

## Make the most of your lump sum

What should you do with your option to take a 25 percent tax free lump sum? In some instances it's not always a no-brainer', reveals Faith Glasgow

One of the more enjoyable dilemmas to chew over as you get older is the question of what to do with the tax-free lump sum to which you're entitled when you tap into your pension fund.

For most people, there is no shortage of possibilities. Those with mortgages outstanding are likely to use at least some of it to reduce the debt; and it's hard to resist the temptation to blow a chunk on a one off treat - a cruise, a camper van, a new car - to herald the start of retirement or at least semi-retirement.

But before you spend the lot several times over in your imagination, it's worth taking a hard-headed view of the spectrum of investment alternatives available to you at that point. The situation varies somewhat depending on whether you're in a money purchase scheme (whether a personal or an occupational pension), or a final salary arrangement.

If you have a money-purchase pension, you're not obliged to take a lump sum at all: you could leave some or all of it in the fund to enhance your pension income. In practice, though, it's pretty much a no-brainer for most people to take the cash. In part that's a psychological thing: here's a chunk of money you've earned over decades of hard work, a reward for your diligent slogging and saving - go out and buy yourself something nice. But financially it usually makes sense as well.

It's almost always sensible to take the maximum cash, because - stating the obvious - it's tax-free, and it's a lump sum there in your hands. In contrast, any pension income generated if you leave it invested will be fully taxable, and if you die

your annuity will generally die with you; explains Richard Harwood, a financial planner and pensions specialist at Brewin Dolphin.

Moreover, even if boosting your income is a priority, annuity rates are so low (and on a downward trend) that you're likely to do better by putting your lump sum elsewhere, as we'll see later.

However, there is one exception to the rule. It may make more sense to leave the 25 per cent invested if you have an old pension (dating back to before the rules were changed in 1988) that provides generous guaranteed annuity rates.

'Back in those days, contracts were offer-annuities paying 10, 11, 12 per cent or even more,' says Carl Lamb, managing director at IFA firm Almary Green. 'We still have clients coming to us with old executive pensions like this, and in these circumstances it can make sense to forgo the cash and take it all as income, even though they'll pay tax on that income.'

Harwood agrees: 'These clients basically need to compare the income they'd get if they took the tax-free cash, with the amount of taxed income they'd be assured of if they left it in the pension. I have seen examples where it's been a pretty close call.

But for most people without such generous income guarantees, that question doesn't arise. Instead, they need to consider whether they can afford to spend the tax free capital, or whether, given the reduced size of the remaining

pension pot, they should sensibly invest it to boost their future retirement income in some way.

If you take professional advice - and this is one of the times when it really makes sense to do so - your adviser will probably make use of cash flow modelling to assess how much income you'll need each year and whether, to achieve that, you'll need to use the tax-free cash to supplement your pensions and other income sources. If you do, there are various options to consider, depending on your needs.

### **Guaranteed income**

The people most likely to be tempted by the idea of leaving their cash in the pension fund to boost their annuity are those who want the security of a guaranteed income for life. But even they have an attractive alternative in the shape of what's known as a purchased life annuity, says Harwood.

These provide a fixed lifetime income in the same way as a conventional annuity, but they can be bought with your own cash, rather than using a pension. Importantly, unlike ordinary annuities which are fully taxable, purchased life annuities are taxed by HM Revenue & Customs (HMRC) as 'return of capital', meaning you only pay income tax on the interest element of the annuity each year.

Harwood gives the example of a 65-year old man with a £400,000 pension who takes the 25 per cent tax-free lump sum and uses that £100,000 to buy a purchased life annuity that pays, say, £6,425 a year: 'If the insurance company assumes he has about 20 years to live, then every year £4,960 of that £6,425 will be treated as returned capital, so he'll be paying income tax only on the £1,464 interest,' he explains. 'The rates are not always as keen as for conventional annuities, but the tax break more than makes up for it. They can be very good for people who want income security.'

### **Hedge against inflation**

As Harwood points out, many people will live 20 years plus in retirement; even at a low rate, inflation will erode any fixed income. Anyone comfortable with some risk could therefore invest their lump sum in a diversified fund portfolio designed to produce income that will supplement their pension, plus some capital growth to boost income potential in years to come.

Again, tax is a consideration. 'For basic rate taxpayers an unwrapped portfolio is relatively tax efficient, and little different from one held in an Isa because dividend income has already been taxed at 10 per cent within the funds and capital gains can usually be kept below the annual allowance; he says. 'Typically, though, we gradually move the cash into an Isa over several years to protect it.'

Carl Lamb says other tax-efficient investments such as offshore or onshore bonds and venture capital trusts may also be used, depending on a client's individual circumstances.

### **Recycling**

Another possibility, if you're still earning, is to 'recycle' some of your tax-free cash by paying it straight back into a pension. Mike Morrison, head of pensions at Axa Wealth, says this could work for someone who took relatively early retirement but then set themselves up as a consultant.

'They would get tax relief on the contribution, and would also be able to take another tranche of tax-free cash when they came to draw that pension. Additionally, because this would count as a new fund that had not been "crystallised" or drawn on, if you died it would not be subject to tax; he explains. However, he warns that HMRC's rules regarding the recycling of tax-free cash are complex and people should take advice before going down that path.

### **Final salary schemes**

If you're lucky enough to be a member of a final salary scheme, you won't necessarily get an automatic 25 per cent lump sum offer. Final salary schemes

have their own rules but normally work on the basis of less than 25 per cent conversion rate to tax-free cash, according to Harwood.

So you'll probably receive a quote as you approach retirement, telling you that your full pension is worth £x a year and alternatively you can take a reduced pension of £y a year, plus a lump sum of £z worked out on the basis of the scheme rules. He gives the example of someone retiring on £60,000 who might typically be offered £30,000 a year plus a £90,000 lump sum.

However, Harwood adds that in practice the schemes often offer 25 per cent as an alternative. 'The big question is what the 25 per cent does to your pension income,' he says. 'In the example above, the tax free lump sum might rise to an alluring £250,000 – but is it worth it if your income falls from £30,000 to £20,000?'

The loss of that income is all the more significant as in most schemes it's likely to be partly or fully index-linked, and will therefore rise with inflation for the rest of your life. So in the above example, the loss of £10,000 a year for, say, 20 years is actually worth a great deal more than £200,000. 'In such cases, it maybe more advantageous to take the lower level of tax-free cash because it's worth so much more within the pension scheme; comments Harwood. 'But you really need to see both options to make a sensible comparison.'

Ultimately, your decision will rest on your personal situation: the size of the pension fund if you leave it be or withdraw cash; your need for a capital lump sum; your other assets; your health. A financial planner should be able to help you decide the best route for your own circumstances.