Taxcafe Tax Guides

Pension Magic

How to Make the Taxman Pay for Your Retirement

By Nick Braun PhD

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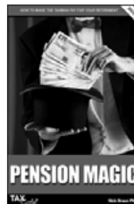

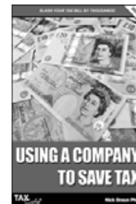

About the Author & Taxcafe

Dr Nick Braun founded Taxcafe in 1999, along with his partner Aileen Smith. As the driving force behind the company, their aim is to provide affordable plain-English tax information for private individuals, business owners and professional advisors.

Over the past 18 years Taxcafe has become one of the best-known tax publishers in the UK and has won several prestigious business awards.

Nick has been a specialist tax writer since 1989, first in South Africa, where he edited the monthly *Tax Breaks* publication, and since 1999 in the UK, where he has authored several tax books including *Small Business Tax Saving Tactics* and *Salary versus Dividends*.

Nick also has a PhD in economics from the University of Glasgow, where he was awarded the prestigious William Glen scholarship and later became a Research Fellow.

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Introduction

Let's get straight down to business. There is only one reason why you should put money into a pension and that is to SAVE TAX.

As a pension saver you enjoy two important tax reliefs:

- Tax relief on your contributions – what I call buying investments at a 40% discount.

- Tax-free growth – all your income and capital gains are completely tax free.

However, if maximising tax relief is your priority, as it should be, there's a lot more to it than simply putting away a fixed amount each year.

You may wish to decide *how much* to invest, making bigger or smaller pension contributions in some years or none at all.

You may wish to consider *who* makes the contributions: you, your employer, or your spouse.

You may also want to look at *when* is the best time to invest.

And, of course, you may want to know *why* you should even bother investing in a pension in the first place. For example, are pensions better than other investments like ISAs and Lifetime ISAs?

All of these important issues are addressed in this guide and I think you will be surprised by some of the results.

In Part 1 we explain how tax relief on pension contributions is calculated and how much you are allowed to invest. However, as we shall discover, calculating the maximum pension contribution you *can* make is not as important as calculating the maximum pension contribution you *should* make to maximise your tax relief.

Over 200,000 people do not claim all the tax relief to which they are entitled, so we also explain how you can make a backdated tax relief claim and avoid other common mistakes that could cost you thousands of pounds.

Pension Freedom Has Arrived

Up until recently the amount of money you could withdraw from your pension was tightly controlled. Most individuals' savings could only come out at a trickle, either through one of those universally detested annuities or something called "capped drawdown".

These restrictions have now been lifted completely, giving pension savers more control over their money than they have ever had.

Once you reach the minimum retirement age (currently 55) you have complete freedom to withdraw as much or as little money as you like from your pension pot, whenever you like.

For the first time, pension savers have the ability to control their tax bills, by making big pension withdrawals in some tax years and smaller withdrawals in others.

The Government has also removed another of the major obstacles that has put people off using pensions to save for retirement. Up until recently, when you died your remaining pension savings were taxed at 55% before being passed on to certain family members.

This hefty tax charge has now been abolished and pension pots can be inherited by family members with no adverse tax penalties.

In Part 2 of the guide we explain all of the "Pension Freedom" changes and show you how to save thousands of pounds in both income tax and capital gains tax by timing your pension withdrawals carefully.

In Part 3 we show how pensions are much more powerful tax shelters than ISAs. We track two investors over a number of years and reveal that a pension saver could end up with as much as 42% more retirement income than an ISA investor.

We also explain some of the lesser known tax differences between ISAs and pensions (for example, why some dividend income is taxed inside an ISA and why your family may be better off if your money is in a pension).

The New Lifetime ISA

Those under the age of 40 can now open a "Lifetime ISA" and use it to save either for a first home or for retirement.

In Part 3 we'll tell you everything you need to know about this fantastic new saving vehicle and why some taxpayers will end up with 18% more retirement income if they use a Lifetime ISA instead of a traditional pension.

In Part 4 we look at the pros and cons of postponing and accelerating pension contributions. We show how basic-rate taxpayers – those earning under £46,350 – can increase their pension pots by 33% by delaying making pension contributions for several years.

This part of the guide also contains a fascinating case study which reveals that – even if you postpone pension contributions for several years – you will not necessarily end up one penny worse off than someone who makes pension contributions for many years.

There is one group who should always consider making pension contributions: households where the highest earner's income is between £50,000 and £60,000 and child benefit is being claimed.

Your family's child benefit payments are steadily taken away as your income rises from £50,000 to £60,000. As a result, by using pension contributions to reduce taxable income, people in this income bracket will enjoy tax relief of up to 72% or more! Full details in Part 4.

Employees, Business Owners & Landlords

In Parts 5 to 8 we look at different types of pension saver: salaried employees, company owners, self-employed business owners and landlords.

In Part 5 we explain 'auto-enrolment': the new system of compulsory pensions that has resulted in many employees enjoying a pension contribution from their employer for the first time.

Some individuals who can receive free money from their employers in the shape of a company pension contribution may decide not to take up the offer. So in this part of the guide we also publish an interesting table which shows you just how much bigger your pension pot will be if you take full advantage of the free cash your employer is offering.

Part 6 looks at salary sacrifice pensions, which can boost your pension contributions by an astonishing 34%! Salary sacrifice pensions allow you to claw back not just income tax but *national insurance* as well, including the 13.8% national insurance paid by your employer.

A salary sacrifice pension is not just a tax-efficient way to save for retirement, it is arguably the most powerful tax-saving tool available to salaried employees.

Part 7 covers company owners and directors and reveals why company pension contributions are a highly tax-efficient way to extract money from your business, following the recent increase in dividend tax rates. We also explain why getting your company to make the pension contributions is currently more tax efficient than making the contributions yourself.

Most of this guide is relevant to self-employed business owners (sole traders and the like). Some additional practical pointers are provided in Part 8 to help this group maximise their tax relief.

I've also included a chapter here for landlords. It explains how, with the help of pension contributions, you can reverse the tax increase you may suffer now that your buy-to-let mortgage interest is no longer fully tax deductible. The final chapter in Part 8 looks at the pros and cons of putting commercial property into a pension.

Finally, we get to Part 9 which, with the help of a detailed case study, answers a key family pension planning question: "Who should make the pension contributions, me or my spouse/partner?"

And in the last chapter we look at the pros and cons of opening a pension for your children or grandchildren.

I hope you find *Pension Magic* an enjoyable and interesting read.

Scope of this Guide

This guide does not cover every aspect of pension saving. The focus is *maximising tax relief*, which is the main reason people invest in the first place.

I do not cover issues like pension charges, how you should invest your money (in shares, bonds, property etc), or how to choose a pension provider. I make no excuses for these omissions. As it is I've struggled to keep the guide to around 200 pages, focusing almost entirely on tax saving strategies.

Furthermore, the focus of this guide is defined contribution pension schemes, also known as money purchase schemes. These include all individual pensions (for example, personal pensions and SIPPs) and most company pension schemes these days. The basic idea is you (and your employer if you have one) put money in and the amount of income you get out at the end of the day depends on how well your investments have performed.

There is very little discussion of defined benefit or final salary pension schemes. With this type of scheme your employer promises to pay you a pension based on your salary and years of service. Final salary schemes are increasingly scarce in the private sector because employers are unwilling to guarantee to pay someone a set amount of income for the rest of their life. However, they are still the order of the day in the public sector, with the taxpayer forced to pick up the tab.

Scottish Taxpayers

The Scottish Parliament now has the power to set its own income tax rates and thresholds. Most of the information contained in this guide is relevant to Scottish taxpayers. However, unless stated to the contrary, all examples and calculations are based on the assumption that the taxpayer concerned is not a Scottish taxpayer.

Finally, please remember that this guide is not meant to be a substitute for proper professional advice. Before you act you should contact either a suitably qualified accountant, tax advisor, IFA or pensions expert who understands your personal circumstances.

Part 1

Putting Money In: The Pension Contribution Rules

Chapter 1

Tax Relief on Contributions: How it's Calculated

When you make pension contributions the taxman will top up your savings by paying cash directly into your plan. Effectively for every £80 you invest, the taxman will put in an extra £20.

Why £20, you might be asking? Well your contributions are treated as having been paid out of income that has already been taxed at the basic income tax rate of 20%. The taxman is therefore refunding the income tax you've already paid.

The company that manages your pension plan – usually an insurance company or SIPP provider – will claim this money for you from the taxman and credit it to your account.

So whatever contribution you make personally, divide it by 0.80 and you'll get the total amount that is invested in your pension pot.

Example

Peter invests £4,000 in a self-invested personal pension (SIPP). After the taxman makes his top-up payment, the total amount of money Peter will have sitting in his pension pot is £5,000:

£4,000/0.80 = £5,000

Basic-rate tax relief isn't the end of the story. If Peter is a *higher-rate* taxpayer, paying tax at 40%, he'll be able to claim even more tax relief.

The Cherry on Top – Higher Rate Relief

For the 2018/19 tax year a higher-rate taxpayer is someone who earns more than £46,350.

If you are a higher-rate taxpayer the taxman will let you claim your higher-rate tax relief when you submit your tax return.

Alternatively, if you are a company employee, higher-rate tax relief can be provided immediately by reducing the tax paid on your salary via your PAYE code.

(See Chapter 4 for more information on how to claim higher-rate tax relief.)

Example

As we already know, Peter's personal contribution is £4,000 and total pension fund investment, including the taxman's top-up, is:

£4,000/0.80 = £5,000

The £4,000 is what's known as the 'net contribution' and the £5,000 is what's known as the 'gross contribution'.

Multiplying the gross contribution by 20% we get:

£5,000 x 20% = £1,000

This is Peter's higher-rate tax relief.

Effectively he has a pension investment of £5,000 which has cost him just £3,000 (£4,000 personal contribution less his £1,000 tax refund). In other words, he is getting all of his investments at a 40% discount.

This is the critical number. Being able to make investments year after year at a 40% discount can have a huge effect on the amount of wealth you accumulate.

Scottish Taxpayers 2018/19

The Scottish Parliament now has the power to set income tax rates and thresholds for most types of income, most notably salaries, self-employment income, rental income and pensions. Interest and dividend income are still taxed using UK rates and thresholds.

Income tax in Scotland is being levied as follows in 2018/19:

£0 - £11,850	0%	Personal allowance
£11,850 - £13,850	19%	Starter rate
£13,850 - £24,000	20%	Basic rate
£24,000 - £43,430	21%	Intermediate rate
£43,430 - £150,000	41%	Higher rate
£150,000 +	46%	Top rate

Scottish taxpayers who pay tax at just 19%, or pay no tax at all, will continue to enjoy 20% tax relief on their pension contributions.

Those who pay the 21% intermediate rate can claim the additional 1% tax relief when they submit their tax returns or by contacting HMRC. The same goes for those paying 41% tax or 46% tax.

Summary

- When you make pension contributions you qualify for two types of tax relief: Basic-rate tax relief which comes in the shape of top-ups to your pension plan and higher-rate relief which is normally claimed when you submit your tax return.

- Your total pension fund investment is found by dividing your personal contribution by 0.80. The taxman's top-up is paid directly to your pension provider who will credit your pension pot.

- Higher-rate relief is calculated by multiplying your gross pension fund contribution by 20%.

- Together these two tax reliefs mean all your pension investments come in at a 40% discount.

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