# The Trustee toolkit downloadable

## Pensions law

### Tutorial three: Tax and the state pension

By the end of this tutorial you will better understand:

- the tax advantages of saving into a registered pension scheme
- the limits that apply to contributions and pension saving that benefit from tax relief
- what the state pension is

This tutorial is part of Scenario two.

**Glossary**

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at www.trusteetoolkit.com

The Pensions Regulator

## Registering a pension scheme

To enjoy tax relief, a pension scheme must be registered with HM Revenue & Customs (HMRC) after it is set it up and ideally before any contributions have been put into the scheme.

There is also a legal requirement for pension schemes to register with The Pensions Regulator following HMRC registration. A registered pension scheme can lose the registration with HMRC if certain circumstances apply. One of these circumstances would be if a scheme administrator has failed to pay a substantial amount of tax which they are liable to pay under law.

If you want to learn more about registering a pension scheme, you can visit http://www.gov.uk/guidance/pension-administrators-register-a-scheme

**Master trusts:** Trustees should note that a new master trust scheme (ie commencing operation after 1 October 2018) is unable to become registered with HMRC unless it has been authorised.

## Tax advantages

One of the advantages of saving into pension schemes that are registered with HMRC is that they are given certain tax privileges (provided certain conditions are met). These tax advantages apply to three main areas.

### Contributions

During active membership, both the employer and employee enjoy full tax relief on the contributions made. The employer does not pay any corporation tax on the money paid on behalf of the employee and the employee receives income tax relief on his or her contributions.

You can pay as much as you like into any number and type of registered pension schemes and get tax relief on contributions of up to 100% of your earnings each year, provided you pay the contributions before age 75. However, the maximum amount that you can save each year towards a pension from which you benefit from tax relief is subject to an 'annual allowance'. There is also a 'lifetime allowance' limit which is the maximum amount of pension saving that you can build up over your life that benefits from tax relief.

### Investment funds

Once the contributions are invested and paid into investment funds, there are further tax advantages. The interest from government bonds (gilts) and corporate bonds is accumulated free of tax in pension funds but dividends from shares owned by equity funds are taxed.

### Lump sum

Finally, once you take your benefits (and in other limited circumstances), a lump sum may be available. In a DB scheme, this lump sum is usually 25% of the pension pot or value of the benefits although there are certain exceptions to this rule. Your pension income, will nevertheless be taxed in the same way as earned income.

Both the annual allowance and lifetime allowance limits are reviewed each year by HMRC. See www.gov.uk/tax-on-your-private-pension for more.

DC schemes have the choice to offer their members, once they turn 55, the option of being able to access their entire pension fund as a lump sum. In total up to 25% of the value of a pension fund can be paid as a tax free lump sum. The remainder can be taken as a further lump sum, a series of lump sums, or used to provide a regular income, but will be taxed at the member's marginal rate of tax.

## The state pension

The UK state pension system has undergone several major reforms and it is still in the process of change.

### State pension reform

This is due to an ageing population in the UK with increased longevity and fewer people working and paying tax to maintain the state pension system. The Government recognises this increasing liability and is working to ensure that it can afford to support pensioners, not only now but also in years to come.

### State pension age

Previously the state pension age in the UK for men and women was 65 and 60. respectively Legislation is now equalising this age, so that by November 2018 the state pension age for women will be 65. From December 2018, the state pension age will gradually be increased beyond age 65 for both sexes.

To work out your actual pension age (shown in years and months) is complex so the government has produced a tool, the 'State Pension Calculator', at www.gov.uk/state-pension-age.

## State pension

A new single-tier 'flat rate' state pension came into force on 6 April 2016. Anyone retiring on or after this date will receive this instead of basic state pension, and possible additional state pension.

The state pension is based on your national insurance record. You'll usually need at least 10 qualifying years on your national insurance record to get any state pension. In general, you would need 35 qualifying years of paying national insurance contributions to receive the full 'flat rate' state pension.

Individuals who had made national insurance contributions before 6 April 2016 will not necessarily receive the 'flat-rate' amount. When the single-tier pension takes effect for these individuals, a test is done to determine each person's so-called 'foundation amount' for the single-tier pension.

### What is the test?

This test translates an individual's pre-6 April 2016 national insurance record into a value under the single-tier system.

For anyone previously contracted out of the additional state pension, a deduction is applied to the single-tier valuation to reflect the lower rate of national insurance contributions he or she paid while contracted out.

This is then compared with the total state pension the individual would have received when valued under the former state pension rules alone. Individuals receive the higher of the two amounts as their 'foundation amount'.

## State pension prior to 6 April 2016

There were two components included in a state pension for employees:

- the basic state pension
- an additional state pension (depending on earnings)

The additional state pension was first introduced as the 'graduated retirement benefit scheme' in April 1961 until April 1975. This was superseded by the 'State Earnings-Related Pension Scheme' (SERPS) from April 1978 until April 2002. This was superseded by the 'State Second Pension' (S2P) from April 2002. These schemes were all implemented to ensure extra state pension savings for employees paying national insurance contributions (and certain other groups).

On 6 April 2016, the additional state pension was abolished and replaced with the new single-tier 'flat rate' state pension. Individuals already in receipt of state pension before 6 April 2016 will however continue to receive their benefits under the former state pension rules. You can learn more about the additional state pension at www.gov.uk/additional-state-pension and the new state pension at www.gov.uk/new-state-pension/overview.

### Pension credit

Some people will be entitled to 'pension credit'. This is a means-tested benefit which ensures that a pensioner's income does not fall below a minimum level. It is made up of two components:

- 'savings credit' - anyone who reaches state pension age after 5 April 2016 will not be eligible for this type of pension credit (unless a pensioner is in a couple and one of them reached state pension age before 6 April 2016)
- 'guarantee credit' - this will still be available for those who meet the conditions

The qualifying age for guarantee credit for both men and women will continue to rise after 6 April 2016 in line with the increases to women's state pension age. You can learn more about pension credit at www.gov.uk/pension-credit.

## Contracting out

Employees have national insurance contributions deducted automatically from their salaries. Certain other types of earner, such as the self-employed, also pay national insurance contributions. These contributions are used to finance the state pension provided at state pension age.

Before 6 April 2016 employers could, subject to certain conditions, choose for their employees to 'contract out' of the additional state pension and benefit from a lower rate of national insurance contributions. Individuals with an appropriate personal pension could also contract out until 6 April 2012.

Members who were contracted out of the additional state pension (SERPS or S2P) lost some or all of their entitlement to the additional state pension and instead receive a pension from their own scheme (this had to provide at least a guaranteed minimum standard of pension benefit). Members who were contracted out will also receive a deduction from the new 'flat rate' state pension.

Before 6 April 2012, members of pension schemes could be contracted out on either a money purchase (ie defined contribution) basis or a salary related (ie defined benefit) basis.

Since 6 April 2012, it has no longer been possible for pension schemes to contract out on a money purchase basis. Contracting out on a salary related basis was also abolished altogether on 6 April 2016 and so it has not been possible to contract out at all since that date.

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