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Tapered annual allowance

How it
works

On 6 April 2016 the government introduced the tapered annual allowance for individuals with adjusted income of over £150,000. However, on 6th April 2020, adjusted income was raised by £90,000 to £240,000. Here we look at who might be affected, what constitutes 'adjusted' and 'threshold' income, how to assess the impact for clients and the planning implications for pension saving.

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How the taper works and who it affects

Rate of reduction: £1 for every £2 of 'adjusted income' over £240,000

Maximum reduction of personal allowance = £36,000

With threshold income less than £200,000 no tapering of the annual allowance

Anyone with a threshold income of more than £200,000 may be subject to a tapered annual allowance. The rate of reduction in the annual allowance is £1 for every £2 of adjusted income that exceeds £240,000. The maximum that a person's annual allowance can be reduced by is £36,000, which means the minimum tapered annual allowance for any individual is £4,000 for individuals with an adjusted income of £312,000 or above. Where an individual has a threshold income of £200,000 or less, they will not be subject to the tapered annual allowance, even if their adjusted income is greater than £240,000.

ADJUSTED INCOME	ANNUAL ALLOWANCE
£240,000	£40,000
£250,000	£35,000
£260,000	£30,000
£270,000	£25,000
£280,000	£20,000
£290,000	£15,000
£300,000	£10,000
£310,000	£5,000
£312,000+	£4,000

Effects of exceeding an annual allowance

Individuals who exceed their annual allowance due to the effects of the taper may face a tax charge. The amount of the charge is calculated by adding the excess level of pension contributions, less any available carry forward, to the individual's taxable income for the relevant tax year – the excess is subject to Income Tax at their marginal rate.

The charge is normally declared and paid through their Income Tax self-assessment. It may be possible for the charge to be deducted directly from the individual's pension arrangement. This is known as Scheme Pays and specific conditions apply.

'Threshold Income' versus 'Adjusted Income'

Threshold Income

Threshold Income is calculated as follows:

The individual's UK taxable income for the tax year

As calculated under steps 1 and 2 of section 23 of the Income Tax Act 2007.

Broadly speaking, this represents taxable income from all sources (therefore likely to include but not limited to):

- salary
- bonus
- profits from self-employment
- benefits in kind
- pension income (including UFPLS payments)
- income from property
- savings
- dividends
- taxable lump sum death benefits (post 5 April 2016)



The amount of any employment income given up for pension provision, as a result of any salary sacrifice or relevant flexible remuneration arrangement made on or after 9 July 2015 (see anti-avoidance section).



The gross amount of any personal pension contributions paid to relief at source pension arrangements.
The amount of any lump sum death benefits paid as taxable income applicable to the individuals in the tax year.

If threshold income is less than £200,000, adjusted income and the tapered annual allowance does not apply for the 2020/21 tax year.

Adjusted Income

Adjusted Income is calculated as follows:

The individual's UK taxable income for the tax year

As calculated under steps 1 and 2 of section 23 of the Income Tax Act 2007 less: certain allowances and reliefs, e.g.

- excess tax relief under net pay pension schemes (where full tax relief is not available through payroll)
- pension scheme tax relief upon making a claim (e.g. for Retirement Annuity Contracts)
- gifts to charities and trade losses



Contributions and relief

Any pension scheme tax relief deducted in the step above.

Any employee pension contributions deducted from gross salary (net pay arrangements) in the tax year the payment is made.

Any tax relief for overseas pensions contributions.

The value of all employer contributions (which includes any employer contributions as a result of a salary sacrifice arrangement) for the tax year.



Any lump sum death benefits paid to individuals in the tax year which were taxable at the individuals marginal rate.

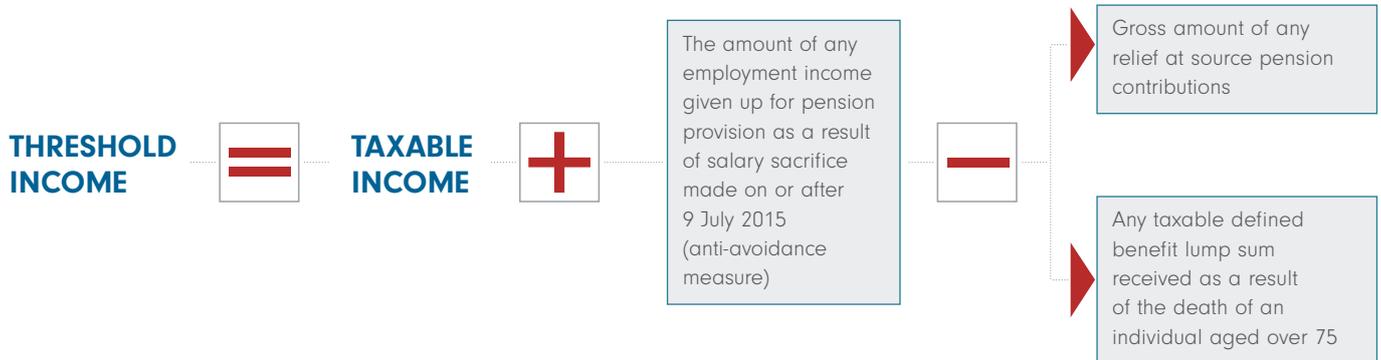
If adjusted income is less than £240,000, the tapered annual allowance does not apply for the 2020/21 tax year.

Note:

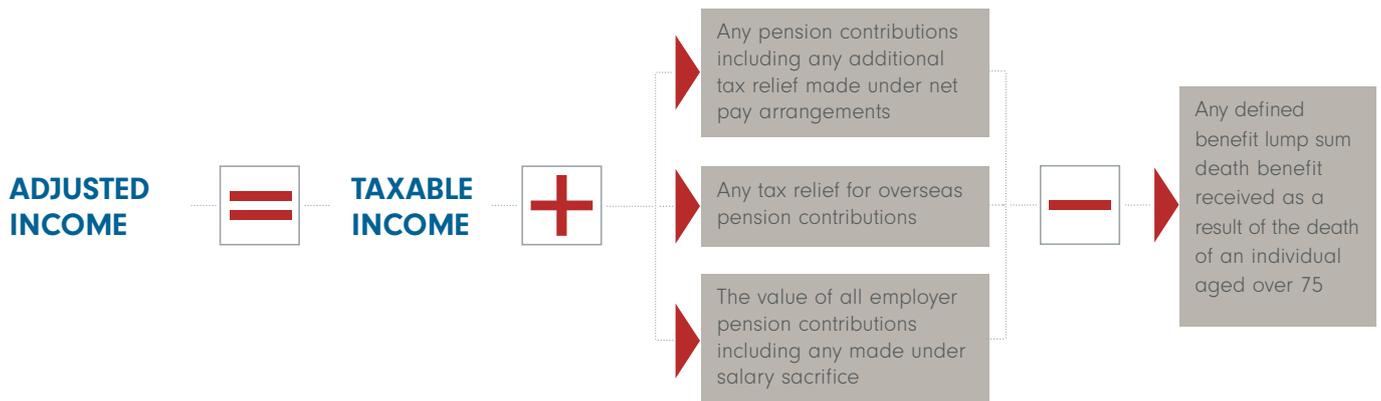
- The only types of contribution that need adding to adjusted income, are employer contributions to any defined contribution arrangement, and employee contributions made to occupational defined contribution schemes out of gross salary (net pay method).
- For defined benefit arrangements, the value of the employer contributions is found by taking the individual's total pension input amount for the tax year, less the total of any member contributions paid during the tax year.
Defined benefit increases do not usually count towards the contribution calculations, however there are exceptions, like increases in excess of the permitted percentages.
- Contributions made to a defined contribution scheme, via the relief at source method (net of 20% basic rate tax from after tax income), don't need adding on as they are already included within the income figure.

'Threshold Income' versus 'Adjusted Income' summary

Individuals should work out their threshold income first to determine if it is less than £200,000.



If an individual's income is less than £200,000 the taper will not apply and they will not need to calculate their adjusted income. If an individual's threshold income exceeds £200,000, they will need to work out their adjusted income.



Individuals with threshold income over £200,000 and an adjusted income over £240,000 will have a tapered annual allowance or the 2020/21 tax year.

Anti-avoidance legislation

The legislation contains anti-avoidance measures to prevent individuals altering their remuneration packages to keep their income below the £200,000 mark. Annual allowance measures therefore cover anyone entering into an arrangement, on or after 9 July 2015 to avoid or reduce the impact of the tapered annual allowance. The following arrangements are potentially captured:

- a salary sacrifice arrangement, under which the individual gives up the right to income in return for an employer making a relevant pension contribution
- a relevant flexible remuneration arrangement, under which the individual and the employer agree that relevant pension provision is to be made, rather than the individual receiving employment income

An arrangement will be caught by the anti-avoidance legislation where:

- it is reasonable to assume that the main purpose, or one of the main purposes, is to reduce the impact of the tapered annual allowance
- the arrangement has the impact of reducing either or both the threshold income or adjusted income figure
- the reduction in either or both threshold income or adjusted income is redressed by an increase in the individual's threshold income or adjusted income for a different tax year

Where an arrangement is caught by the anti-avoidance legislation, the reduction in income is ignored for the purpose of calculating the tapered annual allowance. Arrangements include all instances where income is reduced and not just those where an employer increases their pension contributions.

Note:

It is not entirely clear as to exactly what constitutes a 'new' salary sacrifice arrangement. Current guidance suggests existing arrangements set up prior to 9 July 2015, where a contractual variation to an individual's contract existed, (contractual right to a lower salary and increased pension contributions before that date and that will last as long as the agreement is effective) would not fall under this definition e.g. as a pre-agreed fixed percentage of salary.

However, if the original agreement comes to an end at a particular date, with salary reverting to the original pre-sacrifice agreement, unless the employee confirms otherwise, then there is a new salary sacrifice at the time of the employee's confirmation.

In other words, if the arrangement started, renewed (requiring a choice to be exercised) or changed on or after 9 July 2015, it is likely to be captured by the anti-avoidance legislation. This could be particularly relevant to employees looking to waive bonuses.

Where individuals with a continuing salary sacrifice, simply reduces his/her salary sacrifice to increase their salary and reduce their pension contributions, the view is that this would not be classed as a 'new' salary sacrifice. This is on the basis that, if an employee is varying their original sacrifice, so that the only change is to reverse part of the original sacrifice, so that cash salary is reinstated and pension contributions are reduced, this should not fall within the definition of salary sacrifice as both threshold and adjusted income may be increased.

Examples

EXAMPLE 1



Thomas's gross salary is £230,000 and he has no other income. His employer operates a money purchase **net pay** arrangement which they contribute 15% (£21,000) to, with an additional 3% contribution match (£4,200) if an employee also contributes. Thomas contributes 5% (£7,000) of his salary (gross) as an Additional Voluntary Contribution (AVC).

THRESHOLD INCOME		ADJUSTED INCOME	
INCOME	£230,000	INCOME	£230,000
- ADDITIONAL VOLUNTARY CONTRIBUTION	£7,000	+ EMPLOYER CONTRIBUTIONS OF	£25,200
THRESHOLD INCOME	£223,000	ADJUSTED INCOME	£255,200

Thomas will be affected by the tapered annual allowance as his threshold income is above £200,000 and his adjusted income is over £240,000. **His annual allowance of £40,000 will be reduced by £7,600 (£255,200 - £240,000 = £15,200 divided by 2) and therefore will be £32,400 for the 2020/21 tax year.**

EXAMPLE 2



Felicity has a gross salary of £199,000, bank interest of £2,000 and dividend income of £8,000. She is awarded a £10,000 bonus which she elects to sacrifice in return for an employer pension contribution, she has no other income for the tax year. Felicity's employer makes a contribution to her pension of £30,000, plus the £10,000 bonus waived sacrifice arrangement that was agreed and paid into her pension after 8 July 2015.

THRESHOLD INCOME		ADJUSTED INCOME	
INCOME	£199,000	INCOME	£199,000
+ BONUS	£10,000	+ BONUS	£10,000
- BONUS SACRIFICE	£10,000	- BONUS SACRIFICE	£10,000
+ INTEREST	£2,000	+ INTEREST	£2,000
+ DIVIDENDS	£8,000	+ DIVIDENDS	£8,000
+ BONUS SACRIFICE CAUGHT UNDER ANTI-AVOIDANCE	£10,000	+ EMPLOYER CONTRIBUTION	£40,000
THRESHOLD INCOME	£219,000	ADJUSTED INCOME	£249,000

In this scenario, although Felicity has sacrificed her £10,000 bonus in return for an equivalent employer contribution, this is still included in her threshold income calculation. As the bonus waiver sacrifice arrangement was made after 8 July 2015 it is caught by the anti-avoidance rules. **As a result, the tapered annual allowance will still apply. This will reduce Felicity's annual allowance by £4,500 (£249,000 - £240,000 = £9,000 divided by 2) giving her a tapered annual allowance of £35,500 for the 2020/21 tax year.** As her pension input will exceed £35,500 (employer contributions of £40,000 including the bonus sacrifice contribution of £10,000) she may be subject to an annual allowance charge unless she has carry forward available that might offset this.

Examples continued

EXAMPLE 3



Grant's salary is £240,000. He also receives P11d benefits (benefits in kind) amounting to £10,000 and has taxable rental income of £5,000. Grant's employer makes a contribution of £10,000 into his pension. Grant makes a personal contribution into a relief at source arrangement of £80,000 (gross), using carry forward from previous years.

THRESHOLD INCOME		ADJUSTED INCOME	
INCOME	£240,000	INCOME	£240,000
+ P11D BENEFITS	£10,000	+ P11D BENEFITS	£10,000
+ RENTAL INCOME	£5,000	+ RENTAL INCOME	£5,000
- EMPLOYEE CONTRIBUTION	£80,000	+ EMPLOYEE CONTRIBUTION	£10,000
THRESHOLD INCOME	£175,000	THRESHOLD INCOME	£265,000

In this scenario Grant's adjusted income for the tax year would have been above £240,000, however his threshold income is below £200,000, so his annual allowance will not be tapered and remains at £40,000 for the 2020/21 tax year. **As the total pension contributions exceed the annual allowance (£80,000 employee + £10,000 employer), Grant would normally be subject to an annual allowance charge, but by utilising his available carry forward, no charge should be payable.**

Practically speaking you wouldn't normally need to calculate the adjusted income, if threshold income is calculated first, as the taper would not apply on the basis of that calculation. However, we have shown it here to highlight that there may be times where an individual exceeds the adjusted income, but is not subject to the taper in view of the threshold definition.

Annual allowance considerations

Money Purchase Annual Allowance (MPAA)

Where someone is subject to the MPAA provisions because they have 'flexibly accessed' pension benefits since 6 April 2015, and they are also subject to the taper provisions, the taper is applied to their 'alternative annual allowance' amount. The alternative annual allowance amount is the standard annual allowance less the MPAA, which can be used to fund defined benefit schemes. However, the alternative annual allowance only becomes relevant when the MPAA has been exceeded. When the MPAA has not been exceeded for a tax year, the total pension input amounts are measured against the individuals overall allowance, as determined after the tapering provisions have been applied. The alternative annual allowance amount is £36,000 for the 2017/18, 2018/19, 2019/20 and 2020/2021 tax years.

Carry forward

Carry forward of unused annual allowance can be used from the three previous tax years providing the individual's full annual allowance has been used in the relevant tax year that the individual is looking to rely on carry forward.

Where the annual allowance has been reduced in a carry forward year as a result of the taper provisions, then the carry forward available will be based on the tapered annual allowance amount. For example, if £7,000 of contributions were made in a tax year that an individual wants to carry forward from when a £10,000 tapered annual allowance was applied, there would be £3,000 of unused annual allowance to carry forward from that tax year.

Note that carry forward is not available in relation to the MPAA.

Important information

This guide provides information and is only intended to provide an overview of the current law in this area and does not constitute financial advice, tax advice or legal advice, or provide any recommendations.

This document represents a summary of our understanding of the law at the date of its last review (April 2020). Tax limits, allowances and rules are often subject to change and may change in future. Advisers and individuals should check that tax limits, allowances and rules have not changed. The value of tax benefits from a pension depends on individual circumstances. Withdrawals from a pension will not normally be possible until age 55.

Different options may have different effects for tax purposes, different implications for pension provision and different impacts on other assets and financial planning.

Final thoughts

In some instances, it may be possible for individuals to make personal contributions to a pension, to reduce threshold income where they will exceed the adjusted income definition.

If an individual has unused annual allowance from previous tax years, they may be able to use carry forward to offset any potential annual allowance charge. An individual could also pay higher contributions to bring their threshold income below £200,000 to regain their full annual allowance. However, it should be borne in mind that using up carry forward in this way may mean there is less or no carry forward available to offset an annual allowance charge in future years.

If an individual has no annual allowance available from previous years remaining, they could consider reducing or stopping pension contributions (however, they should check it does not affect their entitlement to employer contributions or other benefits associated with membership of their pension arrangements).

In some cases, employers may allow individuals to choose to receive cash instead of the employer pension contributions. Often the cost of increased employer's National Insurance is deducted from the cash alternative, but it could work out better for the individual than paying the tax charge for exceeding the annual allowance, particularly if they are also at risk of exceeding the lifetime allowance too.

Individuals who run their own businesses may be able to shape their remuneration to avoid/limit the effects of the taper. This is by virtue of the fact that it may be possible, within limits, to take profits from the business as a pension contribution to keep income within the threshold income of £200,000.

High earning individuals building up benefits in defined benefit schemes, who are caught out by the taper have less options available to them in terms of reducing contribution levels. They could remain in the existing scheme and potentially suffer a tax charge, or they could decide to leave the defined benefit scheme and consider funding up to the tapered annual allowance via a defined contribution scheme. Careful consideration will need to be given to the value of the employer's contributions and the future pension benefits against any potential tax advantages, by virtue of switching to a defined contribution arrangement.

Key summary

For the 2020/21 tax year, individuals with threshold income (income excluding pension contributions) of £200,000 or less will see their annual allowance remain at £40,000. (However, individuals should be aware of the inclusion of salary sacrifice arrangements set up on or after 9 July 2015.)

Individuals with adjusted income (income including pension contributions) over £312,000 will see their annual allowance reduced to £4,000.

However, there are many people in that 'middle ground', with adjusted income between £240,000 and £312,000, who won't be sure where their tapered annual allowance falls in the £4,000 - £40,000 range until the end of the tax year when all taxable income becomes known.



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