

Navigating the Tapered Pension Annual Allowance

The tapered annual allowance has evolved into a complex web of regulations, further complicated by ongoing changes to pension legislation. In this article, we address some of the more common questions we receive when dealing with this topic.

What is the tapered annual allowance and how does it affect my pension?

Introduced in 2016/17, the tapered annual allowance limits the amount that higher earners can save into their pension and thereby receive tax relief. The standard annual allowance, which is the maximum you can save into your pension without incurring tax penalties, is currently £60,000 for the 2023/24 tax year (for most individuals).

The annual allowance shrinks for individuals with 'Adjusted Income' exceeding £260,000 per year, decreasing by £1 for every £2 of income earned in excess of that amount. The reduction is capped at £50,000, which means that the maximum annual allowance you could have is £10,000 when Adjusted Income surpasses £360,000.

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How much do I need to earn to be impacted by the tapered annual allowance?

There is no perfect answer to this question, as it depends on a lot of different variables unique to you. When considering your income, it takes into account not only things like salary and dividends, but also if you are part of your company's salary sacrifice scheme and your pension contributions. It is usually the area which catches most people out and adds additional layers of complexity for those looking to save for retirement.

There are two types of income which need to be calculated to see if you are liable to the tapered annual allowance: Threshold Income and Adjusted Income. You must first calculate your Threshold Income. If this is over £200,000 you then need to calculate your Adjusted Income. If your Adjusted Income is above £260,000 the Tapered Annual Allowance is triggered.

Threshold Income

To calculate your Threshold Income, add together your taxable income for the year (including salary, bonuses, pension income, dividend income, interest from savings). Then subtract, amongst other things, personal contributions to a pension. For a complete breakdown of the Threshold Income calculation, see the HMRC website.

If your Threshold Income is above £200,000, you must calculate your Adjusted Income to know if the taper applies to you.

A note for business owners, directors and those who are able to control your methods of income payment: there is the possibility that you can control your income and pension contributions so that you do not pass Threshold Income, and as a result will not need to be tested for Adjusted Income and have your annual allowance reduced. Bentley Reid can work with both you and your tax advisers to maximise tax efficiency in this regard.

Adjusted Income

Adjusted Income encompasses many of the elements within Threshold Income. However, it goes a step further by also taking into account employer pension contributions, which have the effect of further inflating your income for annual allowance purposes. If Adjusted Income is over £260,000, the annual allowance will be reduced by £1 for every £2 over £260,000.

For example, if Adjusted Income is £280,000, this will be £20,000 over the Adjusted Income threshold. The annual allowance is reduced by £10,000 to £50,000. For a complete breakdown of the Threshold Income calculation, see the HMRC website.

Long term, what does triggering the tapered annual allowance mean for my pension savings?

If your income triggers the taper, it means you can contribute less to your pension while receiving tax relief. This reduction in your annual pension allowance can lead to concerns about whether you will be able to save enough for retirement, especially if you are a higher income earner and were accustomed to making larger contributions.

If you exceed your annual pension contribution limit, tax charges can also apply. The charges typically take the form of an annual allowance charge, which is added to your taxable income. The actual charge rate depends on your marginal income tax rate.

How can I mitigate the impact of the tapered allowance?

To mitigate the impact of the tapered annual allowance on your pension, it's crucial to seek professional financial advice given the complex nature of the issue. Bentley Reid could help you optimise your pension contributions as well as explore other tax-efficient savings options.

The views expressed here are those of the author, who works at Bentley Reid. This is not investment advice and provided as guidance only.