How the pensions annual allowance works

Key takeaways:
- Understand the voluntary scheme payment of annual allowance charge
- Learn how the annual allowance charge is calculated

Category: Pre-retirement planning

What is the annual allowance charge?

The annual allowance tax charge arises if a member's pension input amount (contributions in respect of money purchase arrangements) are in excess of the available annual allowance for the tax year. From 6 April 2011 a tailored tax charge at an 'appropriate rate' has applied – this means a tax on the excess is charged at the individual's marginal rate of income tax. The excess over the annual allowance is simply added to an individual's taxable net income to arrive at a total income figure subject to tax.

How does this work in practice?

Although the charge applies in the same way for Scottish and Welsh taxpayers, the tax rates that apply may differ according to prevailing Scottish or Welsh non-savings income tax rates.

Step 1:

Establish the taxable income, after personal allowances, for the year: this is the amount on which the individual will actually pay tax for the year.

Step 2:

Work out how much of the total pension input amount for the tax year is liable to the tax charge. This is the total pension input amount for the tax year, less the annual allowance for that year, less any unused annual allowance carried forward from earlier years.

Step 3:

Add together the reduced net income (from Step 1) and the excess pension savings (from Step 2). The amount of the excess pension saving (from Step 2) that sits:

- over the higher rate limit will be taxed at 45%
- over the basic rate limit but below the higher rate limit will be taxed at 40%
- below the basic rate limit will be taxed at 20%.

The case study

Marcio has an annual allowance excess in 2020/21 due to a significant company contribution and a miscalculation with regards to his carry forward allowance.

- He has a personal allowance of £12,500
- The basic rate band for 2020/21 is £37,500
- Marcio has earned income of £45,000 in 2020/21
- Marcio's taxable income is therefore £32,500

Marcio has an annual allowance excess of £10,000.

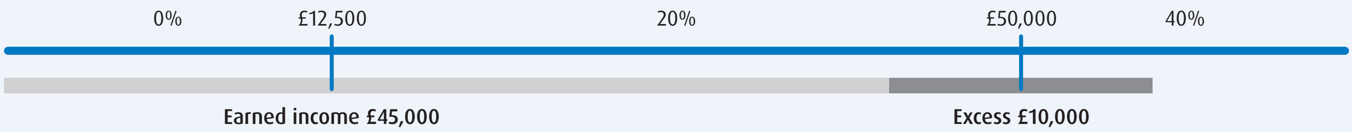
Earned income

Personal allowance = £12,500 @ 0% =£0
Basic rate band = £32,500 @ 20% = £6,500

The basic rate band remaining is therefore £5,000

Annual allowance excess

Basic rate band = £5,000 @ 20% = £1,000
Higher rate band = £5,000 @ 40% = £2,000
£3,000



Scheme pays

Responsibility for paying the charge rests with the individual member. However, subject to certain conditions, the member may elect for the scheme administrator to pay all or part of the charge from scheme funds.

The conditions are:

- The member's annual allowance charge exceeds £2,000[1]
- The total of all pension input amounts in relation to the registered pension scheme to which an election is being made exceeds the annual allowance for the tax year to which the charge relates (£40,000 for tax year 2020/21)[2]
- The election is made within the permitted time allowed

Once an election has been made it cannot be revoked or cancelled although it can be amended where the tax position changes. An election cannot be made after all of the benefits have been taken from the scheme. An election can still be made if only some of the benefits have been taken, but of course care is needed that the equivalent reduction in benefits can be supported by the scheme without affecting the benefits already in payment.

Note: Even where these 'scheme pays' conditions are not met, the scheme administrator can agree to voluntarily make payment of all or part of any tax charge. We will look at the voluntary arrangement later.

Deadline

The election must be received by the scheme administrator no later than 31 July in the year following the applicable tax year.[3]

For example, an election to cover a charge for the tax year 2020/21 must be received by 31 July 2022 at the latest.

Notes: [1] A pension scheme member who has an annual allowance charge liability exceeding £2,000 by reference to the money purchase annual allowance cannot require a scheme to pay if their liability by reference to the standard annual allowance would have been £2,000 or less.

[2] This condition requires the pension input amount into the scheme to have exceeded the standard annual allowance (£40,000), rather than the; tapered, money purchase or alternative annual allowance.

[3] The self-assessment deadline is 31 January following end of tax year (2020/21 tax year, self-assessment deadline would be 31 January 2022) BUT deadline to notify the scheme to pay the charge by 3t July 2022.

Continued

Scheme pays and member benefits

Where the scheme pays the tax charge, there must be a reduction in benefits equivalent to the amount of the tax charge.

Money purchase schemes

The fund value is reduced by the amount of the tax charge paid. The scheme administrator is not allowed to charge for making this deduction although associated costs may be incurred.

Defined benefit schemes

Equivalent deduction must be calculated by considering the scheme's normal actuarial practice. Therefore, the effect in pension terms can vary from scheme to scheme.

Self-assessment

The pension scheme member needs to include the amount of the annual allowance charge on their self-assessment return. The return should be submitted by 31 January of the year following that in which the tax year ended.

They will need to include the tax charge even if their scheme has joint and several liability (scheme pays provisions apply) or the scheme has voluntarily agreed to pay any part of the annual allowance charge.

For paper self-assessment returns the annual allowance charge details should be entered on page Ai4 of SA101:

- Box 10 – details of annual allowance excess
- Box 11 – details of amount of charge that will be paid by the scheme administrator

Pension Savings Tax Charges

7 Value of pension benefits in excess of your Available Lifetime Allowance, taken by you as a lump sum
£ . 0 0

8 Value of pension benefits in excess of your Available Lifetime Allowance, not taken as a lump sum
£ . 0 0

9 Lifetime Allowance tax paid by your pension scheme
£ . 0 0

10 Amount saved towards your pension, in the period covered by this tax return, in excess of the Annual Allowance
£ . 0 0

11 Annual Allowance tax paid or payable by your pension scheme
£ . 0 0

11.1 Value of pension benefits transferred subject to the overseas transfer charge
£ . 0 0

11.2 Tax paid by your pension scheme on your overseas transfer charge
£ . 0 0

12 Pension scheme tax reference number
PSTR

13 Amount of unauthorised payment from a pension scheme, not subject to surcharge
£ . 0 0

14 Amount of unauthorised payment from a pension scheme, subject to surcharge
£ . 0 0

15 Foreign tax paid on an unauthorised payment (in £ sterling)
£ . 0 0

16 Taxable short service refund of contributions (overseas pension schemes only)
£ . 0 0

Box 17 is not in use

18 Foreign tax paid (in £ sterling) on box 16
£ . 0 0

What is the maximum a scheme administrator can be made to pay?

The maximum amount that a scheme administrator can be made liable for is limited to the amount of the tax charge that arises from the excess over £40,000 paid to the scheme.

For example:

Penny has a total pension input for 2020/21 of £90,000;

- £75,000 to Scheme 1 and
- £15,000 to Scheme 2.

Assuming Penny has no carry forward and an annual allowance charge is due in respect of the excess contributions above £40,000 at a rate of 45%:

- £90,000 – £40,000 = £50,000
- £50,000 @ 45% = £22,500 annual allowance tax charge

Scheme pays – scheme liabilities

Assuming a tax rate of 45%:

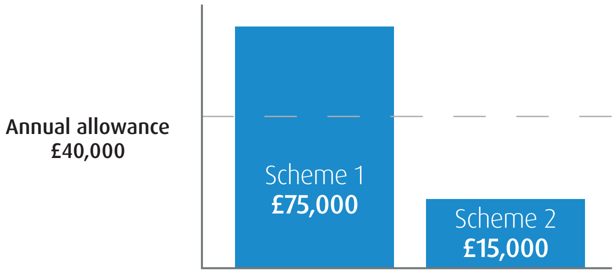
- Scheme 1 is only liable to tax on the excess above £40,000 (£35,000).
- Scheme 1 is jointly and severally liable for £15,750 (£35,000 @ 45%)
- Scheme 2 cannot be made responsible for any of the tax charge.
- As Penny's pension input amount into the scheme was less than £40,000 the balance tax charge on £15,000 of the excess @ 45% (£6,750) is paid by Penny.

Scheme pays and the tapered annual allowance

Assuming Penny was subject to tapered annual allowance of £30,000, the annual allowance charge would be based upon an excess of £60,000:

- £60,000 @ 45% = £27,000 annual allowance tax charge.
- Despite the increase in the tax charge; scheme 1 can only be made to settle £15,750 of the charge (as liable only for charge on excess above £40,000 annual allowance.)

Despite only being jointly and severally liable for £15,750, the scheme may agree to pay all the charge voluntarily.



Scheme 1 - £35,000 excess, election can be made for scheme to pay the tax charge
Scheme 2 – Not possible to make a "scheme pays" election

Scheme administrator voluntary payment option

The option exists for the scheme administrator to voluntarily pay all or part of any annual allowance tax charge.

As long as there is an adjustment to the scheme benefits equal to the tax charge paid, the scheme administrator of one, or more, pension schemes may settle the tax charge on behalf of the member.

As the payment is voluntary there are no legislative requirements that have to be met. This means that the scheme administrator can impose a charge for making the payment.

A scheme administrator can agree to a voluntary payment even where that scheme has received no payments or seen no benefit accrual in the tax year for which a tax charge has arisen.

Voluntary payments and deadlines

Under the voluntary arrangement, as opposed to the 'scheme pays' arrangement, the scheme would not have joint and several liability for the tax charge so the liability would remain with the member.

Note: The payment made by the scheme on a voluntary basis should therefore be paid to the member's normal self-assessment deadline.

Can a scheme administrator refuse to pay the member's annual allowance charge?

A scheme administrator can refuse to pay the charge if:

- The pension scheme is being assessed by the Pension Protection Fund either at the time the member requires it to pay or, after the member requires it but before the tax is actually paid.
- The pension scheme would be unable to make an adjustment to the member's benefits in the scheme because the benefits they would have needed to adjust include 'contracted-out' rights (GMPs and/or protected rights) that are subject to section 159 of the Pension Schemes Act 1993 or section 155 of the Pension Schemes (Northern Ireland) Act 1993.

When else may a scheme avoid payment of the charge despite a valid election by the member?

Where the pension scheme member has already transferred their fund (rights if, for example, a defined benefit scheme) to another scheme, the member cannot require the original scheme to meet the tax charge.

The member can however require the receiving scheme to pay the charge – this election is subject to the normal deadline.

The scheme administrator may also apply to HMRC to discharge their liability to pay the member's annual allowance charge if:

- Paying the charge would substantially harm the interests of the members of the scheme, or
- it would not be reasonable for the scheme to pay the member's charge (e.g. where the value of the member's benefits in the scheme have fallen and there are insufficient funds in the scheme).

Important information

BMO Global Asset Management