

Navigating the pension Annual Allowance (Lecture P1408 – 13.42 minutes)

The generous tax regime

Pensions are the most tax efficient investment on the market. We all know that.

Just as a reminder of how good they are, we receive:

- Tax relief going in (either by way of relief at source through PAYE and/or by the Government adding 25% to personal pension contributions with higher rate relief given via self-assessment);
- A tax-free benefit for employer contributions (plus a corporate deduction for the payer);
- Tax-free growth while the funds remain invested; and
- A 25% tax-free lump sum when funds are withdrawn.

And it doesn't stop there.

There are the often-overlooked secondary benefits of personal pension contributions as they are treated as reducing income (even though they don't). Taxpayers with income over £100,000 can therefore use personal pension contribution top-ups to reduce income and claw back personal allowances which would otherwise be withdrawn. At the slightly lower end, taxpayers with income over £50,000 can make sufficient personal pension contributions to prevent a clawback of child benefit. These knock-on benefits can lead to a very attractive effective rate of tax relief on personal pension contributions of 60% (or even more for large families – 69% for a family with three eligible children, 77% for a family with four). There even reaches a point with families with many eligible children where pension contributions can be made effectively free of charge with relief given at over 100%.

The sting in the tail

But it's not all wine and roses.

Firstly, individuals cannot obtain tax relief on contributions in excess of their earnings. Earnings means employment (including taxable benefits), self-employment (including partnership profits) and furnished holiday let profits. If an individual makes contributions in excess of earnings, most of the time these contributions are allowed to stay in the fund but will have no impact on the tax computation.

Individuals with low or no earnings can make gross annual contributions of £3,600. By the way, this includes children, so parents making net contributions of £2,880 to a person pension for a minor child will find that the Government adds a further £720 of free money. That fund will then grow tax-free for four or five decades (at which point the children will posthumously thank you for it).

More importantly for planning purposes, the pension rules place a restriction on annual "pension input". Pension input means employer plus employee contributions in a tax year. It does not take account of any growth in the fund itself in that period.

This is a slight simplification as “pension input” itself is not restricted as you can pretty much pay in what you like. However, if pension input exceeds the annual allowance (AA), an annual allowance charge will be triggered, thereby taxing these excess contributions at the individual’s marginal income tax rate. The AA charge is made via self-assessment and is either paid by the individual or can be taken from the pension fund if the tax is more than £2,000. Either way, it’s a cost which is best avoided.

Topping up the pension fund

With all this in mind, it is common end-of-tax-year planning for individuals to look at their pension arrangements with a view to using excess cash to top-up the pension in a tax efficient way. The key driver here is to avoid the AA charge.

The eagle-eyed among you will note that it’s not the end of the tax year. But a) time flies, b) your client might need a bit of notice to get their ducks in a row and c) pension providers tend to be busy in March (and extra busy in the first five days in April), so getting plans in place early is never a bad idea.

Also remember that pension contributions must be physically paid before 5 April to qualify for relief in that year. There is no longer a facility to carry back a contribution to the previous tax year. Which is another reason to start having those conversations with your clients earlier rather than later as some educated guesstimates of income may be necessary.

The AA is currently £60,000 for 2023/24 (having been £40,000 up to and including 2022/23). We therefore have an extra £20,000 to play with which your clients should be made aware of.

The AA can be increased by any unused relief brought forward from the previous three tax years (here 2020/21 through to 2022/23), but only if the individual was a member of a registered pension scheme in those three years. Unused relief before 2020/21 can no longer be used. For individuals opening a pension for the first time in 2023/24, the AA is therefore a hard £60,000.

Where brought forward relief is being utilised, the current year AA is used first, followed by brought forward relief on a first-in-first out basis.

Typically, this will be tracked as shown:

Tax Year	Employee Contributions	Employer Contributions	Total Pension Input	Annual Allowance	Unused Relief
	£	£	£	£	£
2020/21	15,000	15,000	30,000	40,000	10,000
2021/22	16,000	16,000	32,000	40,000	8,000
2022/23	17,000	17,000	34,000	40,000	<u>6,000</u>
					<u>24,000</u>

This means that in 2023/24, the maximum pension input without triggering an AA charge will be £84,000 (60,000 + 24,000). If pension input is less than this (say £75,000), current year relief (£60,000) is used first, then £10,000 from 2020/21 then £5,000 from 2021/22. The remaining unused

relief from 2021/22 (£3,000) plus the £6,000 from 2022/23 can be carried forward to 2024/25 giving £69,000 of headroom.

High Income Individuals

The AA is tapered for “high income individuals”. For this population, the AA is reduced by £1 for every £2 of “adjusted income” above £260,000 (£240,000 before April 2023). The AA cannot be reduced below £10,000 (which it will be for individuals with income over £360,000).

There are two tests to perform to determine whether a person is a “high income individual”, these being the “threshold income” test followed by the “adjusted income” test. The tapered AA only applies to individuals who pass (or fail depending on how you look at it), BOTH of these tests. So, if the £200,000 threshold income test is not met, you can stop there and happily use the full AA of £60,000. If not, we test again using adjusted income.

“Threshold income” is:

	£
Total income from all sources (P60 + benefits + other gross income)	A
Less: Employee personal pension contributions (gross)	<u>(B)</u>
Threshold income	<u>X</u>

If X is more than £200,000, we need to carry on to adjusted income which is:

	£
Total income from all sources (P60 + benefits + other gross income)	A
Add: Employee contributions under a net pay arrangement	B
Add: Employer pension contributions	<u>C</u>
Adjusted income	<u>X</u>

If X here is more than £260,000, the AA is subject to tapering.

Note: The threshold income test is designed to protect those employees who have occasional “spike years” where high employer contributions are made (which would then satisfy the adjusted income test).

Illustration

Lewis receives a gross salary of £230,000 and has taxable benefits of £5,000.

He also receives investment income of £15,000 per annum.

He makes personal pension contributions of £24,000 (net) per annum.

His employer matches his net contributions and also pays £24,000 to his personal pension scheme.

Lewis has no unused relief to bring forward.

Threshold income is:

	£
Total income from all sources (230,000 + 5,000 + 15,000)	250,000
Less: Personal pension contributions (24,000 x 100/80)	<u>(30,000)</u>
Threshold income	<u>220,000</u>

As threshold income exceeds £200,000, we carry on.

Adjusted income is:

	£
Total income from all sources (230,000 + 5,000 + 15,000)	250,000
Add: Employee contributions under net pay arrangement	Nil
Add: Employer pension contributions	<u>24,000</u>
Adjusted income	<u>274,000</u>

As adjusted income exceeds £260,000, both tests are met and the tapered AA applies.

Tapering is based on adjusted income in excess of £260,000 and will be as below:

	£
Standard AA	60,000
Less tapering: $\frac{1}{2} \times (274,000 - 260,000)$	<u>(7,000)</u>
AA 2023/24	<u>53,000</u>

We then compare this to pension input:

	£
Personal contributions (gross)	30,000
Employer contributions	<u>24,000</u>
Pension input	54,000
Less: Annual allowance	<u>(53,000)</u>
Excess	<u>1,000</u>

This excess will be taxed at Lewis's marginal rate of 45% giving an AA charge of £450 (payable via self-assessment).

The Money Purchase Annual Allowance

Finally, here be aware that if your client has already accessed their pension fund, they may be subject to the money purchase annual allowance (MPAA) which is only £10,000. This will apply if income has been drawn from the pension (it will not apply if just the tax-free lump sum is taken or if income is taken from an annuity). The rules are complex so talk to a pension specialist if necessary.

Once the MPAA is triggered, pension input above £10,000 per annum will bring about an MPAA charge. This is therefore a question you should ask when dealing with clients over the age of 55 who have the ability to access their pensions.

Contributed by Steve Sanders