Quilter

Tapered annual allowance and high earners

The aim of the tapered annual allowance is to reduce the level of pension funding high earners and their employers can make into pension schemes going forward. In this way HMRC are also restricting the high level of pension scheme tax relief they are liable for, either to the individual or the company.

Anyone who exceeds both the threshold and adjusted income levels will have their annual allowance reduced by £1 for every £2 of adjusted income over this level until the minimum annual allowance level of £10,000 is reached.

Threshold income

The idea of the threshold level of income is to ensure that there is some form of certainty for individuals in terms of levels of income and who may be affected, and to ensure this rule does not impact people who have large one-off employer funded pension contributions.

Threshold income is comprised of the following:

- Start with net income*, which is made up (but not exclusively) of:
  - income from employment (including any benefits)
  - profits from self-employment
  - taxable social security benefits
  - pensions (including the State Pension)
  - savings, dividend and rental income
  - when calculating net income you will always deduct personal contributions paid by net pay arrangement.
- Add any income given up by salary sacrifice arrangements entered into post 8 July 2015.
- Deduct any personal pension contributions made via the relief at source method (i.e. personal contributions paid net and grossed up by basic rate tax within the pension scheme).
- Deduct some allowances (such as tax relief after making a gross RAC contribution) and taxable death benefit lump sums.

** Net income is defined fully within step 2 of the calculation in section 23 of Income Tax Act 2007. Visit* ***www.legislation.gov.uk*** *for more information.*

If the calculated threshold income is below £200,000 (previously £110,00 until 2019/20), no further tests need to be carried out and the client can continue to contribute up to the standard annual allowance of £60,000 unless restricted by the Money Purchase Annual Allowance. If, however, after this calculation the income level is in excess of £200,000 the member will have to undertake the adjusted income test.

Adjusted income

This test is to determine the actual income amount which will be used to work out the appropriate level of annual allowance that a member may use. The income level that triggers the tapering annual allowance is £260,000 (previously £150,000 between 2016/17 and 2019/20), and £240,000 between 2020/21 and 2022/23. This income level has been adjusted to take into consideration employee contributions taken from gross pay under the net pay arrangement, employer contributions and salary/bonus sacrifice.

Again, there are several factors to take into consideration to determine the level of adjusted income. The calculation is as follows:

- Start with net income, as described above under 'Threshold income'.
- Add any claim for excess relief (where the amount of a contribution paid by an individual under a net pay arrangement exceeds the employment income from the individual's employment or it is not possible for the employer for any other reason to deduct the whole amount of the contribution from the individual's income – under these circumstances the individual would need to make a stand-alone claim for the excess tax relief).
- Add any individual contributions made by the net pay arrangement (i.e. where contributions are made via payroll deduction before income tax is paid, therefore giving immediate tax relief.
- Add any UK tax-relieved overseas pension contributions.
- Add employer pension contribution.
- Deduct any lump sum death benefit the individual accrues from another person's death that is taxable (e.g. benefits on death after the age of 75)
- Deduct some allowances (such as tax relief after making a gross RAC contribution) and taxable death benefit lump sums.

In all calculations HMRC has removed the effectiveness of salary and bonus sacrifice to reduce an individual's level of income. This is to prevent employers and employees from artificially reducing the level of income they are deemed to have earned to pass the threshold income test and not have to undergo the adjusted income test to see if they will have their annual allowance reduced.

Salary/bonus sacrifice is specifically added back in for threshold income calculations although not mentioned at all within the adjusted income calculations. This is because, as part of the adjusted income calculation, all pension contributions, including those employer contributions funded by salary sacrifice, are included.

Calculations for both threshold income and adjusted income take into consideration pension contributions in different ways. By removing relief at source contributions from the threshold income calculation, the total income level is reduced to account for those individuals who have net pay contributions and give a lower salary to be considered. By contrast, should the individual fail the threshold test and must apply the adjusted income test, the calculation is less favourable. Previously the relief at source contribution has been removed to reduce the level of calculated income, however, here the calculation adds in the net pay contributions and so effectively raises the calculated income.

Example for threshold income
Individual earns £205,000 and via relief at source arrangement pays £10,000. This amount would be removed from the individual's income to give a figure of £195,000.

Example for adjusted income
Individual earns £205,000 and via net pay arrangement pays £10,000. This amount would be added to the individual's income to give a figure of £215,000.

It is also worth noting that the net income part of the calculations for both the threshold and adjusted income calculations will not include any bond withdrawals that are within the available 5% allowances and will not include collective investment disposals creating a capital gains tax liability. However, any interest and dividends accumulated within a collective will be counted as net income. Also, any chargeable gains triggered within a bond will be counted as net income. This will be the full amount of the gain and not a top-sliced gain (for example where applying top- slicing between higher rate and additional rate tax).

If an individual's annual allowance is reduced due to the adjusted income calculation, any excess over their lower annual allowance will be subject to the annual allowance excess charge. As the annual allowance tax charge is the individual's marginal rate, the tax liability will likely be 45% due to the level of income an individual needs to have been above the adjusted income level.

Carry forward

As the tapered annual allowance calculation will differ each year, an individual may have different annual allowance levels each year depending on their income for that year.

In terms of carry forward, you should first calculate an individual's annual allowance for a particular tax year before assessing whether there is any annual allowance available to be carried forward.

As an example, for someone who:

- is subject to the tapered annual allowance of £10,000 for tax year 2023/24
- and has been a member of a registered pension scheme for the previous three years but
- has made no pension contributions and earned below the threshold income in previous years.

They will be able to fully fund the current tax year to £10,000 and then carry forward unused annual allowance of £40,000 from the following tax years 20/21, 21/22, 22/23.

Further examples

Here we have put together some additional simple examples to explain a few of the different situations and how the client may be affected.

Under examples B, I and J the clients have made pension contributions before the Threshold and Adjusted income levels have been calculated and, in these cases, the reduced annual allowance has meant that the client has now breached the lower annual allowance. This is a scenario that high earners will need to be aware of.

Please note: these examples are designed to be read after you have read the Tapered Annual Allowance & High Earners article.

A. £285,000 income made up of salary, p11D, pension income and savings. No pension contributions

Threshold income calculation

- Total income subject to income tax of £285,000 with no deductions to make. So the threshold income = **£285,000**

Adjusted income calculation

- Adjusted income will have no elements deducted or added so the adjusted income level is **£285,000**
- Tapered annual allowance will be £285,000 – £260,000 = £25,000/2 = £12,500
  £60,000 – £12,500 = £47,500

B. £460,000 income made up of rental income (£270,000), salary (£160,000), and 5% bond withdrawal £30,000). Personal pension contributions of £20,000 made through relief at source (paid from net salary and grossed up by basic rate tax by the pension provider. Any higher rate tax can be reclaimed separately by the client via a stand-alone claim or self- assessment).

Threshold income calculation

- Total income subject to income tax = rental income (£270,000) and salary (£160,000). Bond income within the 5% allowances is not subject to immediate income tax. = £430,000.
- Minus - personal pension contribution of £20,000 = **£410,000.**

Adjusted income calculation

- Total income subject to income tax = £430,000 (5% bond income excluded) = **£430,000**
- Tapered annual allowance will be £430,000 – £260,000 = £170,000/2 = £85,000.

However, tapering is capped to a maximum reduction of £50,000 to take the tapered annual allowance down to **£10,000.**

C. £250,000 income made up of rental income (£120,000) and salary (£130,000). Employer pension contributions of £13,000 are paid by the employer. Personal pension contributions of £13,000 are paid via net pay arrangement. A net pay arrangement is where the contribution is taken from gross pay by the employer. This means it is not taxable income so is not included in the individuals net income and tax relief is immediate.

Threshold income calculation

- Total income subject to income tax = rental income (£120,000) + salary (£130,000) = **£250,000**

Adjusted income calculation

- Total income subject to income tax = £250,000 + employer pension contribution (£13,000) + the employee contribution via net pay arrangement (£13,000) = **£276,000**
- Tapered annual allowance will be £276,000 – £260,000 = £16,000/2 = £8,000
- £60,000 – £8,000 = **£52,000**

D. £250,000 income made up of rental income (£30,000) and salary (£220,000). Personal pension contributions paid of £10,000 via relief at source. In addition the client has paid a further £45,000 personal contribution to utilise some carry forward.

Threshold income calculation

- Total income subject to income tax = rental income (£30,000) + salary (£220,000) = £250,000
- Minus personal pension contributions (£10,000 + £45,000) = **£195,000**

As the personal pension contribution has reduced the threshold income down to below the £200,000 limit, there is no need to do an adjusted income calculation and the client will have a full annual allowance available.

E. £270,000 income made up of rental income (£30,000) and salary (£240,000). Personal pension contributions paid of £15,000 via relief at source.

Threshold income calculation

- Total income subject to income tax = rental income (£30,000) + salary (£240,000) = £270,000
- Minus personal pension contribution (£15,000) = **£255,000**

Adjusted income calculation

- Total income subject to income tax = **£270,000**
- Tapered annual allowance will be £270,000 – £260,000 = £10,000 / 2 = £5,000
  £60,000 – £5,000 = **£55,000**

F. Income made up of savings income (£100,000) and salary (£100,000). Employer pension contributions (£20,000) made up of salary sacrifice entered into from 2014.

Threshold income calculation

- Total income subject to income tax = savings income (£100,000) + salary (£100,000) = **£200,000**

As the salary sacrifice took place prior to 9 July 2015 this is not taken into consideration as part of the calculation and so can be ignored.

The total of the client's threshold income calculation is exactly £200,000 meaning it does not exceed the £200,000 limit so there is no need for an adjusted income calculation and the client will have a full annual allowance available.

G. Income made up of savings income (£5,000), rental income (£100,000) and salary (£120,000). Employer pension contributions (£40,000) made up of salary sacrifice entered into from August 2016.

Threshold income calculation

- Total income subject to income tax = savings income (£5,000) + rental (£100,000) + salary (£120,000) = £225,000.
- As the salary sacrifice was entered into post 8 July 2015 this must be added, so £225,000 + £40,000 = **£265,000**

Adjusted income calculation

- Total income subject to income tax = savings income (£5,000) plus rental (£100,000) plus salary (£120,000) and the employer contributions post 8 July salary sacrifice (£40,000) = **£265,000**
- Tapered annual allowance will be £265,000 – £260,000 = £5,000 / 2 = £2,500 therefore £60,000 – £2,500 = **£57,500**

H. Income made up of £200,000 salary and £30,000 investment income. Employer makes a pension contribution of £60,000 and the employee contributes £5,000 (net pay arrangement). The client also makes a personal contribution (relief at source) of £30,000.

Threshold income calculation

- Total income subject to income tax = salary (£200,000) + investment (£30,000) = £230,000
- Minus personal contribution (£30,000) = **£200,000**

The total of the client's threshold income calculation is exactly £200,000 meaning it does not exceed the £200,000 limit so there is no need for an adjusted income calculation and the client will have a full annual allowance available.

I. Income made up of £110,000 salary and £120,000 investment income. Employer makes a pension contribution of £60,000 and the employee contributes £5,000 (net pay arrangement). The client also makes a personal contribution (relief at source) of £20,000.

Threshold income calculation

- Total income subject to income tax = salary (£110,000) + investment (£120,000) =£230,000
- Minus personal contribution (£20,000) = **£210,000**

Adjusted income calculation

- Total income subject to income tax = salary (£110,000) + investment (£120,000) + personal pension contributions via net pay arrangement (£5,000) + employer contributions (£60,000) = **£295,000**
- Tapered annual allowance will be £295,000 – £260,000 = £35,000/2 = £17,500 therefore £60,000 – £17,500 = **£42,500**

J. Income made up of £40,000 dividends and salary of £170,000. Employer makes a pension contribution of £60,000.

Threshold income calculation

Total income subject to income tax = dividends (£40,000) + salary (£170,000) = **£210,000.**

Adjusted income calculation

- Total income subject to income tax = dividends (£40,000) + salary (£170,000) plus employer contribution (£60,000) = **£270,000.**
- Tapered annual allowance will be £270,000 – £260,000 = £10,000/2 = £5,000 therefore £60,000 – £5,000 – **£55,000**

If the client has carry forward available they could make a personal contribution via relief at source of £10,000. This would change the threshold calculation to £40,000 + £170,000 – £10,000 = £200,000 – meaning the threshold income does not exceed £200,000, so no adjusted income test is needed and they retain their full annual allowance.

K. £275,000 income made up of rental income (£120,000) and salary (£155,000). Personal pension contributions paid of £15,000 via relief at source.

Threshold income calculation

- Total income subject to income tax = rental income (£120,000) + salary (£155,000) = £275,000
- Minus personal pension contribution (£15,000) = **£260,000**

Adjusted income calculation

- Total income subject to income tax = **£275,000**
- Tapered annual allowance will be £275,000 – £260,000 = £15,000 / 2 = £7,500 therefore £60,000 – £7,500 = **£52,500**

In addition to the current year's annual allowance it should be remembered the client can still utilise carry forward from the previous year's unused annual allowance. This would involve applying the taper calculation to any previous tax years where the client was a high earner. Please remember that the taper limits for both threshold and adjusted income levels were lower for tax years 2016/17 to 2019/20.

These examples all show how the client's current year's pension contribution may be restricted for annual allowance purposes. It must be remembered that this amount may change every year depending on the level of income used for the adjusted income calculations.

This document is based on Quilter's interpretation of the law and HM Revenue & Customs practice as at April 2023.
We believe this interpretation is correct but cannot guarantee it. Tax relief and the tax treatment of investment funds may change.

The value of any tax relief will depend on the investor's individual circumstances.

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