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How pension drawdown lump sum payments are taxed

Income payments from pensions are subject to Income Tax but not National Insurance. They are taxed under the PAYE (pay as you earn) regime in the same way as employment income. This means if a client receives regular income payments from their pension, the tax paid during the tax year should be correct.

However, tax issues may arise when income is first taken or large lump sums are taken under flexi-access drawdown.

In addition, how the tax is deducted depends upon whether the payment is from a capped drawdown plan or a flexi-access drawdown plan, and whether the pension scheme has a tax code for the individual or not.

This factsheet explains more about how tax is deducted for pension drawdown lump sums, and how you and your clients can reclaim any overpaid tax.

It's worth saying a provider has no control over the PAYE system and must apply tax as instructed by HMRC.

If you only read one thing...

- If the correct tax code is unavailable an emergency tax code must be applied to income payments from flexi-access drawdown plans. This will mean – in many cases – clients overpay tax, and this can be reclaimed from HMRC by the client.
- For clients who are taking regular withdrawals, HMRC will give the provider a tax code, and the client's tax position will normally be corrected over the rest of the tax year.
- Clients who are taking a lump sum payment can wait until the end of the tax year, when HMRC will reconcile their account and repay any tax.
- Alternatively, they can reclaim tax by completing an HMRC form. The form they must complete will depend on whether they have withdrawn the entire pension plan, or they have partly encashed it, and whether they have any other income.

Capped drawdown

Before pensions freedoms were introduced in April 2015, clients could only take drawdown lump sum payments from capped drawdown. Under the rules then in force, and for withdrawals from capped drawdown today, a long-standing HMRC concession means lump sums are always taxed as if they are paid in tax month 12 – i.e. between 6 March and 5 April – regardless of when they are actually paid.

For example, if a client with no other income took a first lump sum payment of £12,570 from their capped drawdown in September 2026 the full amount of their personal allowance would be considered (instead of working on a cumulative basis and using 6/12ths of £12,570) and no tax would be due.

For clients taking a regular income from their capped drawdown, the normal PAYE rules apply.

Flexi-access drawdown

When pensions freedoms were introduced in April 2015, HMRC decided any lump sum payments taken from flexibly accessed benefits – either flexi-access drawdown or uncrystallised funds pension lump sum (UFPLS) – would be taxed in a different way to those taken from capped drawdown. These methods of deducting tax from lump sum pension payments means significant numbers of people pay too much tax initially and have to reclaim it.

If the pension plan does not have a tax code for the individual

If the pension plan does not have a tax code for the individual, for example it's the first taxed payment from the pension plan, then an 'emergency tax code' or month 1 basis must be used.

The effect of using the emergency tax code is the payment is assumed to be an instalment – in other words the client will continue to receive that same amount for every month for the rest of the tax year. The pension scheme will apply 1/12th of the personal allowance to the payment, and will assess the remaining

payment against 1/12th of each of the income tax bands (this is regardless of the month the payment is made). This approach means considerably more of the payment will be taxed at higher rates of tax.

For most clients, this lump sum payment is a one-off, and therefore the client will overpay tax. The individual will need to correct any over or underpayment of tax directly with HMRC.

If the pension plan has a tax code for the individual

The pension provider could have a tax code for an individual if:

- the client passed them a copy of their pension P45 from the current tax year (for example because they have transferred from another pension plan), or
- they have already paid out withdrawals from the pension plan.

If the individual has a cumulative tax code (such as 1257L) then payments from flexi-access drawdown are subject to tax as if they are a monthly payment. This means when taxing the benefits any unused tax allowances built up to that point in the tax year can be applied.

For example, if a client took a first lump sum payment of £12,570 from their flexi-access drawdown in September 2026, six months into the tax year, where they had a cumulative tax code of 1257L, then they would not pay any tax on the first £6,285 (6/12ths of £12,570) and tax would be due on the remainder.

Taking a small first payment

To avoid the emergency tax code being applied to lump sums from flexi-access drawdown, individuals could take an initial small payment (for example, £200) from the pension plan, which should mean HMRC give the scheme a tax code to use for future payments. This means further payments shouldn't be taxed on such a punitive basis, although a tax reconciliation or reclaim may still be required.

Timing of payments

Many clients may want to consider the timing of taking a lump sum from their flexi-access drawdown. If they have a tax code, then if they wait until March (at the end of the tax year – month 12) and they have taken no other income in the year, they can use their full allowances against the payment and pay the right tax.

Ongoing regular income

If a client takes ongoing regular income, even though the initial payments may be incorrect, HMRC will issue a revised tax code and allow subsequent payments made over the year to be taxed correctly. The client shouldn't have to reclaim any tax or make any extra payments, unless regular income is started close to tax year end.

Reclaiming overpaid tax

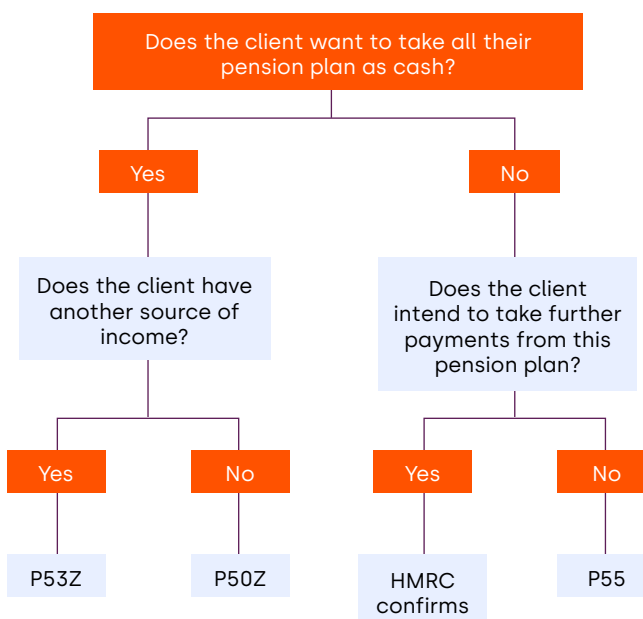
The pension plan is not able to refund overpaid tax on lump sums unless further income is taken. Where no ongoing income is expected, clients will have to reclaim the overpaid tax from HMRC themselves.

Clients taking a lump sum can either wait until the end of the year when HMRC will reconcile their account and make any tax repayment. Or they can claim back any overpayment by completing one of these three forms:

- P55 – when funds have been flexibly accessed but the fund has not been extinguished
- P50Z – when funds have been flexibly accessed, the fund has been extinguished, and the client is not working or claiming benefits
- P53Z – when funds have been flexibly accessed, the fund has been extinguished, and the client has another source of taxable income

These forms are available from the [Gov.uk](https://www.gov.uk) website and can be completed either online or on paper.

Which form to use



Example – comparing taxation of ad hoc lump sum payments

Diana, who lives in England, wants to withdraw a lump sum pension payment of £32,000 – 25% will be tax free, and 75% will be taxed as income. She wants to make the withdrawal in August 2026. She receives no other income for this year (including taking no further withdrawals from her pension scheme).

How much tax does Diana owe

The tax she owes is:

- £8,000 will be tax free, and £24,000 will be taxed as income.
- The whole of her personal allowance (£12,570) can be deducted from the taxable element and the remainder (£11,430) will be taxed at basic rate of 20%.
- Diana should receive £8,000 PCLS plus £21,714 (£24,000 - £2,286)

Because of the way HMRC rounds the calculation deducting the personal allowance, the total tax deducted may be slightly lower – in this example £2,284 rather than £2,286.

Capped drawdown

If Diana took her £24,000 lump sum from a capped drawdown plan, then:

- It would be taxed on the basis that the payment is made in month 12, and the full allowances for the year are available.
- The tax due is £2,286.

Diana should receive £8,000 PCLS plus £21,714 (£24,000 - £2,286), and doesn't have to reclaim any overpaid tax. But as above the tax deducted may be very slightly lower.

Flexi-access drawdown – no tax code

If the pension plan does not have a tax code for Diana, then the emergency tax rate will be applied. The following tax will be deducted:

	Annual tax band	Month 1 Taxable amount (1/12th of the tax band)	Tax rate	Tax due
Personal allowance	£12,570	£1,047.50	0%	£0
Basic rate	£37,700	£3,141.67	20%	£628.33
Higher rate	£37,701 to £125,140	£7,286.67	40%	£2,914.67
Additional rate	£125,141 and above	£12,524.17	45%	£5,635.88
				£9,178.88

Diana should receive £8,000 PCLS plus £14,821.12 (£24,000 - £9,178.88). Although as mentioned previously the amount deducted may be a few pounds different due to the way HMRC deducts the personal allowance. She will have to reclaim her overpaid tax of approximately £6,892.88 (£9,178.88 - £2,286).

Please note: The example uses tax rates and bands in England. Scotland has different tax rates and bands. The tax treatment depends on the individual circumstances of each client and may be subject to change in the future.

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