The PENSIONS Advisory Service

Spotlight

The Annual Allowance

This factsheet outlines the annual allowance rules. The annual allowance has remained unchanged at £40,000 with effect from 6 April 2014. Further changes affecting high earners came into effect from 6 April 2016. In addition, individuals who have flexibly accessed their defined contribution pension pots will have a reduced annual allowance for certain pension savings.

The Pensions Advisory Service is unable to give individual specific advice and you should seek alternative tax or regulated financial advice.

What is the annual allowance?

The annual allowance is a yearly limit set by HM Revenue & Customs on the amount of pension savings that benefit from tax relief.

For defined contribution or money purchase schemes, it's the limit on how much can be paid in total by you and someone else on your behalf — for example, your employer or any tax relief added to your pot.

For defined benefit schemes such as final salary and career average schemes, the limit is on the value of the increase in your pension built up in the pension input period.

Any pension savings that are above the annual allowance (including any carry forward) will be subject to an Annual Allowance tax charge. There is more detail on these topics later in this spotlight.

The annual allowance has been £40,000 since 6 April 2014 (the 2014/15 tax year. Reductions to the annual allowance apply when defined contribution pots have been accessed flexibly and for higher earners from 6 April 2016.

There is a further test on the total amount of tax-favoured pension savings you can build up in your lifetime, known as the **lifetime allowance**. It is set at a high level, so it does not affect most people. However, if you want to know more or are concerned it may affect you, please see our **Lifetime Allowance spotlight.**

Pension input period (PIP)

The interval over which the amount of saving (pension input amount) into a scheme is measured is called the pension input period. The measurement works on the principle of how much was saved between the start and end of the interval. Pension input periods have been aligned to the tax year since the 2016/17 tax year, so they run from 6 April to the following 5 April. Before April 2016 they were usually a year long but did not necessarily coincide with tax years.

If you have more than one pension scheme the annual allowance applies to the contributions paid or increase in value across all of your pension schemes in total.

How does the pension input period interact with getting tax relief on pension contributions in a tax year?

You can usually receive tax relief on personal contributions up to age 75, up to the greater of £3,600 gross or 100% of your earnings from employment, subject to the annual allowance. Contributions for tax relief purposes apply across a tax year and this is separate to the annual allowance test, which acts as the overall limit on tax relievable pension savings over the pension input period.

Testing against the Annual Allowance - Defined Contribution Schemes

The pension input amount is gross contributions (including tax relief) paid to the scheme by you and those paid by someone else, such as your employer, during the pension input period. The following are not included in the pension input amount:

- Your contributions after you have reached age 75.
- Investment income growth in the fund.
- Contributions which are life assurance premium contributions and do not qualify for tax relief.

NB. Personal contributions which exceed your earnings (technically these are called ‘relevant UK earnings’) do not attract tax relief but are included in the pension input amount.

Testing against the Annual Allowance - Defined Benefit Schemes

The pension input amount is the increase in your annual pension during the pension input period. It is worked out by finding the difference between your annual pension at the start and end of the pension input period. The increase between the two amounts is then multiplied by 16. The increase in any tax-free cash over the period is also included in the pension input amount.

The pension at the start of the pension input period is increased by the rise in the Consumer Prices Index (CPI), which may reduce the tax charge. The CPI figure used is for the twelve month period to the September before the start of the tax year of calculation (For example, if the calculation is carried out in the 2020/21 tax year, the CPI increase will be the twelve month increase to September 2019).

If you have ended your active membership of a scheme and are not therefore building up service, increases in your benefits can be disregarded. An increase in your deferred benefits is allowed, provided that it is not more than either CPI or as specified in the scheme rules.

There may be adjustments for certain pension input amounts. For example, the following are subtracted:

- An increase from a pension credit as a result of a pension sharing order on divorce;
- Transfer payments received from another registered pension scheme

And the following are added back:

- A decrease from a pension debit as a result of a pension sharing order on divorce;
- Transfer payments made to another scheme;
- Amounts crystallised by a benefit crystallisation event.

A ‘benefit crystallisation event’ is where pension benefits become payable - for example buying an annuity, death or taking a drawdown pension.

Carry forward of unused allowances

If your pension savings exceed the £40,000 annual allowance in a tax year, you will be allowed to bring forward any unused annual allowances from the previous three tax years, called carry forward, provided you have been a member of a registered pension scheme for the year in question. **Even if you can carry forward, the maximum amount for tax relief purposes is still 100% of your total earnings in the tax year in which you make the contributions.**

You should note that some restrictions on carry forward may apply to you if you are subject to the money purchase annual allowance (MPAA) and/or tapered annual allowance (see below).

In the example below, we assume the standard annual allowance is available and pension savings commenced in 2016/17 so no carry forward is available before then.

Jordan made a large pension contribution in the 2017/18 tax year and uses carry forward.

PIP/tax year	Annual allowance	Pension input amount	Available to carry forward from this PIP	Total amount to carry forward to next tax year
2016/17	£40,000	£12,000	£28,000	£28,000
2017/18	£40,000	£60,000 (Uses £20,000 CF from 2016/17)	Nil	£8,000
2018/19	£40,000	£15,000	£25,000	£33,000
2019/20	£40,000	£51,000 (Uses remaining £8,000 CF from 2016/17 and £3,000 of the CF allowance from tax year 2018/19)	Nil	£22,000

For the 2020/21 tax year, Jordan can have pension savings of £62,000 (£40,000 annual allowance plus £22,000 carry forward) without incurring any annual allowance tax charge. He will only receive tax relief on gross contributions of this amount provided his earnings are at least £62,000 in the 2020/21 tax year.

Reductions to the Annual Allowance – The Money Purchase Annual Allowance (MPAA)

Once you have flexibly accessed a defined contribution pension by taking any money from it in excess of the tax-free amount, your annual allowance for money purchase (defined contribution) pensions each year going forward is £4,000. This is known as the money purchase annual allowance (MPAA). The £4,000 limit includes contributions made by you, any tax relief you receive, and any employer contributions. It will also not be possible to bring forward any unused annual allowances i.e. carry forward from previous tax years to increase this amount, as you are able to do with the £40,000 annual allowance.

If you are subject to the MPAA and you make no contributions to a defined contribution pension scheme you can still save the standard £40,000 annual allowance into a defined benefit scheme, if you are in one. Equally, if you were to save the maximum £4,000 p.a. into a defined contribution scheme the maximum tax relievable savings you can make in a defined benefit scheme would be £36,000, giving a combined pensions savings total of £40,000.

When is the reduced MPAA triggered?

- You will be affected by this new allowance when you: take any income flexibly from your pension for example flexi-access drawdown or a fixed term annuity

- exceed your income limit in capped drawdown
- take an income payment after you have told your scheme administrator you want to move from capped drawdown to flexi-access drawdown
- purchase a flexible annuity that allows income to decrease
- have previously been taking flexible drawdown (before 6 April 2015)
- have taken an Uncrystallised Funds Pension Lump Sum (UFPLS) from your pot (whether a partial withdrawal or full encashment)

You should therefore think carefully about how you take money from a defined contribution pot if you expect to be making contributions in excess of £4,000 a year, including any employer contributions to a defined contribution pension.

You will not be affected by this allowance if you:

- do not touch any of your pension pot
- take a tax-free lump sum but no other income
- cash in up to three small personal pension pots of £10,000 or less (there is no limit on the number of occupational pension small pots you can encash)
- continue to take income below your annual limit in capped drawdown
- purchase a lifetime annuity
- take a lump sum or income as a beneficiary of someone else's pension
- take a pension from a defined benefit pension scheme

When you first trigger the MPAA, the pension scheme must provide you with a statement confirming this. They are required to do this within 31 days of the trigger occurring. You then need to tell any other defined contribution pension schemes that you are contributing to, that the MPAA has been triggered. This must be done within 91 days of receiving the statement or within 91 days of starting to pay into another defined contribution scheme, if later.

Tapered Annual Allowance

The tapered annual allowance (TAA) came into force from 6 April 2016 for high earners. The TAA reduces the annual allowance by £1 for every £2 of gross earnings (pre-pension contribution earnings) of £150,000 p.a. (known as "adjusted income"). This covers all earnings, including savings and pension income as well as the value of your employer's pension contributions. From the 2020/21 tax year the £150,000 limit is being raised to £240,000, so the annual allowance will reduce by £1 for every £2 of gross earnings (pre-pension contribution earnings) over £240,000 p.a. and will reduce to a maximum of £4,000 when your income is £312,000 or more.

An income floor means the taper will not apply unless the individual's total income excluding pension contributions exceeds £110,000 (referred to as the "threshold income"). **From the 2020/21 tax year the £110,000 limit is being raised to £200,000.**

You will still be able to carry forward unused annual allowances from previous tax years (with the TAA figure used if it applied for the year in question) and if your income subsequently drops to below the threshold you will be restored to the normal annual allowance for that tax year.

If you are likely to be affected by the TAA, you could ask your employer if there is an alternative benefit to being a member of a pension scheme. Bear in mind that, even with a tax charge, your employer's pension scheme may still be a valuable benefit. Alternatively, you may wish to consider other investments with tax incentives. **You should consult a regulated financial adviser if you wish to evaluate these alternatives and if you need advice with any of the issues discussed in this spotlight, such as the TAA.**

Useful tools

Further information on the annual allowance, tax relief and connected issues can be found here: https://www.gov.uk/tax-on-your-private-pension

To see whether you are likely to be affected by an annual allowance charge, you can use the pension savings annual allowance checking tool and calculator here: www.hmrc.gov.uk/tools/pension-allowance/index.htm

If you think that you may need to declare an annual allowance tax charge, but you don't normally submit a self-assessment return, you will need to register with HMRC for self-assessment. Further information can be found here: www.hmrc.gov.uk/sa/need-tax-return.htm

Information on the Tapered Annual Allowance can be found here: https://www.gov.uk/guidance/pension-schemes-work-out-your-tapered-annual-allowance#threshold

The Money Advice Service directory of regulated financial advisers can be found here: https://directory.moneyadviceservice.org.uk/en

Further information can also be found in our Spotlight on the Lifetime Allowance which can be found here: https://www.pensionsadvisoryservice.org.uk/publications/category/spotlights

I have received a pension savings statement about the annual allowance

You may have received a pension savings statement informing you that your pension savings in one particular pension scheme alone have exceeded the annual allowance for the year. An annual allowance tax charge is due if you have exceeded the annual allowance in any tax year and do not have enough unused annual allowance to carry forward from previous years.

You will have to complete a self-assessment tax return declaring an annual allowance tax charge. If you think that you might need to declare an annual allowance charge but you don't normally submit a self-assessment tax return, you will need to register with HMRC. Further information can be found here: www.hmrc.gov.uk/sa/need-tax-return.htm. HMRC's HS345 note sets out more details on how you should complete your tax return to allow for the annual allowance.

How much is the annual allowance tax charge?

The tax charge on savings above the annual allowance is at your marginal rate of income tax. This effectively means that any excess amount will be treated as income for tax purposes. It is possible that this could move you into a higher tax bracket.

How is it calculated?

To see whether a tax charge is payable, contributions for defined contribution schemes (including any tax relief and employer contributions) and increases (multiplied by 16) in annual pension for defined benefit schemes over the pension input period ending in a tax year is compared against the annual allowance for that same tax year. For example, if your pension input period covers the 2019/20 tax year, your savings are compared against the annual allowance for the 2019/20 tax year.

Who pays the annual allowance charge?

You are responsible for paying the annual allowance charge. Normally, you would pay the charge, and account for the payment by completing a self-assessment tax return.

You can also choose to have some or all of your annual allowance charge paid by your pension scheme, in return for a reduction in your benefits. You can do this if the following conditions are met:

- your annual allowance tax charge liability for the tax year has exceeded £2,000; and
- the total amount of your pension savings in the pension scheme for the same tax year has exceeded the annual allowance.

The maximum amount you can ask each pension scheme to pay is the total pension input amount in the scheme which exceeds the annual allowance. For example, if the total pension input amount in the scheme was £50,000 and you were entitled to an annual allowance of £40,000, you could only ask the scheme to pay the tax charge on the £10,000 excess as a maximum.

You must notify your pension scheme that you wish the scheme to pay the annual allowance charge by 31 July in the year following the tax year in which the annual allowance charge became due (for example, if the annual allowance charge became due in the 2018/19 tax year, you must notify the pension scheme by 31 July 2020). Alternatively, if you are due to take your benefits before then, you would have to give the scheme notice before the benefits are taken.

A scheme will not have to pay the annual allowance charge, even if you satisfy the conditions, in the following circumstances:

- The MPAA or tapered annual allowance has been exceeded but the standard annual allowance hasn't.
- The scheme is being assessed by the Pension Protection Fund (PPF) at the time you give notice or, at the time the PPF assessment period begins, the scheme has not yet paid the annual allowance charge following an earlier notice from you.
- The scheme would be unable to make an adjustment to your benefits to take account of the annual allowance charge because this would reduce your Guaranteed Minimum Pension (GMP).
- Your pension benefits have been transferred to another scheme (along with the rights of all the other scheme members).
- The deadline for you to ask the scheme to pay has passed.

Exemption to the annual allowance test

- There is an exemption to the annual allowance test in the tax year in which a person dies or becomes entitled to a serious ill-health lump sum under a pension arrangement (a serious ill-health lump sum can only be paid where a person has less than 12 months to live).
- There is also an exemption if you are a deferred member of a defined benefit pension scheme, if you were a deferred member for the whole of the pension input period or a deferred member for part of the pension input period and a pensioner for the rest of it.

This is conditional on any increase in your benefits not being more than:

- is required by the pension scheme rules in force on 14 October 2010; or
- the increase in the Consumer Prices Index (CPI over a twelve month period ending with a month that falls within the scheme's pension input period.

For this purpose, your rights to a GMP do not have to be taken into account when considering the increase in your benefits. The rate of GMP increase may be ignored.

If you have left a pension scheme but your final benefits are linked to your future final salary, you are **not** exempt from the annual allowance test. This is because you are still building up benefits due to the continued salary link.

About Us

The Pensions Advisory Service (TPAS) works to make pensions accessible and understandable for everyone. We provide independent and impartial information and guidance about pensions, free of charge, to members of the public.

We help with all pension matters covering workplace, personal and stakeholder schemes and also the State Pension. We answer general questions, help with specific queries and offer guidance for people with complaints about their private pension scheme.

The Pensions Advisory Service is provided by Money & Pensions Service

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