Taking your pension lump sum?

Just because you can take out a tax-free lump sum from your pension, doesn't mean you necessarily should. Removing this money at an early age could put your financial security in retirement at risk.

Some savers can currently access pension savings from the age of 55, and in most cases can take out a quarter of their fund as a tax-free lump sum. Withdrawals over and above this will be subject to income tax.

New research by Legal & General found a third of women (33%), and more than a fifth of men (22%) are withdrawing the full 25% tax free lump sum at the age of 55. The money is often used to fund home improvements and holidays, according to the research. Funds that are not spent are often squirrelled away in bank accounts and cash ISAs. Almost a third (29%) of women taking this tax-free cash put it into some kind of deposit account, as do 19% of men.

But at the age of 55 most people are still at least ten years away from retirement. Spending this money will seriously reduce the size of retirement savings, while switching to cash means losing out on any future investment growth.

Although these are not guaranteed, over the long-term growth assets, such as equities, typically deliver far better returns than cash. Keeping money invested could potentially make a significant difference to the overall size of a pension fund.

Potential pitfalls

Accessing your pension early can create other problems:

- Withdrawals of more than 25% may be subject to income tax at the marginal rate. If these are significant sums, individuals can be pushed into a higher tax bracket.
- Those taking more than 25% also face restrictions on future pension savings. The annual allowance enables savers to get tax relief on contributions of up to £40,000 a year. This reduces to £4,000 a year for those withdrawing more than their tax-free lump sum.

The L&G research found a significant number of those taking their tax-free lump sum had other savings. Given the potential loss of future investment returns, it may make financial sense to use those other savings first to pay for those home improvement or other short-term spending needs. This should maximise the long-term growth in the pension and may be more tax-efficient.

Remember this 'tax-free' option does not disappear if it is not used at the age of 55. You can withdraw the lump sum at a later date, where it may be 25% of a larger fund.

It's also worth bearing in mind that many pensions offer a degree of flexibility around how savers take this tax-free cash. For example, some allow you to withdraw the lump sum in stages — so if only part of the money is required, the rest can stay invested within the fund. However not all pensions offer this flexibility.

Seek advice on your available options and how taking pension benefits might affect your current tax position and long-term financial plans.

The value of your investment and any income from it can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance. Investing in shares should be regarded as a long-term investment and should fit with your overall attitude to risk and financial circumstances.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax advice, and tax laws can change.