ASSETS FINANCIAL SERVICES

GUIDE TO PENSION CONTRIBUTIONS

Tax year 2025/26

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We are often asked how much can be paid in to a pension and whether tax relief will be granted. Being helpful people we thought a guide might be useful but please bear in mind this is not intended as financial advice. We hope this document is helpful in giving you some background information but some of the issues are complex and we can only provide a summary here. If you are considering your retirement planning and thinking about contributing to a pension it is important to obtain independent financial advice so please contact us for help.

These comments largely focus on tax relief and Pension Lifetime Allowance issues as they relate to money purchase/defined contribution pension arrangements. The Annual Allowance and Lifetime Allowance rules will also take account of the value of any final salary/defined benefit entitlements but we have not considered defined benefit/final salary pension aspects in depth in this document. They will be included within our retirement planning strategy if we work together.

You can generally make pension contributions and potentially qualify for tax relief if you are UK resident and under the age of 75 when the payments are made. Pension rules allow for an employer to make payments after age 75 although many providers will not accept contributions post 75.

Before we look at pension contributions and their tax treatment we thought it might be helpful to consider why there has been such an increase in people making pension contributions in recent years. Excuse us if you are already familiar with these points but it helps put the overall retirement planning in context.

WHY SAVE IN A PENSION?

Most of our clients will have a variety of retirement income sources beyond pensions and our retirement planning advice will include consideration of other means of saving. However, pension contributions have been attractive for many years due to their tax advantages.

TAX RELIEF ON CONTRIBUTIONS

Payments to a pension will usually attract tax relief and who receives the tax relief will depend upon where the money has come from. Therefore, payments from your personal savings could receive Income Tax relief at a rate of between 20% and 45% (depending upon your rate of Income Tax in the year when you make the pension contribution). If the payment comes from a company the contribution will usually be treated as a business expense and will reduce the company’s liability to Corporation Tax.

Employees who wish to make personal payments to their employer’s pension arrangement will often find it best to use salary sacrifice if available. The employee gives up some earnings in exchange for a pension payment made by the employer. This will usually result in National Insurance savings which may boost the payments to the pension further if they are reinvested. Detailed analysis of salary sacrifice is not included here but is an aspect we are happy to advise on.

This tax relief on payments into a pension does not apply when you pay money towards most other investment options including ISAs, purchase of shares or buying an investment property. The availability of tax relief on pension contributions means that you will immediately have more money working for you in your pension than if you had saved by another conventional method.

PENSION TAX RELIEF FOR NON-TAXPAYERS

You can still make pension contributions and benefit from basic rate tax relief up to the age of 75 even if you do not have taxable earnings. For non-earners or those on less than £3,600 the good news is that you are still able to pay £2,880 per tax year into a pension and be credited with a gross contribution of £3,600.

Levels, bases of and reliefs from taxation may be subject to change and their value depends on the individual circumstances of the investor.

The Financial Conduct Authority does not regulate taxation advice.

TAX RELIEF ON GROWTH OF INVESTMENTS

Modern pensions will allow you to invest your pension money into a wide range of investment options but not residential property. Hopefully, your investments will grow over time but when you sell investments that are not held within a pension the profits may be liable to Capital Gains Tax (CGT). CGT can be charged at up to 28% (2025/2026 tax year) which can significantly reduce the gains you make. By contrast, investments held within a pension may be sold free from CGT which will maximise the growth of your wealth.

NO ADDITIONAL TAX ON INCOME

Most investments will create some form of income be it dividends, interest or rent. If these investments are held in your personal name they will usually be subject to Income Tax which may reduce your overall return by up to 45%. If these Investments are held within a pension they will escape any additional tax on any income produced. This roll up of income should allow your pension fund to grow at a faster rate than a taxed investment.

TAX FREE PAYMENT ON DEATH

When we die, our wealth is potentially liable to Inheritance Tax which is levied at 40% to the extent that our wealth that exceeds the tax-free allowance. For many people the value of their home alone will account for their full tax-free allowance leaving their non-pensions savings exposed to 40% tax. At the present time, if you have money left in a pension when you die it does not attract Inheritance Tax. If you die prior to age 75 your pension fund may usually be paid entirely tax free to whomever you choose provided you have not exceeded the Lump Sum Death Benefit Allowance and your pension policy has the flexibility to do so.

However, the Budget on 30th October 2024 announced a major shift in tax policy: from **6 April 2027**, unused pension funds and death benefits will be included in a person's estate for Inheritance Tax (IHT) purposes.

This change will challenge traditional strategies and many of us will need to revisit our planning.

Key Implications for Retirement Planning

- Double Tax Charge: In addition to the new IHT liability, for those who die after age 75 **Income Tax** will still be payable when beneficiaries draw income from inherited pension funds. This double tax charge could significantly reduce the funds passed on to loved ones.
- Potential Loss of MRNRB: Including pension funds in the estate may increase its overall value, potentially reducing or eliminating entitlement to the **Main Residence Nil-Rate Band (MRNRB)** and leading to a higher Inheritance Tax bill on the overall estate.
- Reassessment of Strategies Needed: Many people will need to review their approach and we will be at hand to assist you in making the best of your situation. This may include changing the order in which assets are spent in retirement."

PENSION FREEDOM RETIREMENT FLEXIBILITY

In earlier years when you wished to start spending your pension you could draw any tax-free cash and the rest of your pension fund had to be used to purchase an annuity or provide regular income at a level linked to annuity rates. The level of annuity income and pension rates available was unattractive for many people and did not provide flexibility as to how much was paid and when. Nowadays, HMRC allow you to access all or as much of your pension fund as you wish from age 55 (age 57 from 2028) without stopping work and with no restriction on how much you draw and when. However, some pension arrangements will not allow this Pension Drawdown. If necessary, we can advise on pension transfer options to allow you to access your fund more flexibly.

Usually, 25% of the fund is available tax-free and the rest is taxed at whatever rate of Income Tax applies to you when you draw it. Most people can avoid paying anything more than basic rate Income Tax when they draw their pension and this ease of access and Pension Drawdown flexibility has attracted many investors back to pensions.

INCREASING TAX ON DIVIDENDS

Many shareholding directors choose to remove cash from their businesses by paying themselves dividends. The tax burden on dividends has increased significantly in recent years leading business owners to explore other ways of removing wealth from their business. A straight forward strategy will be for the business to make payments to the director's pension which they can access from age 55 (age 57 from 2028) even if they are still working.

RESTORATION OF PERSONAL ALLOWANCE FOR HIGH EARNERS

We are each allowed to earn an amount each year which is not subject to Income Tax (the Personal Allowance). However, once our earnings exceed £100,000 this Personal Allowance is progressively lost. A personal contribution into a pension for somebody earning marginally over £100,000 will usually attract tax relief and depending upon their circumstances this may serve to reduce their taxable income back under £100,000 thus restoring the Personal Allowance. The combination of higher rate Income Tax relief at 40% and the tax saving made by preserving the Personal Allowance can produce an effective rate of Income Tax relief on the pension payment as high as 60%.

Having looked at the reasons why people are making pension contributions we will now look at the various tax considerations. A key point to grasp is that there are various aspects that need to be borne in mind in deciding whether a payment will be attractive or not. Focusing on one aspect is not usually sufficient and the whole situation needs to be reviewed when providing pension advice. For instance, a company might be able to claim Corporation Tax relief on a payment made on behalf of a director but if the director's Annual Allowance capacity is exceeded, the director may then receive a personal tax charge making the transaction unattractive overall. Similarly, a pension contribution may attract Income Tax relief when the payment is made but the overall tax efficiency may not be attractive if the Lifetime Allowance is restored in the future and a 55% tax charge is payable when the fund is paid out.

TAX RELIEF ON THE PAYMENT

The first consideration is where the money for a pension contribution comes from. If payment is made by a company the business can potentially claim the contribution as a business expense whereas if you make a payment from your personal funds you will be seeking a reduction in your own Income Tax.

Levels, bases of and reliefs from taxation may be subject to change and their value depends on the individual circumstances of the investor.

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CONTRIBUTIONS PAID BY BUSINESS

Payments from a company are always made gross without deduction of tax relief and the business must then claim Corporation Tax relief. Corporation Tax relief on pension payments made by a business are at the discretion of HMRC and relief is given by deducting the gross amount of the pension payment from an employer's taxable profits which reduce the business's Corporation Tax bill. HMRC state that payments 'will be deductible as an expense provided they are incurred wholly and exclusively for the purposes of the employer's profession.' Life would be simple if there was a published list of requirements to be met but there is not, rather we need to show a pension payment has been made for 'trade purposes'.

If this sounds scary, our experience has been that issues are rare and HMRC stress that the 'wholly and exclusively' test should only be necessary in limited circumstances. Their general attitude is that pension contributions will be allowable as part of the cost of employing staff and a pension contribution by an employer to a registered pension scheme will receive Corporation Tax relief unless it can be shown that there is a non-trade or non-business purpose for the contribution. If an employee's overall package including salary, bonus, pension payments and other benefits is in line with expectations for their job their employer can usually expect Corporation Tax relief.

If the payment is made in respect of a controlling director whose contribution is key to the business the level of renumeration paid to the director will usually be regarded as a commercial decision and not challenged unless other factors concern HMRC. We have rarely seen HMRC challenge pension contributions and the most common concern would be where a controlling director's total package including a large lump sum pension payment created an accounting loss. In these circumstances, HMRC might make some enquiries.

If there is any doubt, the employer can request that the local Inspector for HMRC provide advance guidance as to whether tax relief is likely to be granted or not. HMRC are not bound to provide such guidance and plenty of time should be allowed for them to make their response -- don't call them a week before your company year end. Our advice should always be sought prior to making a large single contribution and we will happily liaise with a client's tax advisers to ensure there are no issues.

It should be borne in mind that even though a business may receive Corporation Tax relief on a pension payment the overall tax position needs to be considered in deciding whether the retirement planning is attractive. What is the point of a shareholding director's business receiving Corporation Tax relief at 19% if they then exceed their Annual Allowance and get a personal tax charge at up to 45%?

CONTRIBUTIONS PAID PERSONALLY

If you make a tax relievable payment to a pension from your personal funds it will be usually credited with basic rate Income Tax relief when you make the payment to the pension provider. Therefore, if you pay £8,000 to your personal pension the provider will credit you with a £10,000 investment and the pension company will then claim the £2,000 of basic rate tax relief from HMRC. If you are a higher rate Income Tax payer you may be entitled to additional tax relief to bring the total tax relief up to 40% or even 45%. The net cost of a £10,000 pension payment may be as low £5,500 for a high earner once tax relief has been given. Any additional relief is claimed via your self-assessment return so please let your accountant or tax adviser know about your pension payments when they are preparing your self-assessment return.

For tax purposes, a pension payment will be set against your income in the tax year in which you physically make the contribution. Therefore, if you had paid a pension contribution on 6 April 2025 you could expect it to be allocated against your taxable income in the 2025/2026 tax year which runs 6 April 2025 to 5 April 2026. However, if you had made the payment a day earlier on 5 April 2025 it would be set against the previous 2024/2025 tax year.

THE ANNUAL ALLOWANCE

If you are a UK tax payer you can usually expect Income Tax relief on your individual pension contributions up to a level of 100% of earnings or the Annual Allowance (£60,000 in 2025/2026 tax year) whichever is less.

If you exceed the Annual Allowance your personal tax relief on the excess contributions could be reversed with an Annual Allowance charge. However, if you have not used up all of your allowances from previous years you may be able to carry forward unused allowances from the previous three years to reduce or eliminate any Annual Allowance charge.

This is not the place to go into calculation of the Annual Allowance charge but rest assured it is harsh and is intended to negate the tax benefits of excess contributions made on your behalf. The charge is made by adding an extra amount of notional income to your income when calculating your liability thus giving you a bigger tax bill intended to counteract any tax benefit you have made.

This overall Annual Allowance includes not only the amount you personally pay into personal pensions but also the value of all contributions made to private pensions on your behalf from all sources. Therefore, if you are an active member of a final salary/defined benefit scheme you will need to include the value of your membership of the scheme in calculating how much of the Annual Allowance is still available (see example below).

By way of example, if you earned £90,000 in the 2025/2026 tax year and wanted to make a personal contribution of £80,000 gross into a personal pension you could only expect tax relief on £60,000 of the contribution as your Annual Allowance for that tax year is £60,000. However, if you had not used your annual allowances in previous years you can potentially 'carry forward' these allowances to justify a higher contribution. In our example, if our client had £20,000 of unused allowances available from earlier years these could be carried forward to justify tax relief on the full £80,000.

However, unused allowances can only be carried forward from the previous three tax years and are only available if the person had a qualifying pension arrangement in place in the earlier tax year.

Even if unused allowances are available from earlier years the maximum level of tax relievable individual pension contributions will still be capped at the level of earnings in the present year. Therefore, even if our client had unused annual allowances of £100,000 available from previous tax years the maximum level of tax relievable pension payment would still be restricted to £90,000 for the current year. You probably need a cup of tea after the last few paragraphs and we would strongly suggest that you contact us for professional independent financial advice.

CALCULATING THE ANNUAL ALLOWANCE VALUE FOR DEFINED BENEFIT / FINAL SALARY PENSION RIGHTS

If you are fortunate enough to be a member of a final salary/defined benefit pension scheme the annual allowance value of pension payments made to the scheme by you and your employer are not so easily apparent. Indeed, if your entitlement under the scheme suddenly increases markedly, perhaps due to a pay rise you may unknowingly exceed the annual allowance. For the purposes of the calculation we need to look at the increase in the value of your pension in a tax year to create an ‘input amount’ which counts towards your Annual Allowance.

The arithmetic is not always straightforward, and we would usually suggest that you obtain confirmation of the input amount from your pension scheme administrator and seek independent financial advice. However, to give you some insight into the process we give a summary and a worked example below.

The contribution for Annual Allowance purposes is calculated by determining the increase in the monetary value of your pension benefits over a year. This is done by working out an opening value for your pension rights and then comparing this with a closing value at the year end. The difference between the two amounts represents the contribution amount for Annual Allowance purposes.

Opening value: This is the total value of your annual pension already built up at the start of the year/pension input period in question. You multiply the annual pension amount by 16 and add any lump sum lump sum entitlement already earned as at the same date. You then make an allowance to take account of inflation by increasing the notional amount calculated by Consumer Price Index (CPI) (using the CPI figure for September prior to your valuation date). This inflation adjusted amount will be your opening value.

Closing value: The opening value then needs to be compared with the closing value of your pension rights. You confirm the annual pension at the end of the year/pension input period and again multiply this amount by 16. The value of any additional lump sum entitlement is again added to create your closing value.

The difference in value between the opening value and the closing value represents the value of the increase in your final salary/ defined benefit pension for Annual Allowance purposes. This explanation ignores if you have had transfers into or out of the scheme during the year but in practice these will need to be taken into account in the financial planning.

A WORKED EXAMPLE MAY HELP (OR IT MAY MAKE YOUR HEAD HURT…)

EXAMPLE

Mr Test belongs to a final salary pension that gives him:

A pension of 1/60th final salary for each year of service. In addition, he gets a lump sum at retirement of three times the annual pension.

At the start of the pension input period he has 10 years service and Mr Test's pay is £60,000.

At the end of the pension input period pay has increased to £64,000 by which time he has 11 years scheme membership.

The opening value of his pension rights is:
10/60 x £60,000 = £10,000 multiplied by factor of 16 £10,000 x 16 = £160,000

We also need to add the lump sum entitlement to the notional value of the annual pension.
£160,000 + (3 x £10,000) = £190,000

We now need to increase by CPI (assume 2 per cent)
£190,000 x 1.02 = £193,800 (the opening value)

The closing value at the end of the input period is:
11/60 x £64,000 = £11,733.33

We need to multiply by
16 £11,733.33 x 16 = £187,733.33

Again we need to add the lump sum benefit
£187,733.33 plus (3 x £11,733.33 = £35,199.99) = £222,933.32 – the closing value

The difference between the opening value and closing value over the year is £29,133.32 which represents the amount to be used for Annual Allowance purposes.

REDUCTIONS IN THE ANNUAL ALLOWANCE

Some people may not be entitled to the usual Annual Allowance which is currently set at £60,000.

THE MONEY PURCHASE ANNUAL ALLOWANCE (MPAA)

If you start drawing money from a Money Purchase / Defined Contribution Pension you can find that your ability to make future tax relievable payments is restricted. This will most commonly affect those using Pension Drawdown who draw more than just the tax-free lump sum. The current MPAA for those who have accessed pension benefits is only £10,000 as compared to the usual Annual Allowance of £60,000. People who may wish to make personal contributions or benefit from employer payments in the future need to be careful about accessing their pensions when considering their retirement planning. The regulations are complex but common actions that will trigger the MPAA restriction include

- Transferring all or part of your pension fund into a new style Flexi-Access Pension Drawdown arrangement AND starting to take income (you can however just take tax free cash and not trigger the MPAA).
- If you take all or part of your pension as a lump sum (UFPLS - don't worry about what UFPLS stands for).
- If you use all or part of your pension fund to purchase an annuity such as a flexible or investment linked annuity which could allow a decrease in income.
- If you already have an old style Capped Drawdown arrangement and start to take income that exceeds the level of the cap you will immediately fall foul of the MPAA.

It is possible to access your pension funds without automatically triggering MPAA. The more common strategies include

- Taking only your tax- free cash entitlement, transferring the remaining fund into Flexi-Access Pension Drawdown but not drawing income.
- Taking your tax-free cash but then buying a conventional annuity that provides a level or increasing income for the rest of your lifetime.
- Using the Small Pension Pots legislation to access up to three individual pension pots that are each valued at less than £10,000. There are a number of hurdles to overcome to use this route and you should definitely seek our financial advice.

If you are subject to the Money Purchase Annual Allowance you cannot use carry forward of unused allowances from earlier years to justify a higher pension payment.

The MPAA applies not only in the year when you access your pension and trigger the reduction but also applies to all future years. We would strongly suggest that you take professional financial advice before drawing any money from your pension.

THE TAPERED ANNUAL ALLOWANCE

From 2016 high earners are entitled to a lower level of Annual Allowance. Currently, for every £2 of income in excess of £260,000 £1 of Annual Allowance will be lost subject to a maximum reduction of £50,000. Therefore, a person earning over £360,000 will have their Annual Allowance for that tax year capped at £10,000. If pension contributions have exceeded the Tapered Annual Allowance unused allowances from previous years may be used to protect excess payments from an Annual Allowance tax charge. However, it is only the unused Tapered Annual Allowance that can be carried forward from that year for future carry forward purposes.

The Tapered Annual Allowance only applies on a tax year basis so if a person has high earnings and is affected in one tax year, they will not continue to be affected if their income is below £260,000 in future tax years.

The calculation for income is complex and includes all income not just employment earnings and may also include pension contributions, our pension advice should be sought.

THE LUMP SUM ALLOWANCE (LSA) AND LUMP SUM AND DEATH BENEFIT ALLOWANCE (LSDBA)

The Lifetime Allowance (LTA) was abolished and replaced by two new allowances from 6th April 2024.

Lump Sum Allowance (LSA): This allowance is a limit on how much can be taken as tax-free lump sums from your pension whilst alive. The standard allowance is £268,275.

Lump Sum and Death Benefit Allowance (LSDBA): As well as the lump sum allowance, there is an overall limit on the amount of tax-free lump sums that can be taken during lifetime and by beneficiaries after death. The standard allowance is £1,073,100.

Please note, these allowances are modified by different forms of protection, e.g. enhanced, primary protection, individual and fixed protection.

Although the Lifetime Allowance has been scrapped it is a politically hot subject and could be restored by a future Government. As ever, you should seek the best pension advice possible from an independent financial adviser. Other investment options may be attractive for those who wish to continue to save but are affected by the LSA and LSDBA concerns. Common alternatives include ISA, Venture Capital Trusts (VCT) and Enterprise Investment Scheme (EIS).

We hope these comments are helpful and would love to hear from anyone contemplating pension contributions. All pension planning advice provided by our practice is given by a Chartered Financial Planner so you can rest assured that you are receiving the best possible, independent pension advice.

WARNING TIME

We would stress that these comments are not intended as a substitute for financial advice and we cannot take any responsibility for action taken or not taken by any party as a result of reading this document.

English tax rates in the 2025/2026 tax year have been used in the examples above.

The value of your investment can go down as well as up and you may get back less than the amount invested.

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