This document is for investment professionals only and should not be relied upon by private investors.

Dealing with tax in relation to pension withdrawals

When it comes to making withdrawals directly from a pension, you will know this can be done in many different ways. What may be less clear however, is how the tax is calculated and paid. A key aspect when advising on pension withdrawals is to consider the tax position of the client, so as to determine just how much to withdraw to achieve the net amount required. However, as the withdrawal could be taxed in a number of different ways, this can make it very difficult to determine before the withdrawal is made. To help with this, we've created this factsheet which covers the main points.

Here we explain how the tax on a flexible pension withdrawal is administered initially by a pension provider. It also outlines the process for reclaiming any overpaid tax due as a result of the flexible pension payment.

Please note that the information within this guide is correct as at 6 April 2024. These examples are based on the tax rules in force for the tax year 2024/25. The amount your clients withdraw and the tax they may pay will be entirely dependent on their individual circumstances. Pension providers will deduct Income Tax in line with the rates applicable to the tax residency of the individual. Scottish and Welsh Income Tax rates may differ to the rest of the UK.

Tax rates are subject to change in future. We cannot give advice regarding tax effects and will not accept responsibility for any loss occurring from their use.

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Taxation on pension withdrawals

Taxable pension income, however derived, is taxed as 'Earned Income'. This includes, but is not limited to, payments from lifetime annuities, scheme pensions, drawdown arrangements and Uncrystallised Funds Pension Lump Sum (UFPLS).

This means that the body making payment of the income must operate the taxation of the payments on a Pay As You Earn (PAYE) basis, much in the same way an employee would be taxed by their employer. This means the body paying the pension benefits will pay out the income, net of tax, based on a tax code as instructed by HMRC.

Operation of PAYE

It is important to note that HMRC have specified that flexibly accessed payments are not to be treated as annual payments (i.e. month 12 basis).

Income payments from a pension scheme are taxed at source, at the relevant rate.

The amount of tax that is calculated and deducted will depend on whether it is the first taxable withdrawal the customer is making from their pension and whether the pension provider has been provided with a tax code.

This principle applies equally to withdrawals/pension income being set up on a regular payment basis and to one-off lump sum withdrawals.

All flexibly accessed pension withdrawals that are taxable (i.e. more than the tax-free part) should initially be set up and taxed on a 'month 1' basis. The code that is applied to any taxable withdrawals will then be different depending on whether the provider is in possession of a tax code for the current tax year or not.

If the pension provider does hold a current tax code or P45 for the person making the withdrawal, they can apply the relevant tax code on a month 1 basis and deduct the appropriate amount of tax from the pension payments as they are made. A typical example of this is where an individual has just stopped working and then accesses their pension through their existing workplace pension.

Another example of this could be where a customer is already receiving regular pension payments from that provider and the individual is setting up ad-hoc withdrawals from an additional account.

If the member is unable to provide a P45 from the current tax year, or in scenarios where the pension provider does not already hold a P45 or an up-to-date tax code from HMRC as a result of previous withdrawals from that pension plan, the pension provider will set up the initial income on an emergency tax code, generally month 1 (M1) basis.

If the pension withdrawal that is made extinguishes the pension pot, the provider will send a P45 form to the individual account holder. This will set out how much tax has been deducted by the provider in the tax year in question.

If the initial payment does not extinguish the individual's fund, the pension provider will simultaneously request a tax code from HMRC when they make the pension payment. HMRC will then generally issue the provider with the relevant tax code to be applied to any subsequent payments. A P60 will then be issued to the individual after the end of the tax year detailing the total amount of payments and tax paid during the whole tax year. Annual P60 statements issued to Scottish Residents should show the 'S' prefix tax code along with the total tax deducted. Annual P60 statements issued to Welsh Residents should show the 'C' prefix tax code along with the total tax deducted.

How does it work?

An 'emergency month 1' tax code essentially means any income is tested against 1/12th of the personal allowance, 1/12th of the basic-rate tax band, 1/12th of the higher-rate tax band and at the additional (45%) rate for amounts above those bands, as applicable. The amount being withdrawn is treated as if it will continue to be paid each month for tax purposes. This means the tax is based on that specific payment only, not the individuals income over the whole year. These codes are sometimes referred to as 'non-cumulative'.

The provider will therefore apply 1/12th of the personal allowance (1/12 of £12,570 in 2024/25) to the payment, and will assess the remaining payment against 1/12th of each of the income tax bands currently in force. The table below shows the taxation of income payments where an emergency month 1 tax code applies.

Non-Scottish tax band	Non-Scottish tax rate	Annual Non-Scottish tax band amounts	Month 1 (1/12) position on payments
Personal allowance	0%	£12,570	£1,048.25
Basic rate	20%	£37,700	£3,141.67
Higher rate	40%	£37,701 - £125,140	£6,239.17
Additional rate	45%	Over £125,140	Excess

The calculation method for taxing any flexible pension payments made to Scottish or Welsh Resident tax payers using an emergency tax code, is unaffected by any difference in Income Tax rates and bands that may apply in the relevant tax year. This means the process and tax payable by UK, Scottish and Welsh taxpayers where an emergency tax code is to be operated, will be the same and in accordance with the table above.

Ongoing income and tax codes

After the first flexibly accessed pension withdrawal has been taxed and paid out by a provider, subsequent withdrawals will usually be taxed under PAYE using the relevant tax code as received through from HMRC. Generally, if we have not been contacted by HMRC by 5 April, we will carry forward the existing tax code to the new tax year but use it on a cumulative basis. Tax codes contain information about an individual's tax situation and explain how much tax-free personal allowance is available for the purposes of making the pension payments.

Although there are a lot of tax codes that HMRC could issue. The general principles are quite straightforward. They normally encompass a number followed by a letter, a letter on its own or a prefix letter followed by the number.

- A number tells the employer or pension provider how much personal tax-free allowance an individual has available for the purposes of taxing the income.
- Letters describe the situation and how it affects their personal allowance.

For example, if an individual is entitled to the full personal allowance of £12,570 for the 2024/25 tax year, HMRC will divide this by 10 and issue a tax code of 1257L. The L confirms the individual is entitled to the standard tax-free personal allowance.

Every individual's personal financial circumstances are different, so not everyone has the same tax code or standard personal allowance. Many individuals receive taxable income from a variety of sources, which could include dividends, rental income, other taxable employment benefits etc. HMRC takes all these sources of income and allowances into account to arrive at an individual's tax code.

Here are some of the common codes that HMRC may issue:

Code	What it means
L	The standard tax-free personal allowance is available (£12,570 in 2024/25 tax year)
M	Marriage allowance: confirms an individual has received a transfer of 10% of their partner's personal allowance
N	Marriage allowance: confirms an individual has transferred 10% of their personal allowance to their partner
S	An individual will be taxed using Scottish Income Tax rates
C	An individual will be taxed using Welsh Income Tax rates
T	Includes other calculations to work out the individuals personal allowance (for example, it may have been reduced because their estimated annual income is more than £100,000)
K	Deductions have exceeded the individual's personal allowance. The number in the code after the K is multiplied by 10 and added to their pay (in other words, K500 means the individuals personal allowance is -£5,000)
NT	No tax is to be taken from the income or pension payments
BR	All pay is to be taxed at the basic rate (20%), with no personal allowance. A C or S before the code indicates all pay is to be taxed at the Welsh basic rate (20%) or the Scottish basic rate (20%)
D0	All pay is to be taxed at the higher rate (40%), with no personal allowance. A C or S before the code indicates all pay is to be taxed at the Welsh higher rate (40%) or the Scottish intermediate rate (21%)
D1	All pay is to be taxed at the additional rate (45%), with no personal allowance. A C or S before the code indicates all pay is to be taxed at the Welsh additional rate (45%) or the Scottish higher rate (42%)
SD2	All pay is to be taxed at the Scottish Advanced rate (45%), with no personal allowance
SD3	All pay is to be taxed at the Scottish top rate (48%), with no personal allowance
0T	No personal allowance is available. All income is to be taxed at the basic (20%), then higher (40%), then additional rate (45%) for English, Northern Irish and Welsh tax payers accordingly. For Scottish rate tax payers, all income is to be taxed at the starter (19%), then basic (20%), intermediate (21%), higher (42%), advanced (45%), then top rate (48%) accordingly
W1/M1	An emergency tax code providing 1/12th of all tax bands including the personal allowance

Tax matters can be complex and everyone's tax position is different. Tax codes are supplied to providers by HMRC. If tax is being deducted based on an incorrect tax code HMRC should be contacted first as the provider is not authorised to alter this unless they receive a revised code from HMRC.

Examples

Example 1

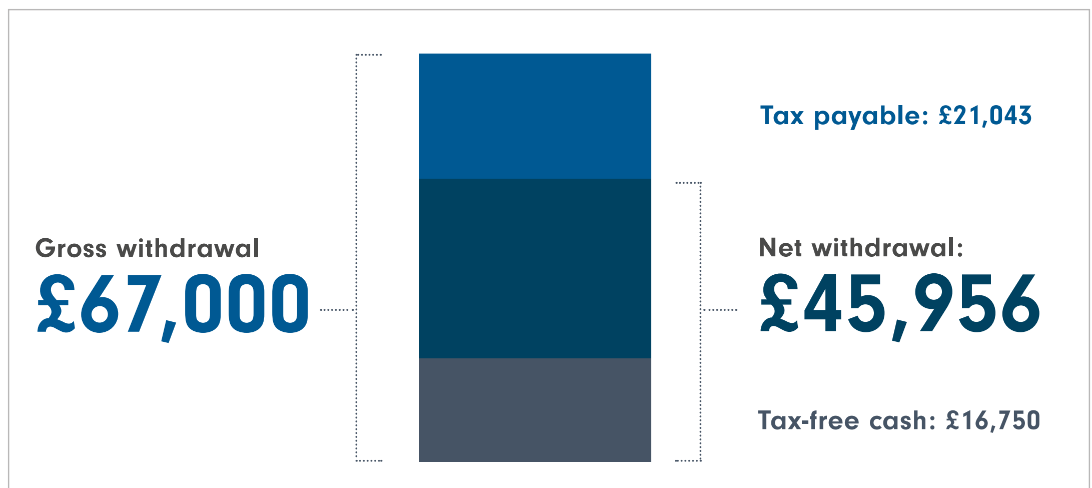
Tara, who is reducing her working hours, anticipates she will have earnings of £30,000 in the 2024/25 tax year. To top up her income for the year, in May 2024 she decides to take an Uncrystallised Funds Pension Lump Sum (UFPLS) from her pension totalling £67,000. Assuming the provider is not already in possession of Tara's tax code, a taxable payment of £50,250 (after the 25% tax-free cash is deducted) will be made and taxed on an emergency month 1 tax code basis, as follows:

Tax band	Annual tax rate	Month 1	Tax rate	Tax due
Personal allowance	Up to £12,570	£1,048.25	0%	£0
Basic rate	Next £37,700	£3,141.67	20%	£628.33
Higher rate	Next £74,870	£6,239.17	40%	£2,495.66
Additional rate	Over £125,140	£39,820.91	45%	£17,919.40

Payment amount =	£67,000.00
Total taxable amount =	£50,250.00
Total tax deducted =	£21,043.39
Net amount =	£29,206.61
Plus tax-free cash =	£16,750.00
Net payment made =	**£45,956.61**

Subject to any rounding applied, the figures shown above may not be exactly the same as might appear in practice.

The graphic below provides a summary of the end result for the individual:



In many situations like this, the individual could be due a tax rebate. However, this will depend on their overall level of taxable income over the tax year. In example 1, based on Tara's earnings from her employment totalling £30,000 for the year, Tara could be due a tax refund of around £4,997.39 for the 2024/25 tax year, subject to any other income she is in receipt of. It's important to bear in mind that where the individual has continuing employment or pensionable income, HMRC will typically issue a revised tax code to the bodies making those payments, which should result in any overpaid tax being reconciled by the end of the tax year.

The point at which this typically changes (and instead of being due a tax rebate, the individual may have additional tax to pay), is where the pension withdrawal, when combined with their total income for the year, exceeds the personal allowance income limit of £100,000. Income above this limit reduces the personal allowance by £1 for every £2 over. As the personal allowance reduces, more tax is payable at 40%/45%, and therefore the total amount of tax payable for the year may be more than the total amount of tax paid, despite the application of the emergency tax code to the pension withdrawal.

Example 2

If Anton had earnings for the 2024/25 tax year of £150,000 and also took an UFPLS payment of £67,000 in that tax year, he could actually have an additional tax bill of approximately £1,569.11 to pay at the end of the 2024/25 tax year, subject to any other taxable income he may have for the year. However, in practice, depending on proximity of the UFPLS to tax year end and whether Anton has any ongoing income, through the operation of PAYE, this may already be accounted for and paid during the tax year without any additional sum being payable at the end of the tax year by Anton.

Example 3

Stuart receives income from a final salary pension scheme of £10,000 per annum and is also in receipt of a State Pension that pays him £10,600 a year in the 2024/25 tax year. Early in the tax year he withdraws £7,000 from his crystallised drawdown account. At that time, £1,752.37 of tax was deducted and paid to HMRC by his provider using an M1 emergency tax code. He intends to make a second withdrawal of £1,500 from the same account in March of the 2024/25 tax year. The provider has been sent a basic rate cumulative tax code from HMRC which will be applied to future payments.

As it's cumulative there are two factors to be aware of:

- Firstly, the need to account for the cumulative gross income in the tax year and the tax already paid
- Secondly, the code will generally apply for the proportion of the tax year the payment is being made in

In this scenario, as the payment is being made on a basic-rate tax code, no allowance/bands apply.

The second payment will therefore be taxed as follows:

Gross taxable pay from provider =	£8,500 (£7,000 + £1,500)
Total tax paid on first withdrawal =	£1,752.37
Total taxable pay taxed at basic rate =	£1,700 (£8,500 X 20%)
Total refund due on second withdrawal =	£52.37 (£1,752.37 - £1,700)
Net amount received (including tax refund) =	£1,552.37 (£1,500 + £52.37)

In principle, if the cumulative tax due is less than the tax already paid, then tax should be refunded (as on a cumulative basis, too much tax has been deducted to that point). It is important to bear in mind that even if tax is refunded at this point, further tax could be refunded or even be deducted on subsequent withdrawals, depending on the tax code or at the end of the tax year when the individual's tax affairs are reviewed by HMRC.

These examples are based on UK Income Tax rates and may be different if Scottish or Welsh Income Tax Rates are used.

Dealing with overpayments or underpayments of tax

In many cases, where an emergency tax code has been operated, the individual making the withdrawal may end up being due a tax refund or having to pay further tax.

The method for claiming any tax back or paying further tax will depend on the person's circumstances – for instance, on their overall tax position for the year and if they have extinguished their pension fund.

Ongoing income

Where a regular income has been set up, any over or under payment of Income Tax is usually accounted for through the PAYE process. This is done through application of an adjustment to the individual's tax code by HMRC, which corrects the individual's tax position. However, where income payments are set up with close proximity to tax-year end, there may not be enough time for the tax to be reconciled.

Where more than one income payment has been made but an overpayment or underpayment has still occurred, depending on the individuals circumstances this could be dealt with in one of three ways:

1. The individual could wait until the end of tax year when HMRC will reconcile their account and make any repayment owed as part of its normal PAYE process. If, as part of that process, it is identified that a rebate is due or tax is owed, a P800 tax calculation will be posted to the individual. These will usually reach the individual by the end of November following the tax-year end.

   If a rebate is due:

   - The P800 the individual receives will notify them of the amount and whether they can claim **their refund online**. If the individual doesn't claim their refund online within 45 days, HMRC will send them a cheque. Individuals can also contact HMRC to request a cheque. If the P800 says HMRC will send the individual a cheque, the individual will usually receive it within 14 days.

   If tax is owed:

   - The P800 the individual received will notify them of the amount owed. HMRC will usually collect this automatically in installments over the course of the tax year following the end of the calculation. If HMRC are unable to collect the money in this way they will write to the individual. The P800 will also indicate if the money owed can be settled online or by cheque.

   Individuals will not receive a P800 if they are registered for self-assessment.

2. Alternatively, if the individual usually completes an annual self-assessment tax return, because they have income from other sources such as rental or self-employed income for instance, they can submit the details on their annual tax return. The individuals tax bill will then be adjusted accordingly.

3. If the individual does not normally complete an annual self-assessment tax return and they have not received a P800, individuals can contact HMRC directly if they believe their tax to be incorrect. HMRC will then assess the information they have received and issue a P800 if their re-assessment indicates the individual has over or under paid tax.

Lump sums and ad-hoc withdrawals

Where a lump sum has been withdrawn from the pension and there is no ongoing income against which any additional tax paid can be offset, the individual can either use the options above or if they want to reclaim during the tax year in question, they can use one of three forms available which are explained below.

- **P50Z** - should be used if the individual has extinguished their whole pension fund and has no continuing source of income (other than the State Pension)
- **P53Z** - should be used if the individual has extinguished their whole pension fund but does have a continuing source of income, for example, employment or other pension income
- **P55** - should be used if the individual has flexibly accessed some of their pension pot, but are not taking regular payments and the pension provider is unable to refund them

To claim in this way, applications can either be made online via the Government Gateway service or posted. Individuals will need to submit their completed form along with parts 2 and 3 of all the P45 forms they have received for any flexibly accessed pension withdrawals.

It is important to remember that these forms can only be used for reclaiming tax on pension flexibility payments.

HMRC have indicated they operate a 30 day turnaround (from the date the information is received by them) to process these forms.

Individuals, who use the standard P50 and P53 forms to request in-year repayments, where a pension flexibility payment has been taken, do not fall within the priority 30 day processing deadline. To avoid unnecessary delays, individuals should **take care to ensure they are using the correct versions of the forms** and ensure they are fully completed.

HMRC can also make payment to the individual's own or a nominee's bank or building society account.

Please note: they will only pay this into an account held in the name of the individual to whom payment is due or in the name of the nominee.

Small pension fund lump sums

This is where the total value of the pension arrangement is below £10,000 and payment is made under the 'small pots rule'. These are taxed slightly differently in that the body making the payment always apply a basic rate (BR) tax code to the payment. The result then is that generally 25% of the payment will be tax-free and the remainder (usually 75%) will be taxed at 20% (based on current rates). Small pots payments will also still be made using the UK basic rate of Income Tax for Scottish and Welsh Resident taxpayers.

Where the total value of the fund was above £10,000 but the residual fund (after any protected tax free cash has been paid), is below £10,000, the whole residual balance is treated as a special kind of trivial lump sum and taxable normally under PAYE.

Where the individual wants to reclaim overpaid tax as a result of a small pension fund lump sum, they can do so using the following form:

- **P53** - should be used if the individual has trivially commuted a pension fund (from April 2015 this only applies to Defined Benefit schemes such as Final Salary or Career Average) or withdrawn under the small pots rule

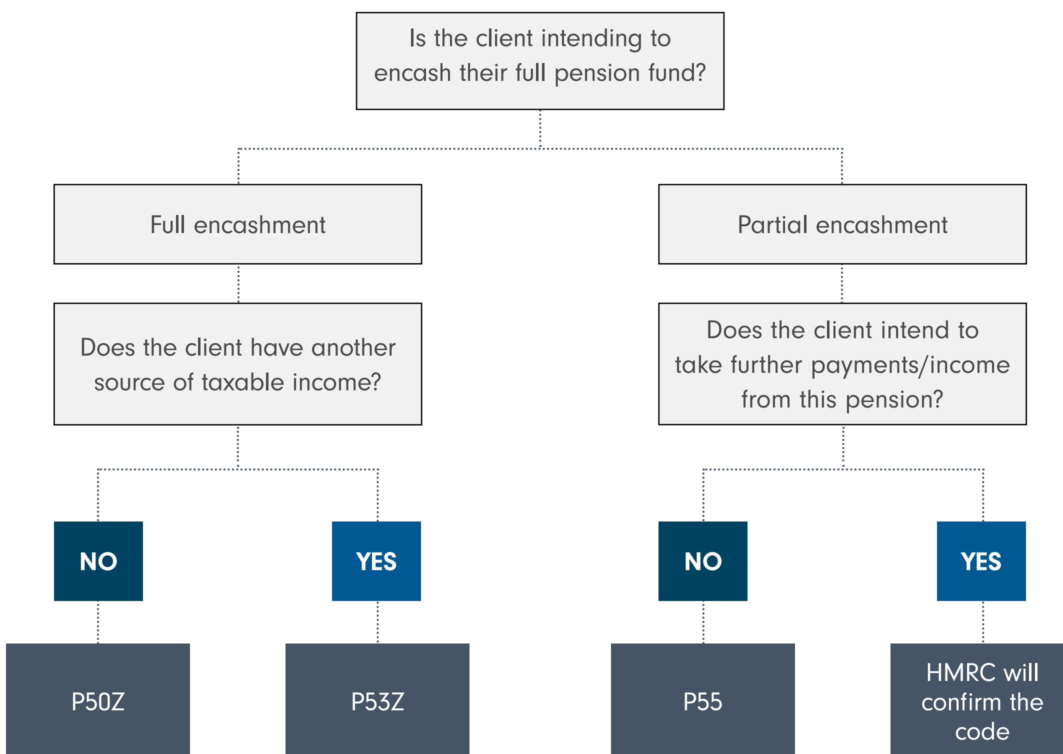
Claims can be made via the Government Gateway or posted. This form should not be used to reclaim overpaid tax for pension flexibility payments. The forms above should be used for that purpose.

Summary

On payment of a first withdrawal from a pension arrangement, the body making the payment will either apply the relevant tax code, if they have it, or apply an emergency tax code, month 1. If the payment is made on an emergency tax code basis, this could result in tax being overpaid. If tax is overpaid then the individual has a number of options:

- The individual could wait until the end of the tax year for HMRC to reconcile their account and make any repayments due. Alternatively they could submit information to their tax office or submit a tax return. Remember, if they have ongoing income for the year, HMRC will update their tax code and this could correct any initial overpayment of tax resulting from any pension withdrawals
- If they would prefer not to wait until the end of the tax year, they can submit a claim using one of the forms available. See the diagram below for details

Tax repayment options for flexible pension withdrawals



Beneficiaries wanting to claim back overpayments of tax deducted on lump sum death benefits taxed using an emergency code, should use the same version number of the forms as indicated above but with a (DB) suffix.

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