

CASE STUDY

TAX RELIEF, THE ANNUAL ALLOWANCE AND CARRY FORWARD

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When thinking about how much to contribute to a pension, terms such as tax relief, the annual allowance and carry forward will normally make an appearance. It's important to understand exactly what these terms mean and how the three concepts interact.

The Challenges

Carlie and Eric are siblings whose latest argument is about pensions, and how much they are able to pay into them. Both Carlie and Eric earn £95,000 a year. Eric has just joined his first ever pension but has not yet paid a contribution. Carlie joined her first pension in May 2014 and had been paying in £10,000 gross at the end of each tax year.

Carlie says that pension contributions are limited to earnings: she believes both she and Eric could contribute up to £95,000 a year with no issues. Eric says that it doesn't matter how much they earn - the most they can each pay each year is £60,000, which is the current annual allowance. He remembers reading that the annual allowance is the maximum you can pay into a pension each year. They decide to call their pension provider to confirm who is right.

The Actions

Carlie and Eric call Curtis Banks and get through to Anja. Once they have explained their opinions and the bickering has subsided, Anja confirms that while there are elements of truth in both of their arguments, strictly speaking they are both wrong. Anja confirms that there is no maximum amount which can be paid into a pension each year. There are, however, limits on how much tax relief each person can benefit from each year, which is where factors such as earnings and annual allowances come into play.

Anja goes on to explain that each year, you can claim tax relief on contributions up to the value of your earnings that year. In other words, this is what Carlie was talking about when she said she thought that she and Eric could contribute £95,000 a year each. This makes sense to Eric now - he can see that it makes sense to be able to claim tax relief on the amount that you pay income tax on during that year.

The second consideration, Anja explains, is how much of the tax relief you've claimed you can actually keep. The amount a person can keep each year is controlled by the annual allowance: if your contributions exceed your annual allowance, an annual allowance charge effectively takes back the tax relief on the excess amount. Anja explains that the normal annual allowance is currently £60,000, which is what Eric had said originally. However, Anja cautions that there are variations to the annual allowance rules, such as the money purchase annual allowance (MPAA) and tapered annual allowance, which Carlie and Eric may need to consider. Anja recommends that Carlie and Eric talk to a financial adviser to confirm if they may be affected by either of these rules.

Carlie is confused: it sounds to her as though Eric was closer to being right initially and the most they can each contribute while benefiting from tax relief is £60,000. However, Anja says that

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individuals can sometimes increase their annual allowance by using the carry forward rules, which allow people to use unused allowance from up to three previous tax years.

However, Anja cautions that one of the conditions of carry forward is that you have to have been a member of a pension scheme during the years from which you want to carry forward unused allowance. Therefore as Eric only recently joined his first pension, he won't be able to use carry forward. He can contribute £95,000 while claiming tax relief, but he will incur an annual allowance charge on the excess £35,000.

Carlie on the other hand joined a pension several years ago. Therefore she can use unused allowance from up to three previous years. Assuming Carlie has been subject to the normal annual allowance in each of those years, she should have £150,000 of unused allowance to carry forward. This means that Carlie can also contribute £95,000 while claiming tax relief, but unlike Eric she has enough annual allowance to be able to keep all of the tax relief and not incur an annual allowance charge.

The Results

Eric decides to stay within his annual allowance for now, contributing £60,000 while claiming tax relief. Carlie plans to contribute the full £95,000 while claiming and keeping tax relief. She realises she will still have some carry forward left over, which she plans to use next year to help her keep more tax relief than as well.

Important points to consider

The value of pension funds may fall as well as rise. Your money is tied up until you take your benefits. Benefits can generally be taken any time after age 55, although this is due to increase to 57 in 2028.

This information is based on our understanding of current legislation, including (but not limited to) FCA, PRA and HMRC regulation. It does not constitute any form of advice.

Contact details

If you'd like to speak to us about anything in this case study, please contact us on:

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