Redundancy payments and pension contributions

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From a pensions point of view, one of the options that redundancy gives is for the individual to re-invest the redundancy payment as a pension contribution into a registered pension scheme.

The key considerations are summarised below:

- The timing of the redundancy payment is crucial as any payment over £3,600 (gross) will need to be supported by relevant UK earnings. Therefore, if the individual only received the redundancy payment in May, and wished to use it to make a large contribution to a registered pension scheme, it is likely that they would not have the earnings at that point in the tax year to support the payment.
- Only part of an actual redundancy payment is treated as relevant UK earnings. The first £30,000 of a redundancy payment is normally tax-free and therefore would not be classed as relevant UK earnings. Any excess would be taxable and therefore treated as relevant UK earnings. Any other taxable payments made to the individual as part of their redundancy such as a payment in lieu of notice (PILON), salary, and holiday pay would also normally be treated as relevant UK earnings.
- It is for the larger redundancy payments that this exercise becomes particularly cost effective, as any tax paid on the redundancy payment received can effectively be reimbursed by making a contribution to a registered pension scheme, and claiming tax relief at the individual's highest rate (i.e. making a contribution net of basic rate tax, and claiming any higher rate tax relief via their self-assessment tax return).

The following example demonstrates how this can work for a UK (non-Scotland) taxpayer:

James, a UK (non-Scotland) taxpayer, is aged 60 and held a senior position in a manufacturing company until being made redundant. He takes a £75,000 redundancy payment, paying tax of £18,000 (£75,000 – £30,000 tax free element x 40% higher rate tax) as it all fell within the higher rate tax band which leaves him with £57,000 net overall.

Being financially secure and thinking of winding down, along with having sufficient unused Annual Allowance, James is able to contribute £36,000 net into his personal pension plan. After the addition of 20% basic rate tax relief, this equates to the £45,000 left after deduction of the tax-free element not considered to be earned income.

Allowing for any higher rate tax relief being claimed via his self-assessment tax return, the overall effect is that he is entitled to total tax relief of £18,000 (£45,000 x 40%), effectively nullifying the tax paid on his redundancy payment.

It is important to note, of course, that higher rate tax relief is only available where higher rate tax is actually paid.

Key point summary
For individuals unfortunate enough to be faced with redundancy, a full review of their circumstances and needs is required.

For some, this may involve tightening the belt until their situation improves but, for others, will lead to investment opportunities – not least into registered pension schemes with the added benefit of reclaiming tax paid on the redundancy payment.

This represents Zurich's understanding of the implications of the use of redundancy payments in pension planning. This is subject to change and Zurich does not accept responsibility for any action taken or refrained from, by any person relying on this information.

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Registered in England and Wales under company number 02456671.
Registered Office: Unity Place, 1 Carfax Close, Swindon, SN1 1AP.

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