Tax relief on pensions

A guide for clients

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Why it pays to save for retirement.

Tax relief is one of the best features of using a pension to save for retirement.

When you pay into your pension, some of the money that would have gone to the Government as tax goes instead into your pension pot, which can help reduce the amount of tax you pay and boost your savings.

How does pension tax relief work?

There are two ways you can get tax relief on your pension contributions.

If you're in a workplace pension scheme, your employer chooses which method you use; if you're in a personal pension, you always have to use the relief at source method.

The easiest way to check which method your scheme uses is to ask your HR department (or whoever handles payroll for your employer) or, if you're self-employed, your pension provider.

Relief at source

With the relief at source method, your pension contributions receive a boost from the Government matching the highest rate of income tax you pay: 20%, 40% or 45%.

In practice, this means for every £1 a basic rate taxpayer contributes to their pension, the Government tops it up by 25p because £1.25 taxed at 20% is £1; conversely, higher and additional rate payers see every £1 they contribute become £1.66 and £1.82 respectively thanks to tax relief on their contributions.

If you live in Scotland and pay tax at the Scottish starter rate of 19%, you still get tax relief on your pension contributions at 20%.

Here's how the relief at source method works step by step:

1. Your employer deducts tax from your taxable UK earnings as usual.
2. They then deduct your pension contribution from after-tax pay and send this to your pension provider. If you're self-employed, you will contribute your taxable UK earnings directly to your pension provider.
3. Your pension provider then claims 20% in tax relief from the Government, which they add to your pension pot.

This method is better for people who don't pay tax – for instance, if their income is below the personal allowance – as they still get tax relief.

However, people who pay higher income tax rates than 20%, whether employed or self-employed, have to claim the extra tax relief through their tax return or directly from HMRC.

Net pay

Through the net pay method, you make your contributions before paying taxes. As a result, you will pay less tax as it will be calculated based on a lower amount of UK earnings.

Here's how the net pay method works in more detail:

1. Your employer deducts the total amount of your pension contribution from your pay before deducting your taxes.
2. You then pay tax on your UK earnings minus your pension contribution. As a result, your tax bill will usually be lower.
3. Although you've paid the total amount of your pension contribution yourself, you get the tax relief straight away by paying less tax.

Unlike the relief at source method, no matter the rate of income tax you pay, you get the entire tax relief without having to claim it.

However, this method means you won't get any tax relief if you do not pay income tax.

Limits on tax relief you can receive

While there is no limit on the amount of money you can put into your pension each tax year, there are limits on the amount you can save while claiming tax relief.

First, the Government only gives tax relief on pension contributions that are the higher of:

- 100% of your relevant UK earnings in a year
- £3,600.

So, if you personally put all of your £20,000 salary into your pension pot one year plus £5,000 you had set aside, you would only be entitled to tax relief on the first £20,000, leaving you with a net contribution of £30,000 (£25,000 from yourself and £5,000 from the Government. You do not get tax relief on contributions made by your employer.

If your relevant UK earnings are less than £3,600, your gross pension contributions are limited to this £3,600. That means only the first £2,880 of your payments will receive tax relief, as the Government's subsidy would leave you with £3,600 in your pension pot.

Second, only contributions within the annual allowance qualify for tax relief; contributions that go over it may be taxable, which effectively claws back any excess tax relief given.

For most people, the annual allowance is £40,000, but it reduces by £1 for every £2 you earn if you have an adjusted income above £240,000. So, an individual with an adjusted income of £280,000 would have an allowance of £20,000.

This 'tapering' ends at £312,000, so everyone will always have an annual allowance of at least £4,000.

If you've triggered the money purchase annual allowance (MPAA), your allowance may also be £4,000. The MPAA is usually activated if you take your entire pension pot as a lump sum or start to take lump sums from your pension pot.

The annual allowance applies across all your pension savings – not per pension scheme. It also applies to combined employee and employer contributions.

However, you can use unused allowance from up to the previous three tax years to receive tax relief on higher contributions (this is known as 'carry forward', and conditions apply).

What counts as relevant UK earnings?

Tax relief on pension contributions is only available on relevant UK earnings, which include:

- income from employment (including salary, wages, bonus, overtime or commission)
- self-employment profits
- benefits-in-kind
- redundancy payments above the £30,000 tax-exempt threshold.

They don't include the following:

- dividends
- savings income
- rental income
- pensions in payment
- state benefits.

To get tax relief on pension contributions, you must be a UK resident and below the age of 75.

How much can you build up in your pension?
Although there is no limit to the amount you can save in pensions, there is a lifetime limit on the amount you can build up without potentially having to pay a tax charge when you access your pension or transfer it overseas.

The lifetime allowance limits your tax-free pension pot to £1,073,100 and will remain frozen until April 2026.

Any amount above your lifetime allowance is subject to a tax charge of 25% if paid as income or 55% as a lump sum.

Talk to us about your pension contributions.

FOR GENERAL INFORMATION ONLY

Please note that this guide is not intended to give specific technical advice and it should not be construed as doing so. It is designed to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.

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