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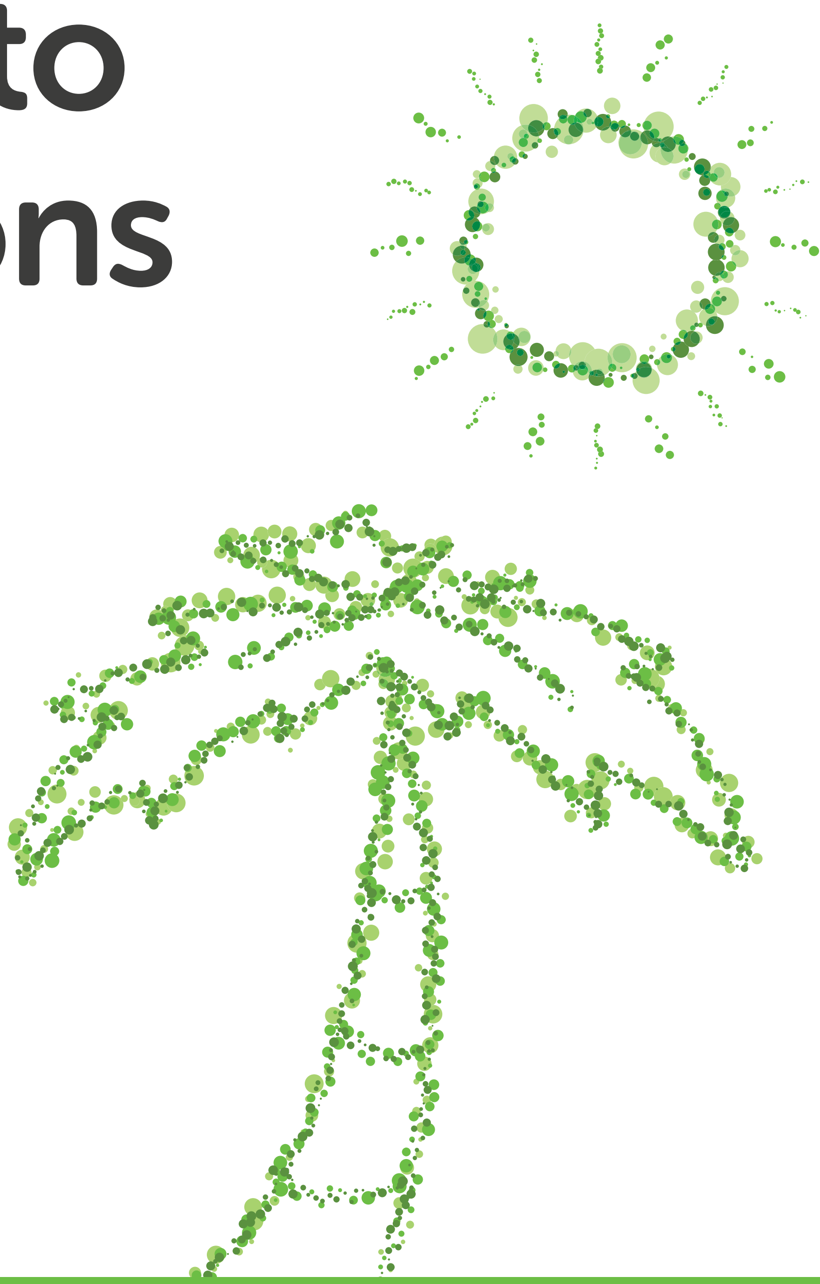
A beginners guide to pensions



Financial Planning & Advice
Your Finances in Focus

A pension is a savings plan with special tax benefits designed to build a fund for retirement. Employees, employers, self-employed and unemployed all may pay into a pension plan.

Why save into a pension?

For starters, you get tax relief on pension contributions. This means that if you are a basic 20 per cent tax payer for every £8 you contribute into your pension plan you will get £10 deposited.

The £8 deposit is called the net contribution, the £10 deposit is called the gross contribution and the difference between the two is called the tax relief.

If you are a nil-rate tax payer and you contribute £3,600 or less per annum you will still obtain 20 per cent tax relief. This means the maximum net figure you would be able to contribute to get tax relief is £2,880.

If you are a higher rate tax payer you will be eligible for 40 per cent tax relief meaning for every £6 you contribute £10 will be deposited.

The tax relief, therefore, makes this type of saving for retirement extremely attractive.

What happens to the contributions?

Clearly, your contributions have to be saved somewhere and that somewhere is called a pension fund. Pension funds are many and varied and this aspect can become very confusing. The fund choice largely depends on your attitude to risk and your age. Typically, but not always, the younger you are and the longer the time period until you retire, the higher the risk you can take and, hopefully, the higher the rewards you will obtain. This is where specialist advice is required to ensure you are investing in a fund or group of funds aligned to your attitude to risk.

Therefore, you should be looking for a pension with a wide range of funds and fund types to give you maximum investment flexibility.

If your income is increasing it makes sense to increase your pension contributions in line with your earnings.

What happens at retirement?

1. Use your pot to provide a flexible retirement income – flexi-access drawdown

You can take up to 25% of your pension as a tax-free lump sum. The remainder of your pension savings stay invested and you can take an income monthly, quarterly, annually – whenever suits you. You set the income you want though you may have to adjust it from time to time depending on the performance of your investments. Your income is not guaranteed so you must manage your investments carefully.

One benchmark to consider when setting your income is the dividend yield on the FTSE 100. This reflects the income paid out on a regular basis to shareholders by companies listed on the UK's stock market index and is currently around 4%. If you based your income on this measure you would be able to withdraw £4,000 of income a year from a £100,000 pension pot.

2. Buy a guaranteed income for life using an annuity

With this option, you can choose to take up to 25% of your pot as a one-off tax-free lump sum before converting the rest into an annuity, which will give you a regular income for the rest of your life. How much you get from your annuity will depend on factors including your age, your health, and whether you opt for a guaranteed amount or for an investment-linked or inflation-linked annuity.

A 60-year old with a £100,000 pot would receive around £5,770 of income a year from a basic single life, level annuity, according to the Money Advice Service's annuity calculator:

www.moneyadviceservice.org.uk

3. Take small cash sums from your pot

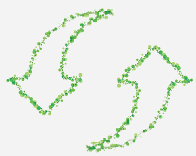
You can take cash as and when you need it directly from your pension fund. Any funds left in your pension after the cash has been paid out will remain invested for you to take further money in the future. Each time you make a withdrawal, 25% will be tax-free and the rest taxed as income.

4. Take your whole pot as cash

While this might seem an attractive option remember that you need to ensure that you will have enough to live on for the rest of your life. Also, anything above the 25% that you are entitled to tax-free is taxed. Withdrawing large sums from your pension could trigger a huge tax bill.

Mix it up

You do not have to choose just one of these options. You can divide your pension into segments and treat each segment differently. You can also leave your pension fund untouched, allowing it to remain invested and hopefully continue to grow: though remember that while it is invested your pension fund could fall in value as well as go up.



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