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Annual Allowance

The annual allowance is the maximum amount of pension savings an individual can make each year with the benefit of tax relief. This includes pension savings that individuals make plus any made by someone else on behalf of the individual - for example, their employer.

There is no limit on the amount of pension savings an individual can make (or can have made for them) each year but there is a limit in respect of the tax relief for those pension savings.

However, the annual allowance is not applied by placing a restriction on the amount of tax relief given out when pension savings are made. Instead the annual allowance works by applying a tax charge when the annual allowance is exceeded. The tax charge recoups, in a broad way, the amount of tax relief given to the part of the annual increase in pension savings that is over the annual allowance.

Pension savings are tested against the annual allowance differently depending on the type of arrangement. For money purchase arrangements it is the actual amount of contributions that are tested. For other types of arrangements (e.g. defined benefits) it is the increase in the value of benefit rights that is tested not the amount of contributions. The tests are carried out separately for each member.

If a member's pension saving is more than the annual allowance they will pay a tax charge on the amount over the annual allowance. This tax charge is called the annual allowance charge. The current allowance (from 2014 - 2015 onwards) is £40,000.

From tax year 2015-16 there is a money purchase annual allowance [(which is different from the annual allowance) for individuals who have flexibly accessed certain money purchase arrangements. From tax year 2016-17 this is tapered for individuals with income for a tax year greater than £150,000. The annual allowance is reduced by £1 for every £2 of income above £150,000, subject to a minimum reduced annual allowance of £10,000.

To find out the amount of the annual allowance charge the individual needs to add the amount of the excess pension savings to the amount of their taxable income. The amount of pension saving:

- over the individual's higher rate limit will be taxed at 45 per cent
- over the individual's basic rate limit but below the member's higher rate limit will be taxed at 40 per cent
- below the individual's basic rate limit will be taxed at 20 per cent.

Carry forward rules

Where the individual was a member of a registered pension at any time during a previous tax year, the individual has unused annual allowance for that previous tax year if the individual's total pension input amount for the previous tax year is less than the annual allowance for that same year. The

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unused annual allowance for the previous tax year is the difference between the total pension input amount for that year and the annual allowance for the same year.

If the individual was a member of a registered pension scheme at any time during a previous tax year but did not have a pension input amount for that particular tax year, they can carry forward the full amount of the annual allowance from that year. From 6 April 2014 the annual allowance reduced to £40,000.

The annual allowance for the current tax year is used first. The unused annual allowance from the previous four tax years is then used, beginning with available unused annual allowance from the earliest tax year first (i.e. any available unused annual allowance from the pre-alignment tax year does not take precedence over the other previous tax years.)

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Borrowing

Trustees of registered pension schemes may sometimes wish to borrow funds, for example to enable them to purchase an asset. There is no objection to a registered pension scheme borrowing funds for any purpose provided that the scheme administrator/trustees are satisfied that the borrowing will benefit the scheme and that the borrowing is within the rules laid down by the Department for Work and Pensions (DWP). A registered pension scheme is treated as borrowing or having a liability of an amount, if that amount is to be repaid or met from cash or assets held for the purposes of the pension scheme.

Restrictions when borrowing money by registered pension schemes

The scheme may borrow an amount up to the equivalent of 50% of the net value of the fund prior to the borrowing taking place. The value of the fund for this purpose would not include the investment that is to be purchased with the borrowing.

This is calculated by the following formula:

(APB + PB) is less than VA/2

Where:

APB is the aggregate amount previously borrowed in respect of the arrangement (excluding any amounts already repaid).

PB is the proposed amount to be borrowed.

VA is the value of the fund (prior to borrowing taking place).

Where the borrowing exceeds the 50% limit, the scheme will be treated as making a scheme chargeable payment and the scheme administrator will be liable to a scheme sanction charge of 40%.

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Contributions

HMRC does not impose limits on the level of contributions that members can pay in registered pension schemes. If certain conditions are satisfied, tax relief on member contributions are available on up to 100 per cent of their relevant UK earnings or £3,600 whichever is the greater. The member must be a relevant UK individual for such contributions to qualify for tax relief.

Any employer of a member of a registered pension scheme may make contributions to that registered pension scheme. Tax relief on employer contributions to a registered pension scheme is given by allowing contributions to be deducted as an expense in computing the profits of a trade, profession or investment business, and so reducing the amount of an employer's taxable profit.

A person other than a member or the employer of a member may make a contribution to a registered pension scheme in respect of a member of that scheme. A person can be an individual, a corporate body or other legal entity. For tax purposes, any contribution that is not an employer contribution will be regarded as if it had been made by the scheme member. This means the member should receive any tax relief due on the contribution, not the person who made the contribution.

There is a limit on the amount of tax relief a member may receive on contributions paid by them, or other persons in respect of them. Any contributions over the tax relief limit may still be paid into the pension scheme, but no tax relief is due on the excess. It should be noted that if any portion of contributions that obtain tax relief results in the annual allowance is being exceeded, there might be a tax charge on the member for exceeding the annual allowance.

Unlike for scheme members there is no set limit on the amount of tax relief that an employer may receive in respect of its contributions. However tax relief is not automatic; it will be considered under the normal tax rules as a business expense. There are also special rules for where a large one-off contribution is made. These special rules allow tax relief to be spread over several years rather than be given in full in the year that the contribution is actually paid.

Tax relief on contributions to registered pension schemes that are paid by members can be given in a variety of ways:

- The pension scheme can obtain basic rate tax relief from HMRC to add to the member's contribution to create the gross contribution in the fund. This is called the relief at source method of giving tax relief; or
- A member pays contributions to their employer's occupational pension scheme where tax relief can be given automatically through the PAYE system The employer deducts the member's contributions from their gross pay before income tax is calculated on the balance. The employer passes the contribution to the scheme administrator or other body. This is called the net pay arrangement of giving tax relief; or
- The member makes a claim to HMRC for tax relief on their contribution. The amount of the gross contribution is then deducted from the amount of the member's total income for the tax year in

which the payment is made to calculate tax on the balance subject to normal taxing rules, allowances etc. This may be done through Self-Assessment.

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Loans

A loan made by a registered pension scheme which is an occupational pension scheme to a “person” (sole trader, partnership, LLP or company) who is or has been a sponsoring employer will (subject to certain conditions) be an authorised employer payment. All schemes may make loans to third parties but loans to members (or those connected to members) will be taxed as an unauthorised payment. Loans are only authorised payments if they are genuine investments of pension schemes.

Loans to sponsoring employers

The tax legislation applying to an occupational pension scheme sets out what payments made to or in respect of a sponsoring employer are authorised payments. Any payment made outside of these rules is an unauthorised employer payment and subject to different tax consequences. There are five key tests that a loan must satisfy to qualify as an authorised employer loan. If a loan fails to meet one or more of these tests there will be an unauthorised payment. The amount of the unauthorised payment will not exceed the amount of the loan when it was made.

The five key tests are

- Security. If an occupational pension scheme makes a loan to a sponsoring employer the amount of the loan must be secured throughout the full term as a first charge on any asset either owned by the sponsoring employer, or some other person. At the time the loan is made the security used must be of at least equal value to the face value of the loan including interest.

- Interest rates. A minimum 1% above the average of the base lending rates of 6 leading high street banks specified in the regulations.

- Term of loan. The repayment period of the loan must not be longer than 5 years from the date the loan was made. An unauthorised payment occurs when the repayment period for a loan is longer than 5 years from the date the loan was made unless the loan has been rolled over in accordance with the requirements i.e. for a period up to a further 5 years starting from the standard repayment date and only once.

- Maximum amount of loan. This restricts the amount of a loan which can be made to a sponsoring employer to 50% of the aggregate of the amount of the cash sums held and the net market value of the assets of the registered pension scheme valued immediately before the loan is made.

- Repayment terms. The loan should be repayable in equal instalments of capital and interest for each loan year.

If the registered pension scheme is not an occupational pension scheme there will be no sponsoring employer. Therefore any loans made by the scheme to an employer who is connected to the member will attract a tax charge on the member. A loan to a person connected to a member or sponsoring employer, and who is not a member or sponsoring employer, is treated as made in respect of the member or sponsoring employer.

Member benefits

Registered pension schemes and the contributions paid to them are granted tax reliefs in order to encourage people to save for benefits for later life. So the tax rules for registered pension schemes are geared towards encouraging provision of benefits within the period that the vast majority of people retire - namely between the normal minimum pension age and age 75.

The normal minimum pension age is currently 55. If a member takes benefits before then, those benefits will be treated as an unauthorised payment unless the member satisfies the ill-health condition or where they have a protected pension age.

Pension benefits that crystallise on or after normal minimum pension age (or any earlier age resulting from ill-health or a protected pension age) may be paid as a secured pension - that is, a lifetime annuity or a scheme pension - or (if a money purchase arrangement) as a drawdown pension or an uncrystallised funds pension lump sum. Pension benefits do not have to be taken before age 75. When the member reaches age 75, any uncrystallised rights are deemed to crystallise for lifetime allowance purposes.

Where benefits are held in a money purchase arrangement, the scheme may allow the member to draw income as a drawdown pension either directly from the scheme through income withdrawal or through the purchase of a short-term annuity contract with an insurance company. When choosing either type of drawdown pension, the member 'designates' the amount of funds they want to be used as their 'drawdown fund'.

A member of an occupational pension scheme that provides defined benefits is likely to have a more limited choice over when they can draw their benefits and no option over the format, because under a defined benefits arrangement the pension can only be paid in one way, as a scheme pension.

To be treated for tax purposes as a pension commencement lump sum the individual's entitlement to the payment must be linked to an arising entitlement to some form of pension benefit. The maximum amount of lump sum that can be paid is linked to the value of that arising pension entitlement. If an individual's benefits are taken in stages, over a period of time, each time a 'slice' of pension benefits is crystallised, the scheme may pay a lump sum related to it. If the lump sum satisfies the conditions necessary to qualify as a pension commencement lump sum, it can be paid free of income tax.

Payment of an uncrystallised funds pension lump sum

A member may take their money purchase pension in stages if they wish, through a series of uncrystallised funds pension lump sums. Each time such a lump sum is paid, 25 per cent of it is paid free of income tax, with the remaining 75 per cent taxed as pension income

Whenever a benefit crystallisation event ("BCE") occurs, a certain amount is deemed to crystallise for lifetime allowance purposes. The amount crystallised for each of the BCEs is measured in a prescribed way. This amount is then compared to the level of the lifetime allowance in force at the time of crystallisation or, if lower, the level of the individual's lifetime allowance remaining after allowing for any amounts that crystallised at previous BCEs for that individual, as appropriate.

Where an individual reaches their lifetime allowance, any amount that crystallises beyond that point becomes what is called a chargeable amount. This chargeable amount is subject to a tax charge called the lifetime allowance charge. The rate of this charge varies depending on how the chargeable amount has arisen under the scheme. If the chargeable amount arose on the payment of a lump sum the charge is higher.

The lifetime allowance ("LA")

The LA for 2018-2019 is £1,030,000 and it will increase each year by inflation (CPI).

There is no limit on the total amount of authorised benefits a registered pension scheme can provide to its members. However, an individual has a single lifetime allowance in relation to the value of tax-privileged benefits they can draw from such schemes - the value of any authorised benefits paid out in excess of their allowance is subject to a tax charge known as the lifetime allowance charge. This applies to all types of registered pension schemes equally.

For most people the standard lifetime allowance applies. However, there are a number of different forms of lifetime allowance protections which might increase an individual's lifetime allowance. There are various lifetime allowance enhancements or protections. These can give the member a personalised lifetime allowance, or protect rights up to a significantly higher level than the standard lifetime allowance.

An individual will use part of their lifetime allowance most commonly when they start to draw a pension but there are also other occasions that trigger a test of pension savings against the lifetime allowance. An event that results in lifetime allowance being used up is called a 'benefit crystallisation event'. If the pension savings being tested exceed the member's available lifetime allowance at that point, a lifetime allowance charge will be due on the excess.

Benefit crystallisation events (BCEs)

The legislation sets out the occasions when a scheme administrator must check whether the pension benefits arising ('crystallising') at that point exceed a member's available lifetime allowance. Generally speaking, the type of event which is a BCE includes:

- taking pensions
- taking lump sums
- reaching age 75
- death
- transferring to qualifying recognised overseas pension schemes.

When a BCE occurs, the scheme administrator compares the amount being crystallised to the member's lifetime allowance that is still available. Where the member has died, the personal representatives of the member may be responsible for carrying out this comparison. Any crystallising amount that exceeds the level of lifetime allowance available is charged to tax.