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PRUDENTIAL

How pensions save u tax

Your pension tax guide

Of all the ways you can reduce tax, a pension is one of the best. It lets you save money that would otherwise be taxed, and achieve tax-free growth on that money. It can also help you retain your allowances, or achieve lower tax in other areas (such as capital gains tax). These tax benefits are there to encourage you to save for retirement, and help your pension to grow large enough to meet your retirement needs.

Whether you are near retirement or just starting to save, this guide will show you how to make the most of your pension's tax-busting features. It will also show you how to minimise tax when you come to draw on your pension pot.

Saving into a pension

The biggest tax advantage comes when you pay into a pension. Because the government gives you tax relief on each contribution, it costs you less than a pound to pay a pound into your pension. Broadly speaking, the higher your rate of income tax, the less it costs you to achieve that £1. It works like this:

Highest rate of income tax	Level of tax relief	Cost of saving £1 into your pension
Basic	20%	£0.80
Higher	40%	£0.60
Additional	45%	£0.55

As you can see, a basic rate taxpayer has to pay in only 80 pence to end up with £1 in their pension. Meanwhile an additional rate taxpayer only needs to pay in 55 pence to get that £1 in total.

How much can you pay in?

You can pay up to the full amount of your earnings as a pension contribution and receive tax relief. There is an overall limit of £40,000 per year, called the annual allowance, and if you exceed this there may be a tax charge to pay.

Sometimes your annual allowance can be higher or lower than £40,000 depending on your circumstances. Note too that this limit includes the value of any increase you may have in defined benefit (aka final salary or career average) pension schemes – so it is possible to exceed the annual allowance by accident.

Good to know: Your employer may also use a salary sacrifice scheme, whereby you forego part of your salary in exchange for pension contributions. This results in you (and your employer) paying lower National Insurance (NI) contributions, which could be used to increase the amount of pension payment for you.

Building up your pension pot

Your pension contributions will be invested in a pension fund, typically made up of many different types of investments. There is no tax to pay on any investment gains or income received within the pension fund.

As you approach retirement, you may find it beneficial to increase your pension contributions as much as your allowances permit. For instance, you could withdraw savings held elsewhere and pay these into your pension, as these too will receive a boost from tax relief if you stay within your limits. However, it's usually best to seek advice when you are going to make large pension contributions.

You can continue paying into your pension after you've started to draw money from it. However, if you do this then your annual allowance may drop from £40,000 to £10,000.

Drawing your pension

You can draw your pension at any age from 55 onwards. There are several ways you can do this.

Regardless of how you take your pension, 25 per cent of it will usually be tax free. When you draw the rest you may pay tax on it, depending on how much money you take in a single tax year and how much other income you have.

Consequently, large pension withdrawals may result in you paying significantly more in tax.

Good to know: The simplest way to take the 25 per cent tax-free slice is as a single lump sum. An alternative method is to take your pension as a series of withdrawals, with 25 per cent of each one being tax-free. You should consult a financial adviser about which option is best for you.

Tax on your retirement income

Remember that even as a pensioner you are subject to the same tax system as everyone else. For the 2016/17 tax year, the tax bands are as follows:

	Total income	Rate of tax on pension income
Personal allowance	£11,000	0%
Basic rate	£11,001 to £43,000	20%
Higher rate	£43,001 to £150,000	40%
Additional rate	£150,001 and over	45%

Good to know: Until you reach state pension age (which may be later than when you actually retire) you will also have to pay National Insurance contributions on all income over £155 per week.

Remember that your income includes all the money you receive during the year, including:

- ✓ workplace pensions
- ✓ personal pensions
- ✓ state pension
- ✓ earnings
- ✓ any taxable benefits
- ✓ income from property
- ✓ taxable income on savings or investments

Example 1: No tax bill

If you are already receiving the full new state pension of £155.65 per week (£8,094 per year), you could take up to £2,906 from a personal or workplace pension in that year and pay no tax on it (assuming you receive no other taxable income). This would make your annual income just £11,000 (not including any money you might decide to use from your tax-free lump sum).

Example 2: A regular income

If you receive the full new state pension and also an annuity (a regular income) of £8,000 then your total earnings above the personal allowance would be £5,094. Taxed at 20 per cent, this would mean a tax bill of £1,018.80 – reducing your net income to £15,075 (again, not including your lump sum).

Example 3: A lump sum

Under pension freedom, you can in principle take your whole remaining pension as a lump sum. But if you had a pension of £100,000 and took £25,000 tax free, then took the remaining £75,000, your taxable income would be £72,094 (if you are receiving the full new state pension). Of this, £32,000 would be taxed at 20 per cent, and £40,094 would be taxed at 40 per cent. Your total tax bill for that year would be £22,437.60.

Why advice on your pension is so important

As you can see from the examples given, tax can very quickly become a factor when you start to draw your pension. You can also end up with a punishing tax bill if you make pension withdrawals without proper forethought.

An independent financial adviser can help you plan your retirement so that you strike the perfect balance – saving enough to have a pension pot that meets your needs, then managing the withdrawals to ensure you can pursue the lifestyle you want, without losing too much of your hard-earned pension in tax.

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