

Retirement planning

Tax relief and the Annual Allowance



When it comes to understanding Pension Tax Relief and Annual Allowance, as Mark Devlin, of M&G Wealth, explains, it's one before the other

Pensions are a cornerstone of long-term financial planning in the UK, offering individuals a tax-efficient way to save for retirement. There is obviously a lot of focus on this with the fact that from 2027 most pensions are to fall under the Inheritance Tax (IHT) net. But a stated aim of bringing pensions into the IHT net was “to ensure that tax reliefs on pensions are being used for their intended purpose – to encourage saving for retirement and later life”.

With that in mind I'll focus on two very important parts of building up that saving for retirement and later life. Tax relief and the Annual Allowance (AA).

However, navigating the rules around tax relief and the annual allowance can be complex. These two systems - while distinct - interact in important ways that can significantly impact how much you can contribute to your pension and how much tax relief you can claim.

We will break down the key concepts, rules

and practical implications of pension tax relief and the annual allowance, helping both individuals and financial advisers make informed decisions.

We quite often hear these common misconceptions:

“I can only contribute what I earn.”
This applies to personal contributions, not employer contributions.

“I can carry forward unused tax relief.”
You can carry forward unused annual allowance, not tax relief.

“Employer contributions are always tax-free.”
They must meet the “wholly and exclusively” test and may trigger a charge if they exceed the annual allowance.

“You have to have had UK relevant earnings in the year you are looking to carry forward from.”
This is not the case, you do not need to have had UK earnings in previous years to use carry forward.

Hopefully, we'll have these cleared up by the end of the article.

Pension Tax Relief

Pension tax relief is a Government incentive that allows individuals to receive tax benefits on contributions made to their pension schemes. It is there to assist and incentivise retirement planning. For the majority, the state pension alone will not be enough to fund their essential, lifestyle and discretionary spending in retirement.

Essentially, it means that some of the money that would have gone to HMRC as tax is instead redirected into your pension pot. You may eventually pay tax on this when taking an income from it, but given most will be able to access 25% of this tax-free, it usually means a lower overall rate of taxation will be applied on extraction.

Who Can Claim It?

You can receive tax relief on personal pension contributions if:

- You are a relevant UK individual, which for most is satisfied by being a UK resident.

- You are under the age of 75, at the time of making the contribution.
- You have relevant UK earnings*, which for most is satisfied by salary or self employed income (or qualify for the £3,600 minimum rule).

Non-UK resident individuals with no relevant earnings can pay in £3,600 gross for five tax-years after leaving the UK.

How Much Can You Contribute?

An individual can receive tax relief on contributions up to the higher of:

- 100% of your relevant UK earnings in the tax year
- £3,600 (* you do not need to have relevant earnings to use this amount)

This limit applies to the gross amount of the contribution, not the net amount you pay. If a third party contribution is being made, the total gross amount into pensions from both the individual and the third party cannot exceed 100% of the recipient's earnings (or £3,600 if that is higher).

Methods of Claiming Tax Relief Relief at Source (RAS)

Under a RAS pension you pay contributions after tax. Your pension provider claims back basic rate tax (20%) from HMRC. For example, if you pay £80, HMRC adds £20, making a total contribution of £100.

This method is common in personal pensions and group personal pensions.

Net Pay Arrangement

Under a Net Pay scheme contributions are deducted before tax from your salary. Therefore you automatically receive tax relief at your marginal rate, meaning higher and additional rate taxpayers benefit immediately.

This method is typically used in occupational pension schemes.

Relief on Making a Claim

A claim must be made to HMRC:

- for contributions paid to retirement annuity contracts ('s226')
- for higher and additional rate tax payers paying contributions via relief at source
- where a member of a scheme operated on the net pay basis wants to pay a contribution that cannot be supported by the earnings in the pay period – e.g. a single contribution at the end of the tax-year

Employer Contributions and Tax Relief

Employers can also contribute to your pension, and these contributions are not limited by your earnings. However, they must meet the "wholly and exclusively" test to qualify for tax relief as a business expense for the employer.

Employer contributions are not restricted

by the employee's earnings or the employee's annual allowance for tax relief purposes. If employer contributions exceed the annual allowance (and any available carry forward), the employee is liable for the tax charge.

The Annual Allowance (AA)

The AA is the maximum amount of pension savings you can make each tax-year without incurring a tax charge.

For money purchase schemes this is the gross amount of personal and third party contributions, as well as the value of employer contributions made.

For defined benefit schemes it's based on the pension input amount for that scheme. The standard annual allowance for the 2025/26 tax-year is £60,000.

Important Distinction

The annual allowance is not the same as the limit for tax relief on personal contributions. You could be eligible for tax relief on a contribution but still face a tax charge if your total pension input exceeds the annual allowance.

Tapered Annual Allowance

If your threshold income is over £200,000 and your adjusted income exceeds £260,000, your annual allowance may be reduced. If you are over both limits, for every £2 your adjusted income is above £260,000 your AA reduces by £1, tapering down to a minimum of £10,000.

This rule is designed to limit tax-advantaged pension savings for the highest earners.

It's important to be aware that the calculations on this can become circular in nature. You can work out how much AA a member has using the taper rules, but if you then do any further pension planning it's important to recheck the taper position post the plan to ensure that there are no unintended consequences (and possibly avoidable excesses).

Money Purchase Annual Allowance (MPAA)

The MPAA only applies to defined contribution pensions, and only when benefits are accessed flexibly (in a manner given to us from pensions freedoms). Once triggered it restricts the amount you can contribute to DC pensions without facing a tax charge and is currently £10,000. Triggering the MPAA can significantly limit your future pension saving options.

Carry Forward Rule

To use carry forward you must exceed the current year's AA first. Therefore if you are self employed and earn £20,000, you will not be able to use carry forward (as you'll be limited to 100% of your relevant earnings and therefore cannot exceed the current year's AA).

You must have been a member of a registered pension scheme during the years you want to carry forward from.

To be clear, you do not need to have had previous UK earnings, or have made a pension contribution in the previous three years, or even have been a UK resident if you are looking to utilise carry forward. You only need to have been a member of a pension scheme (deferred DB scheme, paid up personal pension etc.) in the year you are looking to carry forward from.

Once you have exceeded this year's AA, you then go back three tax-years ago and use up any available carry forward from there. If there is still an excess you offset unused allowance from two tax-years ago, then the last tax-year for any remaining excess. This rule is especially useful for individuals with fluctuating incomes or those who receive large bonuses.

It's important to note that carry forward cannot be called upon to mitigate a DC pension excess over the MPAA.

Tax Charges and Reporting

If an individual exceeds their available AA and carry forward, they are responsible to ensure that the charge is paid. You may be able to compel your scheme to pay this if you meet certain mandatory conditions or you can ask if your pension scheme will pay the charge voluntarily. But conditions apply and timeframes apply to these.

The individual must report the excess on their Self Assessment tax return and HMRC will calculate the tax due based on your marginal rate. Any excess is taxed as if it were earned income and taxed accordingly, this is a "theoretical" amount of income and will not lead to loss of personal allowance, child benefit issues etc.

Tax Relief and AA Planning

- Review contributions annually to avoid breaching the allowance.
- Use carry forward strategically, especially in high-income years.
- Monitor income if close to tapering thresholds.
- Consider Scheme Pays if facing a large tax charge, but always check what produces the best net benefit for your client.
- Coordinate with employers to manage total pension inputs.

Understanding the interaction between pension tax relief and the annual allowance is essential for effective retirement planning. While the rules can be complex, they offer significant opportunities for tax-efficient saving when used correctly. Staying informed and proactive can help clients make the most of their pension contributions while avoiding unexpected tax charges.

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