

The pension lump sum 'emergency' tax trap that could cost you thousands

Telegraph Money explains how to avoid overpaying the taxman in retirement



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Building a good pension takes a lifetime of hard work, so ensuring you are making the most of every pound is essential. But an unfortunate quirk of HM Revenue & Customs' (HMRC) system means pensioners are frequently overtaxed

– since 2015, retirees have overpaid more than £1bn in income tax. Last year, HMRC overtaxed pensioners by a record £200m.

It means you might take out £10,000 from your pension – but get taxed as if you had taken £120,000.

The problem is that the taxman is still hopelessly ill-equipped to deal with the “pension freedom” reforms that took effect eight years ago. The reforms, which broke the shackles of compulsory annuity purchase, have revolutionised how we can spend our pensions.

Over-55s now have much more flexibility about how they spend their savings, but it has introduced a lot of tax complications.

Tom Selby, of pension company AJ Bell, said the overtaking problem was “ridiculous” and that it was “scandalous that the Government has done nothing to address it almost eight years since the pension freedoms were introduced”.

Here, Telegraph Money explains how to get your money back.

What’s the problem?

When retirees first withdraw money from a typical “defined contribution” style pension, they are taxed immediately. However, instead of using the saver’s normal income tax rate, HMRC opts for a higher emergency rate.

This is designed to prevent savers from making multiple withdrawals, which could push them into a higher income tax band. But it means people are handing more money to HMRC than they often should. This can be a costly error – last year the taxman had to refund an average £3,062 to pensioners.

In some cases, the problem is much worse. According to a Freedom of Information request from insurer Royal London, some savers have been charged nearly £55,000 in emergency tax.

Under the emergency tax code, a pension withdrawal is treated as if it were going to happen each month. HMRC therefore divides the saver’s personal allowance, currently £12,570 a year, by 12, and then assesses the excess against 1/12th at each of the income tax bands.

On an emergency tax code, a £50,000 single withdrawal would lead to a tax bill of almost £21,000 if this were a saver's only earnings subject to income tax. If this were taxed on an ordinary basis, the bill would be just £7,846, meaning you were overtaxed by around £13,000.

How to get your money back

If you have overpaid income tax, then you can wait until HMRC automatically reviews its tax codes and assigns you the right one, but you may have to wait until the end of the current tax year. You can ask for a refund sooner by filling in one of three different forms.

The “P55” form is for those who have made only a partial cash withdrawal from their pension.

If you have taken your entire pension as cash, you must fill in either the “P53Z” form if you are still earning other income, or the “P50Z” if you have stopped working.

You can use HMRC's online service to fill in these forms, as long as you have a Government Gateway ID and password. If you do not have an ID, you can create one online. Alternatively, you can print off your relevant form and post a copy to HMRC at this address:

Pay As You Earn
HM Revenue and Customs
BX9 1AS

Once you have filled out the correct form, HMRC should refund any overpaid tax within 30 days.

How to avoid the trap

However, this wait could leave a serious gap in your budget. There is a trick to avoid overpaying so much tax, but it takes a few months of planning ahead of when you want your lump sum.

Carla Morris, of RBC Brewin Dolphin, a wealth manager, said: “Although you can reclaim any tax overpaid either via a form or by self-assessment, you might want to consider taking a smaller income payment at the start so HMRC generates a

new tax code and sends it to the pension provider which will be used for future income payments.

“Most pension providers won’t accept a copy of any tax code notification sent to you – they’ll need HMRC to write to them directly.”

You can stop the overpayment problem by taking out two payments very close together. First, you trigger the emergency tax code by making a nominal withdrawal, at just £1, then wait a few weeks for the correct code to be applied. Then withdraw the sum that you actually want, which should be taxed with the correct code, reducing the overpaid tax.

The state pension tax trap

There is also a danger that in the first year you claim your state pension, you could get overtaxed, some experts have suggested. Chris Flower, of the wealth manager Quilter, said: “State pensions are taxed on an accruals basis, which means tax is due on entitlement to receive and not when the money lands in bank accounts. Most of your income is generally taxed when it is received.”

For example, if someone received their state pension on a monthly basis toward the end of the tax year, one week’s worth of these payments could be paid in the new tax year.

In the 2024-25 tax year, they could receive a total of £11,485.05 in state pension payments, but would be taxed on £11,502.40. This is because of the uplift in the state pension from £203.85 per week to £221.20 per week, and one week being paid at a lower rate. Their “entitlement” – which is how HMRC calculates income tax on the state pension – would be based on 52 weeks of the higher amount.

A spokesman for HMRC said: “State pension is taxed on someone’s annual entitlement to ensure the correct amount is paid. Not taxing payments in this way could result in people underpaying tax, which would see them getting a tax bill at the end of the tax year.

However, HMRC noted that any overpayments would be refunded by the end of the tax year. “People can claim back any overpayment earlier if they wish,” they added.

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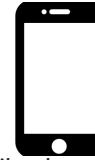
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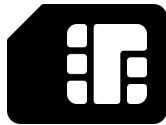
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