



## PENSION SIMPLIFICATION

### Increase your savings over 5 years

**NEW pension rules that came into force on 6 April 2006 mean that a non-taxpayer aged 55 to 70 with £10,000 savings in the bank can turn it into more than £15,000 over five years.**

Rule one - Anyone aged under 75 can contribute up to £2,808 into a pension each tax year, even if you do not pay tax. The Chancellor will contribute another £792 from the Treasury to make the total going into your pension £3,600 every year.

Rule two - People aged at least 60 (and less than 75) are allowed to cash in their pension funds as long as the total value of **all** their pensions (apart from the state pension) comes to £15,000 or less. They must cash in all their pension funds within a 12-month period.

When you combine these two rules it is possible for those who have no pension or other income, but some savings in the bank to move their money into a pension year-by-year until it grows to £15,000, and then take it **all** out. You are allowed to take 25% of the pension fund as a tax free lump sum. The remainder would be taxable as income. You may however be able to spread this taxable income over two tax years. Each time they move £2,808, the Treasury tops it up by £792 - a bonus of more than 28 per cent.

### Who is this available for?

This is not possible for everyone.

First, you must have no other pension arrangements. That means no pension from your job - even one you have not yet started to draw - no pension inherited from a late spouse and no other personal pension.

Second, ideally you are a non-taxpayer. The best results arise if you have no taxable income, not even the state pension.

If you do have income it will still work, but some of the tax savings will be taken back in the form of income tax.

*NB If you are entitled to a state pension, you can defer drawing it and keep your income to zero. Therefore if you have no income, you can time things so that the tax you pay is negligible.*

### How does it work?

#### *Step-by-step guide*

Let us assume you are 56 on 1 June this year, have no taxable income and live on the income that is generated by your PEP/ISA portfolio and the 5% withdrawals that you take from your investment bond. You also retain £10,000 in a savings account.

You could leave your £10,000 in the savings account earning 4.5 per cent gross. As you are a non-taxpayer the interest is paid into your account gross without deduction of 20 per cent tax.

On 1 June you use £2,808 of your savings to start a pension (A). We have called this pension A, because you need to start two separate pensions for reasons that will be explained later.

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As this is a short-term scheme you should not take any risk with your money on the stock market, and so should effect a stakeholder pension with a cash investment option. Allowing for charges the net return on the monies invested could be 3% a year.

After a year, on 31 May 2007, your bank account savings could be in the region of £7,500 and there could be approximately £3,700 in your pension fund A.

The next day you start another pension - pension B - with £2,808 from your savings generating another £792 from the Treasury. Again, you should invest in a stakeholder pension with a cash investment option growing at the same rate of 3 per cent after charges.

A year later, 31 May 2008, your remaining bank account savings are worth just over £4,900 and your two pension funds have grown to more than £7,500. On 1 June 2008, you put more money into pension A. You contribute £2,808 from your savings and again receive tax relief.

At the end of another year, 31 May 2009, most of your savings have been moved into your pensions, but you still have about £2,200 left in your bank account. Your two pension funds have grown to more than £11,400. You use all your remaining savings to add to pension B and you get tax relief added again.

On 1 June 2010, you reach the age of 60. At that age, you can cash in your pensions as long as they are less than a certain amount. During 2006/07 the total amount is £15,000, but by June 2010 the limit will have grown to £18,000. Your total funds in pension A and B are far less than that at around £14,700. You could therefore cash them both in at the same time.

However by cashing them in separately you could reduce the income tax liability that is due on the amounts taken from your pension funds over and above the 25% tax free lump sum to zero.

### ***Cashing in the pension fund***

The first 25% of the fund is tax-free. The rest is added to your income and taxed at your highest marginal rate. If you have no other taxable income, you can receive up to £5,035 during 2006/07 without paying income tax.

Pension A is valued at approximately £8,000. The first 25% is tax-free (£2,000), leaving £6,000 to be taxed as income. In June 2010 we would expect the personal tax allowance will have risen with inflation to around £5,560.

Tax will therefore only be due on a small amount of the lump sum at a rate of 10%. The tax due will therefore be about £35, which would leave you with a total payment from Pension A of £7,965, which can be invested back into your savings account.

You leave pension B where it is for now. You have to cash it in within 12 months of cashing in pension A. If you therefore wait until the next tax year, which begins on 6 April 2011, you will be able to use a fresh personal tax allowance.

During the 2011/12 tax year pension B is possible worth approximately £7,000. The first 25% is tax-free (£1,750), leaving £5,250 to be taxed as income. During 2011/12 we would expect the personal tax allowance will have risen with inflation to around £5,700, and so the full value of pension B (£7,000) can be taken without any tax charge, assuming you still do not receive any other taxable income, which can again be invested in your savings account.

After a year the funds available from pension A could have grown to almost £8,200, and with the new monies available from pension B your savings could now be worth £15,200.

NB It is imperative that the benefits from pension B are cashed in within 12 months of the benefits being taken from pension A, and the benefits from pension B must be taken in a different tax year.

### **Summary of the possible gains in your savings**

In five years you may have gained more than £5,200 after tax, from savings of £10,000. Most of that has come from the tax subsidy paid into pensions by the Treasury and interest earned on your remaining savings.

If you had left your monies within a savings account paying 4.5% gross per annum you could have gained £2,460 over the same period after tax.

Therefore you have increased your savings at the end of 5 years by £2,740, when compared to leaving them in a savings account, or by 22% which is equivalent to the tax relief given on your contributions into pension A and B by the Treasury.

If you pay tax, you can still make use of these rules, but the gain will be less because three-quarters of the lump sum will be taxed at your highest marginal rate. Even so, you could still make £1,200 more than you would get from the savings account.



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