THE TAPERED ANNUAL ALLOWANCE INCOME DEFINITIONS

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Since the tapered annual allowance was introduced, there have been a lot of questions asked about what to include in the two definitions of income. They are termed 'adjusted income' and 'threshold income', and understanding both requires some knowledge of the process for calculating tax against income. We'll look at this in detail before moving on to these two new definitions.

THE SEVEN STAGE INCOME TAX CALCULATION

The tax legislation – specifically, the Income Tax Act 2007 – specifies a seven stage process for calculating an individual's income tax liability:

Step 1: add up all sources of taxable income. This includes salary, bonuses, commission, taxable benefits, rental income, trade earnings, savings interest, dividends, bond gains and others.

Step 2: deduct any tax reliefs that are available. One such reduction arises where the client pays to a retirement annuity contract and makes a separate claim for the tax relief. Tax relief is granted on the contribution by an equivalent reduction in their taxable income. Other deductible payments at this stage include qualifying interest payments.

Step 3: deduct the personal allowance. This will be £11,000 in 2016/2017 for those who are entitled to the full standard allowance. If 'adjusted net income' is greater than £100,000 the personal allowance will be reduced by £1 for every £2 of excess income. This step determines the client's taxable income.

Step 4: calculate tax at each applicable rate. Non-dividend taxable income is taxed at 0%, 20%, 40% and 45% depending on which tax bands it falls in. The equivalent rates for dividend income, which sits 'on-top' of non-dividend income, are 0%, 7.5%, 32.5% and 38.1%.

Step 5: add up the total tax from Step 4. Add together the tax calculated at each rate on all types of income in the previous step.

Step 6: deduct any tax reductions. Any 'tax reducers' are dealt with in this step: investments in tax-efficient schemes such as VCTs and EISs, and the married couples' allowance, for example. These reductions cannot result in a repayment of tax.

Step 7: add any additional tax liabilities. The final step ensures that other tax charges, such as the annual and lifetime allowance tax charges, and the high income child benefit charge, are included.

An example will help explain this process more clearly:

Example

In 2016/2017 Ian is paid an annual salary of £120,000 and a bonus of £25,000. He is a member of his employer's occupational pension scheme paying an annual contribution of 7.5% of salary under 'net pay', which is matched by his employer. In addition, his employer provides a company car with an annual taxable benefit of £6,200.

He also receives the following income in the tax year: £5,000 gross building society interest and a £3,000 dividend. To his two personal pension plans - a section 226 pension plan and a stakeholder policy - he pays £1,000 and £3,000 gross per annum, respectively.

The income tax calculation will work as follows:

Step 1	Add up all sources of taxable income.			
	Salary and bonus		£136,000*	
	Car benefit		£6,200	
	Gross interest		£5,000	
	Dividend		£3,000	
	Total =		**£150,200**	
				*salary is reduced by 7.5% due to net pay contribution
Step 2	Deduct any tax reliefs that are available.			
	Deduction for s226 relief		(£1,000)	
	Net income =		**£149,200**	
Step 3	Deduct the personal allowance			
	No personal allowance available as income exceeds £122,000:			
	Net income from Step 2		£149,200	
	Deduct personal allowance		(£0)	
	Taxable income =		**£149,200**	
Step 4	Calculate tax at each applicable rate.			
	Rate	Non-savings	Savings	Dividends
	20% x	£35,000* = £7,000		
	40% x	£106,200 = £42,480		
	40% x		£5,000 = £2,000	
	0% x			£3,000 = £0**
				*the basic rate band is increased by £3,000 **within the £5,000 dividend allowance
Step 5	Add up the total tax from Step 4.			
	Tax on non-savings income		£49,480	
	Tax on savings income		£2,000	
	Tax on dividend income		£0	
	Total =		**£51,480**	
Step 6 & Step 7	Deduct any tax reductions. Add any additional tax liabilities.			
	No deductions or additional tax liabilities to be applied.			

The outcome of steps 1 and 2 of the income tax calculation can then be used to calculate adjusted income and threshold income for tapered annual allowance purposes. But first, we will look at what is included within those definitions, starting with Adjusted Income.

Adjusted income

- the individual's net income for the tax year (as per steps 1 and 2 above),
  - plus contributions paid to pension schemes under 'net pay',
  - plus contributions paid gross to personal pensions,
  - plus employer contributions for the tax year,
  - plus where non domiciled individuals make contributions to overseas pension schemes, any relief claimed under Chapter 2 of Part 5 of the Income Tax (Earnings and Pensions) Act 2003 for the tax year,
  - less lump sum death benefits (section 636A(4ZA) Income Tax (Earnings and Pensions) Act 2003) that accrue to the individual in the tax year.

Broadly the definition of Adjusted Income starts with 'net income' (as per step 2 above), to which is added all pension funding except personal contributions that benefit from relief at source. The resulting figure may, however, have to be adjusted for the receipt of any lump sum death benefits and/or contributions by non-domiciles.

The reason for excluding relief at source contributions from Adjusted Income is because they do not reduce taxable income whereas contributions to schemes operating net pay or receiving gross personal contributions do. The latter contributions must be added back in for this reason, ensuring that all personal contributions are included in Adjusted Income.

Once Adjusted Income has been calculated, Threshold Income should be relatively straightforward as it also begins with net income as per step 2 of the income tax calculation.

Threshold income

- the individual's net income for the tax year (as per steps 1 and 2 above),
  - less personal contributions paid to pension schemes that operated relief at source,
  - plus the amount of any reduction in employment income in exchange for a pension contribution (salary sacrifice) made on or after 9th July 2015,
  - less lump sum death benefits (section 636A(4ZA) Income Tax (Earnings and Pensions) Act 2003) that accrue to the individual in the tax year.

Threshold Income is arrived at by taking the individual's net income from step 2, deducting personal contributions that benefited from relief at source and adding any employer pension contributions paid under a salary sacrifice agreement that was set up on or after 9th July 2015. Again, there is an adjustment for lump sum death benefits received in the tax year.

The reason for deducting relief at source contributions is again to achieve parity with other types of pension contributions. No personal contributions (unless converted to employer contributions under certain salary sacrifice agreements) should be included in Threshold Income. And personal contributions paid under net pay and other personal contributions that are paid gross with the tax claimed via self-assessment are already excluded from the net income starting point. So, a separate deduction, for relief at source contributions is necessary.

Continuing with the earlier example should help to bring all of this together.

Example

Ian wants to pay the maximum personal contribution to his personal pension in 2016/2017. To do this it is necessary to work out his annual allowance for this year and the previous three tax years. Assuming he has no carry forward available, the maximum will be the amount of the unused annual allowance of this tax year.

With good reason, Ian is concerned that he may suffer a restriction in his annual allowance. His Adjusted Income and Threshold Income, therefore, should be calculated.

Adjusted Income	
Take Ian's net income as per step 2 above	£149,200
plus net pay contributions	£9,000
plus section 226 contributions	£1,000
plus employer contributions	£9,000
Total	**£168,200**
Threshold Income	
Take Ian's net income as per step 2 above	£149,200
less relief at source contributions	£3,000
Total	**£146,200**

Adjusted Income is greater than £150,000. Threshold Income is also greater than £110,000.

The tapered annual allowance will apply, with a reduction of £9,100, which is half of the excess of Adjusted Income above £150,000.

Ian's annual allowance for 2016/2017 is £30,900 (£40,000 - £9,100).

The presence of lump sum death benefits and overseas payments will make for more interesting calculations, but these will be occasional adjustments. For the majority of affected individuals, it will only be necessary to know their pension inputs, broken down by type, and all components of earned and unearned income.

The start date of any relevant salary sacrifice agreement might not always be straightforward to determine. However, HMRC have confirmed in recent guidance that an existing salary sacrifice agreement is not included in Threshold Income because it had already been given up and without an automatic right to revert to the original salary. Existing agreements are commonly reviewed after a fixed period of time, such as every 12 months. This should have no impact on Threshold Income as no further salary is being sacrificed. It is only an increase in the amount of salary sacrifice that must be included.

The components of earned and unearned income may pose more of a problem. A general rule is that any taxable form of income will be included in step 2 of the income tax calculation; in which case it will be within the net income starting point for both income definitions. If you are unsure about a particular form of income and its taxation treatment, the client's accountant should be asked to confirm the position.

Company car benefit is one commonly queried form of income. This is included in step 1 and 2 of the income tax calculation, as it is a taxable benefit. It is, therefore, included within the 'net income' starting point for Adjusted Income and Threshold Income. It is also relatively straightforward to work out the taxable benefit, and the amount will be confirmed to the employee shortly after the end of the tax year.

Following the steps described here will help you to determine the impact of income on the annual allowance. Once this has been determined, carry forward can be worked out, giving you a maximum funding ceiling to base your advice on. In many cases, it will not be possible to work out exact income figures until shortly after the end of the tax year. A pragmatic approach will have to be followed, but there will inevitably be a trade-off between paying the maximum contribution and mitigating the risk of an annual allowance charge.

Every care has been taken to ensure that this information is correct and in accordance with our understanding of the law and HM Revenue & Customs practice, which may change.
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