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MELVILLE & CO
Chartered Accountants

Pensions - Tax Reliefs



Types of pension schemes

There are two broad types of pension schemes from which an individual may eventually be in receipt of a pension:

- Workplace pension schemes
- Personal Pension schemes.

A Workplace pension scheme may either be a defined benefit scheme or a money purchase scheme.

A defined benefit scheme pays a retirement income related to the amount of your earnings, while a money purchase scheme instead reflects the amount invested and the underlying investment fund performance.

The number of defined benefit pension schemes has declined in recent years in part due to the regulations imposed upon the schemes and the cost of such schemes to the employer.

All employers are required to provide a workplace pension scheme due to auto-enrolment legislation and these are mainly money purchase schemes.

A Personal Pension scheme is a privately funded pension plan but can also be funded by an employer. These are also money purchase schemes. Self-employed individuals can have a Personal Pension.

We set out below the tax reliefs available to members of a money purchase Workplace scheme or a Personal Pension scheme.

It is important that professional advice is sought on pension issues relevant to your personal circumstances.

What are the tax breaks and controls on the tax breaks?

To benefit from tax privileges all pension schemes must be registered with HMRC. For a Personal Pension scheme, registration will be organised by the pension provider.

A money purchase scheme allows the member to obtain tax relief on contributions into the scheme and tax-free growth of the fund. If an employer contributes to the scheme on behalf of an employee, there is generally no tax charge on the member and the employer will obtain a deduction from their taxable profits.

When the 'new' pension regime was introduced from 6 April 2006 no limits were set on either the maximum amount which could be invested in a pension scheme in a year or on the total value within pension funds. However two controls were put in place in 2006 to control the amount of tax relief which was available to the member and the tax-free growth in the fund.

Firstly, a lifetime allowance was established which set the maximum figure for tax-relieved savings in the fund(s) and must be considered when key events happen such as when a pension is taken for the first time.

Secondly, an annual allowance sets the maximum amount which can be invested with tax relief into a pension fund. The allowance applies to the combined contributions of an employee and employer. Amounts in excess of this allowance trigger a charge.

There are other longer established restrictions on contributions from members of money purchase schemes (see below).

Key features of money purchase pensions

- Contributions are invested for long-term growth up to the selected retirement age.
- At retirement (which may be any time from the age of 55) the accumulated fund is generally turned into retirement benefits - an income and a tax-free lump sum.
- Personal contributions are generally payable net of basic rate tax relief, leaving the provider to claim the tax back from HMRC.
- Higher and additional rate relief is given as a reduction in the taxpayer's tax bill. This is normally dealt with by claiming tax relief through the self assessment system.
- Employer contributions are payable gross direct to the pension provider.

Persons eligible

All UK residents may have a money purchase pension. This includes non-taxpayers such as children and non-earning adults. However, they will only be entitled to tax relief on gross contributions of up to £3,600 per annum.

Relief for individuals' contributions

An individual is entitled to make contributions and receive tax relief on the higher of £3,600 or 100% of earnings in any given tax year. However, tax relief will generally be restricted for contributions in excess of the annual allowance.

Methods of giving tax relief

Tax relief on contributions is given at the individual's marginal rate of tax.

An individual may obtain tax relief on contributions made to a money purchase scheme in one of three ways:

- A net of basic rate tax contribution is paid by the individual with higher or additional rate relief claimed through the self assessment system.
- A net of basic rate tax contribution is deducted from net pay of the employee. The contribution is then paid over by the employer to the scheme. Higher or additional rate relief is claimed through the self assessment system.
- A gross contribution is deducted from the employee's gross salary and paid by the employer to the scheme. This lowers the employee's PAYE tax bill and no further action is needed by taxpayers as the correct relief has been given through the payroll.

In the first two ways the basic rate is claimed back from HMRC by the pension provider.

One effective route for an employee to consider may be to enter a salary sacrifice arrangement with an employer. The employer will make a gross contribution to the pension provider and the employee's gross salary is reduced. This will give the employee full income tax relief (by reducing PAYE) but also reduces National Insurance contributions.

There are special rules if contributions are made to a retirement annuity contract. (These are old schemes started before the introduction of personal pensions.)

The annual allowance

The annual allowance has been £40,000 in recent years including 2022/23 but is increasing to £60,000 for 2023/24.

Any contributions in 2023/24 in excess of the £60,000 annual allowance are potentially charged to tax on the individual as their top slice of income. Contributions include contributions made by an employer.

The stated purpose of the charging regime is to discourage pension saving in tax registered pensions beyond the annual allowance. Most individuals and employers actively seek to reduce pension saving below the annual allowance, rather than fall within the charging regime.

Individuals who are eligible to take amounts out of their pension funds under the flexibilities introduced from 6 April 2015 but who continue to make contributions into their schemes may trigger other restrictions in the available annual allowance. This is explained later in this factsheet in 'Money Purchase Annual Allowance'.

Lower annual allowance for those with 'adjusted income' over £260,000

Adjusted income means, broadly, a person's net income and pension contributions made by an employer. For every £2 of adjusted income over an adjusted income threshold, an individual's annual allowance is reduced by £1, down to a minimum amount.

The reduction potentially applies to an individual with income before tax, without the addition of employer contributions, above £200,000. This is known as the 'threshold income'.

Prior to 6 April 2023 adjusted income was set at £240,000, threshold income at £200,000 and the minimum annual allowance at £4,000.

The adjusted income threshold has been raised by £20,000 for 2023/24. The threshold income remains at £200,000 and individuals with income below this level are not affected by the tapered annual allowance. The annual allowance begins to taper down for individuals who have an adjusted income above £260,000.

The minimum level to which the annual allowance can taper down is now increased to £10,000.

The rate of charge if annual allowance is exceeded

The charge is levied on the excess above the annual allowance at the appropriate rate in respect of the total pension savings. There is no blanket exemption from this charge in the year that benefits are taken. There are, however, exemptions from the charge in the case of serious ill health as well as death.

The appropriate rate will broadly be the top rate of income tax that you pay on your income.

Example

Anthony, who is employed, has taxable income of £125,000 in 2023/24. He makes personal pension contributions of £56,000 net in March 2024. He has made similar contributions in the previous three tax years. He will be entitled to a maximum £60,000 annual allowance for 2023/24. The charge will be:

Gross pension contribution	£70,000
Less annual allowance	(£60,000)

Excess	£10,000 taxable at 45% = £4,500
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Anthony will have had tax relief on his pension contributions of £31,500 (£70,000 x 45%) and now effectively has £4,500 clawed back. The tax adjustments will be made as part of the self assessment tax return process.

Carry forward of unused annual allowance

To allow for individuals who may have a significant amount of pension savings in a tax year but smaller amounts in other tax years, a carry forward of unused annual allowance is available.

The carry forward rules apply if the individual's pension savings exceed the annual allowance for the tax year. The annual allowance for the current tax year is used before any unused allowance brought forward. The earliest year unused allowance is then used before a later year.

Unused annual allowance carried forward is the amount by which the annual allowance for that tax year exceeded the total pension savings for that tax year.

This effectively means that the unused annual allowance of up to £40,000 can be carried forward from 2020/21, 2021/22 and 2022/23 to 2023/24. Importantly no carry forward is available in relation to a tax year preceding the current year unless the individual was a member of a registered pension scheme at some time during that tax year.

Example

Assume it is March 2024. Bob is a self employed builder. In the previous three years Bob has made contributions of £30,000, £10,000 and £30,000 to his pension scheme. As he has not used all of the £40,000 annual allowance in earlier years, he has £50,000 unused annual allowance that he can carry forward to 2023/24.

Together with the new increased current year annual allowance of £60,000, this means that Bob can make a contribution of £110,000 in 2023/24 without having to pay any extra tax charge.

The lifetime allowance

The lifetime allowance set the maximum figure for tax-relieved savings in an individual's funds at £1,073,100 for 2022/23. In that year, where the value of the pension scheme(s) exceeded the limit, excess tax charges applied when the funds were accessed.

For 2023/24, the lifetime allowance is abolished for certain purposes. This means that there will no longer be excess charges if the value of the scheme(s) exceeds the allowance of £1,073,100.

Accessing your pension - freedom

Individuals have flexibility to choose how to access their pension funds from the age of 55. The options include:

- a tax-free lump sum of 25% of fund value (this is still limited to 25% of the lifetime allowance of £1,073,100 in 2023/24 so a maximum of £268,275)
- purchase of an annuity with the remaining fund, or
- income drawdown (see below for options available regarding flexi access accounts and lump sum payments).

An annuity is taxable income in the year of receipt. Similarly any monies received from the income drawdown fund are taxable income in the year of receipt.

Flexi access accounts and lump sums

Where a lump sum and annuity are not taken access to the fund can be achieved in one of two ways:

- allocation of a pension fund (or part of a pension fund) into a 'flexi-access drawdown account' from which any amount can be taken over whatever period the person decides
- taking a single or series of lump sums from a pension fund (known as an 'uncrystallised funds pension lump sum').

When an allocation of funds into a flexi-access account is made the member typically will take the opportunity of taking a tax-free lump sum from the fund.

The person will then decide how much or how little to take from the flexi-access account. Any amounts that are taken will count as taxable income in the year of receipt.

Access to some or all of a pension fund without first allocating to a flexi-access account can be achieved by taking an uncrystallised funds pension lump sum.

The tax effect will be:

- 25% is tax-free (subject to the limit detailed above)
- the remainder is taxable as income.

Money Purchase Annual Allowance (MPAA)

The government is alive to the possibility of people taking advantage of the flexibilities by 'recycling' their earned income into pensions and then immediately taking out amounts from their pension funds. Without further controls being put into place an individual would obtain tax relief on the pension contributions but only be taxed on 75% of the funds immediately withdrawn.

The MPAA sets the maximum amount of tax efficient contributions in certain scenarios. The allowance has been increased from £4,000 to £10,000 per annum for 2023/24.

There is no carry forward of any of the MPAA to a later year if it is not used in the year.

The main scenarios in which the reduced annual allowance is triggered are if:

- any income is taken from a flexi-access drawdown account, or
- an uncrystallised funds pension lump sum is received.

However just taking a tax-free lump sum when funds are transferred into a flexi-access account will not trigger the MPAA rule.

How we can help

This information sheet provides general information on the making of pension provision. Please contact us for more detailed advice if you are interested in making provision for a pension.

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