Retirement tax planning

Key guides

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Retirement and tax

An end to work, not an end to tax

Tax does not disappear once you start the retirement process. While your income is likely to fall when you cease work completely, you will still have an income tax liability if your pension and other incomes exceed your available allowances.

In some respects, tax can become more complex in retirement than when you are in work. Before retirement normally only one source of earnings is taxed, whereas in retirement you may receive pensions from several different sources, including the state, former employers' pension schemes and personal pensions. To complicate matters, not all pension income is taxed in the same way.

Tax does not stop at retirement

In recent years there have been radical reforms to the tax rules for many pension arrangements mirroring changing working habits and lifestyles. The greater flexibility in income levels has benefited many people, for example in helping them cope with reduced earned income during the Covid pandemic and higher inflation levels now. It has also given greater scope for planning income tax in pensions.

However, the downside to the range of changes is that the complexity of pension tax has increased. The reforms also overhauled the tax treatment of some pension death benefits, a change which could be helpful if you are concerned about estate planning and inheritance tax (IHT). A further significant change was announced in the Spring 2023 Budget with the effective abolition of the lifetime allowance.

With the personal allowance currently £12,570, and frozen at least until tax year 2027/28 despite the recent sharp increase in inflation, it does not take much income over and above the state pension to bring you into the tax net. The maximum single-tier state pension is £10,600 in 2023/24.

This guide looks at the basic treatment of lump sums, income payments and death benefits from the main types of pension arrangement. It is by no means the complete picture and you should seek professional advice if you have any questions about your personal situation.

Planning point

Your retirement income may come from several sources and may not all be taxed in the same way, so advice is crucial in navigating through your arrangements.

State pensions

The State Pension Age (SPA) for both men and women is currently age 66.

The state pension is taxable. However, unlike most other pensions, no tax is deducted at source from the state pension: payments are made gross by the Department for Work and Pensions (DWP), which leaves HM Revenue & Customs (HMRC) to collect any tax due by other methods.

HMRC normally uses Pay As You Earn (PAYE) to collect tax due on your state pension from any private pension or earned income. As a result, if that income has been paid before your state pension started, the net amount you receive could drop to cover the tax due on your state pension once it begins to be paid.

Example – taxing the state pension

In 2023/24 Joan, who lives in England, has a private pension from her former employer of £12,000 a year and a state pension of £9,000 a year. Her personal allowance is £12,570. HMRC calculates her tax code as follows:

Personal allowance	£12,570
Less state pension	£9,000
A tax-free amount of	£3,570 (a tax code of 357)

The £9,000 reduction from Joan's personal allowance means that HMRC collects an additional £1,800 of tax (£9,000 @ 20%) from Joan's private pension because of her state pension.

HMRC will collect any tax due on your state pension when there is no PAYE income it can access. In most cases, HMRC automatically calculates what is due based on information it holds and informs you. You then have 60 days from receipt of the calculation to raise any queries.

However, should HMRC decide you are a 'complex customer' (e.g. because you also have self-employed earnings), you will remain within the self-assessment regime. In the longer term you will only be asked for information that HMRC does not already hold – in effect part of your tax return will be completed automatically by HMRC.

Planning point

You can defer claiming your state pension when you reach your SPA, which may help reduce your marginal tax rate.

Deferral

You do not have to claim your state pension when you reach your SPA. If you do not need the income immediately and decide not to claim, your pension is automatically deferred. Your eventual state pension payment when you do start to draw it will then be higher and you will save tax in the interim. Deferral can be particularly useful if you are still working or have only just stopped earning full time when you reach SPA – you could end up paying 40% tax on your state pension, whereas once you enter a complete tax year of retirement your marginal tax rate may reduce to basic rate.

The current terms for deferral are that your state pension will increase by 1% for every nine weeks of deferment (at the equivalent of 5.78% a year), provided deferral is for at least nine weeks.

Private pensions

There are two main types of private pension you may receive benefits from:

- A defined contribution (DC) pension typically comes either from a scheme set up by an employer or from a personal or stakeholder pension you set up yourself. The DC scheme has a fund, part of which you can draw as a tax-free lump sum. The remainder is taxable, whether taken as income or as lump sums.
- A defined benefit (DB) scheme will provide you with a pension from your employer, which is based on your earnings and how long you have worked for the employer. It could also pay you a tax-free lump sum. DB schemes open to new members are now increasingly rare outside the public sector, but you may well have benefits from schemes operated by previous employers.

The lifetime allowance

Until 5 April 2023, there was a special tax charge if retirement benefits had a value exceeding the lifetime allowance (LTA) of £1,073,100, with some additional protections for those with large pension funds when the LTA was introduced or reduced. The LTA charge was scrapped from 6 April 2023, but the maximum available tax free is restricted to £268,275 (25% of £1,073,100), again with some additional protections. We can help you calculate your entitlement if this is relevant to you. It is possible that a future government could decide to reintroduce an LTA charge.

Planning point

Most pension providers in practice require that you withdraw a lump sum and set up your income source at the same time.

The tax-free lump sum

The tax-free lump sum – technically the pension commencement lump sum (PCLS) – is a feature of nearly all private pension arrangements. The normal maximum amount of the lump sum is 25% of the value of total benefits being crystallised, up to a maximum of 25% of your available LTA, although special transitional rules may apply for pre-April 2006 benefits. With the effective removal of the LTA, the PCLS has been capped currently at a maximum of £268,275 - 25% of the former £1,073,100 LTA cap.

With very few exceptions, the PCLS must be drawn between six months before and 12 months after some form of pension income is established, e.g. by purchase of an annuity. In practice, nearly all pension providers insist on a simultaneous drawing of cash and setting up of an income source.

DC schemes

The PCLS calculation in a DC is usually very simple: however much you allocate to providing an income, you can draw a third of that amount as a lump sum. In most circumstances it makes sense to take the cash because it is tax free, whereas any income will be taxable.

Just because you allocate part of your fund to providing an income does not mean you must draw an income. If the allocation is to flexi-access drawdown, you can opt for a zero level of income withdrawals, effectively allowing you to take cash in isolation and defer receipt of income to a later date.

The flexibility reforms introduced in April 2015 also allow you to draw a lump sum that is 75% taxable and 25% tax free. This option is further considered in the pension income section below.

DB schemes

Private sector DB schemes typically allow you to convert (technically 'commute') part of your pension entitlement into a tax-free lump sum. In many public sector schemes, for longer-standing members the cash and pension combination is automatic and the choice is limited to converting part of the pension to bring the total cash up to the HMRC maximum tax-free amount.

Exchanging pension for cash is not always the better option, even though it is tax free. The terms on which you will be able to swap part of your pension for cash are often far from generous and may unfavourably offset the tax saving.

Planning point

You will have a different PAYE code for each source of income, so check each one carefully on any coding notices to avoid incurring tax liabilities or reclaims.

Pension income

Whether you receive a regular pension income from a DB scheme or choose to take irregular withdrawals from a DC arrangement, these are subject to income tax collected under PAYE, but there are no national insurance contributions to pay in pension income. As mentioned above, the PAYE system will also be used to collect any tax due (but not deducted) on your state pension.

The PAYE code must be correct to make sure the right amount of tax is collected. If you have several sources of pension income, there will be PAYE codes for each one and the coding calculation can be difficult to understand. As mistakes do occur, it is best to check immediately any coding notice you receive to avoid building up a liability for unpaid tax or having to make a tax reclaim.

Pension flexibility and income tax issues

The PAYE system was designed to tax a regular flow of earnings and, as such, works well in most situations. However, if you take advantage of pension flexibility, PAYE can produce some surprising results. The problems usually arise when the pension provider does not hold a P45 for the current tax year or up-to-date cumulative tax code for the individual when the first payment is made. In those circumstances, the ‘emergency rate’ will then apply, which can result in an excessive deduction of tax, particularly when the payment is a substantial one-off amount.

Example – fund withdrawal and emergency tax

Helen, who lives in England, decides to draw £20,000 from her personal pension, which she reckons will keep her as a basic (20%) rate taxpayer because her other taxable income from her state pension and other investments is £23,000.

£5,000 is tax free as a PCLS and the balance is a one-off taxable income payment under flexi-access drawdown. As her pension provider does not have an up-to-date tax code for Helen, the emergency rate is applied and £5,025 is deducted from her £15,000 withdrawal – 33.5% rather than 20%.

Excess tax can be reclaimed from HMRC and there are specific forms covering the various situations that arise. Alternatively, a refund should be produced as the result of HMRC’s end-of-tax year reconciliation – but that might be more than 12 months after the tax has been paid. For instance, in the example of Helen above, the tax repayment would be £2,025 (£5,025 − £3,000).

As well as allowing flexi-access withdrawals, the pension flexibility legislation gives another way to draw lump sums from DC pensions: the uncrystallised fund pension lump sum (UFPLS). This is not offered by all providers and in practical terms there is little difference in drawing out a slice of pension as 25% tax-free PCLS and the 75% taxable flexi-access withdrawal – as Helen did in the above example. The awkwardly named UFPLS has the same potential emergency tax issues as flexi-access withdrawals.

As high inflation and the cost-of-living crisis put many people under financial strain, it might be tempting to start or increase pension withdrawals. However, withdrawals made now could significantly reduce income available in the future. Careful consideration is needed of what level of withdrawal may be appropriate, and what investments should be encashed to provide it. It may be a good time to review your pension investments to ensure they are appropriately diversified.

You also need to be aware that starting to withdraw income flexibly restricts future pension contributions to a maximum of £10,000 a year before suffering tax charges. Professional advice is essential to avoid potential pitfalls.

Planning point

The advent of flexi-access drawdown has meant that for some, a pension fund can pass on down through generations.

Pensions, death and taxes

The tax treatment of DC pensions on death has changed so much in the past few years that, for some people, pension planning has become IHT planning. Under a DC pension plan:

- On death before age 75, any remaining fund, whether paid out as a lump sum or income, is free of income tax.
- On death at or after age 75, all payments are taxable at the recipient’s tax rate(s).

- Normally there is no IHT liability (but transfers need to be treated with care).

If flexi-access drawdown is chosen, either by the original pension owner or their beneficiary(ies), the same options apply on the beneficiary's death. Your pension fund could therefore cascade down through generations. There is no need for beneficiaries to be related to or dependent on each other or the original pension owner.

If the fund was originally used to buy an annuity, the death benefits are usually less attractive – there will be no lump sum nor any scope for passing down through successive generations. Any beneficiary's annuity will still enjoy the same income tax exemption if death occurs before age 75.

DB schemes generally do not provide a lump sum on death once pensions are in payment and any pension benefits for dependants of the original pension recipient are subject to income tax.

How we can help

Dealing with the combination of tax and pensions can be complicated and has been made more so by constant changes to the rules. We make it our business to stay up to date with the latest developments, and to help clients take full advantage of the available tax-planning opportunities associated with pensions. In particular, we can give guidance on:

- Whether your tax code(s) have been correctly calculated.
- The tax impact of drawing or deferring your state pension.
- The maximum tax-free lump sum you can draw within HMRC rules.
- The taxation of one-off withdrawals and the process of tax reclaim.
- Structuring investments when taking flexible withdrawals.
- Using your pensions to minimise the IHT liability after your death.

This publication is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. This publication reflects the income tax position in England, Wales and Northern Ireland, with specialist advice being required in Scotland because of their new rates and bands. This publication represents our understanding of law and HM Revenue & Customs practice as at 31 March 2023.