

THE TAX BENEFITS OF MAKING PENSION CONTRIBUTIONS

The tax benefits of making pension contributions can be significant and although there have not been any major changes in this area in recent years, it is always useful to recap the main tax benefits. This article looks at personal pensions. These can be set up by individuals, or Employers can set up group personal pension plans.

Personal Pension Contributions

As a reminder, Personal Pension Contributions made by individuals are paid 'net' of basic rate income tax (20%) since HM Revenue & Customs (HMRC) pay the 20% tax into the pension scheme. For example, if you pay £8,000 in to your pension scheme during the year, HMRC will add £2,000 to that, giving a total ('gross') contribution to your pension scheme of £10,000.

For basic rate taxpayers therefore (those with total income of up to £50,000 for the tax year ending 5 April 2020), there is no additional tax saving by making pension contributions, since tax relief is given at source.

Higher rate taxpayers however can claim an extra 20% of the gross contribution from HMRC. Using the example above, a higher rate taxpayer can claim an additional £2,000 from HMRC on the £8,000 contribution paid. For additional rate taxpayers (those with taxable income above £150,000 for the year), the extra relief would be £2,500. Higher and additional rate taxpayers can therefore benefit from potentially significant tax savings by making pension contributions. It is wise to consider the benefits of making additional pension contributions before 5 April each year. This is particularly relevant for those individuals who might be in danger of falling foul of the High Income Child Benefit Charge (income over £50,000) or a marginal income tax rate of 60% on a slice of their income above £100,000 (due to the gradual loss of the personal tax allowance).

Is there a limit to the amount of pension contributions I can make?

There is no financial limit on the amount that may be contributed to a registered pension scheme but there is a limit on the amount on which an individual can claim tax relief. This limit is the greater of:

- the individual's UK 'relevant earnings' for the tax year (broadly, the level of their salary and/or self-employment/partnership income); and
- £3,600 (gross).

Furthermore, there is an overriding annual allowance of £40,000, meaning that any contributions which exceed £40,000 (gross) in the tax year will suffer a tax charge on the excess. This annual allowance is reduced for high earners, tapered by £1 for every £2 that an individual's income exceeds £150,000 (subject to a minimum allowance of £10,000). 'Carry forward' provisions are available whereby an individual who has been a member of a pension scheme for the relevant years in question can contribute more than £40,000

(and receive tax relief thereon) by making use of any 'unused' annual allowances from the previous three tax years.

Although beyond the scope of this article, there is also a 'lifetime allowance' (currently £1m) which limits the amount of pension benefit that can be drawn without triggering a tax charge. There are also restrictions on the level of pension contributions that can be made when an individual is already in drawdown on a pension.

What about contributions from my own limited company?

It is relatively common tax planning for those operating their businesses through limited companies to receive a modest salary from their company and 'top up' their income by other means e.g. by way of dividends. By doing this, it does limit the level of personal pension contributions on which tax relief can be claimed.

In this situation, consideration can be given to the company making an employer pension contribution to a pension scheme for the director(s). This is also tax efficient since such contributions will usually qualify for Corporation Tax relief, currently at 19%. The annual allowance of £40,000 as mentioned above applies to contributions made by individuals and employers, so this would still need to be considered when thinking about the level of contribution to make.

Are there any other tax benefits?

Income and capital growth generated within registered pension schemes are exempt from income tax and capital gains tax.

It will also be appreciated from the above that one of the main benefits for higher and additional rate taxpayers in making pension contributions is to receive tax relief during their working lives which may be at a higher rate (hopefully) than the resulting pension income will be subject to in retirement.

With the new flexible pension rules it can also be much easier to transfer pension pots on death to other family members without triggering significant tax charges in doing so. Pension funds can also be free of Inheritance Tax (IHT) if they are suitably written in trust, so that they remain outside one's estate on death. Pensions should therefore form an important part of any IHT and estate planning.

Specific advice in relation to pension schemes should be obtained from your pension adviser or an independent financial adviser. The above is for general guidance only and no action should be taken without obtaining specific advice.

Bath
37 Great Pulteney Street
Bath
BA2 4DA
+44 (0)1225 460491

Chippenham
67 & 68 St Mary Street
Chippenham, Wiltshire
SN15 3JF
+44 (0)1249 444666

Trowbridge
5 Wicker Hill
Trowbridge, Wiltshire
BA14 8JS
+44 (0)1225 764441