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Accountants & Financial Advisors

KEY GUIDE

Retirement and tax

Introduction

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.

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The lifetime allowance for both defined benefit and defined contribution pensions

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PENSION INCOME

How to make sure your pensions withdrawals are taxed correctly

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 5 July 2026.

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Tax does not stop at retirement

Tax rules enable withdrawals from many pension arrangements that mirror changing working habits and lifestyles. Having flexibility in income levels is important to many people, for example in helping them cope with high inflation levels after the pandemic. It also gives considerable scope for planning income tax in retirement.

The abolition of the lifetime allowance from 6 April 2024 removed penal taxes on very large pension pots, though there are still limits on tax-free benefits. It also affected the tax treatment of some pension death benefits, a change which could be helpful if you are concerned about estate planning. However, it was announced in the Autumn 2024 Budget that most unused pension funds and pension death benefits will form part of the member's estate on death and so potentially become liable to inheritance tax (IHT) from April 2027.

The downside of regular changes is that the complexity of pensions tax has increased. With the personal allowance currently £12,570, and frozen until April 2031, it takes very little income over and above the state pension to bring you into the tax net. The maximum single-tier state pension is £12,547 in 2026/27, and would be expected to overtake the personal allowance in the next tax year.

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. It will rise to 67 in stages between April 2026 and March 2028. The full amount of the 'new' state pension (which replaced the basic state pension for new claimants from April 2016) is £241.30 per week in 2026/27. This increases each April in line with the 'triple lock guarantee' i.e. the higher of the increase in average UK earnings growth, CPI inflation, or 2.5%

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.

EXAMPLE
Taxing the state pension

In 2026/27 Anne, who lives in England, has a private pension from her former employer of £15,000 a year and a state pension of £12,547 a year. Her personal allowance is £12,570. HMRC calculates her tax code as follows:

Personal allowance	£12,570
Less state pension	£12,547
A tax-free amount of	£23 (a tax code of 2L)*

The £12,547 reduction from Anne's personal allowance means that HMRC collects an additional £2,509 of tax (£12,547 @ 20%) from Anne's private pension because her state pension has effectively exhausted her personal allowance.

*The tax code is established by replacing the final digit with a letter – in this case 'L' which indicates there is some personal allowance remaining. In practice as there is so little (£23) of the personal allowance left unused HMRC are likely to apply a basic-rate (BR) tax code to Joan's private pension.

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.

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. You will generally 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 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 have benefits from schemes operated by previous employers.

Benefit allowances

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 who already had large pension funds when the LTA was introduced or reduced. The LTA has been scrapped, but the maximum available tax free is restricted by a lump sum allowance (LSA) to £268,275 (25% of £1,073,100), with some additional protections for those who already had large pension funds when the LTA was introduced or reduced. We can help you calculate your entitlement if this is relevant to you.

Planning point

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

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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 tax-free lump sum is 25% of the value of total benefits being crystallised, up to a maximum of £268,275, although special transitional rules may apply.

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 scheme is usually very simple: however much you allocate to providing an income, you can normally draw a third of that amount (a quarter of the total fund used) as a lump sum. In most circumstances it makes sense to take the lump sum 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 a tax free lump sum in isolation and defer receipt of income to a later date.

You can also 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 on 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 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 calculates 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 £5,128 is deducted from her £15,000 withdrawal – 34.2% 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. In the example of Helen above, the tax repayment would be £2,128 (£5,128 – £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 drawdown (FAD) withdrawal – as Helen did in the above example.

The key difference between UFPLS and FAD is that with UFPLS the 75% taxable element has to be taken at the same time as the 25% tax-free PCLS is taken, whereas with FAD the 25% tax-free PCLS can be taken and the associated 75% taxable element left invested within the drawdown plan if not required at that time. The awkwardly named UFPLS has the same potential emergency tax issues as flexi-access withdrawals.

With many people currently 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 (known as the Money Purchase Annual Allowance (MPAA)) before suffering tax charges. It is worth noting however that withdrawing the 25% tax-free PCLS only and taking no other flexible withdrawals (including the taxable element of a drawdown pension) will not trigger the MPAA. Professional advice is essential to avoid potential pitfalls.

Planning point

Flexi-access drawdown enables a pension fund to pass on down through generations.

PENSIONS, DEATH AND TAXES

The current tax treatment of DC pensions on death has meant that, for some people who do not need pension income, pension planning has become IHT planning. However, the Chancellor of the Exchequer announced in the Autumn Budget 2024 that most unused pension funds and pension death benefits will form part of the member's estate on death and so potentially become liable to IHT from April 2027, which may affect the order in which assets are best used to provide lifetime income. Currently under a DC pension plan:

- On death before age 75, beneficiaries may take income payments tax-free. Lump sums on death are tax-free up to £1,073,100, with any excess taxable as income to the recipient if retirement benefits have not yet started. For deaths after 5 April 2024, the tax can also apply where retirement benefits have started, and lifetime tax-free lump sums (PCLS and the tax-free part of UFPLS) taken after 5 April 2024 are included when testing against the £1,073,100 threshold. Where the tax-free limit could be an issue, it may be preferable to set up a drawdown arrangement on death rather than taking a lump sum. This would allow for the possibility of encashing the drawdown tax free very quickly as the subsequent encashment from drawdown would be regarded as income , rather than a lump sum, and so would not be tested against the £1,073,100 threshold.

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- On death at or after age 75, all payments are taxable at the recipient's tax rate(s).
- There is currently normally no IHT on unused pension funds and death benefits. However, from 6 April 2027 tax law is changing and where death occurs on or after this date, most unused pension funds and pension death benefits will potentially be subject to IHT.

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.
- Minimising the IHT liability after your death.

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