The Annual Allowance

Tech-Bites

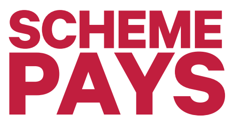
A review of the annual allowance, what it is and how it operates for both defined contribution and defined benefit pension schemes.

Key Points

The annual allowance is currently set at £40,000.

It is possible to carry forward unused allowance from the previous three tax years.

The annual allowance charge is the charge payable for contributions that exceed the allowance and is payable at the individuals' marginal rates of income tax.



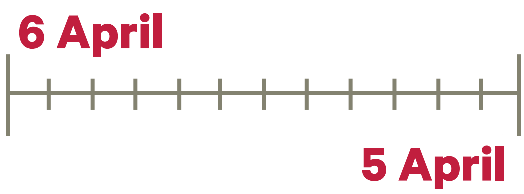
It is possible to use 'scheme pays' to pay any annual allowance charge on either a mandatory or voluntary basis.

What is the annual allowance?

The annual allowance:

- Sets the maximum amount of tax relieved pension savings that can be made to a pension scheme within each tax year.
- Is set at £40,000 for the current tax year 2020/2021.
- Has different limits applicable for those affected by the Tapered Annual Allowance or Money Purchase Annual allowance.

Pension Input Periods (PIPs)



Pension Input Period (PIP):

- The period by which all contributions or benefit accrual is measured between a start point and an end point.
- Since 6 April 2016, PIPs have been aligned to the tax year and run from 6 April – 5 April.

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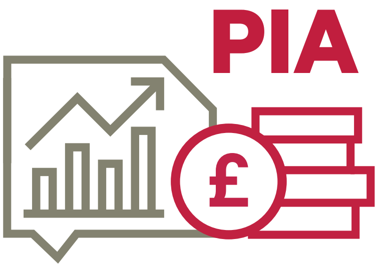
Pension Input Amounts (PIA)



The Pension Input Amount (PIA) is the value used to measure pension savings against the annual allowance. The way this is calculated will depend on the type of scheme as follows:

DC SCHEMES - it is the total gross contributions (any personal or third party contributions, for example, an employer) that are measured

DB SCHEMES - it is the total increase in benefit rights that is measured (not contributions).

This will be based on the difference between the opening (start of the PIP) and closing values (end of the PIP) and will include things like:

- Earnings,
- Length of service;
- Accrual; and
- Any separate lump sums

Defined contribution schemes – working out the Pension Input Amount (PIA)

For a Defined Contribution (DC) scheme:

- The Pension Input Amount (PIA) will be the total of all the contributions made within a tax year (or PIP) for each pension plan.
- So where contributions start or cease at some point within the tax year, they will still form part of that year's PIP.
- The total amount within that PIP will then be the PIA for that scheme for that tax year.

Pension contributions will include

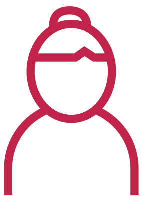
- All gross contributions made by the member (or on behalf of the member)
- All employer contributions made into the plan.

The total of all the PIAs for all DC schemes within the tax year will need to be added up and this will be the total DC contribution to measure against the annual allowance.

Defined contribution schemes

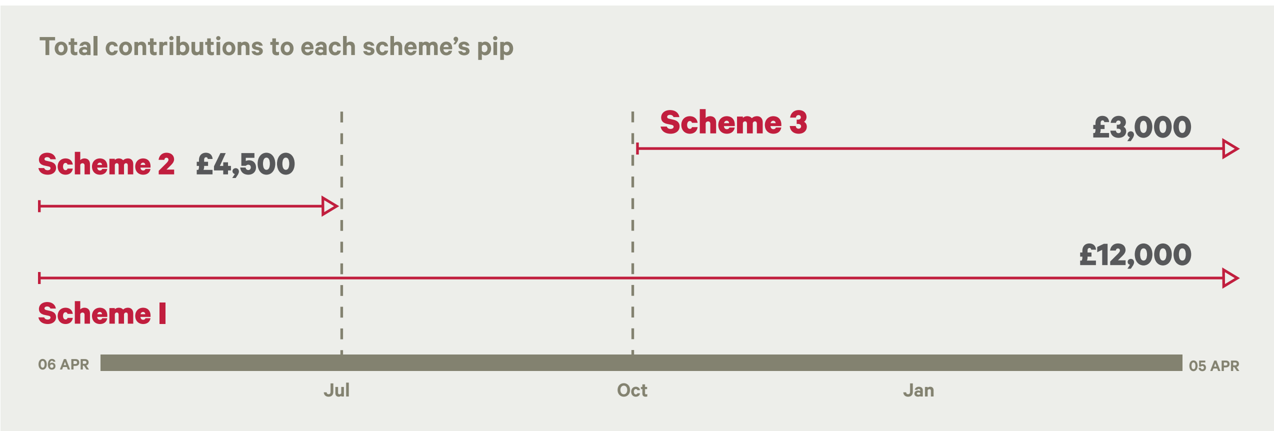
Pension input amount (PIA)

Example - Susan



Susan has contributed on a monthly basis to three different schemes within the tax year, where the total contributions to those schemes are as follows:

- **Scheme 1 - £12,000** (total monthly contributions made consistently throughout the tax year)
- **Scheme 2 - £4,500** (total monthly contributions, which ceased after three months into the tax year)
- **Scheme 3 - £3,000** (total monthly contributions which started six months in to the tax year)



Susan's total DC contributions measured against the annual allowance is £19,500, which is the total contributions from all three schemes for the tax year (i.e. 06 April – 05 April).

Defined benefit schemes – working out the Pension Input Amount (PIA)

Defined benefit schemes

For a Defined Benefit (DB) scheme:

The Pension Input Amount (PIA) will be the increase in benefit rights between the start and end date of the Pension Input Period.

STEP 1

Calculate the opening value (for the start of the PIP):

- Calculate the opening value using salary, length of service and accrual rate (for example 1/60th) at the start of the PIP
- Uplift the value by CPI for the 12 month period from the previous September
- Then multiply by a factor of 16
- Any separate lump sums will also need to be factored into the calculation

STEP 2

Calculate the closing value (for the end of the PIP):

- Calculate the closing value using salary, length of service and accrual rate at the end of the PIP
- Then multiply by a factor of 16
- Any lump sum paid separately should also be added into the calculation

STEP 3

Valuing the Pension Input Amount (PIA):

- Subtract the opening value from the closing value to calculate the individual's deemed PIA for annual allowance purposes

Other factors

Where an individual has any of the following events occurring within the PIP year these will need to be taken into account:

- Transfers in/out
- BCEs
- Pension debits/credits
- Reduction in benefits (due to scheme paying annual allowance charge)

Example - John

Calculate the opening value

At the start of the PIP year:

- John's earnings were £29,644.00
- Completed 25 years' service within a 1/60th accrual scheme,
- CPI over the 12 month period to last September was 1.2%

The opening value would be as follows:

- **DB opening value** = £29,644.00 x 25/60 x CPI (1.012) x 16 = **£200,000**

Calculate the closing value

At the end of the PIP year:

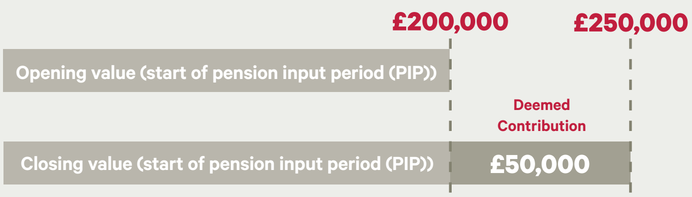
- John's earnings were £36,058.00
- Completed 26 years' service within a 1/60th accrual scheme.

The closing value would be as follows:

- **DB closing value** = £36,058.00 x 26/60 x 16 = **£250,000**

Calculate the Pension Input Amount (PIA)

- Closing value **less** Opening value **equals** Pension Input Amount
- £250,000 **less** £200,000 **equals** £50,000



In this example John would have exceeded his annual allowance by £10,000 and unless he had some unused annual allowance to carry forward, he would face an annual allowance charge on the excess.

Carry forward of unused allowance

Carry forward of unused allowance allows an individual to bring forward unused annual allowance from the previous three tax years to make contributions in excess of their annual allowance in the current tax year.

Individuals must:

- Have used up their annual allowance for the current tax year.
- Have been a member of a UK registered pension scheme over any of those previous three tax years they wish to use carry forward from.
- Have unused annual allowance to carry forward from those tax years.
- Have relevant UK earnings in the tax year that the contribution is made to cover the size of any proposed contribution if made as a personal contribution.

How the annual allowance is tested?

STEP 1

Work out the pension savings for each plan in the tax year

- Determine the level of pension savings for each pension plan for the tax year, known as the pension input amount.
- This will need to be done for all Defined Contribution (DC) and Defined Benefit (DB) schemes for the tax year in question.
- Remember -the pension input period (PIP) from 6 April 2016 is aligned with the tax year and there is no longer scope to change the end date.

STEP 2

Determine the annual allowance available including any carry forward

- Determine whether the annual allowance applies or does the reduced Money Purchase Annual Allowance (MPAA) or Tapered Annual Allowance apply (see our Technical Briefing Notes on these subjects).
- Then calculate how much annual allowance is available – this will be a combination of the annual allowance for the tax year in question plus any unused annual allowance that can be carried forward from the previous three tax years.

STEP 3

Subtract the total pension input amounts (PIA) from the available annual allowance (including any carry forward)

- Subtract the total Pension Input Amounts (PIAs) from the annual allowance; and
- If it is within the available annual allowance limit (including any unused carry forward), then an annual allowance charge will not apply.
- If the total of the PIAs exceed the annual allowance (and available unused carry forward of unused allowance), then the individual will face an annual allowance tax charge.

The annual allowance charge

When does it apply?

- When pension savings are above the level of the annual allowance and unused annual allowance carried forward from the previous three tax years.
- The charge will apply to the member even where a third party or employer has made the contribution.

How much is the charge?

- It's based on the excess over the annual allowance (or chargeable amount) which is then added to the individual's total income for the tax year.
- The rate depends on which income tax bracket it falls into when added to the individual's salary.
- Therefore any charge will be at the individual's marginal rate of income tax.

Using 'Scheme Pays' to pay the annual allowance charge

Individuals can elect for their schemes to pay any annual allowance charge providing that:

- The charge exceeds £2,000;
- The total pension savings within that scheme exceeds the annual allowance (for example £40,000).

Mandatory or voluntary?

The scheme:

- Is only obliged to pay that part of the charge that relates to their scheme;
- Can decline to pay any amount that does not relate to an over payment to their scheme.

Planning considerations

Pension tax planning can help clients:

- Maximise contributions where possible
- Make use of any carry forward of unused annual allowance
- Looking to reduce the tax due on other investment income or gains within the tax year by making a pension contribution in the same tax year as the realised taxable gain
- Reclaim personal allowance or reduce/eliminate the high income child benefit tax charge

This document is based on Canada Life's understanding of applicable UK tax legislation and current HM Revenue & Custom's practice, as at March 2020 and could be subject to change in the future. It is provided for professional advisers only. Any recommendations are the adviser's sole responsibility.

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