WHIreland®
WEALTH MANAGEMENT

Case Study

Tax aspects of pension lump sum

The way defined contribution (DC) members can draw benefits from their pension funds offers unprecedented levels of flexibility following the introduction of pension freedoms and choice in 2015. However, this increased choice means the need for financial advice is more important than ever.

Whilst it is good news for clients to have the option to take all of their pension funds at once, this will rarely be the best option, not least from a tax point of view.

Here is an example:

David has a fund of £300,000. Under the new rules he will be able to take all his funds at once, but in return he would suffer a considerable income tax charge.

Assuming:

- he has no other income;
- using the proposed tax rates and thresholds for 2018/19; and
- £75,000 is taken as tax free cash.

The remaining £225,000 would be taxed as:

£34,500 x 20%	£6,900
£115,500 x 40%	£46,200
£75,000 x 45%	£33,750
	£86,850

Note: David's entire personal allowance is lost as his total income for the year exceeds £123,700.

So an effective rate of tax of over 38% (£86,850/£225,000). The rate would be even higher if he has other income.

If instead he took the same funds over a number of tax years he could keep his personal allowance and not pay any higher or additional rate tax at all.

If David decided to take the funds over just 5 years the tax bill would reduce considerably, even assuming no increases in next year's allowances or tax bands.

- £225,000/5 = £45,000
- £11,850 @ 0% = 0
- £33,150 @ 20% = £6,630
- £6,630 X 5 = £33,150.

So an effective rate of tax of less than 15% and a tax saving of £53,700 with some straightforward planning.

If David chose to withdraw the funds over an even longer time frame then the tax savings could be even higher as a greater proportion will fall into the personal allowance. If withdrawals were always kept within his personal allowance each year i.e. £11,850 for 2018/19, then potentially he could pay no income tax at all. Clearly this may not be practical or desirable for many clients, particularly those with larger funds like David but for those with small funds it would certainly be worth considering.

Taking an example with a smaller fund:

Alex has a fund valued at £79,000

As with the earlier example if he takes the full amount as a lump sum (after £19,750 TFC) assuming he has no other income and based on the tax rates for 2018/19, it will be taxed as:

£11,850 @ 0%	£0
£34,500 @ 20%	£6,900
£12,900 x 40%	£5,160
	£12,060

Effective rate of tax equal to 20.4%. (£12,060/£59,250)

If instead Alex took the funds over 5 tax years he could take the entire fund without paying any tax at all.

£59,250/5 = £11,850

As this is all within the personal allowance the tax will be £0 each year. So with careful planning Alex saves the entire £12,060 of tax and gets to keep the full £79,000 fund.

For simplicity these examples have assumed no growth on the pension funds over the 5 year terms. However, as well as the tax efficiency of taking the funds out over a number of years, it is also worth remembering that while the funds remain invested in the pension, they remain in a tax advantaged environment. If all the funds are withdrawn, assuming they are not instantly spent they will need to be invested elsewhere. Clients are unlikely to find a more tax efficient environment than remaining invested in a pension. So taking a large lump sum all at once is unlikely to be best option for many.

Every care has been taken to ensure that this information is correct and in accordance with our understanding of the law and HM Revenue & Customs practice, which may change. However, independent confirmation should be obtained before acting or refraining from acting in reliance upon the information given.

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