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Pensions and the future of higher rate tax relief.

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Pensions and higher rate tax relief

This is the time of year when higher rate tax payers put reviewing pension contributions back on their 'to do' list. Up to 2015 a number of changes to pension policy significantly improved access to pension funds and made it easier to pass pension benefits free of IHT on death.

No wonder then that pensions became increasingly attractive savings vehicles for higher rate tax payers. But then government policy got very confusing.

Recent government policy

After making pensions easier to use and giving greater flexibility over how benefits are drawn, policy has shifted towards limiting how benefits can be accrued.

The standard lifetime allowance has been gradually reduced over recent years. It was £1.8 million in March 2012. It's now £1 million. Benefits in excess of this cap, when drawn, suffer additional tax charges.

Equally the annual allowance limits the amount of pension contributions that can be made without suffering a tax charge to £40,000 per annum.

These broad constraints are aimed at anyone accruing or having accrued pension benefits. Recently however higher rate tax payers have felt particularly targeted as government looks to drive savings in the pension system.

'According to the Pensions Policy Institute, the current system of pension tax relief costs the Treasury an estimated £35bn annually.'

George Osborne, was one of the first advocates for a more radical overhaul of pension tax relief, but the Tory opposition successfully resisted proposals to altogether remove pension contribution higher rate relief.

According to David Gauke, the current Secretary of State for Work and Pensions, the Treasury and the DWP recognise that policy needs to face up to the longer-term challenges of pension provision and the cost of pension tax relief.

In other words, major and probably controversial reforms are on the cards but may be postponed due to the current government's slim majority.

So where does that leave higher rate tax payers?

Direction of travel for pension policy indicates that higher rate relief might not be available for much longer. Higher rate tax payers should consider this in deciding whether or not to make pension contributions in this tax year. So what are the tax advantages?

Tax relief on contributions

For defined contribution schemes (such as SIPPs), savers pay in an amount net of basic rate tax, with the pension provider adding basic rate tax to the fund (higher or additional rate tax relief is claimed through self-assessment).

Some employees in occupational schemes will have their contributions deducted directly from their salary before tax. This provides them with immediate tax relief at their highest rate without the need to make any reclaim via self-assessment, with all their tax relief going directly into their pension.

In either scenario, the net cost to an investor paying higher rate tax is £6,000 for a £10,000 contribution (assuming they have at least £10,000 of income taxed at the higher rate).

Income tax on withdrawals

Past the minimum retirement age and provided the standard lifetime allowance has not been exceeded, up to 25% of the pension fund can be taken completely tax free, with the balance taxed as income.

This means the £10,000 contribution in the example above (ignoring investment growth and charges), would provide:

- £2,500 tax free cash
- £7,500 of taxable income

If at the time of making a withdrawal the marginal rate of tax for the policyholder is 40%, the net withdrawal from the pension would be £7,000 (£2,500 tax free cash plus £4,500 net income) for a net cost of £6,000.

In reality however, higher rate taxpayers don't pay 40% tax on all of their income. The most any higher rate taxpayer (on incomes up to £100,000) will ever pay on their total income, provided they have a full personal allowance, is c. 29% and that ignores tax free cash. This is because the UK tax system works in bands, which means we don't pay a fixed rate of tax on all our income.

Higher rate earner, basic rate retiree

The tax advantages are more pronounced when contributions attract higher rate relief but withdrawals are subject to basic rate income tax. Research shows this is often the case as most savers who pay higher rate tax during their working life don't continue to do so in retirement.

According to the Centre for Policy Studies less than 1 in 7 higher rate taxpayers will remain subject to higher rate tax once they stop working. This means the effective rate a basic rate taxpayer will pay on their retirement income will be between zero and c. 15%.

> **Example**
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> For a net cost of £30,000, a higher rate taxpayer would get £50,000 into their pension (assuming they have at least £50,000 of income taxed at 40%). On taking benefits, after deducting tax free cash and personal allowance (and ignoring investment growth or charges) it would provide £44,800 of spendable income – a c. 49% uplift on their contribution. This assumes they have no other income which has used up their personal allowance.

Summary

Predicting future government pension policy is difficult but the direction of travel suggests higher rate relief may be reduced or removed altogether.

This alone is not a reason to make pension contributions this year of course. Instead it reminds us that pensions remain one of the most accessible and tax advantageous savings vehicles.

With careful planning and specialist advice, pensions still play an important part in tax planning for higher rate tax payers.

How we can help

We can help individuals weigh up the advantages and disadvantages of maximising pension contributions, against the risk and cost of potential future penalties.

To contact us, do not hesitate to call on 0207 287 2225 or by email (hello@edisonwm.com).

You can view a copy of the Briefing Note on the Insights page on our website.

Important Information

The above is a simplification of the legislation. It does not constitute advice. The views expressed above are subject to changes in legislation. The Financial Conduct Authority does not regulate tax advice.

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