Pensions for the self-employed

Recommended Provider
Which?
Self-Invested Personal Pensions July 2022

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The value of your investments can go down as well as up and you may get back less than you originally invested. We don't offer advice, so it's important you understand the risks, if you're unsure please consult a suitably qualified financial adviser. Tax treatment, including tax relief, depends on your individual circumstances and rules may change. Before you transfer a pension, check with your current provider that you won't lose any money or valuable benefits.

Introduction

In a bid to avert a looming retirement crisis, the UK government introduced automatic enrolment. For the first time, millions have been nudged into saving for a pension.

But there’s still a problem. If you’re one of the nearly five million self-employed people living and working in the UK, automatic enrolment doesn’t cover you. So you’ll need to take responsibility yourself.

Not got round to it yet? You’re not alone. According to official statistics*, just 14% of self-employed people currently save into a pension. But it means you could be at risk of a serious income shortfall when you come to retire – unless you take action.

Whatever your business, putting some of your hard-earned cash into a pension is a brilliant way to prepare for your retirement. The flexibility and choice offered by pensions nowadays makes them increasingly attractive to those who work for themselves.

In this guide you’ll learn how pension tax incentives can boost your retirement pot. We also explain all the key rules you need to know, and offer some practical tips for business owners. Despite their reputation, pensions aren’t as difficult to understand as you might think. But where relevant, we’ll also point you in the direction of resources that can help explain some of the finer details.

The basics

An immediate boost through tax relief

If you're self-employed, you won't usually be auto-enrolled into a company pension scheme. But you can still save efficiently for retirement by opening a self-invested personal pension, or SIPP.

One of the main benefits of saving in a pension like a SIPP is that what you pay in is topped up by HMRC. This big boost to your retirement pot is known as 'tax relief'. When you make a personal contribution to your SIPP, you'll receive tax relief of 20% – meaning the government add 20p to every 80p you save. And if you're a higher (40%) or additional (45%) rate taxpayer, you can claim back an extra 20% or 25% through your tax return.

The below table shows you how, thanks to tax relief, saving £1,000 in a SIPP is much easier.

Tax bracket	Upfront cost of £1,000 in a SIPP	Basic-rate tax relief	Extra relief claimed through tax return	Effective cost to you to save £1,000 in a SIPP
Basic-rate taxpayer	£800	£200	£0	£800
Higher-rate taxpayer	£800	£200	£200	£600
Additional-rate taxpayer	£800	£200	£250	£550

In Scotland, tax rates are slightly different. Through your tax return, you can claim an extra £10 if you pay tax at the intermediate rate (21%), a further £220 at the higher rate (42%), £250 at the advanced rate (45%) and £280 if you pay the top rate (48%).

But there are limits

While tax relief is generous, it isn't limitless. You can receive tax relief only up to a certain amount. And tax relief only applies to your 'relevant UK earnings' (i.e. your earnings that are subject to UK income tax).

We'll discuss the various pension allowances and limits later in the guide.

Total flexibility when you reach age 55

Historically a major drawback of pensions for self-employed people was their perceived lack of flexibility. Business owners in particular like having the option to access their money quickly, so the old 'locked-box' pensions structure – where most people ended up buying an annuity at age 65 – wasn't always right for them.

All that has changed now. Savers can spend their retirement funds however they choose from age 55 (proposed to increase to age 57 from 2028). There are three main ways you can access your pot:

- **Drawdown:** Take up to 25% of your fund tax free. The rest remains invested for you to take a taxable income. When in drawdown you'll need to weigh up many factors including how much income you need, how much investment risk you want to take and how long your pension pot will last for;
- **Ad-hoc lumps sums:** Take individual chunks out of your pension (also known by the jargon term 'UFPLS' - uncrystallised funds pension lump sum), with 25% of each chunk tax free and the rest taxed in the same way as income;
- **Annuity:** Take up to 25% of your fund tax free, hand the remaining pension pot to an insurer and receive a guaranteed income stream in return. You can add extras like pensions for your spouse and inflation protection (although these will lower your starting income).

For many people a combination of these three approaches will provide the right retirement solution.

What are the limits?

Unsurprisingly given the generosity of pension saving incentives, there are limits to what you can contribute tax efficiently.

Annual allowance

The main limit for most people is the 'annual allowance'. This caps the amount you can save each year in a pension at £60,000.

You also only pay up to 100% of your earnings into a pension in any given tax year. 'Earnings' in this context includes things like dividends and investment income, so not just salary. If you're a sole trader, this will be the pre-tax profit you declare to HMRC.

If you are a UK resident but pay no income tax during the year, you can still pay up to £2,880 into a pension and receive basic-rate tax relief, boosting your contribution to a maximum of £3,600.

If you have total earnings above £260,000 your annual allowance may be reduced to a minimum of £10,000. This is known as the 'annual allowance taper'.

Visit https://www.ajbell.co.uk/sites/default/files/AJBYI_Guide_to_annual_allowance_tapering.pdf or speak to a financial adviser to find out more.

Money purchase annual allowance

You can choose to 'flexibly access' your pension from age 55 (rising to 57 from 6 April 2028). The most common way to do this is through drawdown – when you take a 25% tax-free lump sum, then leave your pension invested to take an income from as you choose.

Once you've flexibly accessed your pension, however, your annual allowance will be lowered to £10,000. This is known as the 'money purchase annual allowance' ('MPAA'). It's particularly important to bear this in mind if you're a self-employed business owner who sees a pension as both a retirement savings vehicle and a source of emergency cash for your business. If you flexibly access your pension when you're still working, you won't be able to pay in as much from that point on. (We'll talk more about allowances below.)

Keep in mind you won't be hit by the MPAA if you only take your 25% tax-free lump sum. You can find out more about the money purchase annual allowance here: https://www.ajbell.co.uk/pensions-and-retirement/pensions-explained/money-purchase-allowance

Lump sum allowances

There are no limits or allowances when converting your pension to income drawdown or a lifetime annuity. However, there are a couple of allowances you will need to consider when taking lump sums.

The lump sum allowance – currently £268,275 – puts a limit on tax-free lump sums you can receive during your lifetime. The 25% tax-free part of an UFPLS also counts towards this.

The lump sum and death benefit allowance – currently £1,073,100 – puts a limit on tax-free lump sums paid on death. Note, however, that any tax-free lump sums you take during your lifetime will also count against this.

You can find out more about how this works here: https://www.ajbell.co.uk/pensions-and-retirement/pensions-explained/lifetime-allowance

Top tips to boost your retirement pot

As well as the upfront tax relief on offer, self-employed savers can boost their pension pot in a few other ways.

Pensions 'carry forward'

When you're self-employed, there may be some years when you can't pay much into your pension – when you need to invest into your business, for example. If you leave a little (or a lot) of your annual allowance unused, however, 'carry forward' could help.

In any tax year, you can make use of your unused annual allowance from the three tax years prior – provided you were a member of a pension plan at the time. That means you could benefit from an annual allowance of up to £200,000 (if you had earnings at this level) using carry forward, including tax relief of up to £40,000.

A few things worth noting about carry forward:

- Your pension contribution can never be more than 100% of your earnings, even if you are using carry forward
- You must have been a member of a pension plan during the year you want to carry forward from, but you don't need to have paid into it
- If you have taken taxable income from your pension and triggered the MPAA described earlier in this guide you won't be able to use carry forward
- If you are affected by the tapered annual allowance then you won't be able to carry forward as much. So if, for example, the taper reduced your annual allowance to £20,000 in the previous tax year, that's the maximum you can carry forward

Paying your profits into a pension

If you own your own business you might also want to consider paying part of your salary directly into your pension as a company contribution.

The benefit of doing this is the pension contribution would no longer count as profit. So not only does the lower salary mean less income tax for you to pay, but your business is also liable for less corporation tax. HMRC may question if your total salary and benefit package is excessive, so it's worth speaking to a financial adviser or accountant before going down this route.

Note this option isn't available if you're a sole trader, although you can of course still make personal pension contributions.

The easiest way to show how this could benefit you is through a case study.

Emma, 49, set up a small bakery in her home town four years ago. She now employs two people, is a higher-rate taxpayer and in the 2024/25 tax year expects to turn a profit of £20,000. Emma wants to know what to do with the profit.

If she decides to take the profits as a dividend, corporation tax will first be levied at 19%, reducing the payment to £16,200. She'll then pay tax of 33.75% on the dividend above £500 (the dividend allowance), meaning she ends up receiving £10,401 after tax.

If she takes the profit as salary (assuming the entire £20,000 remains in the higher-rate tax band), she'll have to pay at least £400 in employee National Insurance and £8,000 in income tax. In addition, Emma's business will have to pay employer National Insurance at 13.8% (£2,760).

However, if her company pays the entire £20,000 directly into a pension as an employer contribution her company shouldn't have to pay any tax or employer National Insurance on the contribution. The money will also be able to grow tax-free, with tax only coming into play when she comes to make a withdrawal from age 55 (age 57 from 6 April 2028).

Start early and keep your charges as low as possible

The best ways to achieve the retirement you want are also arguably the simplest. Here are three fundamental things you can do which could radically improve your quality of life when you retire:

1. Make regular contributions as soon as you can afford to, taking advantage of the free money on offer through pension tax relief
2. Invest your pension for the long-term and allow compound growth to work its magic
3. Make sure you don't overpay in charges

It's probably easiest to illustrate the impact of these things with an example.

Dave is 30 years old and is a basic-rate taxpayer. He has put off saving until now because he had been focused on building up his business, a local bike repair shop. After essential expenses and living costs he has about £200 a month (£2,400 a year) he thinks he can save, although at a push he reckons he could stretch to £300 a month (£3,600 a year) and wants to know what difference this would make to his retirement outcomes.

He's also tempted to put it off altogether and start saving at 40 instead.

The below table shows the different outcomes Dave might achieve if he saves £3,000 a year in a SIPP (£2,400 personal contribution plus £600 in basic-rate tax relief) versus £4,500 a year (£3,600 personal contribution plus £900 pension tax relief)and if he starts saving at age 30 versus age 40. It assumes he enjoys inflation-adjusted investment growth of 3% a year after charges.

Age Dave started saving	Fund value at 65 (£3,000 annual contribution)	Fund value at 65 (£4,500 annual contribution)
30	£186,827	£280,242
40	£112,659	£168,989

As you might expect, if Dave saves 50% more on the way in, his fund will be worth 50% more at age 65.

However, it is contributing early that can really boost his retirement prospects. By starting 10 years earlier at age 30 Dave benefits from extra compound growth, dramatically boosting the value of his SIPP at age 65.

Remember this example is just a guide, and investment returns are by no means guaranteed.

Charges have a huge impact too. If Dave were to pay an extra 1% in charges, this is how his outcomes might change.

As you can see high charges can have a devastating impact over the long-term, costing Dave almost £51,000.

Age Dave started saving	Fund value at 65 (£3,000 annual contribution)	Fund value at 65 (£4,500 annual contribution)
30	£152,983	£229,475
40	£98,013	£147,019

Tidying up any old pensions you have

Most people will have more than one job during their careers – in fact, Government figures** suggest we could switch employers up to 11 times during our working lives.

So there's a fair possibility you have one or more retirement pots to your name, started with previous employers before you became self-employed. You may also hold personal pensions, like a SIPP, that you've stopped paying into.

You may even have lost track of an old pension completely. If you need help recovering it, the government's free Pension Tracing Service may be able to help. Visit www.gov.uk/find-lost-pension or call **0345 6002 537** for more information.

One of the best ways of tidying up your old pensions could be to combine them with one provider. This can be a good idea for a number of reasons:

- It's easier to manage all your pensions in one place
- You could lower your charges (particularly if you have an old pension scheme). Unnecessary high charges can wipe tens of thousands of pounds from the value of your pot over the long-term
- Modern platforms are easy to use, and many offer a wide range of investments to suit all risk appetites
- If you find choosing your investments hard work, many platforms can make it easier. AJ Bell have a range of investment ideas to help you on your way.

But before transferring any older pensions you might have, it's worth checking the terms of your pension schemes – some come with valuable guarantees attached which could be lost if you move your money. Others may have exit penalties which could erode the value of your pension if you leave before a set retirement age, or they could have a lower charge than the plan you intend transferring to.

To check whether you might lose out by transferring, have a read of your pension scheme documents. If you're unsure, it's a good idea to call the provider or speak to a financial adviser.

Don’t forget about the State Pension

For many, building up a decent private pension pot can be crucial to ensuring a comfortable retirement. But it’s also important to understand what you’ll get from the state.

Under the flat-rate State Pension system introduced in 2016, self-employed workers enjoy exactly the same State Pension rights as employed workers.

The full flat-rate State Pension is worth £11,502 per year in 2024/54 and rises each year in line with the highest of increases in average earnings, Consumer Prices Index (CPI) inflation or 2.5% (the so-called ‘triple-lock’).

In order to qualify for the full amount you’ll need to have a 35-year National Insurance (NI) record. Deductions will be made for each year where a payment is missed. It’s also possible to buy extra years of NI (known as Class 3 contributions).

To qualify for any State Pension you must have an NI record of at least 10 years. If you have built up State Pension rights under the pre-2016 system you might be entitled to more than the full flat-rate amount.

To find out how much State Pension you have built up so far, visit:
https://www.gov.uk/check-state-pension

Using your SIPP to pass money on to loved ones you have

SIPPs don’t just provide you with flexibility over how you save and invest your hard-earned retirement pot – they also allow you to pass on money tax efficiently to loved ones when you die.

In fact, if you die before age 75 you can usually pass on any unused wealth held within a SIPP tax-free to your nominated beneficiaries. If you die after age 75, your beneficiaries will usually have to pay income tax on the SIPP wealth they inherit from you.

Another advantage is that tax is only taken when money is taken out of the SIPP. It gives you the opportunity to cascade wealth down the generations, potentially without the money ever falling into the taxman’s net.

You can nominate whoever you like to receive your SIPP wealth after you die, and the money can be split between multiple beneficiaries. Keep in mind that your nominations aren’t binding – the scheme administrators of your SIPP have discretion over where and to whom your pension is passed to. But your nominations play an important role in this process, and without them it’s more difficult for the administrators to pass on your pension according to your wishes.

Read more about what happens to your SIPP pension when die here:
https://www.ajbell.co.uk/pensions-and-retirement/accessing-your-pension/sipps-and-death

Why AJ Bell?

Work for yourself? Make your pension work for you too with an AJ Bell SIPP.

When you're self-employed, saving for your retirement can be one of those jobs you never get round to. But an AJ Bell SIPP can make it easier.

As well as offering you all the tax advantages a pension brings, an AJ Bell SIPP gives you the power to control your pot yourself. You can put in as much or as little as you like – from £25 a month up to your full annual allowance – and stay on top of things with our easy-to-use website and mobile app.

And if you're not sure where to invest your money, our investment ideas can give you a little help, or a lot.

- **Low cost** – buy and sell funds for £1.50, and shares for as little as £3.50 online
- **Easy to start** – open an account in 15 minutes, and invest as little as £25 monthly with our regular investment service
- **Easy to manage** – log in 24/7 and deal on the go with our mobile app
- **A helping hand** – get inspiration from our in-house specialists with one of our investment ideas
- **Transfer easily** – have a pension elsewhere? We'll do all the work when you transfer it to us
- **Invest with a trusted name** – we're an award winning FTSE 250 company managing £80.3bn of assets for more than 503,000 customers

Open an account

Find out more about AJ Bell SIPPs and apply – simply visit **ajbell.co.uk**

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