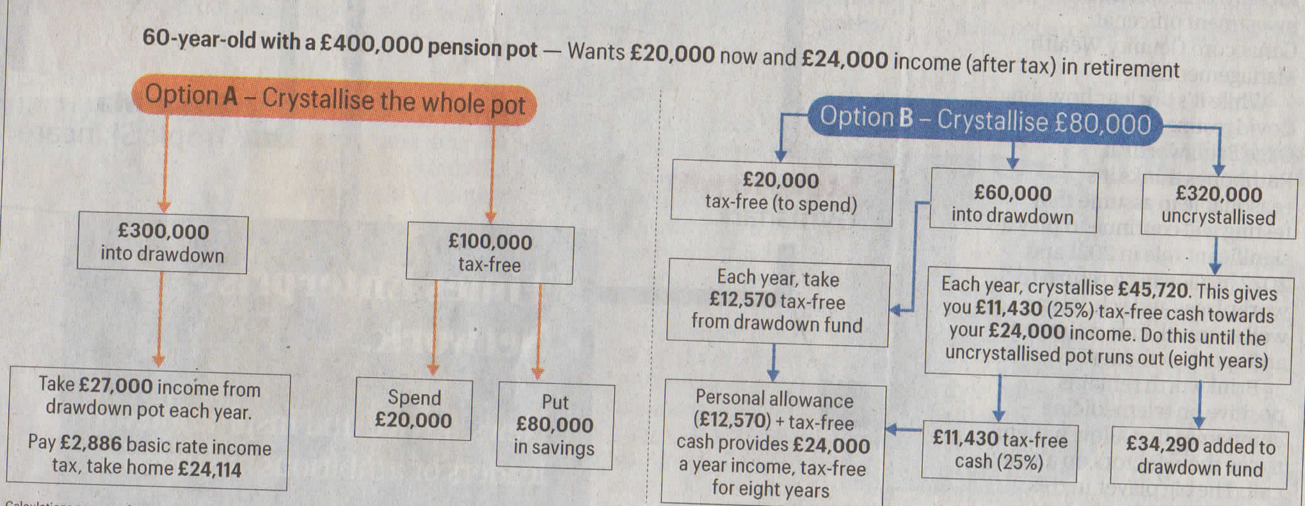
When you take your tax-free lump sum can make a big difference, says *Imogen Tew*

PENSION POT PATHWAYS



Calculations assume: 4 per cent investment growth a year, a reduced drawdown amount once state pension kicks in at age 67, state pension and personal allowance rise 2.5 a year from 2026

After years of having your nose to the grindstone and saving diligently, your reward from the taxman is to be able to take 25 per cent of your pension as a tax-free lump sum. With widespread speculation that the government will target pension reliefs as part of its efforts to claw back some of the costs of the pandemic – which run into hundreds of billions of pounds – some fear that the lump sum would be the easiest place for the Treasury to start.

Those planning to take advantage while they still can should consider their options carefully. While you may like the idea of withdrawing the whole sum as soon as you can, the impact on your pension pot could be stark. Here is what you need to know.

Take it or leave it

Your choices when you reach retirement depend on the type of pensions you have.

If you have a defined benefit (DB) scheme that guarantees you a set annual income for life, often inflation-linked, you can choose whether or not to take the tax-free lump sum. If you do not, your annual income will be higher but you could end up paying more tax.

Retirement income is treated like other income, so anything over the personal allowance of £12,570 is taxed.

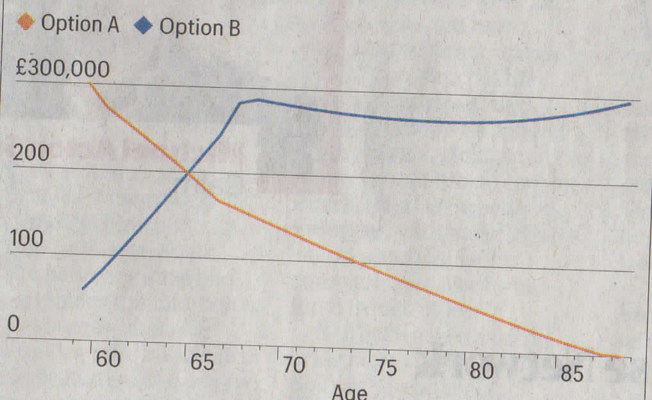
For those in defined contribution (DC) schemes – the most common form of pension today, where the size of your pot depends on how much you contribute and how your investments fare – the decision is not binary.

One option is to take 25 per cent of the pot's value as a tax-free lump sum and leave the rest invested to provide an income during your retirement, a process known as drawdown.

Another route is to leave some of your pension untouched and "crystallise" your money in stages.

By doing it this way, you can benefit from a 25 per cent tax-free lump sum of however much you crystallise each time. The other 75 per cent goes into drawdown or buys an annuity to provide you with a retirement income. Everything else remains uncrystallised. Both the uncrystallised and crystallised parts of your pension can continue to grow but only the former will provide more tax-free cash in the future.

HOW TAX-FREE CASH AFFECTS A DRAWDOWN POT



Calculations assume: 4 per cent investment growth a year, a reduced drawdown amount once state pension kicks in at age 67, state pension and personal allowance rise 2.5 a year from 2026.
Source: LV

For example, if you want an income of £15,000 a year, you could crystallise £15,000 of your pension pot. This would give you £3,750 of tax-free cash. If you withdrew the remaining £11,250 as income from your drawdown pot, this would be within the £12,570 personal allowance so there would be no tax.

If you had taken your tax-free cash as a lump sum, then took £15,000 income in retirement, you would pay 20 per cent basic rate tax on the amount above £12,570, which would be £484. All calculations include fees.

Make it last

Whether you take your tax-free cash as a lump sum or drip-feed it throughout retirement can affect how long your pension pot lasts.

By not crystallising your entire pension pot straight away, you can use your tax-free cash funds alongside your personal income tax allowance to take an income in the most tax-efficient way, which will help your funds last longer. You could also end up with more tax-free cash in the long run.

If you had a £100,000 pension pot that you crystallised immediately by taking £25,000 tax-free and placing £75,000 into drawdown, any money you withdraw after this point will be subject to income tax.

If you crystallised £20,000 – taking £5,000 tax-free and putting £15,000 into drawdown – there would be £80,000 uncrystallised in the pot. If that sum grew 4 per cent a year for six years, it would be £101,660, and you could still take 25 per cent (£25,415) tax-free even though you had already taken £5,000 of tax-free cash the first time you accessed your pot.

"One of the biggest retirement mistakes people can make is whipping all their tax-free cash out as soon as they are able to, without thinking about what to do with the money," said Tom Selby, a financial analyst from the investment platform A J Bell. "Partially withdrawing chunks is a good way to get the tax-free cash while keeping more of your money invested."

Things to think about

Taking a big lump of tax-free cash can make sense if you have a specific purpose for it, such as paying off a mortgage or other debts, or gifting to children and grandchildren.

You should also consider the size of your pension and whether you may breach the pensions lifetime allowance, which is frozen at £1.073 million until 2026.

Anything higher faces a tax charge of 25 per cent if you keep it in your pension and take it as income, or 55 per cent if you take it as a lump sum. It could be worth taking tax-free cash so you do not go over this limit, but remember that any money outside the pension wrapper will be subject to capital gains and inheritance tax.

Any money you leave inside your pension is also free from inheritance tax, so if your estate is likely to have an inheritance tax liability (above the £325,000 threshold and not left to spouse, civil partner or charity), it could be worth keeping your money inside.

When your pension is passed to your beneficiaries, it is free from tax if you die before you are 75. After that age it is taxed as income.