AF1 2021/2022
Pension Rules Part 1

Following the withdrawal of AF3, there have been a number of pension based questions in recent exams. These tend to focus on:

- Calculating the maximum contribution to the subject's pension.
- How the Lifetime Allowance operates and the consequences of breaching this.
- How the State Pension operates, the options on deferring it and how any shortfalls can be made up.

The milestones for this part are to be able to:

- Calculate the maximum contribution to an individual's pension
- Calculate the tax charge if the maximum is breached.
- Understand how carry forward works.
- Understand when individuals are subject to the Tapered Annual and Money Purchase Allowance.

Pension Input rules

There is always a maximum amount that can be invested into a tax privileged investment. With an ISA there is a simple £20,000 limit but the rules for pensions are a more complicated.

In the language of HMRC, the **Total Pension Input (TPI)** in a **Pension Input Period (PIP)** (which is now the tax year) mustnot exceed the available **Annual Allowance (AA)**. If it does an **Annual Allowance Charge (AAC)**will be made.

Total Pension Input (TPI)

There is no limit to the number of active pension arrangements an individual can have and the input into each is called its **Pension Input Amount (PIA).** The total of all these is the **Total Pension Input (TPI)**

There are three possible elements to the pension input:

- The gross tax relievable contributions made by individual member
- The gross contributions made by the member's employer
- Gross contributions made by a third party (for example a parent on behalf of a child.)

On the other hand

- Transferring funds from one pension arrangement to another would not count as input because it is not new money.
- Any investment growth or income is also excluded from PIA.

We'll now look at each element in turn

Individual member contributions

There is no limit as to what an individual can contribute but there is a limit as to the amount that will get tax relief. HMRC call this the member's **Maximum Tax Relievable Contribution**. This is:

The **GREATER** of £3,600 and 100% of Net Relevant Earnings (NRE) which can be split over any number of different pension arrangements.

- Someone with no NRE can always contribute £3,600 if they are under 75.
- Someone with NRE of less than £3,600 can also contribute £3,600 rather than being limited to their NRE.

What are NRE?

- NRE are earnings from employment and taxable benefits in kind together with self- employed profits. For employees it is the total of their P60 and P11D income.
- The first £30,000 of a redundancy payment is not NRE but anything more is.

Jacob is made redundant and had NRE at that point of £32,000. His redundancy pay was £46,000 so his NRE is £48,000 (£32,000 + £16,000)

- NRE is not necessarily the same as Pensionable Pay. Every occupational scheme has a definition of pensionable pay, normally the employee's basic pay which is used to calculate the members' and employer's contributions. Payments such as bonuses, overtime, large town allowances are not usually be classed as pensionable pay but they are part of NRE.
- Pension income, rental income, interest and dividend payments are **not** NRE.

Tom is a director of his own company and pays himself in dividends amounting to £50,000. He takes no salary therefore has no NRE so his maximum individual contribution is £3,600.

Ben has a salary of £30,000 but gets a bonus of £3,000 and a company car with a P11D benefit of £4,000

He is a member of his employer's OPS to which he contributes 5% of his salary (£1,500.)

His NRE is £37,000 so he could contribute a further £35,500 which would be tax relievable

Julie has a salary of £60,000 which means she could get tax relief on a contribution of £60,000 even this is more than the standard Annual Allowance of £40,000. This will be looked at in more detail when we look at the operation of the Annual Allowance Charge.

It may occur to you that if Ben or Julie were to contribute 100% of their NRE they would have nothing to live on. However, the contribution doesn't need to come from earnings. For example, they may have had an inheritance and decided to use some of that to make the maximum contribution.

Employer contributions

An employer can make an unlimited contribution into an employee's pension. This is not a taxable benefit in kind and there is no link between the member's salary and the employer contribution.

Jane employs her husband Jim in her business and pays him £5,000. The business contributes £30,000 to his pension. Jim would not have to pay tax on this even though it is six times his salary

Employer pension contributions are treated as a business expense provided they pass the "wholly and exclusive" test. HMRC may disallow the payment if they consider it to be inappropriate. For example, in the above case HMRC may challenge the amount as being too high but even if it were disallowed Jim would not need to pay any income tax on the contribution.

In addition to an employer contribution being tax free in the hands of the employee neither the employee nor employer is liable to pay NIC on the contribution.

Third Party Contributions

The third possible component of the Total Pension Input is a Third-Party contribution. This is where for example, a parent contributes to their child's pension. As the child will have no NRE the maximum tax relievable contribution would be £3,600. This would not be part of the parent's TPI even though mum or dad had made the contribution.

The Annual Allowance and Annual Allowance Charge.

The **Standard Annual Allowance** is £40,000.

In principle if the TPI in a tax year is higher than £40,000, this will be subject to the **Annual Allowance Charge**. The excess is then taxed as additional income which is normally paid by the member. In practice things are more complicated.

- the TPI can be higher than £40,000 without incurring an annual allowance charge if there is unused annual allowance from the three previous tax years.
- The annual allowance will be lower than £40,000 if someone is subject to either the **Tapered Annual Allowance** or the **Money Purchase Annual Allowance**
- The TPI for a higher rate tax payer may exceed the annual allowance but the charge will only be 20%

Let's look at the last point.

An individual's maximum tax relievable contribution is the greater of £3,600 and their NRE. Therefore someone whose NRE is greater than £40,000 will still get tax relief even though the contribution is higher than £40,000.

Sandra makes a net contribution to her SIPP of £40,000 which equates to £50,000 gross. Her NRE is £61,570 so the full contribution is all tax relievable.

She has her full PA so £49,000 of her income subject to tax. This is in the higher rate tax band so adding the £10,000 excess payment looks as it should all be taxed at 40%.

However,the £50,000 gross contribution increases her higher rate threshold from £37,700 to £87,700.

Adding £10,000 to £49,000 means that it is still in the basic rate band so it is charged at 20%

Effectively HMRC have recovered the 20% tax on the £10,000 excess contribution that Sandra wasn't entitled to.

Employer contributions do not increase the member's higher rate threshold, only member contributions can do that.

Sally has NRE of £61,570 and contributed £8,000 net which is equivalent to £10,000 gross.In addition, her employer contributed £40,000. The TPI is £50,000

Her higher rate threshold will increase from £37,700 to £47,700. The excess amount is £10,000 so we add this to her taxable income of £49,000 which is already above the increased higher rate threshold so the excess is all charged at 40%.

Here’s another example

Jason is a director of his own company and decides to pay £60,000 into his SIPP. This is paid by the company as an **employer contribution**. His salary is £60,000 so he will liable to an AAC of £8,000 (£20,000 x 40%)

If he had paid £60,000 gross as a personal contribution, his Higher Rate Threshold would be increased to £97,700 so the £20,000 excesspayment is all in basic rate and the charge would be £4,000

Some final points on the Annual Allowance and Annual Allowance Charge.

- There is no annual allowance charge in the tax year when the member dies.
  This rule also applies if the member qualifies for a serious ill health payment.
- It is always paid by the member
- Any charge will not be reduced by making contributions to a EIS, SEIS or VCT

Carry Forward

Carry forward enables individuals to have a TPI higher than £40,000 without being subject to an annual allowance charge by “mopping up” unused allowances from thethree previous tax years.

John is self employed. His profits/NRE for 21/22 are £70,000. In the current year he has contributed £15,000. Having received a legacy he decides to maximise his contribution Before he can start to make use of carry forward, he must use up the Annual Allowance for 21/22. This is £25,000 as he has already had an input of £15,000 He then looks back to the three previous tax years to see how much unused relief he has by deducting each year’s input from £40,000 2018/2019 £23,000 2019/2020 £24,000 2020/2021 £35,000 Whilst he has £82,000 of unused relief the maximum tax relievable contribution is limited to his NRE so having maximised the Annual Allowance in 21/22 he can carry forward £30,000 You must always start with the earliest year first so this must come from 18/19. This uses up £23,000 so there is £7,000 left.

We then move to 19/20 and take the remaining £7,000 from that. This leaves £17,000 that is available in 22/23. Together with £35,000 from 21/22

If John's NRE had been £35,000 he could not use carry forward because he could not use up the Annual Allowance for this year

If John had been a director of his own company with the same contribution record the business could carry forward the full £82,000 without John incurring an annual allowance charge since there is no link between the employer's contribution and the employee's NRE.

Let's summarise the main rules

- An individual must use all their annual allowance for the current tax year before usingcarry forward.
- Only the unused allowance from the three previous tax years can be carried forward
- The individual must have been a member of a registered pension scheme for the year theywish to use carry forward. In practice, anyonewho had previously contributed to a personal pension or is a deferred member of an occupational scheme can use carry forward.
- There is no need to use the total unused allowance but the three years must be used in chronological order starting with the earliest year first.
- The maximum tax relievable contribution an individual can make is still limited to their NRE

Now consider this situation. Ranji's contribution record is as follows

17/18 £35,000
18/19 £30,000
19/20 £10,000
20/21 £60,000

Clearly, he has no unused allowance for 20/21 but does it follow that he has £20,000 from 18/19 and £30,000 from 19/20?

To be able to contribute £60K in 20/21 he must have carried forward £20,000 so we have to look at where this came from.

We start by constructing a table for 20/21 looking back three years.

Tax year	Unused Allowance
17/18	£5,000
18/19	£10,000
19/20	£30,000

When the £20,000 was carried forward, £5,000 must have come from 17/18, £10,000 from 18/19 and £5,000 from 19/20.

Therefore the amount on unused relief available in 21/22 is as follow

18/19 Nil
19/20 £25,000
20/21 Nil

Tapered Annual Allowance

The purpose of the TAA is to limit the amount of Pension Input that is available to high earners The calculation must be done every tax year so an individual may be subject to the TAA one year but not in another.

In assessing whether the AA will be tapered we need to establish the individual's:

- **Threshold Income**. Determines whether the adjusted income needs to be calculated
- **Adjusted income**. Determines the amount of reduction in the Annual Allowance

- If the Threshold income is less than £200,000 then the individual has the full AA of £40,000
- If it is above £200,000 you must calculate the Adjusted income.
- If this is below £240,000 the full AA of £40,000 is available
- If it is above, then the AA is reduced by £1 for every £2 above £240,000 to a minimum of £4,000

Threshold income

- The starting point is to calculate the individual's gross taxable income, that is the total of non-savings, savings income, dividends, and chargeable gains under life policies.
- If the individual is a member of an occupational scheme that uses the net pay system,the gross taxable income is the amount of pay after the deduction of the member's contribution.
- Deduct member contributions to Personal Pensions (or any pensions which received tax relief at source)
- Note that Gift Aid contributions **cannot** be deducted
- Finally, you add any employment income given up through a salary sacrifice agreement set up after July 8 2016 and although it's very rare, any taxed lump sum death benefits.
- Income from an ISA or other tax-exempt investments such as rent a room relief can be excluded from the income. However, any interest under the Personal Savings Allowance (PSA), and the first £2,000 of dividends must be included even though theyare taxed at 0%.

Adjusted Income

- This is the member's total income
- **Plus** any employer contribution **less** any taxed lump sum benefits.

Alan's total income is £230,000 and his employer contributes £40,000 to his pension. His adjusted income is £270,000. This is £30,000 in excess of the threshold so his AA is reduced by £15,000 to £25,000

Someone subject to the TAA can still use carry forward but the maximum that can be carried forward will be based on the TAA for that year rather than £40,000.

Money Purchase Annual Allowance.

This applies when an individual has taken benefits from a money purchase arrangement using one of these methods:

- Flexible Access Drawdown (FAD)
- Uncrystallised Fund Pension Fund Lump Sum (UFPLS)
- Exceeds the maximum withdrawal in capped drawdown.

- This sets the AA for money purchase contributions to £4,000.
- This is for life
- Carry forward cannot be used to mitigate this.

Application of rules to a DB/Final Salary scheme

In all the previous examples we have used monetary amounts in determining the TPI. This is straight forward with money purchase arrangements but not as easy with a DB scheme.

The input to the scheme is calculated as the increase in pension benefits multiplied by 16

Ged's pension entitlement increased by £2,000 in 20/21. His input into the scheme was £32,000.

This includes both the member's compulsory and the employer's contribution. For adjusted income purposes the employer contribution is this less the member contributions.

That concludes this part so you should now understand:

- Calculate the maximum contribution to an individual's pension
- Calculate the tax charge if the maximum is breached.
- Understand how carry forward works.
- Understand when individuals are subject to the Tapered Annual and Money Purchase Allowance.