A guide to how your pension is taxed

How your pension contributions and pension income are taxed

MONEY GUIDE

ROYAL LONDON

This guide looks at the tax breaks available when you're building up a pension pot and what happens when you start to take money from your pension. We also include a jargon buster to explain any technical terms used. The guide only covers defined contribution pension schemes where you (and/or your employer) build up a pot of money that you can then use to provide yourself with an income in retirement. These are sometimes called 'money purchase' pensions. It does not cover defined benefit pensions, also known as final salary or career average pensions, where your employer promises to pay you an income in retirement based on how long you worked for them and how much you earned.

Building up your pension

Tax relief on contributions

To encourage people to save for their retirement the government offers tax relief on pension contributions. This typically means that when you pay into your pension, some of the money that would have gone to the government as tax goes towards your pension instead.

For example, if you pay £80 into your pension and you are a basic rate taxpayer then the government will top that up by £20, so that £100 goes into your pension. If you pay more tax then you'll get more tax relief. For example, if you are a higher rate taxpayer, £100 of pension will cost you £60. You'll either receive the extra tax relief automatically, or you may have to claim it from HMRC and instead of going into your pension it will reduce your tax bill. You'll find more information on tax relief **here**.

Tax relief and annual allowance limits

You can usually get tax relief on pension contributions of up to £3,600 or 100% of your relevant UK earnings – whichever is greater. So, if you earn £25,000 a year and put no more than £25,000 into your pension pot, you'll get tax relief on the full amount. But if you put £30,000 into your pension pot in a year, you'll only get tax relief on £25,000 (as this is 100% of your earnings).

However, there is also something known as the annual allowance which restricts the amount you can pay into your pension annually before you have to pay tax. For most people this is £60,000 (it increased from £40,000 on April 6th 2023).

If you earn £70,000 a year and want to put all of this in your pension scheme in a single year, you'll normally have to pay tax on the amount over £60,000 (the annual allowance).

The tax you pay, called a tax charge, is worked out by adding the pension contributions over and above your annual allowance to your other income.

Replacing lifetime allowance

Up until the 6th April 2024 there was something called the lifetime allowance. The lifetime allowance was a limit on how much you could have built up in your pension(s) over your lifetime. From the 6th April 2024 – it's only taking tax-free lump sums that's important.

There are now two allowances; the Lump Sum Allowance and the Lump Sum and Death Benefit Allowance. During your lifetime you will have a tax-free cash allowance, called the Lump Sum Allowance, which is the maximum amount that you're able to take tax-free from your pension or pensions and for most people that is £268,275. This applies to tax-free cash and includes the tax-free element of cash lump sums.

The total of all tax-free lump sums, including tax-free lump sum death benefits and serious ill-health benefits, will be tested against a lifetime limit, set at £1,073,100. This is known as the lump sum and death benefit allowance (LSDBA). Any lump sums paid above this level will be taxed at the individual's or beneficiaries' marginal rate of income tax.

You might have a higher amount of Lump Sum Allowance and Lump Sum and Death Benefit Allowance if you have something called protection from the lifetime allowance. This is something that you had to apply for at points where the lifetime allowance was reduced.

Taking money from your pension

You usually can't start taking money out of your pension pot until you are aged 55 or over. This will change to 57 in 2028. There are two exceptions, which mean you may be able to access your pension earlier:

- If you're too ill to work or if you have a serious illness which means you're expected to live for less than a year.
- If you have a protected retirement date because of the type of pension you are in. An example of someone who might have this is a police officer or a member of the armed forces.

Tax-free cash

You can usually take up to 25% of your pension pot tax-free. The other 75% of your money is taxable.

There are two ways you can take your tax-free cash:

- You can take all your tax-free cash in one go. If you do this, the remainder of your pension pot can be used to buy an annuity (an insurance policy that provides you with a guaranteed income usually for life), or to provide an income through income drawdown. With income drawdown, there is no minimum or maximum income that needs to be taken. You could take the whole fund but remember, anything you take after the tax-free cash will be taxed as income.
- You can take smaller cash sums from your pension pot, rather than taking your 25% tax-free cash as a lump sum. In that case, 25% of each payment is tax-free.

As mentioned earlier, if you have more than £1,073,100 in your pension plans, your tax-free cash limit remains at £268,275, no matter how large your pension is.

How money from your pension pot is taxed

When you request money from your pension pot (outside your tax-free cash element), your provider takes off any tax due on any taxable part of the payment before you receive it.

The first time you take a lump sum (apart from the tax-free lump sum) from your pension, you may well find you are charged too much tax. This is because most initial lump sum payments are taxed using an emergency tax code. This means you're taxed as if you made the same lump sum withdrawal every month of the tax year. You can claim back any overpaid tax by using the forms on **www.gov.uk/claim-tax-refund**.

As mentioned earlier, your tax-free cash limit remains at £268,275, no matter how large your pension is.

Making future contributions into your pension

There is also a limit on the amount that you can pay into pensions if you have flexibly accessed your pensions. This restriction or limit is known as the money purchase annual allowance or MPAA and it is £10,000 a year. If you trigger the MPAA – you will to pay tax on any contributions made by you (and/or your employer) of over £10,000 in a tax year to a defined contribution scheme.

The MPAA is typically triggered if you:

- take your entire pension pot as a cash lump sum or start to take cash lump sums from your pension pot
- put your pension pot money into an income drawdown scheme and start to take drawdown income.

The MPAA is not triggered if you:

- take a tax-free cash lump sum and put your pension pot into a drawdown scheme which you don't take any income from
- start to take a defined benefit (otherwise known as final salary or career average) pension
- take a tax-free cash lump sum and buy a lifetime annuity
- cash in small pension pots valued at less than £10,000
- are already in a capped drawdown plan (these plans were available before 6 April 2015) and you don't take more than the capped drawdown amount you are allowed to take. For more on capped drawdown plans see the MoneyHelper website. **https://www.moneyhelper.org.uk/en/pensions-and-retirement/taking-your-pension/capped-drawdown**

Small pension pots

If you have a pension pot worth £10,000 or less this is called a 'small pot'. You can usually take this money in one go as a lump sum and 25% of this money is tax-free. Unlike larger pension pots, taking money from a small pot does not trigger the money purchase annual allowance (MPAA).

You can take up to three personal pension pots as small pot lump sums as long as each is worth £10,000 or less.

Taking money from your pension pot and state benefits

Any money you take from your pension pot could affect your entitlement to state benefits.

If the state benefit is means tested (where the amount you get depends on your income and/or any capital you have) then taking an income or a lump sum from your pension could affect how much you get or even whether you are entitled at all.

Means-tested benefits include Housing Benefit, Pension Credit, Universal Credit and Council Tax Support.

The rules are different depending on whether or not you've reached your state pension age (this is the earliest age at which you can claim the State Pension).

- If you or your partner is under state pension age, only the money you take out of your pension pot could affect your eligibility for state benefits.
- If you or your partner has reached state pension age, then any money either of you take out of your pension pots and any money left in the pot owned by the person who has already reached their state pension age is taken into account when your income and capital are assessed for benefits.

Tax in retirement

Your income in retirement is taxed in the same way as your income is at any other time. Everyone has a personal allowance (£12,570 for the 2026/27 tax year) which is the amount of income you can have before you need to pay any income tax. After this you have to pay tax on any taxable income you have. Taxable income includes pay from any work you do, any pension income including the State Pension and any taxable state benefits you receive.

Income that is not taxable includes interest from tax-free savings accounts such as ISAs and any tax-free lump sum from your pension. Some state benefits are also tax-free.

You can find the latest income tax and personal allowance rates on the gov.uk website at **https://www.gov.uk/income-tax-rates**.

What happens to your pension pot when you die?

You can usually leave any money in your pension pot to whoever you like. But there may be some tax to pay on this. To make sure your money goes to the right person, you should let your pension provider know who you would like to receive your pension on your death. This can be one person or more than one and it doesn't have to be a family member.

Any money you take out of your pension pot and don't use before you die will count as part of your estate. Your estate is everything you own when you die including savings and investments (but usually not pensions). Depending on the size of your estate there may be some inheritance tax to pay. You can find out more about inheritance tax at **www.gov.uk/inheritance-tax**.

If you die before age 75 then any money left in your pension pot, an income drawdown plan or an annuity (when you've left an income to someone else or you chose a guaranteed period) can be passed on to your beneficiary or beneficiaries. If it is taken as income drawdown or an annuity, there will be no income tax to pay. If it is taken as a lump sum then there will be no income tax to pay up to your Lump Sum and Death Benefit Allowance, and then income tax is paid on the excess.

If it has not been established who is to receive death benefits from your pension(s) within two years of your death, then your beneficiaries could end up paying income tax.

If you die aged 75 or over then your beneficiary/ies will have to pay income tax at their highest rate on any money they withdraw from your pension pot, income drawdown plan or annuity.

Where to find out more

Benefits

For more on how pension payments can affect your eligibility for state benefits see https://www.citizensadvice.org.uk/debt-and-money/pensions/nearing-retirement/what-you-can-do-with-your-pension-pot/

Help with tax

If you're 60 or over and your income is less than £20,000 a year, free tax advice is available from the charity Tax Help for Older People. For details see https://taxvol.org.uk/ or call 01308 488 066.

For younger people on incomes of less than £20,000 a year, or for people who are self employed, free tax advice is available from the charity TaxAid. For details see https://taxaid.org.uk/ or call 0345 120 3779.

Tax on pension contributions

You can find out more about this at www.gov.uk/tax-on-your-private-pension.

Jargon Buster

Annual allowance – this is the maximum amount you can pay into your pension in any one tax year without having to pay an annual allowance tax charge.

Annuity – this is an insurance policy you buy with a lump sum and the insurance company then pays you, and possibly someone else on your death, an agreed income for either a fixed period of time (fixed-term annuity) or for life (lifetime annuity). Some annuities have a guaranteed period. This means they will pay out for a fixed period of, say, five or ten years even if you die before then.

Defined benefit pension – this is also known as a final salary or career average pension, where your employer promises to pay you, and often a spouse or partner on your death, a guaranteed income in retirement based on how long you worked for them and how much you earned.

Defined contribution pension – this is where you (and/or your employer) build up a pot of money that you can then use to take out as income in retirement. It's also known as a money purchase pension.

Income drawdown plan – this is a plan into which you can put some or all of your pension pot money and then make withdrawals when you choose. Your money is invested so the value of your drawdown plan can go up and down. This type of arrangement is also known as flexi –access drawdown. You usually cannot put money into a drawdown plan until you are aged 55 plus. You can find out more about income drawdown at the MoneyHelper website
www.moneyhelper.org.uk/en/pensions-and-retirement/taking-your-pension/what-is-flexible-retirement-income-pension-drawdown

Lump Sum Allowance - for most people this will be £268,275 and is the maximum amount of tax free cash you can take from your pension or pensions.

Lump Sum and Death Benefit Allowance - this is the total tax free lump sums paid during your lifetime and/or on death. For most people it will be £1,073,100 but any money taken during your lifetime is deducted from the total.

Tax year – this runs from April 6th one year to April 5th the following year. When we've mentioned 'a year' in this guide, we mean a tax year, rather than a calendar year.

Your notes

We’re happy to provide your documents in a different format, such as braille, large print or audio, just ask us when you get in touch.

The Royal London Group consists of The Royal London Mutual Insurance Society Limited and its subsidiaries. The Royal London Mutual Insurance Society Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. The firm is on the Financial Services Register, registration number 117672. Registered in England and Wales number 99064. Registered office: 80 Fenchurch Street, London, EC3M 4BY

April 2026

BRPPD0028/4