PENSION WITHDRAWALS: THE BASIC RULES

APRIL 2025

Deciding **when** and **how** to start **taking income** from your pensions can be daunting, and making the wrong decision can be expensive. At the same time as choosing an income contract, you can also choose whether to take some of the fund as a **tax-free lump sum**, the amount of which is limited by the **Lump Sum Allowance**.

Here we take a high-level look at what is available, the rules constraining your choices, and the main factors which need to be considered.

The future. The cost of pension tax relief to the government continues to be significant, and future pension rules may be subject to change. Those adversely affected by historic changes have usually been able to apply for protection, giving some comfort that planning would not be badly affected. As ever, you can only make the best plans possible based upon current legislation, and guard against inaction caused by future uncertainty.

Please note we cover money purchase pensions only here, if you have queries regarding a defined benefits scheme, or other scheme such as s615, s32, FURBS, UURBS, please contact your adviser.

SUMMARY

- **Age Restrictions**: the standard minimum age for making pension withdrawals is age 55 (age 57 from April 2028). You no longer have to take an income from your pension fund before age 75, although the tax position of death benefits does change at 75 so you may at least wish to consider whether to take any remaining tax-free cash by then.

- **Choices**: you have complete flexibility over the timing and amounts of pension withdrawals. The main routes to take income or capital from your pension fund are to:

  - Purchase an **annuity** (guaranteed income for life)
  - Take a flexi-access **drawdown** pension (fund remains invested and you take withdrawals)
  - For one off withdrawals, you can also take an **Uncrystallised Funds Pension Lump Sum**

  The choice will depend mostly upon the level of investment risk you can afford to take, and also want to take. An annuity may be the lowest risk option, but may offer less income and little flexibility compared to drawdown. Those opting to defer annuity purchase should be aware of Mortality Drag and the likelihood of annuity rate changes. If an annuity is the chosen route, you should always shop around as rates can vary widely. See our Planning Notes on the specific income options for more details.

- **Tax**: All pension income withdrawals, or lump sum withdrawals in excess of the Lump Sum Allowance, are subject to income tax as earned income.

- **Lump Sum Allowance**: at, and only at, the point of entering a pension income contract (annuity/drawdown/UFPLS) you can usually opt to take **up to 25% of the fund as a tax-free cash lump sum** (technically known as **Pension Commencement Lump Sum**). The Lump Sum Allowance is the overall maximum amount of tax-free cash you are allowed to take from all of your pensions in your lifetime. For most, this allowance is **£268,275** (although those with pension protection will have a higher personal LSA).

- **Pension Death Benefits**: for death until April 2027, any amount of the fund which you don't use in your lifetime can be inherited by your chosen beneficiaries, usually outside your estate and free from Inheritance Tax. The income tax position for the beneficiary depends on whether you were under or over age 75 when you died, and the form in which the benefits are paid. Please see our Planning Note on Pension Death Benefits for further details. Please note that from April 2027, IHT is due to be applied to pension funds, with further details yet to be confirmed.

- **Guaranteed Annuity Rates**: some older polices may have guaranteed annuity rates attaching, and although these are sometimes offered on restrictive bases (e.g. single life only) they should always be carefully considered as they can be valuable.

- Please note the comments below do not apply to **final salary (defined benefit) schemes**, which are paid as a scheme pension only.

WHAT HAPPENS AT "RETIREMENT"?

Most people will, over the course of their working life, gradually build up a pension fund. Whether they then retire fully, start to phase down from full time work, or simply need some additional capital to help out the family, they will look to this fund for an income and/or lump sum. However, **there is no need to "retire" in any way to take pension benefits, so long as you are over the minimum pension age of 55 (rising to age 57 from April 2028)**.

Income can be drawn from the fund under a **drawdown pension** contract (from April 2015 called Flexi Access Drawdown), or provided by way of **lifetime annuity** contract or **scheme pension**. In addition, an **Uncrystallised Funds Pension Lump Sum** is also available.

There is no compulsion to take any of these options and the fund can be run through until death if you wish. Where practically possible, this is a popular option, as the current taxation of pension death benefits is fairly generous.

At, and only at, the time of entering a pension income contract, you are usually also allowed to take a **tax-free cash** sum (a 'pension commencement lump sum' or PCLS) of up to 25% of the fund, subject to individual scheme rules. This is subject to an overall maximum governed by the Lump Sum Allowance, which for most people is £268,275. If you have Lifetime Allowance protection this maximum may be higher. Any funds not taken as tax-free cash must be used to provide an **income** (although, within a flexi-access drawdown pension contract, you are able to select a **'nil' income** if income is not yet required – and there is no maximum withdrawal limit). Please note, for RAPs and occupational schemes, this is a change of position from pre 6 April 2006 rules, and assumes that the scheme rules have been amended to allow this.

The **pension income is taxed at your highest marginal rate of income tax** and so it is advisable, where possible, to plan income withdrawals in advance to minimise the effective rate of income tax suffered.

It is important to note that tax charges may apply to beneficiary's withdrawals from inherited pension funds, where the individual has died after age 75 (or for lump sum benefits in excess of the Lump Sum and Death Benefits Allowance, on death before age 75). Even if pension income is not yet required, you may therefore wish to consider the pros and cons of taking the tax-free cash lump sum amount before this age.

PENSION INCOME OPTIONS

There are four main routes for taking pension benefits, which are explained in more detail in the separate Planning Research Notes on these areas:

1 Scheme Pension

This is a pension paid to a member by the pension scheme, rather than a specific pension contract purchased by the member. This is the only route available for final salary (defined benefit) pension schemes, but may also be offered by other pension schemes.

2 Pension Annuity

This is subject to similar rules to a scheme pension, although it is not paid out of a pension scheme itself, but by an insurance company. Historically, this was the most popular option, providing a guaranteed income for life. Demand has fallen given the new options detailed below, however, for many, the security of a lifetime income provided by an annuity will remain the most suitable route.

Various options can be chosen, e.g. level or increasing in payment, spouse's pension, guaranteed minimum payment period and capital protected annuities. More flexible rules have also been introduced, which allow differently structured annuities which fall in payment over time, provide longer guaranteed periods, or to be for a fixed period only, for example.

- **Investment Linked Annuity**. This is a less popular form of pension annuity where the income received depends upon the performance of the selected underlying fund, and can fall as well as rise. Those who wish to retain some exposure to equity markets should also consider drawdown.
- **Phased Retirement**. This is simply a linked series of pension annuity purchases. The aim is to use the tax-free cash for each purchase as part of the annual income, thereby averaging annuity purchase over a number of years, and enabling the fund to remain invested for longer than would otherwise be possible, with the hope (but also risk) of capturing some additional growth as a result.

PENSION INCOME OPTIONS

3 Drawdown Pension

This enables the tax-free cash to be taken at once, and the fund to remain invested until a later date, with the possibility of income withdrawals as and when required. Part of the fund can also be used to buy a temporary annuity. This is generally only suitable for those who have a good tolerance of investment risk, due to mortality drag (assuming eventual annuity purchase, see below).

- **Capped Drawdown** (pre April 2015). Income withdrawals are subject to Government Actuary's Department (GAD) limits, with a minimum of 0% and maximum of 150%. This must be reviewed every three years, and every year after age 75. These contracts may continue after April 2015 provided income withdrawals remain within the GAD limits (if exceeded then the contract converts to a Flexi Access Drawdown contract), and the Money Purchase Annual Allowance is not triggered.
- **Flexi Access Drawdown**. All new drawdown contracts from April 2015 are Flexi Access Drawdown contracts, available to everybody, and with no minimum or maximum withdrawals. The Money Purchase Annual Allowance applies after any amount of taxable income has been drawn.

4 Uncrystallised Funds Pension Lump Sum

This allows a lump sum to be withdrawn from a pension fund as a stand-alone option. Up to 25% of the amount withdrawn can be treated as tax-free cash (subject to the available Lump Sum Allowance), and the balance will be taxed at the individual's marginal rate of income tax (although please note that emergency tax codes may apply, with the excess tax paid reclaimed later). Once this facility is used, the Money Purchase Annual Allowance limit applies to future pension contributions.

The best option will only be known with hindsight, and will be dictated by inflation, investment performance, future annuity rates and your mortality. The 'safest' option may be the index-linked lifetime annuity, as this provides a lifetime income guarantee with inflation protection, and could be considered to be a benchmark against which any decisions are made.

MINIMUM PENSION AGE

The normal minimum pension age (NMPA) is currently 55, increasing to 57 from April 2028. Government proposals are to bring forward a further increase to age 58 from the planned date of 2039, but are subject to further consultation. The intention is that the minimum pension age will be 10 years less than, and will rise with, the state pension age. You may be able to take benefits earlier than NMPA if you are suffering from serious ill-health.

There is no maximum age by which you must start taking funds out of a pension, and it can be held throughout your lifetime if no capital or income is required. For occupational scheme members, it is no longer necessary to leave employment to draw benefits.

Some policies may have a protected minimum pension age of below 55. This includes policies held by those in selected occupations, such as sportspeople, who had a pension as at 5.4.06 with a selected retirement age under 50. Also, some of those in occupational schemes at 5.4.06 with an earlier retirement age, who will likely now have a protected age of 50. In addition, some specific pension contracts may include protection from the rises in the minimum pension age from 55 to 57.

TAX

Very simply, **income tax is applied to all pension income withdrawals during your lifetime**. This is regardless of the mechanism you use to take the withdrawal – i.e. annuity, drawdown, or the taxable component of a one off Uncrystallised Pension Fund Lump Sum. Pension income is treated as earned income and taxed at your marginal rate of income tax.

Any lump sum withdrawals, taken as a Pension Commencement Lump Sum, within your available Lump Sum Allowance, are tax-free.

TAX-FREE CASH (PENSION COMMENCEMENT LUMP SUM)

At, and only at, the time at which you choose one of the above income routes, you can usually also choose to take up to 25% of the pension fund as a tax-free lump sum (also called Pension Commencement Lump Sum or PCLS).

Please note that this is subject to the individual scheme rules, and you should check to ensure that you do not have a scheme-specific entitlement before making any decisions. Defined benefit schemes use a different calculation, but the Lump Sum Allowance still applies.

The maximum tax-free cash (PCLS) you can take is the lower of the three amounts below.

Tax-Free Cash (PCLS) limited by the lower of:	
Applicable amount	25% of the pension fund being crystallised [1]
Available Lump Sum Allowance (LSA)	LSA less any ‘relevant BCEs’ (amounts already taken as tax-free lump sums)
Available Lump Sum and Death Benefit Allowance (LSDBA)	LSDBA less any ‘relevant BCEs’. See death benefit section below [2]

Notes:

1. Money purchase schemes only. If you have enhanced protection with protected tax-free cash, the applicable amount is the percentage on your certificate multiplied by the crystallisation amount.

2. In practice this may only reduce the PCLS available below the LSA limit if a serious ill-health lump sum, stand-alone lump sum, or benefits from scheme specific PCLS protection, have already been taken.

TAX-FREE CASH (PENSION COMMENCEMENT LUMP SUM)

Lump Sum Allowance Key Points

- **The standard LSA is £268,275** unless you have existing LTA protection.
- **Your available LSA is reduced by relevant BCEs.** Usually, this is the amount of previous tax-free lump sums taken.
- **Your available LSA is not reduced by** the tax-free elements of trivial commutation lump sums, winding up lump sums, and small pots payments (although you need some allowance available in order to take these).

If you have taken some pension benefits prior to April 2024, and/or have any form of pension protection applying, please see our Planning Research Note on Pension Lump Sums post April 2024 for details of the additional rules applying to your situation.

PENSION DEATH BENEFITS

April 2015 brought enormous changes in the treatment of pension funds on death, with the class of potential beneficiaries opened up without restriction, and the ability for the pension funds to remain within the pension wrapper for two or many more generations. Together with the existing exemption of discretionary pension benefits from Inheritance Tax, this meant that pensions were often the first choice of wrapper for IHT planning for wealthier individuals. The October 2024 Budget proposed to change this treatment, to refocus the primary purpose of pension savings back towards retirement income planning. From April 2027, IHT is due to be applied to pension funds, with further details yet to be confirmed.

Modern personal pension schemes usually offer a return of the fund value at death – although not all offer the full range of flexible death benefits such as beneficiary's drawdown.

Individuals with older pensions such as RAPs should be careful to check the policy details, as the death benefit may be only a return of contributions with interest, which may be significantly less than the fund value. In addition, RAPs may not be written under a master trust, and so death benefits may need to be separately written into trust in order that they can be directed to the desired beneficiaries and for IHT purposes.

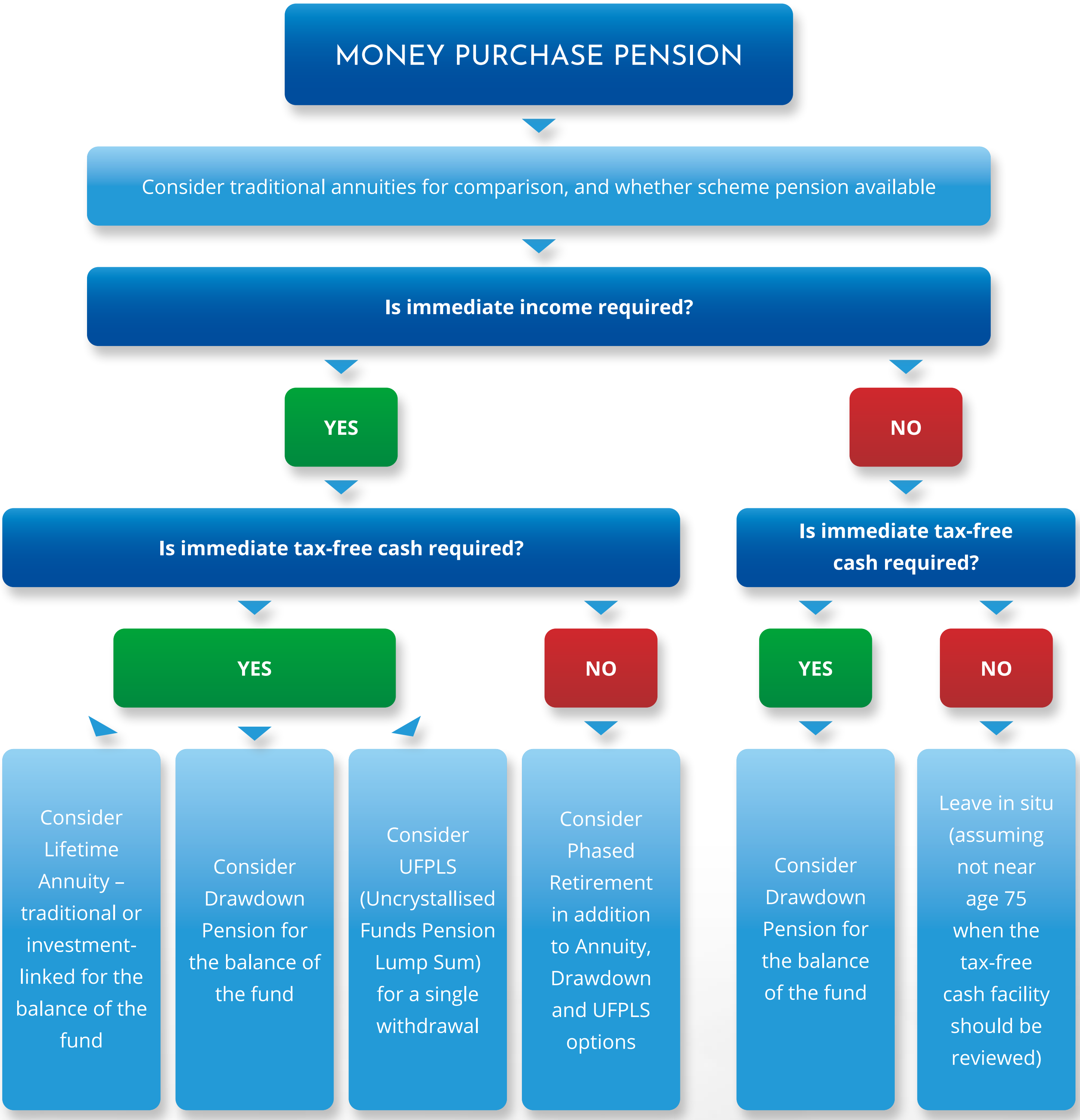
Occupational schemes usually offer a mixture of lump sum and pension death benefits, the amount depending upon the scheme rules.

It is important that you check that your pension scheme offers the range of death benefits that you would wish. Please see our Planning Research Note on Pension Death Benefits for full details, including the tax changes at age 75 and the Lump Sum Death Benefits Allowance.

RETIREMENT OPTIONS PLANNING MAP

MONEY PURCHASE PENSION PLANS

The Planning Map below gives a steer as to which route/s you may wish to investigate further. Please note that individual circumstances vary, and the below is intended to be a very broad guide only. Expert opinion should be sought before any decisions are made.



Important Information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested. This document is provided for information only and does not constitute advice. You should not act on any of the information without seeking professional advice.