young age.

A final point on death benefits is that the penal taxes on death during an Alternatively Secured Pension mean that some clients may wish to minimise the fund remaining at age 75 (and used then to provide an Alternatively Secured Pension or an annuity).

The designation process can help with that, although in this case it is likely that the movement to Unsecured Pension will be quicker. Maximum income can then be drawn and passed on as lifetime gifts, which may qualify for one of the available exemptions. Obviously this is only appropriate for clients whose main source of income is outside the pension.

Remember, if tax-free lump sums are used to fund future pension contributions, tax charges could arise. The value of any tax benefits depends on individual circumstances which can change. Tax rules can also change.

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