Beware this trap if you cash in your pension: Why 350,000 over-55s risk their tax-free savings allowance being slashed

- **People can save £40,000 a year in a pension without paying tax on contributions**
- **They can then take out up to 25% of a pension as a tax-free lump sum at age 55**
- **But once they withdraw any more money, allowance is slashed to £4,000 a year**

By LAURA PURKESS FOR THE DAILY MAIL
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When charity worker Nigel Hughes used his pension to pay off longstanding debts in 2015, he thought he'd stumbled onto a shrewd financial move.

Nigel, from Cheshire, had just turned 55, but was struggling financially and feared losing his job, leaving him unable to pay the interest on his loans.

But new rules introduced that year meant the over-55s could now access their entire pensions in full to use as they pleased.

Allowance: Most people can save £40,000 a year into their pension without paying tax on their contributions. They can then take out up to 25% of their pension tax-free from age 55

For Nigel, it was a lifeline and he cashed out a third of his pension — £36,000 — to clear his debts, with a view to replenishing the pot later.

What he didn't realise was that the decision would irreversibly damage his ability to save for retirement and potentially cost him thousands of pounds.

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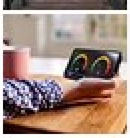
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By withdrawing such a large chunk of cash, he had unwittingly triggered a little-known tax penalty that would reduce the amount he could put back into the pension.

Normally, the amount savers can put into a pension tax-free is capped at £40,000 a year. But once you've tapped into your pension this plunges to just £4,000 a year.

The main exception to this is when you take out only the first 25 per cent of your pot as your tax-free lump sum.

So when Nigel tried to start rebuilding his pension pot three years later, he was horrified to learn that he'd had fallen foul of the rule.

The 63-year-old now misses out on up to £4,500 every year in employer pension contributions he could receive if it weren't for the so-called 'money purchase annual allowance' (MPAA) tax rule.

If he breaks the rule, he faces a huge tax penalty. He has already forgone at least £18,000 in potential pension contributions from his employer.

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Nigel says: 'It just seems so unfair, I'm being penalised for trying not to be a burden on anyone and getting my finances back on track. I had no idea about this tax trap.'

Nigel is one of about 353,500 older workers saving into modern workplace pensions who could fall foul of this 'deeply unfair' tax chokehold, Money Mail can reveal.

One in four over-55s contributed more than £4,000 to their pension pots in 2020-21, according to new Government estimates, meaning they would be liable for a tax charge if they had dipped into their pension.

The new figures were revealed in a letter from economic secretary to the Treasury Andrew Griffith to broker AJ Bell, seen by Money Mail.

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This far exceeds previous estimates from the Government, which claimed that only 3 per cent of older workers — equivalent to 42,400 — paid £4,000 into their pensions.

Pension providers are under no obligation to warn savers of the danger when they put in a request to draw cash out.

About 1,200 people dipped into their pension for the first time every day in the first half of 2022, according to research from retirement provider Just Group. However, there are fears that many more could trigger the tax trap this year.

The number of people accessing their pensions for the first time jumped by almost a fifth last year compared with 2021, with 705,666 taking out money for the first time to make ends meet as living costs soared, according to data from the City watchdog.

Someone contributing 14 per cent a year to their retirement pot would need to earn

only £30,000 — less than the UK's average
salary — to max out their lower £4,000
tax-free allowance.

Even by the most conservative estimates, a worker would need to earn £50,000 a year and pay in just 8 per cent— the minimum amount workers can contribute — to breach the current restriction.

Many older workers are in far more generous pension arrangements than this.

Tom Selby, head of retirement policy at broker A J Bell, says: 'The current allowance is deeply unfair and ridiculously punitive.

'Keeping it as it is risks creating a situation where those who have used their pension pot to cover unexpected costs during the current crisis are hamstrung when trying to rebuild their pots in the future.'

The Government is under pressure to raise the allowance as part of its bid to get more people over 50 to return to work.

Last month, the Chancellor Jeremy Hunt launched a campaign to encourage retirees back into work to increase economic activity, telling them: 'Britain needs you.'

But many who do will be caught in the net of this tax.

Baroness Ros Altmann, a former pensions minister, says the current allowance is a disincentive to keep working for some of the most experienced and valuable staff.

'The rules are complicated and many people may end up paying tax without realising they are liable,' she adds.

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