TAX AND YOUR PENSION

A company or private pension is the most tax-efficient way to provide for retirement

The way pensions are taxed faces a major overhaul from April 2006. We outline the changes on p46. But first we run through the various state and private schemes.

STATE PENSIONS

There are several different state pensions, and most people will receive income in retirement from one or more of them.

Basic state pension

Provided you have paid, or been credited with, enough National Insurance contributions (NICs), you're entitled to the full basic state pension. From April 2005, this is £82.05 a week for people with a full contributions record.

Men can claim the basic state pension when they reach 65. The retirement age for women is going up in stages: it will be 65 for women born after 5 March 1955, but women retiring now can claim their pension from the age of 60.

The 'Pension calculator', opposite, shows what proportion of the basic pension you will receive depending on the number of years you've paid NICs or received credits for them.

If a woman over state pension age receives a pension based on her husband's NICs, the income counts as her own for tax purposes. However, anything paid to a man on behalf of a wife who is under state pension age counts as his income for tax purposes.

S2P

The current state second pension (S2P) replaced Serps (see below). It supplements the basic state pension for employees and non-earning groups, such as carers and some disabled people. It gives proportionately more to low earners, but how much you receive depends on your earnings over your working life from April 2002. (For earnings before that time, see 'Serps', below.)

Many people with an occupational scheme won't be eligible for S2P, as their scheme would have 'contracted out'. Similarly, people who aren't in an occupational scheme but who were advised to contract out into a personal or stakeholder pension won't receive S2P. If you have contracted out, you will receive a replacement pension from a private scheme instead.

For more on S2P, see 'All change for state pensions', *Which?*, March 2002, p48.

Serps

The state earnings related pension scheme (Serps) existed between 1978 and 2002 and, like S2P, supplements an employee's basic pension. As with S2P, many people will have opted out of Serps because either their occupational scheme has contracted out of it, or because they were advised to contract out themselves. The replacement of Serps by S2P won't affect any pension already built up.

Graduated pension

This scheme existed between April 1961 and April 1975. You qualified if you were an employee during any part of this period and you paid NI contributions. However, it was also possible to contract out of the graduated pension.

Non-contributory retirement pension

This is a pension for those aged 80 and over who either have no basic state pension or whose pension is less than three fifths of the maximum basic state pension.

Deferring your state pensions

The government is improving the incentives you get for deferring your state pensions. From April 2005 the percentage increase you get for deferring your state pensions goes up from 7.5 per cent to 10.4 per cent a year. Unlike the old system, where you could defer for a maximum of five years, there is now no limit.

You will have a choice on how the increased pension is paid. You can either take it as an increased weekly taxable pension or, for people who defer for at least a year, you can take the deferred amount as a taxable lump sum.

OPT-OUT ALERT

Have you contracted out of Serps or S2P into a personal pension? If so, and your adviser didn't make it clear at the time that the policy could provide a lower pension than the state, and checked that you accepted this risk, you may have been mis-sold. See our free factsheet for more details: ring 0845 307 4000 and ask for code SERP03.

For more on contracting out, see the July and August 2003 issues of *Which?* or www.which.co.uk/campaigns. We are currently carrying out more research on contracting out, to be published later this year.

PRIVATE PENSIONS

Currently, you have two main options. If your employer offers a pension scheme, you can join that. If it doesn't, or if, for some reason, you don't want to join, or you're self-employed, you can start a personal or stakeholder pension. Some people, though, can join an employer's scheme and start up a stakeholder or personal pension – see 'Topping up', right. This option will be available to everyone from April 2006.

You get tax relief on money paid to Revenue-approved occupational and personal pensions, and many plans let you take part of the proceeds as a tax-free lump sum.

Employers' pension schemes

There are various types of pension scheme that fall under this heading. Here we explain traditional employers' pension schemes, known as occupational schemes, and also look at group personal and stakeholder schemes.

Occupational schemes

If an employer offers a traditional occupational pension scheme, it will generally contribute to it. Usually, employees are also required to pay in – around 5 per cent of your salary is fairly typical. In total, you can currently contribute up to 15 per cent of your annual earnings each year (including the taxable value of most fringe benefits, such as a company car) and get tax relief on your payments. From April 2006, the rules are changing – see 'What's new', p46.

Employers' contributions don't count as a taxable fringe benefit

Employers' contributions don't count towards this 15 per cent limit and aren't treated as a taxable fringe benefit. You receive tax relief by your employer deducting contributions from your pay before working out your tax.

Although you receive tax relief on your contributions, you have to pay tax on your eventual pension. However, at retirement, you can take part of your pension as a tax-free lump sum. The pension you end up with depends on the rules that apply to your particular scheme, and the type of scheme your employer runs. The amount you receive must also not exceed limits laid down by the Inland Revenue – these are changing from April 2006. Contact your scheme administrator for more details.

Group stakeholder/group personal pension schemes

A side effect of the increasingly complex rules applied to occupational schemes is that firms have looked to simpler pension arrangements. However, most employers can't escape from offering any pension provision to their employees.

Employers with five or more employees that don't offer an occupational pension scheme, or group personal pension scheme (that is, a personal pension plans run as a collective scheme with one pension provider) available to all employees within a year of starting work, must offer access to a stakeholder scheme. However, the employer isn't obliged to pay money into a stakeholder pension. If an employer offers a group personal pension, it must also contribute at least 3 per cent of the employee's basic pay to the group personal pension or offer access to a stakeholder pension as well.

PENSION CALCULATOR

Number of years paid, or been credited with, NICs	Percentage of the full basic pension for which you qualify	
	Women born on or before 6 April 1950	Women born after 5 March 1955 and all men
9 or fewer	0	0
10	26	0
11	29	25
12	31	28
13	34	30
14	36	32
15	39	35
16	42	37
17	44	39
18	47	41
19	49	44
20	52	46
21	54	48
22	57	50
23	59	53
24	62	55
25	65	57
26	67	60
27	70	62
28	72	64
29	75	66
30	77	69
31	80	71
32	83	73
33	85	75
34	88	78
35	90	80
36	93	82
37	95	85
38	98	87
39	100	89
40	100	91
41	100	94
42	100	96
43	100	98
44 or more	100	100

TOPPING UP

There are various ways you can boost the pension you get from an employer.

Additional contributions

You can pay additional voluntary contributions (AVCs), either into the AVC scheme attached to your employer's pension scheme or by arranging a free-standing scheme (FSAVC) with an insurance company, although the high charges on these schemes make them poor value. If you belong to an occupational scheme you can also contribute up to £3,600 (including tax relief) a year to a personal or stakeholder pension. To pay into an occupational and stakeholder scheme at the same time, currently you must have earned not more than £30,000 in any of the preceding five years (starting 2000-2001) and not been a controlling director in any of those years or the current year. From April 2006, these restrictions disappear.

Added years schemes

These are a form of AVC where you can 'buy' extra years' service in your employer's pension scheme. They automatically boost all your pension benefits, including the tax-free lump sum.

Tax-free lump sums

You can take a tax-free lump sum from a stakeholder pension or in-house AVCs started before 8 April 1987. This is not currently an option with AVC schemes started after this date, and is not permitted with any FSAVC scheme. Again, the restriction disappears from April 2006.

WHAT'S NEW

The tax rules for pensions face an overhaul from April 2006. We run through some of the main changes.

- Instead of limits on the annual pension you can receive, there will be a single lifetime allowance on the pension benefits that qualify for tax relief. This allowance will be £1.5 million in 2006, increasing to £1.8 million by 2010. If you have a higher pension fund when you retire, the additional amount is taxed. You can choose for pension rights built up before 6 April 2006 to be protected.
- Annual contribution limits will go. Instead, everyone will be allowed to contribute the higher of £3,600 or 100 per cent of their earnings each year.
- There will be a limit on the annual increase in value to an individual's benefits that would qualify for tax relief. In 2006 this is £215,000. Any increases above this are taxed.
- All schemes will allow members to take up to 25 per cent of their pension rights as tax-free cash. This will apply to all AVC schemes and to 'protected rights'- the part of the fund built up with National Insurance rebates for contracting out of the state second pension.
- Everyone will be allowed to keep working for an employer while drawing an occupational pension from it (provided that the employer agrees).
- The minimum age at which people can claim a private pension will be increased from 50 to 55 by April 2010.

Personal and stakeholder pension plans
If your employer doesn't run a scheme, or you are self-employed, you can choose to contribute to either a personal pension plan or a stakeholder pension plan (a stakeholder pension is effectively a personal pension that meets certain conditions, such as low charges and flexible contributions). If you have a pre-1988 retirement annuity contract (RAC), you can contribute to that. With personal and stakeholder pensions, you pay in contributions over a period of time up to your retirement date, at which time you use the fund to provide you with an income. You can take up to 25 per cent of the fund as a tax-free lump sum.

CONTRIBUTIONS AND TAX RELIEF

The same tax regime applies to both personal and stakeholder pensions. Contributions are made net of basic-rate tax, whether you're self-employed, employed, or have no earnings. So, with basic-rate tax at 22 per cent, you pay only £78 for a £100 contribution. Higher-rate taxpayers claim the extra relief via the tax return or form PP120, from tax offices or scheme administrators.

CONTRIBUTIONS LIMIT

Age at start of tax year	RAC taken out before July 1988	PPP/SPP taken out in or after July 1988
Up to 35	17.5%	17.5%
36 to 45	17.5%	20%
46 to 50	17.5%	25%
51 to 55	20%	30%
56 to 60	22.5%	35%
61 to 74	27.5%	40%
75 and over	nil	nil

Non-taxpayers and starting-rate taxpayers still get the basic-rate tax relief, effectively adding a bonus to savings.

You can contribute up to £3,600 a year including tax relief (you pay £2,808), even if you have no income at all. If you want to pay more, the existing personal pension limits will be used to work out the maximum contribution (see the 'Contributions limit' table, above). However, the rules are changing from April 2006 – see 'What's new', left.

You can choose your current earnings as the earnings on which you calculate the percentage you can pay, or the earnings of any of the preceding five years. In addition, you can continue to make contributions over £3,600 for up to five years after the earnings they were based on have stopped.

Paying in ...
The 'Contributions limit' table, above, shows the maximum percentage of 'net relevant earnings' up to a maximum of £102,000 in the 2004-2005 tax year that you can pay in to an RAC (middle column), or to a personal pension plan or stakeholder pension (right-hand column). Remember, most people can pay up to £3,600 including tax relief into a private pension regardless of their current earnings so this table comes into play only if you want to contribute more than this.

Annual contribution limits will go from April 2006

If you're self-employed, net relevant earnings are broadly taxable profits. If you're employed, they are employment earnings that don't carry pension rights (so you can't count income from an employer whose pension scheme you are in). This means that, if you're a member of your employer's pension scheme, you won't be able to contribute more than £3,600 to a personal or stakeholder pension.

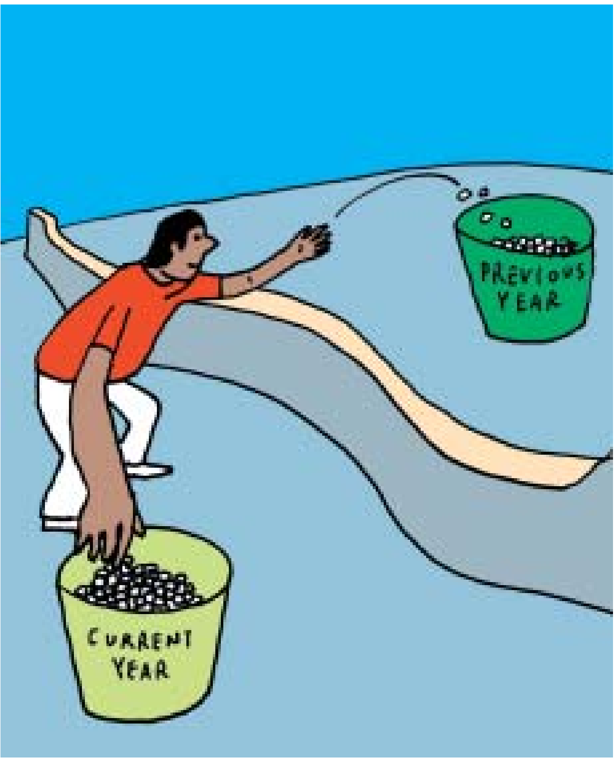
... and taking out
With personal and stakeholder pensions, you can currently draw your pension benefits at any time between age 50 and 75. Up to 25 per cent of your fund can be taken as tax-free cash. You can't currently take a tax-free lump sum from any 'protected-rights' fund, though this is changing from April 2006. 'Protected rights' is any part of a pension fund you build up with money given to you by the government for contracting out of S2P or Serps. The restriction on lump sums from AVCs will also be abolished from April 2006.

With RACs, the maximum tax-free lump sum is three times the income from the remaining fund. There's a £150,000 limit on the tax-free cash from RAC plans taken out on or after 17 March 1987. In reality, the way these plans are structured means you may be able to avoid this cap. See your pension provider for further details.

Carry back
You can ask for all or part of the amount you pay to your personal/stakeholder pension to be treated for tax purposes as if you had paid it in the previous year (as long as you have enough unused tax relief in that year). This is called 'carrying back' pension contributions. You can also carry back contributions with an RAC.

Relief is given at the tax rate(s) applicable in the earlier year. If you owe tax for that year, the relief you carry back is offset against it. If not, the Revenue repays the tax relief. Use Inland Revenue form PP43 and either your self-assessment tax return or form PP120 to carry back contributions.

With a personal pension or stakeholder scheme, you have until 31 January following the



tax year to which you want to carry back the contribution to use the carry-back rule. For example, if you want to carry back a contribution to 2004-2005, you must pay it and make the option by 31 January 2006. The option must be made before or at the time you pay the contribution.

The rules for RACs are different. To carry back a contribution to 2004-2005, it must be paid by 5 April 2006 and you have until 31 January 2007 to decide whether or not to carry it back.

THE TAX RETURN

If you complete a tax return, you will need to include details of the money you have paid into a pension scheme or the benefits you have received from pensions you are drawing on.

Pensions received

You must complete question 11 on the main tax return if you received a UK pension from any source. As a result, you need details of the state pensions that you were entitled to during the 2004-2005 tax year. If you receive a pension from a former employer that is taxed under PAYE, you should get a P60. If you receive any personal pensions, you will need a statement showing how much you've been paid (your pension provider will send you this). Personal and stakeholder pensions (but not RACs) are also taxed under PAYE, so you should get a P60.

When entering private pension income, total up all other UK pensions you received. If you receive more than one pension, you must give the total amount, but you must also list them separately where asked. Include amounts from ex-employers' schemes, personal pensions, retirement annuity contracts or free-standing additional voluntary contributions.

If you have deferred taking an annuity and have opted for the income withdrawal option instead, put the total amount you received during the tax year.

Pension contributions

Tax relief is given at source for most employers' pension schemes. However, if, exceptionally, yours isn't, you'll have to include the contributions you make on your tax return.

For full information on what to include, see p16 of the Inland Revenue self-assessment guide (SA150).

Restrictions on lump sums from AVCs will go from April 2006

Tax relief on non-employer pensions

For personal and stakeholder pensions, and RACs, you need to enter the total gross amount paid to all the policies in this category during 2004-2005. Do not include any contributions paid by your employer.

Contributions to personal pensions and stakeholder pensions are made net of basic-rate tax so you need to gross up your contributions by dividing your payments by 78 and multiplying by 100. For example, if you pay £100 a month, a gross amount of £128.20 is actually allocated to your policy.

Free-standing AVCs

You should also include on your tax return any amounts you paid to a free-standing additional voluntary contribution scheme. You pay premiums net of basic-rate tax but you must enter the gross amount as with personal and stakeholder schemes. ■

MORE HELP

Which? reports
- All change for state pensions, March 2002
- Contracting out of Serps, July 2003 and August 2003

Inland Revenue leaflets and helpsheets
- IR2 Occupational pension schemes
- IR3 Personal pension schemes
- IR330 Pension payments

DWP leaflet
- NP46 A guide to retirement pensions

FSA guides and factsheets
- Saving for retirement – starting to save
- Saving for retirement – reviewing your plans
- Stakeholder pensions and decision trees
- Topping up your pension

(for any of these, phone 0845 606 1234 or visit www.fsa.gov.uk)