AJBell Investcentre

ADVISER GUIDE

Taxation of flexible pension payments

In this guide:

This information is based on current understanding of current pension tax rules. This is provided for information only; we do not provide advice. Tax rules may change in the future and the tax treatment depends on personal circumstances. This guide is provided for professional advisers' use only.

Overview

Since 6 April 2015, it has been possible to take uncrystallised funds pension lump sum (UFPLS) and flexi-access drawdown payments from defined contribution pension schemes. These payments are subject to Income Tax via PAYE.

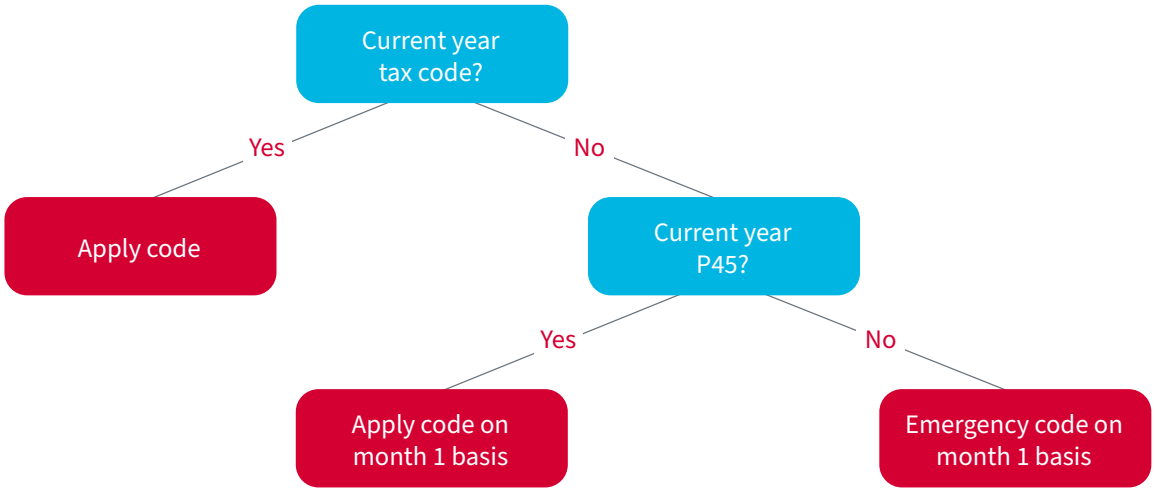
This guide looks at how PAYE is applied to these payments in different circumstances, and how to reclaim any tax that is overpaid.

How is PAYE applied when someone takes benefits?

HMRC has set out to pension scheme administrators how tax codes must be applied under PAYE.

When the member can provide the administrator with a current year tax code, then this can be used and applied on a cumulative basis. In practice, this often only happens when the member is taking a regular income as the current year code is supplied after the first payment is made.

If the member retires from employment and then starts benefits, they may have a P45 valid in the current tax year; if this is the case, this can be used but must be on a 'month 1' basis. If the member has no current year tax code or P45, then an emergency tax code will be used – also on a month 1 basis.



What does 'month 1' mean?

When a payment is made on the month 1 basis, the member will be taxed on that pay period only. Effectively this means that each month is treated discretely, with a twelfth of the personal allowance and each tax band applying.

This is opposed to a 'month 12' basis, where the full annual personal allowance and tax bands are available. When a one-off or annual payment is made, ideally a month 12 basis would be used, but HMRC rules do not permit this in relation to flexible pension payments such as UFPLS and flexi-access drawdown.

For the 2024/25 tax year the emergency code is 1257L. This means that anyone receiving their first payment who doesn't have a current year tax code or P45 will be taxed on a month 1 basis as follows*:

- first £1,048 tax free;
- next £3,141 charged at basic rate tax (20%);
- next £9,358 charged at higher rate tax (40%); and
- any amount above this charged at additional rate tax (45%).

It does not make any difference when in the tax year the payment is made – it will be treated the same whether paid in May or March.

Having a current year P45 may impact the bands given above, but the basic principal of only receiving a twelfth of the personal allowance and each band still applies.

*Members who are resident in Scotland will have different tax bands and rates but, again, the same principal will apply.

What does this mean for one-off payments?

When someone is only taking a one-off payment, the use of the month 1 basis means that over taxation is likely to occur.

All UFPLS payments are 25% tax free and 75% subject to Income Tax. The 75% that is taxed will then have the bands applied as above. A flexi-access drawdown payment is all subject to Income Tax, so the bands would apply to the full amount.

The example below demonstrates the over-taxation that could occur on a one-off UFPLS payment of £100,000 (where £25,000 would be tax free, £75,000 subject to Income Tax), or a one-off flexi-access drawdown payment of £75,000. It assumes there is no other income in the tax year.

	Month 1		Month 12	
Personal allowance	£1,048		£12,570	
Amount chargeable at basic rate	£3,141		£37,700	
Tax at basic rate (20%)		£628		£7,540
Amount chargeable at higher rate	£9,358		£24,730	
Tax at higher rate (40%)		£3,743		£9,892
Amount chargeable at additional rate	£61,453			
Tax at additional rate (45%)		£27,654		
Total tax		**£32,025**		**£17,432**

In this example the over taxation is £14,593 (£32,025-£17,432).

If you are trying to calculate the tax that will be paid on a member's one-off payment, it is worth noting that the monthly personal allowance is always given on a month 1 basis, however large the payment. Where the member would be over the £100,000 threshold for the tax year, the personal allowance is withdrawn via the tax code issued by HMRC after the first payment has been made.

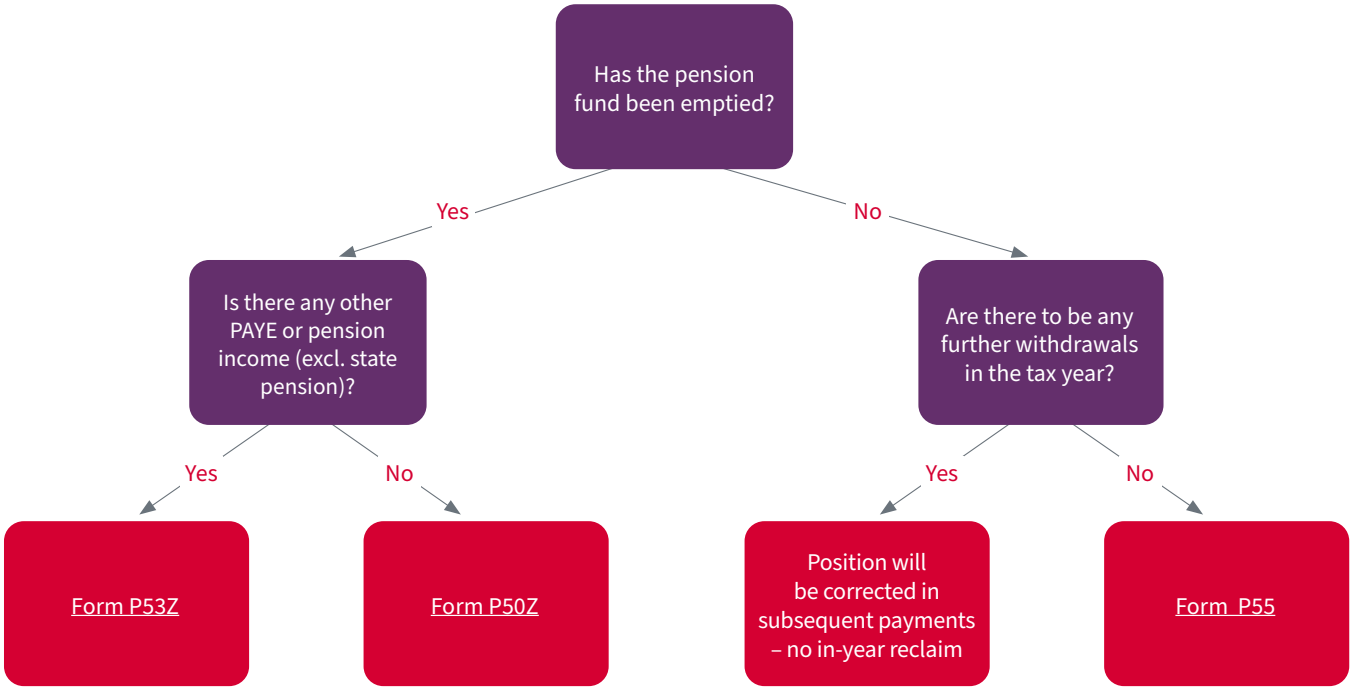
How are new regular payments taxed?

When new payments are set up, we will apply the tax code for the first payments as per the flow chart. We will inform HMRC when the first payment is made and it will issue a new tax code so that the subsequent withdrawals made over the year should correct the tax position as they will be taxed on a cumulative basis.

How can overpaid tax be reclaimed?

If a one-off payment has been made in the tax year, it is likely that tax will have been overpaid. When this is the case, the additional tax paid can be reclaimed in one of two ways.

1. HMRC will automatically correct the tax position at the end of the tax year as part of the normal PAYE process by sending a P800 tax calculation and refunding the overpayment. If too much tax has been paid and a P800 tax calculation has not been received, then a self-assessment can be completed or HMRC contacted directly for a reclaim.
2. An in-year claim can be made using the appropriate form.



Provided the form is correctly completed, HMRC should repay the tax within 30 days.

Planning points

If members are taking a one-off pension payment, it is important that they are aware of how the tax works to avoid nasty surprises, especially if they are withdrawing funds for a specific purpose that is time sensitive.

It is also likely that the first instalment of regular payments may be overtaxed (unless monthly income starts in April). This is less of an issue as it should get corrected throughout the year, but the first payment may still be less than the client would be expecting.

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