Advice: Pensions and tax – the annual allowance

Your annual allowance is the most you can save in your pension pots in a tax year (6 April to 5 April) before you have to pay tax. Here we outline everything you need to know about the NHS Pension and your Annual Allowance.

Contents

This note does not constitute financial advice. Whilst we can outline the pensions and tax systems, the BDA is unable to provide such advice and it is recommended that issues with tax are dealt with by a qualified accountant and that any decisions taken in respect of pensions are discussed with an Independent Financial Adviser.

Pensions and tax efficiency

The state pension has historically been set at a level that is considered insufficient to support older citizens in retirement. Consistently, governments indicate that they expect individuals to make their own provision for retirement to supplement the state pension – such as through workplace pension saving. Government offers an incentive to save for retirement by making pension saving more tax efficient.

The contributions paid by an individual towards a registered pension scheme are tax-deductible. These are not actually tax-free as pensions in payment are taxable, although limited tax-free lump sums can be drawn in retirement. In effect, pension saving is a system of tax deferral. For many people, this deferral of tax can ensure that the eventual tax paid on the money that is saved is charged at a lower rate, particularly if income in retirement is lower than in working years (for example, paying 20% income tax on lower retirement income rather than 40% on higher work-related earnings).

Limits on annual pension growth

The Government limits the amount that can be saved, in a tax efficient manner, towards a pension in any one year. This is measured by calculating your pension input (which is the technical term for either your contributions paid, or benefits accrued in the year).

You can receive tax-relief on pension contributions up to a maximum of 100% of your annual taxable earnings. For example, if you earned £50,000 in a year but paid £80,000 into a personal pension arrangement, you would receive tax relief only on £50,000.

In addition, the annual allowance limits tax efficient pensions growth (pension input) over a tax year. The current standard annual allowance is £60,000, but it has varied significantly since its inception in 2006. Prior to 6 April 2023 the standard annual allowance was £40,000.

Pension input

The method for calculating pension input depends on whether the scheme is based on defined contributions or defined benefits.

Defined contribution pension schemes

These include personal pensions, additional voluntary contributions (AVCs) and stakeholder pensions. Pension input is based on the value of contributions paid into the scheme by the member, their employer or a third party over the course of the pension input period.

Defined benefit pension schemes

These include the NHS final salary or career average plans. Pension input is not based on the contributions paid by a member but on the growth in the value of benefits. The growth (net of inflation) is multiplied by 16 to calculate pension input.
For example:

At the beginning of a scheme year, Fred has a promised pension of £10,000. By the end of the scheme year, this has grown to £12,000. Inflation over the year has been 2%, so the 'real' growth of Fred's promised pension is £1,800. Multiplying this growth by 16 gives a pension input of £28,800.

NHS pension schemes

Pension input requires contributions to be made by or on behalf of the member, or accrual of pension benefits. However, there is an exception for NHS pension scheme members that have been made to move from the 1995 or 2008 section into the new 2015 scheme. Benefits of the 1995 and 2008 sections either grow in line with pay rises (officers) or at a rate of 1.5% above CPI (practitioners); this growth is also regarded as a pension input. So the growth of a 1995 or 2008 NHS Pension is also considered alongside the ongoing growth of a 2015 NHS Pension.

Information about your pension input

Pension schemes must provide information about pension input, for members they know who have breached the standard annual allowance. If someone has not breached this amount, information will only beprovided if requested by the member. The information, contained in a Pensions Savings Statement,should be provided by the October following the end of the tax year. You should use this information in your tax return.

You need information from each pension scheme in which you have benefits. If you moved from either the 1995 or 2008 sections of the NHS scheme into the 2015 scheme, you will need information for each pension.

Carrying forward unused annual allowance

If your input exceeds the annual allowance in any tax year, you can carry forward unused annual allowances from the previous three years, to enhance your current allowance.

For example:

Tax year	Pension input	Annual allowance	Unused allowance to carry forward	Unused Allowance carried forward from last 3 years	Pension Input that is taxable
2019/20	£20,000	£40,000	£20,000		£0
2020/21	£40,000	£40,000	£0		£0
2021/22	£45,000	£40,000	£0	£20,000 (of which £5,000 is used)	£0
2022/23	£80,000	£60,000	£0	£15,000	£5,000

This example shows that in 2021/22, the breach in the Annual Allowance meant that the member had to use £5,000 of Allowance carried forward from 2019/20. The further breach in 2022/23 used up the remaining £15,000 of Allowance carried forward from 2019/20, meaning that the residual £5,000 breach is taxable.

Exceeding the annual allowance

If you exceed your annual allowance after using any unused allowances from previous years, you will be taxed on the excess. The amount by which your pension input exceeded your annual allowance is added to your taxable earnings for the relevant tax year. Income tax on this excess amount is payable at your marginal rate of tax.

An alternative is to ask the pension scheme to pay the tax charge in exchange for a reduction in your pension benefits. This is generally only available if the tax charge exceeds £2,000, although the NHS Pension Schemes allow this exchange for any tax charge. Note that a reduced level of NHS Pension would reduce your potential exposure to a Lifetime Allowance charge (although It should be noted that no further Lifetime Allowance charges will be applied from 6 April 2023 onwards).

Reduced annual allowances

In certain circumstances, the standard annual allowance is reduced.

Money purchase annual allowance

This is available if you are in a defined contribution pension and have accessed your savings in a prescribed flexible manner. The money purchase annual allowance applies from the first tax year after you accessed your defined contribution savings, restricting annual contributions to £10,000 (this was £4,000 prior to 6 April 2023)

This does not apply to defined benefit pension arrangements, such as the NHS Pension Schemes, where pension inputs remain subject to the standard annual allowance.

High earners

High earners are defined as those with an annual threshold income of over £200,000 and an annual adjusted income of over £260,000 (this was £240,000 prior to 6 April 2023)

- Threshold income is taxable income less pension contributions
- Adjusted income is threshold income plus pension input

If you exceed both limits, your annual allowance is reduced by £1 for every £2 by which your adjusted income exceeds £260,000. Your annual allowance cannot fall below £10,000 (this was £4,000 prior to 6 April 2023)

Further reading

HMRC guidance on Annual AllowanceNHS
Pensions (England and Wales) HSC (N Ireland)
Pension Scheme
NHS Superannuation Scheme (Scotland)Universities
Superannuation Scheme