ADVISER FACTSHEET

JAMES HAY PARTNERSHIP

Tech Talk

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# PAYE and flexi-access pension freedoms

Access to pension savings has never been easier. From 6 April 2015, members who have reached their retirement age may be able to take withdrawals from their pension savings without limit until their funds have been exhausted, and non-dependants will be able to take advantage of the new nominee flexi-access drawdown.

It is important to remember that any income the individual takes from the pension fund may be taxable at their marginal rate. In addition, pension providers are legally obligated to operate PAYE on taxable payments. HMRC issued guidance on how PAYE will operate on pension income under the new flexi-access rules in their Pension Newsletters 66, 67 and 68.

This Tech Talk covers how the emergency code works and how it fits within the Real-Time PAYE environment for withdrawals from defined contribution schemes. We will then consider some worked examples based on our interpretation of HMRC's Newsletters and discuss the planning which a member can undertake to try to ensure that the PAYE deducted from income payments under flexi-access is as accurate as possible.

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**For professional advisers only**

## Introduction

Members will have wider access to their pension funds under the new flexibility rules in place from 6 April 2015, though how much flexibility will depend on the scheme rules, amongst other things. There will be no limit on how much income they can take from their fund. However, any income they do take will be taxed at their marginal rate (the specified tax rate on that portion of income). Dependants, nominees and successors taking income under the new rules will generally only pay income tax if the previous holder of the pension fund was 75 or over at the time of their death. Thus it is not determined by the age of the member at the time of their death, but that of the age of the predecessor of the dependant, nominee or successor that dictates the tax treatment of the pension death benefits.

All these income withdrawals are subject to the PAYE rules, which mean that PAYE will apply to each pension income payment received.

## Money purchase income options

Payments from 6 April 2015 can be taken in the following ways:

- A payment from a capped drawdown fund;
- A payment from a flexi-access drawdown fund;
- An uncrystallised funds pension lump sum (UFPLS);
- A payment under an annuity contract, including a flexible annuity contract; and
- A payment of a money purchase scheme.

In addition, anyone who had a valid notification for flexible drawdown before 6 April 2015 will be converted to flexi-access drawdown at 6 April 2015.

PAYE applying to these income payments will apply automatically to all payments made on or after 6 April 2015.

Our Post April 2015: taxation of death benefits Tech Talk discusses the income tax treatment of nominees and successors in more detail.

## A reminder of the income tax rates for 2015/16

The income tax rates for 2015/16 are as follows:

| | | |
|---|---|---|
| **Basic rate** | 20% | £0 - £31,785 |
| **Higher rate** | 40% | £31,786 - £150,000 |
| **Additional rate** | 45% | Over £150,000 |

The personal allowance for 2015/16, where this is available, is £10,600. For taxpayers born before 6 April 1938, the age related personal allowance is £10,660.

Further details of income tax rates are found in our Budget summary.

# The application of PAYE to pension income

PAYE now operates on a Real-Time basis, which means that the Tax Code applied should alter during the course of the tax year to reflect changes in the taxpayer's circumstances.

Under PAYE, one income source (usually the highest source of income for the tax year) will be treated as an individual's primary source of income. When calculating the amount of income tax to be deducted from each payment, any available personal allowance, basic rate and higher rate bands, as well as the benefits of any available income tax reliefs, are automatically applied to the primary source of income.

An individual's other income sources subject to PAYE will usually be taxed using the following common codes, depending on their overall tax position:

| | |
|---|---|
| 0T | 0% |
| BR | 20% |
| D0 | 40% |
| D1 | 45% |

**EXAMPLE 1**

Rita has a tax code of 1060L. This reflects the fact that she is entitled to the tax-free personal allowance. Her income arrangements are unchanged from 2014/15, so all her income sources are ongoing sources with existing PAYE codes. In 2015/16, she receives a gross annuity of £12,000. She also takes a fixed monthly income amount of £1,000 gross from her pension savings held with pension provider A.

The annuity is her primary income source and the 1060L code will be applied to this. Any income taken from the pension from pension provider A should be subject to the BR code because, as a basic rate taxpayer, her pension income should suffer tax at 20%.

**EXAMPLE 2**

Rita's husband Len also continues with the same income arrangements in 2015/16 as were in place in 2014/15, so both sources have existing PAYE codes. In 2015/16, he takes a fixed monthly income amount from his pension savings held with pension provider B. Len still works and receives a salary of £42,000 per annum. His salary is his primary source of income, as his highest source of income for the tax year, and a D0 code will be applied to his pension income because he is a higher rate taxpayer and this income should suffer income tax at 40%.

Where a new income source commences during the tax year, an emergency code may be applied. This occurs most often when an individual does not have a P45 for the current year or where a second income source starts during the tax year.

HMRC explain how tax codes work in more detail, including what the letters and numbers in the Code mean, at https://www.gov.uk/tax-codes/overview.

## How the emergency tax code works

The emergency code for 2015/16 is 1060L. Where it operates on an M1 or Month 1 code basis, 1/12th of the personal allowance will be available before income tax is calculated on the remainder. Income tax will then be calculated on the basis that 1/12th of the basic rate and higher rate bands are available. Any income exceeding the basic rate and higher rate bands applied is taxed at the additional rate.

The application of the emergency code can mean that too much personal allowance has been allocated if the individual has other sources of income which are subject to a PAYE code and the benefit of the personal allowance is given to another source. This on its own should not cause too much of a problem, as any under-payment of tax should be relatively small.

For larger income payments, however, the emergency code can result in an excess of tax being withheld as the higher and additional rates are applied automatically to a portion of the income. When the payment is considered in light of the individual's income for the year, however, the overall income tax liability may be far lower.

**EXAMPLE 3**

Derek, who receives gross annuity income of £15,000 per annum, withdraws £20,000 of gross income under the flexi-access rules from his money purchase pension fund as a one-off payment in 2015/16. An M1 emergency code is applied to the pension income withdrawal. The income tax to be deducted is calculated as follows:

| | | | |
|---|---|---|---|
| 1/12th Personal allowance | £883 | 0% | £0 |
| 1/12th Basic rate band | £2,649 | 20% | £530 |
| 1/12th Higher rate band | £9,851 | 40% | £3,941 |
| Additional rate band on remainder | £6,617 | 45% | £2,978 |
| Total income withdrawn | £20,000 | Total tax withheld | £7,449 |

The application of the emergency tax code means that more tax has been deducted than Derek was expecting. He may well have expected £4,000 of income tax to have been deducted (20% x £20,000), as even after the personal pension withdrawal has been made, he is a basic rate taxpayer and the pension withdrawal's marginal tax rate is 20%.

Derek's annuity income also had £880 of income tax deducted under PAYE, because the PAYE code applied to the annuity income took into account his personal allowance and taxed the remaining income at 20%.

At the end of the tax year, Derek's overall income tax position is as follows:

| | | | |
|---|---|---|---|
| Personal allowance | £10,600 | 0% | £0 |
| Basic rate band | £24,400 | 20% | £4,880 |
| Total income | £35,000 | Total income tax due | £4,880 |
| | | Less income tax paid by PAYE | (£8,329) |
| | | Income tax refund due | £3,449 |

He is therefore due a refund of tax due to the way that the emergency code has operated against the personal pension withdrawal to deduct too much income tax.

In theory, the emergency tax code should only apply to the first payment made from any income source. Real-Time PAYE should operate to adjust the tax code applied to future payments on a cumulative basis. This means that, at the end of the tax year, the correct amount of tax should have been deducted, as later tax deductions using the cumulative code should take into account the member's income withdrawals already made during the tax year, as well as taking into account any tax deducted earlier in the year.

Members who are concerned about making a large over-payment of tax during the year should ensure that the subsequent coding notices are cumulative. If it is unclear from the coding notice whether it is cumulative, the member should contact HMRC to seek clarification. If the coding notice is not cumulative, earlier tax payments will not be taken into account and the tax position may still require correction outwith the PAYE system. The member can contact HMRC to request an amended cumulative code is issued (see below).

The reality, however, is not always so straightforward. In practice, there may be delays in HMRC issuing an updated code, and many of the amended codes issued are not cumulative. This may be drawn to the member's attention by their pension provider, but this is not standard practice and there may not be sufficient time after receiving the code to notify the member before a further income payment is made. Members are therefore advised to review any updated coding notices upon receipt from HMRC and to contact HMRC directly to discuss the coding notice if it is not correct or if it is unclear whether a cumulative code has been applied.

There may also be circumstances where it is not in the member's interests to receive income payments subject to a cumulative code. Where ad hoc payments are made and one payment suffers an under-payment of income tax, a cumulative code applied later on in the year will result in an in-year adjustment. In these circumstances, an M1 code would mean that the further payment of income tax is delayed until after the end of the tax year. This would give the member a cash-flow advantage.

There is one final point to note in respect of the tax codes initially applied to new income sources. By individual agreement with HMRC, providers may agree a code to automatically apply. From 6 April 2015 onwards, James Hay Partnership intends to apply a 1060L M1 code under our agreement with HMRC.

## Amending the tax code applied to flexi-access income withdrawals and processing PAYE refunds

Scheme administrators are obliged to operate PAYE on all pension income payments. This means that it will not be possible for the member to suggest a tax rate to be applied to the withdrawals or request an alternative tax treatment to the income withdrawals and PAYE will automatically apply to income withdrawn under the new flexi-access rules.

As noted above, the member may still be able to control the level of income tax deducted from income withdrawals by asking HMRC to amend their coding notice for those income withdrawals for the year. This can only be done by the member contacting HMRC directly and explaining why the coding notice issued automatically by HMRC will require an amendment.

Further details of how to amend a coding notice can be found at https://www.gov.uk/government/organisations/hm-revenue-customs/contact/income-tax-enquiries-for-individuals-pensioners-and-employees

If HMRC agree that a coding notice can be amended, the new code will only apply to future payments, unless it is a cumulative code.

Some payroll systems are able to process a PAYE refund without the member taking a further income payment. Refunds can be made on the next month of the payroll, provided it is made in the same year as the tax deduction and the plan has not been closed in the interim.

If the payroll system cannot process a PAYE refund without a further income payment being taken, the amended coding notice will have no effect if no further income payments are taken in the tax year.

James Hay Partnership review new tax codes issued and will arrange a refund of PAYE on the next first month of the payroll if it is possible to do so.

## A summary of HMRC Newsletters 66, 67 and 68

HMRC's Newsletters detail their views of how PAYE should operate on the new flexi-access payments. Newsletter 66 originally advised that all flexible access payments would necessitate an emergency code M1 applying to them, even where the pension member was already taking income from the same pension pot with the same pension provider. The Newsletter explained how an overpayment of tax is claimed by the member in the following four scenarios.

**CASE STUDY**

An individual wants to withdraw £40,000 from their pension fund during the 2015/16 tax year. This will be the first income payment and a Month 1 emergency code will apply.

The following income tax will be deducted.

| | | | |
|---|---|---|---|
| 1/12th Personal allowance | £883 | 0% | £0 |
| 1/12th Basic rate band | £2,649 | 20% | £530 |
| 1/12th Higher rate band | £9,851 | 40% | £3,941 |
| Additional rate band on remainder | £26,617 | 45% | £11,978 |
| Total income withdrawn | £40,000 | Total tax withheld | £16,449 |

In the scenarios below, the provider does not have the facility to make a PAYE refund during the tax year for funds which have not been exhausted.

**Scenario 1 – the member has no other existing PAYE/pension income or is only in receipt of the State Retirement Pension and withdraws the fund in its entirety.**

Bet is in receipt of the State Retirement Pension and decides to withdraw her pension savings in full in April 2015. Her pension savings total £53,333. Her pension commencement lump sum (PCLS) will be £13,333, so her income withdrawal is £40,000. £16,449 of income tax is withheld as demonstrated in our calculation above.

Bet has two options:

- she can contact HMRC after the income payment has been received to complete Repayment Claim Form P50Z. HMRC will refund any overpaid tax during the 2015/16 tax year; or
- she can wait until the tax year end. HMRC will automatically review the position and issue a tax calculation detailing any over or underpayment of tax.

**Scenario 2 – the member has no other existing PAYE/pension income or is only in receipt of the State Retirement Pension and makes a partial withdrawal during the tax year.**

Alec is in receipt of the State Retirement Pension and decides to withdraw half of his pension savings as one withdrawal in April 2015. His pension savings total £106,667 so the withdrawal totals £53,333. The PCLS is £13,333 and the income element is £40,000. £16,449 of income tax is withheld.

Newsletter 66 originally stated that, as Alec had not exhausted his fund, he had no mechanism for requesting a refund of the over-payment of tax from HMRC during the tax year. He would have needed to wait until the end of the tax year for HMRC to issue a calculation detailing the overpayment of tax.

Newsletter 68 clarifies the position. If his pension administrator is unable to process a refund through the PAYE system, Alec will be able to complete a P55 to claim the refund of the over-paid tax during the tax year.

**CASE STUDY (CONTINUED)**

### Scenario 3 – the member has one or more existing employments and/or multiple pensions and withdraws the fund in its entirety.

Jack receives a small annuity of £5,000 per annum in addition to his state pension and his remaining pension savings total £53,333. His PCLS will be £13,333, so his income withdrawal is £40,000. £16,449 of income tax is withheld.

Jack has two options:

- He can contact HMRC during the tax year and complete Repayment Claim Form P53Z. HMRC will follow the existing repayment process to refund any overpaid tax; or
- He can wait until after the end of the tax year when HMRC will issue a tax calculation detailing any over-payment of income tax.

### Scenario 4 – the member has one or more existing employments and/or multiple pensions and partially withdraws the pension fund.

Vera receives a small annuity of £5,000 per annum in addition to her state pension and her remaining pension savings total £106,667. The withdrawal totals £53,333. The PCLS is £13,333 and the income element is £40,000. £16,449 of income tax is withheld.

As in Scenario 2, Vera was unable to reclaim the overpayment of tax during the tax year.  If her pension provider is unable to process a refund via PAYE, Newsletter 68 confirms that she will be able to complete a P55 to reclaim the overpayment during the tax year.

The scenarios above demonstrate why the application of an emergency code can cause an over-payment of income tax in the short term. The treatment was originally intended to apply even where the individual had already been issued with a cumulative code with the same scheme administrator.

Newsletter 67 confirmed that HMRC had amended the proposed tax treatment of some pension income payments under the PAYE rules. Where a pension provider was already making regular payments to a member who took further withdrawals under flexible access, it would be possible to treat these payments as part of the same payroll process. This relaxation will only be available where the pension provider has sophisticated systems which can keep track of the payments.

The result of this is that the emergency code does not need to be applied to these payments, and the PAYE deducted should more accurately reflect the pension member's income tax liability in respect of the income.

When considering the scenarios below, we have assumed that the member has reviewed amended coding notices on receipt and requested a cumulative code if this is not automatically issued by HMRC.

**CASE STUDY (CONTINUED)**

**Scenario 5 – the member's sole source of income is the pension source and he has a P45 from a previous income source dated in the current year.**

Alf retired when he sold his trading company on 1 June 2015. The company issued him with a P45 on 30 June 2015 which shows a tax code of 1060L.

Alf takes the maximum PCLS available in June 2015. He takes his first flexi-access income withdrawal from pension provider A on 1 September 2015 and he withdraws £1,500 gross. A 1060L Month 1 code is applied.

When he takes his second flexi-access income withdrawal, HMRC should have issued a cumulative code for pension provider A to apply to the payment. The application of the cumulative code should mean that the amount of income tax withheld under PAYE at the end of the tax year is correct and no under-payment or over-payment of tax will need to be corrected.

**Scenario 6 – the member's sole source of income is the pension source but she has no P45 in the current year. She only has a P45 from a previous income source from an earlier tax year.**

Audrey retired in 2014/15 when she sold her trading company. Her P45 from this employment was dated 1 September 2014. She takes her PCLS in full in September 2014. She embarks on a world cruise before travelling to Canada, where she stays for 6 months, to visit her son. Upon her return to the UK in May 2015, she decides to access her remaining pension savings via flexi-access.

Pension provider A must operate an emergency code on a Month 1 basis.

By the time Audrey takes a second income withdrawal via flexi-access in July 2015, HMRC have issued a cumulative code for pension provider A to apply. The application of the cumulative code should mean that the amount of income tax withheld under PAYE at the end of the tax year is correct and no under-payment or over-payment of tax will need to be corrected.

**Scenario 7 – the member's sole source of income is from a pension provider who can operate the existing tax code against flexibly accessed payments.**

Percy is in receipt of gross income of £15,000 per year from pension provider A, which is taken as a regular monthly payment under capped drawdown. His tax code is 1066L, as Percy is entitled to the age related personal allowance. Percy decides to make further withdrawals from the pension scheme under the flexi-access rules.

Pension provider A has a sophisticated software system which can take account of the tax allowances already used and deduct the correct amount of tax at basic and higher rates. The scheme administrator is able to separately identify and quantify the flexibly accessed element of the payment.

When Percy receives his flexi-access payments from pension provider A, the appropriate rate of income tax is applied.

**Scenario 8 – the member holds a P45 for the current tax year relating to a previous income source. They also receive income from a pension provider, but the provider cannot operate the existing tax code against flexibly accessed payments.**

Phyllis is also in receipt of gross income of £15,000 per year which is taken as a regular monthly payment under capped drawdown, but she receives this from pension provider B. Her tax code is 1066L, as she is entitled to the age related personal allowance. Phyllis decides to make further withdrawals under the flexi-access rules.

Unlike pension provider A, pension provider B does not have a sophisticated payroll software system. Although the scheme administrator is able to separately identify and quantify the flexibly accessed element of the payment, an emergency code month 1 must be applied to the first income payment received in the tax year.

HMRC will issue a cumulative code to apply against future payments.

**CASE STUDY (CONTINUED)**

**Scenario 9 - the member holds a P45 for a previous tax year relating to a previous income source. They also receive income from a pension provider, but the provider cannot operate the existing tax code against flexibly accessed payments.**

Mavis is also in receipt of gross income of £15,000 per year which is taken as a regular monthly payment under capped drawdown, which she receives from pension provider B. She also possesses a P45 from a previous tax year.

The scheme administrator should create a separate payroll and operate emergency code Month 1.

HMRC will issue a cumulative code to apply against future payments.

## What happens if a member exhausts their fund?

Special rules apply where a member exhausts their fund during the tax year. As explained in Scenarios 1 and 3 above, HMRC has agreed a process allowing members to claim an in-year repayment in circumstances where the funds have been fully extinguished. The process is similar to the in-year trivial commutation repayment process. This is the only option available to members who have exhausted their fund, as it will not be possible to pay a PAYE refund once the fund has been exhausted.

At the date that the fund is exhausted, the pension scheme administrator must issue the member with a P45, confirming the amount of withdrawal and any income tax deducted under PAYE.

## Why making multiple withdrawals could be beneficial

A cumulative code will assist members who are not exhausting their funds during the tax year.

There are a number of individuals who could consider making several withdrawals during the course of the tax year and who will be able to take advantage of the application of a cumulative code:

- members who intend to exhaust their funds during the tax year;
- members who may only need to take one large withdrawal but not make any further withdrawals during the tax year and whose provider cannot process PAYE refunds; and
- members who intend to make a larger withdrawal towards the end of the tax year and whose provider may not have time to process a PAYE refund before the end of the year.

**EXAMPLE 4**

Norris wants to withdraw £20,000 gross from his pension under the flexi-access rules. He already receives gross annuity income of £15,000 per annum in 2015/16 and has no PCLS remaining. The tax deducted from his annuity income is £880. He has no other income sources and is entitled to the basic personal allowance.

He withdraws £1,000 in June 2015 as a one-off payment. The M1 emergency code is applied. The following tax is deducted.

| | | | |
|---|---|---|---|
| 1/12th Personal allowance | £883 | 0% | £0 |
| 1/12th Basic rate band | £117 | 20% | £23.40 |
| Total income withdrawn | £1,000 | Total tax withheld | £23.40 |

In August 2015, he withdraws a further £19,000. If a BR cumulative code is applied, the following happens:

| | | | |
|---|---|---|---|
| BR code | £19,000 | 20% | £3,800 |
| £883 @ 20% (adjusting the Emergency code applied in June) | £883 | 20% | £176.60 |
| | | Total tax withheld | £3,976.60 |

At the end of the year, Norris's income tax position is as follows:

| | | | |
|---|---|---|---|
| Personal allowance | £10,600 | 0% | £0 |
| Basic rate band | £24,400 | 20% | £4,880 |
| Total income | £35,000 | Total income tax due | £4,880 |
| | | Less income tax paid by PAYE | (£4,880) |
| | | Additional tax due | £0 |

If we compare Norris's income tax position with that of Derek in Example 3, we can see the advantages of Norris having made two withdrawals in the tax year. Norris's tax position is up-to-date, whereas Derek will be due a tax refund to refund the excess tax deducted following the operation of the emergency code. Even where it will be possible for a member to complete a P55 to reclaim the tax during the tax year, the cumulative code will be preferable as there will be no delays while the refund is processed.

It should be remembered, however, that pension providers will charge for each withdrawal, but members may feel that the additional charge may outweigh the need to claim a tax refund after the income withdrawals have been made.

## Comment

It is important to be aware that any pension income withdrawals made by the member will be subject to income tax rules. Dependants, nominees and successors may also be liable to income tax on any income withdrawals made from inherited pensions. The individual's other income sources will need to be taken into account when working out the overall tax liability on any pension income withdrawn, as well as how additional pension income withdrawals could impact on the income tax rate on other sources of income, such as interest and dividend income. Increased income could also affect entitlement to the personal allowance or means tested allowances and benefits.

The application of Real-Time PAYE should mean that, where possible, the individual can arrange their affairs to ensure that the amount of income tax deducted under PAYE is as accurate as possible and delays in HMRC or payroll systems processing refunds are minimised as far as possible. Any small under-payments which arise during the course of the tax year can be resolved in the individual's PAYE coding notice for the following year. Small over-payments are usually repaid to the member by HMRC directly.

Amending the tax code and ensuring that multiple payments are taken during the year will also assist individuals where the under or over-payment of tax is more significant. Where a fund is exhausted during the year, an in-year tax repayment claim can be made from HMRC, but those individuals who do not exhaust their fund entirely should take extra care to ensure that they have arranged their income withdrawals to take full advantage of the Real-Time PAYE system during the tax year, particularly where their provider is unable to process PAYE refunds without the member requesting a further income withdrawal.

James Hay Partnership intends to operate, where possible, the member's existing tax code against flexibly accessed payments. Where a cumulative code is issued by HMRC, the amount of income tax deducted should in most circumstances reflect the member's overall income tax position during the tax year and mean that large income tax repayments do not need to be claimed after the end of the tax year.

**Joanna Fergusson**
Technical Manager
Tax and Trusts

## Further information

Please contact the Technical Support Unit with any further queries on:

**0845 600 8651**

Tax and Trust Technical Support:
**taxtrust.techsupport@jameshay.co.uk**