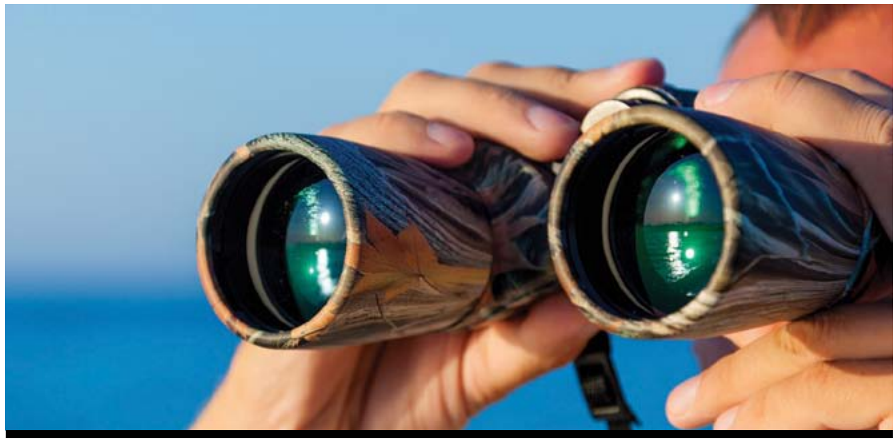
Look out

Jonathan Watts-Lay considers ways to help employees avoid pension pitfalls, leading to better outcomes at retirement



While Lamborghinis and caravans made the headlines at first, the real story of the pension freedoms has been the revelation of how little pension scheme members actually know about their retirement savings; whether it's where they are invested, how much they are worth, or the options they have when they come to take money from them. I stop short of saying 'retiring' because many people are taking cash from their pension schemes before retirement.

Research from a variety of sources continues to support this. Recent FCA data showed the majority of people accessing benefits are aged 55-64 and most are cashing in pension pots in full (usually small pots with an average value of £13,000) and 90 per cent of all pots fully encashed are under £30,000.

Our research findings from 2019 show that 81 per cent of trustees believe members are not equipped to deal with the taxation implications of accessing their pension. This risk is likely to be heightened by the many individuals failing to seek regulated financial advice when accessing their pensions.

The FCA found that almost half (48 per cent) of pensions accessed in 2018/19 were taken without the scheme member receiving regulated financial advice or guidance. Perhaps members think they understand cash rather than the intangible value of a pension scheme, but they are leaving themselves vulnerable to making poor decisions, which can create a permanent dent in their retirement income.

To help overcome this, let's look at some of the tax implications of individuals accessing their pension and the ways trustees and employers can help mitigate these implications to avoid poor outcomes for employees and pension scheme members at retirement.

Firstly, tax planning should be at the heart of any pension transaction. Only the first 25 per cent of the amount that is withdrawn from a pension pot is tax free and the remaining 75 per cent is taxed as earned income. If employees and members cash in a pension during a tax year when they are still working, 75 per cent of the sum withdrawn will be added to their earnings for that tax year and may push them into a higher tax bracket. Employees and members need to be aware of this, as they may want to consider withdrawing smaller amounts from their pot.

They should also be aware that if they withdraw any cash simply to add to their savings, the money withdrawn will form part of their estate for inheritance tax purposes. It's crucial to remember that a pension remains one of the most tax-efficient saving vehicles available.

Many are unaware that accessing a DC pension is a trigger event for the Money Purchase Annual Allowance (MPAA). Those who fully encash pots over the £10,000 limit will trigger it, reducing their annual allowance from £40,000 to £4,000. This could mean they have to revise their retirement plans, as they missed the opportunity to boost their pension savings in their later working years when other financial commitments, such as a mortgage, have ended.

Freedom of Information requests by Just Group and Royal London uncovered that, between 2015 and 2019, nearly one million pension scheme members over the age of 55 triggered the MPAA.

To help combat these issues, it is important to facilitate access to financial education and guidance, as employees and members are more likely to make informed choices if they do; including being able to decide if they need further support such as regulated financial advice. Studies have shown that those who take regulated financial advice are more likely to increase their wealth than those who do not. This is because it provides them with a plan tailored to their needs and added consumer protection for the advice given to prevent them from making costly mistakes.

This approach helps trustees and employers, as well as employees and scheme members by ensuring the retirement process and the options available are well understood, therefore leading to better outcomes.

Written by Jonathan Watts-Lay, director, WEALTH at work

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