WEALTH MANAGEMENT ALERT

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Pension contributions: making the most of reduced allowances

Calculating the limit on pension contributions for a client to whom both the tapered and money purchase annual allowances apply in the same tax year can be complicated.

Peter, a higher earner in 2016/17, asked his IFA to work out if he is affected by the tapered annual allowance. The calculations include contributions from Peter and his employer (he is in a net pay scheme) and no carry forward is available.

The adviser works out that Peter's threshold income is £165,000 (which is also his current taxable salary) and adjusted income is £180,000 (he pays £5,000 under net pay and his employer contributes £10,000), giving a tapered annual allowance of £25,000. This means that Peter has an annual allowance of £10,000 left for this tax year, the minimum annual allowance for people with adjusted income of more than £210,000 for the year.

At the end of the year Peter's employer wishes to contribute an additional £10,000 to his pension.

However, this has to be included in the taper calculation, and increases Peter's adjusted income to £190,000 which reduces his tapered annual allowance to £20,000. As contributions of £25,000 have now been made, £5,000 above the annual allowance, and no carry forward is available, Peter faces a tax charge of £2,250.

Unfortunately he can't ask the scheme to pay the charge, as this is only possible if the charge is above £2,000 and inputs for the tax year are above £40,000. So adding £10,000 to his pension has cost Peter £2,250. If we assume that he has to pay higher rate tax when he takes this £10,000 he will get £7,000 (factoring in a 25% tax-free PCLS), giving a net benefit of £4,750.

Could there be a better solution?
Peter could take the £10,000 as a bonus and then pay £4,000 into a pension scheme with tax relief at source, grossed up to £5,000. He can reclaim the £1,250 tax relief in his tax return. Assuming that he pays higher rate tax when he takes this £5,000, he will receive £3,500 plus the reclaimed tax, and still has £1,300 from the bonus, making his total gain £6,050.

His adjusted income is still £190,000, so his tapered annual allowance is still £20,000. His threshold income falls to £170,000 and he has used all his tapered annual allowance.

If Peter had carry forward available and made a £60,000 gross contribution to a relief at source scheme, his threshold income would fall to £110,000. He would therefore regain the full £40,000 allowance for this year. So another £15,000 gross can be paid into a pension scheme. Plus, as he is below the threshold this can be paid by his employer!

Every client and their situations and objectives are different, which is why it is important to take independent financial advice.

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The money purchase annual allowance (MPAA) is a reduced annual allowance that can apply to contributions to defined contribution schemes. The following outlines what does and doesn't trigger it:

Take PCLS only (Flexi-access drawdown)	No
Take PCLS and income (Flexi-access drawdown)	Yes
Take UFPLS	Yes
Remain in capped drawdown	No
Exceed GAD in capped drawdown	Yes
Take annuity	No
Take "small pot"	No

The MPAA was reduced from £10,000 to £4,000 as of 6 April 2017. The limit applies to all people subject to the MPAA. So someone who has been contributing up to £10,000 p.a. is now limited to £4,000.

You can't carry forward any unused annual allowance relating to MPAA from previous years.

The MPAA only applies to defined contribution savings. Savers with both defined contribution and defined benefits savings get the full annual allowance of £40,000 of which up to £4,000 may be paid into defined contribution plans, leaving an alternative annual allowance of £36,000 that applies to their defined benefits rights if they exceed the MPAA.

A reminder of the basics

The tapered annual allowance replaces the standard annual allowance for all pension savings in the tax year in which it applies.

Whether the tapered annual allowance applies depends on the client's taxable income in a tax year. It may apply in one tax year, for instance due to a spike in earnings or cashing in an investment which incurs a large bond gain, but not in the following tax year.

Mandatory scheme pays conditions may not apply

If your client exceeds the tapered or money purchase annual allowance or both and intends to ask his scheme to pay the charge for him (by reducing his benefits), the mandatory scheme pays conditions may not apply.

Although you cannot use carry forward of unused Money Purchase Annual Allowance, you can use carry forward for the alternative annual allowance, in order to increase DB benefits.

How the rules interact

So let's say Ross accessed his pension benefits in January 2016 and for tax year 2016/17, based on his usual salary and other incomes, he expected to have a tapered annual allowance of £32,000. This means that his annual allowance for all pension inputs would have been £32,000 instead of the standard £40,000.

Ross was an active member of his employer's non-contributory defined benefit scheme and was eligible to make additional contributions to the scheme's money purchase AVC section.

Using the full MPAA

Ross chose to make an individual contribution of £10,000 into his AVC. This used his full money purchase annual allowance limit for 2016/17. His alternative annual allowance of (£32,000 – £10,000) £22,000 can be for his non-money purchase pension savings: his defined benefit pension input.

Using part of his MPAA

If Ross had decided instead to pay only £5,000 to the AVC, he would have had an alternative annual allowance of (£32,000 – £5,000) £27,000 for the defined benefit pension input amount.

Higher adjusted income?

Let's suppose that Ross was unexpectedly made redundant on 31 March 2017. He should have reviewed his tapered annual allowance calculation, but didn't. He simply accepted his taxable redundancy settlement as an employer pension contribution. This increased his adjusted income to £210,000 making him subject to the minimum tapered annual allowance of £10,000.

As Ross paid an AVC of £10,000, this would have used his full money purchase annual allowance limit for 2016/17, and as his tapered annual allowance was also £10,000, there is £0 alternative annual allowance. Unless he were able to offset this amount against unused annual allowances from the three previous tax years, his total defined benefit pension input amount would be considered to be excess pension savings and subject to the annual allowance charge.

He did have other options, as explained below, which demonstrates the value of taking independent financial advice. Our independent financial advisers have the knowledge and expertise required to help clients understand their options for making pension contributions, together with the various tax implications, and help them make the most of whatever allowances and tax relief available to them.

To find out how we could work together with you and your clients email Mark Dallas, Managing Director, Lighthouse Carrwood. mark.dallas@lighthousegroup.plc.uk

The value of your investments, and the income you receive from them, can go down as well as up, so you could get back less than you put in. A pension is a long-term investment and inflation will reduce how much your income is worth over the years. Your eventual income may depend upon the size of the fund at retirement, future interest rates and tax legislation. Tax advice which does not contain an investment element is not regulated by the Financial Conduct Authority.

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