TAX HELP

Pension Flexibility & Taxation

The charity service providing FREE help and advice to older people with tax problems.

2021/22

TAX HELP

CONTENTS

INTRODUCTION

In 2015 the Government introduced changes to how people could access their pension savings. This guide seeks to explain some of the pension freedoms introduced and how this may affect you and your tax. Our guide is aimed at people on a relatively low income (generally those with an income of less than £20,000a year.) and with smaller pension savings. It:

- Aims to help you understand the tax treatment of the options available
- Does not cover every small detail, as the rules are complex
- Does not cover more complicated arrangements, such as taking money out of one pension and putting it back into another scheme. If your plans include these complications, you will need to take professional advice and will probably have to pay for it.

When considering what to do with your pension pot, or pots, you will need to understand the different types of pension available:

- Defined contribution pensions (also known as money purchase schemes), individual, group personal, stakeholder; additional voluntary contribution schemes (AVCs); self-invested personal pensions (SIPPs)
- Defined benefit or final salary; these types of pensions will have stricter rules.

While the advice Tax Help for Older People can provide is limited to the tax consequences of withdrawing your pension, you will need to consider your personal and financial circumstances, investment choices and future plans.

In brief, to access your pension:

- You need to be at least 55 years old

The tax considerations are:

- You are allowed to take some money out of your pension, tax-free up to 25% (one quarter)
- However, the remaining pension 75% (three quarters) will count as taxable income and will be added to your other income in the year, which may result in an extra tax bill
- You might not pay the right tax at the right time and will therefore need to claim a tax refund, or pay some more tax later.

Take further advice:

- Use the Government's 'Pension Wise' guidance, which can be found on the website www.pensionwise.gov.uk
- Get specialist advice on your tax position
- Check whether your decisions will have any effect on your tax credits or state benefits.

The rules of some pension schemes do not allow withdrawal of some sums, even though the tax rules now allow them. Pension providers have been permitted by law to override their own rules, but they do not have to do so. This means that your pension provider might refuse to do some of the things that the general pension rules allow.

If you are unsure which type of pension you are paying into or want to know what you will be allowed to do, ask your scheme provider.

MONEY AND PENSIONS SERVICE

The Government has also guaranteed that everyone with a defined contribution pension will be offered free, impartial guidance. This aims to cover the range of options available, helping you to make sound decisions and get the most from your choices.

This service was available from the Pensions Advisory Service, Pension Wise and the Money Advice Service. However, although you can still search online for these services, a new single financial guidance service called the Money and Pensions Service has been launched by the Government, bringing together the expertise from all three. Contact details are at the end of this booklet.

'Pensions' can be a complex topic with its own terminology; indeed, the term pension itself covers a number of different types of product. In this guide we use a number of technical terms, such as annuity, drawdown and trivial commutation. We have tried to explain these as simply as we can in the glossary of terms which can be found towards the end of this guide.

PENSION ADVICE ALLOWANCE

You may decide that you need specialist advice before choosing your pension option. There are two ways that a person can access money to pay for pension advice, other than using their own funds, and these are:

i. Using funds from their own pension pot; or
ii. Using an employer arranged service.

The funds that can be accessed in these ways, known as allowances, are limited to £500 each, but can be combined to offer up to £1,000.

Funds from their own pension pot

An allowance can be withdrawn from a registered pension scheme and used to pay for pension or retirement advice. The allowance:

- Will be limited to a maximum of £500 per use
- Is available at any age
- Is available for a maximum of three uses in total, but not more than once per tax year
- Can be withdrawn from defined contribution pensions and hybrid pensions with a money purchase or cash balance element
- Must be paid directly from the pension scheme to the adviser
- Is only available for regulated financial advice
- Can be used alongside the employer arranged pension advice allowance.

The £500 will not be taxed on withdrawal from the pension pot, regardless of an individual's income for that tax year.

Taking your Pensions Advice Allowance will not affect your 25% tax-free lump sum benefits, and will not be deducted from the maximum permitted pension commencement lump sum.

Employer arranged pension advice

Also available is a tax exemption covering the first £500 worth of pensions advice provided to an employee in a tax year, whether the employer pays for or reimburses the employee for the cost of the advice. It will allow advice not only on pensions, but also on general financial and tax issues relating to pensions.

PENSION FLEXIBILITY

Pension flexibility mainly affects people with defined contribution pensions, also known as 'money purchase schemes'. So the changes will apply to you if you have built up one or more 'pots' of cash or investments in pensions and you have to decide what you do with it. These include:

- Individual
- Group personal
- Stakeholder
- Most additional voluntary contribution schemes (AVCs) and,
- Self-invested personal schemes (SIPPs).

Pension flexibility mostly does NOT cover defined benefit schemes, often known as final salary pensions. These are pensions where the money you take from them is worked out based upon how much you earned with an employer and how long you were a scheme member.

Flexible access to pensions

- Since 2015 an individual of 55 or over may choose to take their pension. There are four main options: Withdraw all the money in one go
- Leave it in the scheme and take a regular, or occasional, income
- Buy an annuity
- Enter into a 'drawdown' arrangement, or
- A combination of all four.

The tax implications of these options will depend on your own personal circumstances. Taking benefits in any of the ways highlighted above will mean that future contributions to money purchase plans could be restricted (this is known as the money purchase annual allowance, which is described later). Essentially, contributions will be limited (with exceptions) to a maximum of £4,000 per year. If you think that this might impact on your plans, we recommend that you seek independent financial advice.

'Tax-free' cash

You can take up to 25% of your pension pot as a tax-free lump sum, but how you do this is up to you. The options are:

- Take the whole of the amount in one go, meaning that any further withdrawals will be taxed as income; or
- Take 25% of each cash withdrawal tax-free, with the remaining 75% taxable as income.

Trivial commutation

Trivial commutation only applies to Defined Benefit Schemes (also known as final salary pensions). If you have been employed in a number of different organisations and contributed to works pensions for a short time in each, or have worked for only a short time, you may have only saved small amounts towards your pension. If the total value of all your pension pots is less that £30,000, you may be allowed to take this as a lump sum (remember, anything over 25% of the total is taxable), this is known as 'trivial commutation'. With final salary schemes, you don't have your own ‘pot’; the valuation of benefits in a final salary scheme for testing against the triviality limit (£30,000) is based on the pension you could receive multiplied by 20. However the lump sum that is then paid to you is broadly equivalent to the amount that would be available to transfer to a new scheme.

An occupational pension scheme benefit worth £10,000 or less can also be taken as a small pot lump sum separately from the triviality rule above. In addition, individuals over the age of 55 can also claim small pot lump sums from up to three personal pensions worth £10,000 or less, without having to purchase an annuity. Taking a small pot lump sum will not trigger the rules around the money purchase annual allowance (see the section on MPAA later).

New safeguards for transfers out of defined benefit schemes

Some people may wonder whether they can move money from a defined benefit or final salary scheme to a defined contribution scheme so that they can take money out under pension flexibility rules. This is not a decision to be taken lightly and so the Government has brought in safeguards to protect scheme members.

Transfers from private sector defined benefit schemes to defined contribution schemes will continue to be allowed (but will continue to exclude pensions that are already in payment). However, for members of all public sector defined benefit schemes except for the local government scheme, transfers to defined contribution schemes will be restricted, although such transfers may be allowed in very limited circumstances. You will need to talk to your pension provider to establish the exact position in relation to the scheme of which you are a member.

Safeguards have been put in place to help ensure that you and your pension benefits are protected, including:

- You must take advice from a regulated adviser before transferring from a defined benefit scheme, unless your transfer value is under £30,000
- You will have to pay for the advice, but, if the transfer is to a connected employer scheme or it is an ‘incentivised transfer’, your employer will pay. In addition, you may be able to use the pension advice allowance (see page 5)
- Scheme trustees will be given guidance on how to protect their scheme’s funding position from the impact of transfers out.

TAXATION IN MORE DETAIL

If your scheme provider allows, you can use your pension pot like a bank account rather than buying an annuity. You have two options, you can either:

i Take part of your fund, or,
ii Take all of your fund

But you will need to be aware that you may have to pay tax on what you take out, so it is not as easy as when you take money out of a bank account.

i If you choose to take part of your fund, you will first decide whether you take 25% of the whole fund as a tax-free amount or 25% of each withdrawal. Whichever you choose, any amount taken in excess of the 25% will be taxed under Pay As You Earn (PAYE)

ii If you choose to take all of your fund, 25% will be tax-free and the remaining amount will be taxed under PAYE.

In most cases these payments will be taxed without consideration to any other income you may have during the tax year. This will mean that you could pay too much tax (an 'overpayment') or not enough tax (an 'underpayment') by the end of the tax year.

How your pension payment is taxed

Tax is taken using the PAYE system. If you are or have been an employee, you may recognise this as similar to the way your employer took tax off your wages or salary. How your pension payment is taxed depends on whether:

- you decide to take part or all of your fund,
- you have other PAYE income, and,
- you receive the State Pension.

Unless you can provide a P45, the pension provider will most likely use an emergency code (also known as Month1/Week1 code). This may not apply to pensioners who are no longer employed, but the emergency code may still be used by the pension provider. The pension provider should then inform HMRC who should take into account any other income and calculate your new code for future payments.

How an emergency code works

When a pension provider operates an emergency code on a 'month 1 basis' they are making an assumption that this payment is the first of 12 similar payments and will therefore calculate the tax to be deducted in this way:

- take off £1,047, which is 1/12 of the standard Personal Allowance (£12,570 in 2021/22) - this is not taxed
- tax the next £3,141 at 20%, which is 1/12 of the basic rate tax band (£37,700 in 2021/22)
- tax the next £9,358 at 40%, which is 1/12 of the higher rate tax band (£112,300 in 2021/22)
- tax any remaining amount (that is any amount above £13,546) at 45%

NOTE: Tax rates in Scotland and Wales may differ.

If the pension provider were to use a weekly payroll scheme, the yearly figures would be divided by 52 and would mean even more tax was deducted, but most are likely to use a monthly calculation.

Emergency tax codes can be difficult to understand, you do not need to learn it, but it explains why the tax taken on these payments can be so high. An example can be easier to follow:

Examples:

Taxable payment taken from flexi-access drawdown fund of £50,270 (after the 25% tax-free payment has been taken):

	£
Payment from Flexi-Access drawdown (after 25% tax-free amount)	50,270
Less 1/12 Personal Allowance	1,047
Amount taxed under PAYE	49,223
Tax @20% on first £3,141	628
Tax @40% on next £9,358	3,743
Tax @45% on remaining £36,724	16,525
Total tax deducted	**20,896**

At the end of the tax year you may have paid too much tax or too little, and this could be because:

- You have already used all of your Personal Allowance– in which case the example above might have given you too much tax-free allowance.

  This could be the case if, for example, you already take another small pension payment and have worked and paid tax under PAYE in the same tax year on the standard Personal Allowance code (1257L). This would mean that you have not paid enough tax and HMRC will contact you about this 'underpayment' to agree with you how it should be paid.

Or, as is more likely to be the case:

- You should not be paying tax at the higher rates on some of your income for the year.

  It is unlikely for many people that they should be paying the higher rate of tax and, if this is the case, HMRC may contact you about this 'overpayment' and refund it to you. However, depending on the situation, you may be able to claim this sooner (see the section on 'Getting a tax refund' for more information).

The table on the next page shows how incomes from other sources can affect the tax due on a lump sum, and illustrates how important it is to understand the full tax implications before making a decision on when, and how much, to take out of a pension scheme.

The three examples shown are all for people aged 66, with a personal tax allowance of £12,570. They have all chosen to take a single payment in the tax year of £50,270 from a flexi-access drawdown fund, having already received a 25% tax-free lump sum from their pension savings. As already shown in the last example, the tax taken by the pension provider will be £20,896.

The three examples cover someone with:

1. No other income
2. A low income (£5,000)
3. A moderate income (£17,000)

	1. No other income £	2. Low income £	3. Moderate income £
Other income (gross)	0	5,000	17,000
Flexi-access drawdown	50,270	50,270	50,270
Less Personal Allowance	12,570	12,570	12,570
Taxable income for the year	37,700	42,700	54,700
37,700 @ 20%	7,486	7,486	7,486
Remaining @ 40%	0	2,000	6,800
Total tax due	7,486	9,486	14,286
Tax taken under PAYE	0	0	886
Tax taken by scheme provider	20,896	20,896	20,896
Tax overpaid	**13,410**	**11,410**	**7,496**
Tax underpaid			

As you can see from these examples, you should make sure you understand the full tax implications before taking money out of a pension pot.

MONEY PURCHASE ANNUAL ALLOWANCE (MPAA)

Since an individual can now take their pensions flexibly but may also continue to pay into another pension pot, restrictions have been introduced in some cases for tax relief on these further pension contributions.

Currently most people can get tax relief on pension contributions of up to £40,000 a year (or 100% of your salary, if less) but, if you start to take money from a pension using the flexibility options, you may trigger a restriction called the money purchase annual allowance (MPAA). The current MPAA is £4,000.

If you have triggered the MPAA and your future pension contributions exceed £4,000 in a single tax year you will not receive tax relief on the excess and will be subject to additional tax charges. Both your own pension contributions and any made on your behalf by an employer will count. There are exceptions (some of which are mentioned in this guide) and it can become a complex issue on which you may need to take independent financial advice. If you think your future annual pension contributions may be more than £4,000 you should investigate the potential implications of the MPAA before you finalise any decision to access pension monies flexibly.

PENSION FLEXIBILITY AND STATE BENEFITS

Payments may also affect means tested state benefits such as tax credits, universal credit and pension credit. In particular, under what is called the ‘deprivation rule’, if you spend, transfer or give away any money that you take from your pension pot, the Department for Work & Pensions (DWP) will consider whether you have deliberately deprived yourself of that money in order to secure, or increase, your entitlement to benefits. If it is decided that you have deliberately deprived yourself, you will be treated as still having that money and it will be taken into account as income or capital when your benefit entitlement is worked out. More details can be found at www.gov.uk/government/publications/pension-flexibilities-and-dwp-benefits.

Changes in your circumstances for tax credits should be reported to HMRCs tax credits helpline on 0345 300 3900. You will need to contact the DWP (contact details at the end of the booklet) if your situation changes to see if there is any effect on your state benefits. Your council tax support or housing benefit may also be affected, so contact your local council for detailed advice.

TIMING OF TAKING MONEY OUT OF YOUR PENSION

The above examples show that you can trigger a large tax bill when you take taxable lump sums from pensions under flexi-access arrangements.

Even though many people will get a refund because the PAYE system takes too much tax off the payments when they are taken, you may still have given yourself a tax bill that you could have avoided.

Much depends on your circumstances, e.g. how quickly you need to access the money. However, in many cases there is no need to rush, so take your time over the decision. If you are unsure about the possible impact that your plans might have on the amount of tax you will pay you should think about seeking independent financial advice.

Take, for example, the person in the table on page 9 with no other income. By taking out £50,270 all in one go, they have given themselves a tax bill of £7,486. That is a big bill and means they are left with only £42,784 (£50,270 minus £7,486). Did they need to pay that much tax?

The answer might be no, if, for instance, they had taken out £10,000 of taxable pension a year over five years. With the standard personal tax allowance set at £12,570 for 2021/22, and with this possibly to increase in future tax years, they might have paid no tax at all.

But tax is not the only factor; there might be other reasons you need more money sooner. You will need to take into account possible future changes in your circumstances and you will have other investment based issues to think about. We cannot cover those, but do strongly suggest you think about the tax situation very carefully before acting and, if in doubt, seek independent financial advice.

GETTING A TAX REFUND

The system differs depending on whether you have

i. Taken all of your money out of a pension pot, or,
ii. Taken part of your money out of a pension pot

If you take all of your money out of a pension pot (defined contribution)

If you pay your tax under PAYE you can claim the overpaid amount back during the tax year. Your scheme provider should provide you with a P45 showing details of the payment. You may have to send this form to HMRC when you claim a repayment. If you have no other income or just receive your State Pension, use form P50Z.

If you have other PAYE income, use form P53Z. You can either telephone HMRC for the forms (see contacts list on page 15) or search www.gov.uk for P50Z or P53Z.

If you have taken only part of your money out of a pension pot (defined contribution)

Unless you plan to make any further withdrawals in the tax year, you can reclaim any overpaid tax without needing to wait until the end of the tax year by using form P55, which you can find to download, or complete online, on the www.gov.uk website.

Example: Let's say you had two pension pots, one of £20,000 and the other of £10,000. You have taken out £12,000 from the first, so there is still £8,000 left in it. Although your pension provider will take some tax under PAYE and tell HMRC about the payment and tax deduction, they will not issue a P45 as you still have money left in the pot. After the first withdrawal, HMRC should issue a tax code number to the pension provider to be used when you take further withdrawals. If you intend no further withdrawals before the end of the tax year you can use form P55 to reclaim any overpaid tax, without needing to wait until the end of the tax year.

If you have or open a **Personal Tax Account** with gov.uk, you will be able to make a claim for a refund online. For more information go to the www.gov.uk website, or find Tax Help's guide 'Accessing your Personal Tax Account' available on our website.

If you don't reclaim tax before the end of the tax year

The P53Z, P55 and P50Z forms are no longer relevant as they are for 'in year' reclaims only. If you haven't made a claim during the tax year HMRC should automatically look at all of your PAYE records after the end of the tax year. Where there has been a tax overpayment of any amount or an underpayment of at least £50, HMRC will send you a 'P800' calculation. This should pick up on overpayments that haven't been claimed within the tax year, but, if the system fails, you may not hear from HMRC or you may get a P800 calculation that is incorrect, so you need to try to understand your situation for yourself.

Other considerations

If you usually complete a Self Assessment tax return, you may have to wait until the end of the tax year to balance your account. You can still apply for an in year refund, but must remember to report this on your Self Assessment.

If you have taken a defined benefit trivial commutation from final salary pensions or a small lump sum from any type of pension, your pension provider will usually take tax at basic rate (20%) from the taxable part of these payments and should then provide you with a P45 showing the details. You may have to send this form to HMRC to claim any appropriate repayment on form P53.

You can either telephone HMRC for the form (see contact details at the end of this booklet) or search www.gov.uk for P53.

GLOSSARY OF TERMS

Annuity

An annuity is a means of taking a regular guaranteed income. It is normally paid for the rest of your life, but can be for a fixed period. It means that you hand over your capital to an insurance company (not necessarily the same one you saved up your pension pot with) and in return they promise to pay you a guaranteed income stream. You can buy different varieties of annuity to suit your personal or family circumstances.

Defined benefit pension scheme

Also known as final salary schemes, these are a type of workplace pension and they provide benefits based on your final salary from your employer and length of time you were a member of the scheme. The amount is determined by the rules of your pension scheme.

Defined contribution pension scheme

Also known as money purchase schemes, these provide benefits on retirement based on the amount of money that has been paid in to the scheme, for how long and how the money has been invested, the level of charges and the investment returns over this period.

Drawdown

Income drawdown lets you take an income from your pension pot while the rest is left invested. Check with your pension provider to see if they offer income drawdown.

Flexible access

Flexible access is a form of income drawdown which allows individuals to take taxable income from their pension fund with no upper limit.

HMRC

HM Revenue and Customs (HMRC) is the government body that collects tax and National Insurance Contributions (NICs). It also administers the tax credits system.

Marginal rate

This is the usual rate at which you pay income tax. It could be 0%, 20%, 40% or 45% (or even higher if your income exceeds £100,000 a year so that you lose your Personal Allowance). If you are thinking of taking money out of your pension that is taxable watch out – it will be added to your other income for the year and could tip you into a higher tax rate.

P45

The form given to you when you cease employment or stop claiming certain taxable state benefits. When you start a new job or start to get a pension, your employer or pension provider needs to know your tax code. If you were given a form called a P45 from a previous job or the DWP in the same tax year, your new employer will use the information to deduct the right amount of tax. Your pension provider should also give you a P45 if you take all the money out of your pension pot and there is nothing left in it, and you may need that P45 if you need to make a tax reclaim.

Personal Allowance

A fixed amount of income you are allowed each year before you start paying tax (in the tax year 2021/22 this is £12,570). A tax year runs from 6 April to 5 April the following year.

Pay As You Earn (PAYE)

The method of paying income tax and national insurance contributions on your wages and pension income. Your employer or pension provider deducts tax (and national insurance contributions, if necessary) from your wages/pension before paying the remainder to you. Your employer or pension provider sends the amounts taken off to transfer the deductions to HMRC, together with information about how much wages or pension they have paid to you.

Pension pot

The name sometimes given to the fund that holds your money or assets.

Small lump sum

A special type of lump sum payment that can be made where the pension pot is worth £10,000 or less. This is different from a trivial commutation payment.

Tax-free cash

A sum of money available to pension scheme members in exchange for a reduction in pension payments. It is currently paid free of tax.

Trivial commutation

The conversion of a defined benefit pension, which is below a certain level (£30K), into a cash sum (commutation).

USEFUL CONTACTS

MONEY & PENSIONS SERVICE

Advice line Monday – Friday 8am to 4pm; Saturday 9am to 1pm	0800 138 7777

HM REVENUE AND CUSTOMS (HMRC)

HMRC – main number	0300 200 3300
Tax credits	0345 300 3900

DEPARTMENT FOR WORK AND PENSIONS (DWP) – STATE BENEFITS

Pension Credit	0800 99 1234
Carer’s Allowance	0800 731 0297

Or visit www.gov.uk and search for the benefit you are interested in

COUNCIL TAX

Contact your local council

TAX HELP FOR OLDER PEOPLE

Can help those over 60 or near retirement (55 for Pension Flexibility advice) on low income; as a guide, £20,000 per year.

Helpline: 0333 207 5653 Monday – Friday 9am to 5pm

Email: taxvol@taxvol.org.uk

Website: www.taxvol.org.uk

Address: Unit 10, Pineapple Business Park, Salway Ash, Bridport, Dorset DT6 5DB

TAXAID

Can help anyone on low income who has been unable to resolve their tax problem with HMRC. As a guideline, a low income is up to about £380 a week before tax for a single person – equivalent to £20,000 per year.

Helpline: 0345 120 3779 Monday – Friday 10am to 4pm

Website: www.taxaid.org.uk

Address: Unit 2, 33 Stannary Street, Kennington, London SE11 4AA

PAID PROFESSIONAL TAX ADVICE

The Government’s Pension Wise service will provide basic guidance on pension options for all those who have savings in defined contribution schemes. But you might find you need further information to understand your tax situation and how taking money out of your pensions will affect you.

Those that can afford to pay for professional help can look for a qualified Chartered Tax Adviser via http://core.tax.org.uk/members/findamember

TAX HELP

Tax Help for Older People

Pineapple Business Park, Salway Ash, Bridport, Dorset DT6 5DB