For professional clients only.
Not to be distributed to retail clients.

Cold hard cash: Making the lump sum less taxing

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Walter Mischel's marshmallow test showed that most children would rather receive a reward now (one marshmallow) than four later. In Legal & General Investment Management's 2021 research into 1,500 people's attitudes to tax-free cash, we found that retirement savers are no different. As with sweets, when it comes to pensions, more efficient saving now means more to spend later. Unlike marshmallows, however, the way you spend your gains is just as important.

We know that today's savers aren't savvy spenders: in part one of our research, we examined the key myths surrounding tax-free cash that are stopping scheme members from maximising retirement outcomes. The question is how to change ingrained behaviours. To take this forward, we tested if some relatively straightforward stimuli could change how people think about their tax-free cash: from a windfall at aged 55 to part of their retirement income. We focused on the key issues that first part of our research uncovered: a reluctance to stay invested, tax-inefficient withdrawals, a lack of awareness about the Money Purchase Annual Allowance (MPAA) and lack of confidence in the benefit's longevity.

Source: LGIM research, took place in August 2021, 1,526 quantitative interviews and 50 qualitative interviews with DC pension members over the age of 55.

What did we do?

1. Qualitative research of 50 one-hour interviews with three core groups of non-advised defined contribution (DC) pension scheme members:
    - **Group 1:** Over 55-year-olds who had accessed tax-free cash and moved into some form of drawdown
    - **Group 2:** Over 55-year-olds who had not yet started to access any of their DC pensions
    - **Group 3:** 50-54-year-olds who were starting to think about what to do with their DC pots

Quotas were set to screen out people with small pots of less than £10,000, those with large defined benefit (DB) provisions in their household, and those who had decided to generate their pension income from a buy-to-let portfolio. All interviews were conducted in July 2020.

2. Quantitative research took place in August 2021 among 1,526 DC members:
    - **Group 1:** 417 respondents aged 55-70 who had taken a cash lump sum out of a DC pension in the last five years
    - **Group 2:** 560 respondents aged 55-70 who hadn't yet accessed any of their DC pensions
    - **Group 3:** 549 respondents aged 50-54 with a DC pension in accumulation

> "If I'd had a financial adviser sitting on my shoulder saying, that's not a good idea because of this, I might have rethought it."
>
> Female, aged 55-70, taken tax-free cash

Section 1

Invest is best

Whether down to loss-aversion or a keenness to have their money in their hands today, non-advised savers – who are the majority of retirees in the UK – remain firmly in the dark as to the relative merits of investments over cash. Those who have been to see a financial adviser in the past are more 'awake'.

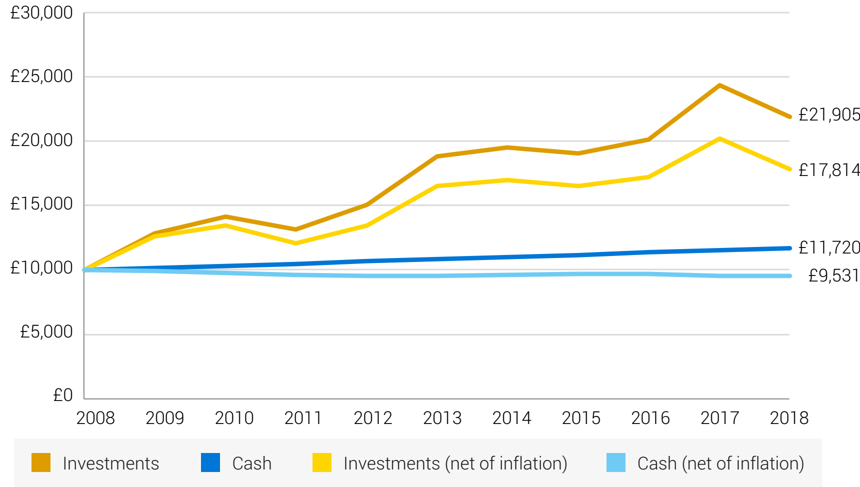
Starkly, however, few people overall keep their tax-free lump sum invested in their pension over the long term. Over 60% (61%) of those who have withdrawn their money already have taken it out by the time they reach their 65th birthday and only 13% of those we interviewed kept their tax-free cash invested beyond aged 65.

Similarly, over a quarter (26%) of our retirees told us: 'I did not think too deeply about the pros and cons of taking my pension money when I did, versus whether I would need it to live off in retirement'. Any attempt to persuade retirees to think differently would have to build on delayed gratification to overcome short-termism in the way retirees conceive of their tax-free cash.

But could a simple prompt which encouraged them to visualise the long term make them reconsider their decision? We found that a chart showing the different values of a pension versus cash ISA over the last 10 years has the power to instantly change views:

"It's double what you'd get in a savings account. So would I put it in a pension rather than a savings account, are you so mad? Put it in a pension!"
Female, aged 59, not accessed their pot.

Example of cash savings versus pensions:



Note: Annual UK CPI inflation sourced from inflation.eu. Cash ISA returns of 1.6% per year, based on the average monthly rate between 2011-2019 from Bank of England data (UK one-year fixed rate cash ISA deposits). Investment returns calculated using the MSCI World Index less a 1.5% annual charge.

Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested. The above information does not constitute as investment advice.

As 52% of savers who have already taken cash admit they could have taken less, it was unsurprising that after being shown the chart, the statement which resonated with most people was:

"The chart is useful and it would make me think twice about taking more tax-free cash out than I need".

Nearly half (47%) of those who had already taken part or all of their tax-free cash agreed.

A similar number (43%) would take this concept even further, agreeing that:

"The chart is useful and it would make me think twice about taking any tax-free cash out of my pension until I get to retirement".

This represents an encouraging shift away from the numbers who currently withdraw on their 55th birthday.

A problem that we identified earlier on in the research is that many retirees are using their pensions more like a savings account – instead of their savings. But after seeing the chart, nearly four in 10 (39%) agreed with the statement:

"The chart is useful and I would now take money out of my savings account before accessing my tax-free cash".

Meanwhile, the chart prompted over 40% (41%) to think more holistically about their total wealth and what to use it for, as they agreed with the statement:

"The chart is useful and it might have made me consider paying less into my savings and more into my pension".

Despite its game-changing potential, most savers we spoke to had never seen this key information presented in this way. They had seen plenty of information about the four options for their DC pot – leaving the money alone, taking all the money in one go, annuitising, or withdrawing money out over time. But they had never seen a black and white comparison such as this featured in any provider wake-up pack.

To provide more tailored guidance, a tool like this can be personalised to show the value of savers' individual pensions now, alongside projections into the future. Visualising an enhanced future income is a powerful way to incentivise retirees to reconsider moving their savings into cash. This is just one method providers can use to overcome scheme members' behavioural biases – especially loss aversion.

Section 2

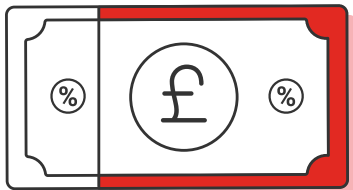
Taking cash: One lump or two?

56%

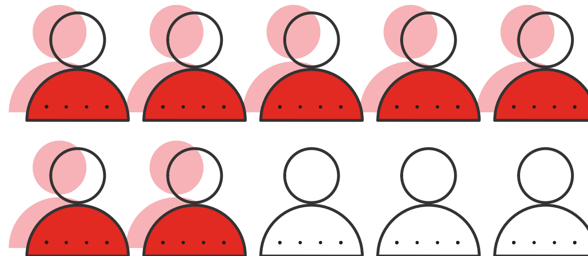
of our **respondents** had **never heard** of the **Money Purchase Annual Allowance**

But after some educational prompts...

Only **70%** wanted to **split their withdrawals** to **pay less tax**



7/10 would be **interested** in **splitting their 25% tax-free cash** across **several years**



A major barrier to changing the perception of tax-free cash as a 'retirement windfall' is the way the benefit is structured. Some 40% of our respondents overall were not even aware that they could take less than 25%, and there was considerable confusion about how to do so, and what the tax effects would be. As a result, people were focused on the immediate future, de-coupling their tax-free cash from the rest of their pensions: 41% of our respondents who have taken cash agree with the statement, "I was just focused on taking the cash lump sum, I wasn't ready to decide what to do with the rest of my pension pot".

Equally, retirees were familiar with the phrase, "you can't have your cake and eat it". But what if the way they cut the cake could leave them with more on their plates?

Stimulus B: Tax-free cash as a retirement income

Jane is 55 and thinking about stopping work at 60, at which point she will have no income until the state pension starts at 67. From 60 to 67, she wants to drawdown an income from her pension money so that she keeps within her personal allowance and the money is completely tax free. Her personal income tax allowance is £12,570.

Jane is also thinking about taking 25% of her tax-free cash at 55. But If Jane doesn't need to take all her tax-free cash upfront, at 60 she could take more than £12,570 tax free by using a combination of taxable income from her pension and tax-free cash.

This approach would allow her to take withdrawals of £16,760 tax free – 25% of £16,760 (£4,790) is from her tax-free cash in addition to the £12,570 from her personal allowance.

When shown a simple example (B) of how savers could use their tax-free cash as retirement income rather than a lump sum by splitting their 25% tax-free withdrawals across several years, seven in 10 of those who had already withdrawn cash said they would be interested in taking this approach. Unsurprisingly, the more important DC was as a source of income in retirement to savers, the more interested they were in this option.

Stimulus C: Tax-efficient drawdown

Drawdown allows withdrawals to be taken which are part taxable income and part tax-free cash. Such withdrawals will typically consist of 75% taxable income and 25% tax-free cash. However, some providers may allow income withdrawals to be taken in different proportions. Spreading tax-free cash across retirement to supplement income can lead to lower overall tax in retirement and allows the money left in the pension to grow for longer.

When the possibility of using withdrawals to increase the amount of tax-free cash, and therefore overall cash, available to retirement savers was on the table (C), over 70% (71%) said they would be interested. This is particularly interesting to those likely to fall into higher tax bands: 36% of those with pensions of between £50,000 and £250,000 and 38% of those with pensions of over £250,000 were very interested in this method, versus just 13% of those with less than £10,000 in their pension. This is an unsurprising finding, as including some tax-free cash in lieu of money from the taxable part of their pension each year may mean that higher-rate taxpayers could potentially be pulled down a tax band and pay less tax overall.

Practical examples which demystify tax rules can help change members' perceptions so that they see tax-free cash as part of a retirement income solution. Similarly, it is incumbent on providers, employers and the pensions industry to improve by helping to give members the option of splitting their tax-free withdrawals in a straightforward and intuitive way.

Money talks

A lack of forward planning means that nearly three in 10 (28%) of our respondents who have taken tax-free cash already are still contributing to a pension. Withdrawing as they accumulate means they are compromising their Money Purchase Annual Allowance (MPAA), which reduces the annual amount they can pay in, tax-free, from £40,000 to £4,000.

56% of respondents who had accessed their tax-free cash were not aware of the MPAA.

Yet after a simple explanation of the concept, over 27% of those yet to access their pension pot said that it would affect them. Meaning that over a quarter of respondents could limit their potential to top up their pension in their late 50s and early 60s.are paying more tax than they need to when they withdraw their pension. Women are particularly vulnerable to this, with over 30% (31%) saying the loss of the MPAA would apply to them, versus 22% of men. Women are particularly vulnerable to this, with over 30% (31%) saying the loss of the MPAA would apply to them, versus 22% of men. With only 15% of pension savers overall saying that they were aware of losing the benefit but had chosen to forgo it anyway by withdrawing, a simple educative nudge at 55 could mean substantially better outcomes throughout retirement, particularly for savers who may have smaller pensions to start with.

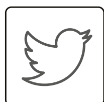
Reassuring stretched savers

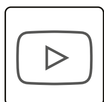
Overcoming savers' pension biases isn't as complicated as it seems – the challenge is making it simple enough. There is still a long way to go in providing clear messaging to savers about everything from tax to investments. However, the intelligent use of behavioural nudges paired with tailored guidance can help bring savers' tax-free cash choices to life. Real-life examples and visual comparisons work.

Delving a little deeper, it's clear that the fewer savings prospective retirees have, the more they need reassurance from the government that the tax-free perk isn't going to vanish into thin air. Something as simple as a check-box declaration made at aged 55 that they intend to withdraw their tax-free cash, but in incremental chunks or later on down the line, could be the difference between losing out on tax benefits and optimal retirement outcomes and giving savers the confidence to stay invested and withdraw at their own pace – multiplying their future supply of marshmallows.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative





Important information

Important information Past performance is not a guide to future performance. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

This document is designed for the use of professional investors and their advisers. No responsibility can be accepted by Legal & General Investment Management Limited or contributors as a result of information contained in this publication. The information contained in this brochure is not intended to be, nor should be construed as investment advice nor deemed suitable to meet the needs of the investor. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision. The views expressed here are not necessarily those of Legal & General and Legal & General Investment Management Limited may or may not have acted upon them. This document may not be used for the purposes of an offer or solicitation to anyone in any jurisdiction in which such offer or solicitation is not authorised or to any person to whom it is unlawful to make such offer or solicitation. No party shall have any right of action against Legal & General in relation to the accuracy or completeness of the Information, or any other written or oral information made available in connection with this publication. Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon. There is no guarantee that any forecasts made will come to pass. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision. Contact us for further information about LGIM, please visit lgim.com or contact your usual LGIM representative As required under applicable laws Legal & General will record all telephone and electronic communications and conversations with you that result or may result in the undertaking of transactions in financial instruments on your behalf. Such records will be kept for a period of five years (or up to seven years upon request from the Financial Conduct Authority (or such successor from time to time) and will be provided to you upon request.

© 2021 Legal & General Investment Management Limited. All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, including photocopying and recording, without the written permission of the publishers. Legal & General Investment Management Limited.

Registered in England and Wales No. 02091894. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 119272 Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA Authorised and regulated by the Financial Conduct Authority.

D002200