Pension and tax planning for higher earners

Practical financial planning tips for employees with annual income of £50,000+

2019/2020 tax year

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Pension and tax planning tips for higher earners

By checking you have taken a few key actions each tax year, you can make a big difference to your savings and investments - and reduce your overall tax bill.

This short guide summarises the key areas for you to consider and, where appropriate, discuss with your adviser. Read on for simple explanations and practical tips covering:

Personal allowance tax trap

For the 2019/20 tax year, the **standard personal allowance for UK residents is £12,500**. This is the amount that can be earned each year before any income tax is payable.

However, **for anyone earning £100,000 a year or more, the personal allowance is gradually tapered away**. The overall impact of this is an effective income tax rate of 60% on earnings between £100,000 and £125,000.

Making a pension contribution to reduce your income below £100,000 could help maintain your personal allowance and deliver big tax savings.

How it works:

- for every £2 earned over £100,000, you lose £1 of personal allowance
- that £2 is taxed at 40% and a further £1 of your income loses the protection of the personal allowance and is also taxed at 40%
- that's £1.20 in tax for every £2 earned between £100,000 and £125,000 - equivalent to 60% income tax

Child benefit

The reduction in child benefit kicks in at a much lower threshold than the tapered personal allowance, affecting anyone earning £50,000 or more a year.

For every £100 earned between £50,000 and £60,000, you'll be taxed at a rate of 1% of eligible child benefit. If your annual income is £60,000 or more, you no longer receive any child benefit.

number of children	annual child benefit	total tax* on earnings between £50k-£60k	effective tax rate
1	£1,076.40	£5,076.40	50.67%
2	£1,788.80	£5,788.80	57.88%
4	£3,213.60	£7,213.60	72.14%
6	£4,638.40	£8,638.40	86.38%

*Including child benefit taper, based on earnings of at least £60,000 per annum.

Making an eligible pension contribution could help you maintain your entitlement to child benefit.

Pensions annual allowance

The annual allowance (AA) is the maximum amount of pension savings you can make each year with the benefit of tax relief. This includes pension savings made on your behalf, such as employer contributions.

Going over the AA can result in a tax charge, so it is best avoided. The standard AA is the lower of your earnings in that tax year and £40,000.

However, **the AA is reduced if your income is over £150,000 a year** (that's from all sources, not just earnings, including employer pension contributions). Tapering is applied to reduce the AA **by £1 for every £2 of income above £150,000, down to a minimum of £10,000**.

Once you are aged 55 or over, **if you have started to take an income from your defined contribution (DC) pension savings, the cap is even lower**. You are then subject instead to **the money purchase annual allowance (MPAA), which is just £4,000 a year**. It is crucial to carefully consider your options before starting to access your pension benefits. The MPAA can seriously affect your ability to rebuild your pension funds in the future.

You can carry forward unused allowances from previous tax years, which can provide some wiggle room.

Pension freedoms

In 2015, we saw the introduction of the 'pension freedoms', which apply to all DC (also known as 'money purchase') pensions*. This removed the restrictions on how you could access your pension savings once you are aged 55 or over.

- up to 25% of your total pension fund can be taken tax free – either in one go or in separate payments as and when needed
- you still have the option to buy a secure income for life (known as an annuity), or you can instead purchase a series of short-term annuities
- you can take a flexible income from your pension savings with no minimum or maximum limits on the amount you can access each year
- your flexible income can be made up of a combination of the 25% tax-free/75% taxable elements of your pension savings
- you can take all of your pension savings as a single lump sum – but watch out for tax with this option

*Defined benefit (DB) pensions, such as final salary or career average ('CARE') schemes are not covered by the freedoms.

Death benefits

Another benefit of the pension freedoms is that they allow you to leave the full value of your pension benefits to whoever you choose. In addition, if you die before reaching age 75, your beneficiaries can receive tax-free withdrawals from your pension fund.

The majority of pensions sit outside of your estate for inheritance tax (IHT) purposes, so they can be a very useful tool in passing on your assets tax-efficiently.

With so many options – and the differing tax consequences – it is essential to obtain appropriate advice when you want to start accessing your pension.

Lifetime allowance

Your lifetime allowance (LTA) is the total amount you can build up in registered pension schemes throughout your life. **For the 2019/20 tax year, the standard LTA is £1,055,000**. Some people have historically protected a higher LTA; if this applies to you then you must be very careful not to take any action that could negate your protection.

Each time you access money from your pensions, it is known as a 'crystallisation event', and part of your LTA gets used up. If you have pension savings in excess of the LTA, lump sum withdrawals are taxed at 55%. The amount that is assessed against the LTA depends on how you take your benefits:

- if you take your maximum 25% tax-free cash lump sum (even if you are not yet drawing an income), 100% of your fund is 'crystallised' against the LTA
- when buying an annuity, the 'crystallisation' amount is the value of the fund used to make the purchase
- if receiving a pension from a DB scheme, the yearly pension is multiplied by 20 to calculate the crystallisation amount

If you are at, or near, the LTA – or have one of the various forms of protection – speak with your adviser to make sure your retirement savings remain as tax efficient as possible.

Salary exchange

There are typically two ways you can make contributions to your workplace pension scheme:

1. Employee contributions: this uses the 'relief at source' system, where your contribution is deducted from your net salary and basic rate tax relief is added automatically by your pension provider. Higher rate tax is then reclaimed via your tax return.

2. Salary exchange: you choose to receive a lower salary in exchange for additional employer pension contributions. This approach means you benefit from national insurance, as well as income tax, savings and higher rate tax relief is given immediately (with no need to reclaim via your tax return).

Do you need to review the structure of your workplace pension contributions?

Pensions carry forward

In order not to unfairly penalise people with large one-off pension increases or high bonuses in a single year, legislation allows you to go back and use any annual allowance that you have 'left over' from the last three years. However, you have to use your current year's allowance first, so careful planning is needed.

The table below provides an example of how carry forward could work for a higher earner who is subject to a tapered annual allowance. This shows the maximum they could contribute this year, by using up their unused allowance from 2016/17 onwards.

year	contribution	unused allowance
2016/2017	£20,000	£10,000*
2017/2018	£15,000	£15,000*
2018/2019	£20,000	£10,000*
2019/2020	None so far	£30,000*
Totals	**£55,000**	**£65,000**

*Due to tapering

Find out more

For more information on any of the issues raised in this guide, or to speak to an experienced financial adviser about your own personal circumstances, please get in touch:

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