

Annual Allowance Employee Guide 2025/26*

The Annual Allowance

Your annual allowance (AA) 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. It is a limit on the total amount of contributions that can be paid to Defined Contribution (DC) pension schemes from any source (employee, employer and any third party), and a limit on the total amount of benefits that can build up in Defined Benefit (DB) pension scheme(s) each year, for tax relief purposes.

The standard AA for the 2025/26 tax year is £60,000; however personal contributions are also restricted to 100% of relevant earnings, if these are lower. Depending upon your circumstances, your AA may differ from the standard £60,000. This is explained in more detail later in this document.

The Annual Allowance Charge

If your pension savings go above the AA you will pay an annual allowance tax charge on the excess amount. Tax will be charged at your marginal rate of income tax.

If you have exceeded your AA you will need to pay this tax charge via your self-assessment tax return. In some circumstances, such as if the charge exceeds £2,000, it may be possible to pay the charge from your pension fund. You should speak to your pension provider to find out what is permitted and what their procedure is for this as special rules apply. Details of when this may apply, and how to do this, can be found at the following link.

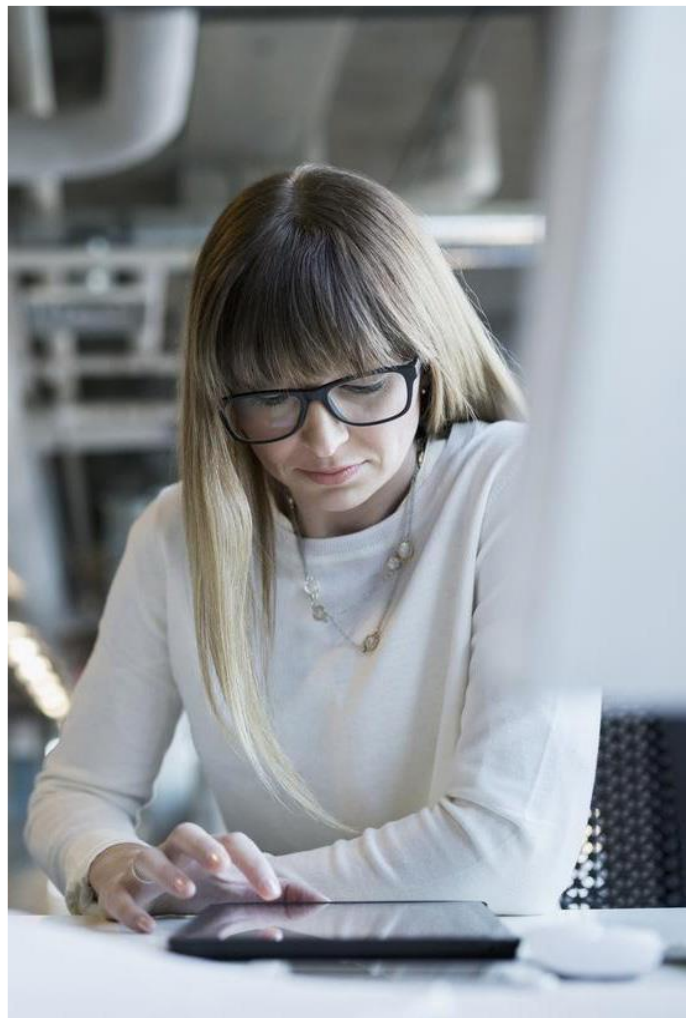
<https://www.gov.uk/guidance/who-must-pay-the-pensions-annual-allowance-tax-charge>

The following allowances remain unchanged for the 2025/26 tax year:

- Standard Annual Allowance - £60,000
- Money Purchase Annual Allowance - £10,000

Tapering of the standard Annual Allowance:

- Adjusted income threshold - £260,000
- Threshold income - £200,000.
- Minimum Tapered Annual Allowance - £10,000.



*Please note that the content of this guide is based on information available as at 1 February 2025, but may be subject to change by the Government before 6 April 2025.

Please note that the annual allowance charge does not apply in the tax year that the individual dies. This is because for the tax year in which an individual dies their total pension input amount (pension saving) is set at nil. Special rules also apply in the case of retirement due to serious ill-health. Full details can be found here –

<https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm051200>

Tapering of the Annual Allowance

The tapering of the AA was first introduced in April 2016. As of 6 April 2023, individuals with a threshold income of more than £200,000, and an adjusted income of more than £260,000 in a tax year, will have their AA reduced. Government guidance states that an individual's AA will not be reduced if their threshold income for the current tax year is £200,000 or less, no matter what their adjusted income is¹.

This reduction is applied by tapering the AA by £1 for every £2 earned over £260,000. The maximum reduction applied (for those earning £360,000 or more) is £50,000, leaving an AA of £10,000. The following table gives examples of the reductions applicable.

Adjusted Income*	Annual Allowance
Up to £260,000	£60,000
£280,000	£50,000
£300,000	£40,000
£320,000	£30,000
£340,000	£20,000
£360,000 and over	£10,000

* where threshold income is more than £200,000

Threshold Income

Broadly speaking threshold income includes all taxable income for the tax year (less a few specific deductions and adjustments for certain taxable death benefits), plus any income you have given up through a salary exchange arrangement commencing after 8 July 2015.

However, any income you have given up under a salary exchange arrangement can be excluded if the arrangement commenced before 9 July 2015 and has not subsequently been renewed or increased. If you think this may apply to you, you should check the details carefully and you may also wish to take financial advice.

Threshold income excludes employee pension contributions. Therefore, increasing employee pension contributions paid through a net pay arrangement or relief at source, can reduce threshold income.

Adjusted Income

Adjusted income is also, generally speaking, your total taxable earnings for the tax year (with similar adjustments as per threshold income).

However, it includes your pension contributions and, in respect of a DC scheme, any employer pension contributions received for the same period (including those made using salary exchange). In the case of benefits in a DB pension scheme, it includes the value of pension savings accrued in the scheme over the tax year.

If your earnings are above the adjusted income threshold, the usual methods of reducing taxable income by entering into salary exchange arrangements or increasing pension contributions will not be effective for the purposes of reducing your adjusted income. Both personal contributions to pension arrangements and employer contributions, are taken into account when calculating adjusted income, so there is limited scope for planning opportunities.

Examples of taxable earnings include salary, commissions, bonus, benefits in kind, rental income, dividend payments and interest on most savings. This list is not exhaustive. The calculation of threshold and adjusted income is complex. Further details can be found here –

¹<https://www.gov.uk/guidance/pension-schemes-work-out-your-tapered-annual-allowance>

<https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm057100>

Please note that Mercer Marsh Benefits are not tax advisers, and that this guide is designed to give an overview only. It is not intended to be used as a step by step guide to calculating your adjusted income and threshold income and should not be construed as tax advice or relied on for this purpose. Given the complexities involved, you may wish to speak to a regulated financial adviser on how to calculate your adjusted income and threshold income.

See the example at the end of this document of how the tapering of the AA can work in practice.

Keeping track of your pension savings

You may receive a statement from your pension provider if you exceed the standard AA for that scheme in any tax year. However, it is important to keep track of all pension savings in any tax year to make sure that you do not incur a tax charge. This is especially important if you are subject to tapering as your AA will be reduced, or if you are subject to the Money Purchase Annual Allowance of £10,000 (see later).

In the case of a DC pension arrangement, your pension savings is the total amount of contributions paid by yourself, your employer and any third party on your behalf.

In the case of a DB pension arrangement, your pension savings is the increase in the value of your promised benefits under the pension scheme, from the start to the end of the tax year.

If you have contributed to a DC pension arrangement such as a workplace group personal pension or group self-invested personal pension, or a master trust, you may be able to obtain contribution information by logging into your online account or through their app. Alternatively, you could contact your pension provider and request this information for the tax year. If you have contributed to more than one pension scheme, you should do this for each one.

If you have accrued pension benefits within a DB scheme you will need to speak to your pension provider for information on the amount of benefits built up within the tax year.

Carry forward availability

If you have used all your AA for the current tax year, you may carry forward any allowance you did not use from the previous three tax years (taking unused allowance from the earliest tax year first), subject to certain conditions.

The 2025/26 tax year therefore allows use of unused allowance from the 2024/25, 2023/24 and 2022/23 tax years.

If you have unused money purchase annual allowance (see later) you cannot carry this forward.

For further information please see the following link:

<https://www.gov.uk/guidance/check-if-you-have-unused-annual-allowances-on-your-pension-savings>

You may wish to seek financial advice in this area.



Money Purchase Annual Allowance (MPAA)

This is a specific allowance in respect of DC pension savings and is triggered when you flexibly access your pension savings using the pension freedom options. It applies to the tax year it was triggered, and to subsequent tax years. With effect from the 2023/24 tax year the MPAA increased to £10,000 and remains unchanged for the 2025/26 tax year.

Paying pension contributions after starting to draw benefits can be complex and we recommend you seek advice from a regulated financial adviser.

You will trigger the MPAA test if you do any of the following:

- take an income withdrawal from a Flexi Access Drawdown (FAD) plan,
- take an uncrystallised funds pension lump sum (UFPLS),
- you have a capped income drawdown plan (that came into effect before 6 April 2015) and
 - choose to convert it to a FAD, or
 - your income exceeds the capped amount,
- you become entitled to a lifetime annuity on or after 6 April 2015 that can reduce in amount (specific rules apply).

This list is not exhaustive as other circumstances also exist which can trigger the MPAA. Full details of the MPAA trigger events can be found here:

<https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm056520>

Events that will not trigger the MPAA test are as follows (again this list is not exhaustive):

- taking a pension commencement lump sum (PCLS) from a FAD (without also taking an income),
- taking income from a capped drawdown fund which is within the capped amount,
- taking an annuity (other than a flexible annuity as outlined above),

- taking a small pot payment (pension freedom rules allow three pots of up to £10,000 to be withdrawn from a non-occupational DC pension).

Your pension provider will send you a flexible access statement within 31 days of flexibly accessing your pension for the first time.

Any DC savings made after the date the MPAA is triggered will be tested against this £10,000 allowance. Any DC savings made in the same tax year before it was triggered, will be tested against the Alternative Annual Allowance, along with any DB benefits earned.

The Alternative Annual Allowance is essentially your standard AA (less any tapering if applicable and including unused AA carried forward) less the MPAA.

For example, for the 2025/26 tax year, if you are entitled to a standard AA of £60,000 and you trigger the MPAA in that tax year, your MPAA would be £10,000 and your Alternative Annual Allowance would be £50,000. For the 2025/26 tax year only, any DC savings made before the trigger event would be tested against the £50,000 allowance, along with any DB benefits earned in the same tax year (if applicable). DC savings made after the trigger event would be tested against the £10,000 allowance. In the following tax year, 2026/27, (assuming the allowances remain the same), only DB benefits earned for that tax year would be tested against the £50,000 allowance, with all DC savings being tested against the £10,000 allowance.



Let's look at an example of the tapered Annual Allowance

Anna earns £240,000 in 2025/26.

Anna pays a 6% employee pension contribution into her workplace DC pension scheme. In addition to this Anna also benefits from a 12% employer pension contribution into her workplace DC pension scheme.

Anna's threshold income is £240,000 less her 6% employee pension contribution (£14,400) = £225,600.

As Anna's threshold income exceeds £200,000, her income needs to be tested to get her 'adjusted income'.

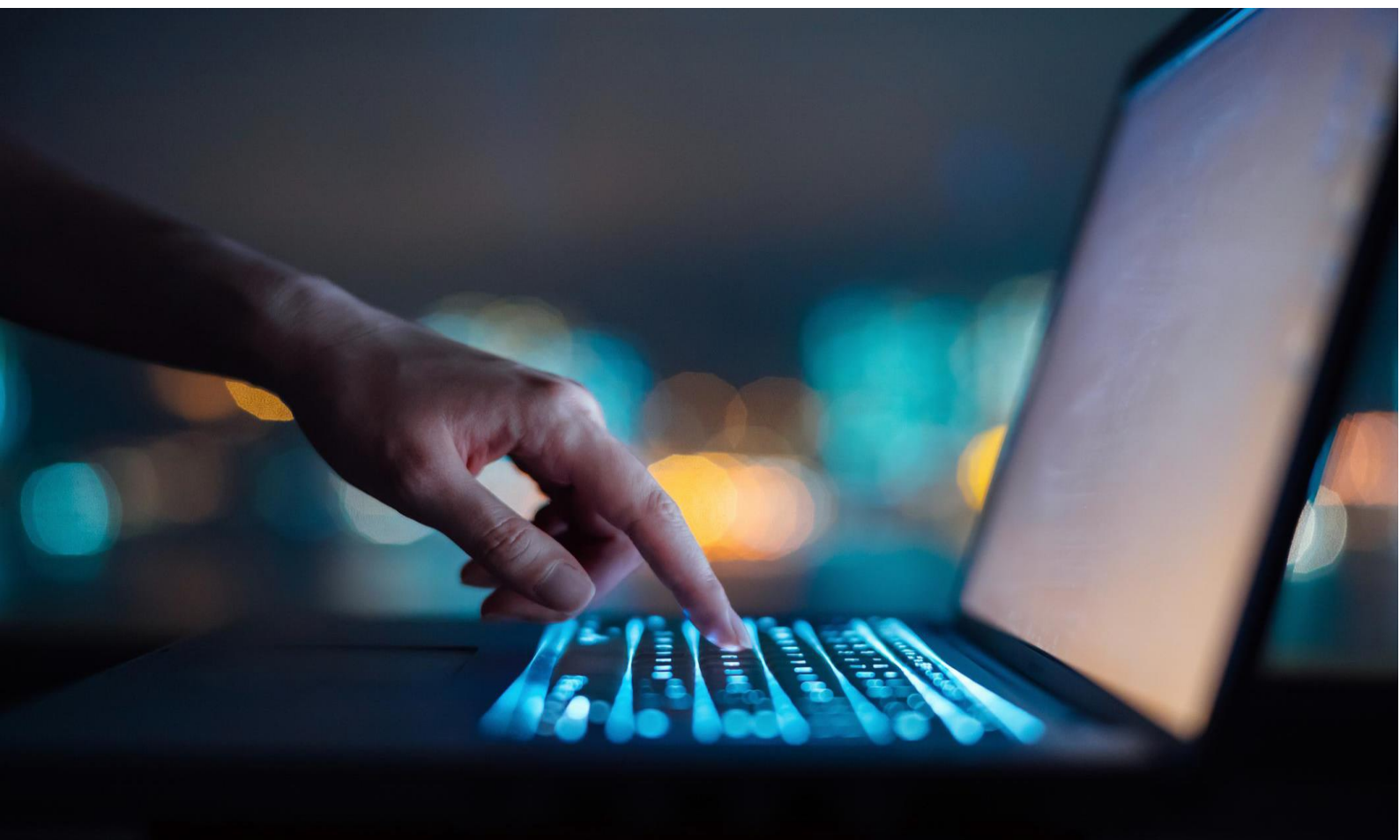
Anna's adjusted income for the tax year is her taxable income (before employee pension contributions are deducted as these are included when calculating adjusted income) plus her employer pension contribution.

Anna's adjusted income is £240,000 plus her employer's 12% contribution to her workplace DC pension scheme (£28,800) = £268,800.

So, Anna's threshold income is greater than £200,000, and her adjusted income is greater than £260,000. As a result, Anna's AA for 2025/26 will be tapered as follows:

Value of adjusted income in excess of the 2025/26 threshold	$£268,800 - £260,000 =$	£8,800
Annual Allowance reduction	$£8,800 \div 2 =$	£4,400
New Annual Allowance	$£60,000 - £4,400 =$	£55,600

However, Anna's total pension contributions of £43,200 are within her tapered AA and so no tax charge will be payable.



Help

If you are potentially affected by the tapering of the AA, financial planning can be complex. Consideration of the two thresholds, any carry forward availability, and the possible application of a salary exchange scheme, to avoid or reduce any tax charge, can be very difficult. Furthermore, it is not always possible to determine your adjusted income until the end of the tax year, yet this directly affects any tapering calculation for the tax year, and your ultimate tapered AA.

Application of the MPAA can also catch individuals unawares should they decide to take advantage of the pension freedom options, and flexibly access their pension savings.

It is therefore recommended that you obtain regulated financial advice if you are affected by any of these issues, to assist you with your tax and pension planning.

Important notices

This document is based on our current understanding of legislation, taxation and HMRC practice, which may change in the future, for example if Government policy changes.

This document is for information only and is not personal financial advice. If you require financial advice you should seek this from a regulated financial adviser.

Please also note that we are not lawyers or tax advisers and nothing in this document should be construed as legal or tax advice or relied on for this purpose. We strongly recommend that you seek appropriate advice in relation to matters of law and taxation.

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