BloomsburyWealth®

The tapered annual allowance: Confused? You should be!

One of several amendments to the 'simplified' pensions regime was the introduction from 6th April 2016 of the tapering of the annual allowance for individuals deemed to have high incomes.

Since that date individuals with taxable income of greater than £150,000 in a tax year have had their pension annual allowance for the tax year restricted, potentially to as little as £10,000. As might be expected with the simplified regime, all is not wholly straightforward, given the evident concern that individuals might seek to avoid the new provisions by taking reduced remuneration in exchange for increased pension contributions. The extent of any tapering is therefore based on 'adjusted income'.

However, to provide some certainty for individuals with lower incomes who might periodically experience spikes in their employer's pension provision, a test is first made to see whether the individual's income exceeds the 'threshold income' figure. It is therefore first necessary to define the terms involved.

Adjusted income for the tax year is the individual's taxable income (i.e. after trading losses, share loss relief, charitable donations, and various other allowances, as detailed in s.23 of the Income Tax Act 2007) from all sources ('net income'),

- plus the value of pension contributions made under a net pay arrangement,
- plus the value of any pension contributions using excess relief under net pay provisions,
- plus, for UK non-domiciled individuals making contributions to overseas pension schemes, any contributions attracting UK tax relief,
- plus the value of pension contributions using 'relief on making a claim' provisions.
- plus the value of any employer contributions to defined contribution schemes,

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- plus the pension input amount (calculated using the annual allowance methodology) less the gross total of any pension contributions paid by the member to defined benefit and cash balance schemes,
- less any taxed lump sum death benefits received.

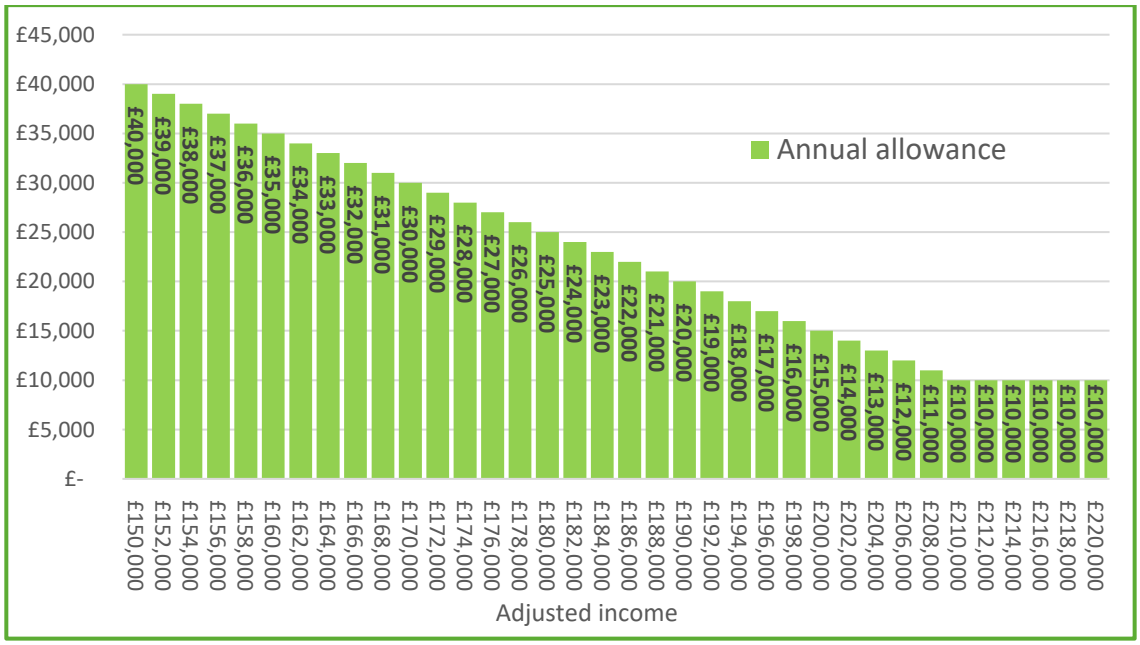
Threshold income for the tax year is the individual's taxable income as defined above,

- plus the amount of any employment income foregone via a salary sacrifice arrangement made on or after 9th July 2015,
- less the gross total of any pension contributions paid by the member
- less any taxed lump sum death benefits received.

- If threshold income is less than £110,000, then no tapering applies. However, if it exceeds this figure, it is necessary to calculate 'adjusted income'.

Individuals whose income from all sources in a tax year exceeds the 'threshold income' of £110,000 and the 'adjusted income' of £150,000 will have their annual allowance tapered down from the normal level of £40,000 by £1 for every £2 of their 'adjusted income' over £150,000, down to a minimum of £10,000 for that tax year. The consequence is an annual allowance of £40,000 for those with adjusted income of up to £150,000, reducing to £10,000 for those with adjusted income of over £210,000. See chart below.

Tapering of annual allowance according to adjusted income



Data source: Bloomsbury Wealth

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Being subject to the tapered annual allowance does not affect the ability to carry forward unused allowance from previous tax years, although the unused allowance being carried forward from a year in which the taper applied will be the balance of the tapered allowance for that year.

Since individuals who have elected for access to their defined contribution pension benefits via flexi access drawdown become subject to the money purchase annual allowance (MPAA) of £10,000 (it has already been announced that this will soon reduce to £4,000, although the 2017 general election delayed its implementation) there would normally be an 'alternative annual allowance' (the standard £40,000 less the MPAA of £10,000, so £30,000 – to become £36,000 when the legislation is passed) against which their defined benefit savings would be tested. However, individuals subject to the tapering provisions will have this restricted so that for adjusted income of more than £210,000, the alternative annual allowance is reduced to zero (although when the MPAA is reduced this will be £6,000).

Some examples may serve to highlight how the system operates in practice.

Example 1

Boris is a member of his employer's defined benefit scheme to which he pays 5% of salary and he also pays gross contributions into a personal pension scheme of £6,000. In 2016/17, his position is:

Earned income		
Pensionable pay	£111,000	plus
Benefits in kind	£ 5,200	less
Deductible expenses (subscriptions)	£ 500	less
Less member's contributions under net pay	-£ 5,500	
Taxable pay*	£110,200	
Investment income		
Gross interest	£ 500	plus
Rents	£ 9,100	plus
Dividends	£ 6,800	
Taxable income	£126,600	
Pensions		
Total defined benefit increase	£ 32,000	less
Member's gross contributions (net pay)	-£ 5,550	
Effective value of employer contributions	£ 26,450	
Member's gross contributions (relieved at source)	£ 6,000	
Annual allowance carried forward	£ 20,000	

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The first step is to calculate the threshold income.

Taxable income	£126,600	less
Gross contributions relieved at source	£ 6,000	
Threshold income	£120,600	

Since this exceeds the upper limit of £110,000, it is necessary to calculate adjusted income.

Taxable income	£126,600	plus
Member contributions under net pay	£ 5,550	plus
Effective value of employer contributions	£ 26,450	
Adjusted income	£158,600	

Since Boris's threshold and adjusted income figures both exceed the relevant limits, his annual allowance will be tapered by £1 for every £2 that the latter exceeds £150,000, i.e. by £8,600/2 = £4,300, to £35,700. However, since he has £20,000 of unused relief available, he avoids any annual allowance excess tax charge on this occasion.

Example 2

Teresa owns her own limited company and pays herself a modest salary but having unused allowance of £41,000 at the start of the year, decided to use this and the current year's allowance to extract profits in a tax-efficient way by making an employer contribution to her SIPP.

Earned income		
Pensionable pay	£ 17,000	plus
Benefits in kind	£ 6,100	less
Deductible expenses (subscriptions)	£ 250	
Taxable pay*	£ 22,850	
Investment income		
Gross interest	£ 720	plus
Rents	£ 6,700	plus
Dividends	£ 80,000	
Taxable income	£110,270	
Pensions		
Employer contribution to defined contribution scheme	£ 81,000	
Annual allowance carried forward	£ 41,000	

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Again, the first step is to calculate the threshold income.

Taxable income	£110,270
Threshold income	£110,270

Since this exceeds (albeit only slightly, due to an increase in the premiums for her private medical insurance, something which might well be unknown at the time the contribution was paid) the upper limit of £110,000, it is necessary to calculate adjusted income.

Taxable income	£110,270	plus
Employer contribution to defined contribution scheme	£ 81,000	
Adjusted income	£191,270	

Teresa's threshold and adjusted income figures both exceed the relevant limits, so her annual allowance will be tapered by £1 for every £2 that the latter exceeds £150,000 (i.e. by £41,270/2 = £20,635) down to £19,365 (what is left of the £40,000 AA after the tapering £20,365 is deducted) and since the carried forward annual allowance had already been used, there would be an annual allowance excess tax charge.

This might be disconcerting to Teresa, who probably does not consider herself a high earner at all. However, there is a solution if she realises the situation before the end of the 2017/18 tax year. If she were to make a personal contribution of just £300 to her SIPP before 5th April 2018, that would have the effect of bringing her threshold income down to £109,970 which, as it is below £110,000, would bring her income below the figure that triggers the adjusted income calculation. She still breaches the annual allowance but her annual allowance excess tax charge would now be based on £300 rather than £20,365.

In such circumstances, it may therefore be beneficial for those who could be caught by tapering to make personal contributions to a personal pension scheme rather than use employer contributions. Obviously, this requires that the personal contribution is also covered by earnings, which can be an issue where profits are extracted substantially in the form of dividends.

Quite how 'the man on the Clapham omnibus' can be expected to understand the intricacies of the tapered annual allowance is beyond me. Even advisers struggle to get to grips with it (in 2016, Prudential's adviser helpline fielded 14,000 calls from advisers, with the highest number relating to the tapered annual allowance). This might help to explain why, in the last five years, HMRC has collected £180m in annual allowance tax charges from defined benefit occupational

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pension schemes paid under 'scheme pays', a facility whereby the charge can be paid by the scheme rather than the member. This does not allow for those who did not choose the 'scheme pays' option.

The figures provided by HMRC show that a total of 9,257 scheme members was affected during that five-year period. Interestingly – and somewhat tellingly – the number of cases varies significantly each year, which perhaps best illustrates the random nature of the policy and the likelihood that most charges arose as a result of people being caught out rather than knowingly breaching the limit.

What is clear is that if there is likely to be any chance that you might be affected by this tax charge, paying for advice may well prove to be extremely cost-effective.

If you would like to learn more you can download our Guide to Pensions here: http://www.bloomsburywealth.co.uk/guide-to-pensions-updated-may-2017-pdf/

For further information please get in touch with your usual Bloomsbury Wealth contact, telephone 020 4502 4560 and ask for a member of the wealth team or alternatively
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