ACUMEN
FINANCIAL PARTNERSHIP LTD

KEY GUIDE

Pensions and tax planning for high earners

The rising tax burden on income

If you find more and more of your income is taxed at over the basic rate, you are not alone. The point at which you start to pay 40% income tax is £41,865 for 2014/15, down from £43,875 in 2010/11. Around 1.4 million people are paying higher rate tax than when the current government came to power in 2010, according to the Institute for Fiscal Studies.

The Chancellor has announced that the threshold will rise to £42,385 in 2015/16, an increase of 1.2% which just matches the rate of inflation. You may also be feeling the impact of the tax on child benefit and you may be subject to the withdrawal of the personal allowance on income over £100,000.

The increased tax burden for higher earners is a deliberate policy, as the 2014 Autumn Statement made clear: "As a result of the government's reforms to tax, welfare and public spending across this parliament, the richest households will make the biggest contribution to reducing the deficit, both in cash terms, and as a proportion of their income." The message is clear: if you want to reduce the amount of tax you pay, then the solution is in your own hands. Thinking and planning ahead could help you to lessen the rising tax burden – and we're here to help.

This guide explores a key tax planning opportunity: making pension contributions. These qualify for tax relief at your highest rate, which may be 40% or 45%. And the effective rate of relief could be even higher – up to 60% or even higher – if your pension contributions help you to avoid the withdrawal of child benefit or your personal allowance.

Focus point

Rumours regularly appear that higher and additional rate relief for contributions will be withdrawn, saving the Treasury an estimated £7 billion a year.

Pensions – less tax now, more income later

The generous tax reliefs successive governments have given to pension arrangements mean that they have long played an important role in tax planning for high earners.

However, in the last six years, increasingly tight restrictions have been placed on these reliefs, just as the rising burden of income tax has made them all the more valuable. The amounts you can pay in and take out without suffering heavy tax charges have been reduced significantly, saving the Treasury an estimated £7 billion a year, but while the reliefs remain, pensions continue to offer significant tax benefits.

The use of pensions in income tax planning is often divided into two areas: pre-retirement and at-retirement. In practice, such a demarcation is an over-simplification because there is often no longer any link between physical retirement – stopping work – and drawing on a pension arrangement. You may draw benefits, notably tax-free lump sums, before retirement and make pension contributions after your working life has ended. In any event, the move between work and retirement is itself often a transition phased over several years rather than a one-off event. Really there are three phases:

- Before age 55 you can pay into a pension but not take anything out unless you are in serious ill health.
- Between age 55 and age 74 you can pay in or draw out (or do both at once), and this gives you real flexibility to manage your income as you move into retirement.
- After the age of 75 it is not currently possible to make pension contributions, but you can still choose to have flexibility in the amounts you draw out each year. From

6 April 2015 all restrictions on what you can withdraw from your pension from age 55 are removed.

Pensions can also play an important role in combatting another tax that may concern you and your family: inheritance tax (IHT). The table below summarises key tax benefits of pensions.

When contributions are made	Within the annual allowance, individual contributions up to the level of your earnings qualify for income tax relief and employer contributions normally reduce taxable profits.
When the pension fund is invested	The scheme pays no tax on investment income or capital gains, although tax deducted from dividend income before it is paid cannot be reclaimed.
When you take your pension benefits	Within the lifetime allowance, a quarter of the value is available as a tax-free lump sum. Income is taxable, but possibly at a lower rate than when you were working.
When you die	From 6 April 2015, if you die before age 75 payments made from your pension fund, whether as lump sums or income, are normally tax-free. This applies whether or not you have started drawing income.

Focus point

The calculation of unused relief and the identification of contributions to tax years can be far from straightforward.

Pre-retirement planning

Your personal contributions to a pension normally qualify for income tax relief at your marginal highest rate(s). Pension contributions reduce your taxable income, so they can help you to avoid the phasing out of the personal allowance, which starts at £100,000 of income, resulting in an effective tax rate of up to 60%. Contributions can also help you to sidestep the additional rate tax band, which starts at £150,000 of taxable income, or the high income child benefit tax charge, which affects those with income over £50,000.

Personal allowances

For example, Esther has income of £112,000 for tax year 2014/15. Her personal allowance is reduced by £1 for every £2 of income over £100,000, meaning she loses £6,000 from her personal allowance. As a higher rate (40%) taxpayer she pays £2,400 on this extra taxable income. If she makes a pension contribution of £12,000 including the tax relief, this reduces her relevant income and she recovers her full annual allowance. In addition, she gets full 40% tax relief on the contribution, amounting to £4,800. This means that the £12,000 contribution actually only costs her £4,800 (£12,000 minus £2,400 minus £4,800). This is equivalent to tax relief of 60%.

You may also need to take child benefit into acccount. For example, James has income of £55,000 for tax year 2014/15. He has two children for whom child benefit is payable, totalling £1,770.60 in the tax year. However, because James has income above £50,000 the high income child benefit charge applies, under which he is charged 1% of the child benefit for every £100 of earnings above £50,000. The charge for James will be 50% of the child benefit, which comes to £885.30. If James pays £5,000 into a pension, he recovers this amount and also gets £2,000 (40% x £5,000) in tax relief. So the cost to him of the pension contribution is £2,114.70 (£5,000 minus £885.30 minus £2,000). This is equivalent to tax relief of 57.7%.

The rules on limits for tax relief are complicated, with yet more changes in April 2014 and April 2015. Contributions, including deemed contributions from an employer's defined benefit scheme (e.g. that provides a pension based on your final salary) must be kept within an annual allowance to avoid tax charges. For the tax years 2014/15 and 2015/16 this annual allowance is £40,000, down from £50,000 in 2013/14. From tax year 2015/16, the maximum contribution to your pensions (excluding any defined benefit schemes) without tax charges may be reduced to £10,000 a year if you have started to receive payments from your pensions. We can provide more details of when this would apply.

Carry forward

There are some special rules that may allow you to catch up on the pension contributions you could have made in the previous three tax years. For example, in 2014/15 you could exploit your unused allowance dating back to 2011/12. This is known as 'carry forward'. It may also be possible to change the dates used when assessing contributions made. The rules are relatively complicated in their application. But, in theory at least, if your earnings are high enough and you have not paid into a pension recently it would be possible to make up to £230,000 of pension contributions in 2014/15 with full tax relief (or £220,000 in 2015/16). If this type of planning could be relevant to you, then please seek our professional advice. Both the calculation of unused relief and the identification of contributions to tax years are often not straightforward.

Focus point

The right structure for retirement benefits is best chosen in the run-up to retirement, but the flexibility available underlines the fact that a retirement income is now about much more than just a fixed annuity.

For example, Elaine has paid £20,000 into her pension in the input periods for each of the three tax years 2011/12, 2012/13 and 2013/14. She is able to carry forward £30,000 (£50,000 minus £20,000) from each of these tax years – a total of £90,000. She can add this to her annual allowance of £40,000 for the input period for tax year 2014/15 and pay in up to £130,000, assuming she has sufficient earnings to qualify for tax relief on the whole amount. By changing her input period, she could also potentially use her annual allowance for 2015/16 in tax year 2014/15 and pay in an additional £40,000 if she wishes to.

Making contributions

Whether or not you wish to maximise your pension contributions, it is well worth taking some trouble with the arrangements for making them. If you are an employee, then you (and your employer) can save national insurance contributions (NICs). The secret is for you to reduce your salary or your bonus, and ask your employer to use the money, including the NIC saving, to make the pension contributions for you. The technical name for this is salary or bonus sacrifice and it is all perfectly legal if you do it correctly. If you pay higher or additional rate income tax, the result could be an increase of nearly 18% in the amount being paid into your pension.

It is not surprising that the well-respected Institute for Fiscal Studies has described the NIC treatment of employer contributions as 'excessively generous.' Even so, salary sacrifice

is not always the right option because it potentially affects your entitlement to state pensions and other benefits, and possibly the maximum you can borrow for a mortgage so, again, advice is necessary.

Salary sacrifice example Tom, who is a 40% taxpayer, agrees with his employer that his salary will reduce by £500 a month. The employer agrees to pay this amount into a pension, plus £69 that would otherwise have been due in employer NICs – a total of £569. If Tom instead used the £500 to pay a pension contribution himself then, allowing for NICs, income tax and tax relief, he would end up with just over £483 in his pension and the same take-home pay. That represents an increase of £86 into the pension at no extra cost to either Tom or his employer.

You should note that this reduction in your salary would not have the same effect as asking your employer to make the contributions on your behalf. Your cash salary will be reduced and replaced with the pension benefit. Before taking this out you should consider the effect this may have on:

- Your ability to borrow money, for example for a mortgage;
- The amount you can contribute to your pension plans, or to this plan if you are taken ill; and
- Your entitlement to redundancy payments and national insurance rebates, state pensions, or other benefits such as statutory maternity pay, working tax credit or child tax credit.

This may also affect other policies you hold, such as some forms of income protection.

Focus point

Early action gives us plenty of time to gather the necessary data on all of your existing arrangements, sometimes a protracted task.

Lifetime allowance As well as the annual allowance, there is also a lifetime allowance (LTA), which sets a ceiling on the total value of your tax-efficient pension benefits. On 6 April 2012 the LTA was cut from £1.8 million to £1.5 million and on 6 April 2014 it fell even further, to £1.25 million. This reduction was accompanied by the introduction of two new transitional protections, known as Fixed Protection 2014 and Individual Protection 2014, allowing you to keep an LTA over £1.25 million.

It is now too late to apply for Fixed Protection 2014, but Individual Protection 2014 is still available. If the total value of all your pensions was over £1.25 million at 5 April 2014 this protection may be relevant to you, and you should get advice about it.

At retirement

When you decide to draw your pension benefits you have to decide the balance between lump sum and income. If you have a personal pension or other defined contribution pension scheme, the chances are that you should take the maximum possible tax-free lump sum, which is normally 25% of your total fund. The remainder is fully taxable. Alternatively, from 6 April 2015 the whole value can be taken as a lump sum, but this may not be advisable from a tax viewpoint.

If you are a member of a defined benefit pension scheme, such as one that pays benefits linked to your final salary, the taxable income could be a better deal than the lump sum. This is because you have to exchange (technically, 'commute') your pension income for cash, and many such schemes commute members' pensions into cash sums at rather ungenerous conversion rates. The pension could be better value in the end even after paying tax on the income.

If maximising the lump sum is the right move, that does not necessarily mean you should draw all of it at once. With modern pension arrangements it is possible to draw benefits in stages, and one option might be to supplement your income tax-free through a series of lump sums. How you deal with the rest of your fund can then be a more complicated issue.

- From a purely tax planning viewpoint drawing your pension income directly from your fund – called pension income drawdown – will often be attractive. This is because it gives you some flexibility to tailor your pension income to both your financial needs and your tax position. It can also help in your estate planning, as you can usually arrange for any residual fund on death to be passed to your chosen beneficiaries as a lump sum, which from 6 April 2015 is normally tax-free if you die before age 75. Alternatively, your spouse, civil partner or other beneficiary can continue to draw an income from the drawdown or buy an annuity, which is also tax-free if you die before age 75 and the first payment is on or after 6 April 2015. Drawdown charges are likely to be higher than those in a pension annuity, and you run the risk of your income reducing if investment returns are not good. You also lose the cross-subsidy annuities offer from those who die soon after retirement to those who live for a long time.
- You could use your fund to buy a pension annuity, a guaranteed regular payment for the rest of your life from an insurance company. From an income security viewpoint, buying a traditional annuity removes the investment risk and the danger of possible enforced cuts in your income that might happen as a result of choosing income drawdown. However, annuity death benefits are generally less attractive and there will be no scope to vary income each year for tax purposes. You also have to consider whether you want your annuity to increase each year and whether you would like it to continue to your spouse or civil partner after your death. Both these options will reduce the yearly income you receive initially.

Focus point

There are many different investment options you can use for retirement planning, and each has its own benefits and drawbacks.

Alternatively, from April 2015, you can take the whole amount as a lump sum, with 75% treated as taxable income in the year when you receive it. However, doing that could both mean you face a high tax bill on it and leave you without enough income later in retirement.

Before taking any benefits, you should always explore your options with us.

Choosing the right investment solution for retirement planning

There are many different investment options you can use for retirement planning, and each has its own benefits and drawbacks.

Pensions have some very valuable tax advantages. If you are a 40% or 45% taxpayer now, the tax relief on pension contributions is particularly attractive. But in return for these privileges, there are some restrictions. For example, you cannot access your money until you reach age 55.

Individual savings accounts (ISAs) are invested in funds with the same tax-efficient characteristics that pensions enjoy. And unlike pensions, the whole of the proceeds are free of both income tax and capital gains tax. What's more, you can cash them in when you want or pass them on to a spouse or civil partner when you die. But the contributions do not qualify for tax relief, and unlike pensions there is a potential inheritance tax liability on ISAs if they are not passed to a spouse or civil partner.

Property investment appeals to many people because they feel it is relatively secure and can produce good returns. It is also possible to borrow for buy-to-let property and get tax relief on the interest, which can greatly increase the returns, although with greater risk. However, the rental income and capital gains are both taxable, and it may be difficult to sell property quickly.

For most people, a combination of different investments will meet their needs, with pensions playing an important role. There is also a wide variety of different pension arrangements. Stakeholder pensions are simple and have a cap on charges, but only offer limited investment choice. Personal pensions generally offer a much wider range of investment funds.

Self-invested personal pensions (SIPPs) give the greatest flexibility. As well as access to a much wider range of investment funds, this can include direct investment in shares, discretionary management – where specialists put together a portfolio of investments to meet your specific needs – and investment in commercial property. A SIPP need not be very expensive for those with large pension funds, but is likely to cost more than investment funds for those with lower savings. Many SIPP investments also carry increased investment risk. You will need professional advice if you want to take advantage of their investment flexibility.

We can help you to establish your priorities and choose suitable investments.

How we can help

Retirement planning is complicated, and has been made even more so by constant changes to the rules. We make it our business to stay up-to-date with the latest developments, and to help clients take full advantage of the available tax breaks. In particular, we can give guidance on:

- Assessing your financial priorities and choosing suitable investments;
- Maximising pension contributions, using carry forward where appropriate;
- Advising whether salary sacrifice could increase the amount invested in your pension at no extra cost to you or your employer;
- Managing the move from saving to withdrawing from your pension: and
- Minimising the inheritance tax liability after your death.

The value of your investment can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax advice and some forms of Inheritance Tax Planning.

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