CURTIS BANKS

CASE STUDY

THIRD PARTY CONTRIBUTIONS AND ANNUAL ALLOWANCE CHARGES – PART 1

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This case study is from Meet the Joneses - Series 1. Information about the family and further case studies can be found on our website, www.curtisbanks.co.uk. All characters in the Jones family are fictional and intended for demonstrative purposes only.

The Challenges

Julia Jones (47) has lived in the apartment above her boutique clothing store for many years. Her daughter Flo (24) recently moved back into the apartment after Julia ended her civil partnership with her ex-partner Sara. There was a financial advantage to the move, as Flo is starting out as a freelance illustrator and has a very unpredictable income; however, her main motivation was to be on hand to help Julia out around the apartment and shop as needed, as Julia suffers from osteoarthritis which has been gradually worsening.

Over coffee with her sister-in-law Karolina, Julia mentions how proud she is of her daughter for pursuing her dream job, and that she is even more grateful to Flo for wanting to help her at the same time. Julia tells Karolina that she would like to thank Flo by contributing to her pension. She hadn't been aware that it was possible to contribute to another person's pension until her ex Sara had helped Flo to start her first pension last year.

Julia's only concern is around inheritance tax, as she wonders if giving a significant sum to Flo's pension could be seen as some kind of avoidance exercise, particularly if she does it more than once as she's considering.

She wondered if Karolina knew anything about this from her time as a legal secretary or from her current job at a legal aid charity.

Karolina warns that this isn't her area of expertise, but she doesn't believe it poses a specific issue. Her understanding is that Julia's contribution to Flo's pension will be treated as any other gift for inheritance tax purposes, so it shouldn't be a problem as long as Julia survives seven years.

Reassured about her situation contributing to Flo's pension, Julia decides to go ahead with her plan. She pays £16,000 into Flo's pension, giving a total contribution of £20,000 with the tax relief.

The Actions

Unfortunately, Julia hasn't considered that third party contributions count towards the annual allowance, and are only eligible for tax relief if they are within the recipient's earnings for the year, rather than the payer's.

Separately, Flo has been planning to use the £80,000 lump sum she received from her late grandmother to make larger pension contributions, based on how much tax relief she would be eligible to receive. Thanks to a couple of unexpectedly large commissions, Flo's total income this year is £30,000.

She had therefore contributed £24,000, which would give a total gross contribution of £30,000 with tax relief.

When Julia surprises Flo with the news of her contribution, Flo is extremely grateful, but immediately realises the possible problem with the tax relief. Julia had assumed the contribution would be eligible for tax relief because it was within her earnings and she was the one paying the money, but Flo isn't so sure. She calls her provider and speaks to Danny, confirming her suspicions that the contributions need to be within her earnings in order to be eligible for tax relief. Danny says that an easy way for Flo to remember the tax treatment, is that contributions made by anyone other than an employer are treated exactly the same as though Flo made them herself.

This makes Flo think of something else: does this mean her mother's contribution will also count towards the annual allowance? Danny confirms that this is the case. Flo is surprised that her mother's contribution would be tested against the annual allowance even though it won't receive tax relief. Danny confirms that unfortunately that is the case, because personal and third party contributions are tested against the annual allowance if they would be eligible to receive tax relief, even if the individual's earnings mean they can't actually receive it.

Danny goes on to explain that Flo has two options: she can either ask the provider to refund the entire amount of the contribution in excess of her earnings, or she can ask them to return the tax relief only to HMRC, and keep the £16,000 Julia paid in the pension as a gross contribution.

Worried about hurting her mother's feelings by having the money returned, Flo decides to have the tax relief position corrected and keep the gross contribution. She realises that this still leaves her over the annual allowance though, and asks Danny how she would pay the charge. Danny explains that there are two methods; Flo can either pay the charge herself, or use a process called 'scheme pays' to pay the charge from her pension. He mentions that the provider offers scheme pays on a voluntary basis, which means that Flo doesn't have to meet certain criteria such as a minimum amount of charge to be paid.

The Results

Flo decides to use scheme pays to pay her annual allowance charge. Her provider has a form for her to complete with all the required information for them to arrange to deduct the charge from her pension and pay it to HMRC.

Danny mentions that Flo will receive a letter from them later in the year stating that she has exceeded her annual allowance and prompting her to consider whether she needs to take action. Danny explains that it is a regulatory requirement for providers to send these letters, even though in this case Flo is already aware and has taken action. She won't need to worry about the letter.

Julia is very sorry for causing Flo these issues, although Flo remains very grateful to her mother for her generosity. Julia resolves to talk to Flo about these matters in the future rather than trying to surprise her.

Read Part 2 of this case study to see the mistake Flo has made in her calculations and how she corrects it.

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.

Contact details

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

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We may record and monitor calls. Call charges will vary.

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