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Taxing times ahead

Don't be penalised by the tax system when you exercise your freedoms

The 'pension freedom' reforms of 2015 were welcomed by consumers, as they vastly widened options available to most savers at retirement.

Pension freedoms allow savers to have the flexibility on how and when to spend their money without being penalised by the tax system, but it is worrying that some individuals plan to withdraw more than the tax-free lump sum limit.

POTENTIAL TAX BILL SHOCK

For those who take their entire pension fund in cash, they not only face paying more in tax than they have to but also put their long-term retirement income security at risk. If you exercise this option, you can't change your mind – so you need to be certain that it's right for you.

Around one in ten (10%) planning to retire this year expect to withdraw their entire pension savings as one lump sum, new research^[1] reveals, risking a potential tax bill shock and their future retirement income. The findings show in total that one in five (20%) retiring this year will risk avoidable tax bills by taking out more than the tax-free 25% limit on withdrawals.

FLEXIBLE PAYMENT WITHDRAWALS

The research suggests that some of this cash has been spent paying down debt, renovating

homes, upgrading cars or helping adult children onto the property ladder. However, not everyone is necessarily spending all the cash – the main reason given by those taking all their fund in one go was to invest in other areas such as property, a saving accounts or an investment fund (71%). And interestingly, research shows around two thirds (66%) of people are planning on retiring early.

Since the launch of pension freedom reforms in April 2015, more than 1.1 million people aged 55-plus have withdrawn around £15.744 billion^[2] in flexible payments. Government estimates^[3] show around £2.6 billion was paid in tax by people taking advantage of pension freedoms in the 2015/16 and 2016/17 tax years, with another £1.1 billion raised in the 2017/18 tax year.

SHOW ME THE MONEY

The most popular use of the cash is for holidays, with 34% planning to spend the money on trips. Around (25%) will spend the money on home improvements, while one in five (20%) will gift the money to their children or grandchildren. Other popular uses include buying cars or paying off mortgages.

Top five items retirees plan on spending their lump sum cash on

Item	Percentage
Holiday(s)	34%
Home improvements/decoration	25%
Gifts to children or grandchildren	20%
New car or second-hand car	20%
Paying off mortgage	18%

ADDED TO YOUR OTHER INCOME

Under rules introduced in April 2015, once you reach the age of 55, you can now take your entire pension pot as cash in one go if you wish. However, if you do this, you could end up with a large tax bill and run out of money in retirement.

Three quarters (75%) of the amount you withdraw counts as taxable income. Depending



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on how much your pension pot is, when it's added to your other income, it might increase your tax rate. Your pension scheme or provider will pay the cash through a payslip and take off tax in advance – called 'PAYE' (Pay As You Earn).

HIGHER RATE TAX BAND

You could end up paying more if your withdrawal added to any other income in that year takes you into a higher rate tax band. You may pay less tax if you spread out your cash withdrawals over several years and keep below higher rate bands. If you are thinking of totally withdrawing your pension fund, you might want to take into account any other earnings that you will have in the tax year, as the pension fund will be added to your earned income for tax purposes.

DRAWING PENSION FUNDS IN STAGES

Everyone has a personal tax allowance of earnings before they pay tax, which might provide a way to draw pension funds in stages over a number of years. It's a good idea to only take cash from your pension if you need it. The more you take now, the less you'll have in future. Once you go over your tax-free cash limit, you'll pay Income Tax on the rest.

Taking out more than your tax-free cash limit (when you start accessing taxable income) restricts the payments you or an employer can make to any of your pensions to £4,000 a year. This can be a problem if you're still earning and either have other savings you want to pay into a pension or if you want to make significant payments into any of your pensions. In addition,

any means-tested state benefits you receive may be affected if you take cash or income from your pension – check this isn't going to be a problem before going ahead. ■

ONE OF THE MOST IMPORTANT DECISIONS YOU WILL MAKE FOR YOUR FUTURE

For many or most people, it will be more tax-efficient to consider one or more of the other options to gain access to a pension pot. Deciding what to do with your pension pot is one of the most important decisions you will make for your future. When looking at the best income option for your retirement, it is essential to obtain professional financial advice. To find out more, please contact us.

Source data

[1] Research Plus conducted an independent online survey for Prudential between 29 November and 11 December 2017 among 9,896 non-retired UK adults aged 45+, including 1,000 planning to retire in 2018.

[2] www.gov.uk/government/uploads/system/uploads/attachment_data/file/675350/Pensions_Flexibility_Jan_2018.pdf

[3] <http://obr.uk/overview-of-the-november-2017-economic-and-fiscal-outlook/>

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