INVESTMENTS • ADVICE • PLANNING

Power of Pensions

Background

Defined Contribution (DC) schemes: In a defined contribution (DC) scheme also known as a 'money purchase scheme' the member's benefit (or pension) is based upon the amount that is contributed by them (or on their behalf by their employer before they retire). The employee takes the entire risk of the investment, including inflation.

Both defined contribution (DC) and defined benefit (DB) (the latter also known as final salary), schemes are tax efficient vehicles for saving for retirement. DB schemes allow you to build retirement benefits by accruing a portion of your salary for each guaranteed pensionable year worked at the company you work for, though new schemes are generally a rarity.

Pension arrangements are often established by employers, particularly given the requirements around UK workers having a workplace pension, but they can also be opened for individuals for their financial planning.

Contributions to pension schemes, where meeting certain criteria, can reduce your earnings and therefore your marginal rate of tax, with basic rate tax relief applied within the pension, and relief at higher or additional rates of tax being reclaimed via tax return (unless paying via your workplace pension with a net pay arrangement or salary exchange, in which case no tax return is required).

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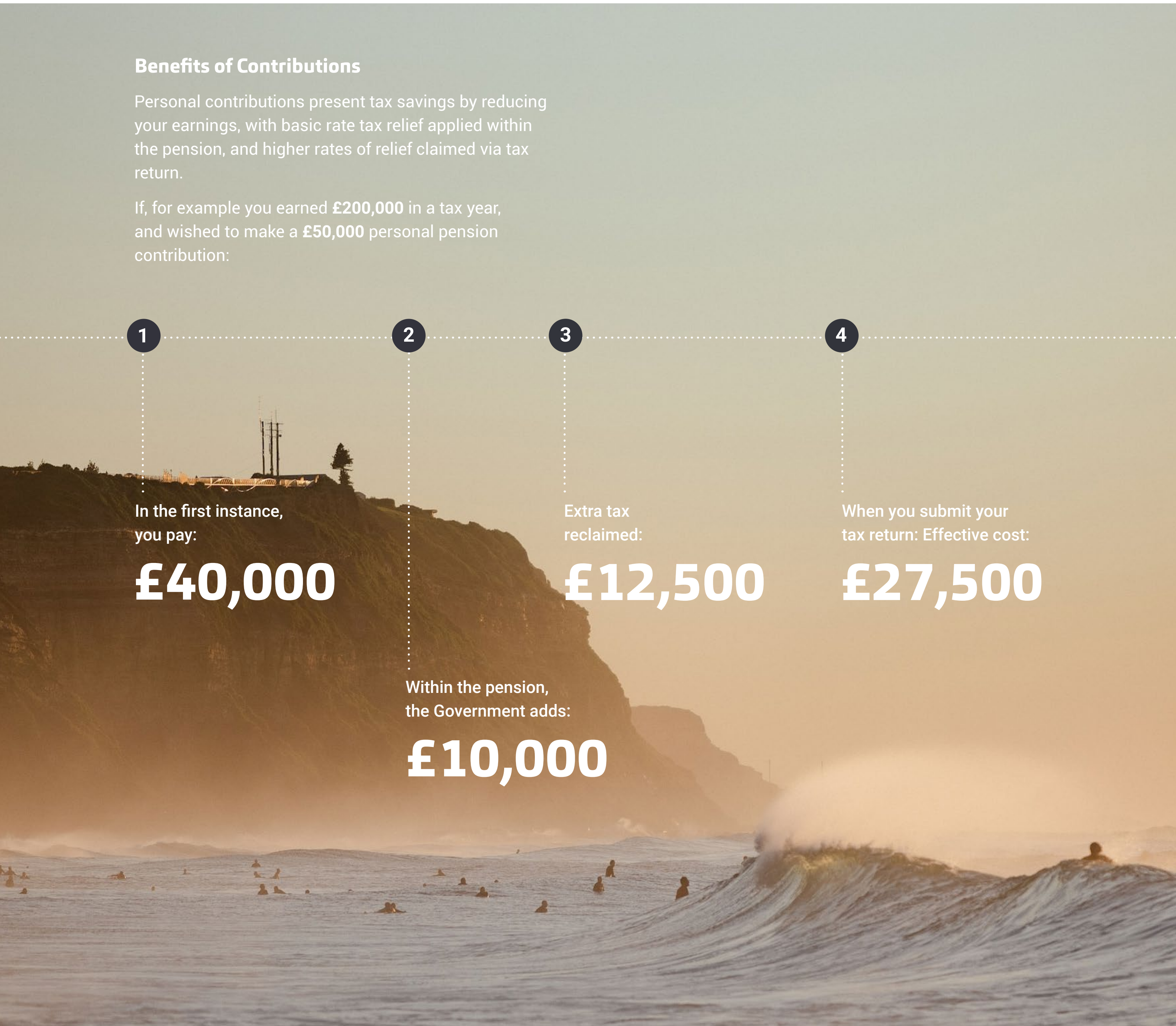
Growing Your Defined Contribution Pension Fund

Following contributions, various investments can then be held within a pension. For typical pensions set up by workplaces, or group personal pensions, a range of funds are available to choose from – though often limited.

Some will be sector or asset class specific, and some will be risk-rated funds. Some pension contracts are structured as Self-Invested Personal Pensions (SIPPs), whereby a greater range of underlying investments can be held, with providers of SIPPs offering a vast range of funds, individual shares, alternative investment strategies such as 'smoothed' investments, structured products and even commercial properties.

Growth within the pension is free of capital gains, tax on interest and tax on dividends, so profits as they accrue don't get reduced by tax, resulting in 'gross roll-up' (a positive impact on growth of growth already achieved).



Benefits of Contributions

Personal contributions present tax savings by reducing your earnings, with basic rate tax relief applied within the pension, and higher rates of relief claimed via tax return.

If, for example you earned **£200,000** in a tax year, and wished to make a **£50,000** personal pension contribution:

1. In the first instance, you pay: **£40,000**
2. Within the pension, the Government adds: **£10,000**
3. Extra tax reclaimed: **£12,500**
4. When you submit your tax return: Effective cost: **£27,500**

Whilst this gives an effective tax saving of 45%, because the contributions reduce your total earnings on which you are taxed, higher rates of tax relief can be achieved where contributions bring your income down through thresholds where your personal allowance is tapered (with this occurring for earnings over £100,000), or where child tax credits received are tapered. Slightly higher rates of tax reliefs on contributions can also be achieved if your employer will allow you to exchange your salary into a pension, reducing your gross earnings and what is assessable for National Insurance.

What are the rules around pension contributions?

You can technically pay as much into a pension as you want, but the amount of tax relief you get by paying into a pension is limited to a gross pension contribution of the lower of your UK Relevant (employment) earnings, or £60,000 per tax year (from 2023/24). If you have no employment earnings, you are restricted to £3,600.

Where your earnings are higher than £260,000 (Adjusted Income) in a tax year, the £60,000 annual allowance is reduced by £1 for every £2 of earnings in excess, all the way down to a maximum contribution of £10,000 from the 2023/24 tax year where earnings are in excess of £360,000. You can also carry back (as long as your employment income supports the gross payment) unused pension allowances for the previous 3 tax years).

Rules for company owners

As part of a limited company, Directors can choose to make pension contributions for themselves, as well as their employees. Making contributions as a Director to your own pension is a very tax efficient way of extracting capital from a company, as contributions are not taxed as income for salary, or at dividend tax rates.

Pension contributions are also deemed to be allowable expenses where made 'wholly and exclusively' for the purposes of the business, which generally means that contributions for those that generate revenue for the business are a cost to the business and will potentially reduce corporation tax payable.

It's important to remember that you are still restricted to £60,000 per annum, as well as the £1 for every £2 reduction that applies where income and dividends are over £260,000 (down to a minimum of £10,000). Carry forward rules can also be applied where unused allowances are available from the last 3 tax years.

Key considerations

1. Pension contributions are generally a very tax efficient way to save for retirement.

2. When accessing your pension, 25% of the fund (up to what was the Lifetime Allowance) is available as 'tax free cash'. The remainder can be withdrawn, taxable at marginal rates of income tax potentially giving a degree of control as to how much tax you pay in retirement if you also have other sources of income.

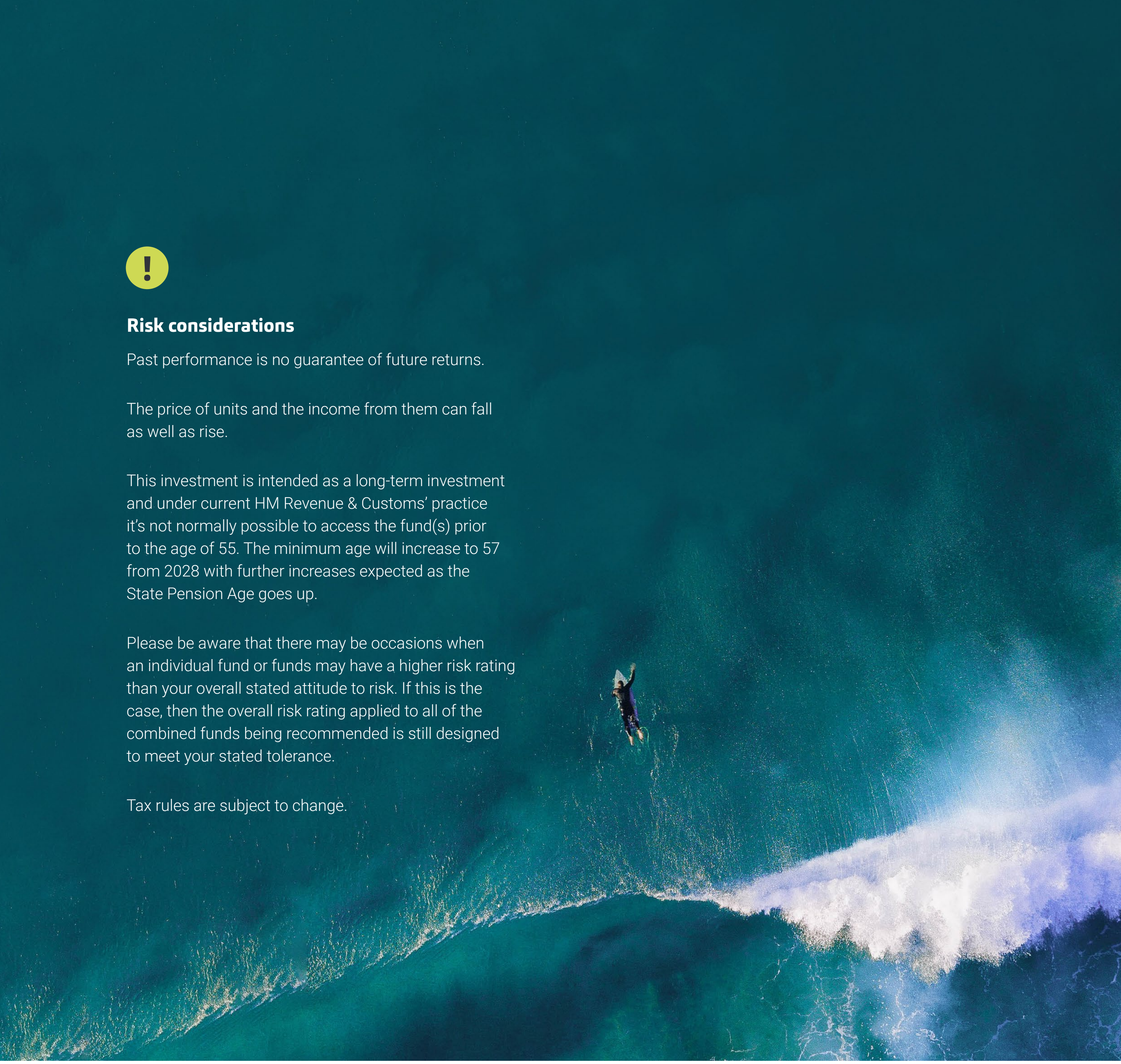
3. You can use your pension assets to purchase a guaranteed income, called an Annuity, so you don't have to rely on investment returns to produce a sustainable income in retirement.

4. Pensions above the historic lifetime allowance may be subject to additional tax charges on death. Given the tax relief that individuals receive, and with contributions being made by an employer, it can still be worth making further contributions and breaching this, though it is worth consulting a financial adviser at the time.

5. Whilst the same tax rules generally apply to pension contracts (aside from some older pensions that have protections or guarantees in place), features of pensions such as investment range, the ways in which they are accessed, cost and their administration does differ between providers, and it is therefore worth reviewing these with a financial adviser to check the pension best meets your needs.

6. Pensions are outside of the estate for Inheritance Tax purposes, and for those with larger estates, it may be beneficial to limit the use of assets within a pension and use assets that would otherwise be assessable for IHT at 40% first.

7. As pensions generally hold investments (unless used to purchase an annuity), the value of a pension can go up or down, and performance or return of capital is not guaranteed.



Risk considerations

Past performance is no guarantee of future returns.

The price of units and the income from them can fall as well as rise.

This investment is intended as a long-term investment and under current HM Revenue & Customs' practice it's not normally possible to access the fund(s) prior to the age of 55. The minimum age will increase to 57 from 2028 with further increases expected as the State Pension Age goes up.

Please be aware that there may be occasions when an individual fund or funds may have a higher risk rating than your overall stated attitude to risk. If this is the case, then the overall risk rating applied to all of the combined funds being recommended is still designed to meet your stated tolerance.

Tax rules are subject to change.

MHA Caves Wealth is authorised and regulated by the Financial Conduct Authority (FCA), Financial Services Register number 143715.

Risk Warnings

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