The PENSIONS Advisory Service

Spotlight

Saving into a Pension

This spotlight talks about the type of pension schemes available, the tax relief you may receive and some top tips for finding a pension provider.

The Pensions Advisory Service is unable to give individual specific advice and you should seek alternative tax or independent financial advice.

Why save into a pension?

Whether you are saving for income in retirement or looking to build up a lump sum over the long term, pensions are a tax efficient way to save.

- You get tax relief on your contributions (subject to limits).
- The investments grow in a tax-friendly way; and
- You have the option to take 25% of your pension as a tax-free cash lump sum when you retire

In addition, as well as being tax efficient:

- If you are in a workplace scheme, you will generally benefit from employer contributions; and
- There has been legislation to ensure that cost effective pensions are available

What types of pensions are there?

Defined Contribution schemes A Defined Contribution scheme may also be known as a money purchase scheme. This type of scheme is a pot of money which you build up by paying regular or ad hoc contributions. These contributions will be invested into funds of your choice. The value of your pension pot over time will depend on the amount you have contributed and how well the investments have performed. Once you reach age 55, you can use the money in your pot to provide yourself with an income, a one off lump sum, several smaller lump sums, or you can leave it for a later date. We have detailed your pension pot options on the next page.

You can set up your own Defined Contribution scheme, or your employer might set one up on your behalf.

Defined Benefit Schemes Defined Benefit schemes are occupational or workplace pension arrangements. There are two main types of Defined Benefit schemes, one which is based on your salary when you reach retirement, and one which is based on your average salary throughout your career. The amount of income you will receive during your retirement is based on the salary used (pensionable salary) and how long you were a member of the scheme (pensionable service). The scheme will also use an accrual rate which is used to work out your income. For example, if the scheme has an accrual rate of 1/60 then you will receive 1/60th of your pensionable earnings for each year of pensionable service

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If you are thinking of saving into a pension scheme, you might be wondering what you can do with the money you save. Below are 6 options available to you if you have a Defined Contribution pension pot:

- **Uncrystallised Funds Pension Lump Sum (UFPLS)**. This is where you withdraw smaller sums of money as and when you want or need to. 25% of the amount you withdraw will be tax free, and 75% will be taxable.
- **Flexi-Access Drawdown**. You can take up to 25% of your pot tax free then receive an income using the rest of the funds. You can choose to receive as much or as little as you want until the pot runs out.
- **Annuity**. You can take up to 25% of your pot tax free then give the rest of your pot to an insurance company to buy an annuity. They will then pay you an income until you pass away.
- **Cash the whole pot in**. Regardless of the size of the pot, you can take it all out as a one off lump sum. 25% will be tax free, and 75% will be taxable.
- **Do nothing with the pension pot**. You do not have to take any of your pension pot for instance you can pass your pot on to your beneficiaries, or save it for a rainy day.
- **You can mix your options**. For example, use some of your pot as a flexi-access drawdown and some to buy an annuity or a mix of any of the other options.

How can I get tax relief?

When you pay contributions into your pension scheme you are entitled *to tax relief (subject to limits* which we will explain later on in this spotlight). There are three ways in which you can get tax relief known as relief at source, net pay arrangement and salary sacrifice. These are explained below.

Relief at source When you pay pension contributions directly to your pension scheme, they will automatically add 20% tax relief regardless of what rate of tax you are on. If you are a higher or additional rate tax payer you will need to reclaim the additional tax relief from HMRC via a self-assessment.

For example, if you are a basic rate tax payer and paid £80 into your pension scheme, they will add 20% tax relief and top your pension pot up to £100.

Net Pay This option is available if you pay your pension contributions via your salary. Your pension contributions will be deducted from your gross pay before tax is applied. This option gives you tax relief at your marginal rate so if you are a higher rate tax payer you do not need to apply for the additional tax relief. If you do not earn enough to pay tax then you will not benefit from tax relief under this arrangement.

For example, if you are a 20% tax rate payer and paid £100 as a pension contribution your take home pay will be £80 less than you normally would get.

Salary sacrifice with this option you agree with your employer to give up some of your salary in return for pension contributions. You cannot sacrifice all of your salary and must still receive a salary at least equal to the minimum wage.

For example, if you earn £25,000 and sacrifice £5,000 then you will be taxed on £20,000. You and your employer will also pay National Insurance contributions on £20,000 rather than £25,000. The salary you have sacrificed will be paid into your pension and classed as an employer contribution rather than your own personal contribution.

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How much can I pay into my pension?

Annual Allowance this is the amount you can pay into your pension every year and receive tax relief. For the 2017/18 tax year this is £40,000. If you earn less than £40,000 then the tax relief on your own contributions will be limited to the higher of 100% of your earnings and £3,600, although your employer can pay up to your Annual Allowance if they wish to.

Any contributions you pay over the Annual Allowance will be subject to a tax charge.

Tapered Annual Allowance the tapered annual allowance came into force at 6 April 2016 for high earners. For every £2 of income above £150,000 per annum, £1 of annual allowance will be lost. The maximum reduction will be £30,000 meaning that anyone earning over £210,000 will have their annual allowance capped at £10,000.

An income floor will mean the taper will not apply unless the individual's income excluding pension contributions exceeds £110,000 (referred to as their "threshold income"). We have more detail on this in our Spotlight on End of Year Tax Planning.

Money Purchase Annual Allowance if you have taken any money from a Defined Contribution scheme then you may be subject to the Money Purchase Annual Allowance (MPAA) of £4,000. This applies to anyone who has flexibly accessed their pension pots as a UFPLS, either by taking the whole pot as a lump sum, taking smaller lump sums or taking income from their flexi-access drawdown fund and limits the future contributions that can be made to a defined contribution scheme. Larger Annual Allowance limits will still apply to defined benefit arrangements.

Your pension provider will let you know if the MPAA applies to you.

Lifetime Allowance the Lifetime Allowance is a limit on the amount of pension savings that can be taken from your pension schemes. When you take your benefits from your pension scheme, either as a lump sum or as income, they will be tested against the Lifetime Allowance. If your pension savings exceed the Lifetime Allowance you will be subject to a tax charge. For the 2017/18 tax year the Lifetime Allowance limit is set at £1 million.

Where can I get more information?

The Pensions Advisory Service has published other spotlights which you may find useful.

- If you need more information on the Annual Allowance this spotlight will be useful to you www.pensionsadvisoryservice.org.uk/content/spotlights-files/uploads/Annual_Allowance_SPOT004_V1.8.pdf
- Our spotlight on End of Year Tax Planning might be useful to those who have a Tapered Annual Allowance https://www.pensionsadvisoryservice.org.uk/content/spotlights-files/uploads/End_of_Tax_Year_Planning_SPOT024_V1.2.pdf
- Our Lifetime Allowance spotlight will give you any additional information you are looking for www.pensionsadvisoryservice.org.uk/content/spotlights-files/uploads/Lifetime_Allowance_SPOT021_V2.9.pdf
- If you are interested in taking financial advice from a regulated professional this spotlight tells you how they can help you with your retirement planning. www.pensionsadvisoryservice.org.uk/content/publications-files/uploads/Financial_Advice_SPOT009_V1.3.pdf

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- **Check with your employer to see if they offer a pension scheme.** If they do, you can ask to join the scheme, or, if you are already a member, you can ask to increase your contributions. By 2018 all employers will need to automatically enrol eligible employees into a pension scheme if they have not already done so. To be eligible for automatic enrolment you need to be aged between 22 and state pension age and earning at least £10,000 per year. If you are eligible your employer will also contribute to your pension. If you are not eligible, your employer will still need to provide you with a pension scheme and may also contribute.

- **Speak to a financial adviser.** When setting up a pension, it is worth getting advice from a professional. A regulated financial adviser will look at all of your financial circumstances and your goals and put in place a retirement plan that's suitable for you. You can find a financial adviser here - https://directory.moneyadviceservice.org.uk/en or www.unbiased.co.uk

- **Speak to your bank, building society, insurance company.** Most people will use a bank account, building society or an insurance provider (for example home or car insurance) who may also offer pension schemes. It's important to note that this doesn't necessarily mean that their scheme is the most suitable one for you, but it is a good place to start.

- **Do you have any old pensions?** You may have an old pension which you are no longer contributing to, perhaps from an old employer. If you do, you may be able to speak to the provider to see if you are able to restart contributing to it.

- **Look online.** Most pension providers will have a website which will detail the schemes they offer. If you decide to do this you will need to make sure the company is regulated by the Financial Conduct Authority (FCA). You can check the FCA register by visiting www.fca.org.uk/register

- **Decide how much you want to contribute.** Contributions can be paid on a monthly or ad hoc basis. Although you can pay as much as you like into your pension scheme, there is a limit on the amount of tax relief you can get. This is known as the Annual Allowance and is explained in more detail on the previous page.

- **How much income will you need in retirement?** By working out how much income you need in retirement you will have an idea of how much you may need to contribute to meet your needs. You might want to think about what outgoings you will have such as rent/mortgage payments, utility bills, hobbies, clothing, holidays, special occasions, emergency bills or financial dependants.

- **Do you have other income or savings?** If you receive a pay rise or pay off a loan for example, you may find yourself with more disposable income. You might want to consider increasing your pension contributions if this does happen.

- **Investment options.** Your pension provider will offer you a range of investments; some pension schemes will have more choice than others. Each investment will have a level of risk attached to it. Speak to your pension provider to see what investment options they have which match the level of risk you are prepared to take. It is important not to put all your eggs in one basket, so you should consider spreading your investments over several different funds; this is called **diversification**.

- **Regularly review your pension pot and the contributions you are making.** You don't have to do this every day but you might want to regularly review the value of your pension pot, the charges you are paying, your investment choices and the amount you are contributing. You can do this annually or following significant life events for example, getting married, having a baby, moving house or getting a new job.

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