Financial Planning infobyte

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AN INCOME OF £6,184 PER YEAR AT A SINGLE COST OF ONLY £5,370, IS THIS POSSIBLE?

ANSWER: YES!

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It is amazing to believe the above statement can be true, but it is indeed possible for this to be achieved.

This opportunity specifically affects those people who earn between £100,000 and £118,880 per annum. Those people in this income bracket progressively lose their personal tax allowances at a rate of £1 for every £2 earned above £100,000. The standard personal income tax allowance is currently £9,440 per individual and for someone earning £118,880 per annum they will lose their entire personal allowance. This means they are paying an effective rate of income tax on this part of their income of 60%.

Anyone making a personal pension contribution effectively reduces their taxable income. Therefore, it is possible for individuals within this earnings bracket to make a pension contribution to reduce their taxable income below the £100,000 and in doing so recover their full personal income tax allowance.

If we consider an individual earning £110,000 per annum they will only need to make a pension contribution of £10,000 each year to reduce their taxable income back to £100,000 and recover all of their personal allowances.

This individual will be a higher rate tax payer paying income tax at a marginal rate of 40%. The pension contribution itself will attract income tax relief at the individual's highest marginal rate of tax of 40% effectively reducing the cost of the gross pension contribution from £10,000 to £6,000.

In addition to this saving the individual will also have saved additional tax from the recovery of their full personal allowances of £1,888. These two tax savings reduce the gross pension contribution from £10,000 per annum to £4,112 per annum.

If these contributions are made for a period of 10 years the total cost to the individual will have been £4,112 x 10 years; being £41,120.

The resulting pension fund value at the end of 10 years if we assume a pension investment growth rate of 7% per annum will be £143,000.

Pension benefits can be drawn between age 55 and 75 and when the benefits are commenced the individual can first take their pension commencement lump sum (PCLS) from the pension fund being a tax free lump sum of 25% of the fund. In this example, the PCLS will amount to £35,750. This will leave a remaining pension fund of £107,250 (£143,000 - £35,750). The final cost of providing this pension fund amounts to only £5,370 (the original net premiums of £41,120 minus PCLS £35,750).

Using standard annuity rates for someone drawing their pension benefits at age 65 the remaining pension fund of £107,250 would provide a lifetime annual income of £6,184per annum.

So as you can see, amazingly, this annual income for life has been achieved at a cost s than only one year's worth of that income.

The above example has been based on a 10 year term but these benefits will still apply albeit to greater or lesser degrees over shorter or longer term periods.

In addition, the benefits of this approach will still apply to those whose earnings are greater than £118,880 albeit to a lesser degree. For those earning more than £150,000 it will not be possible to recover all of your personal allowances as the maximum contributions that can be made into pensions is currently £50,000 per annum, reducing to £40,000 per annum from April 2014. It is possible to carry forward unused pension contribution reliefs from the previous 3 years and therefore for those earning over £150,000 it may be possible to achieve these benefits albeit for a limited period.

In a similar way, this benefit can be achieved for those who have lost some or all of their child benefits. Child benefits will be withdrawn from families in January 2014 where there is an earner earning more than £60,000 per annum and it will be gradually reduced for those earning between £50,000 and £60,000 creating an effective marginal rate of income tax for those effected of up to 65%.

Individuals affected in this way can reduce their taxable income to below £50,000 in the same way as above through making pension contributions which as you have seen can be very cost effective.

June 2013

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