RULES ON SAVING INTO PENSIONS

APRIL 2023

Pension savings offer an **extremely valuable tax benefit**, and so there are a whole raft of rules which put an **upper limit** on the amount of tax relief you can receive. These rules are, of course, not simple, and you should be very careful that you understand what levels of contribution are allowable **before** making them.

With the recent announcement of the **removal of the Lifetime Allowance charge**, the rules may become a little 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. This area can be complex, and if you are at all unsure, we recommend you take advice to ensure you are maximising the benefits available to you.

SUMMARY

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 to be recommended to ensure that maximum tax efficiency is achieved. Please note that this Research Note concentrates on the main types of pension schemes; if you have queries regarding a SSAS, UURBS, FURBS, s615 plan etc., please contact your usual adviser.

For those who have elected for any form of protection from the lifetime allowance, or who have tax-free cash entitlements greater than 25%, please contact your adviser with any queries. **The details below assume no such protection applies**.

When considering making pension contributions, two factors may need to be considered in conjunction: the total amount of tax-relieved pension funds that can be built up during a **lifetime** (perhaps less relevant now); and also the level of contribution that is eligible for tax relief in **any single year**.

LIFETIME ALLOWANCE (LTA)

It is the government's intention that the lifetime allowance test be removed completely from April 2024, with no charge for exceeding the lifetime allowance from April 2023. Future governments may, however, seek to reverse this change. The details below therefore outline the current position (23/24) but may be subject to future change.

Each individual has a maximum total pension fund that they can accumulate in their lifetime, and from April 2023, the **charge for exceeding this maximum is a zero percent charge, i.e. effectively nil**. However, the lifetime allowance calculations and documentation will still take place during 2023/24, perhaps being removed from April 2024 should the legislation be enacted for this in time.

The lifetime allowance is tested at the point of taking any benefits from a pension scheme or age 75 if sooner. This lifetime allowance is £1,073,100 (frozen until 5.4.26). The limit remains subject to change up or down by the government of the time, and has been reduced greatly from the £1.8m peak in 2011/12.

Any excess funds above the LTA when benefits are taken are subject to a lifetime allowance charge. From April 2023, this is a 0% charge, with any excess taken out of the pension fund taxable to income tax at marginal rates.

ANNUAL ALLOWANCE (AA)

An individual (or third party on behalf of the individual) can usually contribute up to the **greater of 100% of the individual's 'relevant earnings', or £3,600, into a pension scheme in a tax year**, with the member receiving tax relief on these contributions.

Most Personal Pensions (and some Occupational Schemes) give **basic rate relief at source**, i.e. the actual amount the individual would pay in to the pension would be the gross amount less basic rate tax. Any **higher rate relief** then due is given via **self-assessment or claim**. 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 tax relief is given at source for basic taxpayers and those who pay tax at a higher rate.

Additionally, **employer contributions** 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).

However, the '**annual allowance**' limits the amount of tax relief that is effectively available for individuals with higher earnings, or employers, who wish to make larger contributions. This applies to the total of all contributions made, whether individual, third party or employer. The 'standard' annual allowance for 2023/24 is **£60,000**. Contributions in excess of the available allowance will usually suffer a tax charge.

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 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); who have received an Uncrystallised Funds Pension Lump Sum; or who are in receipt of a flexible lifetime annuity.

CARRY FORWARD

A carry forward facility is available (**not applicable for the Money Purchase Annual Allowance** of £10,000), which will enable any unused annual allowance to be carried forward for the following three tax years (provided the individual has been a member of a pension scheme in that time). This will work 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
2020/21	£40,000	£10,000	£30,000	£30,000
2021/22	£40,000	£60,000	(£20,000)	£10,000
2022/23	£40,000	£30,000	£10,000	£20,000

In the example above, the annual allowance for 2023/24 would therefore be £80,000 (£20,000 carried forward plus the £60,000 current year allowance).

Any contribution above the annual allowance is subject to a tax charge on the member which will effectively claw back the tax relief received.

A single conversion factor of 16:1 is used to determine the value of the annual increase in pension for current members of final salary schemes. 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. Contracted-out rebates are also not included.

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

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.

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.

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	-		-
			Relief At Source – gross member pension contributions
	Taxable Lump Sum Death Benefit (gross)		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.

TAPERED ANNUAL ALLOWANCE FOR HIGHER EARNERS

Contributions need to be made during the tax year of earnings, and so individuals 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.

Individuals may wish to err on the side of caution, taking the risk of underfunding their pension and then using carry forward, rather than facing an annual allowance charge for exceeding their annual allowance.

TAX FREE CASH ('PENSION COMMENCEMENT LUMP SUM)

At the time of drawing an income from your pension (i.e. entering an annuity or drawdown pension contract), a tax free cash ('pension commencement lump sum') amount can be taken.

The maximum tax-free cash from any pension arrangement is 25% of the value of the pension rights, subject to the overall maximum of 25% of the lifetime allowance of £1,073,100 = £268,275 (and assuming no pensions protection applies which may confer a higher maximum level).

For money purchase schemes, this is 25% of the fund value. For final salary schemes, the amount is 25% of the total of the lump sum amount (LS) and the final salary pension after commutation (P), valued at a factor of 20 (i.e. 25% x (LS+20P).

The formula to ascertain the maximum lump sum based on pension before commutation is:

$$\frac{\textbf{20 x pension before commutation}}{\textbf{(3+20/commutation factor)}}$$

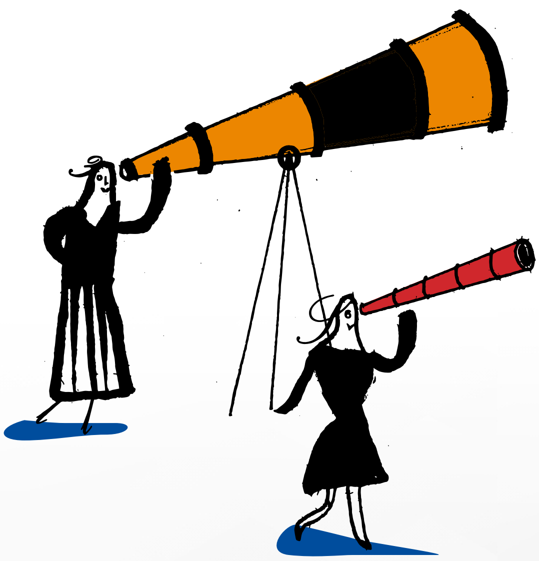
The balance of the funds must be used to provide a taxable income in one of a number of forms.

ELIGIBILITY

'Relevant UK individuals' can claim tax relief on pension contributions up to age 75, and are generally individuals 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. An enhanced lifetime allowance may apply in this case.



RETIREMENT AGE AND DEATH BENEFITS

The minimum pension age is currently 55, increasing to 57 from April 2028. Government proposals are to bring forward the further increase to age 58 from 2039, but are subject to further consultation.There is no maximum age by which you must start taking funds out of a pension, and it can be held throughout your lifetime if no capital or income is required. For occupational scheme members, it is no longer necessary to leave employment to draw benefits. For further details on income choices at retirement please see our separate Research Notes on the subject.

Occupational schemes usually offer a mixture of lump sum and pension death benefits, the amount depending upon the scheme rules. Modern personal pension schemes usually offer a return of the fund value at death. However, individuals with older pensions such as RAPs should be careful to check the policy details, as the death benefit may be only a return of contributions with interest, which may be significantly less than the fund value. In addition, RAPs may not be written under a master trust, and so death benefits may need to be separately written into trust in order that they can be directed to the desired beneficiaries and for IHT purposes.

TAX ON DEATH BENEFITS

For death benefits where an individual **dies before age 75**: any remaining pension fund **within the LTA** (whether in a crystallised or uncrystallised pension), can be paid as a lump sum or income to a nominated beneficiary, **free from income or capital gains tax**. This is also true for pension funds in **excess of the LTA** where the death benefits are paid as **income**. However, an anomaly exists where benefits in excess of the LTA are paid as a **lump sum**, in which case these are taxable at the beneficiaries' marginal income tax rate. This may be addressed in future legislation changes. For joint life or guaranteed term annuities where no payments have been made to the beneficiary before April 2015, the benefits can also be paid tax-free.

For death benefits where an individual **dies after age 75**: any lump sum or income payments will be **taxed at the beneficiary's marginal income tax rate**. Similarly, annuity benefits will also be taxed at the beneficiary's marginal income tax rate.

If funds are inherited as Beneficiary Drawdown, the nominated beneficiary will be able to **retain the benefit** of the tax favoured drawdown pension wrapper around the funds until they need to be withdrawn. If any funds remain unused on their own death, these can be passed on to their own beneficiaries under the same rules. The tax treatment applying at this second death depends upon the beneficiary's own age at death.

Individual scheme rules may restrict the above options, particularly for older schemes, and so should be checked to ensure that the desired flexibilities are allowed. In particular, the advantages of Beneficiaries Drawdown may not be able to be offered unless the beneficiary is either a dependant (e.g. a spouse or minor child), or is specifically named as a nominee on the **expression of wish form**. It is therefore extremely important that the expression of wish is completed and kept up to date.

The following tests still apply during 2023/24, but the LTA charge rate is now set at zero: **A Lifetime Allowance test** is also made on the value of the death benefits, where an individual dies before age 75 and benefits are being paid tax-free, and a LTA charge (at 0%) may therefore be payable if the benefits are in excess of the LTA. The exception to this is where an individual with a drawdown pension dies before age 75 - in this case, the fund has already been tested on moving into drawdown, but any subsequent growth within drawdown is not subject to an LTA test under current legislation.

INVESTMENTS

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 OPS/GPP 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, on an arm's length basis.

SCHEME RULES

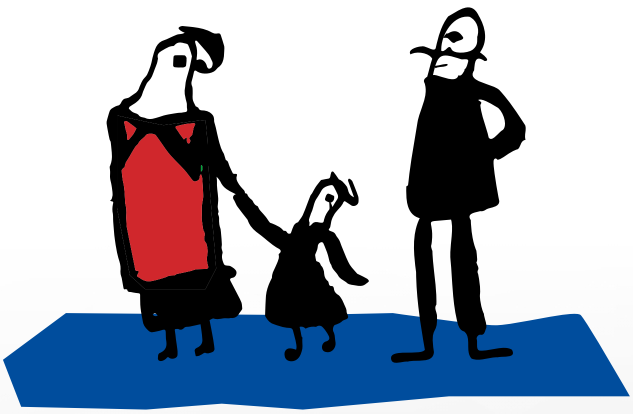
Please note that the above outlines the general HMRC rules within which registered pension schemes can operate.

Individual schemes may have more restrictive rules applying (e.g. occupational schemes may not have amended the scheme rules to allow tax free cash to be taken from AVCs), and so individuals should also check their scheme booklet and with scheme administrators before taking any action.

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.



 |

FIND OUT MORE

If you have any questions about our investment methodology, or would like some financial planning or investment advice, the clarity team are here to help.

Please contact your usual clarity adviser, or get in touch using the details below:

Tel: **+44 800 368 7511**

Email: **enquiries@clarityglobal.com**

Address: **1 Crown Square, Woking, Surrey GU21 6HR**

Web: **clarityglobal.com**

Twitter: **twitter.com/clarityglobal**

Instagram: **instagram.com/clarity_global**

LinkedIn: **linkedin.com/company/clarity_7**

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. 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.

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.