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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 to £240,000 and then raised again on 6th April 2023 to £260,000. 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 £260,000

Maximum reduction of personal allowance = £50,000

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

Anyone with a threshold income of more than £200,000 could potentially 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 £260,000. The maximum that a person's annual allowance can be reduced by is £50,000, which means the minimum tapered annual allowance for any individual is £10,000 for individuals with an adjusted income of £360,000 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 £260,000.

ADJUSTED INCOME	ANNUAL ALLOWANCE
£260,000	£60,000
£270,000	£55,000
£280,000	£50,000
£290,000	£45,000
£300,000	£40,000
£310,000	£35,000
£320,000	£30,000
£330,000	£25,000
£340,000	£20,000
£350,000	£15,000
£360,000	£10,000

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 rates.

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 net 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
- 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).

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The gross amount of any personal pension contributions paid to pension arrangements, to which the member is entitled to be given Relief at Source.

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 2024/25 tax year.

Note:

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.

Adjusted Income

Adjusted Income is calculated as follows:

The individual's net 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
- income from property
- savings
- dividends
- taxable lump sum death benefits (post 5 April 2016)

+

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 £260,000, the tapered annual allowance does not apply for the 2024/25 tax year.

Note:

- For defined contribution arrangements, adjusted income will need to include employer contributions and only employee contributions paid out of gross salary (net pay method).
- For defined contribution arrangements, contributions made via the relief at source method (net of basic rate tax), don't need adding on as they are already included within the net taxable income figure. Only include those amounts contributed to such schemes that are not within the net taxable income figure.

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 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.

Examples

EXAMPLE 1

Thomas's gross salary is £250,000 and he has no other income. His employer operates a money purchase **net pay** arrangement which they contribute 15% (£37,500) to, with an additional 3% contribution match (£7,500) if an employee also contributes. Thomas contributes 5% (£12,500) of his salary (gross) as an Additional Voluntary Contribution (AVC).

THRESHOLD INCOME	
INCOME	£250,000
— ADDITIONAL VOLUNTARY CONTRIBUTION	£12,500
THRESHOLD INCOME	**£237,500**

ADJUSTED INCOME	
INCOME	£250,000
+ EMPLOYER CONTRIBUTIONS OF	£45,000
ADJUSTED INCOME	**£295,000**

Thomas will be affected by the tapered annual allowance as his threshold income is above £200,000 and his adjusted income is over £260,000. **His annual allowance of £60,000 will be reduced by £17,500 (£295,000 - £260,000 = £35,000 divided by 2) and therefore will be £42,500 for the 2024/25 tax year. As his pension input will exceed £42,500 (employer contributions of £45,000 and his additional voluntary contribution of £12,500) he may be subject to an annual allowance charge unless he has carry forward available that might offset this.**

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 £35,000 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 £35,000 bonus waived sacrifice arrangement that was agreed and paid into her pension after 8 July 2015.

THRESHOLD INCOME	
INCOME	£199,000
+ INTEREST	£2,000
+ DIVIDENDS	£8,000
+ **BONUS SACRIFICE CAUGHT UNDER ANTI-AVOIDANCE**	**£35,000**
THRESHOLD INCOME	**£244,000**

ADJUSTED INCOME	
INCOME	£199,000
+ INTEREST	£2,000
+ DIVIDENDS	£8,000
+ **EMPLOYER CONTRIBUTION (INCLUDING BONUS SACRIFICE)**	**£65,000**
ADJUSTED INCOME	**£274,000**

In this scenario, although Felicity has sacrificed her £35,000 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 £7,000 (£274,000 - £260,000 = £14,000 divided by 2) giving her a tapered annual allowance of £53,000 for the 2024/25 tax year.** As her pension input will exceed £53,000 (employer contributions of £65,000 including the bonus sacrifice contribution of £35,000) 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		
INCOME		£240,000
+	P11D BENEFITS	£10,000
+	RENTAL INCOME	£5,000
–	EMPLOYEE CONTRIBUTION	£80,000
THRESHOLD INCOME		**£175,000**

ADJUSTED INCOME		
INCOME		£240,000
+	P11D BENEFITS	£10,000
+	RENTAL INCOME	£5,000
+	EMPLOYER CONTRIBUTION	£10,000
ADJUSTED INCOME		**£265,000**

In this scenario Grant's adjusted income for the tax year would have been above £260,000, however his threshold income is below £200,000, so his annual allowance will not be tapered and remains at £60,000 for the 2024/25 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.**

Annual allowance considerations

Money Purchase Annual Allowance (MPAA)

Where this has been triggered it is not affected by any tapering, and remains at the standard £10,000 irrespective of the individual's income.

Alternative Annual Allowance

Where an individual has triggered the MPAA they benefit from the Alternative Annual Allowance in relation to any Defined Benefit arrangement contributions. This is currently set as £50,000, this can be subject to tapering where the appropriate thresholds have been exceeded.

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 amount of carry forward available will be based on the individual's tapered annual allowance for that tax year. 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 2024). Tax treatment depends on individual circumstances and all tax rules may change in the future. Advisers and individuals should check that tax limits, allowances and rules have not changed. Withdrawals from a pension will not normally be possible until the client reaches age 55 (57 from 2028).

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

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