Tech Talk - The Annual Allowance

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Introduction

Since it was introduced in 2006 there have been many changes to the annual allowance (AA). Those of a certain age will recall the heady days when the AA was £255,000, before the reduction to £50,000 in the 2011/12 tax year and then a further reduction to £40,000 in 2014/15.

Over the years we have written a number of Tech Talks covering the more esoteric elements of the AA, such as the tapering of the AA and the money purchase annual allowance (MPAA) when in reality for most individuals saving into a pension, these elements are of little relevance. With this in mind, I thought it worthwhile to consider just the basics of the AA in one Tech Talk (TT), rather than advisers having to trawl through a series of TTs to glean the relevant information. I will, however, reference any of these previous TTs where appropriate.

The Basics Of The AA

The purpose of the annual allowance is to limit the maximum amount of pension savings an individual can make in a particular tax year, whilst also, from a personal perspective, enjoying the benefits of full personal tax relief on any personal savings. Pension savings include those made by the individual themselves, plus any made on their behalf, whether that is another individual, like a grandparent for a grandchild, or an employer, all of which have a bearing on the individual's AA.

Contrary to what is commonly believed, there is in fact no limit to the amount of pension savings an individual can have in a tax year. What generally determines the amount of the individual's pension savings, is the tax relief available and the annual allowance. There are potentially two forms of tax relief available for pension savings. Personal and third-party contributions could enjoy income tax relief for the member, whereas for employer contributions, corporation tax relief may be available. The latter, from a tax relief perspective, is of little relevance for the individual, unless that person is also a director of the company making the contributions and is therefore concerned about the overall corporation tax bill the company may have.

For the purposes of keeping things simple, I'll ignore the impact of the MPAA in this TT, and so the AA works by applying a tax charge when the AA is exceeded, including any carry forward of unused AA from previous years, by broadly recouping the amount of tax relief given to the excess part of the increase in pension savings. The tax charge is known as the AA charge (AAC) and is applied to what is termed the "chargeable amount", i.e., the amount in excess of the individuals AA, inclusive of any carry forward. It is taxed at the individual's marginal rate, and could be taxed at 20%, 40%, or 45% or indeed a combination of these. Since 2018/19, Scottish taxpayers have had to pay any AAC on different bands and rates.

The type of pension arrangement determines how the pension savings are tested against the AA. For other money purchase arrangements, it is the actual amount of contributions paid in the pension input period (PIP). For other types of arrangements (e.g. defined benefits) it is the increase over the PIP in the value of benefit rights that is tested, and not the amount of actual contributions.

The AA rules apply to members of registered pension schemes, and also to members of overseas pension schemes where either they or their employer qualify for UK tax relief:

- under a double taxation agreement
- under section 307 Income Tax (Earnings and Pensions) Act 2003
- due to migrant member relief, or
- due to transitional corresponding relief

If a UK pension scheme is not a registered pension scheme, any accrual does not count towards the AA. This means savings under a UK employer-financed retirement benefits scheme do not count towards the AA. Also, savings under a non-UK scheme will not count towards the AA if neither the individual, nor their employer, qualified for UK tax relief under the provisions shown above.

Other pension savings that do not count towards the AA are any savings made in a tax year in which the individual:

- dies, or
- becomes entitled to those pension savings due to severe ill-health, or
- is a deferred member, whose benefits do not increase beyond a certain level

To determine whether an individual has an AAC to pay, they need to find the total amount of their pension saving for the tax year. Individual pension input amounts (PIA) for each arrangement the individual is a member of need to be calculated. The amount of pension savings under all their arrangements is called the total PIA.

The value of an individual's PIA for an arrangement is measured over the PIP. Since 6 April 2016, the PIP for existing arrangements matches the tax year, so that they run from 6 April to the following 5 April. Before this date PIPs could straddle tax year end. This change to the tax year end resulted in two mini tax years for AA purposes being introduced in the tax year 2015/16.

Please see the TT Pension input amounts for 2015/16

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Most people will be subject to an AA of £40,000. However, some individuals will have a lower AA than this figure, as they will be impacted by the tapered AA, which can range from £10,000 to £39,999. The tapered AA still allows the individual to carry forward unused AA from previous years, though it should be noted the amount that can be carried forward from a tax year in which tapering applies, is any unused portion of their tapered AA in that year. For individuals affected by the MPAA, the AA test is modified and the identification of chargeable amounts is more complicated. As stated previously, I will not be covering the MPAA in this TT, though further details can be found:

TT Taxation of Pensions Bill: Money Purchase Annual Allowance

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More detail on how the tapered AA works can be found in the following TTs:

Income definitions for the tapered annual allowance Tech Talk In Full >

Tapered annual allowance and planning considerations Tech Talk In Full >

Tapered annual allowance and the annual allowance charge Tech Talk In Full >

Pension Input Periods and Pension Input Amounts

The PIP is the period over which the individual's PIA is measured. Prior to the 8th July 2015, it was possible for PIPs to straddle the tax year end. For example, an individual could have a PIP that started on the 1st July and ended on the 30th June the following year. For personal contributions to their pension this meant that contributions from 1st July to 5th April the following year received tax relief in the tax year ending 5th April. However, for AA purposes their pension savings in that same period, plus those from 6th April to 30th June, were measured against their AA for the following tax year.

With the introduction of the tapered AA with effect from 6th April 2016, it was felt that this approach would simply increase the complexity for those affected by tapering. Therefore, all PIPs that were open on 8th July 2015 closed on that date, with a new PIP starting on 9th July and ending on 5th April 2016 with the result that all PIPs now run from 6th April to 5th April the following year. For more information on this change and its impact, please see the previously mentioned TT, Pension input amounts for 2015/16.

While this change to PIPs may appear to no longer have any relevance, it is important to factor it in if an adviser is looking at a client's pension savings history, particularly where there have been fluctuating savings, with in some instances, the savings exceeding their AA in a particular year. To carry out a full review for the current year (2019/20) the adviser may have to consider looking at pension savings as far back as the 2014/15 tax year, not forgetting to factor in the complexity of the 2015/16 tax year, to determine whether an individual is liable for an AAC in the tax year. A similar exercise may be required to establish whether there is any carry forward of unused AA to work with.

As mentioned previously it is the PIA that is measured against the individual's AA, plus any unused AA carried forward, to determine whether there is an AAC to pay. For money purchase arrangements the PIA is relatively straightforward, in that the individual simply totals all the following:

- any relievable pension contribution paid by the member
- any relievable pension contribution paid by someone else on behalf of the member
- any contribution paid in respect of the member by an employer of the member

For a relievable pension contribution, the calculation needs to include any basic rate tax relief paid to the scheme by HMRC on the member's behalf; i.e., it is the gross amount of the contribution that is used. A relievable contribution can also include any part of a contribution paid by, or on behalf of, the individual that does not actually receive any tax relief. For example, the amount of the relievable pension contribution in excess of the individual's relevant UK earnings that are chargeable to income tax for the tax year. Such a scenario would be where the individual paid a personal contribution of £32,000, which with basic rate relief is grossed up to £40,000 under relief at source, and yet they only have relevant UK earnings of £30,000. In principle the scheme administrator returns the £2,000 in excess relief to HMRC and the individual is left with a PIA for that year of £38,000 despite only having received relief of £6,000 (20% of £30,000).

The amounts that do not actually receive any relief are still included, as they were still paid during the PIP concerned. In situations such as this the individual may be able to have the excess contribution refunded through what is termed an excess contributions lump sum. If successful in this approach, the PIA is reduced accordingly for the year in which the excess contribution was paid.

The TT Refund of Contributions covers this aspect in some more detail:

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In the case of an active member of a defined benefit arrangement, the PIA is not arrived at by adding together the employer's and employee's agreed percentage of pensionable salary, but rather it is a notional amount based on the increase in benefits over the PIP. The increase is derived by looking at the individual's benefits immediately before the start of the PIP, known as the opening value, which in turn is uprated by CPI, and the value of the individual's benefits at the end of the PIP, known as the closing value. In some scenarios the difference could be a negative amount for the PIP, in which case, the PIA is treated as being zero for that PIP. The easiest way to explain the calculation is to consider an example.

EXAMPLE 1 - PIA for a DB Arrangement

Charlotte and Daniel are members of a defined benefit (DB) scheme with an accrual rate of 1/60th for each year of service (PCLS is by commutation of pension income). Both have just received a promotion with their pensionable salary increasing from £60,000 (at the end of the previous PIP) to £70,000. Charlotte had 20 years of service at the start of the PIP and Daniel 30 years. They are concerned about the impact this has on the AA and whether they will have a tax charge to pay.

Charlotte's Opening Value

- **(£60,000 x 20/60) x 16 = £320,000**
- **Uprate by CPI of 2.4% (September 2018) = £327,680**

Charlotte's Closing Value

- **(£70,000 x 21/60) x 16 = £392,000**

Charlotte's PIA

- **£392,000 - £327,040 = <u>£64,320</u>**

Daniel's Opening Value

- **(£60,000 x 30/60) x 16 = £480,000**
- **Uprate by CPI of 2.4% (September 2018) = £491,520**

Daniel's Closing Value

- **(£70,000 x 31/60) x 16 = £578,667**

Daniel's PIA

- **£578,666 - £488,160 = <u>£87,147</u>**

Both Charlotte and Daniel will have an AAC to pay unless they have sufficient carry forward of unused AA to work with.

It can be seen in Example 1 that whilst Charlotte and Daniel have matching salaries pre and post their promotion, the actual PIAs are quite different. This is due to Daniel having greater pensionable service than Charlotte and so it should be noted that where an individual has long service and enjoys a significant increase in salary there is a greater chance that they will exceed their AA in that year, despite perhaps in previous years never having come close to using their full AA.

For calculating the PIA for the other forms of pension arrangements, cash balance arrangements and hybrid arrangements, please refer to the Pension Tax Manual pages PTM053400 and PTM053500.

Carry Forward of Unused AA

As mentioned previously, the AA was reduced from £255,000 to £50,000 for the tax year 2011/12, and subsequently reduced to £40,000 from 2014/15; an implication of which is demonstrated by Example 1, in that individuals with long service in a DB scheme who receive a significant pay rise can easily exceed this lower AA. To alleviate the potential problem, the ability to carry forward unused AA from previous years was introduced. This also benefits those individuals who fund money purchase arrangements, in that it allows them some flexibility in their pension funding, particularly so for those who run their own businesses where their income/profits fluctuate from year to year.

Carry forward works on the basis that the individual must fully use the current year's AA, then consider the furthest back of the preceding three years to determine whether there is any unused AA to carry forward from that year, then the second furthest back year and finally the previous year. It is only possible to carry forward any unused AA if the individual was a member of a registered pension scheme at some point in the tax years in question. For clarity, 'member' includes active member, deferred member, pensioner member and pension credit member of any registered pension scheme.

To explain further, let's reconsider both Charlotte and Daniel and the implication for them of exceeding the AA in the 2019/20 tax year.

EXAMPLE 2 - Carry forward of unused AA for Charlotte

Revisiting Charlotte first; presume that her pensionable salary is as stated in the table below. As her PIA for the 2019/20 year is £64,960, we need to determine whether Charlotte has sufficient carry forward from the three preceding years to avoid an AAC.

	2019/20	2018/19	2017/18	2016/17
Service	21/60	20/60	19/60	18/60
Salary	£70,000	£60,000	£58,200	£57,618
Opening Value	£327,680	£303,726	£279,332	£258,590
Closing Value	£392,000	£320,000	£294,880	£276,566
PIA	£64,320	£16,274	£15,548	£17,977
Unused AA	£0	£23,726	£24,452	£22,023

Charlotte's PIA for 2019/20 is estimated to be £24,320 above this year's AA of £40,000. Fortunately, she has sufficient carry forward from 2016/17 and 2017/18 to cancel out this excess.

Going forward for the 2020/21 tax year, she will have carry forward of unused AA from 2017/18 and 2018/19 to work with, giving her a total of £45,881 over and above her AA for 2020/21.

Daniel has greater service than Charlotte, therefore his PIA will be higher for each of the years.

EXAMPLE 2 - Carry forward of unused AA for Daniel

For Daniel, his pensionable salary follows those of Charlotte.

	2019/20	2018/19	2017/18	2016/17
Service	31/60	30/60	29/60	28/60
Salary	£70,000	£60,000	£58,200	£57,618
Opening Value	£491,520	£463,582	£434,517	£410,701
Closing Value	£578,667	£480,000	£450,080	£430,214
PIA	£88,147	£16,418	£15,563	£19,513
Unused AA	£0	£23,582	£24,437	£20,487

Daniel's PIA for 2019/20 is estimated to be £48,147 above this year's AA of £40,000. Like Charlotte, he has enough carry forward from previous years to cancel out this excess.

Looking at the 2020/21 tax year, he will have much less carry forward of unused AA to work with than Charlotte, namely £20,359 (£68,506 - £48,147)

Responsibility for Paying the AAC

HMRC are not concerned with an individual who is funding a pension within their AA, including any carry forward of unused AA from previous years, presuming of course they have the relevant UK earnings to support the personal contribution. They are only interested where the individual has an AAC to pay, and the individual needs to tell HMRC they are liable for this charge.

If they normally complete a Self Assessment tax return, then they include their pension savings and liability to the AAC as part of the return. This requires completion of the appropriate Additional Information pages of the tax return to indicate the amount by which their total PIA exceeds the AA. If they haven't completed a tax return before, or haven't completed one recently, they will need to let HMRC know there has been a change in their circumstances and submit a tax return.

The AAC is a tax charge on the individual, and normally they will pay the charge, accounting for it as previously mentioned through their tax return. However, if certain criteria are met, they may request that the scheme administrator of their scheme pay their AAC liability in return for an appropriate reduction in their pension benefits. This is what is referred to as 'Scheme Pays', and it is an option for the individual provided both of the following conditions are met:

- their AAC liability for the tax year has exceeded £2,000 and
- the total amount of their pension savings into the particular pension scheme for the same tax year has exceeded the AA

If met, and the member asks the scheme to pay the charge, the scheme administrator becomes jointly and severally liable with the member to pay the charge. Where an individual does not meet the conditions for 'Scheme Pays' to apply or they do not ask the scheme in time, then a scheme may decide to pay the member's AA charge on a voluntary basis. Bear in mind that in either case, there has to be an appropriate reduction in the member's pension benefits.

For the interaction between the tapered AA and scheme pays rules, please see the TT Tapered Annual Allowance and the Annual Allowance Charge.

Tapered Annual Allowance and the Annual Allowance Charge

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Comment

In 2011/12, when the AA was reduced to £50,000, there were 5,570 individuals who reported pension contributions exceeding the AA in that year. In 2016/17, with the introduction of the tapered AA, the number increased to 18,500 and a reported £578m of AA excess. For the last year of available statistics from the Office of National Statistics (ONS), 2017/18, the numbers increased once again to 26,550 and £812m respectively. If nothing is done to address the issue of the tapering of the AA, then these figures are likely to increase. Individuals affected by the tapering will soon run out of unused AA that they can carry forward, meaning more are likely to be subject to an AAC. It should be noted that the figures from the ONS do not differentiate between those paying the charge for exceeding £40,000 and those liable for it due to a tapered AA.

For 2017/18, the ONS seem to indicate that there were around twenty-seven million active members of pension schemes. This includes both occupational and personal pension schemes. That being the case, then the percentage of people paying the AAC in that year was approximately 0.1% of the active membership. Despite the headlines, the vast majority of pension members are unconcerned with the AA, hence the reason for simply focussing on the basics of the AA in this TT. Advisers, though, still need to be conversant with the more esoteric aspects of the AA, due to many inhabiting the somewhat rarefied position of working with a high proportion of clients who are nevertheless impacted in an adverse way by the AA.

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