HOW TO MAKE THE TAXMAN PAY FOR YOUR RETIREMENT

PENSION MAGIC

TAX Cafe®

Nick Braun PhD

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Pension Magic

How to Make the Taxman Pay for Your Retirement

By Nick Braun PhD

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Dr Nick Braun founded Taxcafe in 1999, along with his partner Aileen Smith. As the driving force behind the company, their aim is to provide affordable plain-English tax information for private individuals, business owners and professional advisors.

Since then Taxcafe has become one of the best-known tax publishers in the UK and has won several prestigious business awards.

Nick has been a specialist tax writer since 1989, first in South Africa, where he edited the monthly *Tax Breaks* publication, and since 1999 in the UK, where he has authored several tax books including *Small Business Tax Saving Tactics* and *Salary versus Dividends*.

Nick also has a PhD in economics from the University of Glasgow, where he was awarded the prestigious William Glen scholarship and later became a Research Fellow.

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Introduction

Let's get straight down to business. There is only one reason why you should put money into a pension and that is to SAVE TAX.

As a pension saver you enjoy three important tax reliefs:

- Tax relief on your contributions – what I call buying investments at a 40% discount.
- Tax-free growth – all your income and capital gains are completely tax free.
- Tax-free cash – up to 25% of your pension savings can be taken as a tax-free lump sum. The rest is taxed as income.

If maximising tax relief is your priority, as it should be, there's a lot more to it than simply putting away a fixed amount each year.

You may wish to decide *how much* to invest, making bigger or smaller pension contributions in some years or none at all.

You may wish to consider *who* makes the contributions: you, your employer, or your spouse or partner.

You may also want to look at *when* is the best time to invest.

And, of course, you may want to know *why* you should even bother investing in a pension in the first place. For example, are pensions better than other investment vehicles such as ISAs and Lifetime ISAs?

All of these important issues are addressed in this guide and I think you will be surprised by some of the results.

In Part 1 we examine how tax relief on pension contributions is calculated and how much you are allowed to invest.

In the March 2023 Spring Budget the Government raised the annual allowance (the amount you can invest each year) from £40,000 to £60,000. This was a welcome announcement but, as we shall discover, calculating the maximum pension contribution you

can make is not as important as calculating the maximum pension contribution you *should* make to maximise your tax relief.

Over 200,000 people do not claim all the tax relief to which they are entitled, so we also examine how you can make a backdated tax relief claim and avoid other common mistakes that could cost you thousands of pounds.

In the March 2023 Budget the Government also surprised everyone by scrapping the complicated and much hated lifetime allowance charge.

Previously, if your pension pot exceeded the £1,073,100 lifetime allowance, you faced paying up to 55% tax on the excess. You can now save up as much money as you like in a pension, without fear of paying a tax penalty.

That's the good news. The bad news is the Government has also placed a cap on the amount of tax-free cash you can take from pensions over your lifetime: £268,275 (25% of the old lifetime allowance).

However, as we shall discover, even if you've used up your entitlement to tax-free cash, additional pension contributions are still worth considering. You could end up with 33% more money than someone who puts their money in an ISA – and ISAs themselves are pretty good tax shelters!

New Allowances from 6th April 2024

The lifetime allowance charge was scrapped on 6th April 2023 but the lifetime allowance itself was only removed from the pensions legislation on 6th April 2024.

It has been replaced by two new allowances:

- The lump sum allowance – £268,275
- The lump sum and death benefit allowance – £1,073,100

Both allowances limit the tax-free lump sums that can be paid out of your pension savings. The lump sum allowance limits the amount of 'tax-free cash' you can receive when you start accessing your pension savings. The lump sum and death benefit allowance

potentially limits the amount of any tax-free lump sum your beneficiaries can receive, if you die before reaching age 75.

We will take a closer look at both of these new allowances in Chapters 3 and 10.

There's also a third new allowance called the overseas transfer allowance, which has also been set at £1,073,100 for most people. This applies to any pensions that you transfer overseas to a 'qualifying recognised overseas pension scheme' (QROPS).

Pensions can be transferred overseas if they remain within the allowance but any excess may be subject to the 25% 'overseas transfer charge'.

We will not discuss the overseas transfer allowance any further in this guide.

Pension Freedom

Prior to April 2015 the amount of money you could withdraw from your pension was tightly controlled. Most individuals' savings could only come out at a trickle, either through an annuity or something called "capped drawdown".

These restrictions have been lifted completely, giving pension savers more control over their money than they have ever had.

Once you reach the minimum retirement age (currently 55) you have complete freedom to withdraw as much or as little money as you like from your pension pot, whenever you like.

As a result, pension savers have the ability to control their tax bills, by making big pension withdrawals in some tax years and smaller withdrawals in others.

In Part 2 of the guide we explain all of the "Pension Freedom" changes and show you how to save thousands of pounds in both income tax and capital gains tax by timing your pension withdrawals carefully.

Death Taxes

In April 2015 the Government also removed another of the major obstacles that put people off using pensions to save for retirement. Prior to this, when you died, your remaining pension savings were taxed at 55% before being passed on to certain family members.

The abolition of this "death tax", coupled with the fact that your pension savings are also typically exempt from inheritance tax, means that pension pots can be inherited by family members with no adverse tax penalties.

Furthermore, the recent scrapping of the 55% lifetime allowance charge (not to be confused with the old 55% death tax) has created what some commentators are calling "an unlimited inheritance tax shelter".

Pensions versus ISAs and Lifetime ISAs

In Part 3 we show how pensions are much more powerful tax shelters than ISAs. We track two investors over a number of years and reveal that a pension saver could end up with 41.67% more retirement income than an ISA investor.

We also explain some of the lesser known tax differences between ISAs and pensions (for example, why some dividend income is taxed inside an ISA and why your family may be better off if your money is in a pension).

Those under the age of 40 can open a "Lifetime ISA" and use it to save for either a first home or retirement. Part 3 tells you everything you need to know about this fantastic saving vehicle and why some taxpayers could end up with 17.6% more retirement income if they use a Lifetime ISA instead of a traditional pension.

Postponing & Accelerating Pension Contributions

In Part 4 we look at the pros and cons of postponing and accelerating pension contributions. We show how basic-rate taxpayers – those earning under £50,270 – can increase their

pension pots by 33% by delaying making pension contributions for several years.

This part of the guide also contains a fascinating case study which reveals that, even if you postpone pension contributions for several years you will not necessarily end up one penny worse off than someone who makes pension contributions for many years.

There is one group who should always consider making pension contributions: households where the highest earner's income is between £60,000 and £80,000 and child benefit is being claimed. This is a significant recent change, applying from 6th April 2024: your family's child benefit payments are now taken away as your income rises from £60,000 to £80,000. By using pension contributions to reduce taxable income, people in this income bracket can typically enjoy tax relief of between 47% and 64%!

High Income Earners

Part 4 contains a special chapter for high income earners, which has been fully updated and expanded in recent editions.

High income earners include those with taxable income of £100,000 or more, as well as those whose income is getting close to £100,000.

When your income rises above £100,000 your personal allowance is gradually withdrawn. The end result is anyone in the £100,000 to £125,140 income bracket can enjoy 60% tax relief on their pension contributions.

And when your income rises above £125,140 (previously £150,000) you start paying tax at the 45% additional rate and can enjoy 45% tax relief on your pension contributions.

Additional-rate taxpayers can enjoy a combination of 45% tax relief and 60% tax relief if their pension contributions are big enough to reduce their 'adjusted net income' below £125,140.

For example, someone who has taxable income of £140,000 and makes a £40,000 pension contribution can enjoy 54.4% tax relief.

There are a number of different strategies high income earners can follow if they want to enjoy 60% tax relief or something close to 60%.

These include postponing pension contributions or making bigger than normal contributions in some tax years. These tax saving strategies are explored in detail.

The chapter also explains the special rules for the highest income earners who may be affected by the 'tapered annual allowance'.

Employees, Business Owners & Landlords

In Parts 5 to 8 we look at different types of pension saver: salaried employees, company owners, the self employed and landlords.

In Part 5 we explain 'auto-enrolment': the compulsory pensions that have helped many employees enjoy a pension contribution from their employer for the first time. Some individuals who can receive this free money from their employers may decide to opt out. So in this section we publish an interesting table which shows just how much bigger your pension pot will be if you take full advantage of pension contributions from your employer.

Part 6 looks at salary sacrifice pensions, which can boost your pension contributions by an astonishing 26%. Salary sacrifice allows you to claw back not just income tax but *national insurance* as well, including the 13.8% paid by your employer. A salary sacrifice pension is arguably the most powerful tax-saving tool available to salaried employees.

Part 7 covers company owners and directors and reveals why company pension contributions are now, more than ever, a highly tax-efficient way to extract money from your business. We also explain why getting your company to make the contributions is more tax efficient than making the contributions yourself.

There is also a chapter looking at the benefits and drawbacks of using your pension to make a loan to your company – you can do this if you have a small self-administered pension scheme (SSAS).

Most of this guide is relevant to the self employed (sole traders and business partners). Some additional practical pointers are provided in Part 8 to help this group maximise their tax relief.

I've also included a chapter for landlords. It explains how pension contributions can help reverse the tax increase you may suffer now that your mortgage interest is no longer tax deductible.

Did you know that pension contributions can also provide *capital gains tax relief*, not just income tax relief? The chapter for landlords explains how pension contributions can reduce your capital gains tax rate from 24% to 18% when you sell residential property.

The final chapter in Part 8 looks at the pros and cons of putting commercial property into a pension.

Part 9 answers a key family pension planning question: "Who should make the pension contributions: me or my spouse/partner?" There is also a chapter looking at the pros and cons of opening a pension for your children or grandchildren.

Future Changes to Pension Tax Relief?

Most of the content of this guide is based on the *current* tax rules affecting pensions. However, it's important to remember that pensions are long-term saving vehicles, which means some of the tax rules are likely to change while you are contributing to one.

For many years newspapers have been reporting that the Government plans to take away some of the tax benefits, in particular higher-rate tax relief. Fortunately there hasn't been any bad news recently, only good news. However, we wouldn't be surprised to see an announcement at some point in the future, especially if there is a change of Government.

For this reason we believe that some individuals, such as higher-rate taxpayers, should make the most of the current tax incentives while they are still available. Other individuals, for example basic-rate taxpayers, could end up better off if there are changes.

Readers should bear all this in mind when we talk about things like the benefits and drawbacks of postponing pension contributions (Part 4 and Chapter 32). The tax rules could change!

Recent Tax Changes

In recent times there have been several announcements on the tax front that have made pensions even more attractive tax shelters.

These include:

- Freezing the £50,270 higher-rate threshold until 6th April 2028
- Reducing the additional-rate threshold from £150,000 to £125,140
- Higher income tax rates on dividend income and a reduction in the dividend allowance to £500
- A reduction in the annual CGT exemption to £3,000
- An increase in the rate of corporation tax

In the March 2023 Budget and in subsequent announcements the Government has made several changes to the pension rules, all of which make pensions more attractive to savers and are covered in detail in this guide.

These include:

- An increase in the annual allowance (the amount you can invest in a pension each year) from £40,000 to £60,000

- The scrapping of the 55% lifetime allowance charge

- Allowing beneficiaries to make uncapped tax-free withdrawals if they inherit a pension pot from someone who dies before reaching age 75, as long as the inherited pension pot is placed into a drawdown arrangement

- An increase in the money purchase annual allowance from £4,000 to £10,000, allowing those who withdraw income from their pensions to make bigger contributions and rebuild their pension savings

- An increase in the tapered annual allowance from £4,000 to £10,000 and an increase in the adjusted income level from £240,000 to £260,000

I hope you find *Pension Magic* an enjoyable and interesting read.

Scope of this Guide

This guide does not cover every aspect of pension saving. The focus is *maximising tax relief*, which is the main reason people invest in the first place.

I do not cover issues like fees, how you should invest your money (in shares, equity funds, bonds, property etc), or how to choose a pension provider. I make no excuses for these omissions. As it is, I've struggled to keep the guide to a manageable size focusing on tax-saving strategies.

Nevertheless, it's important to point out that these other issues are extremely important. Annual account charges vary significantly from one pension provider to the next (from around 0.45% to 0.15%). If you invest in funds, the annual fees also vary considerably (for example, 0.95% for one popular managed fund compared with 0.08% for one well-known tracker fund).

There's no point maximising the tax relief on your pension contributions if you give away all these savings over time by paying high fees.

The focus of this guide is defined contribution pension schemes, also known as money purchase schemes. These include all individual pensions (for example, personal pensions and SIPPs) and most company pension schemes these days.

The basic idea is you (and your employer if you have one) put money in and the amount of income you get out at the end of the day depends on how well your investments have performed.

There is very little discussion of defined benefit (final salary) pension schemes. With this type of scheme your employer promises to pay you a pension based on your salary and years of service.

Final salary schemes are increasingly scarce in the private sector because employers are unwilling to pay someone a guaranteed level of income for the rest of their life. However, they are still the order of the day in the public sector, with the taxpayer picking up the tab.

Lifetime Allowance Protection

Before it was abolished, the lifetime allowance placed a cap on the amount of money you could save in pensions without incurring a tax charge.

The lifetime allowance was £1.8 million in 2011/12 but was steadily reduced to just £1 million in 2016/17. It was then increased with inflation to £1,073,100 before being scrapped.

When the lifetime allowance was being lowered, existing pension savers could apply for various forms of 'protection', which allowed them to benefit from the previously higher lifetime allowance and a bigger tax-free lump sum.

These protections are still relevant and allow some individuals to benefit from a lump sum allowance of more than £268,275 and a lump sum and death benefit allowance of more than £1,073,100. However, we do not discuss any protection-related issues in this guide. The focus is on individuals whose pension pots are much smaller than the old lifetime allowance but want to grow their pension wealth in the years ahead.

We also do not discuss in any detail things like 'serious ill health lump sums' and some of the lump sum death benefits that affect the new allowances.

Scottish Taxpayers

Pensions are all about income tax and income tax in Scotland is different to the rest of the UK. Most of the information in this guide is relevant to Scottish taxpayers. However, unless stated to the contrary, all examples and calculations are based on the assumption that the taxpayer concerned is not a Scottish taxpayer.

Finally, please remember that this guide is not meant to be a substitute for proper professional advice. Before you act you should contact a suitably qualified accountant, tax advisor, financial advisor or pensions expert who understands your personal circumstances.

Part 1

Putting Money In: The Pension Contribution Rules

Chapter 1

Tax Relief on Contributions: How it's Calculated

When you make pension contributions the taxman will top up your savings by paying cash directly into your plan. Effectively for every £80 you invest, the taxman will put in an extra £20.

Why £20, you might be asking? Well your contributions are treated as having been paid out of income that has already been taxed at the 20% basic rate of income tax. The taxman is therefore refunding the income tax you've already paid.

The company that manages your pension plan – usually an insurance company or SIPP provider – will claim this money for you from the taxman and credit it to your account.

So whatever contribution you make personally, divide it by 0.80 and you'll get the total amount that is invested in your pension pot.

Example

Peter invests £4,000 in a self-invested personal pension (SIPP). After the taxman makes his top-up payment, the total amount of money Peter will have sitting in his pension pot is £5,000:

£4,000/0.80 = £5,000

Basic-rate tax relief isn't the end of the story. If Peter is a higher-rate taxpayer, paying tax at 40%, he'll be able to claim even more tax relief.

The Cherry on Top – Higher Rate Relief

A higher-rate taxpayer is someone who earns more than £50,270.

If you are a higher-rate taxpayer the taxman will let you claim your higher-rate tax relief when you submit your tax return.

Alternatively, if you are a company employee, higher-rate tax relief can be provided immediately by reducing the tax paid on your salary via your PAYE code.

(See Chapter 5 for more information on how to claim higher-rate tax relief.)

Example
As we already know, Peter's personal contribution is £4,000 and total pension fund investment, including the taxman's top-up, is:

£4,000/0.80 = £5,000

The £4,000 is what's known as the 'net contribution' and the £5,000 is what's known as the 'gross contribution'.

Multiplying the gross contribution by 20% we get:

£5,000 x 20% = £1,000

This is Peter's higher-rate tax relief.

Effectively he has a pension investment of £5,000 which has cost him just £3,000 (£4,000 personal contribution less his £1,000 tax refund). In other words, he is getting all of his investments at a 40% discount.

This is the critical number. Being able to make investments year after year at a 40% discount can have a huge effect on the amount of wealth you accumulate.

Basic-Rate Tax Relief – Time Delays

As mentioned earlier, your pension provider claims basic-rate tax relief from HMRC and adds it to your account. The delay could be anything from 6 to 11 weeks.

For example, looking at two well-known pension companies, if you make a contribution between, say, the 6th of March and 5th of April 2025 (inclusive) the tax relief will be paid into your account on either the 21st or 25th of May 2025.

By timing your contributions carefully you can ensure that your basic-rate tax relief payments are received sooner rather than later. For example, a contribution made on the 1st of each month is better than a contribution made just after the 5th of each month.

Scottish Taxpayers 2024/25

Income tax in Scotland is being levied as follows in 2024/25:

£0 - £12,570	0%	Personal allowance (PA)
£12,570 - £14,876	19%	Starter rate
£14,876 - £26,561	20%	Basic rate
£26,561 - £43,662	21%	Intermediate rate
£43,662 - £75,000	42%	Higher rate
£75,000 - £100,000	45%	Advanced rate
£100,000 - £125,140	67.5%	PA withdrawal
£125,140 +	48%	Top rate

The higher-rate threshold, where 42% tax kicks in, remains at £43,662. A new 45% 'advanced rate' has been introduced for those earning over £75,000. And the top rate has been increased yet again to 48%.

The good news is Scottish taxpayers who find themselves in these tax brackets can enjoy 42%, 45% or 48% tax relief on their pension contributions. Those who find themselves in the £100,000-£125,140 income bracket can enjoy 67.5% tax relief on their contributions!

Scottish taxpayers who pay tax at just 19%, or pay no tax at all, continue to enjoy 20% tax relief on their pension contributions.

National Insurance Relief?

Pensions provide income tax relief but generally no national insurance relief. However, it's important to point out that:

- Although there is generally no national insurance relief on pension contributions, there is also no national insurance payable on the income you withdraw from your pension. For example, someone who earns a salary of £50,000 this year needs pension income of just £46,258 to end up with *exactly* the same after-tax income.

- If you are a higher-rate taxpayer your combined tax rate (income tax and national insurance) will be 42%. Pensions provide 40% tax relief which is pretty close to full tax relief.

- Although there is generally no national insurance relief on pension contributions, there is one important exception: salary sacrifice pensions. We cover these in detail in Part 6.

Summary

- When you make pension contributions you qualify for two types of income tax relief: Basic-rate tax relief which comes in the shape of top-ups to your pension plan and higher-rate relief which is normally claimed when you submit your tax return.

- Your total pension fund investment is found by dividing your personal contribution by 0.80. The taxman's top-up is paid directly to your pension provider who will credit your pension pot.

- Higher-rate relief is calculated by multiplying your gross pension fund contribution by 20%.

- Together these two tax reliefs mean all your pension investments come in at a 40% discount.

- There is generally no national insurance relief on pension contributions.

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