Understanding annual allowance and the potential tax implications!

Failure to understand the implications of [tapered] annual allowance can result in a very nasty surprise in the form of a hefty and unexpected tax liability!

The annual allowance is a limit to the total amount of contributions that can be paid into defined contribution pension schemes and / or the total benefit growth in defined benefit pension schemes each year, for the purpose of tax relief. The annual allowance is based on pension input periods which in turn are aligned to tax [fiscal] years.

Any amount of annual pension contribution / fund growth in excess of the annual allowance limit may be liable to a tax charge calculated using the individual's marginal tax rate [1].

Standard Annual Allowance Rates

YEAR	RATE
2018/19	£40,000
2017/18	£40,000
2016/17	£40,000
2015/16: 6/4/15 to 8/7/15 (Pre-alignment) 9/7/15 to 5/4/16 (Post-alignment)	£80,000[2] £0
2014/2015	£40,000

A reduced annual allowance could apply if 'tapered' annual allowance has been triggered.

HMRC introduced tapered annual allowance in 2016/17 as a means to control the cost of pensions tax relief and help ensure pensions tax relief was fair and affordable for all. Consequently, a reduced 'tapered' annual allowance is dependant upon the individual's level of taxable income within a specific tax year.

Tapered annual allowance is activated when 'threshold' income exceeds £110,000 and 'adjusted' income exceeds £150,000.

Broadly speaking, 'threshold' income is defined as an individual's net income [total income from all sources less allowable tax reliefs] and 'adjusted' income is 'threshold' income plus pension contributions and / or annual pension fund growth depending upon the type of pension fund(s) held.

When both limits are exceeded, annual allowance will be tapered [reduced] by £1 for every £2 of adjusted income exceeding the £150,000 limit. The maximum reduction is currently £30,000 [adjusted earnings of £210,000 or over] which would result in a capped annual allowance of £10,000.

A worked example is detailed overleaf.

Notes:
1. Marginal tax rate is the percentage of tax applied to your income for each tax bracket in which you qualify.
2. £40,000 can be carried forward into the post alignment period.

Carrying Forward Unused Annual Allowance

Carry forward allows you to make use of any annual allowance that you may not have used during the three previous tax years, provided that you were a member of a registered pension scheme.

To use carry forward, you must make the maximum allowable contribution in the current tax year (£40,000 in 2019/20 or a lessor amount if your annual allowance is tapered) and can then use unused annual allowances from the three previous tax years, starting with the tax year three years ago.

Tax Liability

Any pension contribution and / or pension fund growth in excess of the available annual allowance will be subject to a tax charge at your marginal rate.

Scheme Pays Election

You can elect for your pension scheme to settle your tax liability by completing and submitting form SPE 2 within the designated time period [31 July following the the tax year to which the annual allowance charge relates ended].

We recommend that any such election is only made after discussion with an IFA as it will impact your future pension fund value.

Armstrong Watson Financial Planning and Wealth Management has an abundance of experience with this regard and would welcome the opportunity for a non-obligatory meeting with you to discuss your pension fund and potential implications thereof.

Worked example

Mary and John have the same annual earnings: self employed income of £45,000 and partnership profits of £85,000 with total taxable reliefs of £7,000.

Mary's and John's threshold income is £123,000 which exceeds the £110,000 limit.
Mary has a defined benefit pension scheme into which she has contributed £18,000 but the annual growth on the fund is £37,000.

John has a defined contribution scheme and has contributed £18,000 in the year.

Mary's adjusted income is £123,000 + £37,000 equating to £160,000 which exceeds the adjusted income limit. As such, Mary will have a reduced annual allowance of £35,000.

John, however, has an adjusted income of £123,000 + £18,000 equating to £141,000. As this is below the £150,000 adjusted income limit, John will be entitled to the full amount of annual allowance, namely £40,000.

With no unused annual allowance to carry forward, Mary will have an annual allowance tax charge of £800 [marginal tax rate of 40%] and John will have no tax liability with this regard.

This is a complex area of tax and one which cannot be overlooked. For more information and / or to arrange a non obligatory meeting, please contact your local Armstrong Watson team:

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