Six common mistakes people make with tax-free pension cash

"Just because you can, doesn't mean you should"

Under the new pension freedoms, taking tax-free cash before full retirement is proving very popular – so much so in fact that data shows as many as three-quarters of those going into drawdown are simply taking their tax-free cash and leaving the rest of their pension pot invested.

Using Tax-Free Cash Ahead of Other Savings

Once someone takes tax-free cash from their pension it becomes part of their estate and will also generally limit its ability to grow tax-efficiently in the future. As a general rule, individuals should consider withdrawing from taxable savings first, then tax-free savings such as ISAs and then their pension.

In this way, they can ensure they keep their pension, which is generally the most tax-efficient way of saving, sheltered from the tax man for as long as possible.

Taking More Than Is Needed

Pension rules do not require individuals to take all their tax-free cash at once. If their pension supports it, someone can access only part of their tax-free cash and keep the rest invested for later. This means they can continue to grow more tax-free cash for the future.

Taking Tax-Free Cash at The Wrong Time

Understandably, once an individual has identified a use for their tax-free cash, they will be keen to take it out. But if they do that just after the investments in their pension have fallen in value, they will be locking in that loss.

We are not suggesting they try timing the market exactly, but if there has been a big market fall for example, they should ask themselves if they really need the money now or can they afford to keep it invested for longer with a view to making up any losses.

For those with larger pension pots, taking tax-free cash (crystallising) can mean they avoid going over the Lifetime Allowance and paying penal tax rates.

They should usually wait, however, until they are right up to the Lifetime Allowance before taking tax-free cash. This will make sure they maximise their tax-free allowance while still avoiding a big tax bill. Crystallising early will avoid the tax bill but mean they miss out on some tax savings.

Taking Tax-Free Cash and Doing Nothing With It

Many people accessing tax-free cash are doing so for a specific reason, maybe to pay off debts or to fund home improvements. But equally, it seems that many people are taking it out simply to save it elsewhere, often in a bank account.

There are a number of reasons why this is not a good idea, the first being that once it is in a bank account, any returns it earns could be subject to tax whereas it would have grown tax-free in a pension.

Furthermore, the bank deposit will be included in the person's estate for inheritance tax purposes whereas it is exempt from inheritance tax while in a pension. Finally, having additional assets in a bank account may affect the person's ability to claim certain benefits whereas, if it is held in a pension, it is generally not considered.

Even if someone puts the money in other investments, they may find they are just receiving the same returns they could have done in their pension but are now subject to the problems listed above.

Taking Tax-Free Cash When Not Paying Tax

If someone does not have enough other income to use up their personal income tax allowance – currently £11,000 for the 2016/17 tax year – then it may not make sense to take out tax-free cash. Instead, they may want to consider making a withdrawal from their pension plan that is partly taxable.

Since April 2015 pension savers over the age of 55 have been able to make a lump sum withdrawal where 25% of the withdrawal is tax-free and the rest is taxable as income. As an example, if someone had £6,000 of unused personal allowance then they could take £8,000 from their pension plan in this way and still pay no tax. The advantage is that they keep more of their tax-free cash in their pension and growing for the future.

Accessing their pension in this way does limit a person's ability to save more that £10,000 each year into their pension but, for many people, this will not be a problem.

Not Claiming the Full Tax-Free Amount

If someone has been in a pension scheme before 2006, then they may be able to take advantage of so-called 'protected tax-free cash'. The rules are quite complex but could mean that a person is entitled to more than 25% of their pension savings as tax-free cash.

They or their adviser should check with their pension plan provider to see if they are eligible. If they are, they will probably need to provide earnings details from before 2006 to allow the pension provider to calculate what they are due.

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