



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 £43,000 for 2016/17, which is lower than six years ago – it was £43,875 in 2010/11. You may also be feeling the impact of the tax on child benefit, which applies to those earning over £50,000, or 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 Spending Review and Autumn Statement 2015 made obvious: “The richest 20% of households will be paying a greater proportion of taxes in 2019/20 than in 2010/11 as a result of government policy.”

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 – up to 60%, or even higher, – if your pension contributions help you to avoid the withdrawal of child benefit or your personal allowance.



### Action point

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The guide also explains how a self-invested personal pension (SIPP) could help you take control of your pension, and even to develop your business.

## 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 but 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, but there is no direct link between physical retirement – stopping work – and drawing on a pension arrangement. You may draw benefits before retirement and make pension contributions after your working life has ended. 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** you can no longer receive tax relief on pension contributions, but you have a free choice of how much or how little you draw out each year.

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 the key tax benefits of pensions.

<b>When contributions are made</b>	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.
<b>When the pension fund is invested</b>	The scheme pays no tax on investment income or capital gains, although tax deducted from dividend income before it is paid cannot be reclaimed.
<b>When you take your pension benefits</b>	Within the lifetime allowance, a quarter of the value is normally available as a tax-free lump sum. Income is taxable, but possibly at a lower rate than when you were working.
<b>When you die</b>	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.



**Action point**

*Pensions contributions reduce your taxable income, so they 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%.*

**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.

**Example – pension tax relief**

Esther has income of £112,000 for tax year 2015/16. 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 – £2,400 – £4,800). This is equivalent to tax relief of 60%.

The rules on limits for tax relief are complicated, with yet more changes implemented in April 2016. 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 year 2016/17 this annual allowance is £40,000, but it reduces for those with adjusted incomes over £150,000, and will be just £10,000 for adjusted incomes of £210,000 and over. Adjusted income includes pension contributions paid by an employer or deducted from your pre-tax pay, as well as normal taxable income. In addition, regardless of your earnings, the maximum contribution to your pensions (excluding any defined benefit schemes) without tax charges falls to £10,000 a year if you have started to receive payments from your pensions flexibly. 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. In 2016/17 you can exploit your unused allowance dating back to 2013/14. This is known as 'carry forward'. 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 in recent years it would be possible to make up to £170,000 of pension contributions in 2016/17 with full tax relief.

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.



#### Action point

*Whether or not you wish to maximise your pension contributions, it is well worth taking some trouble with the arrangements for making them.*

#### Example – carry forward

Elaine has paid £20,000 into her pension in the 'input periods' for each of the three tax years 2013/14, 2014/15 and 2015/16. She is able to carry forward £30,000 (£50,000 – £20,000) from 2013/14, when the annual allowance was higher at £50,000, and £20,000 (£40,000 – £20,000) from 2014/15 and 2015/16 – a total of £70,000. She can add in £40,000 for tax year 2016/17 and contribute up to £110,000, assuming she has sufficient earnings to qualify for tax relief on the whole amount and that her adjusted income is not over £150,000.

### 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.

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;
- 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; and
- Any life insurance or income protection where the amount paid is linked to your salary.

## Taking control of your pension plan – SIPPs

Pension schemes and providers generally offer a wide range of investment funds, which meet the needs of most people. However, if you have already saved a substantial amount, a self-invested personal pension (SIPP) offers you the opportunity to take control of your pension. A SIPP gives you a much wider choice of investments to suit your priorities and preferences, and if you have your own business you may be able to use your pension to help develop it tax-efficiently. For example, in a SIPP you can hold commercial property and company shares, or you can build up a portfolio of investments. A SIPP also offers a flexible and tax-efficient way to turn the pension fund you have accumulated into an income for your retirement. There are, however, downsides to SIPPs which will be touched upon later.



### Action point

*If you are currently paying an employee contribution, find out whether your employer offers salary sacrifice.*

### What is a SIPP?

A SIPP is a special form of personal pension that allows you, as the pension scheme member, to choose and control the investments within your pension plan. SIPPs are offered by most of the major insurance groups and a range of specialist providers.

The benefits that you can draw from a SIPP and the contributions that can be made are subject to exactly the same rules as any personal pension. The key differentiator is the range of investments available. These vary among providers, with insurance companies typically offering a relatively limited range that will suit most investors, while specialist providers may offer the full range. Typically, investments options include:

- A very wide range of investment funds;
- Direct investment in stocks and shares;
- Cash deposits; and
- Commercial property.

### SIPP as part of your investment portfolio

Most SIPPs include funds and quoted investments, which you may also hold among your other assets. It is important that your investments are integrated as far as possible and are considered together in your financial planning.

A key consideration is ensuring that your investment portfolio balances risk and reward in a way you are comfortable with. This will take account of the time horizon of your investments as well as your individual attitude. This will largely be reflected in asset allocation, which is simply the balance between secure but low-growth investments, such as cash deposits, and more risky but higher-potential investments, such as company shares. You will also need to consider the selection of investment funds, which are likely to make up a large part of your portfolio, and ensure they are suitably diversified and reviewed regularly.

The taxation of investments can also help determine whether they are held inside your SIPP or among other investments. Changes to the taxation of interest payments and company dividends from 6 April 2016 have changed the position for you.

## Consolidating your pensions in a SIPP

Many of us build up several different pensions over the years. Some pension funds may still be with former employers while others are those we have saved in ourselves. Some may have high charges and under-performing investments. Consolidating old pensions into a SIPP can reduce charges and allow investments that meet your needs better.

This must be done with caution, though. Some employer schemes have very low charges, so you could pay more after switching to a SIPP and you will need to be confident this is justified by the additional investment flexibility. Even more importantly, you must be careful about giving up guarantees in your old pension arrangements. In particular, some older arrangements, which are usually on a 'with profits' basis, guarantee the terms on which you can convert your pension fund into an income through an annuity. Guaranteed annuity rates can give you a pension that could be twice as high as buying the best annuity available on standard rates today.



### Action point

*Consider the selection of investment funds which are likely to make up a large part of your portfolio, and ensure they are suitably diversified and reviewed regularly.*

## Commercial property investment

A major attraction of SIPPs is that they can invest in commercial property, although not in residential property.

Commercial property can be let to the pension scheme member's company or partnership. You can even sell a property that you or your business owns to the pension scheme (although this might result in a tax charge on any capital gains). Any sale transaction must use an arm's length valuation, because there are tax penalties for 'value shifting'. Similarly, the business must always pay a full commercial rent, which the SIPP will receive tax-free.

A SIPP can borrow up to 50% of its net assets for property investment (or any other purpose). For example, a SIPP with net assets of £300,000 could borrow £150,000 and spend £450,000 on a commercial property. Often SIPP property purchase is financed by a combination of transfers from previous pension arrangements, new contributions and borrowing.

SIPPs that hold commercial property as an investment normally have higher annual charges than simpler pension arrangements with investments in listed securities, collective funds and cash.

## Specialised investments and taxable investments

In theory, almost any investment can be held in a SIPP but those that are not approved by HM Revenue & Customs are subject to heavy tax charges that make them unattractive. They are known as 'taxable property' and include, for example, residential property, works of art, antiques, fine wine and other collectibles.

The maximum tax charge on taxable property can be 104% of the investment's value, most of which would fall on the member. Some forms of indirect investment in property and chattels are exempt from the tax penalty, but the definitions are strictly drawn.

Unfortunately, the way in which the legislation operates will potentially catch a controlling director's pension scheme investing in the shares of their own unlisted company. While there is a limited exemption for indirect investment in chattels with a market value of no more than £6,000, many providers ban investment in chattels and member-related unlisted securities. However, some SIPPs do permit investment in suitably structured residential property funds.



### Action point

*When you decide to draw your pension benefits you have to decide the balance between lump sum and income.*

## Withdrawing money from your pension

Since 6 April 2015, the rules have provided much greater flexibility than before once you reach the minimum pension age of 55 (which increases to 57 in 2028). There are no restrictions on how much income you can take each year from drawdown and the ability to take withdrawals direct from the paying-in part of a pension, with a quarter tax free and the remainder taxed as income. The best way to structure withdrawals from your pension will depend on your personal circumstances.

We can give guidance on how you might take lump sums and income from your pension, including ways to combine them with other income sources, what happens if you die and when it may be beneficial to buy guaranteed income through an annuity. We can also help you understand how you can take advantage of the increased flexibility now available.

**Lifetime allowance** There is a lifetime allowance (LTA), which sets a ceiling on the total value of your tax-efficient pension benefits. The LTA was £1.8 million to before £1.5 million before 6 April 2012 but has since fallen three times and is now £1 million. The reductions were accompanied by transitional protections, allowing you to keep an LTA higher than the standard one, and some are still available.

If your pension may reach more than £1 million and you have not contributed since 6 April 2016, you can use **fixed protection 2016** to keep an LTA of £1.25 million, as long as you do not add to your pension in the future. If the total value of all your pensions was over £1.25 million at 5 April 2014 or over £1 million at 5 April 2016, you can apply for **individual protection 2014** or **individual protection 2016**, which keeps your LTA at the level of your savings at the date of the reduction (or the level of the previous LTA, if lower). If your pension could exceed the LTA you should seek advice about it.

## Choosing the right retirement options

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, the whole value can now be taken as a lump sum, with tax payable on 75% of it, 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.



### Action point

*Consider whether your pension savings could be restricted by the lifetime allowance.*

- 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 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. 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.
- You could 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 mean that you both 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.



## 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;
- The appropriateness of a SIPP, and the right investment strategy;
- Transferring existing pension arrangements into your new pension arrangement;
- Managing the move from saving to withdrawing from your pension; and
- Minimising the IHT liability after your death.

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

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. Investment in a registered pension fund is subject to many restrictions on access and how the funds can be used.

*This publication is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The Financial Conduct Authority (FCA) does not regulate tax advice, so it is outside the investment protection rules of the Financial Services and Markets Act and the Financial Services Compensation Scheme. This publication represents our understanding of law and HM Revenue & Customs practice as at 30 June 2016.*



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