Pensions & Retirement: the guide

CHARLES STANLEY Direct

Introduction

Whether you are new to investing or nearing retirement pensions are likely to be an important consideration. When you make a contribution to your pension, the government adds money. This is called tax relief and is one of the main advantages of using a pension to save for retirement.

Not everyone is aware of this special helping hand offered to pensions, but it can have a considerable impact on the size of your retirement funds - and your income in retirement. What's more you don't even have to be earning or paying tax to benefit. If you are a UK resident and under 75 you'll still receive some tax relief.

With the full State Pension from the government providing little more than £9,000 per year it is unlikely to represent more than a subsistence level of income, so it makes sense to start planning as soon as possible to ensure you give yourself the best chance of the retirement you desire.

This guide sets out basic information about pensions and retirement planning in order to assist decision making. It is designed to assist people with 'money purchase' pensions, such as a Personal Pension, Stakeholder Pension. It will not explain the options for final salary pensions from your employer, or any other pensions with guarantees or promises. These require more specific decision making and we recommend you understand your options fully and take advice if unsure.

Pension Wise, the Government's pension guidance service, provides free, impartial information to help you understand your options at retirement or you can discover more about Charles Stanley's Financial Planning Services by visiting: www.charles-stanley.co.uk/products-and-services/financial-planning-services.

Part 1: Pensions

The helping hand: how pension tax relief works

In the 20/21 tax year, an investor can receive up to 45% tax relief when they make a contribution to a personal pension such as a SIPP (Self Invested Personal Pension), with 20% paid by the HMRC into the pension and any higher and additional rate income tax reclaimable.

For example, an investor contributes £8,000 into their SIPP and £2,000 is claimed back from HMRC by the pension provider. A higher rate tax payer could claim back up to a further 20% via their tax return, reducing the overall cost of the contribution to as little as £6,000. In the same instance, additional rate tax payers could claim back up to a further 25% making the cost just £5,500 for a £10,000 contribution.

Income tax rates, and therefore tax relief on pensions, differs in Scotland. If this could affect you please refer to our 'Pension tax relief for Scottish taxpayers guide'.

Contribution limits

Tax relief on your personal contributions is limited to 100% of your relevant UK earnings. Contributions, including those paid by your employer, are also subject to the annual allowance, which for the current (2020-21) tax year is usually £40,000.

Those with 'adjusted' income over £240,000 have a reduced annual pension allowance, the minimum being £4,000. There's also a lower annual allowance for those that have started to access their pensions flexibly, for example by taking an income through drawdown. This is known as the money purchase annual allowance (MPAA) and is currently £4,000 per tax year.

If you haven't used your full annual allowance from up to three previous years, you might be able to carry it forward and use it in the current tax year provided your earnings are high enough and you have been a member of a registered pension scheme in those preceding years. Guidance and examples can be found on the Pensions Advisory Service website.

Non-tax payers can contribute £2,880 to a pension in the current tax year and receive tax relief of £720, resulting in a total contribution of £3,600. In addition to upfront tax relief, money in a pension is free from capital gains tax or any further income tax on the investments.

The tax treatment of pensions depends on individual circumstances and is subject to change in future.

Is a pension better than an ISA?

For those who need access to their money before age 55, ISAs offer greater flexibility than pensions.

As with pensions there's tax-free growth on your investments, but you can also take your money out whenever you like and it is free from tax. However, there is no tax relief on when you pay money into an ISA, so they are often a less efficient way to invest overall. You can shelter up to £20,000 this tax year in an ISA, and you get a new allowance each year.

At present, pension benefits cannot be accessed until 55, and this minimum age is set to rise in the future. Those choosing a savings vehicle specifically for retirement must weigh up whether they want to lock money away until late in life as well as the relative tax advantages of ISAs and pensions.

Assuming that investments grow at the same rate in both a pension and an ISA account, in the majority of cases the benefit of upfront tax relief at a person's highest income tax rate means investing in a pension works out mathematically better. This reflects the fact that pension tax relief on the way in makes an important contribution to overall return. The fact that you can generally take 25% as a tax-free lump sum before drawing the pension also helps.

The main exception to this is for a basic rate taxpayer funding a pension and then becoming a higher rate taxpayer when taking benefits – a situation that could arise if an entire fund is taken in a lump sum. In this scenario an ISA would produce a better overall return. However, given that it is possible to take periodic income or variable lump sums from pension pots there is scope to plan how to withdraw money tax efficiently.

What about the Lifetime ISA?

Available to UK residents aged between 18 and 40, it is possible to pay in up to £4,000 each tax year into a Lifetime ISA (LISA) as part of the annual ISA allowance and continue making contributions up to the age of 50. The government adds a 25% bonus to each of these contributions, which means individuals who save the maximum will receive a £1,000 bonus each year from the government. As with a regular ISA, the money grows tax-free. **Tax rules can change and any benefits depend on individual circumstances.**

The accumulated pot can be used to buy a first home of up to £450,000 at any time from 12 months after opening the account. Alternatively, money can be withdrawn tax and charge free from age 60 for any purpose. Withdrawals before age 60 other than for a first property purchase are usually subject to a 25% government withdrawal charge.

For basic rate taxpayers investing for retirement the 25% Government bonus added to your savings in a Lifetime ISA will work out at the same as 20% pension tax relief, so you will not get any more money in a Lifetime ISA than you would in a pension if you are a basic rate tax payer. However, LISAs do have the advantage that all withdrawals are tax free whereas for pension pots it is only the first 25%.

For higher and additional rate tax payers there is an incentive to favour pensions. The potential for relief at 40% or 45% results in a more efficient way to build a retirement pot, and although pension income is taxable it can be taken on a flexible basis in order to maximise the tax efficiency of withdrawals.

Some people will choose to use both pensions and Lifetime ISAs at some point in their investing lives. A £4,000 annual Lifetime ISA limit gives limited scope for building a retirement pot, particularly for those closer to 40 than 18, but the annual contribution limits on pensions may also fall short of what some higher earners will wish to put aside.

Take advantage of pension tax relief while it lasts

As it stands today a pension is a financially appealing retirement investment vehicle for most people. Including those remaining in the same tax band, or drop down a tax band or two, once they draw their pension.

However, no one can be sure of pension rules in the future. Tax relief may become less generous, especially for higher earners. For instance, a flat rate incentive of between 25% and 33% for all pension contributions has been suggested. It may make sense for some people to secure pension tax relief in its current form while it lasts.

Remember, the tax treatment of pensions depends on individual circumstances and is subject to change in future. Please note this guide refers to pension tax relief in personal pensions. If you'd like to learn more about how pension tax relief works with workplace or other pensions, visit the HMRC website at www.gov.uk/tax-on-your-private-pension

The lifetime allowance – your overall pension limit

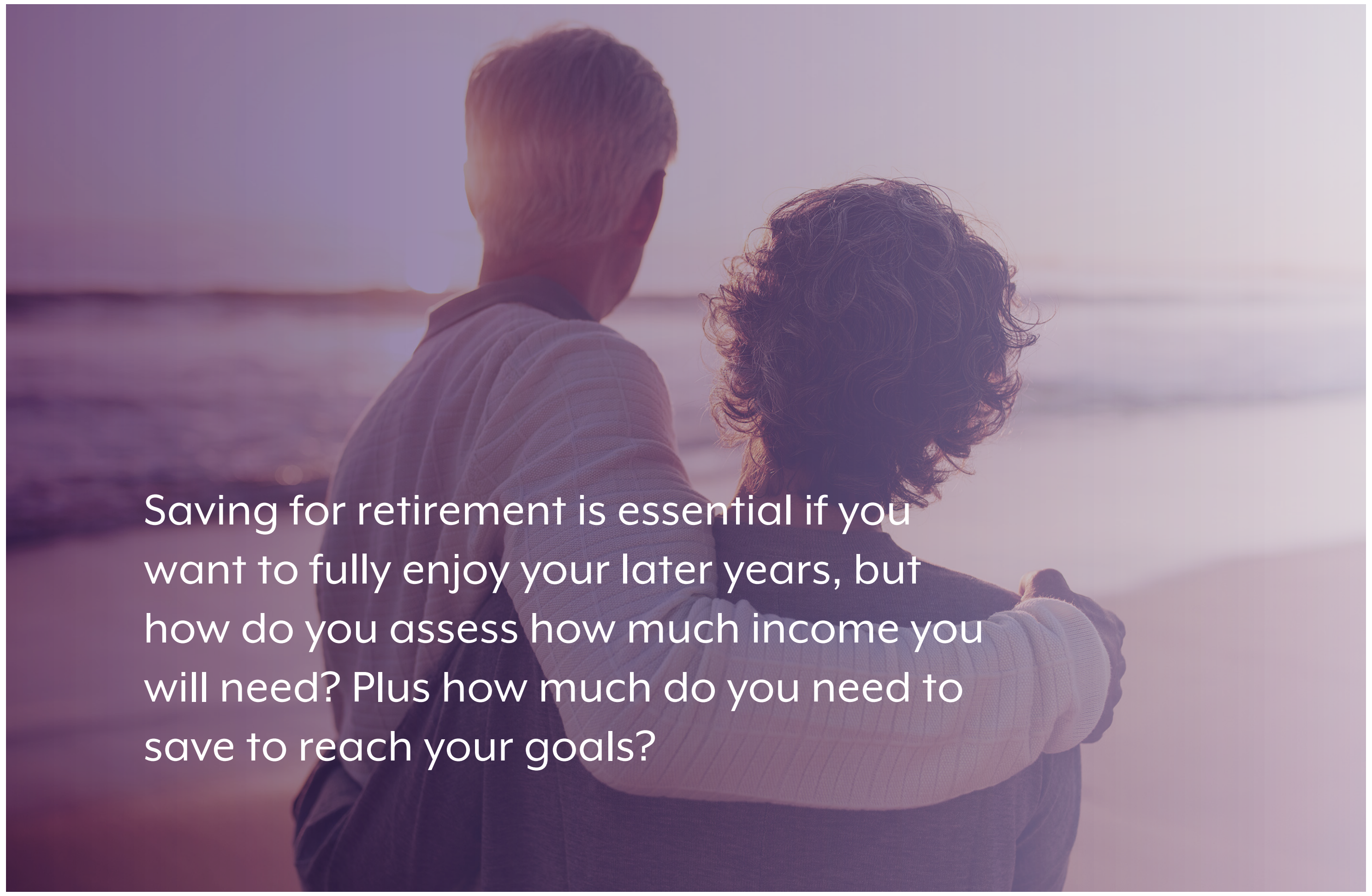
As well as the annual allowance described above, the value of your total pension savings is subject to a lifetime allowance which is **£1,073,100** for 2020/2021 tax year. This limit is set to rise with inflation but a future government could change the rules.

If your pension pot is worth more than the Lifetime Allowance, tax is due on the excess amount of 25% on income and 55% on cash lump sums. Defined benefit pensions are usually valued at 20 times the income you get in the first year plus your lump sum – but you should check this with your pension provider.

The lifetime allowance is tested when you take benefits (e.g. via a lifetime annuity or drawdown – these are explained later in this guide) and/or when you reach 75. When you take pension benefits your pension or annuity provider may need to obtain details of all your other pensions for confirmation of how much of the lifetime allowance you have already used up. Tax charges may also apply if you exceed the lifetime allowance and die before age 75.

It is very important that you seek personal financial advice as soon as possible if your pension fund is likely to exceed the lifetime allowance now or at some point in future.

Part 2: Planning Retirement



For many people retirement seems a long way off and saving into a pension isn't always seen as a top priority. After day-to-day living expenses, and other needs such as buying a house, it can be hard to put money aside. Yet the earlier you start the easier it will be. If you have less time to invest then the amount of money that you have to save is likely to be higher. Fortunately, a few small steps can help you formulate a plan.

Assess your needs

Everyone wants different things from retirement. However, most people want to maintain their standard of living. This typically means less income is required than during your working life because you are no longer spending money on paying your mortgage or raising children. You also won't be saving towards retirement! One rule of thumb is that around half to two-thirds of the income you had during your working life is sufficient and a reasonable goal.

Find out how much income you could get from the State Pension and any 'defined benefit' schemes

Some of your retirement income requirements may be covered by your State Pension, though how much depends on the number of years you have worked and paid full National Insurance (NI) contributions.

The State Pension changed in April 2016 with the earnings-related part of the old system applied to employed people called the Additional State Pension abolished. The new State Pension is based on your NI record alone. For the current tax year, 2020/2021, the full State Pension is £175.20 a week (or £9,110.40 a year). However, you may get more than this if you have built up entitlement to additional State Pension under the old system – or less than this if you were 'contracted out' of the additional state pension. You can get a State Pension forecast telling you how much you can expect and from what age by visiting: www.gov.uk/check-state-pension.

You should also take account of any income payable to you from 'defined benefit' pensions, such as a final salary schemes. These are pensions where the amount of income you are paid is based on how many years you've worked for your employer and the salary you earned. Defined benefits schemes were once commonplace, and for some people a combination of these and the State Pension will be sufficient to meet much, if not all, of their retirement income needs. However, few are open to new members today, and people are increasingly reliant on 'defined contribution' schemes such as personal pensions to fund retirement.

You should receive an annual statement from the trustees of the defined benefits scheme, and you can obtain an estimate of the pension you might receive by writing to the trustees at the address given in the statement. If you haven't received a statement for over a year, get in touch to make sure they have your current contact details.

Use a pension 'calculator' to determine how much you need to save

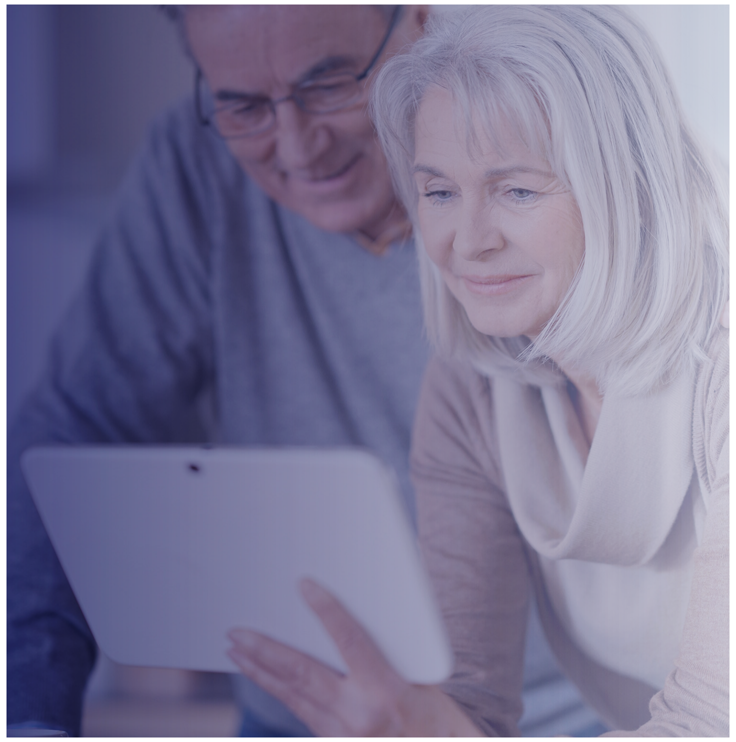
Having accounted for the State Pension and any defined benefit scheme pension, it is useful to calculate how much money you will need to save to produce the remainder of your target income. This can depend on factors such as the age you want to retire, income yields available on investments, how much prices rise during your retirement and how long you live for – so it's hard to make a precise prediction. Of course it also hinges on how much you have put aside already.

Online calculators such as The Money Advice Service Pension Calculator can help you see if you are on target to meet your retirement objectives taking into account your current retirement savings and future contributions into defined contribution pensions. It works out how much you might accumulate given current levels of saving, as well as the effects of increasing or decreasing contributions. Calculators have to make a number of assumptions about various factors – so what actually happens could be significantly different – but they do at least give you an idea of what to expect.

The contribution levels produced by the calculator might seem large but with the assistance of any employer contributions the amount you need to save may be much lower. In addition, when investing through a pension you may also receive tax relief on your contributions. These factors often make pension the most effective means of saving for retirement.

Check your investment strategy

In addition to pensions you may have ISAs or other investments that you are planning to use to generate income. Ahead of retirement these should be reviewed to ensure the investment strategy is appropriate. The asset mix may require adjusting in terms of the level of risk or to provide greater ability to generate income.



Part 3: Retirement

The most significant for many people is how best to generate an income from a pension pot having given up work, and there are many considerations involved such as providing benefits to your family in the event of your death, how tax-efficient your arrangements are and, very importantly, taking the right level of risk for your circumstances.

The rest of this guide is intended as an overview of these issues and we hope it helps you think about and prioritise your needs. However, many of the topics covered are complex and making sure you have all the information you need is vital – should you be in any doubt we suggest you take guidance or regulated financial advice.

When can I retire?

The earliest age at which you can normally take benefits from your personal pension is 55 (rising to 57 in 2028). That's earlier than the State Pension, which only becomes payable at 65 currently, and this is set to rise. You can check your State Pension Age by visiting: www.gov.uk/state-pension-age.

Methods of taking income

For many people with a personal pension, taking income means choosing between a **lifetime annuity** or a **drawdown pension**, or a combination of the two. However, there are now a myriad of other options, particularly in light of changes to pension regulations in recent years which has made taking pension benefits from personal pensions such as SIPPs more flexible. You can usually take up to 25% of your personal pension pot tax free, whichever method you choose.

Lifetime annuity

An annuity offers a regular income for life which can be purchased from an insurance company using all or part of your pension fund. The most important aspect of a lifetime annuity is that it gives peace of mind the income it provides will not run out – no matter how long you live. However, it involves giving up the capital value of your pension pot and, depending on the type of annuity you choose, the death benefits can be less attractive or less flexible than with drawdown.

How much income you get each year from an annuity depends on your circumstances when you purchase it: The size of your pension pot, your age, your health, whether you want the income to increase each year, and if you want the annuity to pay out to someone after you die.

Drawdown pension

Drawdown allows you to take a variable income directly from your pension pot, which remains invested. You can choose where to invest and what level of income to take.

Pension freedoms introduced in 2015 removed many limitations over how pension funds are accessed, and this has increased the popularity of drawdown. Under current rules people can withdraw as much, or as little, as they like, and when they like from the normal minimum retirement age (currently 55). However, in many cases taking a large proportion of a pension would result in a large tax bill, so it is important to plan withdrawals carefully.

It is also now possible to pass on your pension pot to another nominated beneficiary tax efficiently after you die. Your heirs may have to pay tax on the inherited pension pot when they take funds out of it, but potentially it could be an effective way of passing on wealth through the generations of a family.

Any decision to use drawdown must be carefully considered. It can be a risky option because the investments you choose within it can fall as well as rise in value. There is also the danger that your source of income could run out as a result of poor returns, excessive withdrawals and charges eroding the value of the pot. There are more details on drawdown, and the risks involved, in our dedicated drawdown guide.

Alternatives

There are a number of other options, notably revolving around UFPLS (Uncrystallised Funds Pension Lump Sums), which is a route that allows you to draw a series of lump sums directly from the pension pot, 25% of each should be tax free, and the rest taxable. A series of UFPLSs could provide a regular income in a tax-efficient manner for some people.

Further options include ways to arrange an annuity for a fixed number of years within drawdown (thereby taking a secure income while retaining a portion of the pension fund from which to draw benefits later), and mixing the above options at different times in your retirement. For example, you can take some cash from your pot first and buy an annuity later.

How to take pension benefits: the key considerations

Level of income

Your costs and financial needs are likely to change going into and during retirement. You will need to think about when you'll start taking money from your pension and how much you'll need at various times - taking into account income from other sources.

This will require some forward planning. People are living longer, and on average those aged 55 today will live to their mid-to-late 80s. Around 1 in 10 men and 1 in 5 women are forecast to live to 100, so as well as the costs of day-to-day living such as food and household bills you may need to consider care costs in later life.

It is also important to take inflation into account. Inflation is a measure of the rate of increase in prices for goods and services. In the UK the main measures are the Retail Price Index (RPI) and the Consumer Price Index (CPI). If the return on your money is less than the rate of inflation, it will erode the purchasing power of your capital, and if you have a level amount of income the spending power of this is likely to gradually diminish over time as prices rise.

Risk

Everyone is different, and you must judge your own 'capacity for loss' in relation to the amount of income you need to live on and do not wish to take a risk with. For this level of income a more secure option such as a lifetime annuity may be preferable. This provides a regular income for life and removes the worry about your pension income running out.

Any decision to use drawdown must be carefully considered. It can be a risky option, particularly if you are relying on the pension pot involved for a significant part of your retirement income. In particular there is a risk to capital value because the value of the investments (and the income from them) can go down as well as up.

There is also the risk that income and the impact of charges will reduce the value of the pension fund and the potential for future growth, making the required level of income unsustainable. The sequence of returns and when (as well as how much) income is drawn can have a considerable impact on results. For more see our drawdown guide.

Death benefits

The treatment of pensions on death will vary according to individual circumstances and pension and tax rules, which are subject to change.

An annuity will stop on death unless specific options to protect the income or purchase price have been selected at the start. Once set up an annuity cannot normally be changed or cancelled so it's important to choose options carefully.

At present with drawdown and UFPLS the remaining fund stays invested and you have a say over what happens to it when you die. Under both options, your beneficiaries have the options of taking the remaining fund as a lump sum, continuing in drawdown or buying a lifetime annuity. If you die before 75 both lump sums and income from the nominated beneficiary's drawdown or annuity are paid tax free. On death after 75 such payments are taxed as income at the beneficiaries' rate.

Very wealthy investors who don't need income may elect to take no benefits at all from their pension, keeping it invested with the aim of passing on as much as possible to their family.

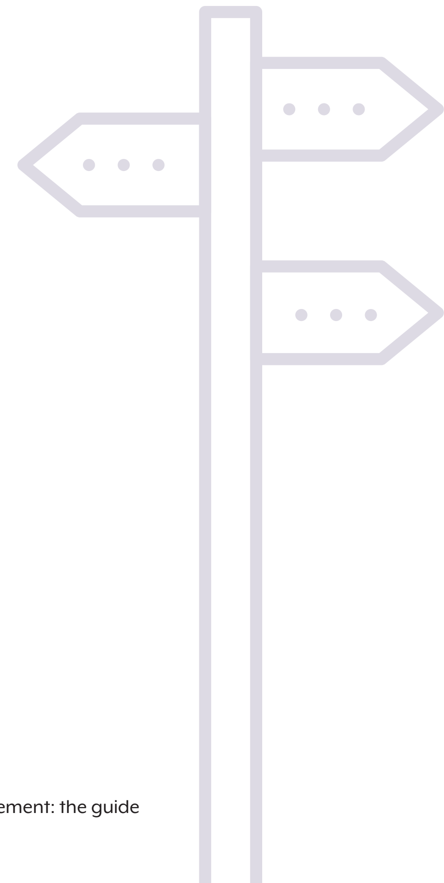
Tax

When you receive benefits from a pension you pay income tax above the level of your tax-free personal allowance, just like you do on your salary. The only difference is that you can take part of your pension pot (usually 25%) tax-free. Any decision to take pension benefits must therefore be planned carefully.

In particular, taking your entire pension as a lump sum may sound an attractive option but it could have significant consequences such as tax penalties or moving you into a higher tax bracket. In most cases it will be more tax-efficient to stagger withdrawals.

Changing circumstances and legislation

Retirement can last several decades. A change in circumstances may require different levels of expenditure and the need to build flexibility into your affairs. In addition pension and taxation rules are constantly changing and the pace of change shows no sign of abating.



Guidance and advice

What you do with your pension is an important decision and making the wrong choices can be costly.

If you are uncertain about which pension options are suitable for your circumstances, we strongly recommend taking appropriate regulated advice or guidance. Pension Wise, the Government's pension guidance service, provides free, impartial information to help you understand your options at retirement or you can discover more about Charles Stanley's Financial Planning Services by visiting **www.charles-stanley.co.uk/products-and-services/financial-planning-services.**

Beware of investment scams

More flexible rules on taking benefits from pensions have unfortunately led to more instances of scams. Once money is drawn from a pension, you should be very careful where you reinvest it and be particularly wary of unsolicited approaches (for instance by phone or text), the promise of unique opportunities or anything that seems too good to be true. Never invest with a firm that is not regulated. You can check if a firm is regulated and obtain further information on scams at **www.scamsmart.fca.org.uk**.

The value of investments, and any income derived from them, can fall as well as rise and investors may not get back the original amount invested. The information contained within this guide is based on our understanding of current UK tax provisions. It is solely for information purposes and does not constitute advice or a personal recommendation. The taxation and rules surrounding pensions (and other tax efficient products) could change in the future. If you are unsure as to whether an investment or a pension is suitable for you, please seek professional financial advice.

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