Investment Solutions

FIVE THINGS NOT TO DO WITH YOUR PENSION

The onus is now on retirees to decide what to do with their pension savings.

However, while you may not be planning to blow your savings on a sports car or an expensive cruise habit, it is easy to make costly mistakes even when you have the best intentions.

Make sure you do not wipe thousands off your pension by following these five steps:

1. **Cash is not king**

   Some people are taking cash out of their pension, not to spend in retirement, but to put in to a Bank Account. Whilst some people do have a lack of trust in pensions and see getting money out as a good thing, it may not make any financial sense.

   Example 'Carol regards cash as a safe investment'

   So, following the Pension Freedoms in April 2015, she withdrew £10,000 - not to spend but to deposit in an Instant Access Account to have on hand for emergencies. However, only the first 25% was paid tax-free and after basic rate tax was deducted from the remainder, she only had £8,500 to pay into her account. With the top-paying Instant Access Account paying less than 1.5%, it would take a serious amount of time to recoup the money lost to tax. Throwing inflation into account, Carol may lose more money in real terms.

   While it is invested within your pension, your money is protected from income tax and when you die, it will be outside of your estate for Inheritance Tax purposes.

   At Investment Solutions, we would suggest that if individuals prefer to hold some cash, you could consider switching part of your pension fund into cash, but still keep it in the pension wrapper so it keeps its tax-free status.

2. **Withdrawing To Invest**

   There may be the temptation to cash-in your pension and re-invest the money in shares. This does not make sense for two important reasons. Firstly, 75% of the withdrawal will be taxed at your highest rate of income tax and secondly, you lose protection from Income Tax, Capital Gains Tax and Inheritance Tax.

   Example 'Investing Ian'

   Ian wants to buy a portfolio of shares, so he cashes in his pension to do this. Over the years the value of these shares grows and he is now looking to sell. As his gains exceed the Capital Gains Tax Allowance he has another tax bill to pay (after paying income tax when he cashed his pension-in). He was not aware that if he had kept his money in his pension, and reviewed where his money was invested, his money would have continued to grow tax-free and remain sheltered from IHT.

At Investment Solutions, we would advise that if individuals wish to invest in different shares and investment funds to those offered by their current pension provider, then they should consider switching to another provider, which offers the choice.

An eager investor, for example, could switch into a Self-Invested Personal Pension (SIPP) which offers access to shares in addition to the full universe of investment funds. As a regulated Financial Adviser, we can help with decisions like this.

3. **Withdrawing from a Pension**

When you have spent your working life saving into a pension it seems only natural that it is your first port-of-call when you retire and need an income. However, the tax benefits of pensions (including tax-free growth and protection from Inheritance Tax) mean it may make more sense to spend other less tax efficient assets first. A pension is a great IHT planning tool as if you die before age 75 it is paid free of Income Tax, as well as being free of IHT. If you die at age 75 or over, it will only be taxed at the recipient's marginal rate.

Example 'Portfolio Paul'

Paul has a variety of pension and investment plans. When he retired he started taking money out of his Defined Contribution Pension first, but does not realise that he might be better off living off his other taxable assets like cash deposits and dividends from shares, while his pension continues to grow in its tax efficient wrapper until needed.

Likewise as income from pensions is taxable, you may find it makes sense to draw an income from any assets that pay a tax-free income first, such as ISAs.

'For many' retirement income is not just about pension savings but all assets such as ISA's and shares. This new retirement world is about looking at all assets to provide a retirement income in a tax-efficient way. The trick is using your personal allowance every year. So you might take up to your personal allowance (£11,500 in 2017/18) from taxable assets like pensions and then use tax-free assets like ISA's over and above that.

This makes it possible to have an income in excess of the personal allowance and still pay no income tax.

4. **Don't Ignore Income tax**

Income tax doesn't just apply to earnings and will be payable when your overall income for the year exceeds the personal allowance of £11,500 (2017/2018). If you make any lump sum withdrawals from your pension, these will be added to your income for the year.

Example 'Working Wendy'

Wendy earns £19,000 a year and is a basic rate tax-payer. She decides to cash-in her £10,000 pension but does not realise that only the first 25% is paid tax-free. The remaining 75% - £7,500 is counted as income and increases her overall income for the year to £26,500 and so 20% tax is applied to this total. This means that after withdrawing £10,000, £1,500 gets swallowed up by tax and she only gets £8,500.

At Investment Solutions, we would advise that when it comes to income taxes, many people think only of the money they earn in their payslips. It is important to account for all taxable sources of income and this can include income from pensions, savings and investments.

5. **Don't Become An Accidental Higher Rate Tax-Payer**

Taking cash out of your pension will not increase your tax bill, depending on how much you withdraw and your overall income, it may even push you into a higher rate tax-bracket. This means that people who have paid basic rate tax throughout their working lives could become higher rate tax-payers overnight if they cash in, or take a lump sum out of their pension.

Example '40% Phil'

Phil earns £38,000 and pays basic rate income tax of 20%. He decides to cash-in his £42,000 pension. The first 25% - ie, £10,500 is paid tax-free. However, he needs to pay tax on the remaining £31,500 which is added to his overall earnings for the year. This bumps him up into the higher rate tax-bracket and he is taxed as if he has earnt £69,500. £7,000 of his pot will be taxed at 20% and a whopping £24,500 at the higher rate of 40%, giving him a total tax bill of £9,800 on his pension and leaving him with a pension of £32,200.

It is important to remember income tax when withdrawing money from a pension. Phil could have withdrawn his money over a number of years, keeping withdrawals below the 40% bracket and saving him thousands in unnecessary tax. He could also look at ways of paying the lowest amount of tax possible by considering how he could utilise all his assets to make the best use of all available tax allowances.

Need Advice?

We are here to help

For independent financial planning advice, please do not hesitate to contact us on:

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