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A look at pension contributions and their advantages

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A pension is one of the most tax efficient ways to save. This article by Bigmore Associates – one of our trusted business partners - examines the ways to optimise your tax relief on your pension contributions.

As an IFA firm we are frequently approached by our clients with questions regarding pension contributions, especially about how much they can invest, how they get tax relief, how they make the payment, would it be more advantageous to invest in an ISA rather than in a pension, etc.

There is a lot of literature out there, but sometimes you need to access multiple sources to get answers to all your questions. The terminology might also be quite complicated, thus creating even more confusion.

This article is intended to shed some light on pension contributions and their advantages in a way that is easy to understand.

Why pay into a pension?

My business is my pension, Pensions are a waste of time, I would rather invest in property. We hear many lines such as these as to why people don't pay into pensions, so why should they reconsider?

Pensions are a form of tax efficient savings; they don't have to replace other options for saving and investing but are simply a tool in your armoury for making the most of your money. You receive tax relief on contributions, tax free growth, 25% tax free lump sum on taking your pension and your savings are typically a tax-free death benefit (before death pre age 75) that falls outside your estate on death for inheritance tax purposes.

Moreover, one of the first rules of saving and investing is not to put all your eggs in one basket – diversification. Pensions don't need to be an all or nothing decision on where to invest your money, but with the tax advantages they do offer, the question is really why wouldn't you pay into a pension?

Limits to annual allowance

When it comes to UK registered pension scheme contributions, you are not limited to a certain amount that you can pay in and if you are a UK resident under the age of 75, you can benefit from tax relief. However, you can receive tax relief only on contributions 'up to the higher of' 100% of your UK gross salary or £3,600 if you earn up to this amount or nothing at all.[1]

Even if there is no limit on pension contributions, there is an annual allowance set each tax year for the amount that benefits from tax relief. The 'annual allowance is made up of all the contributions' made into 'your pension by you, your employer and any third party', meaning that tax relief is also included in the calculation.[2]

The annual allowance for 2021 – 2022 is £40,000 and going over will trigger the annual allowance charge, which 'is added to the rest of your taxable income for the year in question' to calculate the total income tax that needs to be paid.[3] You do not get any tax relief on the contributions over the annual allowance.

There are cases in which your annual allowance can be less than £40,000.

1) This applies to you if you do not have any earnings or your annual salary is £3,600 or less, in which case the net amount you can pay into your pension is limited to £2,880 net per annum and you would get tax relief of 20% on it.

2) Also, if you have flexibly accessed your defined contributions pension, your annual allowance reduces to £4,000 gross. This is called the Money Purchase Annual Allowance (MPAA) and it is triggered when you take 'cash or a short-term annuity from a flexi-access drawdown fund and / or cash from a pension pot ('uncrystallised funds pension lump sums')[4]. Taking tax free cash from your pension fund does not trigger the MPAA.

3) If your total income from all sources exceeds £240,000, your £40,000 annual allowance is reduced by £1 for every £2 over the limit, so that if your total income goes over £312,000 your annual allowance is just £4,000.[5] This is a complex area of planning and always seek advice to avoid painful unexpected tax charges, especially if you get generous bonuses or share options.

Taxpayers with a reduced annual allowance can invest in other tax efficient vehicles like ISAs and Venture Capital Trusts (VCTs). ISAs are tax-free and you can invest up to £20,000, which is the ISA allowance for the tax year 2021 – 2022. You can benefit from potential tax-free growth and can also use your ISA to provide tax free income in retirement.

[1] *Do you know how tax relief on your pension contributions works?* (2021, July 22) Low Incomes Tax Reform Group. Retrieved from https://www.litrg.org.uk/tax-guides/tax-basics/do-i-have-join-pension-scheme/do-you-know-how-tax-relief-your-pension
[2] Davies, P. (2021, November) *How the pensions annual allowance works*. Which. Retrieved from https://www.which.co.uk/money/pensions-and-retirement/personal-pensions/contributing-to-a-private-pension-explained/how-the-pensions-annual-allowance-works-ac8d33u9v9ch#:~:text=Your%20annual%20allowance%20is%20made,earn%20%C2%A340%2C000%20a%20year.
[3] Ibid.
[4] *Tax on your private pension contributions* (n.d.) GOV.UK. Retrieved from https://www.gov.uk/tax-on-your-private-pension/annual-allowance
[5] *Tapered annual allowance – threshold and adjusted income* (2021, April 6) PRU. Retrieved from https://www.pruadviser.co.uk/knowledge-literature/knowledge-library/tapered-annual-allowance/

VCTs are higher risk investments as they invest in small companies or start-ups unlisted or listed on AIM (Alternative Investment Market), 'the London Stock Exchange's market for small and medium size growth companies'.[6]

They attract investors by offering several tax benefits such as:

- up to 30% income tax relief on investments of up to £200,000
- tax-free dividends
- exemption from capital gains tax upon sale of the VCT shares.[7]

VCTs are longer term investments as the shares need to be kept for at least 5 years in order to enjoy all these tax benefits.

How tax relief is obtained

Tax relief can be obtained in three ways: net pay, relief at source and assessment.

The net pay method implies that pension contributions are deducted from your gross salary by your employer, which means you get tax relief immediately.

Individual pension contributions paid from your salary after tax get 20% tax relief at source. This means that your pension provider will claim the tax relief from HMRC on your behalf.

If you are a higher or additional rate taxpayer, you will need to claim your extra tax relief – 20% for higher rate taxpayers and 25% for additional rate taxpayers - through your self-assessment tax return. Similarly, corporation tax relief can be claimed by filing the Company Tax Return.

You do not get tax relief on pension contributions made after age 75, on employer contributions or 'new contributions that are life assurance premium contributions'.[8]

Personal contributions can extend income tax bands

As mentioned above, higher and additional rate taxpayers can get extra tax relief through self-assessment when they make personal contributions to their pensions. If they claim it, their basic rate tax band gets extended over £50,000 'by the gross contribution'.[9]

Taxpayers whose adjusted net income is over £100,000 – 'your total income before any personal allowances and less things like Gift Aid' [10]- 'lose their personal allowance at a rate of £1 for every £2

[6] *AIM* (n.d.) London Stock Exchange. Retrieved from https://www.londonstockexchange.com/raise-finance/equity/aim
[7] *Guide to Venture Capital Trusts* (n.d.) Octopus Investments. Retrieved from https://octopusinvestments.com/resources/guides/venture-capital-trusts/
[8] *Tax relief on member contributions* (2021, April 6) PRU. Retrieved from https://www.pruadviser.co.uk/knowledge-literature/knowledge-library/tax-relief-members-contributions/
[9] Davison, P. (n.d.) *Pensions: Tax Considerations*. PD TAX CONSULTANTS. Retrieved from https://www.pd-taxconsultants.co.uk/pensions-tax-considerations/
[10] *High Income Child Benefit Tax Charge* (n.d.) GOV.UK. Retrieved from https://www.gov.uk/child-benefit-tax-charge

of income over £100,00'[11] so that for an adjusted net income of £125,140 or above, the personal allowance - £12,570 for the tax year 2021 – 2022 – drops to zero.[12]

You can recover it by making a personal pension contribution of £20,000 on which you will get tax relief of 20% at source and thus bring your adjusted net income down to £100,000. Plus, you can also claim the extra tax relief. This is effectively a 60% tax saving on a pension contribution.

The carry forward option

If you have used up your annual allowance for the tax year, it might still be possible to make pension contributions through an exercise called carry forward. This allows to carry forward unused annual allowances from the previous three tax years to make pension contributions over the current annual allowance without triggering any charge and still receive tax relief.

The carry forward option is available to you if you 'have been a member of a UK-registered pension scheme in each of the tax years from which you wish to carry forward', regardless of whether you have made any pension contributions or not.[13] It is not available if you have already triggered the MPAA, in which case your pension contributions cannot exceed £4,000 per tax year.

Another rule of the carry forward exercise is that no matter how much unused allowance you have from the previous three tax years, you cannot bring forward an amount that would make your pension contributions exceed your annual salary.[14] For instance, if you earn £70,000 in this tax year and you have already made a pension contribution of £40,000, you can bring forward only £30,000, no matter how much unused allowance you have left.

If, however, you earn £180,000 and have not made any pension contributions in the current tax year and the previous three but have been a member of a UK-registered pension scheme, you could contribute £160,000 to your pension through the carry forward option.

Your pension is also a good instrument to mitigate inheritance tax as it will be out of your estate for inheritance tax purposes and can be passed on to your beneficiaries.

Benefits of company over personal contributions for small business owners

For small business owners it is often more tax-efficient to make company rather than individual contributions to their pensions as this will reduce the limited company's taxable profits and consequently the corporation tax bill.[15] For the current tax year, 2021 – 2022, the corporation tax rate for company profits is 19%.

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[11] *Reclaiming the Personal Allowance* (n.d.) Canada Life. Retrieved from https://www.canadalife.co.uk/technical-support/reclaiming-the-personal-allowance/
[12] *Income Tax rates and Personal Allowances* (n.d.) GOV.UK. Retrieved from https://www.gov.uk/income-tax-rates/income-over-1000000
[13] *Carry forward* (n.d.) Money Helper. Retrieved from https://www.moneyhelper.org.uk/en/pensions-and-retirement/tax-and-pensions/carry-forward
[14] *Pension carry forward rule* (2021, July 7) Pension Bee. Retrieved from https://www.pensionbee.com/pensions-explained/pension-contributions/pension-carry-forward-rule
[15] Green, N. (2021, April 19) *Contributing to your pension via a limited company explained*. Unbiased. Retrieved from https://www.unbiased.co.uk/life/small-business/contributing-to-your-pension-via-a-limited-company-explained

By making employer contributions the company can save on National Insurance as it is not paid on pension contributions. This would mean saving up to 13.8% (the employer National Insurance rate for 2021 – 2022) by paying directly into the pension rather than as a salary and consequently as an individual contribution.[16]

Employer pension contributions also qualify as allowable business expenses and 'can be offset against your company's corporation tax bill' if they pass the 'wholly and exclusively' test.[17] If they are made 'wholly and exclusively for the purposes of the business' and if the pension contribution is 'reasonable' for the work the individual does, it can be deducted as an expense from the company's profits and therefore qualify for corporation tax relief[18] saving the company up to 25% in corporation tax.

Bigmore Associates

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[17] Ibid.
[18] *Employer pension contributions* (2021, April 6) abrdn. Retrieved from https://techzone.abrdn.com/public/pensions/Employer-pension-contributions#anchor_1