A lesson in pensions

We should all be thinking about our pension funds but the tax rules as they relate to pensions investments are obscure and complex. Sarah Thomas gives us practical examples of their application.

Having made it to the end of another week of teaching from the kitchen table, I was looking forward to putting away my tax books and starting the weekend with our family 'Zoom' call that has lately become a Friday night tradition. Little did I know I was in for a taxing evening.

Uncle Albert set the tone for our conversation as he announced that he had decided it was time to hang up his boots and retire. 'I've decided that this home working is not for me' he said. 'Fortunately I followed my dad's advice for once when I was still young and started saving towards my pension. So although I don't get my state pension for a few more years, I think I can afford to retire a little early. However, I am still trying to get my head around the options I have for taking my modest private pension – it's quite a mine field.'

Belinda, my sister-in-law then chipped in. She's the high flyer, working in some high tech, web-based company. After congratulating Albert, she explained that she had just had a big bonus and she had put it in her pension as she didn't want to have to pay 45% of it to the government. 'That makes £40,000 put in this year which I believe is the maximum allowed' she said quite smugly.

It seemed that pensions was going to be the theme of the evening, because Billy Moon (as he likes to be called), my 25 year old nephew, then piped up. 'Do you think I should be starting a private pension; I do put a little bit into my employer's pension scheme and I think they also make a small contribution, but I'm not spending much at the moment so perhaps I should put some more away for the future. You know a bit about tax, Aunt Sally – what do you think?'

Key points

- If a pension scheme is registered with HMRC the fund does not pay income tax or capital gains tax and grows tax-free.
- At age 55 a lump sum of up to 25% can be taken with the rest of the fund generating an annual taxable income.
- Income tax relief is given differently on contributions into an employee scheme and a personal pension scheme.
- Higher rate taxpayers must consider the annual allowance rules when paying into their pension pots.
- For those of retirement age who want to realise their investments the two main options are a pension annuity or a 'flexi access drawdown' fund.

'Well,' I said, 'if you all want some answers we're in for a long session so let's top up our drinks then I'll explain.'

When I finished I thought this would make a good case study so I have recounted the details below.

First, I explained to the family that I was not a financial adviser and I could not give them any specific investment advice. I could only explain the tax rules as they related to pensions investments.

So let's start with Billy Moon, after all, he's the youngest and best to start at the beginning of the story.

Billy Moon

To recap, Billy wants to know if he should start investing in a personal pension. He already has a small workplace pension.

First, I explained why pensions are such a tax efficient investment:

The government is keen that we each take on some responsibility for saving for our retirement, so offers generous tax incentives to encourage pension saving. As long as a pension scheme is registered with HMRC the fund does not pay income tax or capital gains tax and so grows tax-free. At retirement, a limited tax-free lump sum (up to 25%) may be taken and the rest of the fund should generate an annual taxable income for Billy during retirement.

With tax relief on contributions, tax-free growth and potentially no tax on 25% of the fund extracted, pensions can be a very tax efficient investment. The downside is that Billy will have to wait until he is at least 55 to realise this investment, but then that is the purpose of a pension after all. And Billy would only waste it on fast food and faster cars if it was there to spend now.

I then went on to look at the two alternative types of scheme, explained below.

The main tax efficient ways of providing funds for retirement are through an occupational pension scheme (available to most employees) or a personal pension scheme (available to both employees and self-employed individuals).

We established that Billy's current pension was an occupational workplace pension. Employers have to offer most workers a workplace pension. It involves contributions being made by both the employer and the employee. While there will be an opt out clause for employees, Billy would lose the benefit of the employer contributions if he decided not to participate.

The mechanism for obtaining tax relief depends on whether it is a personal or occupational pension.

Billy's workplace pension is an occupational pension. As such, his employee contribution is an allowable deduction in calculating his employment income figure to be included in his tax computation. PAYE is applied to the net salary after the pension contribution is deducted. So Billy will have had full income tax relief on his contributions via PAYE. This is sometimes called a 'net pay arrangement'. The employer contribution to the scheme is a tax-free benefit, but must be considered when looking at the annual allowance (discussed later).

Billy is also considering investing in a personal pension. Income tax relief is given in a different manner on employee contributions to a personal pension scheme – basic rate relief is given at source by the individual only paying 80% of the contribution directly to the pension. So, if Billy wants £100 to go into the pension fund, he will actually pay £80 and HMRC will make up the difference of £20. Currently Billy is a basic rate taxpayer so no further income tax relief is available. However, in the future if he becomes a higher or additional rate taxpayer (like his Aunt Belinda), further relief is given by extending the basic and higher rate limits by the gross contribution. So, when doing an income tax computation, it is necessary always to look to see if a personal pension payment has been made and remember to extend the tax thresholds by 100/80 x the amount paid. Again, any employer contributions directly to the fund are a tax-free benefit.

It is fine for Billy to contribute to more than one pension. The gross contribution qualifying for tax relief that he can make into pension schemes each year is the higher of 100% of 'relevant earnings' for the tax year or £3,600. Remember this is the gross amount, but personal pensions are actually paid net of 20% tax. As an aside, for personal pensions this means £2,880 can be actually paid into a pension fund for anyone, even without earnings. This could be used by wealthy grandparents starting to set aside money for a grandchild's pension. (Just thought I would drop that one in while all the grandparents were listening.) 'Relevant earnings' includes employment income, trading income and income from furnished holiday lets.

Belinda

Belinda is a high earner and believes she will get 45% tax relief on pension contributions of £40,000 in the year.

I warned Belinda that she needed to tread with care as she is likely to be caught by the annual allowance rules designed to ensure the most wealthy don't get excessive tax relief.

The annual allowance is the most that can be put into pensions for an individual in one tax year and get full tax relief. While the employer contributions are a tax-free benefit, the allowance takes into account both employee and employer contributions as well as gross contributions made to a personal pension scheme. The current annual allowance for most people is £40,000, but it can be increased by any unused annual allowance for the previous three years. Any input in excess of the annual allowance is subject to a tax charge under self-assessment on the individual at their marginal rate of tax (45% for Belinda), thus negating any tax relief given by the mechanisms already described.

However where we have a high income individual, the current £40,000 annual allowance may be subject to tapering. The allowance for 2020-21 is £40,000 but is gradually reduced for individuals with high income. However, it cannot be reduced below £4,000. A high income individual is someone who has 'threshold income' exceeding £200,000 and 'adjusted income' exceeding £240,000. This is where Belinda has faltered.

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I realised this was going to be complex, and not wanting to bore the others on a Friday night, I suggested Belinda let me have some details and I would ring her separately.

First we established Belinda's salary and bonus and her pension contributions. She told me she had no other income in 2020-21. (See ***Belinda's details for 2020-21***.)

Belinda's details for 2020-21

Belinda had opted out of her employer scheme and has always paid into her own personal pension scheme instead. Her employer contributes £15,000 to her personal pension.

She has no other income.

Salary and bonus	£275,000
Contributions to personal pension scheme (net)	£20,000

Unused annual allowances brought forward to 2020-21 are as follows:

- 2017-18 £5,000
- 2018-19 £5,000
- 2019-20 £5,000

In order to determine whether the tapering provisions apply, we must first calculate 'threshold income'. Threshold income is net income for tax purposes less the gross amount of any personal pension contributions. If this is below £200,000 then there is no tapering. But if this exceeds £200,000 we must then calculate 'adjusted income', which also starts with net income for tax purposes. But here, we add employee contributions to an occupational scheme (which were deducted in arriving at employment income). We also add any pension contributions paid by the employer. Where adjusted income exceeds £240,000, the tapering provisions apply to reduce the annual allowance by £1 for every £2 that adjusted income exceeds £240,000.

So, I prepared the calculations for Belinda as follows:

Belinda's annual allowance calculation

Threshold income	£	Adjusted income	£
Net income (after occupational contributions)	275,000	Net income	275,000
Less personal pension contributions x 100/80	(25,000)	Add employer contributions	15,000
Threshold income	250,000	Add employee contributions to an occupational scheme	Nil
		Adjusted income	290,000

Annual allowance	£40,000
Less: (290,000-240,000)/2	£(25,000)
Current year annual allowance	£15,000
Add: unused allowance – previous 3 years	£15,000
Annual allowance available in 2020-21	£30,000

Notice that after calculating the tapered annual allowance for the current year, any unused allowance from the previous three years can also be used to increase the available amount.

So, Belinda was wrong in thinking that she could get tax relief on £40,000 of contributions. Her annual allowance available is only £30,000. I explained that when she submitted her self-assessment return there would be a clawback charge, called an 'annual allowance charge' on the excess contributions of £10,000 as if it was the top slice of her taxable income, so at 45%. The aim of the annual allowance charge is to remove tax relief on pension savings in excess of the annual allowance.

Lastly, I explained that she should also be mindful of the lifetime allowance, currently £1,073,100. If the fund value exceeds the lifetime allowance, when accessing the funds on retirement, then additional tax charges are invoked on the excess fund value. So, this is a further mechanism to ensure nobody gets too generous tax relief.

Planning point

Anyone wishing to save for a retirement pension, or considering drawing down on their pension should consult with a financial adviser – they will be best placed to give specific investment advice.

Uncle Albert

Albert is about to retire with a modest personal pension and he is looking at his options.

Having paid National Insurance contributions all his working life, Albert will be entitled to a full state pension, which is taxable income, when he reaches state retirement age (currently 66).

He is 60 years old, so above the age of 55 where he can draw benefits from his private pension. He confirmed his fund is below the lifetime allowance, so he can extract up to 25% of the pot tax free with the balance taken as taxable pension income.

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I explained that a flexi access drawdown might quite suit him. He could take 25% of the pot immediately with no tax, and then extract a taxable income from the balance flexibly at any time he chooses. If he wishes, he could take more in the early years when he has no state pension. In the meantime, the remaining funds continue to be invested in a tax sheltered pension fund. But with this option the fund will deplete as he extracts it, so the income is not guaranteed for life. Alternatively, he could consider extracting 25% tax free and then use the rest of the pot to buy an annuity guaranteeing an income for life, however long that may be.

Due to the complexity of the investment decision he needs to make I suggested that he should consult a financial adviser who would be able to run through the various options with him.

More than a little enviously, I wished Albert all the best in his retirement.

So plenty for Albert, Belinda and Billy Moon to ponder. They might think twice before asking about tax on a Friday night again! ●

Author details

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