PENSION CONTRIBUTIONS: THE BASIC RULES

APRIL 2025

Contributions into a pension attract **extremely valuable tax benefits**, and so there are a whole raft of rules which put an **upper limit** on the amount of tax relief you can receive. To avoid penalties on excess contributions, you should understand what levels of contribution are allowable **before** making them. If you are unsure, we recommend you take advice to ensure you are maximising the benefits available to you.

With the **removal of the Lifetime Allowance regime**, the rules have become somewhat simpler. However, pensions legislation is seemingly ever changing, and you should be aware of the possibility of reintroduction, or alternative change, in the future.

This note looks in detail at the rules governing **how much** you can save into a pension. Please see our separate Planning Note on Pension Withdrawals, which covers the restrictions and tax involved in taking money out of pensions.

SUMMARY

Pension contributions are generally the first port of call for anyone saving for income in retirement, offering several tax benefits:

- Income tax relief is received on contributions
- Growth on the fund is largely tax-free
- Up to 25% of the fund can be taken as a tax-free lump sum on retirement (up to the Lump Sum Allowance which for most people is £268,275)
- On death, any unused fund can be passed on free from Inheritance Tax (and sometimes free from income tax as well). This applies only until Apr27, with IHT due to be imposed after that date.

Although there is technically no limit on the level of pension contribution you are allowed to make, in practice there are two main sets of rules which cap the level of tax relief available:

- Your **UK relevant earnings** for the tax year in which you make the contribution
- Your available **Annual Allowance** for that tax year, including carry forward.

Employers may also make pension contributions as part of your overall remuneration (including that made via salary sacrifice). These do not attract personal tax relief (although the company may be able to claim these as a deductible expense for themselves), and so do not come into this first set of rules. However, **employer contributions do count towards the Annual Allowance** and so cannot be ignored when you decide what level of personal contributions you can make.

The operation of the income tax relief available is covered below. Essentially, the pension contribution gives you **income tax relief at your highest marginal rate**, within the two rules above. This can be especially attractive where you anticipate paying a lower rate of tax in retirement, or are effectively removing income from one of the tax trap bands such as the loss of the Personal Allowance. However, the possibility of up to 25% tax-free cash on withdrawals means that the tax relief can be valuable even where the tax rate going in will be the same as coming out of a pension. A further benefit of pensions is the tax-free growth and income available on investment returns whilst the funds are within the pension wrapper.

Recent years have seen a **myriad of changes** in the world of pensions, and there is no sense that these are over. For larger contributions, or those with higher incomes, consultation with an adviser is recommended to ensure that maximum tax efficiency is achieved. Please note that this Research Note concentrates on the main types of modern pension schemes; if you have queries regarding a SSAS, UURBS, FURBS, s615 plan etc., please contact your usual adviser.

When considering making pension contributions, there is **no longer a Lifetime Allowance to consider** on the total value of pension funds. However, if you have elected for protection from the Lifetime Allowance since 15 March 2023, or have any tax-free cash entitlement greater than 25%, please contact your adviser with any queries. **This Note assumes no such pensions protection applies**. Those who had applied for lifetime allowance protection prior to 15 March 2023 are once again allowed to make pension contributions, without losing this protection (which remains relevant for potentially enhanced levels of tax-free cash and death benefit payments, as covered in our separate note on Pension Withdrawals).

LIMITS ON TAX RELIEF

There is actually no limit on the annual or lifetime level of pensions contributions.

However, there is a limit on the contributions which are eligible for personal income tax relief, and in practice you will want to remain within this limit. All contributions made by (or on behalf of) an individual in a tax year are included, and the level of tax relief is restricted to the **lower** of two figures:

- **100% of UK relevant earnings, or £3,600 where earnings are less than this**. This figure includes employment income, trading income and taxable benefits in kind
- **Your available Annual Allowance**. This can be increased with carry forward, but can also be reduced for higher earners or where flexible pension income has already been taken

EMPLOYER CONTRIBUTIONS

Employer contributions to your pension only count towards use of the Annual Allowance. They can be made to an individual's pension scheme **without reference to the level of earnings** (different restrictions apply for the company to be able to deduct these as employment expenses for corporation tax). Please note that pension contributions via salary sacrifice are technically employer contributions, not your own personal contributions.

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LIMITS ON TAX RELIEF

ANNUAL ALLOWANCE

The 'standard' Annual Allowance is currently £60,000.

This limits the amount of tax relief that is effectively available for individuals with higher earnings who wish to make larger contributions. The Annual Allowance applies to the total of all contributions made, whether individual, third party or employer, and so it also places a cap on the level of employer contributions which can effectively be made.

Contributions above the available Allowance will usually suffer a tax charge equivalent to the income tax which would have otherwise been paid. This can be paid directly or in certain circumstances payment can be made via the scheme.

For current members of **final salary schemes**, a single conversion factor of 16:1 is used to determine the value of the annual increase in pension. The opening value, for this purpose, is increased in line with the 12 month increase in CPI for the September preceding the relevant tax year. For deferred members of final salary schemes, increases up to the greater of 5% and RPI (or more for GMP rights) each year are ignored for this purpose. The value of the increase in pension, less any personal contributions (not made by salary sacrifice), is considered to be an employer contribution.

The annual allowance does not apply in the year of benefit crystallisation due to serious ill health or death of the member.

LIMITS ON TAX RELIEF

ANNUAL ALLOWANCE

CARRY FORWARD

Carry forward allows any unused Annual Allowance (but not the Money Purchase Annual Allowance detailed below) to be carried forward for the following three tax years. This is provided the individual has been a member of a pension scheme in that time. Carry forward works on a rolling basis rather than the average of the three years (i.e. each year's carry forward is calculated discretely, oldest year first). For example:

	Annual Allowance	Pension Contributions	Unused Current Year Allowance (excess)	Unused Balance Carried Forward
2022/23	£40,000	£10,000	£30,000	£30,000
2023/24	£60,000	£80,000	(£20,000)	£10,000
2024/25	£60,000	£30,000	£30,000	£40,000

In the example above, the annual allowance for 2025/26 would therefore be £100,000 (£40,000 carried forward plus the £60,000 current year allowance).

MONEY PURCHASE ANNUAL ALLOWANCE (MPAA)

A more restrictive Money Purchase Annual Allowance of £10,000 applies for any individuals who have taken flexible income, from the point at which this is taken (not the whole tax year) and applying only to money purchase (or defined contribution) pension contributions. 'Flexible' income includes income from Flexi Access Drawdown (or above the GAD limit for capped drawdown, or for those previously in flexible drawdown); withdrawals of an Uncrystallised Funds Pension Lump Sum; and income via a flexible lifetime annuity. Any unused MPAA cannot be carried forward.

LIMITS ON TAX RELIEF

ANNUAL ALLOWANCE

TAPERED ANNUAL ALLOWANCE FOR HIGHER EARNERS

The annual allowance for those with 'adjusted income' over £260,000 is subject to a taper. For those affected, the standard annual allowance of £60,000 is reduced by £1 for every £2 that 'adjusted total income' exceeds £260,000, down to a base level of £10,000. Prior years have differing levels of restriction.

The 'higher earner' designation applies to those who have income, including the value of pension contributions, of over £260,000, and also income excluding pension contributions of over £200,000 (this is so lower earners with one-off spikes in pension contributions are less likely to be affected).

Both tests start with the concept of '**net income**'. This includes all taxable income – including earned, investment, rental, and pension income, relevant state benefits, and benefits in kind. Deducted from this figure are any payments into a company net pay scheme (these payments are made out of gross income), or trading losses and other tax reliefs.

The first rule tests whether your '**adjusted income**' for the year exceeds £260,000. The calculation takes your net income as above, adds back any employer pension contributions or pension contributions made for you that haven't received tax relief (e.g. because someone else made them, or the scheme is a net pay scheme), and deducts any taxed lump sum death benefits received.

The second rule tests whether your '**threshold income**' for the year exceeds £200,000. Again, the calculation starts with your net income as above, and then deducts member pension contributions to 'relief at source' schemes (where payments are made net of basic rate tax), adds back employment income given up via salary sacrifice or flexible remuneration (arrangements on or after 9.7.15) and again deducts any taxed lump sum death benefits received.

LIMITS ON TAX RELIEF

ANNUAL ALLOWANCE

TAPERED ANNUAL ALLOWANCE FOR HIGHER EARNERS

	Adjusted Total Income		Threshold Income
Start with	Net Income (total income from all sources LESS net pay scheme contributions and tax reliefs)		Net Income (total income from all sources LESS net pay scheme contributions and tax reliefs)
Add	+		+
	Net Pay Scheme – member pension contributions Employer Contributions – to both money purchase and defined benefit schemes		Employment income given up under salary sacrifice/flexible remuneration – arrangements set up on or after 9.7.15
Deduct	-		-
	Taxable Lump Sum Death Benefit (gross)		Relief At Source – gross member pension contributions Taxable Lump Sum Death Benefit (gross)
	=		=
Taper Applies If	Result over £260,000	**AND**	Result over £200,000

Notes:

- '**Net Pay Scheme**' = pension contribution collected before PAYE applied, so full tax relief given at source. Most company pensions and old s226 operate in this way.
- '**Relief at Source**' = pension contribution made out of taxed income, and made net of basic rate tax. Higher/additional tax relief claimed via self-assessment. Most group or personal pensions operate in this way.

LIMITS ON TAX RELIEF

ANNUAL ALLOWANCE

TAPERED ANNUAL ALLOWANCE FOR HIGHER EARNERS

Contributions need to be made during the tax year of earnings, and so those affected need to be very clear on their exact level of final earnings during the year when making pensions contributions. This may not be particularly easy to do, for example when including year-end bonuses or if self-employed. You may wish to err on the side of caution, taking the risk of underfunding your pension and then using carry forward, rather than face an annual allowance charge for exceeding your annual allowance.

OPERATION OF TAX RELIEF

Pension contributions made within the relevant limits are eligible for tax relief at your highest marginal rate of income tax. The way in which this tax relief is given depends upon the type of pension scheme used.

RELIEF AT SOURCE

Most Personal Pensions (and some Occupational Schemes) operate on a Relief at Source basis. **Here, your pension contribution is boosted by a basic rate tax credit from the government**. The total of these two amounts is the **gross** contribution. Some schemes credit you with this straight away, others wait several weeks until it has been received from the government. If you pay tax at a higher or additional rate, it is important that you also **claim this extra tax relief** (via self-assessment or stand-alone claim).

*For example, if you pay £80 into your pension, the pension provider will top this up by £20 (which is the 20% basic rate tax relief they claim from the government). The total **gross** pension contribution is £100. If, for example, you are an English/Welsh higher rate tax payer, you could claim another 20% or £20 tax relief, bringing the overall net cost to you down to £60.*

OPERATION OF TAX RELIEF

RELIEF AT SOURCE

The basic rate tax credit is available for **all** payments into these schemes, even where you haven't actually paid this tax. **This means that those who have no earnings can still make tax efficient pension contributions up to the maximum level of £3,600 gross, with a net payment of £2,880**. This is a particularly useful facility to help non-earning spouses, children or grandchildren build up pension savings.

In your income tax calculation, the mechanism by which the higher and additional rate relief is given is by adding the amount of the gross pension contribution to your basic rate band. This means more of your income is subject to basic rate tax, rather than your highest rate of tax. **The actual level of tax relief given will depend upon the difference between the tax band the income would have fallen into, and the basic rate band**. So for higher rate taxpayers in England and Wales, this gives a further 20% relief, for additional rate taxpayers (or where dividend income is the top slice of taxable income) this gives a further 25% relief.

The effective tax relief can be even greater where the income would otherwise have fallen into a **tax-trap band such as the loss of the personal allowance above £100,000 or the High Income Child Benefit Charge, where effective tax rates can be 60% and above**.

Scottish rates of relief will be given according to the Scottish rates of income tax, but the mechanism is the same.

NET PAY

Some Occupational Schemes/Group Personal Pensions will instead operate a net pay system, where the **payment is taken from the individual's pay before tax is applied, and in this way full income tax relief is given immediately for basic taxpayers and those who pay tax at a higher rate**. However, those with earnings below the Personal Allowance **do not** necessarily benefit here from the same level of tax relief they would otherwise have done using a Relief at Source scheme, and so may end up out of pocket. To address this anomaly, HMRC are due to start making payments to those affected from April 2025, in respect of the 2024/25 tax year.

OPERATION OF TAX RELIEF

SALARY SACRIFICE

Although not in themselves a form of pension tax relief, salary sacrifice arrangements are frequently offered by employers to enhance workplace pension benefits. **A salary sacrifice arrangement involves an employee agreeing to give up an amount of their cash pay, in return for non-cash benefits provided by the employer**. These can cover a range of workplace benefits, but very commonly include pensions and childcare vouchers.

The addition of National Insurance savings to income tax savings, mean that salary sacrifice arrangements can offer an even greater overall tax saving than stand-alone personal pension contributions, or personal contributions via a workplace pension. You should always check that you are making full use of any such offer, before making personal contributions.

With salary sacrifice into pension, the employee agrees to reduce their pay by a certain amount, thus saving both the income tax and employee National Insurance which they would otherwise have suffered on that amount.

The employer then offers to put the equivalent amount into the employee's workplace pension scheme as an employer contribution. Note that employer contributions are still included under the Annual Allowance rules. The employer also saves the employer National Insurance they would otherwise have paid, and so frequently offer to boost the contribution by some or all of that saving. A common arrangement is to split the saving, meaning an additional boost of around 6% to 8%.

There are some caveats to using a salary sacrifice arrangement, in that take-home pay cannot be reduced below National Minimum Wage and care should be taken that entitlement to benefits and statutory rights are not affected. Salary sacrifice arrangements also reduce the pay figure used in other areas, for example for student loan calculations and mortgage applications, and so may increase a student loan repayment period or decrease a mortgage offer.

BENEFIT OF TAX RELIEF

Even ignoring the potentially enormous benefit of largely tax-free growth over decades, the table below shows the enormous uplift potentially given by the initial income tax relief, and 25% tax free cash where available.
The tax-free cash amount is limited by the maximum Lump Sum Allowance of £268,275 (or your own transitional amount if pension protection applies). Even if you have no LSA left, you can see that pension saving still offers tax benefits, especially if you may be paying tax at a lower rate when you retire. Of course, if you might, unusually, be paying a higher rate of tax in retirement then you should consider carefully in all cases.

For example: If you are a higher rate taxpayer when making pension contributions, and a basic rate taxpayer in retirement, your savings would benefit from a massive 41.67% boost from the tax advantages afforded to pensions. This includes the relief received at source, and the additional relief claimed via your tax return.

For those where even higher effective tax relief could apply (e.g. where effective rate tax traps are avoided as above), the benefits can be even greater.

Taxpayer Rate		Boost to Net Contribution	
When Contributing	**When Taking Withdrawals**	**With LSA (25% tax-free cash)**	**Without LSA (no tax-free cash)**
Basic rate (20%)	Basic rate (20%)	6.25%	-
Higher rate (40%)	Basic rate (20%)	41.67%	33.33%
Higher rate (40%)	Higher rate (40%)	16.67%	-
Additional rate (45%)	Higher rate (40%)	27.27%	9.09%
Additional rate (45%)	Additional rate (45%)	20.45%	-

Note: Ignoring the additional benefit of tax-free growth for the period invested, and based on current tax rates and legislation, which are subject to change. England & Wales only, the rates and 'net boost to savings' are different if you are resident in Scotland.

ELIGIBILITY

Tax relief can be claimed on pension contributions up to age 75 made by 'relevant UK individuals'. These are generally those who:

- Have relevant UK earnings chargeable to income tax in that tax year, or
- Are resident in the UK for some part of that tax year, or
- Were UK resident both at some time in the five years preceding the tax year when the contribution is made, and were also UK resident when they became a member of the scheme. Only relief at source is available in this instance and is limited to contributions up to £3,600 per tax year.

Any individual not satisfying these requirements can make unlimited personal contributions, but will not receive any UK tax relief.

PENSION INVESTMENTS

Another major benefit of investing within a pension is that all income and growth within the wrapper is free from income and capital gains tax. The pension itself is simply a tax wrapper, and the investment choices to be made within the wrapper are the same as for any other type of investment. Of course, the investment timescale may be long (given that there is a minimum age for withdrawals) and so the level of risk able to be tolerated may be higher than for shorter-term investments. The choice of pension wrapper should include consideration of charges, choice of underlying investments, and quality of administration. In addition, not all pensions offer full flexibility of death benefits, as covered in our separate Note on Pension Death Benefits.

The types of investments permitted within pension schemes are relatively unrestricted, although punitive tax charges make investments in 'personalised assets' such as residential property, fine art, wines etc. unattractive. The other main controls concern loans made from the scheme to a member or employer, investments in a sponsoring employer (for a workplace pension or group personal pension this is restricted to 5% of scheme assets), and scheme borrowings (no more than 50% of net fund value). Dealing between schemes and members is now allowed, but only on an arm's length basis.

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INDIVIDUAL RESPONSIBILITY

The onus is on each individual to make the appropriate submissions to HMRC, e.g. reporting use of the annual allowance and personal contributions through the self-assessment return. Individuals therefore need to keep thorough records of pension contributions and benefits.

SCHEME RULES

Please note that the above outlines the general HMRC rules within which registered pension schemes can operate. Individual schemes may have more restrictive rules applying, and so individuals should also check their scheme booklet and with scheme administrators before taking any action.

Important Information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested. This document is provided for information only and does not constitute advice. You should not act on any of the information without seeking professional advice.