Savers 'overpaying £400m in pension tax'

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Steve Webb, the former pensions minister, defended savers' rights to buy a Lamborghini with money withdrawn from their pension pot

Savers are being overtaxed by an average of £2,000 on lump sums withdrawn from their pension pots because HM Revenue & Customs insists on imposing an emergency tax code on them.

Collectively, savers have overpaid at least £400 million in tax since the ability to withdraw money from pensions without being tied to buying an annuity was introduced by George Osborne in April 2015.

An average of 88,000 people accessed their pension pots every month during the second quarter of this year, according to HMRC.

Tom Selby, a senior analyst at AJ Bell, an investment platform, has claimed that most of these withdrawals were likely to have been overtaxed.

Under pension freedoms, people aged 55 or over may withdraw up to 25 per cent of their pension pot free of tax. Any additional money taken will be taxed at the savers' marginal rate. Any person making their first withdrawal under pension freedoms is taxed using an emergency income tax code. This means that HMRC taxes it as if the withdrawal were the first monthly payment of 12 and reflects a new level of annual income.

It is up to the saver to claim back the overpaid tax. The tax office should then correct the tax for subsequent withdrawals. At present, the average withdrawal per person is £8,595, down from £18,571 when pension freedoms were first introduced.

About 264,000 people withdrew money from their pensions between April 1 and June 30 this year, although not all of these people were accessing their pension pots for the first time. HMRC's latest figures showed that only 18,353 people reclaimed overpaid tax between July 1 and September 30, amounting to just over £38 million. Although this is a record number of claims, it suggests that many savers do not know how to reclaim.

So far £372 million of overpaid tax has been reclaimed since 2015, but this covers only those who have filled in the official forms to receive a repayment — and so is not likely to be the full picture, according to Mr Selby. He said: "While it is good news HMRC is processing record numbers of claims, it also demonstrates that this problem is not going away."

According to Mr Selby, some people are taking more from their pensions to cover their tax bill, which results in more tax being owed.

Pension freedoms were controversial when they were introduced. Steve Webb, then the pensions minister, defended savers' rights to spend their cash as they saw fit. "If people do buy a Lamborghini but know that they'll end up just living on the state pension, that becomes their choice," he said at the time.

Mr Webb, now director of policy at Royal London, the insurer, said yesterday: "HMRC must be rubbing their hands with glee as taxpayers are forced to fork out millions of pounds in unnecessary tax on pension withdrawals, all for the administrative convenient of the government . . . There must be a better way than the current system where taxpayers have to fill in one of three forms to claim back the tax that they should never have had to pay."

A spokesman for HMRC said that it had reviewed the PAYE process where the emergency tax code was applied. "We concluded that any changes would not significantly improve the tax position for the majority of recipients," he said. "The existing treatment remains the most effective method in these cases."