Factsheet – Pension: Annual and Lifetime Allowances

Annual Allowance

<u>What is it?</u>

The annual allowance is the maximum amount you or your employer can contribute to a pension plan for you or the total amount of benefits that you can build up in a defined benefit pension scheme each year and on which you can receive tax relief.

For the current year this is set at £40,000, carry forward may be available (see below).

The amount you, or your employer, can contribute is also restricted to 100% of your earnings or £3,600, whichever is greater.

The gross amount of all contributions paid by member / employer or any 3rd party is included within the Annual Allowance.

<u>Tapered Annual Allowance</u>

The tapered annual allowance came into force as of 6th April 2016 for high earners.

- For every £2 of income above £150,000 per annum, £1 of annual allowance is lost.
- The maximum reduction is £30,000 meaning that anyone earning over £210,000 will have their annual allowance capped at is £10,000.
- Income is defined as all taxable income including any pension contributions.

However, taper does not apply unless the individual's income excluding pension contributions exceeds £110,000 (referred to as their "threshold income")

<u>Money Purchase Annual Allowance (MPAA)</u>

Whilst the Annual Allowance for each tax year is currently £40,000; as soon as you (or if you already have) accessed your pension income 'flexibly' using "Flexi-Access Drawdown" or" Uncrystallised Funds Pension Lump Sum (UFPLS)", the amount of your annual allowance is reduced to £4,000. This lower allowance is known as the Money Purchase Annual Allowance (MPAA).

The MPAA does not apply where you only draw your Pension Commencement Lump Sum (PCLS) and no income under Flexi-Access Drawdown.

<u>How is the annual allowance calculated?</u>

Defined contribution schemes - the gross amount of any contributions paid into your pension schemes between 6th of April and 5th of April i.e. within the tax year.

Defined benefit schemes - the calculation is based on the increase in the benefit you are entitled to at beginning of the input period and at the end of the input period, with an allowance for revaluation in line with inflation (CPI). This difference is multiplied by a factor of 16 for the pension and 1 for the pension commencement lump sum (PCLS). Any contributions you are required to pay towards a defined benefit scheme have no bearing on the Annual Allowance in this instance.

Offsetting any previously unused Annual Allowance

A three year carry forward rule allows individuals to carry forward any unused Annual Allowance from the last three tax years (but you can only do this if you have been a member of a pension scheme during these tax years).

You can carry forward your unused Annual Allowance from the previous 3 tax years. Thus, carry forward is available against an Annual Allowance of £40,000 for tax year 2019/20 and from 2016/17 plus 2017/18 plus 2018/19.

There is a strict order in which you can use up the Annual Allowance. The Annual Allowance in the current tax year is used up first, followed by the unused Annual Allowances from the three earlier years, using the earliest tax year first (if you were not member of a pension scheme in that earlier year then there will be no Annual Allowance for that year to carry forward).

Exemptions for Annual allowance

The Annual Allowance test is not applied in the year of death and in cases of serious (terminal) ill-health.

Tax relief on contributions

Relief on personal contributions is available at your marginal rate of tax for contributions up to the available Annual Allowance, including carry forward of unused annual allowance from previous years, or your UK relevant earnings if this is lower.

No tax relief will be granted on contributions paid to registered pension schemes after age 75.

Annual Allowance tax charge

Contributions paid in excess of the annual allowance are unlimited but will give rise to a tax charge on the pension scheme member.

A tax charge equal to the tax rate applied to the top slice of your income will be applied to the part of your pension savings which is over £40,000.

So for example, if you are a 45% tax payer then you would pay a tax charge of 45% on any contribution over the annual allowance and similarly a 40% charge would be applicable for 40% tax payer and 20% for basic rate tax payers.

Lifetime Allowance (LTA)

What is it and how much is it?

The lifetime allowance is the maximum amount of fund or equivalent benefit you can accumulate within your lifetime in a pension scheme or schemes, without incurring a tax charge.

The LTA for the current tax year (2019/20) for most people will be £1,055,000. This is set to rise annually in line with CPI.

Individuals who have Enhanced, Primary or Fixed protection have their own protected lifetime allowance (see below).

Testing of benefits against the Lifetime Allowance:

Pension benefits are tested against the LTA on various occasions – these occasions are referred to as Benefit Crystallisation Events (BCEs). There are 13 BCEs and each triggers a lifetime allowance test. In essence, a test is triggered each time you draw benefits including:

1. Taking the pension commencement lump sum (also known as tax free cash)
2. Buying an annuity
3. Commencement of occupational pension
4. Taking income in form of drawdown
5. Payment of death benefits
6. At age 75
7. Transfer to overseas pensions

Each time a BCE is triggered you use up a percentage of the LTA.

Lifetime Allowance Charge

Once you have utilised 100% of your available LTA; any excess benefits will be taxed by way of the Lifetime Allowance Charge. The amount of the charge depends on how the excess benefits are paid.

In addition, once you have utilized 100% of your LTA, no further PCLS will be available.

- If the benefit is paid in the form of a pension, the excess is subject to a 25% tax charge and the income is then subject to Income Tax. For example, if you have utilised all of your LTA and then crystallise (draw benefits from) a fund of £100k, you will pay a tax charge of £25k, the balance of £75k will then be taxed as income.

- If the excess is paid as a lump sum, it is subject to a one-off charge of 55%. Using the example about, you would pay a tax charge of £55k, with £45k paid to you as a lump sum.

Fixed Protection Against the LTA

The lifetime allowance was reduced from £1.25m to £1m in April 2016. Individuals with Fixed Protection (Fixed Protection 2012, 2014 and 2016) have protected lifetime allowance at £1.8m, £1.5m and £1.25m respectively. Those individuals with 2006 primary protection also retain their privileged Lifetime Allowance (subject to conditions).

Individuals may also have Individual Protection 2016 to freeze their LTA at £1.25m (or IP 2014 with an allowance of £1.5m). Or Enhanced Protection where the full value is protected.

To continue to benefit from Fixed & Enhanced Protection, individuals have to meet certain conditions. These conditions are:

- Cannot start a new arrangement under a registered pension scheme other than to accept a transfer of existing rights, permitted transfers are as follows:
    - Money Purchase to Money Purchase
    - Defined Benefit / Cash Balance to Money Purchase
- Protection will be lost is the transfer is:
    - To an unregistered pension scheme or QROPS
    - From a money purchase to a Cash Balance / Defined Benefit
    - Defined Benefit / Cash Balance to Defined Benefit / Cash Balance, unless due to scheme wind up or sale of business
    - Enhanced transfer value under Defined Benefit / Cash Balance to Money Purchase
- Cannot have further benefit accrual:
    - For Fixed Protection Defined Benefit Schemes are permitted to increase each year by CPI or the rate of increase in the scheme rules as at 09/12/2010 for FP2012, 11/12/2012 for FP2014 or 09/12/2015 for FP2016
    - For Enhanced Protection, the test is undertaken upon transfer / drawing benefits. The amount crystallised or transferred is tested against the appropriate limit, being the greater of indexed amount (value of benefits as at 05/04/2006 increased by greater of RPI and 5%) and the earnings recalculation amount (value as at 05/04/2006 revalued in lien with earnings).
- Under the proposed auto-enrolment rules individuals wishing to register for this form of protection will have a one month opt-out window, otherwise a contribution will be applied that will invalidate the fixed protection