Karen Goldschmidt and Tim Sexton
ACA sessional meeting 3 September 2015

"Strengthening the incentive to save: a consultation on pensions tax relief"

ACA Note "Creating a sustainable Pensions Tax Framework" 4 March 2015

"It is critically important that there are meaningful incentives to employers and employees to encourage retirement savings and to cover potential costs of long term care …
Constant chipping away of tax relief undermines faith in the system and erodes the belief that saving for old age is appropriate. ..

"Furthermore, the ACA has been concerned for some time about the complexity of the current system and believes that very few people, even those working in the pensions industry, fully understand the many nuances of the pension tax system."

ACA guiding principles…

ACA note asked that a new regime should (ideally)…

- **incentivise individuals** explicitly to save for retirement while they are working and **encourage employers** to make suitable arrangements;
- **replace** the current regime
  and not require, for example, creation of two separate regimes to run in parallel dealing with past and future savings;
- ideally, be simpler to understand and operate than the existing regime; where it cannot be simpler it should at least be **fairer and intuitive**, with anomalies and perverse outcomes eliminated;
- be capable of targeting tax **relief in line with the Government's intentions**; and
- minimise opportunities to manipulate the system.

The review process should

Involve

- no “knee jerk” changes [sadly ignored]
- a fundamental cross-party review
- cross-party support so that any new framework can endure.
- appropriate lead time
- no further changes for many years.

Start with

- understanding the true cost of tax relief
- Government deciding how the relief is to be allocated between the various constituencies (high v low earner,
young v old,
DC v DB)
- The AA DB “flat” assessment of value is not fit for purpose

Status Quo – is it that complex? (1)

The current system has four main tax incentives for pension savings:

- Gross roll-up of investment returns
- PCLS (the “tax-free” lump sum at retirement)
- Defers income into a lower tax-band in retirement (“band-shifting”)
- No National Insurance on employer contributions

Status Quo - is it that complex? (2)

Easy for some? if low contribution contract-based DC only

When LTA/AA charge is actually payable

Even when LTA/AA does not bite

- LTA test every time benefits start
- Tax free cash sum formulae
- Anomalies in DB AA calculations
- DB/CB Dependent spouse pension
- UFPLS, CFAD, SLS, TCLS, TLS
- DB v DC anomalies
- Constant change

The delivery system

- AA information provision untested/undesigned
- 9 different LTA protections

Even when a DB scheme has closed

- deferreds

Status quo is not status quo…

- Further tax takes – and changes in policy on distribution of incentives
- DC Freedom and Choice: opportunities for tax turns for the over 55s
- Significant differences in tax relief for DB and DC unsustainable?

But any major change may involve huge work
so has to be worth the candle to someone

The consultation: *“The principles the government believes any reform should meet”*

- It should be simple and transparent.

… greater simplicity and transparency may encourage greater engagement with pension saving and strengthen the incentive for individuals to save into a pension.

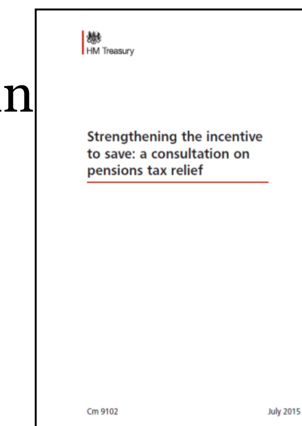
- It should allow individuals to take personal responsibility for ensuring they have adequate savings for retirement.

It should encourage people to save enough during their working lives to meet their aspirations for a sufficient standard of living in retirement.

- It should build on the early success of automatic enrolment in encouraging new people to save more.

- It should be sustainable.

Any proposal for reform should also be in line with the government’s long-term fiscal strategy.


HM Treasury

Strengthening the incentive to save: a consultation on pensions tax relief

Cm 9102

July 2015

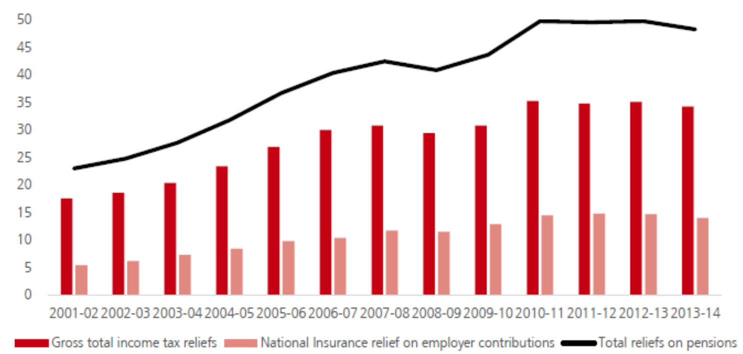
The cost of pensions tax relief

"Including relief on both income tax and National Insurance contributions, the government forwent nearly billion £50 in 2013-14."

"Footnote: Costs are subject to large revisions and have a particularly wide margin of error"

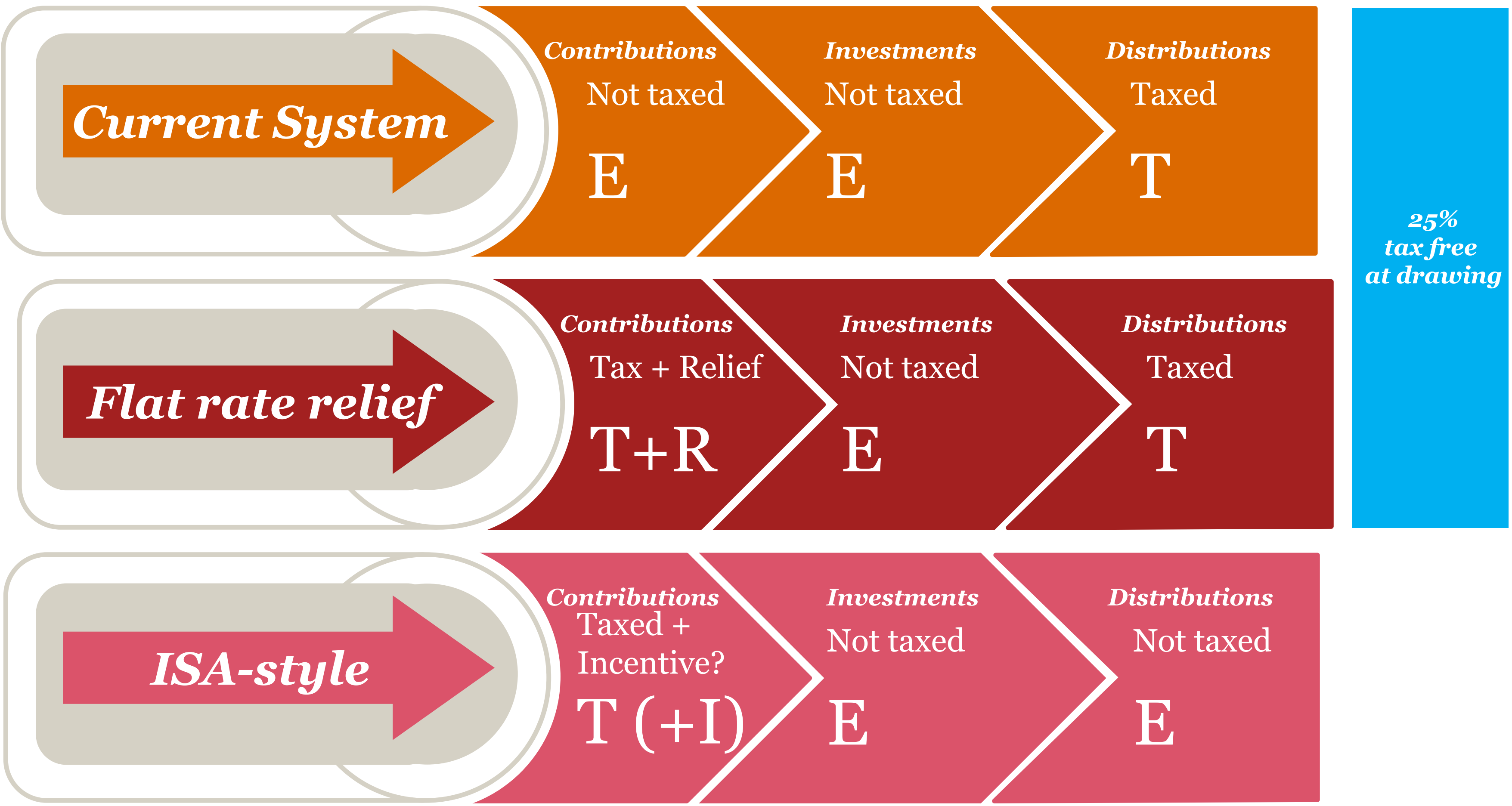
34.3bn	Income tax relief **for DB:** crude conversion of funding/includes deficit contributions
-13.1bn	Tax paid on when pension is paid: current cohort
£21.2bn	
+14.0bn	National Insurance relief

Chart 2.A: Gross cost of registered pension scheme tax relief, £billion



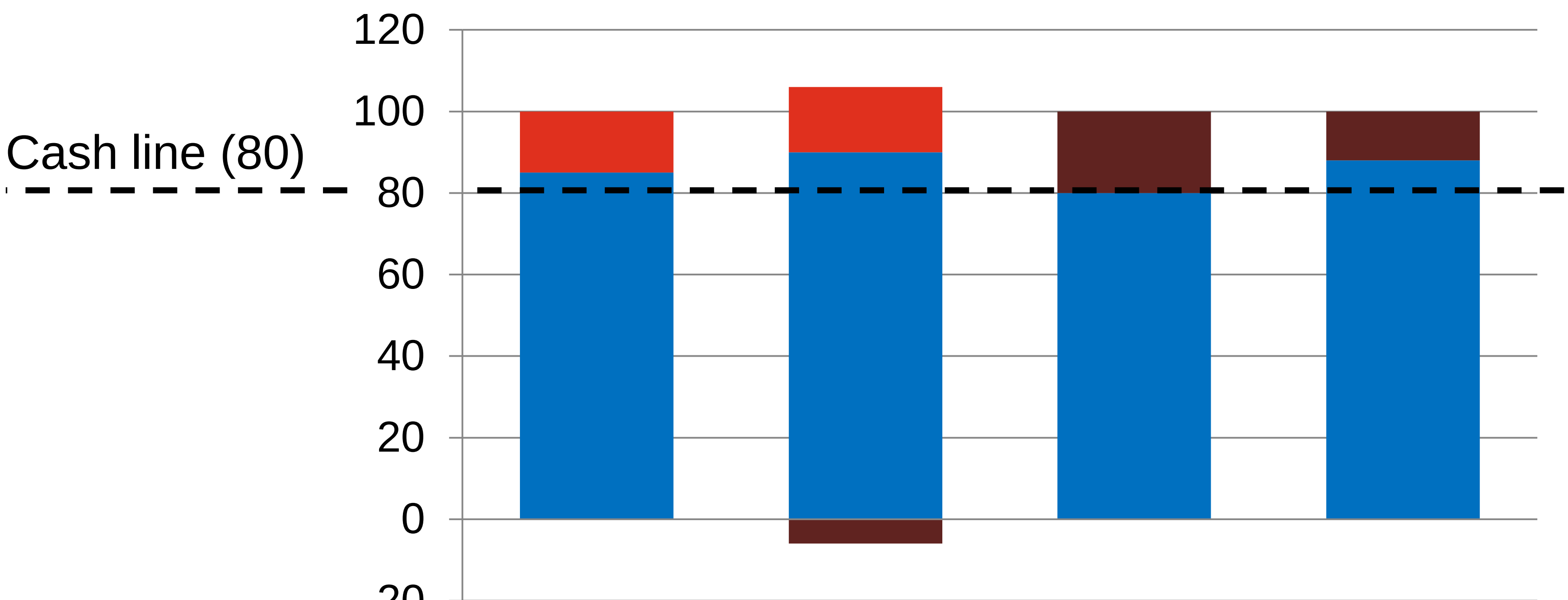
Source: HMRC, Table PEN 6[1]

Three potential systems of tax relief



Tax paid under different options

Basic rate (20%) in work and in retirement

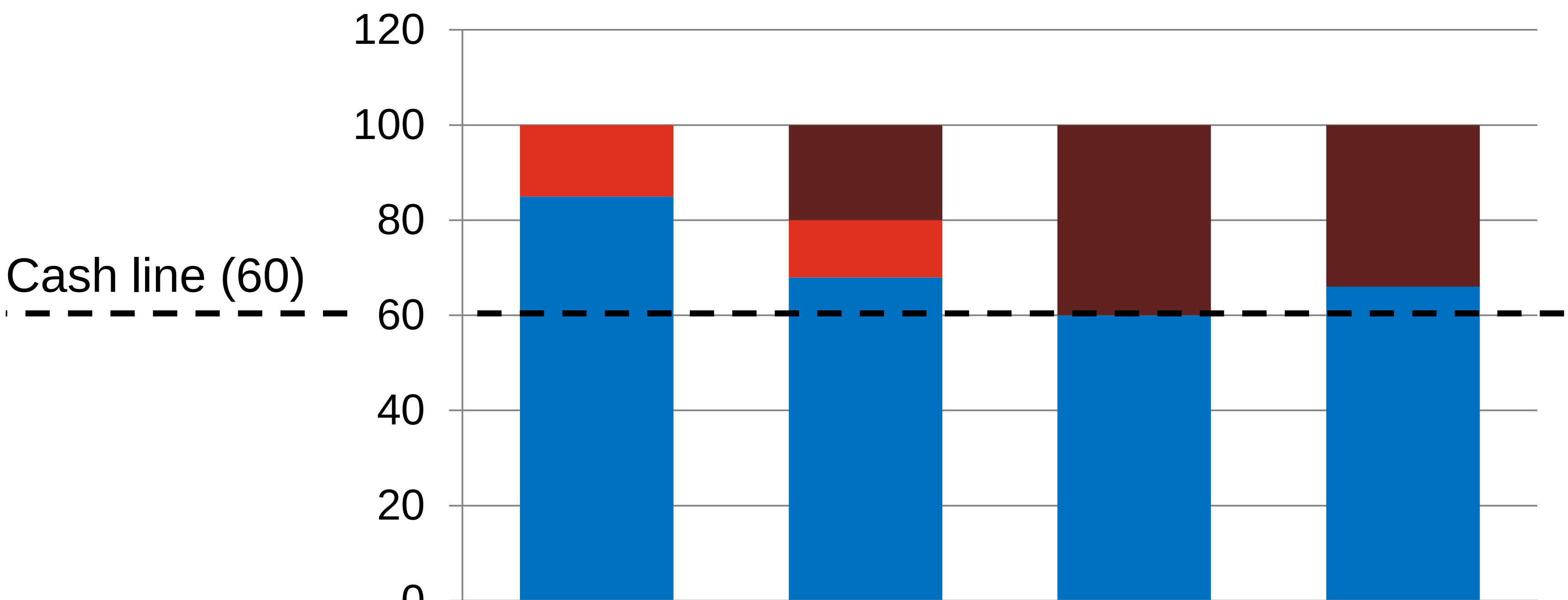


	Current	Flat Rate (25%)	ISA	ISA+10%
HMRC: Now	0	-6	20	12
HMRC: At Retirement	15	16	0	0
Member: At Retirement	85	90	80	88

Assumptions: Many, including assuming no National Insurance
Note: Tax relief at 25% is equivalent to a Match of £1 for every £3 of (net)

Tax paid under different options (2)

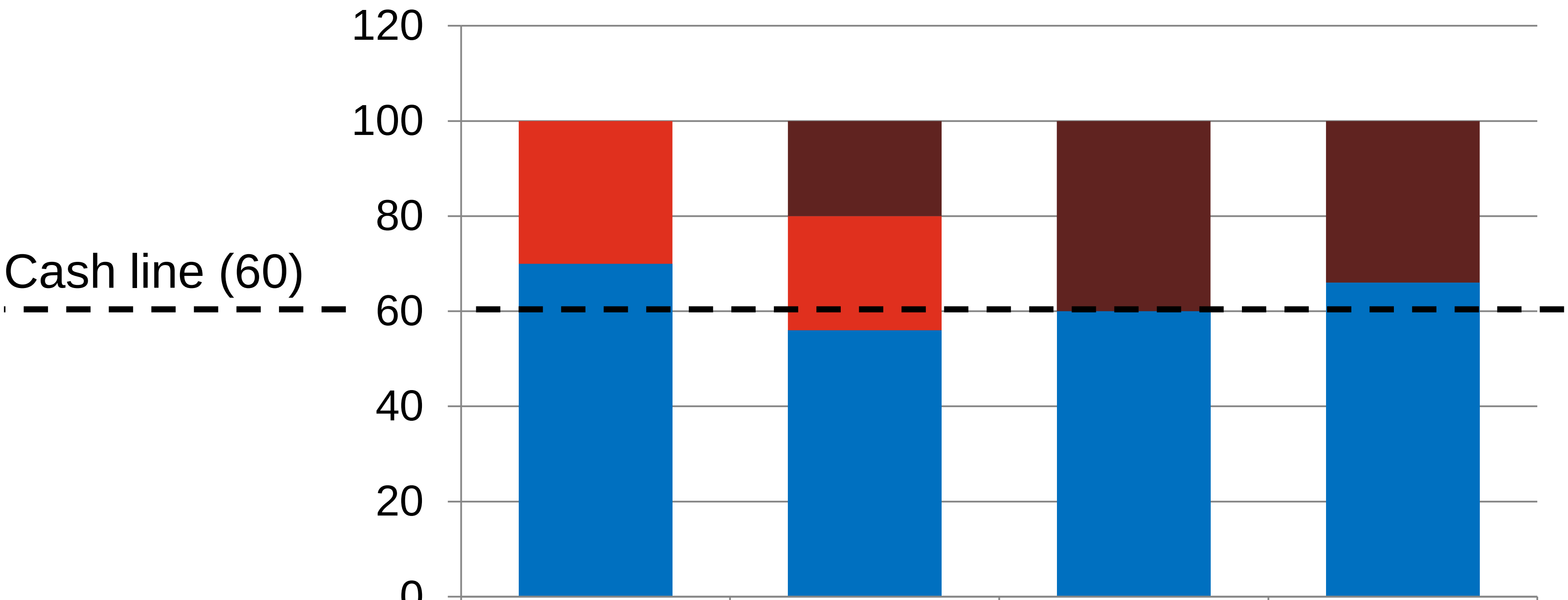
Higher rate (40%) in work and Basic rate (20%) in retirement



	Current	Flat Rate (25%)	ISA	ISA+10%
HMRC: Now	0	20	40	34
HMRC: At Retirement	15	12	0	0
Member: At Retirement	85	68	60	66

Assumptions: Many, including assuming no National Insurance
Note: Tax relief at 25% is equivalent to a Match of £1 for every £3 of (net)

Tax paid under different options (3)
Higher rate (40%) in work and in retirement



	Current	Flat Rate (25%)	ISA	ISA+10%
HMRC: Now	0	20	40	34
HMRC: At Retirement	30	24	0	0
Member: At Retirement	70	56	60	66

Assumptions: Many, including assuming no National Insurance
Note: Tax relief at 25% is equivalent to a Match of £1 for every £3 of (net)

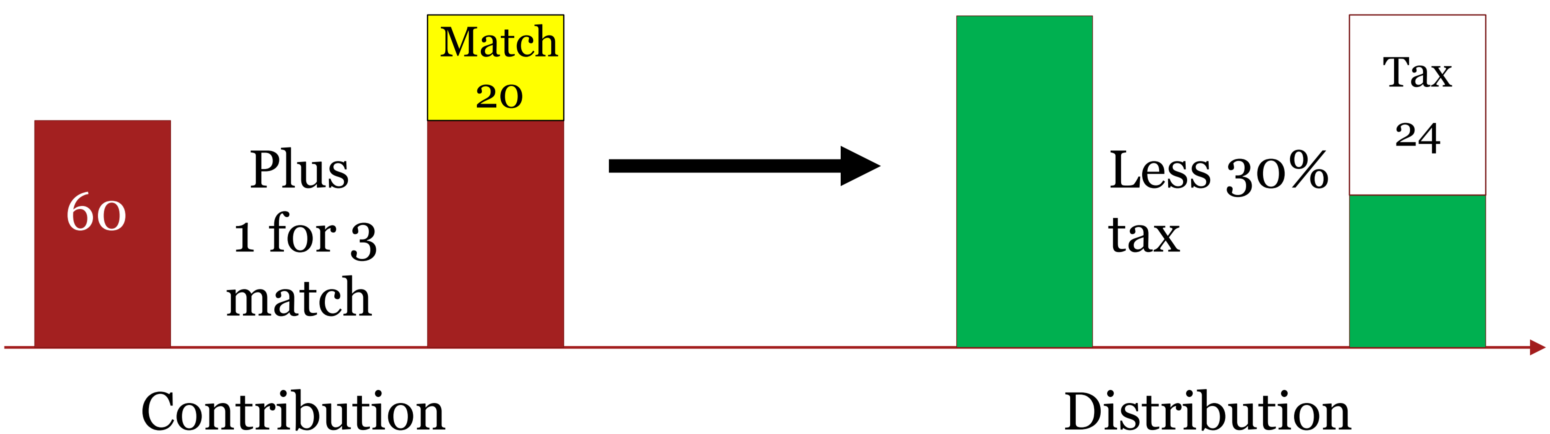
Flat rate relief

Value to the member depends on tax rate at retirement

Whether a pension contribution with matching payment under flat rate relief is better than cash depends on the expected rate of tax at retirement.

Is:

$$(1 + M) \quad \times \quad (1 - \tfrac{3}{4} T) \quad > 1\ ?$$



Flat rate relief

Defined Contribution Schemes (1)

All DC schemes operate as "relief at source" schemes

- Do you need taxable earnings to enjoy the top-up from HMRC?

Employer's contributions would be taxable on employees

- "Dry tax" unless employer reduced contribution to provide cash for the tax bill
- But reduced contribution means reduced match from HMRC: no HMRC match on cash element

Assumption of no other change, ie tax free cash sum, Annual Allowance and Lifetime Allowance continue to apply

Leaves open the age 55+ churning (unless extra measures apply)

Flat rate relief

Defined Contribution Schemes (2)

Negative cashflow for HMRC on contributions for basic rate taxpayers

- Auto-enrolment bringing in many lower paid workers into pensions
- Steps to shift future pension contributions from the higher-paid to the lower paid would exacerbate this cashflow
    - If the relief is not larger than the tax bill then the incentive disappears
    - If the relief is larger than the tax bill then this costs HMRC cash
    - Might impose Employer NIC, but this then increases the cost of auto-enrolment

Scottish rate of income tax: should it affect the flat rate relief?

ISA-style retirement savings plus incentive
Defined Contribution Schemes (1)

The current system has four main tax incentives for pension savings:

- Gross roll-up of investment returns
- PCLS (the "tax-free" lump sum at retirement)
- Defers income into a lower tax-band in retirement ("band-shifting")
- No National Insurance on employer contributions

ISA-style retirement savings plus incentive
Defined Contribution Schemes (2)

ISA-style retirement savings would remove two and possibly three of these incentives:

- Gross roll-up of investment returns
- ~~PCLS (the "tax-free" lump sum at retirement)~~
- ~~Defers income into a lower tax-band in retirement ("band-shifting")~~
- No National Insurance on employer contribution **??**

But arguably easier to understand and explain compared to the two other systems

No Annual or Lifetime Allowance but need a cap on contributions

ISA-style retirement savings plus incentive
Defined Contribution Schemes (3)

Eliminates the relief solely from tax band-shifting at retirement

- Does not affect the very rich
- May hurt the low-paid, who might not pay tax in retirement

Risk of a future Chancellor taxing distributions

Either need to run two systems (existing and new) for many years

- Or taxing existing funds to convert to after-tax ISAs:
  - Is regressive if use a flat rate
  - Is complex if tax rate varies by fund size (member of multiple schemes) and age

Leaves open the age 55+ churning (unless extra measures apply)

The alternative models

Defined Benefits

Tax adjustment for all

- Flat-rate relief: a credit OR charge for all
- ISA + incentive: charge AND credit for all

- All DB accrual would need to be valued
- Any anomaly in valuation would result in anomalous charge
- Valuation only possible in arrears
- Scheme Pays for net charges/tax code adjustment for net credit?
- If valuation is by pension scheme – liability for delays/corrections?
- If one-off move to TEE, appropriate tax take/benefit reduction

Annual Allowance/CETV(on GAD basis?)/Employer on-going contribution%
Allowance for strength of employer?

National Insurance
the complicated elephant

Employer contributions do not attract employer or employee NIC
– should they?

- NI exemption creates changed behaviour
- Employers encourage pension savings rather than take-home pay
- Lessens impact of regressive employee NIC rates
- Same issues as employer contributions as BIK for collection
  (or if just an employer NI charge, global charge using actual employer contributions ex deficit elements)?
- Circularity in charging employer NI for unfunded public sector

Possibly combine different models?

DC

TEE ISA + incentive

No LTA

AA-consistent cap on incentive

Tax levy to move past funds to current system

Or EET flat rate (“tax and match”)

DB

EET current system with either:

No LTA and **AA** retained

or

No AA and **LTA** retained

Age/quality-related factors

Would government demand

- *remaining Allowance is reduced?*
- *rebased higher factors?*

- Members with both?
- Hybrids etc
- Opportunities for arbitrage

What makes people save towards pension?

INDIVIDUAL	GOVERNMENT
PROVIDER	EMPLOYER

Consultation Questions
Closing Date: 30 September 2015

To what extent does the complexity of the current system undermine the incentive for **individuals** to save into a pension?

Do respondents believe that a simpler system is likely to result in greater engagement with pension saving? If so, how could the system be simplified to strengthen the incentive for **individuals** to save into a pension?

Would an alternative system allow **individuals** to take greater personal responsibility for saving an adequate amount for retirement, particularly in the context of the shift to defined contribution pensions?

Would an alternative system allow **individuals** to plan better for how they use their savings in retirement?

Should the government consider differential treatment for defined benefit and defined contribution pensions? If so, how should each be treated?

What administrative barriers exist to reforming the system of pensions tax, particularly in the context of automatic enrolment? How could these best be overcome?

How should employer pension contributions be treated under any reform of pensions tax relief?

How can the government make sure that any reform of pensions tax relief is sustainable for the future?