Making sense of the

tapered annual allowance

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REVIEWS

Welcome to Drewberry

Drewberry Wealth is a thriving advice business that aims to guide clients through every stage of their financial lives. We have a passionate team of financial planning experts in our London and Brighton offices, each of whom is focused on making a difference for our clients.

Tom Conner
Director

We set out to provide the highest levels of customer service in our industry and have more five-star reviews than virtually any other adviser in the UK. No less than 98% of our clients say they'd be happy to recommend us.

We run one of the top-rated personal finance websites in the UK and are frequently quoted as experts in our field by the national press.

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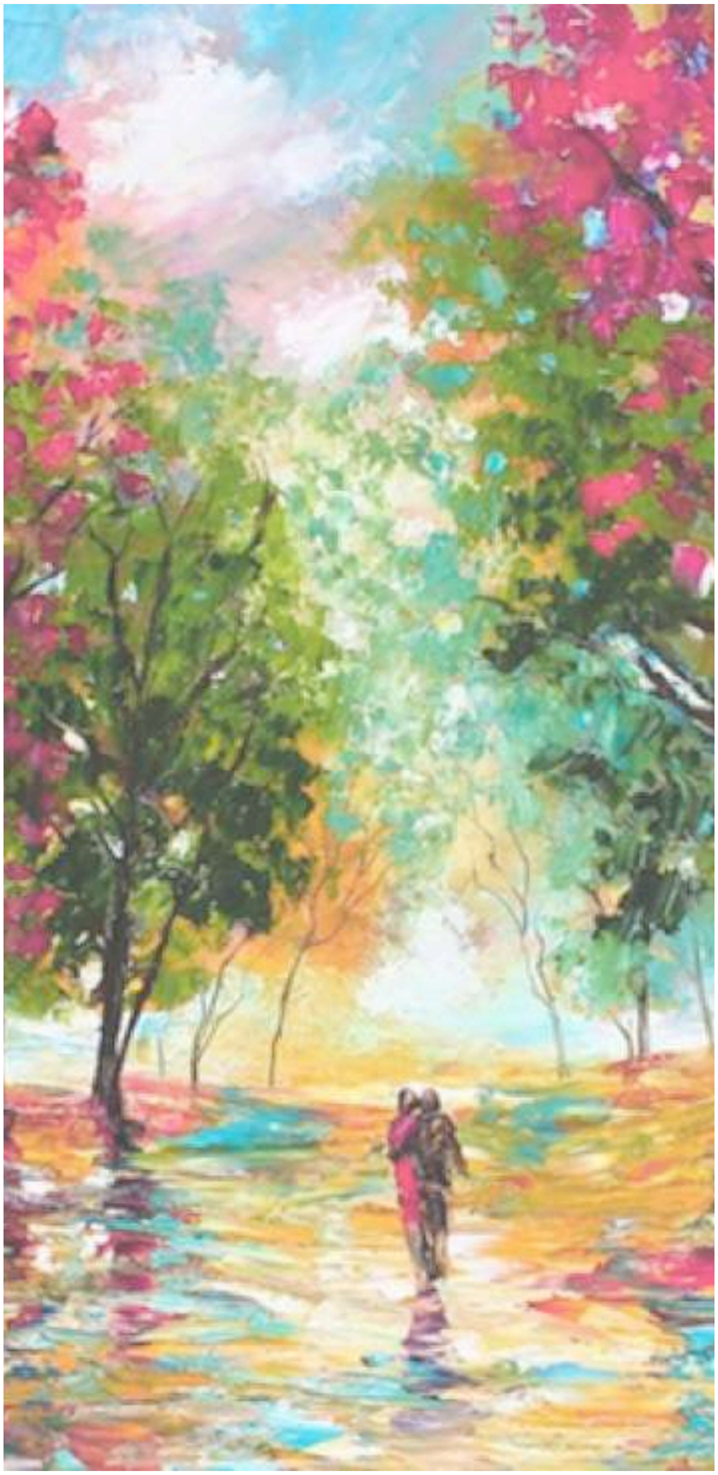

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How Drewberry can help

At Drewberry Wealth we have experts in all aspects of investment, pension and tax planning.

Because we analyse your assets alongside your future income needs, your financial ambitions and those of your family, we can create investment solutions that are tailor-made to your unique needs.

Whatever your circumstances, we can help ensure that you don't pay more tax than you need to on the wealth you worked so hard to create.

At Drewberry we'll help you to make the most of your tax allowances and to turn your savings into an efficient long-term portfolio designed to meet your individual needs.

This can include:

- Helping you and your family make the most of the UK pension regime;
- Creating a programme of long-term tax efficient savings;
- Managing your portfolio to make the most of your annual capital gains tax and dividend allowances including 'bed & ISA' arrangements;
- Advising on a broad range of recognised tax-shelter products including venture capital trusts, enterprise investment schemes and offshore bonds;
- Setting up and monitoring any trust arrangements that might be required; and
- Regulated advice.

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Under siege

Successive governments have raided the UK pension regime time and again.

Most recently, the government set its sights on the pension annual allowance, which has hit the UK's higher earners squarely in the pocket

The UK's higher earners came under fire again in 2016 with the advent of a tapered pension annual allowance that puts a ceiling of £10,000 a year on pension contributions (that receive tax relief) for those at the top of the 'earnings tree'.

Since 6 April 2016, those earning £210,000 or more in salary, commission, bonuses, investment income and (gross) pension contributions stand to lose a whopping £30,000 a year in potential pension contributions.

The quickest way to work out how the new rules will impact on your annual pension allowance is to use the Drewberry Pension Annual Allowance Calculator.

Personal attack

But the new tapered allowance isn't the only front on which higher earners face attack.

In 2010, changes to the income tax personal allowance came into force meaning that those with annual earnings of over £123,000 lose their entire personal allowance (£11,500 in the 2017/18 tax year) and are instead required to pay 20% income tax on this part of their earnings.

In the 2017/18 tax year, this alone equates to an added tax bill of £2,300 for higher-rate taxpayers.

Under siege

Taken together, the introduction of a tapered annual pension allowance and the changes to the income tax personal allowance amount to a significant additional tax bite. The former will cost anyone earning over £210,000 a year £13,500 in lost tax relief. Meanwhile, the latter amounts to an additional £2,300 a year in tax for anyone earning over £123,000.

The price of freedom

To make matters worse, when the government last reshuffled the pension deck with the new 'pension freedoms', it introduced what's known as the money purchase annual allowance (MPAA).

The money purchase annual allowance was aimed at curtailing 'pension recycling', namely, the reinvestment of pension savings to earn an additional dollop of tax relief.

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It did this by imposing a £10,000 a year contribution ceiling for anyone who flexibly accesses one of their pension pots (although most government employees, inexplicably, remain exempt from this rule).

Following the Chancellor's November 2016 Autumn Statement, from the start of the 2017/18 tax year, the MPAA was due to be reduced still further to a measly £4,000.

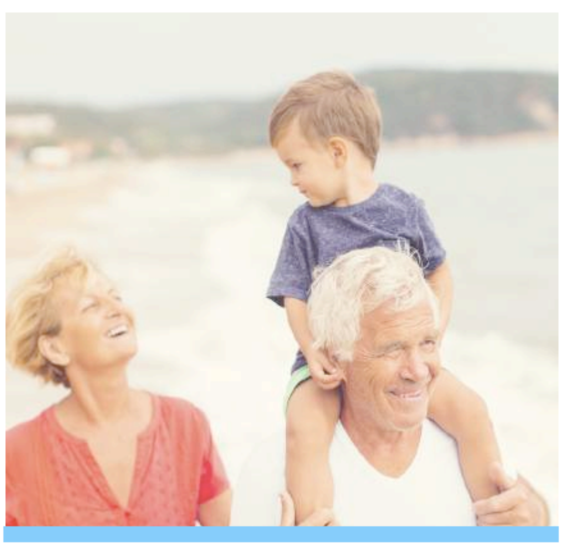
Thanks to a snap general election, the issue remains in limbo but, in theory, anyone who's drawn taxable income from their pension can now contribute just £4,000 a year (gross) to their pension. Those who choose to contribute more risk a potential retrospective tax charge when a new government comes to power.

Losing out…

"For an additional-rate taxpayer who's lost the maximum £30,000 due to the new tapered annual allowance, this equates to lost tax relief of £13,500 a year."

Making the adjustment

It's important to understand how the tapered pension allowance will eat into your retirement wealth



Since the start of the 2016 tax year, the new pension rules have acted to steadily whittle down the pension annual allowance by £1 for every £2 of 'adjusted income' that someone enjoys over £150,000.

The rules apply to anyone with 'adjusted income' over £150,000 and a 'threshold income' of more than £110,000.

What counts as adjusted income?

Considering that adjusted income consists of pre-tax annual income, investment income and the (gross) value of any pension contributions made by you or your employer, it's a ceiling that's likely to bump the heads of a good many UK pension investors.

The maximum reduction in annual allowance, £30,000, is reserved for those with adjusted income of £210,000 a year or more. This means that the most such earners can now contribute to a pension – including the tax relief they'll receive – is a measly £10,000 pa. If they contribute more they'll face a tax charge.

Calculated risk

We've included an illustration (see p13), which shows how to go about calculating your 'threshold' and 'adjusted income'. As always with pensions, applying the new rules correctly to your circumstances is a fraught process.

That's why Drewberry Wealth has created an online Annual Allowance Calculator to help those Britons in the firing line to get to grips with their pension options.

Making the adjustment

Unfortunately, the penalties for getting your sums wrong are not small. Any excess contributions made during a pension input period (PIP) will be charged against your income so you'll effectively pay an annual allowance charge that equates to your highest marginal rate.

This means that unwary pension savers will effectively pay tax twice on the same money.

Making the most of your pension

Even if your annual allowance has been reduced to just £10,000, you need to ensure that you make the maximum allowable contribution every year.

This alone will be worth £4,500 a year in tax relief for an additional-rate taxpayer.

The next step is to contribute as much to your pension in the next few years as you can. You can do this by taking advantage of 'carry forward'.

An ace up your sleeve

The introduction of the tapered annual allowance has transformed 'carry forward'. It was once a useful (albeit complicated) way for wealthier Britons to make additional pension contributions or to mop up any excess contributions they may have made in any one pension year.

But thanks to the new tapered allowance it's become the last opportunity for the UK's higher earners to capture the pension tax relief to which they're entitled.

If this makes carry forward sound like 'the last chopper out of Saigon' that's because, for those affected by the tapered annual allowance, it is.

By the start of the 2019 tax year, the carry forward 'window' will have effectively closed meaning that those Britons with adjusted income of over £150,000 will be forever constrained to their new tapered annual allowance – whatever that may be.

Working out how much you can 'carry forward' from previous years can be hard work, so let Drewberry's Carry Forward Calculator do the heavy lifting for you.

Use ‘carry forward’ while you still can

Because carry forward only allows you to ‘reach back’ over the previous three years of pension contributions the clock is ticking for those with a newly tapered annual allowance.

Those who fail to act before the start of the 2019/20 tax year will have missed the boat

The carry forward rules allow you to make use of any previously unused annual allowance from the preceding three tax years (starting with the tax year three years ago) and to receive tax relief on these contributions at your current highest marginal rate.

This means that, assuming you earned this much, you could potentially invest up to £80,000 in your pension in the 2017/18 tax year (assuming you didn’t use any of your allowance in the previous three tax years) on top of your newly tapered allowance for the 2016/17 and 2017/18 tax years.

This is because, prior to the introduction of the tapered allowance in April 2016, the annual allowance was still set at £40,000 in the 2014/15 and 2015/16 tax years.

Use 'carry forward' while you still can

But the clock is ticking on carry forward for higher earners. This is because the onset of the 2018/19 and 2019/20 tax years will close the door on the two remaining past years when higher earners still enjoyed a £40,000 annual allowance.

If you wait until the outset of the 2019 tax year you'll have lost all of the now generous-seeming annual allowances of yesteryear and be left with just your tapered allowance for each of the preceding three years.

A sitting target?

More broadly, there's a growing consensus in the pension industry that the government's next major raid on the market will be to remove higher-rate tax relief altogether.

This is yet another reason for higher earners to ensure that they don't delay maximising their pension contributions.

To help illustrate how carry forward works in practice, we've included a worked illustration overleaf.

Don't forget to top up your spouse's pension…

If you've been impacted by the tapered allowance you can still capture the tax-relief offered by the UK pension regime through your spouse's pension arrangements.

If your spouse or civil partner is employed they'll also have their own personal allowance equal to their annual earnings and capped at £40,000 a year.

So long as you're confident that you'll be spending your retirement years together, there's nothing to prevent you from providing the funds they need to maximise their pension contributions. This will ensure they receive all of the tax relief to which they might be entitled.

Even if your other half isn't employed, you can still fund a pension for them with a net contribution of up to £2,880 a year. This will qualify for an additional £720 of tax relief (although you can't make use of carry forward here).

Relief from headaches…

In real life, calculating your previously unused allowances for the purposes of carry forward can be a complex business. That's why our Annual Allowance Calculator will also calculate your 'carry forward' entitlement for you.

You can work out just how much your future pensions will be worth – and how long they're likely to last – using Drewberry's Pension Pot Calculator.

Carry forward in action…

An illustration

Let's imagine that Elaine, who runs her own business, wants to make the largest pension contribution she can in the 2017/18 tax year by carrying forward any unused annual allowance from the previous three years. Let's also assume that, thanks to her high level of income, since the new tapered allowance was introduced in April 2016, her annual allowance has been tapered to just £20,000.

Let's imagine Elaine paid £5,000 into her pension in each of the last three years. This means she has £15,000 of unused allowance for the 2016/17 tax year, and £35,000 of unused allowance from the 2015/16 and 2014/15 tax years (which must be used first after Elaine's made the maximum contribution for this tax year).

The annual allowance for both the 2015/16* and 2014/15 tax years was still £40,000.

This means Elaine has total unused allowances of £85,000 from the three previous years.

Consequently, Elaine could choose to contribute her full 2016/17 annual allowance of £20,000 as well as an additional £85,000 in unused allowances making a total of £105,000.

To receive full tax relief on this, Elaine would need to have earnings of at least this much in the current tax year. Hence, opting to stagger her carry forward contribution across more than one tax year would enable Elaine to not only claim tax relief on the whole amount but to claim significantly more higher-rate tax relief.

* Any unused annual allowance for 2015/16 must be based on the contributions paid in the 'post-alignment tax year', 9 July 2015 to 5 April 2016.

Remember

You'll only receive tax relief on total contributions that don't exceed your earnings in the tax year that you pay them and you'll only receive higher-rate tax relief to the extent that you've paid it.

Drewberry Wealth regularly updates all of its 'Making Sense...' guides to ensure that we offer only the most up-to-date information available. We've taken every care to ensure that this information is correct and in accordance with our understanding of the law and HM Revenue & Customs practice, at the date of publication: 12 June 2017.

The information contained in this guide does not constitute advice and Drewberry Wealth accepts no liability for any use you may choose to make of it. We always recommend that readers seek professional advice before taking any major financial decision.

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