CHAPTER 28

PENSION SCHEMES

28.1 Introduction

There are a number of ways in which an individual can provide funds for his or her retirement. Most UK individuals, when they retire, will be entitled to some sort of **State Pension**. The basic State Pension is currently available to men over the age of 65 and women over the age of 60. The unification of pensions at aged 65 for all taxpayers will be phased in between 2010 and 2020. Further increases in state pension age will take place after this date.

The State Pension is funded from National Insurance Contributions. NICs currently being paid by employees and employers are funding the benefits for those over retirement age. Taxpayers who receive the State Pension receive it gross and the income is taxable under ITEPA 2003. The State Pension will not be considered any further during this course. ITEPA 2003, s. 577

If an individual wishes to put funds aside to draw on during retirement, he or she can do so via a company pension scheme. A company or occupational pension scheme is provided by the employer for the benefit of the employees. If the occupational scheme is registered with HMRC there are tax advantages for both employer and employee.

Another way of providing a retirement fund is via a personal pension scheme. Personal pensions are available to all individuals in the UK, be they employed or self-employed. Self-employed persons cannot join an occupational pension scheme because they do not have an employer. As such, provision for their retirement will be made via a personal pension scheme.

In April 2001, the Government introduced Stakeholder pensions. Stakeholder pensions are modified versions of personal pensions designed to encourage all individuals, especially those with low incomes, to save for their retirement.

Individuals who wished to make personal pension contributions before July 1988, did so via a retirement annuity scheme. Retirement annuity schemes were replaced by personal pension schemes in July 1988, although members of "old" retirement annuity schemes can continue to make contributions.

28.2 Pension Funds

Before we get into the detailed rules regarding pension schemes, it is worth explaining what a pension fund actually is. A **pension fund** is essentially a **"money box"** into which a taxpayer makes contributions which he or she can **draw on during retirement**. The taxpayer will make contributions to a pension company and the pension fund manager, on behalf of the company, will invest those contributions, often on world stock markets.

One of the main advantages of registered pension funds is that **any growth is completely tax-free**. The pension fund will not pay any income tax on any interest or dividend income and it will not pay any CGT on any capital gains.

All personal pensions are what are known as "money purchase" schemes. This means that the money invested by the taxpayer is used to purchase units in the fund and the value of those units is entirely dependent on the underlying investments made by the fund manager. If the fund does well, the taxpayer may draw a very healthy pension. However, if the fund performs badly, the amount of money left in the "box" to draw on during retirement may not be as high as the taxpayer had hoped. Occupational pension schemes may also be money purchase schemes.

These money purchase schemes are also known as "**defined contribution**" schemes.

On retirement, the taxpayer is entitled to draw a lump sum from the fund and this **lump sum is completely free of tax**. This process is known as "commutation" and the maximum amount that a taxpayer can commute by way of a lump sum is normally **restricted to 25% of the value of the fund**. The **remainder** of the fund will be used to **generate an annual income** for the taxpayer during his or her retirement. This pension income is taxable in the year in which it is received. ITEPA 2003, s. 571

Where pension rights do not exceed **1% of the lifetime allowance** (i.e. £18,000 for 2010/11), the whole of the pension rights may be paid out as a lump sum. This is known as a **trivial commutation lump sum**. FA 2004, Sch 29 para 7

An amount equal to **75% of the lump sum** will be treated as taxable pension income in the year the lump sum is paid. ITEPA 2003, s.636B

An occupational pension scheme may be a **defined benefit scheme**, also known as a final salary scheme. Benefits can be taken in the same way, although in this case the amount of the benefit is set by the terms of the scheme, rather than by the size of a fund.

Contributions to pension funds eligible for tax relief are restricted depending on the level of the taxpayer's earnings. Taxpayers with higher earnings can make larger pension contributions than taxpayers with lower earnings.

28.3 Registered pension schemes

A pension scheme will need to be **registered with HMRC** in order to be tax-privileged. FA 2004, s. 153

The scheme may be established by an employer for the benefit of its employees. Alternatively, the pension scheme may be established by certain other providers, such as insurance companies and banks. FA 2004, s.154

FA 2004, s. 186

Registered pension schemes will not be liable to pay tax on income and gains.

28.4 Maximum contributions

The maximum contribution to a pension fund that a taxpayer can obtain tax relief for in any one tax year is the lower of **100% of his "relevant earnings"** for that year and the annual allowance (see later). FA 2004, s.190

Anybody can pay **up to £3,600** per year into a pension scheme **regardless of the level of his or her earnings**. This is to encourage individuals on modest incomes to make provision for their retirement.

Contributions are not permitted by taxpayers over the age of 75, although taxpayers who have reached 75 will probably be drawing on their pension rather than making further contributions into it.

Contributions can be made by the scheme member, a third party on the member's behalf (such as a parent on behalf of a child) or by an employer or former employer.

28.5 "Relevant Earnings"

FA 2004, s.189(2)

"Relevant earnings" are calculated as follows

	£
Employment income (including benefits)	X
Trading income	X
Furnished holiday lettings	X
Patent income in relation to inventions	X
Relevant earnings	X

Employment income will be regarded as earnings for pension purposes. As well as salary, this will also include the cash equivalent of any benefits, taxable termination payments and share options gains. FA 2004, s.189(2)(a)

The profits of the self-employed chargeable as trading income are also earnings for pension purposes. This includes income from professions and vocations which is taxed as trading income. Profits from a furnished holiday letting are relevant earnings. ITTOIA 2005, s. 325

28.6 Employer contributions

If an employer makes a contribution to an employee's pension scheme, this is a **tax-free benefit**. The member is not entitled to any further tax relief in respect of these contributions. However, employer contributions do need to be considered for the purposes of the **annual allowance**. This is discussed below.

Employer contributions to a pension scheme on behalf of an employee will be deductible expenses for the purposes of calculating the taxable profits from the employer's business, as long as the contributions are "wholly and exclusively for the purposes of the trade". Pension contributions are deductible for the period in which the payments are actually made.

28.7 Annual allowance

The annual allowance is the amount by which pension savings in a registered pension scheme (the "total pension input") are allowed to increase each year. FA 2004, s.228

Pension input could be by contributions to a "**money purchase**" or "**defined contribution**" scheme. Such a scheme is one where there is **no guarantee of the pension benefits** available and these are the most common type of scheme. In this case, "Pension input" broadly means **employee's plus employer's pension contributions** in the tax year.

The annual allowance also applies to increases in the capital value of benefits in a "**defined benefits" scheme**. An example of a defined benefits scheme is a "**final salary" scheme** provided by an employer. In such schemes, the benefits an individual can draw on retirement are linked to his remuneration in the final year (or years) of employment. FA 2004, s.229

The **annual allowance for 2010/11 is £255,000**. Annual increases in the capital value of a pension over and above this limit will be subject to a tax charge. FA 2004, s.228

Annual increases in excess of the annual allowable amount are subject to an annual allowance charge of 40%. The charge is payable by the individual member and will have to be declared on the self-assessment return. FA 2004, s. 227

28.8 Tax relief for contributions

We have seen that a pension fund is a very tax efficient investment. Registered pension funds themselves are not charged to income tax or capital gains tax and a member of a scheme can withdraw up to 25% of the value of the fund on retirement completely tax-free. However, perhaps the main reason that pension funds are popular is that taxpayers receive a measure of **tax relief every time they make a contribution** to a registered scheme.

Tax relief is obtained on pension contributions in one of two ways:

1. By "Relief At Source" (RAS)
2. Under "net pay arrangements"

Relief at Source (RAS) FA 2004, s.192

Relief at Source applies where contributions are made to **personal pension schemes.**

Under the Relief at Source (RAS) rules, **payments to a pension scheme are made net of 20% basic rate tax.** This means that if a taxpayer wants £1,000 to go into his pension fund, he will actually pay £800 and HMRC will make up the difference of £200.

If the taxpayer pays tax at the higher or additional rates of tax, extra tax relief is given on these contributions by **extending the basic and higher rate bands**. This is exactly the same as the way in which tax relief is given on donations to charity under the Gift Aid scheme.

Therefore, where a pension contribution is made, the original basic rate limit of £37,400 is extended by the gross amount of the pension contribution – i.e. the net contribution multiplied by 100/80. This gives us a new basic rate limit and we use this new figure to calculate the taxpayer's tax liability.

$$\text{New basic rate limit} = £37{,}400 + \text{pension contribution} \times \frac{100}{80}$$

Equally, the higher rate limit of £150,000 is extended by the same amount.

It is important to note that the taxpayer's **maximum contribution eligible for tax relief – i.e. the higher of 100% of relevant earnings or £3,600 – gives us the gross amount**. So having calculated the maximum contribution in this way, the **amount the taxpayer will physically pay is this figure multiplied by 80%.**

Net pay arrangements FA 2004, s.193

Net pay arrangements apply to contributions to **occupational pension schemes.**

Employees making contributions to an employer run scheme can obtain tax relief via a net pay arrangement. When deducting tax under PAYE, the **employer will operate PAYE on the employee's "net pay**" – i.e. gross pay less the pension contribution. Therefore, the more an employee pays by way of a pension contribution, the less tax will be deducted under PAYE.

Pension contributions do not receive relief from national insurance contributions so NICs are calculated on gross salary.

When putting together the employee's income tax computation, pension contributions to an employer scheme are given as a deduction from earnings as below:

	£	£
Salary, bonus etc		X
Benefits		X
Taxable earnings		X
Less allowable deductions:		
Employment expenses	X	
Pension contributions	**X**	
		(X)
NET TAXABLE EARNINGS		X

28.9 Lifetime allowance

A lifetime limit is placed on the total value of the pension fund that can benefit from tax relief. This limit is called a **lifetime allowance**. The lifetime allowance is **£1.8m for 2010/11**. FA 2004, s. 218

Where pension funds have been built up and the capital value **exceeds the lifetime allowance**, a **tax charge will be levied on the excess**. This is called a "**lifetime allowance charge**". FA 2004, ss.214 - 226

The charge is triggered by a "**benefit crystallisation event**", for example where **payments are made from the retirement fund**, such as the payment of a pension or a lump sum.

There will be a charge on the amount crystallised to the extent that payments from the fund exceed the lifetime allowance at the date of the benefit crystallisation event. The excess is charged at 25% to the extent that it is used to buy a pension and at 55% where it is taken as a lump sum.

The liability for the lifetime allowance charge is **jointly and severally on the individual member and the scheme administrator**. In practice, the scheme administrator will **deduct the relevant tax** from the fund and pay it over to HMRC.

Example 1

Hubert is self-employed. He pays £500 per month into his pension scheme. He has taxable trading profits of £50,000 and receives bank interest (net) of £6,000 each year.

Calculate Hubert's tax payable for 2010/11.

Example 2

Mr Branston is Chief Executive of a small airline company. He has a salary of £800,000. In 2009/10, Mr Branston paid £15,000 per month into the pension fund run by his employer. He had made this contribution regularly for several years. His employer also contributed £180,000. Mr Branston has no other income.

Calculate Mr Branston's tax liability for 2010/11.

Answer 1

	Non Savings	*Interest*
	£	£
Trading profits	50,000	
Bank interest (x 100/80)		7,500
Less: Personal allowance	(6,475)	
Taxable Income	£43,525	£7,500

Tax	£
43,525 @ 20%	8,705
1,375 @ 20%	275
44,900 (W)	
6,125 @ 40%	2,450
Tax liability	11,430
Less: tax deducted on interest	
(7,500 @ 20%)	(1,500)
Tax due	**£9,930**

Working:

Basic rate threshold	£
Original	37,400
Add: gross pension contribution	
£500 x 12 x 100/80	7,500
New threshold	£44,900

Answer 2

	Non Savings
	£
Employment income	800,000
Less: employee pension contributions	(180,000)
Net taxable earnings	620,000
Less: Personal allowance	(Nil)
Taxable Income	£620,000

Tax	£
37,400 @ 20%	7,480
112,600 @ 40%	45,040
470,000 @ 50%	235,000
	287,520
Add: annual allowance charge	
£(360,000 – 255,000) @ 40%	42,000
Tax liability	**£329,520**