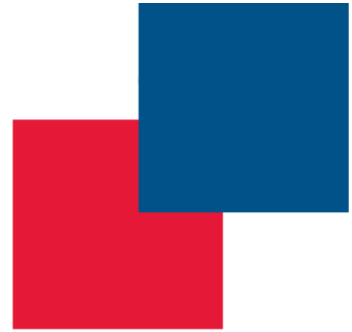

Defined Contribution Pensions and Tax

A guide for clients

A guide to the tax implications of accessing your pension

After decades of contributing to a defined contribution pension and watching it grow, there comes a point when an individual's working life ends and their retirement begins. Your pension savings are likely to be the primary financial tool that you have to ensure you live the life you want in your twilight years.

When planning there are 2 important factors to consider: the different options for withdrawing your money and the tax implications of each.

The majority of people will become eligible to start accessing their pot when they turn 55.

The tax benefits of paying into a pension are significant. The government provides tax relief on each contribution made into a private pension, which effectively means it costs less than a pound to put a pound into your pot. The tax relief provided is based on income tax bands:

- basic - 20%
- higher - 40%
- additional - 45%

There is an annual allowance for pension contributions of £40,000 for 2016/17, above which a tax charge may be incurred.

While the tax efficiency of paying into a pension is clear, the question on most people's minds is how much the taxman is entitled to when they want to start making use of their pot.

Accessing your pension

The tax treatment of your pension pot depends on the way you access it. The pension reforms initiated by ex-chancellor George Osborne (often referred to as 'pension freedoms') have given people more flexibility in what they can do with their pension savings.

There are 4 main options available, but the strategy that can come from mixing them can be suited to your circumstances.

Cash lump sums

Some pension providers allow you to withdraw chunks of your pension pot for use however you want. Perhaps you want to pay off the remainder of your mortgage to see out your days debt-free, or maybe you have always wanted a luxury trip to the other side of the world.

How much you take from your pot is up to you, but the tax treatment is always the same. The general rule is that 25% of the sum is tax-free while the remainder is taxed as income.

Each time you withdraw a cash lump sum, this rule will apply. Your provider may also charge a standalone fee for withdrawals so make sure to confirm this before taking any lump sums.

The money you take from your pension is added to your income for that year.

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Taking your whole pot

Alternatively, you may be able take your whole pot in one go as cash. The same general rule as smaller lump sums applies here: 25% is tax-free and 75% is taxed as income.

Pension providers deduct tax before you receive your money.

With such a potentially large sum being added to your annual income, it is important to plan for the tax implications of moving into a higher tax band (including entitlements to benefits).

You may pay emergency tax when you take money from your pot, which you then claim back.

Annuities

Using your pot to purchase an annuity will guarantee you income for the rest of your life, or for a set number of years.

The level of income you receive from your annuity will depend on:

- the size of your pot
- your age
- your health and lifestyle choices
- whether you want steady or increasing income
- whether you want continue payments to continue going another person after your death.

The income you receive from your annuity is taxed as such, so you won't be liable for income tax if your annual earnings fall below the personal allowance.

It is possible to take up to 25% of your pot as a tax-free cash sum and use the remaining money to purchase an annuity. The tax-free cash sum does not use up any of an individual's personal allowance.

Flexi-access drawdown

It is possible to get an adjustable level of income from your pension pot. This option is known as flexi-access drawdown and usually involves taking up to 25% tax-free and investing the remainder in a way that provides you the kind of income you want.

This means that you can adjust the level of income you receive and the intervals at which you receive it. Because the remainder of your pot is invested, market risk is a much bigger factor to consider.

The income you receive from your investments will be taxable, but your provider will likely deduct any tax due before paying you. If you begin to flexibly access your pension, you may trigger the money purchase annual allowance rules. This reduces the annual allowance for 2016/17 to £10,000 (£4,000 for 2017/18) and is designed to prevent people avoiding tax on their earnings by diverting salary into their pension and withdrawing it.

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Deferring

The final option is to do nothing and let your pot sit for a bit longer. A person is under no obligation to start drawing their pension when they reach 55 and for many this will be significantly earlier then their actual date of retirement.

You are not liable to pay tax on your savings if the money stays in your pot and you can continue to get tax relief on contributions until the age of 75.

Some pension scheme providers will charge extra fees if you do not begin drawing your pension when you reach your selected retirement age. It is also possible that you may lose income guarantees.

As always, the value of any investment has the potential to fall as well as rise over time.

Our expert team can help you create an effective, tailored retirement strategy.

Creating a strategy that works for you

Everyone who reaches their retirement will be in a unique position, with varying sized pots, different assets and individual goals and aspirations. The best strategy for accessing your pension will use the 4 options at your disposal in a mix that reflects your circumstances and desires.

Some examples of mixed strategies:

- you use a portion of your single pension pot to buy an annuity and invest the rest for an additional, adjustable income stream
- using multiple pots to utilise different options such as purchasing an annuity with one and taking lump sums from another as and when they are needed.

Not all pension providers offer all of the options. You can transfer your pension pot to another provider if your current provider does not offer the option you wish to use (though there may be charges to do this).

Your income level in retirement will have a significant effect on the life you are able to live. Any strategy for accessing your pension needs to be weighed up, not just in terms of tax liability but also in the long-term effects it is likely to have on your standard of living.

It is always advisable to consult a professional adviser before you commit to a plan of action. Our expert team can help you work out which strategy will be best-suited to help you achieve the retirement you want while maximizing tax-efficiency.

Contact Tax Partners Sue Stephens or John Elliott to talk about your retirement.

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Please note that this guide is not intended to give specific technical advice and it should not be construed as doing so. It is designed to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.

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