ACTION POINTS

Save for retirement
Pension schemes are a tax-efficient way to save for retirement.

Invest a lump sum
Lottery win? Inherited some money? New rules mean you can pay large sums into your pension scheme.

Consider pension instead of pay
You pay tax and National Insurance on your pay. But contributions your employer pays into a pension scheme for you are free of both.

Protect your family
You can buy large amounts of life cover tax-efficiently through a pension scheme.

Tax and your pension

Retirement may be a long way off but you need to think how to fund it. A company or personal pension is tax-efficient – and now more flexible

A private pension is still the most tax-efficient way to boost your income in retirement. This chapter explains the different types of private pension schemes and some of the new rules that came in on 6 April this year. See our 'Tax in later years' chapter, p31, for how state pensions are taxed.

PRIVATE PENSIONS

There are tax advantages when you save through most types of private pension scheme. These are as follows:

- you get tax relief on the money you pay in
- your savings build up largely tax-free
- you can take part of your savings at retirement as a tax-free lump sum, though the remainder must be paid as taxable pension.

ALAMY

THE NEW RULES

The new tax rules give you wide freedom to save as much as you like in any combination of pension schemes, and can even mean that you start drawing your pension while working for your employer – though individual schemes can set their own rules, which may limit your choice.

See *Which?*, March 2006, p21, for full details of the new rules and how they affect you.

WHAT'S NEW AT A GLANCE

- Freedom to save as much as you like in any combination of pension schemes.
- Possibility of starting to draw your pension while carrying on working for the same employer.
- Greater choice of ways to draw your pension.
- Possibility of tax-free cash from any type of pension scheme.
- Scope to arrange large amounts of life cover through a pension scheme.

! Warning

You have to pay tax on any pension savings in excess of your annual and lifetime allowances. In 2006-2007, the annual allowance is £215,000 and the lifetime allowance is £1.5 million. Guidance in this chapter assumes that you are near or within these limits. If you're not, contact an independent financial adviser or pensions adviser.

SAVE FOR RETIREMENT – AND SAVE ON TAX

People who are under 75 years old are eligible for tax relief on their pension contributions

You can save through a pension scheme and get tax relief on the amount you pay in provided you are under 75. You get tax relief up to your top rate of tax (see 'Example', below).

CONTRIBUTIONS YOU CAN MAKE

There is now no limit on the amount you can pay each year into different types of pension scheme but you get income tax relief only on contributions up to:

- 100 per cent of your relevant UK earnings – basically, the pay and benefits on which you're taxed if you're an employee or your taxable profits if you're self-employed – for the year in which contributions are paid, or
- £3,600 a year if you earn less or have no earnings.

Some payments (for example, contributions paid by your employer) don't count towards the limit. There is no relief from National Insurance on contributions you pay.

Anything your employer pays into a pension scheme for you is a tax-free fringe benefit (see p17). You do not have to pay either income tax or National Insurance on it. This means that you can save more tax overall if you give up some pay and your employer agrees to make pension contributions for you instead.

There is now much more scope for you to pay large contributions into pension schemes. This can be useful if, say, you inherit some money – see 'Example', right.

HOW YOU GET THE TAX RELIEF

The way you get tax relief depends on the type of pension scheme.

- With occupational schemes, your employer deducts your contributions direct from your pay before working out the tax due. This means that you automatically get the correct amount of tax relief.
- With most other schemes, the amount you contribute is treated as if basic-rate tax has been deducted. The scheme provider claims the tax from Revenue & Customs and adds it to your scheme. For example, if you pay in £78, the scheme provider adds a further £22 it has collected from Revenue & Customs and the total paid into your scheme is £100. You get the basic-rate tax relief even if you are a non-taxpayer or you pay tax at the starting rate – in effect, you get a bonus. Higher-rate taxpayers can claim extra relief through their tax return.
- With retirement annuity contracts (a type of personal pension started before mid-1988), you may have to pay contributions gross and claim all tax relief via your tax return.

EXAMPLE

Sumey pays £100 a month into an occupational pension scheme. She pays basic-rate tax on some of her pay but 40 per cent on the last £40 a month. This means she gets tax relief on her pension contribution of 40% x £40 + 22% x £60 = £29.10, reducing the cost of each contribution to £70.80.

Warning

If your contributions go over the annual limit, any tax relief you've already had must be paid back. The scheme provider usually repays relief that was added to the scheme. You repay, through your tax return, relief that you received directly. You can either leave the excess contributions invested or ask for a refund.

EXAMPLE

Dan inherits a lump sum and wants to pay as much of it as he can into a pension. In 2006-2007 he earns £35,000 which sets the maximum amount he can pay towards a pension for that year. If Dan chooses to invest his money in a stakeholder pension, he need pay in only £27,300 to get the full £35,000 invested. The £7,700 balance will be reclaimed in tax relief (22 per cent of £35,000) by the scheme provider.

USING A PENSION FOR LIFE INSURANCE

You get tax relief on premiums if you take out life cover through a stakeholder or personal pension. And changes to the pension rules mean you can now use all your annual contribution limit to buy life cover

If you need extra life insurance, you could consider taking it out through a stakeholder or personal pension scheme. Doing so will mean that you get tax relief on the premiums and you should be able to buy more cover for the same money, or pay less for the cover you need.

In addition, because most pension schemes are written under a trust arrangement, life cover paid as part of a pension scheme is normally free of inheritance tax.

Before April 2006, you could use only a maximum of 10 per cent of your annual contribution limit to a personal or stakeholder pension to buy life cover. But the changes to the pension rules mean that you can now spend 100 per cent of the limit on life cover. So even if you are in a good employer's pension scheme and don't need another pension, you can now take out a stakeholder or personal pension just for the purpose of having life cover.

Employers' pension schemes usually pay out a lump sum if you die while you are still employed by the company. The amount varies from scheme to scheme but will often be something like two or four times your salary. Before getting extra cover, check what your scheme pays, as there is no point paying for more than you need. If you do decide to get extra cover, shop around all providers to get the most competitive rates, just as you would with non-pension life cover.

DRAWING YOUR PENSION

The new rules mean greater flexibility for starting your pension and how it's provided

You now have a lot more freedom about when you can start your pension and what form it takes.

STARTING TO DRAW YOUR PENSION

The tax rules let you draw your private pension at any age between 50 (increasing to 55 by 2010) and 75. You can draw your pension earlier in some cases – for example, if you have to retire because of ill health.

Many occupational schemes set a normal age of 65 under their own rules, usually with a much reduced pension payable if you retire earlier.

As long as your employer and the occupational scheme agree, you can now draw your pension while still working for the employer whose scheme is providing it. So you could, if you wanted, go part-time and draw your pension to top up your income.

A CHOICE OF PENSIONS

All money-purchase pension schemes must let you shop around with your pension fund to buy an annuity. But under the new rules, instead of an annuity, you now also have the option of an 'unsecured pension'. This is a more flexible way of arranging your retirement income provided through either:

- income withdrawal – this is where you draw income to live on direct from your pension fund, while leaving the rest invested. The new rules have made income withdrawal more flexible: you can take between 0 and 120 per cent of the available annuity income, or
- temporary annuities – here, you swap part of your pension fund for an income lasting up to five years (the rest stays invested). You can repeat the exercise and get another temporary annuity provided that it ends before you reach age 75.

If you've opted for an unsecured pension, by age 75 you must switch to a pension arranged by your employer's scheme (if available), a lifetime annuity or an 'alternatively secured pension' (Asp). An Asp is a more limited form of income withdrawal before age 75: you can take no income at all or up to 70 per cent of your available annuity income. However, the government is looking to restrict the use of Asps – see 'Warning', left

Whatever form your pension takes, it counts as taxable income. See pages 31 to 32 for details of how pensions are taxed.

TAKING A TAX-FREE LUMP SUM

When you start drawing your pension, you may also be eligible for a tax-free lump sum. In the past, this was not allowed with some types of scheme (for example, free-standing AVC schemes). The new rules now let you take a tax-free lump sum from virtually any type of scheme. But the scheme's own rules can override this.

The maximum lump sum you are allowed is generally a quarter of the fund from a money-purchase pension scheme. With a defined benefit scheme, the amount of tax-free cash you can take depends on the rate at which your own scheme converts pension into cash – check with your scheme's administrator.

DEFERRING YOUR PENSION

Most people build up some state pension during their working life. Currently, this is payable from age 65 if you are a man and age 60 if you are a woman. But you can put off drawing the pension to earn either extra pension once it does start or a lump sum.

The extra pension is taxable as normal. The lump sum is taxed in the year you receive it but only at the top rate of tax that you had been paying before taking the lump sum into account. The lump sum will not affect entitlement to age-related allowances (see p33).

CONTRACTING OUT ALERT

Have you contracted out of the part of the state pension called Serps or S2P into a personal pension? If so, it might be time to think about going back in. Last year, our research showed that 4.5 million people who had contracted out into a personal pension were likely to get back less than they would have from the state – see the September 2005 issue of *Which?* (p10). For more details, send for our free pack: ring 0845 307 4000 and ask for code CONTRA.

! Warning

Income withdrawal and temporary annuities involve higher charges and higher investment risks. Get professional advice.

! Warning

In the 2006 Budget, it was announced that legislation will be introduced in the 2006 Finance Bill to ensure that inheritance tax charges apply to any 'leftover' Asp funds on death. This is to avoid pension funds being used as a way of avoiding paying inheritance tax.

TAX RETURN

Complete question 11 on the main return if you receive a UK pension from any source.

- Usually through PAYE you'll already have been given tax relief on contributions to an occupational scheme. If, exceptionally, you haven't, you'll need to include them on your tax return at question 14. See page 23 of HMRC *Self Assessment Guide* (SA150).
- For contributions to other schemes, you need to enter the gross amount paid to all the schemes during 2005-2006. Do not include any contributions paid by your employer.
- This means grossing up contributions paid net of basic-rate tax relief. Divide the amount you actually paid by 78 and multiply by 100 to find the grossed-up amount. For example, if you paid £100, the grossed-up amount is £100 /78 x 100 = £128.21. Round this up to £129.

PENSION SCHEMES AT A GLANCE

Type of pension	How it works
Basic state pension	A state pension not related to earnings, based on your National Insurance contributions record. Currently pays up to £84.25 a week.
State second pension (S2P)	The current additional state pension scheme (it replaced Serps – see below) paid to employees on top of the basic state pension. Carers and some disabled people also qualify. The amount you receive depends on earnings but is more generous for low earners.
State earnings-related pension scheme (Serps)	The earlier state second pension, replaced by S2P (see above) in 2002. Also earnings related.
Pensions credit	The main means-tested benefit for pensioners, which provides a guaranteed minimum pension. It currently guarantees a minimum of £114 a week for a single person, and £174 for couples.
Employer's occupational scheme (defined benefit or final salary)	A scheme that your employer, and usually you, pay into. The amount of pension depends on your final salary and length of time you are in the scheme.
Employer's occupational scheme (defined contribution or money purchase)	A scheme that you and your employer pay into; the money is invested to build up a pot with which you buy a retirement income. The amount of income depends on investment performance and annuity rates.
Personal pension/ retirement annuity contract (RAC)	A contract between you and a pension provider – you pay in, and the money buys an income when you retire. A personal pension can be provided through an employer, as a group personal pension, or purchased individually. The pension paid depends on investment performance and annuity rates. An RAC is an old type of personal pension started before mid-1988.
Stakeholder pension	A personal pension with capped charges and no penalties for stopping premiums or transferring. As with personal pensions, it can be provided through an employer or purchased individually. The pension paid depends on investment performance and annuity rates.
Appropriate personal or stakeholder pension	Scheme used to contract out of the state scheme for employees who are not members of an employer's occupational scheme, or whose scheme is contracted-in to the state scheme. Also used for people who are members of a group personal or stakeholder scheme if they wish to contract out. Part of the National Insurance contributions you and your employer pay are invested directly into your pension plan.

PENSION TERMS AT A GLANCE

ANNUAL ALLOWANCE
The maximum amount by which your total pension savings can increase each year without tax being charged. In 2006-2007, the annual allowance limit is £215,000 and any excess is taxed at 40 per cent.

ANNUAL LIMIT
The maximum amount that you pay into pension schemes each year on which you can get tax relief. It is the higher of your whole earnings for the year or £3,600.

ANNUITY
An investment where you give up a lump sum and get an income in return. Most annuities pay an income for life. A temporary annuity pays it for a fixed period then stops.

INCOME WITHDRAWAL
This allows you to keep a money-purchase pension invested and take an income directly from it. The government limits the maximum income you can draw.

LIFETIME ALLOWANCE
The overall limit on the amount of pension savings you can build up without tax being charged. At retirement and when other withdrawals are made (on death, say), the value of the benefits drawn is compared with the allowance. In 2006-2007, the lifetime allowance is £1.5 million. Each time you draw benefits, what's left is reduced. If the benefits exceed the allowance, tax is charged on the excess (at 55 per cent if taken as a lump sum or 25 per cent if drawn as taxable income).

MORE HELP

HMRC booklets and leaflets
- IR2 Occupational pension schemes
- IR3 Personal pension schemes
- IR76 Inland Revenue guidance notes on personal pension schemes
- IR330 Pension payments

DWP booklet
- NP46 A guide to state pensions

Useful websites
- www.hmrc.gov.uk/pensionschemes/index.htm
- www.thepensionservice.gov.uk