Why you'll pay the price for new pension rules

The government is penalising workers trying to save for old age

David Prosser
April 15 2017, 12:01am, The Times

New restrictions mean that more people are likely to face tax charges GETTY IMAGES

As pension rules become more complicated, more people are falling foul of them. New data from Royal London, the pension company, shows that there was a 79 per cent increase in the number of people who saved more than their pension limit in the three years to April 2015, the most recent period for which statistics are available. With further restrictions having come into force since then, including rules introduced on April 6, it's likely that more people will be hit with tax charges and penalties.

The rules are also having an unfortunate side-effect — on the National Health Service. More GPs are leaving the profession to take early retirement because they are being hit by the £1 million lifetime cap on savings. Wondering if you too will be affected? This is what you need to know.

What is the annual allowance?
This is the maximum amount you may pay into tax-efficient private pension schemes over the tax year. In the 2017-18 financial year the allowance for most people is their salary level, up to a maximum of £40,000, although it is lower for those with incomes of more than £150,000.

The allowance applies across all the pension schemes you belong to, so if you are a member of more than one, you will need to add up your total contributions to make sure you are staying within the cap. Employer contributions count towards the allowance.

How do I check my position?
Add up all the contributions due to go into your pension schemes over the year — what you are paying and what your employer puts in.

For members of final-salary or defined-benefit schemes, which offer guaranteed benefits in retirement, the rules are more complicated and you may need to ask your scheme administrators for help. You will need to check the value of your pension benefits at the beginning and end of the tax year — the increase is what counts against the annual allowance — but the formula for making this calculation is quite technical.

What if I earn more than £150,000?
On incomes above £150,000 the annual allowance falls by £1 for every £2 earned over the threshold, until your income reaches £210,000. At this level and beyond, your annual allowance is capped at £10,000. All your income counts when working out whether you ’re affected by this “tapered” allowance; that’s your pay and any bonus you earn, as well as savings interest, dividends on shares, rent from buy-to-let properties, and any other income. The calculation also includes pension contributions made by your employer, but special rules apply if it’s only this element of your income that takes you over the £150,000 threshold.

Does anyone else have a reduced annual allowance?
Yes. Under the pension freedom rules, if you have started withdrawing income from your pension fund through a drawdown scheme you are entitled to make further pension contributions, but as of April 6 this year the annual allowance is only £4,000.

This rule is designed to prevent people withdrawing money from pension schemes so they can put it back in and claim extra tax relief on their contributions. Yet it does penalise some people; for example, those continuing in part-time work and enjoying membership of a workplace pension scheme while drawing on a private pension.

What if I exceed the annual cap?
You will have to pay tax at the highest marginal rate on contributions over and above the allowance, which will be 40 or 45 per cent if you are a higher-rate tax payer. You will also be denied any tax relief on the excess, or be asked to repay it.

Is there any way round it?
You may be able to use the carry-forward rules. These allow you to use any annual allowance you didn't take advantage of in the previous three tax years in the present tax year. In the extreme, someone who made no pension contributions in 2014-15, 2015-16 and 2016-17 could have up to an extra £120,000 of annual allowance to use this year. Alternatively, consider using other tax-efficient savings vehicles to save money for later in life. Individual savings accounts, venture capital trusts and the enterprise investment scheme are popular long-term savings options offering generous tax benefits.

What is the lifetime allowance?
This is the maximum amount you are entitled to accumulate across all your private pension schemes (but excluding state benefit entitlements). For the 2017-18 tax year the lifetime allowance is £1 million and the government has promised to increase it in line with inflation each year from 2018-19.

How do I calculate it?
The number you need is the total value of all your pension savings. If your pension schemes are money-purchase or defined-contribution

plans, such as individual personal pensions, for example, the calculation is simple; it's the total value of each pension pot you have added together.

In a defined-benefit scheme you multiply the value of the pension you have built up so far by 20. So if your scheme advises that your expected annual pension stands at £15,000, your pension pot would be worth £300,000 for the purposes of the lifetime allowance.

A small number of schemes also promise tax-free cash in addition to the pension entitlement and you should add this to your allowance calculation; but you don't need to do that if you can get tax-free cash only by accepting a lower pension, as in most schemes. If you have defined-benefit and defined-contribution pensions, you will need to add calculations for both.

What if I go over the allowance?
Nothing will happen until you start claiming your pension, but each time that you withdraw benefits, the value of your savings in that scheme will be checked against your remaining lifetime allowance. Once you have used it all up, any additional pension savings you make will be subject to swingeing tax charges.

These are applied slightly differently depending on whether you take the excess savings as lump sums or regular pension income. Either way you will have to hand 55 per cent of your money to the taxman.

How do I protect myself if I'm over the lifetime allowance?
Two schemes may be of use. If your pension savings were worth more than £1 million on April 5, 2016, you can apply to use the Individual Protection 2016 facility. This sets your lifetime allowance at the value of your savings on that date, subject to a maximum of £1.25 million, and allows you to continue saving in a pension scheme, although you will still have to pay 55 per cent tax if you go over your designated lifetime allowance.

Alternatively, you could apply for Fixed Protection 2016, which sets your lifetime allowance at £1.25 million, but prohibits you from making any further pension savings.

Are you in the danger zone?
Anyone earning more than £80,000 a year, or with savings worth more than £600,000, is in the lifetime allowance danger zone. The course of action you take will depend on age, attitude to investment risk and the value of the pension contribution from your employer. Some people may take the view that, even after the 55 per cent tax hit, they are still getting money they would otherwise miss out on. Take financial advice and talk to your employer. Some are reshaping their remuneration packages, but don’t expect your employer to monitor your exposure.

1 comment

Post comment

Turnbacktime The difference in the way the pension cap is applied to DC and DB schemes is obscene. A £1M pot in a DC scheme will get you a pension of about £24k by most experts opinions. Yet you can build up a pension of £50k a year before yiu hit the limit in a DB scheme.
Note most public sector employees are in DB schemes, so hardly surprising this doesn't get addressed by changing their multiple to say 40x, more in line with real current returns and formula recently applied by DoJ on insurance payouts.