MES PENSIONS

A Guide to Income Tax on your SIPP for Clients and Advisers

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Income tax from your pension
Taking an income from your pension involves the payment of UK income tax. Tax on pension income is collected before we pay you your income payment under the Pay As You Earn system by HMRC.

Whilst employment income is generally a regular amount, the flexibility in which you can take pension income means that HMRC have to estimate how much tax to deduct month to month. This potentially means that it is the end of the tax year before any under or overpayments are settled.

The tax-free element of your pension withdrawals
You are allowed to take 25% of the value of your pension tax free which can be taken as a single tax-free lump sum or as the tax-free portion of a withdrawal. For example, if you took a £2,000 Uncrystallised Fund Pension Lump Sum (UFPLS) withdrawal, £500 of this would be tax free and £1,500 would be liable for income tax. This tax-free allowance is currently capped at £268,275.

The taxable element of your pension withdrawals
If you take 25% of the value of your pension savings tax-free as a Pension Commencement Lump Sum (PCLS), the remaining 75% is allocated to a drawdown that you can either take straight away as income or defer for a future date that is more suitable for you. This 75% is subject to tax and when taking income, the tax due is calculated in the same way as the income tax paid on earnings from employment.

What tax will I pay?
The amount of tax deducted from pension income will depend on how much of your taxable income is above the personal allowance, a PAYE tax code, the amount requested and at what point you take the income payment in the tax year.

PAYE Tax
When you first take income from your pension, you will usually be taxed using a standard tax code. This means that you could potentially pay considerably more tax than you may have anticipated.

Can I claim back tax?
If you have overpaid tax and you are not expecting to take further pension income payments in the same tax year, you must reclaim the overpaid tax directly from HMRC. In addition to this, any pension income may affect the tax rate that is applied to any other UK sourced income you receive, such as employment income.

A non-UK resident may be able to reclaim some or all the overpaid tax from HMRC using the terms of a double tax treaty between the UK and their country of residence and by completing the appropriate claim form.

Does living outside the UK affect my pension?
Your pension income is taxable under UK rules so we will deduct the UK tax under PAYE rules as required.

If you are subject to tax in any country outside the UK, please contact your financial adviser or a tax specialist in the country concerned to understand whether you will be liable for tax in that other country because of receiving a payment from a UK pension scheme.

If you are a tax resident in a country that has a Double Taxation Agreement with the UK, HMRC can potentially issue an NT (No Tax) code if you submit an application to them. A NT tax code means that no tax is to be deducted from your pension income because you are exempt from UK income tax due to a valid Double Taxation Agreement. Please note we are unable to assist you in the application for an NT code where you are eligible to apply.

It is important that you and/or your financial adviser check the appropriate Double Taxation Agreement to ensure that this covers pensions income from a SIPP.

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You will only be able to apply for this NT code after the first income payment from your pension. This process can take several months so it is important to plan well in advance before taking income from a UK pensions.

NT application forms
HMRC has a standard claim form, plus a country specific form for tax residents in 13 countries:

- Australia
- Canada
- France
- Germany
- Ireland
- Japan
- Netherlands
- New Zealand
- South Africa
- Spain
- Sweden
- Switzerland
- United States of America

Further information is available on the government website: www.gov.uk/tax-right-retire-abroad-return-to-uk and www.gov.uk/tax-foreign-income/residence.

Your tax code
HMRC will give your pension provider a tax code which reflects your personal tax position. Your tax code tells the pension provider how much tax to deduct from each income payment, including how much can be paid tax free.

HMRC will consider all sources of UK income - including employment income, savings interest, investments and other pension income to arrive at a final tax code.

Where the tax code is a number followed by a letter, the number indicates the amount of income your pension provider can pay without deducting tax, per tax year. If you have more than one source of taxable income, e.g. two pensions, you might have different tax codes with each provider.

It is possible for your tax code to change during a tax year, especially if your circumstances change or you start to receive a state pension or drawdown pension income from another pension provider.

Your tax code tells the pension provider payroll system how much tax to deduct. It is your responsibility to check that the tax due has been calculated using the correct information. We will always inform you of the tax code used for any taxable payment we make to you.

What tax code will we use?
MES Financial Services Limited is required by HMRC to use the tax code we are instructed by them to use.

If we do not hold a tax code for you, we use a standard tax code. We will notify HMRC of any payments made and they should then inform us of the tax code we have to use ongoing.

If you have transferred previous pensions from other providers to us, if your previous pension provider has sent us a P45 (in respect of a pension in payment that they have transferred to us) for the same tax year as the payment we are making, we will use the tax code included in the P45.

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If we already hold a tax code for you, we will continue to use that tax code until such time a revised tax code is instructed to be applied by HMRC.

It is your responsibility to inform HMRC when there's a change to your personal circumstances or taxable income which could affect the tax you pay, otherwise HMRC may give an incorrect tax code. For further information please visit www.gov.uk/tell-hmrc-change-of-details/income-changes.

Emergency tax code
If we have not received a tax code from HMRC, or we don't have a valid P45 for the current tax year from your previous pension provider, we will need to use an emergency tax code.

The emergency tax code is applied because the pension scheme doesn't know what income the individual may have already had in the current tax year and what tax code they have. The emergency code will allow the application of the standard personal allowance and the normal tax bands.

An emergency tax code works on a 'month 1' basis. That means HMRC assumes that you get one twelfth of the basic annual tax allowance (£12,570 for the current tax year) each month, and any income above that is taxed assuming you'll have the same income every month. It doesn't take into account any other income or tax you may have paid. So, if you take £20,000 as taxable income, we must deduct tax as if you were taking 12 times this amount (£240,000) in this tax year.

The emergency tax code for the 2024/25 tax year is 1257L. This will give a tax-free amount of £1,057.50 and the rest of the payment will be taxable.

The month 1 basis can produce unexpected results. The PAYE system was designed so a regular income can have a known amount of tax deducted each month, without large spikes, so the correct amount of tax is paid by the end of the tax year. This can mean that it doesn't cope well with initial payments and ad hoc amounts.

After making the first drawdown income payment, HMRC will issue a revised tax code for us to apply to future payments.

Considerations
Emergency tax will generally result in too much tax being deducted, which can be a problem if the withdrawal is needed for a specific purpose because you may be left with a shortfall until the overpaid tax can be reclaimed.

This may mean a larger amount needs to be crystallised to get the net result you wanted. The downside of this is that more is taken out of the tax privileged pension than was needed and when the tax liability for the year is reconciled, you will have had more income than was needed.

If immediate cash flow is less important, then you could crystallise just enough to give you the required net amount after the accurate amount of tax due for the year but receive a lower net amount after the emergency tax and then to apply to HMRC for a tax refund. However, it is important to note there is no guarantee on how quickly overpaid tax will be refunded.

The other option might be to avoid one-off payments and look at a regular pension income spread over the year. Though the first payment might be overtaxed, the scheme should receive a tax code to apply to future payments, which would provide a greater certainty of net income levels for the rest of the tax year.

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There are some situations where the application of the month 1 emergency tax code will result in an underpayment of tax. This is typically for higher or additional rate taxpayers who may, for example, see part of their withdrawal amount benefit from a slice of the personal allowance (and basic rate tax band) which may not otherwise be available to them. The additional tax they are required to pay is likely to be accounted for by adjusting their tax code.

We have used the word 'nomally', in this guide because tax can become complicated at times. Tax rules and legislation can change, and any information given is based on our understanding of law and current HMRC practice as at April 2024.

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