Your easy-to-understand guide to pensions

Together.
A better future.

Introduction

Making sure you can afford the lifestyle you dream of in retirement requires planning. If you don't, you could be putting your retirement lifestyle at risk without realising it, which is why it's often best to start preparing for this exciting stage of life as early as possible.

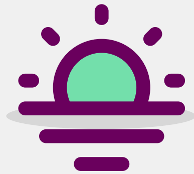
For many of us, saving for retirement involves putting some of our income aside during our working life, so that we can then fund the standard of living we want when we stop working. While you may have savings and other investments, pensions are usually used as they provide important tax benefits that can help to significantly boost the value of your retirement fund.

That said, it's important to understand how best to get the most from pensions.

Understanding the State Pension

While the State Pension has increased over the years, it's unlikely to provide you with the funds you're likely to need in order to support the lifestyle you want in retirement. If you qualify for a full State Pension in 2024/25 you'll receive £221.20 a week, or £11,502.40 a year.

To receive the benefit, you'll need between 10-35 years' worth of National Insurance Contributions (NICs) on your record. If you have fewer than 35 years, you'll receive a portion of the full amount based on how many years you've contributed.



In 2024/25 the State Pension age is 66 for both men and women, although it's expected to rise to 67 by 2028. To check your State Pension Age, visit: gov.uk/state-pension-age

As you can see, if you rely on the State Pension alone, you may not be able to afford the standard of living you aspire to later in life. This is why contributing to a private or workplace pension scheme, which can then be used to fund the standard of living you would want in retirement, is so important when planning your long-term financial security.

The benefits of Income Tax relief

While pensions are complicated, it's worth remembering that at their core, they are a tax-efficient savings plan that usually include an element of investing. When you make contributions to your scheme, the Government provides tax benefits that could give your retirement fund an important boost.

As a result, every £100 you place into your pension scheme could cost:

- £80 if you're a basic-rate taxpayer
- £60 if you're a higher-rate taxpayer
- £55 if you're an additional-rate taxpayer.

Higher-and additional-rate taxpayers normally claim their total tax relief through self assessment.

Pension contributions and ‘relevant earnings’

Not all types of earnings receive tax relief when they are used to make pension contributions. Only ‘relevant UK earnings’ enjoy relief, which include:

- income from employment, such as your salary, bonuses or commission
- income from a trade, profession, or vocation
- rental income from UK holiday lets.

Please note that this is not an exhaustive list.

Tax relief and your Annual Allowance

The Annual Allowance is the maximum amount of money that can be contributed to a pension and recieve tax relief. In 2024/25, the allowance is £60,000 or the amount you earn, whichever is the lower.

There are some situtions, however, when your Annual Allowance could drop significantly.

These are:

- if you earn more than £200,000 a year. This could trigger the tapered annual allowance, which could reduce it to between £10,000 and £59,999

- when you draw an income from a defined contribution pension, otherwise known as a money purchase scheme. This results in the Money Purchase Annual Allowance being triggered, which will reduce your allowance to £10,000. Please note, the MPAA does not come into effect when you withdraw tax-free lump sums* from your pension.In some situations, you may be able to use "carry forward", which allows you to use the unspent amount of your Annual Allowance from the previous three years.

As such, you might be able to place up to £240,000 into your pension in 2024/25 and still receive tax relief, although certain criteria has to be met.

Pensions are free from Capital Gains Tax

Any growth a pension enjoys is typically free of Capital Gains Tax, which in turn, could help to boost the value of your retirement fund over time. This could result in you enjoying an even better standard of living when you finish work.

Pensions often provide a tax-free lump sum

Most pension schemes allow you to take 25% of your pension tax-free when you first access it. This is known as the 'pension commencement lump sum' (PCLS). That said, if your pension pot is worth more than £1 million, the amount of 'tax-free' cash you're allowed to take is limited to £268,275 in 2024/25.

Your pension could become liable to Inheritance Tax

In the 2024/25 tax year, your pension is unlikely to fall into your estate for Inheritance Tax (IHT) purposes if you die. This is because historically pensions have not normally been liable to the tax.

This will change after the Chancellor, Rachel Reeves, announced new rules around pensions and IHT during the 2024 Autumn Budget. As from April 2027, the unused element of your pension will fall into your estate for IHT purposes, meaning it may become liable to the tax.

As IHT is typically charged at 40%, it could significantly reduce the amount you can leave to loved ones when you die. A financial adviser could help you to understand whether you could reduce your pension's exposure to the tax after April 2027, and the potential risks involved.

The different types of pensions

Depending on your situation, there are different types of pension schemes that may be better suited to your needs. As the following is a broad roundup of the main types of pension schemes, it should not be used to decide when might be the most suitable for you.

A financial adviser will be able to explain which of the following is the best choice for you, and whether alternatives exist that you may want to consider.

1. Auto-enrolment

In 2012, auto-enrolment was introduced in the UK, meaning employers now have a duty to place you into a pension scheme if you're aged between 22-66 years. Before this, the onus was on you to join the workplace scheme.

Typically, auto-enrolment pensions are 'defined contribution' (DC) schemes, which means that their value depends on how much money you place into it, and how the investments held within it performs. In 2024/25, you have to pay a minumum of 4% of your salary into your auto-enrolment scheme, and your employer must contribute a minimum of 3%.

2. Defined benefit

A 'defined benefit' (DB) pension, otherwise known as a 'final salary' scheme, provides a level of income in retirement that's based on your salary and length of service with the employer. There are two types of DB schemes: final salary or career average.

The amount of income you receive with a final salary scheme is based on how much you're paid at the point you leave the scheme or retire. Your income for the latter is based on an average of your salary while with your employer.

Your employer is responsible for ensuring the pension can fund your retirement. Some employers will also allow you to make additional contributions to boost your retirement income.

3. Stakeholder pensions

A stakeholder pension must meet specific Government requirements. They have limits on charges, low minimum contributions and a default investment strategy.

4. Defined contribution

Nowadays, DB schemes are less common, as private and workplace pensions tend to be 'defined contribution' (DC) schemes. With this type of scheme your contributions (and those made by your employer if it's a workplace pension scheme) is placed into a range of different investments, which could include shares, Government bonds and commercial property.

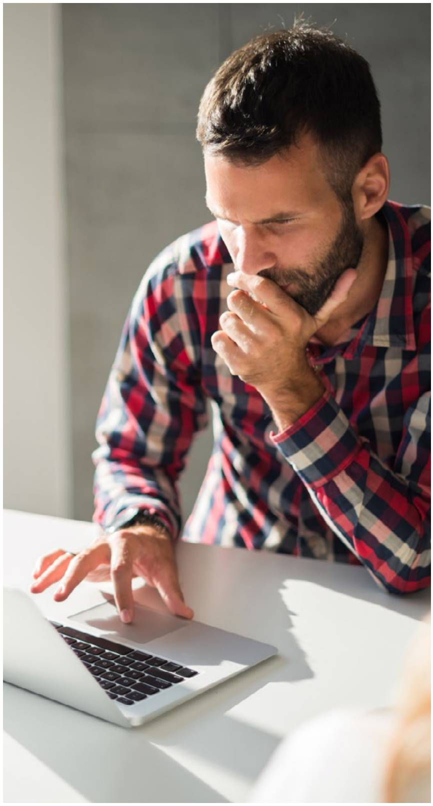
The amount that you receive at retirement depends on how much you paid into your pension, the length of time it has been invested and how the investments performed over time. DC pensions are also known as money purchase schemes.

5. Self-Invested Personal Pension (SIPP)

A SIPP allows you to control the investments within your pension fund. It's important to remember that diversification of investments typically reduces risk, so the range of choice being offered is an important consideration when choosing a pension.

Similarly, as charges can vary, it's important to fully understand the costs involved with a SIPP you may be considering, something a financial adviser can explain in a clear and jargon-free way.

Inflation could reduce your pension's real value



Over time the cost of living rises, which means £100 is likely to buy you more today than it will tomorrow. This increase is known as 'inflation'.

According to the Bank of England's inflation calculator, you needed £173.35 in January 2025 to have the same spending power as £100 in January 2005. This means your money had to grow by more than 73% to keep pace with inflation, and if it didn't, its value dropped in real terms.

This is why pensions typically hold assets such as shares, as historically the potential growth offered by these have tended to out-perform the growth provided by cash savings. This in turns help to inflation-proof your pension pot.

Always remember that investing in stocks carries risk, and past performance is no guarantee of future performance. This means you may get back less than you originally invested. A financial adviser can help you to understand the growth potential and risks involved with a pension scheme you may be considering, and whether it's right for you.

At AFH, it's all about you

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AFH is a truly independent financial advice company with more than 200 advisers across the UK. This means we're not restricted in the products we can offer and search all of the market to recommend the right solution for you.

As a result, you can rest easy that your financial future is in safe hands.

*Assets under Management and Assets under Influence combined for AFH Financial Group companies, accurate at March 2025. Figure is rounded to the nearest billion.

Get in touch

If you're considering your retirement lifestyle and whether your pensions are on track to provide the standard of living you aspire to, We would be happy to help. We'll provide you with peace of mind by confirming whether your retirement fund will provide the lifestyle you want, and if not, how to get it on track.

If you would like to arrange a no obligation meeting with one of our advisers, please contact us.

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