PARTNERS WEALTH MANAGEMENT

AN INTRODUCTION TO

Tax and pensions

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Tax relief on pension contributions is a familiar feature of the fiscal landscape that has so far survived calls for it to be bulldozed; but, as most high earners discover as their careers progress, there are limits to the taxman's largesse

Tax relief is now more constrained

For many decades, successive governments adopted a benevolent view of citizens saving for the future. This was partly because thrift was recognised as virtuous and partly because people with savings were less likely to need financial support from the authorities. Offering tax relief on pension contributions was a major plank of this strategy and grateful individuals have been enjoying the benefit ever since.

Many taxpayers across the earnings spectrum were naturally inclined to make the best use they could of the tax relief facility. So, high earners were able to save tax at their highest marginal rate on very substantial pension contributions. Curtailment of this entitlement was probably inevitable, but when in 2006 the newly-formed HM Revenue & Customs introduced limits (the HMRC annual and lifetime allowances) these seemed quite generous. Since then, both allowances have been scaled back and careful planning with specialist advice may be needed to ensure avoidance of pitfalls.

Repeated cuts to annual allowance

The annual allowance in effect places a cap on the level of pension contributions anyone may make with the benefit of tax relief and it takes into account employer contributions; anything above the cap would not qualify for relief. For its debut in April 2006, the annual allowance was set at £215,000 and it rose to £255,000 before being cut back sharply to £50,000 in April 2011. It was further reduced to £40,000 in April 2014. An allowance for the current tax year may be enhanced by unused allowances from the three preceding tax years.

There are further complexities, including around 'salary sacrifice' pension contributions, affecting how the annual allowance applies to many high earners. Since April 2016 there has been a system for tapering the allowance. The rules were subsequently updated in April 2020. Someone earning more than £200,000 excluding (or £240,000 including) pension contributions loses £1 of annual allowance for each additional £2 of earnings, until the allowance is reduced to £4,000. Whether or not tapering applies, if someone starts drawing from their pension whilst still paying in, a lower 'money purchase annual allowance' of just £4,000 applies.

Tax charge for lifetime allowance breach

Complexities also arise in keeping pension savings within the lifetime allowance, failing which some of a person's pension wealth could become subject to a 55% tax charge on an excess amount taken as a lump sum or 25% if drawn as pension income. Planning to avoid the worst effects of the lifetime allowance needs to be started at the earliest possible stage, as the impact of poor decisions may be felt a long way down the line.

One of the more difficult aspects applies where someone has a defined benefits (final salary) pension rather than a money purchase pot of known value. The calculated value of a final salary pension may be surprisingly high in relation to the income it will generate and could unexpectedly exceed the allowance, so it is important not to be caught out through failure to seek advice on correct valuation of the pension.

Similarly to the annual allowance, the lifetime allowance increased for several years after being set at £1.5m in April 2006. It reached £1.8m with effect from April 2010, but two years later came the first step in a phased reduction to £1m in April 2016. The annual allowance is increased in line with inflation, in April 2020, when it rose to £1,073,100. Further inflation-linked enhancements are expected in future tax years. However, it will be a long time before the earlier high levels of lifetime allowance are matched through such inflation linkage.

Mitigation may be available

Reductions to the lifetime allowance in recent years presented potential problems for pension savers who had been planning their contributions on the basis of a pre-reduction allowance. HMRC acknowledged the problem and have over the years introduced protections for qualifying individuals against the impact of a reduction. It is important to establish likely eligibility for such protection and make the necessary application for it.

First of the two forms of protection currently available is Fixed Protection 2016, which can preserve a £1.25m lifetime allowance for someone whose pension has seen no contributions since 5 April 2016. The second is Individual Protection 2016, available if someone had funds exceeding £1m as at 5 April 2016; it permits further contributions and provides an enhanced allowance up to that 2016 valuation but with an absolute limit of £1.25m.

The best course for our clients

Anyone potentially affected by the annual allowance and/or lifetime allowance could benefit from advice on their options. Various choices may be available, depending upon their specific circumstances. For example, they may be best advised to stop making pension contributions and direct any further retirement savings towards other forms of investment deemed suitable for their needs. On the other hand, in some cases it may make sense to continue making contributions and face up to the tax charge when payable.

The April 2006 changes that introduced annual and lifetime allowances, coupled with the April 2015 freedoms around how and when pension pots may be invested, drawn upon and inherited, may seem daunting. Our expert advisers have been working with the current rules since their inception and are equipped to present a full range of options to clients and advise on selection of the most appropriate course.

We're here to help

We're only a phone call or email away. If you have any queries or would like to discuss any aspect of pensions, tax relief or HMRC allowances, please do get in touch.

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