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HOW PENSIONS ARE TAXED

In April 2015, the government introduced pensions flexibility; this has made drawing an income in retirement easier for many people since they are able to determine the amount they draw and how frequently they do so. Unfortunately, while it has simplified drawing a pension, it has made the tax situation far more complicated.

The way pensions are taxed depends on the type of pension and which of the multitude of options of drawing funds is selected.

To start with, we need to consider that there are three types of pensions: Defined Contribution, Defined Benefit and State Pensions.

DEFINED CONTRIBUTION

These are the most popular and most flexible type of scheme and consist of Personal Pensions, Group Personal Pensions and Automatic Enrolment Schemes.

There are three methods to drawing benefits from Defined Contribution schemes: Annuity, Uncrystallised Funds Pension Lump Sum (UFPLS) and Drawdown. These types of schemes will provide a Pension Commencement Lump Sum (often called Tax Free Cash or TFC) of 25% of the pension. However, plans commencing pre 2006 may have varying levels of Tax Free Cash. While Tax free cash is, as described, tax free, it is worth considering that this could be a large lump sum which will form part of your estate upon death.

ANNUITIES

As described above, it is likely that 25% of the fund value would be taken as a tax free cash lump sum leaving the remaining 75% of the fund value to purchase an annuity. The annuity itself will be subject to income tax at your marginal rate and will be paid net of tax based on your tax code each year.

UNCRYSTALLISED FUNDS PENSION LUMP SUM (UFPLS)

An UFPLS does not pay a tax free cash lump sum; instead 25% of any withdrawal is free of tax (provided this withdrawal is within your Lifetime Allowance). These withdrawals are taxed on a month one basis. This means that it is assumed you will be drawing this amount each month for the remaining months of the tax year so you will only receive a percentage of the personal allowance and each subsequent tax bracket. For example, if a withdrawal is made in July - the fourth month of the tax year - you will receive 4/12ths of the personal allowance, basic rate tax band, higher rate tax band and additional rate tax band.

This can mean more tax is paid than is due which will need to be reclaimed by either using the appropriate HMRC form or waiting until the end of the tax year once a tax return has been completed.

DRAWDOWN

Drawdown pensions - particularly the new Flexi-Access Drawdown plans - are the most Flexible types of withdrawals. They have the ability to draw purely tax free cash as either a lump sum or a number of regular withdrawals effectively producing a regular income, or by taking a mix of tax free cash and taxable income.

The amount of tax is determined by the type of withdrawals which take place.

With regards to taxable income, if it is drawn in any frequency other than on a monthly basis, it will be taxed on a month one basis. If it is a regular withdrawal of any frequency other than monthly then tax can be reclaimed by an adjustment to your tax code which will balance things out through the remaining withdrawals in a tax year.

If a monthly withdrawal is selected, it is still possible that a month one basis is used for the first withdrawal and then the remaining withdrawals may have an adjusted tax code to balance out the tax on the subsequent withdrawals.

Alternatively, if the pension provider already has your correct tax code then they will be able to deduct the correct amount of tax from the first withdrawal onwards.

DEFINED BENEFIT

These types of pensions are similar to annuities in that you have the option of taking tax free cash and then converting the remainder of the plan into a regular income. The income will be paid net after being taxed as pension income. These plans often have escalation attached and someone may find they go from being a basic rate taxpayer to a higher rate taxpayer later in life - particularly once they start to receive the state pension.

STATE PENSIONS

State Pensions will always be paid gross and will never have tax deducted. However, these are a taxable source of income and use up the first portion of your personal allowance meaning less income can be drawn elsewhere without paying tax.

CONCLUSION

With the many different methods of drawing pension income, it can be difficult to find the balance between drawing more income to meet requirements and paying more tax. It is therefore important to make the most of all the different tax allowances available as well as the tax free cash within your pension plan.

ANY STATEMENT ABOUT TAX LIABILITY IS BASED ON OUR UNDERSTANDING OF CURRENT LAW AND TAX PRACTICE. FUTURE CHANGES IN LAW AND TAX PRACTICE COULD AFFECT HOW MUCH YOUR PENSION IS WORTH AND YOUR TAX LIABILITY. YOUR PENSION COULD ALSO BE AFFECTED BY CHANGES IN YOUR PERSONAL FINANCIAL CIRCUMSTANCES.

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