Briefing

# A guide to pension taxation and reliefs

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**The common view is that income tax relief is given on pension contributions, and the resulting pension benefits from investing these contributions (tax-free in the pension provider's hands) are taxed when received.**

**This is achieved in a rather complicated way, and in this guide we explain the current rules and key things to bear in mind.**

**Over the years since the tax system for pensions was 'simplified' in 2006 there have been changes almost every year. Some were announced and legislated, but dropped before being implemented!**

The government has recognised that the complexity of pensions has meant members of pension schemes now have a greater need now for professional advice. The government is offering tax breaks towards the cost of advice (see page 6).

The pension taxation rules for 2020/21 are summarised below.

## The annual allowance explained

The annual allowance for tax relief, which applies to pension inputs in a tax year, fell to £40,000 in 2014/15 and has stayed at that level since. It is restricted to £4,000 [£10,000 before 6 April 2017] once benefits are drawn from a pension scheme, more on this later.

The term 'pension inputs' covers:

- contributions to personal pension policies and retirement annuity contracts,
- contributions met by deduction from pay,
- employers' contributions to defined contributions schemes and
- benefits accrued in defined benefits schemes met by employers.

## The pension input period

Each pension arrangement has a 'pension input period' ('PIP'). The first PIP used to end on the first anniversary of its beginning, unless an earlier date was nominated, with successive PIPs ending on each anniversary of that first end date unless an alternative date was nominated in the tax year following that in which the preceding PIP ended.

This changed in July 2015, so that all PIPs now end on 5 April.

The annual allowance for a tax year is increased by any shortfall in pension inputs in the previous 3 years. This starts with the earliest year, provided that the member was in a registered pension scheme in that earlier year.

The annual limit since 2014/15 has been £40,000 (this had been £50,000 in both 2012/13 and 2013/14).

As a transitional measure, 2015/16 was notionally divided into two periods:

1. The 'pre-alignment tax year - 6 April to 8 July 2015. The allowance this period was £80,000.
2. The post-alignment tax year - 9 July 2015 to 5 April 2016. For this year the allowance was nil, but up to £40,000 of the allowance unused in the pre-alignment tax year could have been carried forward to the post-alignment tax year.

## The annual allowance and high incomes

From 6 April 2016, the annual allowance was also reduced for 'high-income individuals'.

This means someone with 'threshold income' over £200,000 (£110,000 for years before 2020/21) and 'adjusted income' over £240,000 (£150,000 for years before 2020/21 ).

For these individuals, the annual allowance of £40,000 (enhanced by any shortfall in pension inputs below £40,000 in the preceding three tax years) is reduced by £1 for every £2 the adjusted income exceeds £240,000 (£150,000 for years before 2020/21), to a minimum of £4,000 (£10,000 for years before 2020/21). By way of an explanation:

- *Threshold income* is taxable income plus any remuneration 'sacrificed' under arrangements entered into after 8 July 2015.
- *Adjusted income* is taxable income before any pension inputs.

In both cases the income is after various deductions, including relief for gifts to charity of shares, securities and real property, but (possibly by an oversight) ignoring relief for cash gifts to charity under gift aid.

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# A guide to pension taxation and reliefs continued

## Income tax relief

Income tax relief is available on all pension inputs into registered pension schemes that are made by or for an individual under 75 (other than any made by the individual's employer). This is up to a maximum equalling the individual's relevant earnings [which includes income from UK and EEA furnished holiday lettings] or, if more £3,600 per annum.

Do bear in mind that, if pension inputs exceed the annual allowance, the effect is essentially withdrawing the initial tax relief.

## How the tax relief is obtained

This varies according to where the contributions are made and by whom. Here are some points to note:

- **Schemes established by employers** may use the net pay arrangements; deducting tax under PAYE on earnings net of pension contributions.
- **Contributions to retirement annuity policies** are payable gross, with tax relief obtained through the self-assessment return.
- **Contributions to other pension schemes** attract basic rate tax relief by deduction at source, with taxpayers paying tax at a higher rate, claiming relief at the excess through their self-assessment tax return.
- **Employers get tax relief on contributions made in respect of their employees**, save that the deduction has to satisfy the 'wholly and exclusively' test. In essence this means it must be made for the purposes of the business (so the contribution should be at a reasonable level for the individual concerned). For more details on the test, see: https://tinyurl.com/ybfs8x5l Employers may also make contributions for employees aged over 75.
- **Employees are not taxable on their employer's contributions** or benefits accrued under a defined benefit (final salary) scheme as a benefit; save where the annual allowance is exceeded, as explained below.
- **Different rules apply to people who are not resident in the UK**, with some relief available if, they were either resident in the UK or have UK chargeable earnings in the previous five tax years

## Recapturing tax relief given at source

An individual making contributions after deduction of basic rate will be chargeable at basic rate on the excess of their grossed-up contributions over their relevant earnings.

## An example - Flora

In each of the 3 years to 5 April 2020, Flora, whose employment income is £100,000 a year, pays £24,000 pension contribution, representing £30,000 after 20% tax.

In April 2020 she gets a new job and expects to earn £200,000 in 2020/21.

Unfortunately, just after she has used her savings to make a rather rash early pension contribution of £40,000 (£50,000 gross), her new employer goes bust, with Flora only receiving £40,000 pay.

Flora fails to get another job in 2020/21. Flora advises her pension provider that her relevant earnings are £10,000 short of her contributions, and has a tax liability at 20% thereon.

## Exceeding the annual allowance

An individual whose 'pension inputs' in pension input periods ending in a tax year exceed the limit for that year is liable to income tax on the excess.

Any excess is charged at the individual's marginal rate. In this situation, he or she would have had income tax relief on their contributions (or not been taxed where the contributions are by their employer).

The pension inputs in a year in which the individual dies or retires through severe ill health are not tested against the annual allowance. They are not limited. In valuing accrued benefits in a defined benefits scheme in the context of the annual limit, £16 is attributed to every £1 of defined benefit pension accrued.

## Some further examples using the 2020/21 tax rates

### Flora

Flora's employer in the earlier years contributed £10,000 a year to her pension scheme. Her short-lived employer in 2020/21 contributed £2,000. So in 2020/21 Flora's pension inputs are £42,000; the sum of her contributions limited to her relevant earnings and her employer's contributions.

As this exceeds the annual allowance of £40,000, Flora is liable at her marginal rate on the excess of £2,000.

### Anne

Anne, a single woman, is in a defined benefits pension scheme giving her n/60ths pension at age 60. She has 25 years' service and receives a salary increase from £52,000 to £60,000.

Her pension fund becomes 25/60ths of £60,000 x 16 = £400,000. The previous year it was 24/60ths of £52,000 x 16 = £332,800. Indexation might increase this by, say, 2.4% to £340,788.

So Anne's pension inputs are £59,212 [£400,000-£340,788].

Unless Anne's pension inputs in the preceding three years fell short of the annual maximum, so that she can use the shortfall, she would have an income tax liability at her marginal rate on the £19,212 excess over the annual maximum of £40,000.

This could mean a liability at 40% on £19,212, £7,685, quite apart from tax and NIC on the extra salary, which might be at 42%, £3,360.

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### Anne's example continued.

So the total tax and NIC could be £11,045 as a result of an extra £8,000 salary.

If Anne's salary increase were instead from £152,000 to £162,000, her pension fund would have increased from 24/60ths of £152,000 x 16 = £996,147 (after indexation) to 25/60ths of £162,000 x 16 = £1.08m, making her pension inputs for the year £83,853.

Unless her pension inputs in the preceding three years fell short of the annual maximum, she would have an income tax liability at her marginal rate on the excess over her annual allowance (still of £40,000), £43,853.

Assuming her marginal rate to be 45%, this is £19,734. This is in addition to tax and NIC at up at 47% on her £10,000 pay increase.

A £10,000 salary increase could therefore result in total extra tax and NIC of £24,434.

It is these sorts of results that have led to recent press reports of medical consultants refusing to do extra work. The Government was proposing to deal with this by permitting the affected employees to reduce their pension inputs. It is notable that Anne's pension fund in this example is already more than the current lifetime maximum, increasing the tax liability on the pension fund when she is able to draw the benefits.

### The lifetime allowance explained

The lifetime allowance has varied since 6 April 2006 as you can see from this table on the right. It is subject to transitional provisions as described on pages 5 and 6.

The lifetime limit will apply on or after reaching pension age and a 'benefit crystallisation event' [generally, but not invariably on drawing benefits]. A single factor is adopted for valuing defined benefits against the lifetime allowance – it is 20:1 at all ages.

If the pension fund exceeds the lifetime allowance, the excess will be subject to a lifetime allowance charge at 55% if it is drawn as a lump sum, and 25% if it is retained in the scheme or paid as income.

So, if the excess is £20,000 and is to be paid as income, the lifetime allowance charge would be £5,000 and the remaining £15,000 would be subject to tax at the recipient's marginal rate. If that is 40% the amount received after tax would be £9,000, reflecting a combined tax rate of 55%.

| Lifetime Allowance (£) | |
|---|---|
| 2006/07 | 1,500,000 |
| 2007/08 | 1,600,000 |
| 2008/09 | 1,650,000 |
| 2009/10 | 1,750,000 |
| 2010/11 | 1,800,000 |
| 2011/12 | 1,800,000 |
| 2012/13 | 1,500,000 |
| 2013/14 | 1,500,000 |
| 2014/15 | 1,250,000 |
| 2015/16 | 1,250,000 |
| 2016/17 | 1,000,000 |
| 2017/18 | 1,000,000 |
| 2018/19 | 1,030,000 |
| 2019/20 | 1,055,000 |
| 2020/21 | 1,073,100 |

### Flexible drawdown for defined contribution schemes

From April 2015 the previous flexible drawdown regime introduced in 2011 was replaced by 'flexi-access'.

A member of a defined contributions pension scheme (also known as 'money purchase schemes'), may, from age 55, access as much as he or she wants, under the 'pensions flexibility' rules.

Schemes don't have to offer these options. However, it may be possible to transfer the pension fund to a provider that offers these options.

Once benefits have been flexibly accessed [which isn't available for defined benefit schemes], the annual allowance is reduced to £4,000 (for that pension scheme), [£10,000 before 6 April 2017].

Benefits may be accessed in a number of different ways...

### Accessing the benefits

**Lump sum payment –** Money may be drawn direct from a pension pot without having to buy an annuity or put the money into drawdown, and 25% of this sum will be tax free. The other 75% will be taxed as income. This is an 'uncrystallised funds pension lump sum' (UFPLS).

**Lifetime annuity –** Some or all of the pension funds may be used to buy an annuity, perhaps after taking a tax-free lump sum of up to 25% of the pension pot. This is a pension commencement lump sum.

**Flexi-access drawdown –** Funds may be put into a drawdown fund. Since 6 April 2015 there are no limits on how much or how little may be taken from a drawdown fund each year. A tax free pension commencement lump sum of

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up to 25% of the pension fund may be drawn at the outset. Any other drawdown payments are taxed as income. Benefits may be taken by purchasing short term annuities. These are paid by insurance companies at least annually and for no more than 5 years.

**For defined benefit (final salary) schemes-** if the pension funds do not exceed the lifetime allowance, the whole fund may be taken as a lump sum, of which 75% will be taxable. People in serious ill health who have a severely reduced life expectancy may draw the whole of their pension funds, if no more than the lifetime limit, as a lump sum, which is tax-free if the member is under 75.

**Inheritance tax** is not charged on drawdown pension funds remaining except where pension scheme trustees have no discretion with regard to the distribution of lump sums after the member's death.

## Death benefits

On the death of a member under the age of 75, before drawing pension benefits, a scheme may pay a lump sum which is free of tax.

On death after the age of 75, a lump sum will be subject to tax at the recipient's marginal rate.

As noted above, there is not normally an inheritance tax liability on pension funds at death.

## Overseas pension schemes

Changes made to the legislation covering pensions savings in overseas schemes brought them in line with the 2015 changes to UK registered pension schemes.

These changes affect:

- **qualifying recognised overseas pension scheme** (QROPS) – schemes that can receive transfers from registered pension schemes as authorised payments
- **currently relieved non-UK pension schemes** – where UK tax relief has been given on or after 6 April 2006 in respect of pension savings under the scheme

Collectively, these schemes are known as 'relevant non-UK schemes' and will be subject to the same rules as UK registered pension schemes.

## Employer-Financed Retirement Benefit Schemes (EFRBS)

Unapproved Schemes - FURBS (funded unapproved retirement benefit schemes) and UURBS (unfunded unapproved retirement benefit schemes) do not receive tax-favoured status. They are now referred to as Employer-Financed Retirement Benefit Schemes (EFRBS).

As any future retirement provision made through the equivalent of unapproved pension schemes does not attract any specific tax privilege, amounts saved in any such scheme are not tested against the annual and lifetime allowances and the recovery charge does not apply to them.

For unfunded schemes the value of the promise to pay a pension on retirement will not be taken into account when considering the annual allowance and will not be tested against the lifetime allowance.

When benefits are paid out, whether by lump sum or pension, they will be fully subject to tax at the member's marginal rate.

- Contributions by an employer to an EFRBS will not result in a tax charge on the employee or be liable to National Insurance Contributions (NICs), but nor will the employer get any deduction for his contributions until benefits start to be paid to the employee.
- An EFRBS is subject to tax on its income and capital gains.
- Benefits paid out by the EFRBS will be liable to income tax within the general taxation provisions, subject to transitional protection.
- Benefits paid out by the EFRBS will not be subject to employers' or employees' NICs if the benefits are consistent with the general benefit rules for an approved scheme.
- An EFRBS has no inheritance tax-favoured status, subject to transitional protection.

### Transitional protection for EFRBS – points to note

- A tax-free lump sum may be taken from an EFRBS if the scheme started before December 1993 and it has not been varied subsequently, or all of the scheme's income and gains have been taxable and no contributions have been made since 5 April 2006. Otherwise a lump sum is only tax-free to the extent that it doesn't exceed the amount of employer contributions made before 6 April 2006 and any employee contributions. In either case this is conditional on the employee having been taxed on the employer's contributions as they were made.
- Amounts in a FURBS at 5 April 2006 continue to retain their previous inheritance tax treatment. Where additional contributions are made after 5 April 2006, funds will be apportioned.
- Any UURBS in place on the day before 6 April 2006 could have been consolidated and rolled into a registered scheme before 6 July 2006. The increase in value of benefits in the registered scheme caused by the incorporation of the UURBS did not count towards the annual allowance but will be tested against the lifetime allowance when vested.
- A UURBS consolidated and rolled into a registered scheme at any other time will count towards both the annual allowance and the lifetime allowance.
- Previously approved schemes had the choice of opting out of the new regime at 5 April 2006.

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### Employer-Financed Retirement Benefit Schemes (EFRBS) continued

Where they did so, the new regime imposed a 40% tax charge on fund assets immediately before opt-out. This charge was to recover the tax relief originally given. Funds withdrawn from the opted-out scheme after 5 April 2006 are subject to tax and NIC, with no entitlement to a tax-free lump sum.

### Surpluses

Because benefits will be unlimited (albeit with a varying tax burden), the concept of surplus falls away almost entirely in defined contribution schemes. However, a surplus could arise for defined benefit schemes. Department for Work and Pensions (DWP) rules will be relied on to determine when a surplus arises in a defined benefit scheme. When a surplus is paid to an employer, there is a tax charge of 35%.

### Investment

There is a single set of investment rules. They were to be simple, flexible and impose as few restrictions as are compatible with prudent standards. As originally envisaged, the new regime would, subject to DWP requirements, have allowed pension schemes to invest in all types of investments, including residential property.

However, the Government, seemingly swayed by Press comments that misunderstood the tax position, imposed restrictions on certain investments made by 'self-directed' pension schemes such as self-invested personal pension schemes (SIPPS) by imposing tax charges on any such investment.

Those affected are investments made directly or indirectly in residential property or 'tangible movable property'.

### For all schemes

- There is a limit for shareholdings in the sponsoring employer and associated/connected companies of 5% of fund value.
- Loans to members are not allowed.
- Loans to employers, other than in the form of bonds issued on the open market, must be secured as a first charge on assets that are and will remain of at least equal value to the face value of the loan, have an interest rate at least equal to the Corporation Tax SA rate up to the normal due date, not last for more than 5 years, not be more than 50% of the value of the fund at the date the loan is taken out, and be repaid either by equal annual instalments of capital or by equal annual instalments.
- Scheme borrowing will be limited to 50% of scheme assets at the date the loan is taken out.

The minimum retirement age is 55, subject to an exception for ill health retirement (it will rise to 57 from 2028). This applies even to those such as certain professional sportsmen whose retirement age is lower than 50. But the Government allows people in pension schemes at A-Day with a low normal retirement age to keep their existing rights to take benefits early, but subject to two conditions

1. the pension will be tested against a reduced lifetime allowance
2. the full pension must be vested.

A reduction of 2.5% will be applied to the lifetime allowance for each year before 55 that the pension is taken.

### An example

A pension taken at age 35 would reduce the lifetime allowance of that individual by 50%. The pension fund would therefore be valued against 50% of the prevailing lifetime allowance. 50% of the lifetime allowance would remain unused and could be carried forward for use in determining the amount of any further tax-privileged savings that could be built up.

The reductions in the lifetime allowance are not to apply to members of the armed forces and police and fire services. Deferred and active pension scheme members at on 6 April 2006 with a contractual right to draw a pension after 50 have that right protected, so long as that right was extant at 10 December 2003.

## Further information

### Transitional position for those affected by the reductions in the lifetime allowance – implications of 6 April 2006 on pension funds.

### Primary protection

Where an individual had pension funds valued in excess of £1.5 million at 6 April 2006 he or she could have given notice of his intention to rely on that value by 5 April 2009 from defined contribution schemes. Values registered are expressed as a percentage of the statutory lifetime allowance. For example, for someone who had a fund of £2.25 million at A-Day, the percentage will be 150%.

By expressing the 6 April 2006 value in percentage terms, the value will be automatically indexed in parallel with the change in the lifetime allowance. When the pension vests, the individual can take benefits, in this example up to 150% of the value of the statutory lifetime allowance in that year, without incurring any tax liability under the recovery charge.

### Enhanced protection

There was an alternative approach for the protection of pre 6 April 2006 pension funds against the recovery charge.

This is available for those who, before that date, stopped contributing to their pension funds. This is not restricted to individuals with pension values exceeding £1.5 million. Under this alternative approach all increases after 6 April 2006 in the value of pension funds and benefit rights accrued before that date are protected from the recovery charge. Notice of an intention to rely on this protection had to be given by 5 April 2009.

Anyone who has taken the alternative approach may resume active membership of a pension scheme any time before they reach age 75. For those who resume active scheme membership, protection from the recovery charge will be determined by their pension value on 6 April 2006.

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## Enhanced protection continued

For those whose pension value did not exceed £1.5 million, their personal lifetime allowance will be 100% of the lifetime allowance.

For those who registered pension values exceeding £1.5 million, their personal lifetime allowance will revert to the percentage of the lifetime allowance which corresponded to the value of their pre A-Day fund.

Those who registered funds in excess of £1.5 million at A-Day will also protect any tax-free lump sum entitlement over £375,000. After 6 April 2006 they can take the amount of the lump sum rights up to 5 April 2006 increased to the same extent as the increase in the lifetime allowance.

People who retain enhanced protection from the recovery charge can take 25% of the pension value vesting after 6 April 2006 as a tax-free lump sum.

On 6 April 2006 some members of occupational schemes, who had not registered for transitional protection, will have been entitled to a tax-free lump sum in excess of 25% of the value of their pension benefit. At vesting they will be able to take the tax free lump sum to which they were entitled on 6 April 2006, increased to the same extent as the increase in the lifetime allowance to the date of vesting.

Pensions already in payment on 6 April 2006 were treated as having used up part of an individual's lifetime allowance where, after A-Day, the individual has a new benefit coming into payment. The factor for valuing such pensions is 25:1.

Where income is being drawn from a pension fund under an income drawdown arrangement, the annual level of the pension in payment is deemed to be the maximum permitted annual income determined at the most recent valuation of the member's fund.

**Fixed protection 2012** could be claimed by 5 April 2012 by those without existing protection, to secure a lifetime allowance of £1.8 million, provided that there are no pension inputs after 5 April 2012.

**Fixed Protection 2014** could be claimed by 5 April 2014 by those without existing protection, to secure a lifetime allowance of £1.5 million, provided that there are no pension inputs after 5 April 2014.

**Individual Protection 2014** could be claimed before 6 April 2017 by those whose pension funds exceeded £1.25m at 5 April 2014, so that their lifetime limit is equal to the value of their pension funds at that date, but with a maximum of £1.5m.

**Fixed protection 2016** may be claimed at any time before benefits are taken and after obtaining an HMRC allocation number. The member will have a protected lifetime allowance of £1.25m provided that there are no pension inputs on or after that date.

**Individual protection 2016** also may be claimed at any time before benefits are taken and after obtaining an HMRC allocation number. It protects the value of the member's pensions in payment as at 5 April 2016 plus their pension savings not yet taken, if they exceed £1m; to a maximum of £1.25m.

Those whose transitional protection depends on having no further pension inputs need to be alert to the possibility of involuntary contributions following auto enrolment in a workplace pension scheme.

## Tax relief for pensions advice

Since 6 April 2017, up to £500 may be drawn tax-free from an individual's pension fund during their lifetime.

It can be used a total of three times, only once in a tax year, allowing people to access retirement advice at different stages of their lives (for example when first choosing pension or just prior to retirement).

- It will be available at any age, allowing people of all ages to engage with retirement planning
- It can be redeemed against the cost of regulated financial advice, including 'robo advice' (online advice) as well as traditional face-to-face advice
- It must be paid direct to the adviser
- It will be available to holders of defined contribution pensions and hybrid pensions with a defined contribution element, not defined benefit or final salary type schemes.

This is in addition to the tax-free allowance of up to £500 that employers may give their employees for pensions advice after 5 April 2017.

### Can we help?

**If you need advice on the latest tax implications of your pension arrangements, please speak with your Shipleys contact or one of our specialists.**



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