7 min read

Quilter

Helping you understand pensions

Many people find pensions easier when they understand the language that is sometimes used. As a result, we have prepared this guide to give you a helping hand.

We have split this guide into three sections:

1. **When you make a withdrawal from a pension**
2. **The main types of withdrawals you can take from your pension**
3. **The main pension allowances**

1. When you make a withdrawal from a pension	
Tax-free cash	When you take money from your pension pot, you're normally entitled to take up to 25% of it tax-free. You can take 25% of your pension pot value or £268,275, whichever is lower. Some people with older pensions can take more than 25% tax-free. If you think you might have a higher entitlement, please contact us and we will be able to check for you. If your money is in a drawdown pot, it means that you have already had your chance to take tax-free cash and can't take it again.
Taxable income	When you take money from your drawdown pot it is classed as taxable income. It is taxed at your marginal rate of income tax, the same way as money you earn when working. When a pension provider pays you taxable income from your drawdown pot, they pay it through the pay as you earn (PAYE) system. When income tax is deducted it is calculated depending on your tax code. Unless the pensions provider has your correct tax code, it is likely an 'emergency' tax code will be used, and you may need to recover overpaid tax from HMRC. Income tax rates can vary across the UK depending on which country you live in. If you live outside of the UK, you will need to check with your tax authority whether you have to pay more tax in the country you live in.
Marginal tax rate	The percentage of tax paid on earnings for the next pound earned.
Emergency tax	If this is your first taxable income payment, your pension provider will put you on the emergency tax code until they are given an updated tax code from HMRC. The emergency tax code is designed so that you will be taxed by being given 1/12th of the standard personal allowance and 1/12th of each of the relevant tax bands until you reach the highest tax band. This will ignore any other income you have from other sources. For example, If you take monthly payments or a one-off payment, you will receive only one month's worth of your annual personal allowance (1/12th), and HMRC will assess the remaining payment against 1/12th of each of the relevant income tax bands.
Disqualifying pension credit	Normally you can take 25% from your pension pot tax free. However, if you have received a pension sharing order (divorce) where your ex-spouse has already taken tax-free cash, you will have a pension pot that cannot pay you tax-free cash. You can only take taxable income.

2. The main types of withdrawals you can take from your pension	
Drawdown	You can choose to move some or all your pension pot into drawdown. This means after you take tax-free cash the pension money you moved into drawdown will remain invested (ringfenced) and you can take income from it a bit at a time. This is known as drawing down an income or withdrawing your capital. Unlike an annuity, drawdown does not provide a guaranteed income. That means if you withdraw all the money in your pension, you will no longer be able to use it to provide an income. **There are two types of drawdown:** – Capped drawdown – Flexi-access drawdown
Capped drawdown	If you moved some or all your pension pot into drawdown before 6 April 2015, you'll have capped drawdown. It's 'capped' because the amount of income you can take is limited at a maximum amount. The cap, or limit, is reviewed every 3 years until you're 75, and then every year after that. As long as you don't take out more than your capped limit, you can put up to the annual allowance into any pension in the future. If you take more than the capped limit, your plan will convert to a flexi-access drawdown. This still allows you to take your pension income from drawdown. However, once you move to flexi-access drawdown the amount you can save into some pensions in future could be limited. This is called the money purchase annual allowance. You can also choose to convert your capped drawdown to flexi-access drawdown.
Flexi-access drawdown	If you move some or all your pension pot into drawdown now or in the future, you'll have flexi-access drawdown. Flexi-access means there's no limit on how much you can take from your pension pot every year. You could take it all, you could take a little, or you could leave it all invested. For instance, you might just have taken a tax-free cash lump sum, so you might not need any money from your drawdown for a while. However, as soon as you start taking money using flexi-access drawdown you'll be limited to how much you can save into some types of pension pots in the future. This limit is called the money purchase annual allowance.
Annuity	You can use some or all your money to buy a guaranteed, regular income from an insurance company. This is called an annuity. Annuities will pay you an income for life. They can be helpful if you're looking for security, and don't want the hassle of managing your money throughout retirement yourself. However, once you buy an annuity you can't usually change your mind and switch to another product. An annuity won't leave any money to your loved ones when you die, unless you choose a specific annuity product that does this. Look out for 'joint life' annuities if you want to choose something that will pay money toward someone else after you die. There are also different types of annuity. Some will always pay the same level of income. Over time, this may mean that your spending power declines as inflation leads to high prices in the future. Other annuities pay an income that rises in line with inflation, protecting your spending power in future. But they will pay you less when you first buy the annuity.

3. The main pension allowances	
Annual allowance	There's a limit on how much money you can save or build up in all your pension savings each year without having a tax charge. This is called the annual allowance. Normally the annual allowance is £60,000 but it could be a lower amount if you take your pension income in a way that is considered 'flexible' or if you have a large taxable 'income'. These lower annual allowances and how they work are briefly explained below. If you go over your limit, you'll have to pay extra tax. You'll need to think about this if you're putting money in at the same time as taking it out, which might be the case if you're continuing to work while taking some of your pension.
The money purchase annual allowance	A money purchase pension is a pension pot where the money that is saved into it is invested and the value depends on what those investments are worth. Your pension with us is a money purchase pension. When you take income from your flexi-access drawdown, take an uncrystallised funds pension lump sum or an investment linked annuity you are considered to have flexibly accessed your pension. At this point the amount you can save into your money purchase pension without having a tax charge is £10,000. You may still be able to build up more savings than £10,000 without a tax charge if you have a defined benefit pension. A defined benefit pension provides a pension income for life, based on your earnings and the amount of time you have worked for the employer who offers that pension.
The tapered annual allowance	If you have a high taxable 'income' your annual allowance might be reduced depending on the amount of 'income' you have. The 'income' for this purpose considers taxable income for the year and the amount of pension savings made in the same tax year. Working out where it applies to you can be complicated so you should speak to us if you are not sure.
Lump sum allowance	Normally you can take up to 25% of your pension as tax-free cash. However there's an overall limit on how much tax-free cash you can take in total. This limit is currently £268,275 and is known as the Lump Sum Allowance (LSA). You can take your tax-free cash in one go or a bit at a time. Regardless of how you take it, each amount of tax-free cash you take (except for a serious ill-health lump sum) will use up some of your £268,275 allowance until it's gone. Your lump sum allowance may be higher if you have a form of protection that enhances your allowance. Your financial adviser or pension provider can tell you more about this.
Lump sum and death benefit allowance	As well as the lump sum allowance, there is an overall limit on the amount of tax-free lump sums that can be taken from your pension during your lifetime and by your beneficiaries after your death. Currently this limit stands at £1,073,100. Your Lump Sum and Death Benefit Allowance will be reduced whenever money is taken tax free under any of the following circumstances during your lifetime: 1. You take tax-free cash covered by your lump sum allowance (described above). 2. You take a tax-free serious ill-health lump sum before age 75. If you die before age 75, the remaining Lump Sum and Death Benefit Allowance will be available to your beneficiaries. Should they decide to take your pension fund as a lump sum, any amounts within this allowance will be tax free, while any amounts exceeding the allowance will be taxable. Your Lump Sum and Death Benefit Allowance may be higher if you have a form of protection that enhances your allowance. Your financial adviser or pension provider can tell you more about this.

Your investment may fall or rise in value and you may not get back what you put in.

The value of any tax relief will depend on the investor's individual circumstances.

This document is based on Quilter's interpretation of the law and HM Revenue & Customs practice as at May 2024. We believe this interpretation is correct, but cannot guarantee it. Tax relief and the tax treatment of investment funds may change.

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