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A fresh approach to accounting

PENSION SAVINGS - TAX ASPECTS

Types of pension schemes

There are two broad types of pension schemes from which an individual may eventually be in receipt of a pension:

- Workplace pension schemes
- Personal Pension schemes.

A Workplace pension scheme may either be a defined benefit scheme or a money purchase scheme.

A defined benefit scheme pays a retirement income based on final salary and years of service, while a money purchase scheme instead reflects the amount invested and the underlying investment fund performance.

The number of defined benefit pension schemes has declined in recent years in part due to the regulations imposed upon the schemes and the cost of such schemes to the employer. The majority remaining are in the public sector. Each scheme sets its own rules within the permitted legislation so professional advice is always recommended when dealing with such schemes. Detailed aspects are therefore not covered in this fact sheet.

All employers are required to provide a workplace pension scheme due to auto-enrolment legislation and these are mainly money purchase schemes. A separate factsheet on auto- enrolment is available.

A Personal Pension scheme is a privately funded pension plan but can also be funded by an employer. These are also money purchase schemes. Self-employed individuals can have a Personal Pension.

To benefit from tax privileges all pension schemes must be registered with HMRC. For a Personal Pension scheme, registration will be organised by the pension provider.

We set out below the tax reliefs available to members of a money purchase Workplace scheme or a Personal Pension scheme.

It is important that professional advice is sought on pension issues relevant to your personal circumstances.

What are the tax breaks and controls on the tax breaks?

An individual is entitled to make contributions and receive tax relief on the higher of £3,600 or 100% of earnings in any given tax year. However, tax relief will be restricted for contributions in excess of the annual allowance.

A money purchase scheme allows the member to obtain tax relief on contributions into the scheme and tax-free growth of the fund. If an employer contributes to the scheme on behalf of an employee, there is generally no tax charge on the member and the employer will obtain a deduction from their taxable profits.

Under the current pensions regime, there are no limits on either the maximum amount which can be invested in a pension scheme or on the total value within pension funds. However, there are controls which limit the tax reliefs available. Firstly, there are limits on the amount of tax relief available to the member in making the contributions to or accruing the benefits in their pension schemes. Secondly, there are tax free limits in accessing those benefits.

Each individual has an annual allowance which sets the maximum amount which can be invested with tax relief into a pension fund. The allowance applies to the combined contributions of an employee and employer (where relevant). Amounts in excess of this allowance trigger a charge.

When benefits are accessed, there is a lump sum and death benefit allowance which limits the amount which can be accessed tax free depending on various circumstances.

Key features of money purchase pensions

- Contributions are invested for long-term growth up to the selected retirement age.
- At retirement (which may be any time from the age of 55) the accumulated fund is generally turned into retirement benefits which may include a tax-free lump sum and then taxable income.

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Tel: 020 3915 8585

- Employer contributions (where relevant) are payable gross direct to the pension provider.

Persons eligible

All UK residents may have a money purchase pension. This includes non-taxpayers such as children and non-earning adults. However, they will only be entitled to tax relief on gross contributions of up to £3,600 per annum.

Methods of giving tax relief

Personal Pension Plans

Personal contributions are generally payable net of basic rate tax relief, leaving the pension scheme provider to claim the tax back from HMRC.

Higher and additional rate relief is given as a reduction in the taxpayer's tax bill. This is normally dealt with by claiming tax relief through the self assessment system.

There are special rules if contributions are made to a retirement annuity contract. (These are old schemes started before the introduction of personal pensions.)

Workplace pension schemes

There are two distinct methods which operate and it is vital that the method applying to particular pension arrangements is identified to ensure the correct tax treatment. The alternative methods are as follows:

- A net of basic rate tax contribution is deducted from net pay of the employee. The contribution is then paid over by the employer to the pension scheme. The basic rate is claimed back from HMRC by the pension provider. Higher or additional rate relief is claimed through the self assessment system.
- A gross contribution is deducted from the employee's gross salary and paid by the employer to the scheme. This lowers the employee's PAYE tax bill and no further action is needed by taxpayers as the correct relief has been given through the payroll.

One effective route for an employee to consider may be to enter a salary sacrifice arrangement with an employer. The employer will make a gross contribution to the pension provider and the employee's gross salary is reduced. This will give the employee full income tax relief (by reducing PAYE) but also reduces National Insurance contributions (NICs).

The annual allowance

The annual allowance was increased to £60,000 from 6 April 2023. Previously it had been £40,000.

Any contributions in excess of the £60,000 annual allowance are potentially charged to tax on the individual as their top slice of income. Contributions include contributions made by an employer.

The stated purpose of the charging regime is to discourage pension saving in tax registered pensions beyond the annual allowance. Most individuals and employers actively seek to restrict pension saving so as to not exceed the annual allowance, rather than fall within the charging regime.

Carry forward of unused annual allowance

A carry forward of unused annual allowance is available for three years. This is useful for individuals who may have uncertain income streams or in situations where the 'owner managed business' company employer has fluctuating profits, allowing higher contributions to be made in a given tax year where there is brought forward capacity available.

For 2025/26, the unused allowance that can be brought forward is from 2022/23, 2023/24 and 2024/25, provided the individual was a member of a registered pension scheme at some time during the relevant brought forward tax year. Note however, that the annual allowance available for 2022/23 was only £40,000.

Unused annual allowance carried forward is the amount by which the

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annual allowance for that tax year exceeded the total pension savings for that tax year.

The annual allowance for the current tax year is always used before any unused allowance brought forward. The earliest year unused allowance is then used before a later year.

Example

Assume it is March 2026. Bob is a self employed builder who has had a very profitable year.

In the previous three years Bob has made contributions of £30,000, £10,000 and £30,000 to his pension scheme. He therefore has spare capacity of £10,000 from 2022/23 (£40,000 - £30,000), £50,000 from 2023/24 (£60,000 - £10,000), and £30,000 from 2024/25 (£60,000 - £30,000) to carry forward to 2025/26.

In 2025/26, Bob has the current year annual allowance of £60,000 and £90,000 brought forward amounts, which means that Bob can make a contribution of £150,000 without having to pay any extra tax charge.

If he decides to make a contribution of say £70,000, this will use the current annual allowance of £60,000 and £10,000 brought forward from 2022/23. This would be sensible as the brought forward capacity from that earliest year will expire on 5 April 2026.

Lower annual allowance for those with high levels of income

Individuals with high levels of income may have their annual allowance reduced to limit the tax reliefs they obtain. This is known as tapering the allowance and applies where both their 'adjusted' and 'threshold' income exceeds certain levels. Professional advice should be sought as to the detailed meaning of these terms.

However, 'threshold' income means, broadly, a person's taxable income and 'adjusted' income is' threshold' income plus pension contributions made by an employer.

Currently the threshold income level is £200,000 and the adjusted income threshold £260,000. For every £2 of adjusted income over the adjusted income threshold, an individual's annual allowance is reduced by £1, down to a minimum amount. The minimum amount is currently £10,000.

Example

Victoria has adjusted income of £280,000 and threshold income of £220,000. Her annual allowance will therefore be tapered. As she has £20,000 excess income above the £260,000 limit she will lose £10,000 (£1 for every £2 excess) of her annual allowance. Her annual allowance is therefore £50,000.

The rate of charge if annual allowance is exceeded

The charge is levied on the excess above the annual allowance at the appropriate rate in respect of the total pension savings. There are exemptions from the charge in the case of serious ill health as well as death.

The appropriate rate will broadly be the top rate of income tax that you pay on your income.

Example

Anthony, who is employed, has income (before pensions tax relief) of £200,000 in 2025/26. He makes personal pension contributions of £56,000 net in March 2026. He has made similar contributions in the previous three tax years.

He will be entitled to a maximum £60,000 annual allowance for 2025/26. The charge will be:

Gross pension contribution	£70,000
Less annual allowance	(£60,000)
Excess	£10,000 taxable at 45% = £4,500

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Anthony will have had tax relief on his pension contributions of £31,500 (£70,000 x 45%) and now effectively has £4,500 clawed back. The tax adjustments will be made as part of the self assessment tax return process.

The lump sum allowance (LSA) and the lump sum death benefit allowance (LSDBA)

The annual allowance rules control the level of tax relief on contributions to money purchase schemes and accrued benefits in defined benefit schemes whilst growing your pensions tax savings. The LSA and the LSDBA determine the amount of benefits which can be accessed tax free depending on set circumstances.

Individuals who have money purchase schemes and some defined benefit schemes can take a tax free lump sum when accessing pension benefits.This is referred to as the LSA. Generally, this is limited to 25% of the standard LSDBA. The LSDBA is set at £1,073,100 so 25% is a maximum of £268,275. Other pension income extraction is subject to normal income tax rules. Where individuals are permitted to take a higher lump sum, the excess above the limit is subject to income tax.

Certain individuals with pension protection certificates are entitled to higher tax free limits. This is a complex area and specialist professional advice should always be taken.

In certain situations, the whole of the LSDBA can be accessed tax free. This occurs for example where an individual dies before the age of 75 or qualifies due to serious ill health.

Accessing pension benefits from money purchase schemes

Individuals have flexibility to choose how to access their pension funds from the age of 55.

The options include:

- a tax-free lump sum of 25% of fund value (as detailed above)
- purchase of an annuity with the remaining fund, or
- income drawdown (see below for options available regarding flexi access accounts and lump sum payments).

An annuity is taxable income in the year of receipt. Similarly any monies received from the income drawdown fund are taxable income in the year of receipt.

Flexi access accounts and lump sums

Where a lump sum and annuity are not taken access to the fund can be achieved in one of two ways:

- allocation of a pension fund (or part of a pension fund) into a 'flexi-access drawdown account' from which any amount can be taken over whatever period the person decides
- taking a single or series of lump sums from a pension fund (known as an 'uncrystallised funds pension lump sum').

When an allocation of funds into a flexi-access account is made the member typically will take the opportunity of taking a tax-free lump sum from the fund.

The person will then decide how much or how little to take from the flexi-access account. Any amounts that are taken will count as taxable income in the year of receipt.

Access to some or all of a pension fund without first allocating to a flexi-access account can be achieved by taking an uncrystallised funds pension lump sum.

The tax effect will be:

- 25% is tax-free (subject to the limit detailed above)
- the remainder is taxable as income.

Money Purchase Annual Allowance (MPAA)

The government is alive to the possibility that those aged 55 and over could take advantage of the flexibilities by 'recycling' their earned income into pensions and then immediately taking out amounts from their pension funds. Without further controls being put into place an individual could obtain tax relief on the pension contributions but only be taxed on 75% of the funds immediately withdrawn.

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A reduced annual allowance therefore applies in certain scenarios to limit the tax relief on contributions. This is known as the MPAA and the allowance is currently £10,000 per tax year, overriding the normal £60,000 annual allowance.

There is no carry forward of any of the MPAA to a later year if it is not used in the year.

The main scenarios in which the reduced annual allowance is triggered are if:

- any income is taken from a flexi-access drawdown account, or
- an uncrystallised funds pension lump sum is received.

However just taking a tax-free lump sum when funds are transferred into a flexi-access account will not trigger the MPAA rule.

How we can help

This information sheet provides general information on the making of pension savings provision. Please contact us for more detailed advice.

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