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Pension lump sums

Everything you need to know about taking your pension flexibly.

Former chancellor George Osborne introduced pension freedoms back in April 2015 and the number of individuals raiding their pension pot flexibly continues to rise.

Data from HMRC shows 198,000 savers used the freedoms to access their pension early – up 20% on the same time in 2016.

The freedoms allow over-55s to take their entire pension pot as a lump sum, with the first 25% tax-free and the rest taxed as if it were income.

But what are the rules governing lump sums? Are there any tax pros and cons to accessing your pension in this way? And what essential information do you need before making your final decision?

The rules

The conditions associated with withdrawing a tax-free lump sum from your pension will depend on what type of pension you have and how much it is worth.

No matter what kind of pension you have, tax-free lump sums will not affect your income tax personal allowance.

Defined contribution schemes

Since 2015, it has been possible to withdraw an entire defined contribution (DC) pension in cash.

Members of DC schemes can withdraw up to 25% of their pension tax-free and the remaining 75% can then be used to fund retirement in other ways, such as purchasing an annuity or an income drawdown product.

After you have withdrawn 25% of your pension, further withdrawals are taxed at your marginal rate of income tax.

The marginal rate takes into account your total taxable income for the year, an important thing to remember when calculating the potential tax effects of withdrawing beyond the 25% tax-free allowance.

Alternatively, if you don't take all of your tax-free cash up front, you can withdraw smaller amounts of cash and you will only pay tax on 75% of the amount withdrawn.

Defined benefit schemes

Defined benefit (DB) or final-salary pensions operate in a different way to DC schemes as they guarantee you a certain amount each month in retirement.

Although members of DB schemes are entitled to the tax-free lump sum in the same way as individuals with DC pensions, DB members must give up part of their pension in exchange.

This is calculated using what's known as a commutation factor.

For example, a commutation factor of 20:1 means the scheme will provide a £20 lump sum for every £1 of pension income you give up.

You will need to speak directly to your pension scheme for more information about commutation.

Small pots

Small pot lump sums allow you to withdraw all of a pension worth £10,000 or less; 25% of these withdrawals are tax-free and the remainder will be taxed at your marginal rate.

You may have built up several smaller pensions over the course of your career. However, you may not be able to take each one as a small pot lump sum.

This will depend on whether they are workplace or personal pensions.

You can withdraw small pot lump sums from an unlimited number of workplace pensions, whereas you may only withdraw the entirety of up to three personal pensions.

Pension lump sums

You are also eligible for a 25% tax-free withdrawal if you have £30,000 or less across all of your private pensions, one of which is a DB pension, and the pensions are not already in payment. If the pensions are in payment, the lump sum is added to your income.

In order to withdraw a lump sum from multiple pensions, you must have each of them valued on the same day within three months of the first payment and you must receive all the payments in a 12-month period.

Withdrawing entire pensions tax-free

Under certain circumstances you may be able to withdraw your entire pension as a tax-free lump sum.

Only individuals who are not expected to live more than 12 months are able to do this and the following conditions apply:

- you must be able to demonstrate that your life expectancy is less than12 months
- you must be under 75 years old
- your pension must not be in excess of the £1 million (rising to £1.03 million from April 2018) lifetime allowance (LTA).

The lifetime allowance

Withdrawing amounts greater than the LTA will land you with an additional tax charge.

Lump sum withdrawals exceeding the current £1 million LTA threshold (in 2017/18) attract a 55% tax charge.

This is far higher than the 25% tax charge on regular retirement income that exceeds the LTA (this is in addition to any tax paid at your marginal rate).

Lump sum withdrawals from pensions exceeding the LTA are limited to 25% of the allowance (£250,000).

Protecting your lifetime allowance

Individual Protection 2016 and Fixed Protection 2016 are schemes operated by HMRC that allow you to protect yourself against future reductions in the LTA.

Meeting the conditions for these schemes will return your LTA up to £1.25 million, the threshold until 6 April 2016.

Lump sums: advantages and disadvantages

Advantages

Tax exemption

Withdrawing 25% of your pension as a lump sum is tax-free.

If you have already taken your entire lump sum, any other withdrawals from your pension pot are added to your marginal income and taxed at your marginal rate.

Capital injection

The ability to access 25% of your pension in an instant can be beneficial, especially if you have a mortgage you want to pay off or a child who needs assistance paying for university fees.

Reinvestment

Lump sum withdrawals provide an additional opportunity for increasing your retirement income after you stop paying into a pension.

Reinvesting the cash into stable, low-risk assets may provide you with extra capital later on.

However, there are strict rules about using tax-free lump sums to pay into a pension.

Disadvantages

Lower retirement income

Taking a lump sum from your pension will mean you have less money to spend on retirement income further down the road.

Having less money to spend on an annuity or drawdown product could end up reducing your monthly income.

Less growth

Taking 25% of your pension in a single lump sum will mean you will benefit less from any capital growth experienced by the fund.

Making a smaller withdrawal and leaving most of your pension invested could net you larger gains.

As an example, withdrawing £20,000 from a pension worth £600,000 rather than the full £150,000 may be more sensible if capital growth is what you're interested in.

Complexity

Withdrawing lump sums from DB schemes can be complex and the variance of commutation factors may mean you get a poor deal.

If you're part of a DB scheme it is essential you seek professional help before making your decision.

We can discuss your retirement planning strategy.