Taxation of flexible pension payments Q&As

This update aims to answer some of the questions we have been asked as to how pension freedoms payments will be taxed and, where tax is overpaid, how it can be reclaimed.

Questions and answers

How will a one-off taxable lump sum payment be taxed?

All taxable lump sum payments (also known as 'uncrystallised funds pension lump sum' or 'UFPLS' payments) made are 25% tax-free and 75% subject to Income Tax. The amount of tax paid will vary depending on the tax code used.

If we have no tax code and no P45 for an individual, then HMRC rules state we must apply an emergency tax code on a month 1 basis. Using a month 1 basis means that the person will be taxed as though they are going to continue to receive payments of the same amount each month throughout the year. This will have an impact on the amount of personal allowance allocated to the payment, and the marginal rates applied.

In most scenarios where a month 1 emergency code is used, tax will be overpaid and will need to be reclaimed.

If we hold a P45 from the current tax year, we can apply the code given on that P45, but are still required to use it on a month 1 basis. Again, for one-off payments this is still likely to result in tax being overpaid.

If we hold a P45 from a previous tax year we cannot use this – we must apply an emergency code on a month 1 basis. If we do hold a current tax code for an individual, then we will usually be able to apply it.

How will a one-off flexi-access drawdown payment be taxed?

A one-off income payment under flexi-access drawdown will be subject to Income Tax on the whole amount, and any tax-free payment (also known as a 'pension commencement lump sum') will be paid separately. Funds in flexi-access drawdown remain invested and you can take an income from them as you choose.

Where we hold a person's tax code, due to previous payments made, then we can usually apply the correct code.

If we do not have a tax code or a current year's P45, we must use an emergency code on a month 1 basis in the same way as for one-off taxable lump sum payments. If we have a current year's P45, then we can use that code on a month 1 basis.

The use of any code on a month 1 basis is likely to result in tax being overpaid in most circumstances.

How will a series of irregular payments be taxed?

The first payment will be taxed in the same way as a one-off payment, as detailed above. HMRC should then issue a tax code that can be applied to the future ad hoc payments within the same tax year, which will correct the tax position.

How will new regular payments be taxed?

When new payments are set up, we will apply the correct tax code where supplied. However, in most cases this will not be available before the first payment. Where we have a current year's P45 we can use this code on a month 1 basis; if not we will apply an emergency code on a month 1 basis.

We will inform HMRC that payments have started and they will issue a new tax code so that the subsequent withdrawals made over the year will correct the tax position.

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 usually 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 a person thinks too much tax has been paid and a P800 tax calculation has not been received, they can complete a self-assessment or contact HMRC for a reclaim.
2. An in-year claim can be made as follows:
   - If the pension fund has been emptied:
     - the pension provider will issue a P45, which should be sent to HMRC along with:
       - form P50Z if there is no other PAYE or pension income (other than state pension)
       - form P53Z if there are other employments or pensions
   - If the pension has not been emptied and no further withdrawals are to be made within the tax year:
     - by completing form P55

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The information contained in this document is based on our understanding of current law, practice and taxation which may be subject to change.