Tapering of annual allowance for high incomes

- adjusted and threshold incomes

INVICTUS
Independent Financial Advice

This restricts pension tax relief by introducing a tapered reduction in the amount of annual allowance for people with an adjusted income over £150,000 and a threshold income over £110,000.

Since 6 April 2016, people with a taxable income over £150,000 will have their annual allowance for that tax year restricted. This means that for every £2 of income they have over £150,000, their annual allowance is reduced by £1. Their reduced annual allowance is rounded down to the nearest whole pound.

The maximum reduction will be £30,000. So, anyone with an income of £210,000 or more will have an annual allowance of £10,000. People with high income caught by the restriction might have to reduce the contributions paid by them and/or their employer or an annual allowance charge will apply.

However, the tapered reduction doesn't apply to anyone with 'threshold income' of no more than £110,000

Key Facts

- *The annual allowance will be reduced for people who have 'adjusted income' over £150,000 a year.*
- *The annual allowance reduces by £1 for every £2 over £150,000.*
- *The maximum reduction is £30,000.*
- *The reduction doesn't apply to people with a 'threshold income' of no more than £110,000.*

Adjusted income v threshold income

Definitions of adjusted income and threshold income are crucial to understanding whether or not someone's affected by the tapered reduction.

Both include all taxable income - so this isn't restricted to earnings. Investment income of all types and benefits in kind, such as medical insurance premiums paid by the employer, will also be included.

The difference is pretty simple; adjusted income includes all pension contributions (including any employer contributions), while threshold income excludes pension contributions.

Unfortunately, HMRC's definitions of adjusted and threshold income tend to cause a bit of confusion because they start with something called 'net income'. A common sense meaning of this would be 'income after tax', but it's not.

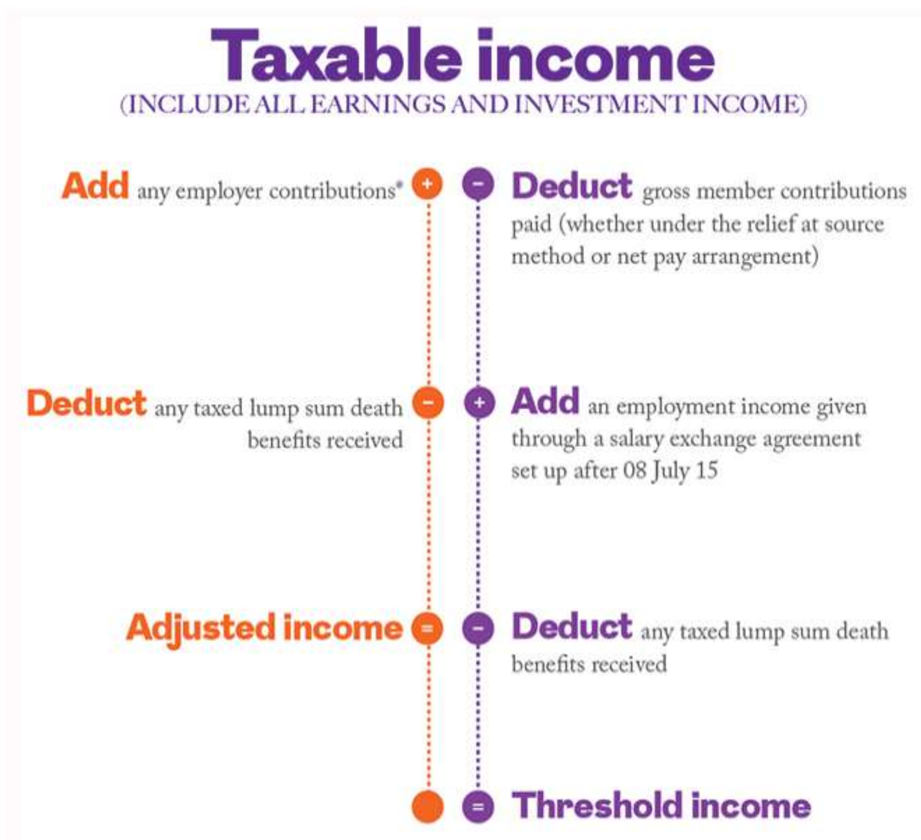
Net income in this context is all taxable income, minus various deductions. The most important (or at least the most common) of these deductions are member contributions paid to money purchase and defined benefit occupational pension schemes, under the net pay arrangement. This is where the sponsoring employer of the pension scheme deducts employee contributions before tax under PAYE.

The other deductions include things like trade losses, share loss relief and gifts to charities. A full list of the deductions can be found at s.24 of the Income Tax Act 2007.

Understanding the two definitions becomes easier if we consider taxable income from a more practical view point. For example, when someone says, 'I earn £x', they don't usually mean the amount after the deduction of net pay arrangement contributions. We can therefore assume that when someone has earnings of £160,000 and pays contributions of £20,000 under the net pay arrangement, they'll say their earnings are £160,000, not £140,000. The £160,000 includes the pension contributions.

So, this is a good place to start when calculating adjusted income (which includes pension contributions). For threshold income, all member pension contributions need to be deducted and you don't include employer contributions.

Calculating adjusted income and threshold income

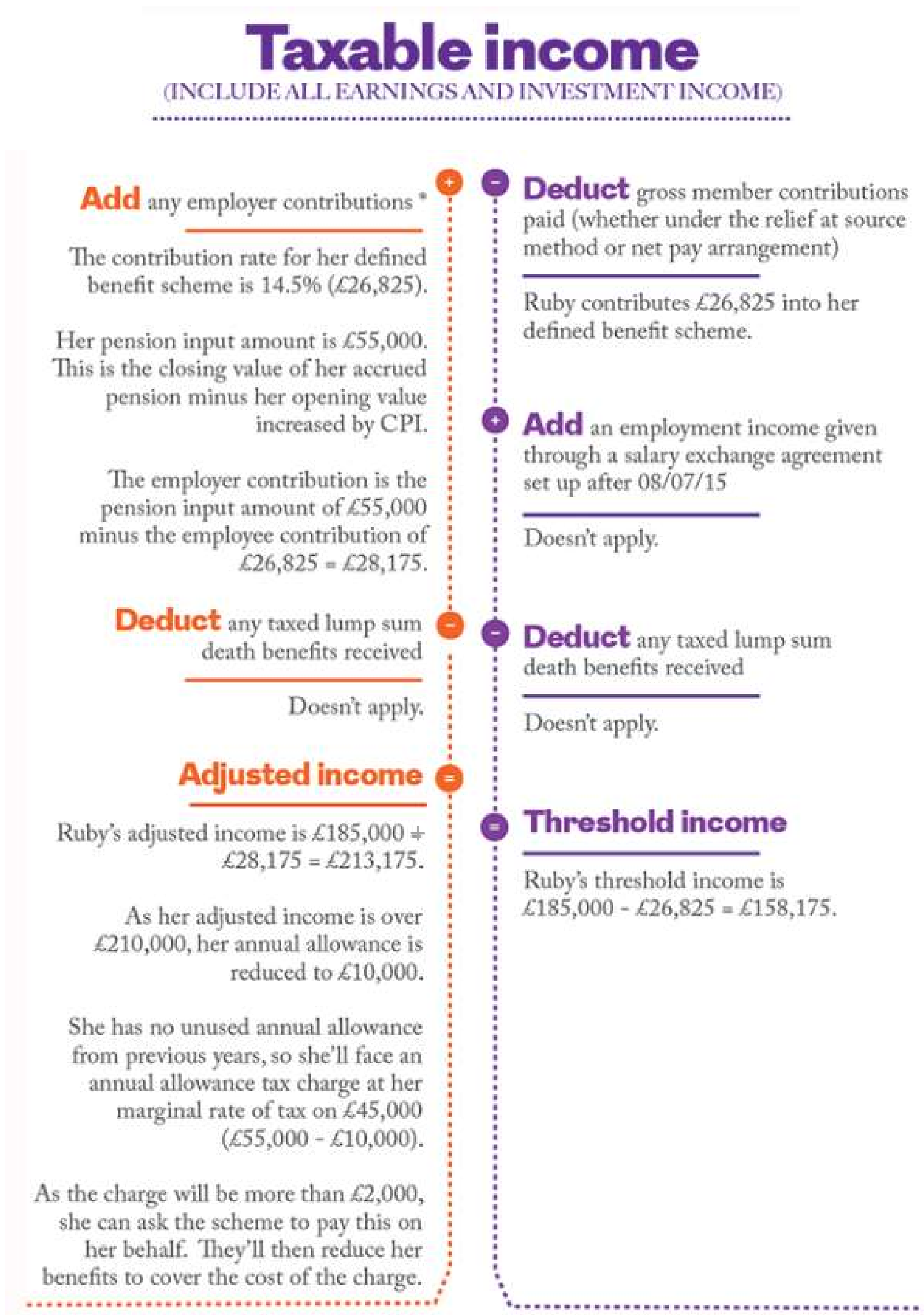


*for a DB scheme, this would be the pension input amount minus any employee contributions.

Case Study

The following case study shows how the tapered annual allowance works in practice.

Ruby: *Ruby is employed in the public sector with earnings of £185,000 this tax year and she is a member of her employers defined benefit pension scheme*



Anti-avoidance

Anti-avoidance rules were put in place to stop people entering into a salary exchange or flexible remuneration arrangement after 9 July 2015 so they could receive additional pension contributions, but reduce their adjusted or threshold income.

The anti-avoidance rules apply if:

- it's reasonable to assume that the main purpose, or one of the main purposes, is to reduce the amount of their reduction under the tapered annual allowance for the current tax year, or two or more tax years which include the current tax year

- they involve reducing adjusted income or threshold income for the tax year (or both)

- they involve any of the reductions above, being cancelled out by an increase in the adjusted income, or threshold income, for a different tax year

If the anti-avoidance rules apply, the income used to calculate the reduction to the annual allowance for that tax year is the income before any adjustments were made.

Carry forward

It's still possible to carry forward unused annual allowance from previous years to a year where the taper applies.

However, the amount of unused annual allowance available when carrying forward from a year where the taper has applied will be the balance of the tapered amount.

Flexible drawdown

If someone flexibly accesses their retirement savings, they're subject to the money purchase annual allowance.

People who have flexibly accessed their retirement savings will continue to have a money purchase annual allowance of £4,000. But where this applies, the alternative annual allowance (normally £36,000), which their defined benefit savings are tested against, will be restricted by the same taper.

Money purchase annual allowance (MPAA)

If someone's subject to the MPAA as well as tapering, the taper reduces the 'alternative annual allowance' which applies to any DB benefits they may have. This is the standard annual allowance minus the MPAA of £4,000, so currently the alternative annual allowance is £36,000.