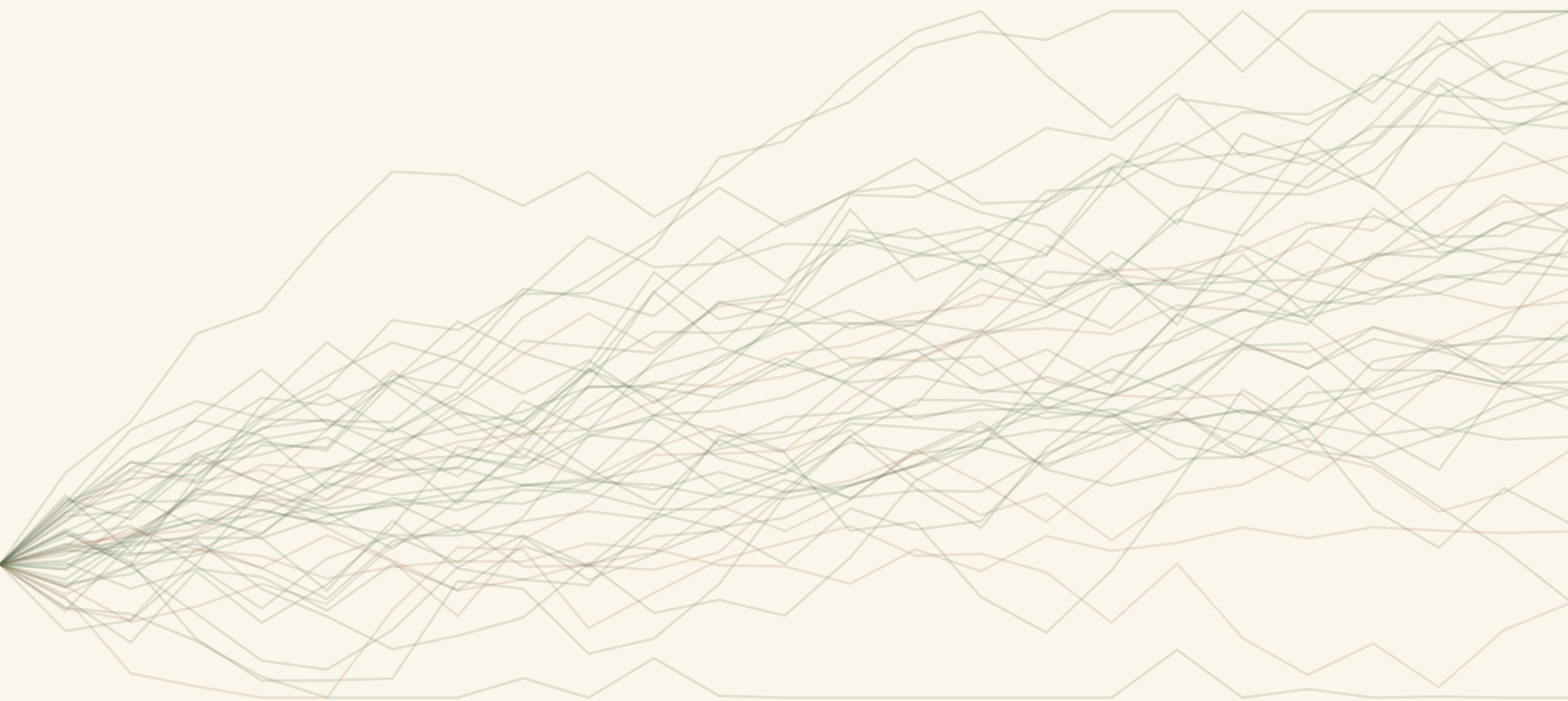
Your Future Compass

RETIREMENT GUIDE

Pension tax-free lump sum: the 25% explained

The 25% tax-free lump sum is one of the most valuable, and most misunderstood, pension features. Here's how it works, the £268,275 cap, why you don't have to take it all at once, and the tax traps to avoid.



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Pension tax-free lump sum: the 25% explained

> **Guidance and illustrations only, not regulated financial advice.** This guide explains how the pension tax-free lump sum works in general terms. It isn't a recommendation about whether, when or how *you* should take yours. That depends on your circumstances. Pension and tax rules change; consider a free Pension Wise appointment or a qualified, regulated financial adviser before deciding.

The **25% tax-free lump sum** is one of the best-known features of a UK pension, and one of the most misunderstood. Get it right and it's genuinely valuable; get it wrong and you can hand HMRC far more tax than you needed to. This guide explains how the 25% actually works, the cap that limits it, and the traps worth knowing before you touch it.

How the 25% works

When you start taking money from a **defined-contribution** pension (a pot you've built up, as opposed to a *defined-benefit* / final-salary pension that promises a set income), you can usually take **up to 25% of it free of income tax.** The remaining **75% is taxable** as income when you draw it, at your normal income-tax rate in the year you take it.

In the jargon, the tax-free lump sum is called a **Pension Commencement Lump Sum (PCLS)**. You don't have to take it as one big cheque (more on that below).

The cap: the Lump Sum Allowance

There's a ceiling on how much tax-free cash you can take across all your pensions. Since the **Lifetime Allowance was abolished in April 2024**, the limit is the **Lump Sum Allowance (LSA)**, currently **£268,275** for most people (a small number with older HMRC protections have a higher figure).

For the vast majority of savers this cap never bites, because you'd need a pension pot of over roughly £1.07m for your 25% to reach it. But if you have very large pots, the tax-free portion is limited to the LSA, not a full 25% of everything.

You don't have to take it all at once

This is the single most useful thing to understand: **the 25% is not "use it or lose it" on day one.** You have two broad ways to take it:

- **Taking the tax-free cash up front (PCLS), then drawing taxable income later.** You crystallise part of the pot, take that slice's 25% tax-free, and move the rest into drawdown.
- **Taking it in slices (UFPLS).** With an *Uncrystallised Funds Pension Lump Sum*, each withdrawal is **25% tax-free and 75% taxable**, so the tax-free entitlement is spread across many withdrawals over the years instead of being taken in one lump.

Neither is the better route in general; they trade off differently. Phasing it leaves more of the pot invested and gives more control over which tax band each year's income falls in, at the cost of not having the cash in hand. Taking it up front does the reverse.

The tax trap: taking too much in one year

Because only the 25% is tax-free and the rest is taxed **as income**, a large one-off withdrawal can do real damage:

- A big taxable withdrawal is added to your other income for the year, and can **push you into a higher tax band**, so a slice that would have been taxed at 20% ends up taxed at 40%.

- Spreading the same withdrawals across two or more tax years, staying within a lower band each time, can leave you with noticeably more money.

The tax-free 25% itself is never taxed, but *how and when* you take the taxable 75% around it is where a lot of avoidable tax is lost.

Emergency tax: why your first withdrawal may look wrong

The first time you take taxable money from a pension, providers often have to apply an **emergency tax code**, which can over-tax that first payment as though you'll take the same amount every month. It looks alarming, but it's **reclaimable**. HMRC refunds the overpayment, either automatically or via a simple form (P55 / P53Z / P50Z depending on your situation). It's worth expecting, so it doesn't panic you into a decision.

It's also worth knowing the size of it before it happens rather than after: on a £30,000 pot taken in one go the emergency calculation can hold back around £6,570 more than is actually due. Emergency tax on your first pension withdrawal works through the arithmetic band by band, which form applies, and the order that avoids it.

What people use tax-free cash for (generally)

People use their tax-free lump sum for all sorts of things: clearing a mortgage or other debt, home improvements, helping family, holidays, or simply holding it as an accessible cushion. There's no single "right" use, and taking a large amount you don't have a purpose for means moving money out of a tax-sheltered pension unnecessarily. Whether taking it, and how much, makes sense for you is exactly the sort of decision worth talking through with Pension Wise or a regulated adviser.

Timing: now versus later

Even if you can take your 25% now, it isn't automatically the best time. The trade-offs:

- **Taking it early** gives you cash in hand and certainty, but moves money out of a tax-sheltered environment where it could otherwise keep growing and pass on efficiently.
- **Leaving it invested** keeps the pot working and preserves flexibility, but rules can change, and your circumstances might too.

Because the taxable 75% interacts with your other income each year, the *timing* of tax-free cash can change your lifetime income-tax bill significantly, which is why it's worth modelling rather than guessing. That timing decision sits inside the wider question of how you turn the pot into income: pension drawdown explained covers taking it in stages, and annuity versus drawdown covers the choice the 25% sits on top of.

Common mistakes

- **Taking the whole 25% with no plan for it**: moving money out of a tax shelter for no reason.
- **Triggering higher-rate tax** by taking a large taxable amount in a single year.
- **Being spooked by emergency tax** into stopping, when it's simply reclaimable.
- **Forgetting the cap** if you have very large pots (the Lump Sum Allowance).
- **Assuming "now" is best** without weighing what leaving it invested could do.

See it on your own numbers

The timing of your tax-free cash, and the order you draw your pensions and ISAs, changes the income tax and inheritance tax your plan faces. You can see how taking your tax-free cash now versus later plays out on your own figures with a planning tool. It’s an illustration to help you weigh it up, not a recommendation. For free, impartial guidance, book a Pension Wise appointment (over-50s) or read more at MoneyHelper.

Quick checklist

1. **You can usually take up to 25% tax-free** from a defined-contribution pension; the rest is taxed as income.
2. **Check the cap**: the £268,275 Lump Sum Allowance only matters for very large pots.
3. **You don’t have to take it all at once**: phasing leaves more invested and gives more control over the band each year’s income falls in.
4. **Watch for the higher-rate trap**: a large taxable withdrawal in a single year can push income into a higher band that spreading it across tax years would not.
5. **Expect emergency tax** on the first withdrawal (it’s reclaimable).
6. **Model the timing**: now vs later can change your lifetime tax bill.

The 25% is a valuable entitlement, and one that rewards a bit of planning. The cap, the effect on your tax band, and what leaving it invested could do are all worth understanding before deciding.

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