



How pension contributions could lower your tax bill

Many of us know that saving into a pension is a great way of improving our long-term financial security. What is less well known is that pensions can also be a useful financial planning tool for those whose income puts them in a higher tax band.

Pension and tax planning can be complicated, so it's important to seek advice on what's best for your individual circumstances. In the meantime, here are some of the main considerations.

Crossing into a higher tax band

Saving into a pension could be particularly tax efficient if your salary and / or bonus means you cross into a higher tax band. Assuming you have a standard personal allowance of £12,570, the income tax bands for England, Wales and Northern Ireland are as follows:

Income tax bands and rates 2021/22

Band	Taxable income	Tax rate
Personal allowance	Up to £12,570	0%
Basic rate	£12,571 to £50,270	20%
Higher rate	£50,271 to £150,000	40%
Additional rate	Over £150,000	45%

Source: HM Revenue & Customs

Let's imagine your total income is £55,270. You would pay 40% tax on the £5,000 of income that falls within the higher-rate tax band. If, however, you made a £5,000 gross pension contribution (£4,000 plus £1,000 tax relief) your 'adjusted net income' would fall to £50,270, potentially avoiding higher-rate tax.

The same principle applies to the additional-rate tax band, which kicks in once your income exceeds £150,000. Income above this level is taxed at 45%, but you might be able to mitigate this by paying into a pension and lowering your adjusted net income to below the threshold.

Reinstating your personal allowance

Pensions could be an even more valuable financial planning tool for those earning more than £100,000 and whose personal allowance is tapered. The tax-free personal allowance reduces by £1 for every £2 your adjusted net income exceeds £100,000. It is nil once your income exceeds £125,140.

Although income that falls within the higher rate band is taxed at 40%, the personal allowance taper means some of your income could effectively be taxed at a staggering 60%.

Let's say you earn a £100,000 salary and are awarded a £1,000 bonus. Not only would you pay £400 in tax on the £1,000, but you would also lose £500 of your personal allowance. This extra £500 would also be taxed at 40%, costing you another £200. As a result, earning an extra £1,000 would cost you £600 in tax, which equates to a 60% effective tax rate.

One way to mitigate the so-called '60% tax trap' is to save into a pension. If you made a gross pension contribution of £1,000, your adjusted net income would fall to £100,000, thereby reinstating your personal allowance and giving an effective rate of tax relief of 60% on your pension contribution.

What to watch out for

Bear in mind that there is a cap on the amount you and your employer can pay into your pension each year and still get tax relief. For most people, the pension annual allowance is 100% of your UK taxable earnings or £40,000, whichever is lower. However, this might be tapered if your adjusted income exceeds £240,000.

It's also important to ensure you're not at risk of breaching the pension lifetime allowance. This is a limit on the total value of benefits you can accrue in your pension during your lifetime without incurring a tax charge. For the 2021/22 tax year, the lifetime allowance is £1,073,100. An adviser can help you monitor the value of your pensions and, if you're approaching the lifetime allowance, explain the steps you could consider taking. If you have lifetime allowance protection under a scheme such as Enhanced Protection, then it is especially important to inform your adviser and seek specialist advice.

Next steps

Understanding pensions and tax and their impact on your overall finances can be bewildering. An adviser will take a thorough look at your financial situation to determine whether making or increasing pension contributions suits your individual circumstances. They can also help you select the right pension fund for your needs, advise on other tax-efficient forms of investing, and keep on top of any changes to pension rules.

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