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Is freedom today hurting freedom tomorrow?

Tax-free cash allowances putting some retirements at risk

A new study has identified that Britain's future pensioners are putting their retirement future at risk by withdrawing cash from their pension pots while still in the accumulation phase[1]. The findings were that some people are confusing their pension pots for savings accounts, which may have a detrimental impact on their retirement.

Rather than its original intention of incentivising saving, tax-free cash allowances appear to have the opposite effect in practice – encouraging members of pension schemes to spend more before they retire and take their tax-free cash savings while they still have other sources of cash savings. This is a potentially very damaging situation for whole generations of future retirees.

The study highlighted that 76% of savers do not intend to use their tax-free cash for retirement income, with nearly a third (28%) accessing their pension pots while still in 'accumulation' phase and female pensions savers being over 10% more likely to sacrifice returns by taking cash at 55.

TAX-FREE CASH

Nearly three-quarters of those who access their tax-free cash believe that the main purpose of their pension is to provide an income for life. However, 76% of respondents do not intend to use their tax-free cash to provide them with an income in retirement.

Over 50% of those who had withdrawn their lump sum said they did not need to take as much at that time and of those who decided to withdraw a lump sum, the most popular choice of what to do with it (27%) was to spend it on home repairs and improvements.

POTENTIAL FOR GROWTH

The tax-free aspect of taking a special lump sum at the age of 55 is a clear driver behind this behaviour. Nearly half (46%) would not have withdrawn their cash if it had not been tax-free. This is also implied by the timing of withdrawals.

Among those polled who have withdrawn from their pension, more than a quarter (26%) did this as soon as possible at the age of 55 exactly, with many unaware of the potential for growth had they kept their money invested for longer.

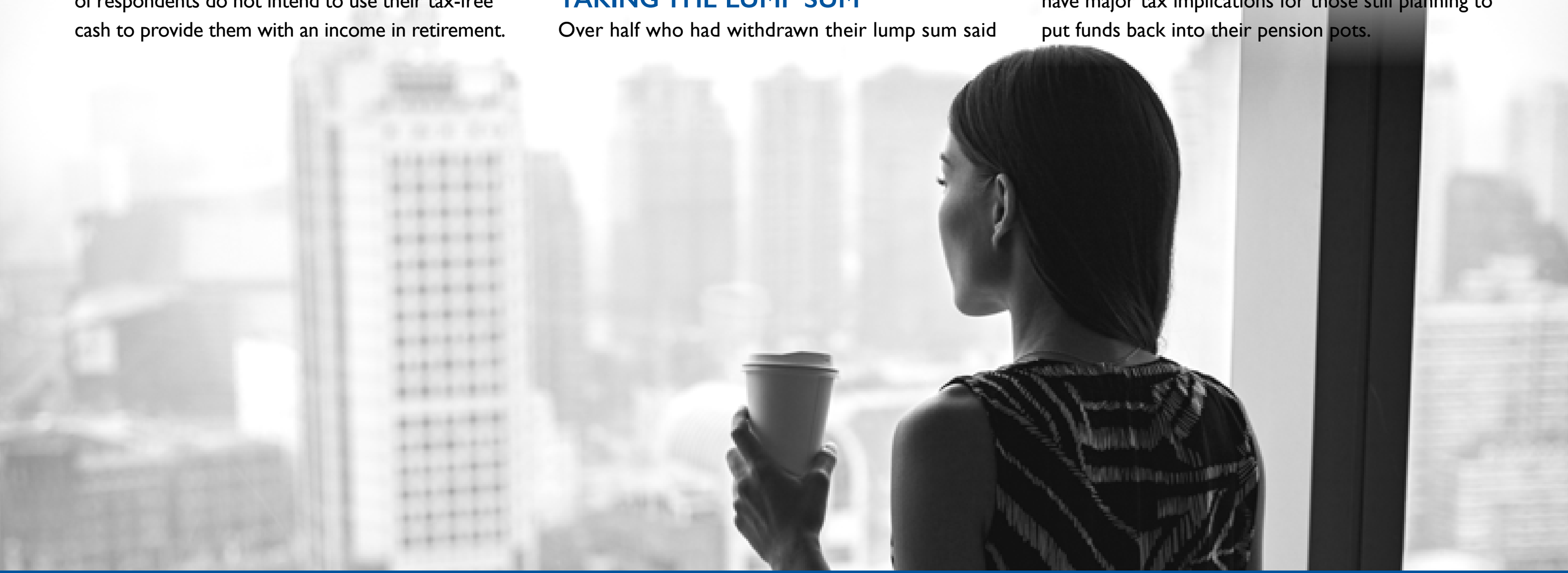
TAKING THE LUMP SUM

Over half who had withdrawn their lump sum said they did not really need as much right away and that they could have taken less. Meanwhile nearly one-third (29%) said that they could have used other savings instead of taking the lump sum out of their pension.

This highlights that the decision of when to take cash from pension pots – and how much to take – is not often based on financial planning. While minimising tax is often the driver of 'tax-free withdrawals', in many cases it can actually lead to less tax-efficient outcomes for members.

ACCUMULATION STAGE

Those who withdraw while still in the accumulation stage of their pension – which is the majority as mentioned above – compromise their 'Money Purchase Annual Allowance' (MPAA), which reduces the annual amount they can pay in to their pension each year, tax-free, from £40,000 to £4,000. This can have major tax implications for those still planning to put funds back into their pension pots.



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Those with less in their pension are more susceptible to these trends. More than two-thirds (68%) of those who have taken tax-free cash from a larger pension pot (of over £250,000) have a plan so that their cash withdrawal provides them with an income in retirement.

BONUS OR A WINDFALL

This compares to only 13% of those with less than £10,000 in their pension – two-thirds (65%) of whom haven't yet worked out what monthly income they will need in retirement. Over half (53%) of those with pots of less than £10,000 agreed with the statement that tax-free cash is 'there to spend, like a bonus or a windfall' compared to less than a third (30%) of those with pots of over £250,000.

INVEST FOR BETTER RETURNS

But even among more financially well-off savers, there is an aversion to keeping their tax-free cash invested in their pension. While nearly half (48%) of those with pots of over £250,000 say they believe their lump sum is something to 'invest elsewhere, for better returns', those with pots of over £250,000 are three times more likely to keep their tax-free lump sum in cash rather than invest it (54% in cash savings versus 18% in a Stocks & Shares ISA or other investments).

Women are also more at risk from the side effects of tax-free cash. Female pensions savers are more likely to withdraw earlier (33% of women versus 22% men at age 55) and to put their tax-free cash in a savings account, current account or Cash ISA to keep for a rainy day (29% women versus 19% men), leaving them vulnerable to accepting a low cash interest rate instead of an investment return in their pension for longer. ■

YOUR RETIREMENT – WE'RE HERE TO HELP

Pensions can be complex with so many considerations, including your family circumstances, pension rules and tax regulations. Whatever your situation, and however you want to enjoy retirement, we can help you. To find out more – speak to us to review your options.

Source data:

[1] Research was conducted for Legal & General in August 2021, surveying 1,526 members of defined contribution (DC) pension schemes in the UK, aged 50 years and older.

A PENSION IS A LONG-TERM INVESTMENT NOT NORMALLY ACCESSIBLE UNTIL AGE 55 (57 FROM APRIL 2028 UNLESS THE PLAN HAS A PROTECTED PENSION AGE). THE VALUE OF YOUR INVESTMENTS (AND ANY INCOME FROM THEM) CAN GO DOWN AS WELL AS UP WHICH WOULD HAVE AN IMPACT ON THE LEVEL OF PENSION BENEFITS AVAILABLE. YOUR PENSION INCOME COULD ALSO BE AFFECTED BY THE INTEREST RATES AT THE TIME YOU TAKE YOUR BENEFITS.

THE TAX IMPLICATIONS OF PENSION WITHDRAWALS WILL BE BASED ON YOUR INDIVIDUAL CIRCUMSTANCES, TAX LEGISLATION AND REGULATION WHICH ARE SUBJECT TO CHANGE IN THE FUTURE. YOU SHOULD SEEK ADVICE TO UNDERSTAND YOUR OPTIONS AT RETIREMENT.