



## BRIEFING PAPER

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# Reform of pension tax relief

By Djuna Thurley

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## Summary

The principle of the current system of tax relief is that contributions to pensions are exempt from tax when they are made, but taxed when they are paid out to the individual. Pension contributions made by individual employees are usually paid out of pre-salary, so tax relief is received at the individual's marginal tax rate. The main limits that apply are the lifetime allowance (LTA) and annual allowance (AA). (*Finance Act 2004 (FA 2004)*, Part 4).

At introduction in 2006, the AA was set at £215,000 and the LTA at £1.5 million. Both were set to increase in stages, with the LTA reaching £1.8m and the AA £255,000 by 2010. (*FA 2004* s218 and 228).

Since 2010, both allowances have been reduced on a number of occasions. The Government estimates that these reductions have "significantly reduced the share of pensions tax relief that goes to additional rate taxpayers" and reduced costs to the Exchequer by over £6 billion a year. ([Cm 9102](#), Cm 9102, July 2015, para 1.5 and 2.6.) For more detail, see Library Briefing Paper SN-05901 [Restricting pension tax relief](#) (February 2016).

Calls for more fundamental reform continued, partly fuelled by concerns that the current system is not effective in encouraging saving particularly among those most at risk of not saving enough for their retirement. The Government launched a consultation on reforming pension tax relief to [strengthen the incentive to save](#) in July 2015. Debate focused on three approaches to reform:

- **A shift to a single-rate of relief**, possibly rebadged as 'matching contributions' from the Government. Advocates of this approach say it would improve incentives to save for low earners and could reduce Exchequer costs. On the other hand, there are those who argue that it would be expensive and complex to administer, unfair and inappropriately distort behaviour.
- **Moving to a TEE (taxed-exempt-exempt) system** where contributions are made out of taxed incomes (and then topped-up by the Government) while investment returns and any income ultimately received would be tax-free. Advocates of this approach say it could allow individuals to better understand the benefits of contributing to a pension and make the Government's contribution more transparent. Others argue that it would be very complex in transition, could undermine pension saving and have a negative fiscal impact.
- **Retaining the current system**, with some modifications, for example regarding the LTA and AA. This would have the advantage of lower implementation costs, meaning that reforms could be delivered quickly and with minimal risk.

However, in Budget 2016, the Chancellor did not announce any fundamental change to the tax treatment of pension on the grounds that there was 'no consensus' ([HC Deb 16 March 2016 c966](#)). It announced other measures to encourage saving, such as the introduction of a Lifetime ISA, which individuals aged between 18 and 40 could open to save for a first home or to withdraw from age 60 - see [CBP-7724](#) (November 2016).

In July 2018, the Treasury Select Committee suggested the Government return to the question of reform – and in particular that it should "give serious consideration to replacing the lifetime allowance with a lower annual allowance, introducing a flat rate of relief, and promoting understanding of tax relief as a bonus or additional contribution" ([para 117](#)). However, in its [response](#) on 12 October, the Government said that "no

consensus for either incremental or more radical reform of pension tax relief has emerged since the consultation in 2015.”

[Calls](#) for the Government to address the fact that non-taxpayers in pension schemes using the ‘net pay’ arrangement do not receive the tax relief they are entitled to. There have been reports that the Government is looking at whether the move to a modern digital tax system could be an opportunity to address this.

# 1. Background

The tax treatment of pensions follows an “exempt, exempt, taxed (EET) model”:

- (Exempt). Pension contributions by individuals and employers receive tax relief and employer contributions are exempt from national insurance contributions. The main limits applying are the annual allowance (AA) and lifetime allowance (LTA);
- (Exempt). No tax is charged on investment growth from pension contributions; and
- (Taxed). Pensions in payment are taxed as other income, but individuals are able to take up to 25% of their pension fund as a lump sum on retirement.<sup>1</sup>

A general overview can be found on Gov.UK – [Tax on your private pension contributions](#).<sup>2</sup>

The main pension tax legislation is set out in Part 4 of the [Finance Act 2004 \(FA 2004\)](#). Legislation relating to the taxation of pension income is in the consolidated [Income Tax \(Earnings and Pensions\) Act 2003](#).

The principle of the current system of tax relief is that contributions to pensions are exempt from tax when they are made, but taxed when they are paid out to the individual. Pension contributions made by individual employees are usually paid out of pre-salary, so tax relief is received at the individual’s marginal tax rate. The main limits that apply are the lifetime allowance (LTA) and annual allowance (AA).<sup>3</sup> At introduction in 2006, the AA was set at £215,000 and the LTA at £1.5 million.<sup>4</sup> Both were set to increase in stages, with the LTA reaching £1.8m and the AA £255,000 by 2010.<sup>5</sup> Since 2010, both allowances have been reduced on a number of occasions.

- In October 2010, the Government announced that the AA would reduce from £255,000 to £50,000 from 2011 and the LTA from £1.8m to £1.5m from 2012.<sup>6</sup> This was legislated for in the [Finance Act 2011](#) (s66-7 and Sch 17 and 18).
- In the Autumn Statement 2012, the Government announced that from 2014-15, the LTA would reduce from £1.5 million to £1.25 million and further reduce the AA from £50,000 to £40,000.<sup>7</sup> This was legislated for in the [Finance Act 2013](#) (ch 4).

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<sup>1</sup> HM Treasury, [Removing the requirement to annuitise by age 75](#), July 2010, para 2.3; [Bill 97-EN](#), page 2

<sup>2</sup> More detailed information is on archived versions of the HMRC website – [pension schemes and tax – the basics](#) and [tax relief on your private pension contributions](#).

<sup>3</sup> [Finance Act 2004](#), Part 4

<sup>4</sup> [Finance Act 2004](#) s218, s218 and 228

<sup>5</sup> HM Treasury, [Budget 2004](#), para 5.45

<sup>6</sup> HM Treasury, [Restricting pensions tax relief through existing allowances: a summary of the discussion document responses](#), October 2010, para 2.6 to 2.7

<sup>7</sup> HM Treasury, [Autumn Statement 2012](#), para 1.179

- In the March 2015 Budget, the Government announced a reduction in the LTA from £1.25 million to £1 million from April 2016 (para 1.232). This is to be legislated for in *Finance Bill 2016*.<sup>8</sup>
- In the Summer [2015 Budget](#), the Government announced that it would introduce a taper to the Annual Allowance for those with adjusted incomes, including their own and employer's pension contributions, over £150,000 from April 2016 (para 1.223).<sup>9</sup> This was legislated for in the *Finance (No. 2) Act 2015* (s23 and Sch 4).

For more detail, see Library Briefing Paper SN-05901 [Restricting pension tax relief](#) (February 2016).

## 1.1 Cost

In 2016/17, an estimated £38.6 billion in tax relief was provided on contributions to approved pension schemes. In the same year, £13.5 billion in tax was collected on private pensions in payment. National Insurance (NI) relief on employer contributions cost £16.2 billion.

HMRC estimates of cost of tax relief on pensions, 2016/17 <sup>p</sup>	
	£ billion
<i>Income tax relief on:</i>	
Occupational Scheme Contributions	
By Employees	4.6
By Employers	18
Personal Pension Scheme Contributions	
By Employees	2.4
By Employers	5.1
Contribution to PPs and RACs by self employed	0.7
Investment income of pension funds	7.9
<b>Total reliefs</b>	<b>38.6</b>
<i>Less tax liable on:</i>	
Pension payments	13.5
<b>Total (net) reliefs</b>	<b>25.2</b>
<i>Memorandum item</i>	
National Insurance relief on employer contributions <sup>1</sup>	16.2
notes:	
p provisional figures	
<sup>1</sup> This is a combination of National Insurance relief for employers on the pension contributions they make as well as the saving for individuals from the employers contributions not being treated as part of their gross income and subject to employee National Insurance contributions.	
source:	
HMRC. Cost of Registered Pension Scheme Tax Relief. PEN6	

<sup>8</sup> HM Treasury, [Budget 2015](#), March 2015, para 1.232

<sup>9</sup> HM Treasury, [Summer Budget 2015](#), July 2015, para 1.223

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While it could be argued that the net cost to the Exchequer was £25.2 billion (£38.6 billion minus £13.5 billion), HM Treasury explains that this could misrepresent the actual cost to the government each year:

First, the income received by the government from pensions in payment will in all likelihood come from pensions which received tax relief many years ago. Therefore subtracting it from the gross costs of relief provided on pensions today may not provide an appropriate estimate of the next cost. Second, tax rates of individuals may change over their lifetime and therefore the rate of relief they may not correspond to the amount of tax they ultimately pay on their pension.<sup>10</sup>

As the Pensions Policy Institute points out, these are 'snapshot' figures and care needs to be taken in extrapolating any potential savings from reform:

For example, relief on contributions and investment income is currently more than double the tax collected on pensions in payment. As the number of pensioners increases, and if private pension contributions fall, it could be that more tax is collected than relief is given, resulting in a net saving. However, no projections of this cost are made by government, or by other organisations.

In the absence of tax relief, many pension contributions would be redirected to other tax efficient vehicles such as ISAs, or spent. This suggests that were all tax relief to be abolished, tax revenues would not increase by the full 1.8% of GDP. The extent of this overestimation is unclear as there are much stricter limits on contributions to ISAs, and many people with pension contributions may already use some or part of their ISA allowance. However, money could also be invested tax-free offshore, where there are no limits.<sup>11</sup>

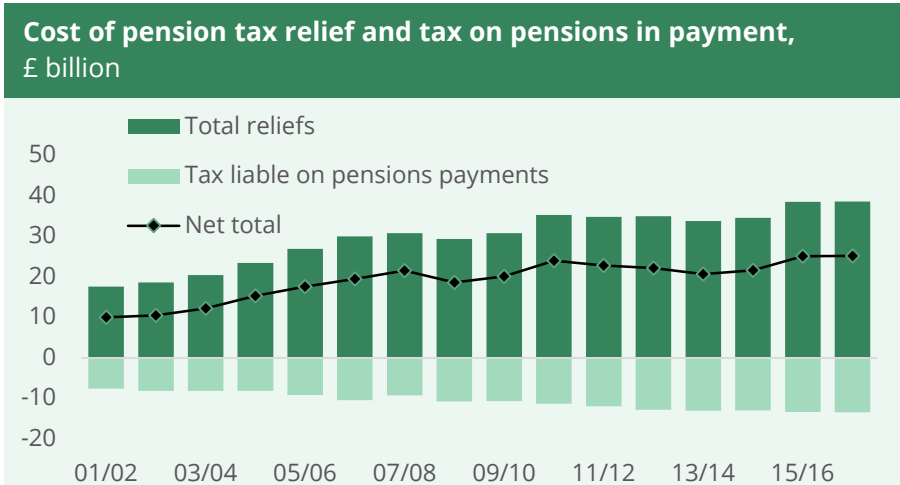
### How the costs break down

Gross pension tax relief in 2016-17 is projected to be £38.6 billion, up from £34.6 billion in 2014-15. This 12% increase is partly explained by the introduction of automatic enrolment, which has increased the number of individuals saving and thus the total amount saved into workplace pensions in recent years. Reductions in the annual and lifetime allowances was behind the flattening cost of pensions tax relief between 2010-11 and 2014-15.

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<sup>10</sup> HM Treasury, [Strengthening the incentive to save: a consultation on pensions tax relief](#), Cm 9102, July 2015

<sup>11</sup> PPI, [Tax Relief and Incentives for Pension Saving](#), 2004



Individuals receive tax relief on contributions at their marginal tax rate. However, when they are in receipt of their pension, they may have retired and face a lower marginal tax rate than they did in work. Furthermore, individuals can typically receive 25 per cent of their pension funds tax free. Tax received by the government on pensions in payment in 2016-17 was £13.5 billion; the highest level since these statistics began, and reflecting the general year-on-year increase seen since 2009-10.

Contributions to occupational schemes (employee and employer) account for 59% of the total relief. Contributions to personal pensions account for about 19% of the total relief and contributions by the self-employed a further 2 per cent. The remainder of the cost of relief is relief on investment income.<sup>12</sup>

## 1.2 Distribution

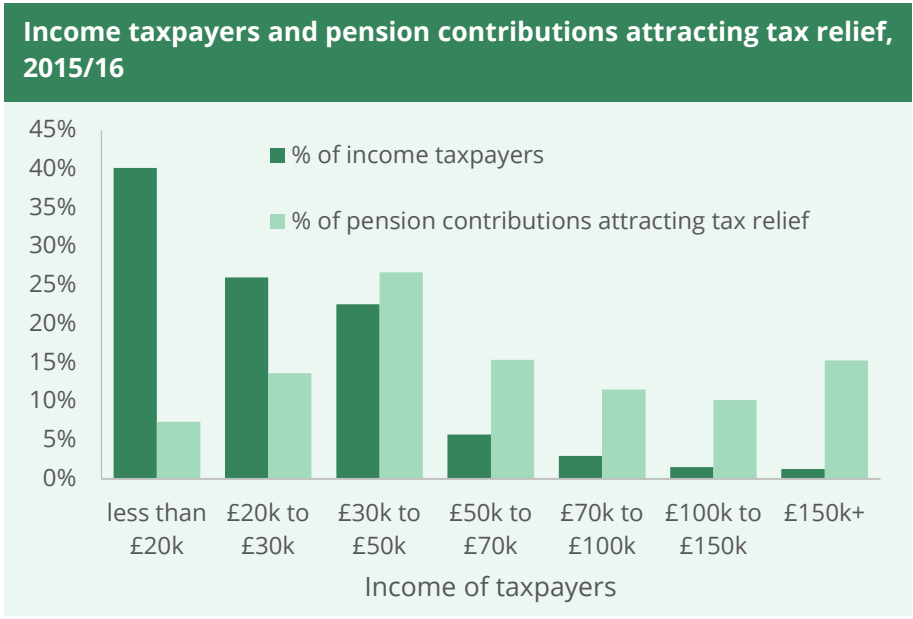
In 2015/16, people with annual incomes over £50,000 accounted for 11% of income tax payers, but over half (52%) of private pension contributions attracting tax relief. The 1 per cent of income tax payers within incomes of £150,000 and above accounted for 15% pension contributions attracting tax relief.

Conversely, while those earning less than £20,000 per year are 40% of taxpayers, they account for just 7% of personal pension contributions attracting tax relief.<sup>13</sup>

<sup>12</sup> HMRC [Personal Pension Statistics](#), September 2018

<sup>13</sup> HMRC [Deductions and reliefs: 2015 to 2016](#), March 2018; HMRC [Distribution of total income before and after tax by gender: 2015 to 2016](#), March 2018





The Government estimates that reductions in the AA and LTA since 2010 have significantly reduced the share of pension tax relief going to additional rate taxpayers:

[...] significantly reduced the share of pensions tax relief that goes to additional rate taxpayers since 2009, a trend that is likely to continue when the tapered annual allowance is introduced in April 2016 for those with an income over £150,000. Increases in the Personal Allowance in recent years have also led to a decrease in the share of pensions tax relief which goes to those with an income below £19,999.<sup>14</sup>

In 2016, the Pensions Policy Institute said that - despite the effect of auto-enrolment, and only 17% of all taxpayers being higher or additional rate taxpayers - it expected 65% of tax relief to be spent on them in 2018:<sup>15</sup>

**Table 1.3: The projected distribution of tax relief by the marginal rate of pension tax relief in 2018 under the current system of tax relief (£billions, current earnings terms)<sup>15</sup>**

Marginal rate	Amount of tax relief	Proportion
Basic	10.5	35%
Higher	15.7	52%
Additional	4.0	13%
<b>Total</b>	<b>30.1</b>	<b>100%</b>

The Institute for Fiscal Studies (IFS) comments that it is unsurprising that individuals with “a higher current income are, on average, estimated to receive more up-front relief than individuals who have a lower current income.” Focusing only on the proportion of relief on contributions going to higher earners takes no account of the income tax that will eventually be paid on that income. Furthermore, some individuals may have high incomes temporarily and may be making greater pension contributions to benefit from tax-rate smoothing. It argues that the tax

<sup>14</sup> HM Treasury, [Strengthening the incentive to save: a consultation on pensions tax relief](#), Cm 9102, July 2015, para 2.6

<sup>15</sup> PPI, [Future trends in pensions tax relief](#), July 2016

system should treat pension contributions and income in a symmetric way.<sup>16</sup>

### 1.3 Objectives

Successive Governments have set different principles to underpin the system of pension tax relief.

In 2007, the Labour Government said that “a principled and transparent tax regime was crucial to providing the right environment and incentives to encourage long-term saving.” Its approach was underpinned by the following principles:

- generous tax relief is provided to support pension saving to produce an income in retirement. Pension saving is not, however, provided to support pre-retirement income, asset accumulation or inheritance;
- pensions are provided with more favourable tax treatment, compared to other forms of saving, in recognition that they are less flexible than other savings, and are locked away until retirement;
- incentives for employer contributions are provided as it is more efficient for pensions to be provided on a collective basis through the employer; and
- the cost of pensions tax incentives must be affordable and fall within current fiscal projections.<sup>17</sup>

In 2010, the Conservative-Liberal Democrat Coalition Government said the purpose of tax-relieved pension saving was to provide an income in retirement but that individuals should have the flexibility provided that they had sufficient income to avoid exhausting savings prematurely and falling back on the state:

**Box 2.A: Principles for a new tax framework for retirement**

1. The purpose of tax-relieved pension saving is to provide an income in retirement.
2. Any changes to the pensions tax rules should not incur Exchequer cost and should not create any opportunities for tax avoidance.
- 3 Individuals should have the flexibility to decide when and how best to turn their pension savings into a retirement income, provided that they have sufficient income to avoid exhausting savings prematurely and fall back on the state.
4. In line with the EET model, pension benefits taken during an individual’s lifetime should be taxed at income tax rates. The tax-free pension commencement lump sum will continue to be available.
- 5 On death, pension savings that have been accumulated with tax relief should be taxed at an appropriate rate to recover past relief

<sup>16</sup> IFS [Green Budget 2014](#), Chapter 10, p231; IFS, [Green Budget 2015](#), p260

<sup>17</sup> HM Treasury, [Budget 2007](#), HC 342; Chapter Five; See also, HM Treasury and HM Revenue and Customs, [Implementing the restriction of pensions tax relief](#), December 2009, pages 6-9

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given, unless they are used to provide a pension for a dependant.<sup>18</sup>

In April 2015, it introduced reforms, allowing people aged 55 and over greater choice about when and how to draw their defined contribution (DC) pension savings.<sup>19</sup>

The current Government said thought a reformed system should encourage saving and be 'sustainable':

- It should be **simple and transparent**. The government believes that 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.<sup>20</sup>

### Comment

The IFS argues that some incentive needs to be provided to encourage individuals to lock away their savings until they retire but that any such bonus should be tailored to the problem it is trying to solve:

If the issue is that individuals would otherwise actively choose to save too little from society's point of view because of the presence of means-tested benefits, then it would make sense to target the incentive towards those who are likely otherwise to end up on means-tested benefits in retirement. If the issue is a concern that individuals might be saving too little from their own point of view, then it would make sense to target any incentive towards potential undersavers. In both cases, the incentive – relative to EET tax treatment – should be designed in a way that encourages individuals to respond to it (for example, a transparent and simple incentive is likely to be more effective than an opaque and complicated one) and potentially it should only be targeted towards those who are actually likely to respond.<sup>21</sup>

It says the current system – while not flawless - achieves two objectives:

- First, it ensures that, at the personal level, there is no tax on the normal return to saving but any returns in excess of this return are subject to tax. This feature comes from the fact that, if higher returns are generated, a greater amount of tax will be paid on the eventual pension income. In this respect, EET tax treatment works as well as TTE tax treatment.

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<sup>18</sup> [HM Treasury, Removing the effective requirement to annuitise by 75, July 2010](#)

<sup>19</sup> For more detail, see Library Note SN 6897 [Pension flexibilities](#) (July 2015).

<sup>20</sup> HM Treasury, [Strengthening the incentive to save](#), July 2015, Cm 9102

<sup>21</sup> IFS, [Green Budget 2014](#), chapter 10

- Second, it means that individuals who are subject to a higher rate of income tax during part of their working life but subject to the basic rate of income tax during their retirement are able to smooth their income so that they need not end up paying more tax over their lifetime than an otherwise-equivalent individual who receives the same lifetime income in a less variable way. Essentially, an EET regime allows tax-rate smoothing so that changes in the marginal income tax rate can be evened out over the lifetime.<sup>22</sup>

In its response to consultation, PPI noted that there two main reasons why tax relief is given on pension saving, encouraging saving for retirement and avoiding double taxation:

Tax incentives are used to support retirement saving by encouraging individuals to save for their retirement and employers to contribute to pension schemes. The ultimate objective is to ensure that people have enough money to live on once they have retired, limiting the extent to which they rely on the state in retirement. In this way, tax relief looks to compensate people for the fact that they cannot access their money before a particular date and, when they are able to access this money, it must be accessed in a particular way (for instance, they must take it as an annuity or via a Capped Drawdown arrangement).

Tax relief is also designed to help people defer consumption by ensuring that people do not pay tax twice on the same income if they save it to spend in the future; e.g. at the point where they earn the income and when they receive the income in retirement. This centres on the avoidance of double taxation. This is sometimes called a "tax neutral" system, as it is neutral between spending and saving.<sup>23</sup>

The relative importance should determine the structure of relief:

4. These two reasons are not mutually exclusive and are, in some cases, complementary – avoiding double taxation may also incentivise pension saving over other forms of saving. However, the relative importance given to each of these reasons can lead to different conclusions about the best structure for tax relief. An emphasis on avoiding double taxation means that high earning individuals with high marginal tax rates can receive large amounts of tax relief. However, an emphasis on incentivising pension saving to ensure adequacy of retirement income might suggest that limiting relief to high earners (who are more likely to save in the absence of incentives) and targeting incentives on low income individuals could be the most beneficial approach in the long run.<sup>24</sup>

Other issues were incentives for employers and the contribution made to private saving, particularly in an auto-enrolment context:

### **The role of employers**

13. The relative value of pension contributions to employers and employees is likely to be an important determinant of behaviour.

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<sup>22</sup> Ibid

<sup>23</sup> PPI, [Response to HM Treasury consultation: strengthening the incentive to save](#), October 2015; See also PPI, [Tax relief for pension saving in the UK](#), July 2013, p9

<sup>24</sup> Ibid

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In the current system, there is a clear financial benefit to both the employer and employee of an employer making an employer pension contribution, in part due to the tax relief and tax-free lump sum, and in part due to the NIC relief on pension contributions. If there was no longer a clear financial benefit, employers and employees might prefer other methods of remuneration after meeting the statutory minimum requirements of automatic enrolment.<sup>25</sup>

### Government contribution to saving

14. Even if individuals have only limited responses to incentives, tax relief can still be seen within the automatic enrolment framework as a Government contribution to pension saving. Moving to a single rate of tax relief presented as a matched contribution would, depending on the rate used, change the distribution of the Government contribution to pension saving compared to the current system, leading to increased contributions and therefore larger pension funds for basic rate taxpayers, and lower contributions and therefore smaller pension funds for higher rate and additional rate taxpayers. If matching contributions encourage higher levels of participation in workplace pension saving, there may also be a reduction in opting-out.<sup>26</sup>

In their manifestos for the 2015 election, the main political parties with a position on tax relief intended either to restrict relief for higher earners or review the system with a view to doing so:

This will be paid for by reducing the tax relief on pension contributions for people earning more than £150,000 ([The Conservative Party Manifesto 2015](#))

Establish a review to consider the case for, and practical implications of, introducing a single rate of tax relief for pensions, which would be designed to be simpler and fairer and which would be set more generously than the current 20% basic rate relief ([Liberal Democrats Manifesto 2015](#))

We support [...] a review of the pension tax relief available to the wealthiest ([SNP Manifesto 2015](#))

Labour will cut tuition fees from £9,000 to £6,000 a year, funded by restricting tax relief on pension contributions for the highest earners and clamping down on tax avoidance ([Labour Party Manifesto 2015](#))

We will end the unfair 40% plus pensions relief subsidy for higher rate tax payers. (Plaid Cymru 2015 Westminster Election Manifesto)

The Liberal Democrats repeated its commitment in their 2017 manifesto:

Establish a review to consider the case for, and practical implications of, introducing a single rate of tax relief for pensions, which would be designed to be simpler and fairer and would be set more generously than the current 20% basic rate relief.<sup>27</sup>

### For more detail, see

Gov.UK – [Tax on your private pensions](#)

The Pensions Advisory Service – [Tax relief and contributions](#)

HMRC Pension Tax Manual – [Contributions: tax relief for members: methods](#)

TPR – Guidance for employers - [What to consider when choosing a scheme/tax relief](#)

<sup>25</sup> Ibid

<sup>26</sup> Ibid

<sup>27</sup> [Liberal Democrat Manifesto 2017](#);

## 2. Current issues

### 2.1 Renewed calls for reform

In a report published in July 2018, the Treasury Select Committee suggested the Government look at again at whether reforms could be made:

117. There is widespread acknowledgement that tax relief is not an effective or well-targeted way of incentivising saving into pensions. Ultimately, the Government may want to return to the question of whether there should be fundamental reform. However, the existing state of affairs could be improved through further, incremental changes. In particular, the Government should give serious consideration to replacing the lifetime allowance with a lower annual allowance, introducing a flat rate of relief, and promoting understanding of tax relief as a bonus or additional contribution.<sup>28</sup>

This was followed by speculation, in advance of the Budget on 29 October, that further reductions in tax relief might be announced – for example, by cutting the annual allowance or lowering the rate of relief.<sup>29</sup>

However, in its response to the Treasury Select Committee, the Government said no consensus for either incremental or radical reform had emerged since the [2015 consultation](#):

At summer Budget 2015, the government consulted on whether there was a case for reforming pension tax relief to strengthen incentives to save and offer greater simplicity and transparency, or whether it would be best to retain the current system. The four principles used to assess the options were:

- Simplicity and transparency – to encourage greater engagement with pension saving and strengthen the incentive for individuals to save into a pension
- Personal responsibility – so individuals are responsible for ensuring they have adequate savings for their retirement, to encourage them to save during their working lives to meet their retirement aspirations
- Build on automatic enrolment – so individuals are encouraged to save more
- Sustainability – and in addition it should be in line with the government's long-term fiscal strategy.

The consultation showed there was no clear consensus on reforming pensions tax relief in a way that met the four principles set out above. The government is also aware that any changes to the pensions tax relief regime could have significant impacts for pension schemes, employers and individuals. While the government keeps all taxes under review, no consensus for either incremental or more radical reform of pensions tax relief has emerged since the consultation in 2015.

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<sup>28</sup> Treasury Select Committee, [Household finances: income, saving and debt](#), 19<sup>th</sup> report of 2017-18

<sup>29</sup> Pension tax relief cut will fund NHS, *The Daily Telegraph*, October 2018

However, the government has made important changes recently. From 6 April 2016 the government restricted the Annual Allowance on tax relieved pension savings for those with an income over £150,000. At the same time, the government reduced the Lifetime Allowance for tax relieved pension savings from £1.25 million to £1 million. In order that this benefit is not eroded over time, in April 2018 the Lifetime Allowance increased in line with CPI, as confirmed at Autumn Budget 2017. This means for 2018–19 the Lifetime Allowance increased to £1,030,000. These changes allow savers to continue to make significant pension savings tax-free, while ensuring sustainability of public funds, and that incentives to save are targeted across society.<sup>30</sup>

### 2.2 Net pay and relief at source

The principle of the current system of tax relief is that contributions to pensions are exempt from tax when they are made, but taxed when they are paid out to the individual.

The principle of the current system of tax relief is that contributions to pensions are exempt from tax when they are made, but taxed when they are paid out to the individual. Pension contributions made by individual employees are usually paid out of pre-salary, so tax relief is received at the individual's marginal tax rate.

There are two ways to administer tax relief on pension contributions:

- "Net Pay" takes pension contributions before tax has been paid, so people automatically receive tax relief at their correct marginal rate;
- "Relief at Source" where contributions are deemed to have had tax at the basic rate deducted and the pension scheme then claims the relief from HMRC.

According to a recent report, the vast majority of occupational pension schemes operate on a net pay basis while traditionally, contract-based schemes have operated on a RAS basis.<sup>31</sup>

#### Non-taxpayers

As Gov.Uk explains, non-taxpayers can benefit from tax relief but only if their pension scheme operates 'relief at source' arrangements.

##### **If you don't pay Income Tax**

You still automatically get tax relief at 20% on the first £2,880 you pay into a pension each tax year (6 April to 5 April) if both of the following apply to you:

- you don't pay Income Tax, for example because you're on a low income
- your pension provider claims tax relief for you at a rate of 20% (relief at source)<sup>32</sup>

<sup>30</sup> [Household finances: income, saving and debt: Government Response to the Committee's Nineteenth Report](#), HC 1627, October 2018

<sup>31</sup> '[Campaigners press government for action on pension tax relief](#)', LITRG press release, 5 October 2018

<sup>32</sup> Gov.UK [Tax on your private pension contributions](#)

Concerns have been raised that this is unfair to low earners in net pay arrangements, particularly given that they had no influence over the choice of scheme and may have been encouraged into auto-enrolment on the basis that, as well as their own contribution, their employer and the government will pay in. The Low Income Tax Reform Group estimates, based on HMRC figures, that in the 2015/16 tax year, 1.22 million in net pay arrangements received no tax relief on their pension contributions because they were non-taxpayers. It thinks this figure will have increased significantly, with the roll-out of auto-enrolment and increases in the income tax personal allowance.<sup>33</sup>

In response to PQs, the Government has indicated that the type of scheme is a choice for employers – one on which the Pensions Regulator provides guidance:

Stephen Barclay: No estimate has been carried out on the cost of providing tax relief for non-taxpayers enrolled in net-pay schemes. Legislation determines the difference between net-pay and relief-at-source systems, and ultimately, it is for pension schemes to choose which to apply. To help employers choose an appropriate pension scheme, The Pensions Regulator offers guidance, including information on the different methods by which tax incentives are obtained.<sup>34</sup>

In its 2017 review of auto-enrolment, the Government said that it had not been possible to identify a straightforward or proportionate solution so far but that this might change as tax administration is digitised:

To date, it has not been possible to identify any straightforward or proportionate means to align the effects of the net pay and relief at source mechanisms more closely for this population. The government is currently increasing the data provided directly to HMRC as part of our ambition for HMRC to become one of the most digitally advanced tax administrations in the world. The government is already committed to ensuring we can deliver a modern digital tax system to make it more effective, more efficient and easier for customers to comply and reduce the amount of tax lost through avoidable error. This may present opportunities to look afresh at the two systems of paying pension tax relief. Alongside further work on the automatic enrolment changes in this report, the government will examine the processes for payment of pensions tax relief for individuals to explore the current difference in treatment and ensure that we can make the most of any new opportunities, balancing simplicity, fairness, and practicality. We will also engage with stakeholders to seek their views.<sup>35</sup>

A letter to the Chancellor of the Exchequer in advance of the 2018 Budget, signed by former pensions Ministers, Steve Webb and Ros Altmann and organisations including Age UK and the Low Income Tax Reform Group argued that action on the issue was becoming

<sup>33</sup> LITRG, [Budget 2018 representation. Net pay arrangements for lower paid workers](#), September 2018

<sup>34</sup> [PO 10359, October 2017](#)

<sup>35</sup> DWP, [Automatic Enrolment Review 2017: Maintaining the Momentum](#), Cm 9546, December 2017, p47-48



increasingly important with the increase in minimum auto-enrolment contributions:

Under net pay arrangements, the pension contribution is deducted before the tax is calculated. In RAS arrangements, the pension contribution is deducted after tax is calculated and HMRC later sent the tax relief, at the basic rate (20%) to the pension scheme.

[...]

Somebody earning £11,850, paying auto enrolment minimum contributions, is missing out on £34.91 in the current tax year. By 2020/21, when the personal allowance is expected to have risen to £12,500 (and the minimum contribution rate has also risen to 5%), affected savers could miss out on nearly £65 per year.<sup>36</sup>

They argued that savers should automatically pension tax relief, regardless of the type of pension arrangement, without having to ask HMRC for it. They urged the Chancellor to legislate for a solution in the Finance Bill and to use the system of changes already underway in HMRC to tackle the devolution problem.<sup>37</sup>

In its Budget 2018 representation, LITRG said it thought it had found a solution, by using HMRC's Pay As You Earn Real Time Information:

1.8 We now believe we have found such a solution, which would see HMRC using Pay As You Earn (PAYE) Real Time Information (RTI) data to identify those making pension contributions under net pay arrangements. They could then provide tax relief (where appropriate) through an annual reconciliation process – whether that is through self-assessment or – as is more likely – the informal P8002 process.

1.9 As part of the P800 'solution', HMRC would have to look at an individual's total income, the amount of pension contributions paid and the amount of tax free allowances due (information that is readily available to them), in order to identify the amount of unrelieved pension contributions. This amount would then become eligible for a 20% tax refund. We enclose as an Appendix, a graphic showing how this solution would work in practice.

1.10 The change could be effected by a simple amendment to s23 *Income Tax Act 2007*,<sup>3</sup> cross referring to some amended provisions in Chapter 4 of *Finance Act 2004*.<sup>38</sup>

According to the *Financial Times*, the Government is "looking at the opportunities provided by the move to a modern digital tax system to tackle any differences of treatment in provision of tax relief for pensions."<sup>39</sup>

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<sup>36</sup> ['Campaigners press government for action on pension tax relief'](#), LITRG press release, 5 October 2018

<sup>37</sup> Ibid

<sup>38</sup> LITRG, [Budget 2018 representation. Net Pay Arrangements for lower paid workers](#), September 2018

<sup>39</sup> ['Treasury to tackle pensions anomaly'](#), *FT Adviser*, 10 October 2018; 'UK to tackle pension anomaly hitting 1.2 m low earners', *Financial Times*, 10 October 2018 (£)

## Scottish rates of income tax

The [Scotland Act 2016](#) provided the Scottish Parliament with the power to set income tax rates and bands (except the personal allowance) for Scottish taxpayers non-savings and non-dividend income, although HMRC remains responsible for its collection and management. The rates for 2018/19 are in the table below: <sup>40</sup>

Bands	Band name	Rates (%)
Over £11,850-£13,850	Starter rate	19
Over £13,850-£24,000	Basic rate	20
Over £24,000-£43,430	Intermediate rate	21
Over £43,430-£150,000	Higher rate	41
Above £150,000	Top rate	46

This has implications for Scottish taxpayers who pay income tax above the basic rate and whose providers operate the “relief at source” arrangement. In a newsletter of February 2018, HMRC explained that for 2018/19, they have the option of completing a self-assessment tax return or contacting HMRC. It would continue to work with the Scottish Government for a longer-term solution:

### For the tax year 2018 to 2019

#### Net pay

Members of pension schemes who get pension tax relief through the ‘net pay’ mechanism have their pension contributions deducted before Income Tax is applied to their pay, so only pay tax on what’s left. Pension tax relief on these contributions will continue to be given by default at members’ marginal rate of tax, including the new and newly increased Scottish rates.

#### Relief at source

If you are the administrator of a pension scheme using the relief at source mechanism, you will continue to claim tax relief at the rate of 20% for members who are Scottish taxpayers.

For pension scheme members who are Scottish taxpayers liable to income tax at no more than the Scottish starter rate of 19%, or who pay no tax, current tax rules will continue to apply. This means that scheme administrators will continue to claim relief at 20% in respect of these individuals, and HMRC will not recover the difference between the Scottish starter and Scottish basic rate.

Pension scheme members who are Scottish taxpayers liable to income tax at the Scottish intermediate rate of 21% will be entitled to claim the additional 1% relief due on some or all of their contributions above the 20% tax relief paid to their scheme administrators.

These pension scheme members will be able to claim the additional relief for 2018 to 2019 by [contacting HMRC](#) if they

<sup>40</sup> – See [Scottish Government website – Scottish income tax 2018/19](#). The rates for 2018/19 are:

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don't already complete Self-Assessment returns, or through their [return](#) if they do. HMRC will engage with stakeholders to help affected members claim this additional tax relief.

Pension scheme members who are Scottish taxpayers liable to Income Tax at the Scottish higher rate (41%) and Scottish top rate (46%) will be able to claim additional relief on their contributions up to their marginal rate of tax in the usual way, either in their [Self-Assessment tax return](#) or if they don't complete a tax return by [contacting HMRC](#).

### **After 2018 to 2019**

We'll continue to explore the most appropriate way to cater for the new income tax rates and bands announced by the Scottish Government, as well as future changes by the devolved administrations.

To this end, HMRC will continue to engage with stakeholders to help establish an approach for the longer term.<sup>41</sup>

The National Audit Office explains that changes are planned to "relief at source" arrangements and that "until the new system is in place, HMRC is responsible for calculating any shortfall or excess payment given to Scottish taxpayers."<sup>42</sup>

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<sup>41</sup> HMRC, [Pension schemes relief at source for Scottish Income Tax newsletter – February 2018](#); [Gov.UK – Tax on your private pension contributions](#)

<sup>42</sup> NAO, [The administration of the Scottish Rate of Income Tax 2016-17](#), November 2017, para 3.40

## 3. 2015 Consultation

### 3.1 The case for change

The Government launched a consultation on reforming pension tax in July 2015. Its objectives were to improve incentives and contain costs:

1.3 Longevity has also changed the way that pensions are provided. In the private sector, employers are now less likely to offer a defined benefit pension scheme to new employees and instead are frequently turning to defined contribution pensions. This has changed the way that the pensions industry is structured and consumer expectations of how pensions should be provided.

[...]

1.4 Increasing longevity and changes in pension provision therefore provide the context for considering whether there is a case for reforming pensions tax relief. As our society continues to age, it will become increasingly important for government to ensure that all individuals are supported to save for their retirement by offering clear, simple and transparent incentives. However, in the context of the deficit and the continuing press on public finances, it will also be important to ensure that this support is sustainable for the longer term.<sup>43</sup>

### Savings incentives

On incentives, the Government cited research by the Pensions Policy Institute (PPI) suggesting that “for lower income groups tax relief is not an important determinant in people’s decision to save.” Trends in workplace pension saving made it increasingly important to ensure the right incentives were in place. This is because auto-enrolment is increasing the numbers saving in a pension. However, the majority are being auto-enrolled into a defined contribution (DC) scheme, increasing the importance of ensuring they are contributing enough to achieve an adequate income in retirement.<sup>44</sup> DWP analysis in 2014 suggested that almost half of adults below State Pension age are not saving enough for their retirement.<sup>45</sup>

A 2013 report from the PPI found that the evidence around the effectiveness of tax relief as an incentive was limited. However, some inferences could be drawn:

Evidence around the effectiveness of tax incentives in encouraging pension saving is limited. However the literature enables some understanding around the effectiveness of tax relief as well as reasons why tax relief is not effective. There are some issues which relate directly to the tax relief system:

- Lack of understanding around tax relief.
- People redirect money from savings into a pension, rather than increase their savings overall.

<sup>43</sup> HM Treasury, [Strengthening the incentive to save: reforming pension tax relief](#), Cm 9120, July 2015, Foreword

<sup>44</sup> Ibid para 1.24; DWP, [Scenario analysis of future pension incomes](#), August 2014

<sup>45</sup> DWP, [Scenario analysis of future pension incomes](#), August 2014

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- Higher earners, who may be more likely to save, are more likely to respond to incentives.
- Tax relief has not led to enough saving to close the 'Savings Gap'.

There are some more general barriers to pension saving, which an effective incentive system would need to overcome:

- People have insufficient income to make pension savings.
- Lack of understanding around pensions.
- Issues related to the current design and delivery of pensions.
- Inertia.<sup>46</sup>

In its response to the current consultation, it argued that a large fiscal incentive was not necessarily enough in itself to change behaviour. However, if an incentive was not easily understood, individuals would not be able to respond to it. There was some evidence that matching contributions affected behaviour:

10. The evidence surrounding the potential behavioural changes in response to changes in tax relief is limited, and where there is evidence of changes in behaviour in response to changes in rates of return, responses are usually relatively small.

11. As highlighted by the lack of impact on pension saving of the current system, providing a large fiscal incentive is not necessarily enough in itself to change behaviour. If the incentive is not clear, well defined, or easily understood, individuals cannot respond to it. Even if it is clear, individuals will not necessarily respond in the way that might be expected.

12. There is some evidence to suggest that such matching contributions do affect behaviour, in the context of US pension saving and in other savings policy areas in the UK. This might be easier with a single rate of matching than, for example, in the current system where the match depends on the tax band of the individual. Presenting the current system as a match could also lead to questions as to why higher earners receive a higher match, and the technical explanations might be hard to get across to individuals.<sup>47</sup>

The Pensions and Lifetime Savings Association (previously the National Association of Pension Funds) argues that looking at tax relief in isolation could be counter-productive and that the Government should focus on auto-enrolment:

The NAPF shares the Government's desire to get more people saving more for their retirement but warns there are significant risks associated with a move to either TEE or a single rate. Instead, the NAPF urges the Government to focus its efforts on securing and building on the success of Automatic Enrolment as we reach the crucial point for millions of small employers starting to enrol their employees for the first time.

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<sup>46</sup> Ibid, p24

<sup>47</sup> PPI, [Response to HM Treasury consultation: strengthening the incentive to save](#), October 2015

The NAPF argues that, over the long term, a move to a pensions tax regime of either 'taxed, exempt, exempt' (TEE) or a single rate jeopardises both pension saving and the tax revenues of future governments. Furthermore, separating DB from DC, while initially appealing, is impractical and will introduce more complexity over time. No change to the system is the most appropriate solution if we want to continue to: support automatic enrolment; sustain employer engagement in pensions; allow low earners to benefit from cross-subsidies from higher earners in schemes; deliver private incomes in later life; and protect future governments against increased dependency on the state.

While the Chancellor may raise more tax revenue in the short term by a change to pension tax but there is no evidence to show that savers would save more or take greater personal responsibility for their incomes in retirement as a result of further changes to the system.

Therefore, a review which seeks to address tax relief in isolation can only provide a partial answer. Worse, it risks being counterproductive if it overlooks the unintended consequences in other parts of the ecosystem which supports retirement income and planning. **We urge the Government quickly to follow this consultation with a thorough, independent review of pensions and retirement policy in the round so that we can seek sustainable solutions which continue the alignment of Government (both current and future), savers, employers, industry and broader society which has driven the success of automatic enrolment so far.**<sup>48</sup>

## 3.2 Response - Budget 2016

In Budget 2016, the Chancellor did not announce any fundamental change to the tax treatment of pension on the grounds that there was 'no consensus'.<sup>49</sup>

Response were mixed. The Pension and Lifetime Savings Association, for example, described "no change" as the right decision.<sup>50</sup> However, Mick McAteer of the Financial Inclusion Centre said it was disappointing that the Government had stepped away from "the clear inequality in our pension system."<sup>51</sup> Dot Gibson of the National Pensioners Convention agreed, saying the Chancellor had "wasted a golden opportunity to not only reform the unfair system of pension tax relief, but at the same time solve the funding crisis in social care."<sup>52</sup>

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<sup>48</sup> [Strengthening the incentive to save: an NAPF response](#), October 2015

<sup>49</sup> [HC Deb 16 March 2016 c96](#)

<sup>50</sup> [Pensions and Lifetime Savings Association comments on early reports of 'no change' to pension tax relief in 2016 Budget, 4 March 2016](#)

<sup>51</sup> ['Osborne scraps pension tax relief shake-up', \*Financial Times\*, 6 March 2016 \(f\)](#)

<sup>52</sup> [Pensions: George Osborne drops plans to cut tax relief, BBC News, 5 March 2016](#)

## 3.3 Issues debated

### A single rate of relief

One option for reform is that tax relief on contributions should be provided at a single rate (rather than at the individual's marginal rate), possibly recast as a matching government contribution.

#### Advantages

Advocates of such an approach argue that it could improve incentives to save for lower earners and – particularly if recast as a 'matching contribution' from the Government – could make the incentives much clearer. For example, in its Second Report published in 2005, the Pensions Commission said a single rate of relief, recast as a government "matching contribution" had significant attractions in principle:

This proposal clearly has significant attractions in principle. It would improve rational incentives to save via pensions (individually or via employer contributions) for many lower income people who are currently accruing inadequate pensions. It would also make these incentives much clearer; people would be far more likely to understand the benefit offered.<sup>53</sup>

In response to the Government's recent consultation, the ABI called for a single rate of relief – badged as a Savers' Bonus:

A single rate will be easier to communicate than the current system, ensuring people understand the tax benefit of saving into a pension. It is well established that matching contributions are the most effective incentive for increasing pension participation and contribution rates, as loss aversion means people save so as not to miss out on them. Following the example of the Automatic Enrolment advertising to make the Savers' Bonus as visible at the matched employer's contribution could therefore have a powerful impact.<sup>54</sup>

This approach was supported by the Low Income Tax Reform Group (LITRG), which argued it would improve incentives for those on low incomes:

LITRG therefore proposed a standard rate of tax relief for all of 33.3% in order to incentivise those on low incomes in particular to set aside money for later years and possibly a top-up at age 30 to encourage an early start to the savings habit, vital to accumulate the pension pot needed to support maybe 30 years of post-employment life. The competing demands of starting work at the bottom of the salary scale, repaying student loans, saving for the deposit for a house and starting a family make saving for the far-distant years of retirement a low priority and in many cases an impossibility when there simply is no spare money after the basic bills have been paid.<sup>55</sup>

And could simplify aspects of the system:

Doubtless Governments would be keen to apply an annual cap to avoid an open-ended drain on the public purse [...] The connection, however, between the amount contributed and the

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<sup>53</sup> Pensions Commission, [A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission](#), November 2005, p318

<sup>54</sup> ABI, [A Savers Bonus](#), October 2015

<sup>55</sup> LITRG, [Strengthening incentives to save for pensions](#), 29 October 2015

state top-up would be much clearer if annual statements showed savers' contributions and Government additions separately and in aggregate. [...] **It would also render unnecessary the complex structure of lifetime allowances, annual allowances, tapering allowances, individual protection and the uncertainty of the ultimate valuation of both DB & DC pensions pots.**<sup>56</sup>

Other supporters of the policy included former Pensions Minister Steve Webb and former Financial Secretary to the Treasury Mark Hoban.<sup>57</sup>

Citizens Advice said a flat rate of 33% would be an improvement but questioned how much it would do to deliver incomes in retirement:

Moving to a flat rate tax relief of, say, 33% would be an improvement on the current system. It would increase rewards for basic rate taxpayers while ensuring that higher rate earners are not taxed more for paying into pensions than taking money up front as income. However, we question how much this reform would in itself drive changes in behaviour to deliver genuinely adequate incomes in retirement.<sup>58</sup>

### Disadvantages

On the other hand, there were those who argued that it would be expensive to administer, unfair and inappropriately distort behaviour.

PPI explained some of the complexities in providing tax relief at a flat-rate, particularly for defined benefit (DB) schemes:

While it is relatively straightforward to give tax relief at an individual's marginal rate, it is more difficult to give tax relief at a single rate. It would be difficult to operate Net Pay Arrangements with a single rate of tax relief. In such cases employers could use alternate arrangements, which might require them to make changes to their payroll software. Alternately a compensatory mechanism could be used, for instance changes to the employee's PAYE code or the requirement for them to pay or claim back outstanding tax through the Self-Assessment system.

It would also be more difficult to implement for Defined Benefit pensions. In a Defined Benefit scheme, contributions are paid by the employer and employee into a common fund, which is invested to provide all retirement benefits. In the current system, unless there is a risk of the deemed contribution – an estimate of the increase in the individual's Defined Benefit pension entitlement in the previous year - for an individual exceeding the Annual Allowance the deemed contribution is not calculated. A single rate would require the employer to calculate the deemed contribution for a larger number of employees. As the deemed contribution is based on the increase in value of the fund, the deemed contribution and the extra tax may not bear any resemblance to the employer's and employee's contributions

<sup>56</sup> LITRG, [Strengthening Incentives to Save for Pensions – Response for the Low Incomes Tax Reform Group \(LITRG\)](#), October 2015

<sup>57</sup> 'Call for 33% flat rate pension tax relief', *Financial Times*, 12 February 2015' See also, 'Pensions minister floats standard rate of tax relief', *Financial Times*, 17 April 2014; 'Scrap higher-rate pensions tax relief, says senior Tory', *Financial Times*, 25 February 2015

<sup>58</sup> Citizens Advice, [Strengthening the incentive to save: a consultation on pensions tax relief](#), 29 September 2015



made on behalf of that employee. As such, this system may not appear transparent to pension savers, and could reduce the attractiveness of pension saving to employers and employees if they face higher income tax payments and more complexity.<sup>59</sup>

PLSA argued the pension system is too complex to be used for the purposes of redistribution.<sup>60</sup> Complexities included the fact that members of defined benefit (DB) schemes would “need to be provided with a statement at the end of the year showing the deemed value of their pension contributions.”<sup>61</sup> Furthermore, it would probably require all employers to move to a ‘relief at source’ arrangement:

Implementing a single rate through net pay would be extremely complex and perhaps unworkable through payroll systems and scheme administration systems. This would bring about the same changes to payroll and costs to employers identified under TEE above. Employees would see their pension contributions initially reduced by tax.<sup>62</sup>

It said that little work has been done on how to apply a single-rate to the employer contribution, which would be “necessary to avoid unfairness and arbitrage.” It says the Government would need to:

[...] undertake a thorough analysis if there is any intention of changing the tax basis for DB pensions. What is clear is that most, if not all, DB schemes that remain open to future accruals and that have the ability to do so would close altogether.<sup>63</sup>

The IFS argued that restricting the rate of relief on pension contributions would undermine the logic of pension taxation and would be complex, unfair and inefficient. On the fairness point, it said the current system allowed smoothing over the lifetime:

In particular, allowing those who are subject to a higher rate of income tax during part of their working life but subject to the basic rate of income tax during their retirement to smooth their income is fair in the sense that it would be unfair for them to pay more tax over their lifetime than an otherwise-equivalent individual who has an income that, on average, is at the same level but which is less variable.<sup>64</sup>

### Impact on individuals

The PPI pointed out that the gains and losses to different groups of a single rate of relief would depend on the rate at which it was set.<sup>65</sup> It looked at the outcomes of different flat rates of relief, compared to the current system for individuals in different scenarios – saving from different ages at different rates of pay. It found that:

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<sup>59</sup> PPI, [Tax relief for pension saving in the UK](#), July 2013, p48

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<sup>61</sup> NAPF, [Strengthening the incentive to save: a consultation on pension tax relief – A response by the National Association of Pension Funds](#), September 2015 p15

<sup>62</sup> Ibid

<sup>63</sup> NAPF, [Strengthening the incentive to save: a consultation on pension tax relief – A response by the National Association of Pension Funds](#), September 2015

<sup>64</sup> IFS [Green Budget 2014](#)

<sup>65</sup> PPI, [Tax relief for pension saving in the UK](#), July 2013, Executive Summary

- Individuals who are basic rate taxpayers through their working life tend to do better under a single tier which offers tax relief at greater than 20%.
- Higher rate taxpayers derive a lot of value in their pension from the 40% tax relief. An EET system with a reduced level of tax relief will leave them worse off.<sup>66</sup>

LITRG argued that a single rate of 33.3% would strike the right balance:

2.4 Fairness to all and control of public expenditure would be best met by a flat-rate tax relief on pensions contributions regardless of the level of income or employment status of the saver. A 33.3% rate would be an encouraging lift to the basic rate taxpayer while not depressing unduly the contributions of the higher rate taxpayers. It would abolish the complex apparatus of controls and limits currently deployed against higher earners while leaving largely unchanged the system for granting tax relief, thus avoiding costly developments for employers and pension schemes. EET would remain the core principle.<sup>67</sup>

### Exchequer impact

As the IFS pointed out, the rate chosen would determine tax revenues:

It would be possible to design the flat-rate relief in such a way that it reduced revenues in both the short and long runs – for example, if the flat rate of relief were set at a fairly high level. However, the Treasury’s consultation suggests that it is looking to make net exchequer savings, suggesting that this is an unlikely outcome.<sup>68</sup>

The impact on revenues in the longer term was more uncertain:

If lower- and middle-income individuals end up having larger pension pots (for example, because they choose to save more or just because of the higher amount of up-front tax relief), then tax revenue on the resulting pension would increase. But if higher-income individuals end up having smaller pension pots (due to them saving less or just because they received less up-front tax relief), then this would result in less tax revenue on the resulting pension. Any impact on household saving and spending decisions would also impact upon future indirect tax revenues.<sup>69</sup>

In October 2015, the Association of British Insurers (ABI) said its modelling showed that:

[...] a flat rate of anywhere between 25% and 33% applied to defined contribution (DC) alone could yield sustainable savings of around £1.3bn per annum when coupled with adjustments to the Annual Allowance.<sup>70</sup>

In 2016, the Pensions Policy Institute estimated that, where a 30% flat rate was broadly cost neutral before auto-enrolment, following it a 30% flat rate was more expensive than the current system. The proportion of

<sup>66</sup> PPI, [Comparison of pension outcomes under EET and TEE tax treatment](#), October 2015

<sup>67</sup> [Strengthening incentives to save for pensions](#), Low Incomes Tax Reform Group, 29 September 2015; [Strengthening Incentives to Save for Pensions – Response from the Low Incomes Tax Reform Group](#), October 2015

<sup>68</sup> IFS, [Green Budget 2016](#), February 2016, p118-9

<sup>69</sup> IFS, [Green Budget 2016](#), February 2016, p119

<sup>70</sup> ABI, [A Savers Bonus](#), October 2015

tax relief that would go to basic rate taxpayers would increase if the rate of relief were flat. If a flat rate system was to be put in place at a level between basic and higher rate taxation, it could relatively incentivise pension saving in basic rate tax payers and relatively dis-incentivise pension saving in higher rate tax payers when compared to the current system.<sup>71</sup>

### TEE

Another option considered was to move to from the current EET (where contributions and investment returns are tax exempt but pension income is taxed) to a TEE system in which contributions are taxed upfront and then topped up by the government but pension income is exempt from tax. The Government's consultation paper said:

[...] this may allow individuals to better understand the benefits of contributing to their pension as the government's contribution might be more transparent, and they would no longer need to consider the future tax implications of their pension choices or work out how much their pension pot is worth given their expected tax rate in retirement. Equally, others have argued that the current system, where no tax is due on pension contributions while working but tax is paid in retirement, is simple for individuals to understand and also provides an incentive to leave money in their pension pot.<sup>72</sup>

Reform along these lines had been proposed by the Centre for Policy Studies in 2014:

1. Pension contributions from employers should be treated as part of employees' gross income, and taxed as such.
2. Tax relief on pension contributions should be replaced by a Treasury contribution of 50p per £1 saved, up to an annual allowance, paid irrespective of the saver's taxpaying status.
3. ISA and pension products should share an annual combined contribution limit of £30,000, available for saving within ISA or pension products (or any combination thereof). This would replace the current ISA and pensions tax-advantaged allowances.
4. The 25% tax-free lump sum should be scrapped, with accrued rights to it protected.
5. The Lifetime Allowance should be scrapped. It adds considerably complexity to the pensions landscape, and with a £30,000 combined contributions limit for pensions and ISAs, it would become less relevant over time.
6. The 10p tax rebate on pension assets' dividend income should be reinstated.
7. People should be able to bequeath unused pension pot assets to third parties free of Inheritance Tax (perhaps limited to £100,000), provided that the assets remained within a pensions framework.
8. The annual allowance should be set at £8,000, with prior years' unutilised allowances being permitted to be rolled up, perhaps over as much as ten years, all subject to modelling confirmation.<sup>73</sup>

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<sup>71</sup> PPI, [Future trends in pension tax relief](#), July 2017

<sup>72</sup> [Cm 9102](#), July 2015 para 3.12

<sup>73</sup> [Retirement savings incentives: the end of tax relief and a new beginning](#), Centre for Policy Studies, 2014

It argued that the current tax-based incentives for pension saving were expensive, had failed to stimulate a broad-based retirement savings culture and represented a “huge subsidy for the pensions industry”. It said international evidence showed that default policies are far more effective for broadening retirement savings. Its proposed reforms would:

[...] boost the efficacy of the Treasury spend; to achieve a much broader distribution of retirement savings; and to increase the size of the nation’s pool of savings.<sup>74</sup>

In a further note published in advance of Budget 2016, the Centre for Policy Studies argued that a 50p incentive per incentive per post-tax £1 saved within a Lifetime ISA framework, combined with other changes:

Ending NICs relief (and snaring salary sacrifice schemes in the process) would be the most simple and politically expedient reform, saving perhaps some £8 billion per year. Introducing any flat rate of Income Tax relief above 20% would, unless accompanied by other cost-saving measures, have to be accompanied by a reduction in the Annual Allowance (from today’s £40,000), to generate a similar saving.

Meanwhile, the Treasury would remain exposed to a ridiculously costly tax arbitrage, as those approaching the age of 55 can flip existing savings into pension pots to collect tax relief, only to then take out the 25% tax-free lump sum at 55. The truth is that retaining *any* form of Income Tax relief is fundamentally incompatible with pensions’ “freedom and choice”, which ended any requirement to annuitise.

The 25% tax-free lump sum should be scrapped in respect of future contributions but, in so doing, there would be minimal fiscal advantage in the near term. One positive consequence would be that this would encourage people to use their entire pension pots to purchase annuities that would be 33% larger than otherwise: potentially significant at this time of low interest rates.

This paper also considers a 50p incentive per post-tax £1 saved embedded in a Lifetime ISA framework incorporating a Workplace ISA for employer contributions. This would provide the simplicity and flexibility that savers crave: a single savings vehicle capable of meeting almost everyone’s short-term and long-term saving requirements from cradle to grave.

The Lifetime ISA, detailed herein, combines some ready access to contributions with an up-front incentive, leaving the saver in control. A modest annual allowance, sufficient to accommodate at least 90% of the population’s savings capabilities, would facilitate cost control, while leaving scope for the Treasury to save some £10 billion per annum.

The Lifetime ISA would meet the Government’s four principles behind any reform of pensions tax relief, as detailed in its consultation document.<sup>75</sup>

Critics of the approach argued that it has significant shortcomings – that it would be very complex in transition, could undermine pension saving and have a negative fiscal impact.

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<sup>74</sup> Ibid

<sup>75</sup> Centre for Policy Studies, [The 2016 Budget: Pensions](#), 18 February 2016

### Complexity in transition

An ABI factsheet set out '[ten reasons not to move to Pension ISA](#)'. One of its concerns was that the transition to the new system would be complex, as for the foreseeable future anyone who already had pension savings would have a "confusing mixture of taxed and untaxed pension income when they come to retire". Furthermore:

- A move to a TEE system for pensions would be both very costly and time consuming to implement. For pension providers alone, costs are likely to be in the hundreds of millions for the system changes necessary for employers, payroll providers and the pensions industry are such that the implementation timeline would risk stretching over two parliaments.
- More concerned than the build cost is the creation of EET legacy system which will need to be serviced for decades. For example, a 22-year old who already has a workplace pension through AE would open an additional pension account under TEE, and both would run in parallel until their retirement.<sup>76</sup>

The PLSA said there would need to be "two, possibly three, different systems being applied to legacy and future benefits", entailing cost and complexity for schemes and savers:

Unless a way can be found to 'grandfather' legacy arrangements to the new tax system through some type of tax amnesty or tax-advantaged transfer, schemes will also have to make changes to their administration systems to accommodate running both the legacy accounts under EET and new accounts under TEE [...]

42% of NAPF respondents to the survey thought that a move to TEE would bring about a change both to how and where their scheme was administered and changes to the benefits of the scheme. When asked about those changes to benefits, 75% thought that TEE would trigger a change in benefits suggested that employers would respond to the change by reducing contributions and offering either cash or other benefits in their place.<sup>77</sup>

It was particularly concerned about the impact on DB schemes:

While TEE is complicated, costly and appears to have largely negative consequences for retirement savings, they pale into insignificance in comparison to the challenge that would be faced by DB schemes (open to any future accruals) and their employer sponsors. TEE would be technically possible within DB. However, the way to achieve it would probably involve closing the scheme or section and reopening again with benefits pinned to net pay rather than gross pay. The consequences for employment relations, particularly in the public sector (undermining as it would the public sector deal struck under the previous Government), would be considerable, the costs of closing the schemes and recasting them would be sizeable and the behavioural effects on both employers and employees would be unlikely to be positive.<sup>78</sup>

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<sup>76</sup> ABI, [A Savers' Bonus](#), October 2015; [ABI response to the consultation Strengthening the incentive to save](#), October 2015

<sup>77</sup> NAPF, [Strengthening the incentive to save: a consultation on pension tax relief – A response by the National Association of Pension Funds](#), September 2015

<sup>78</sup> Ibid

## Impact on retirement incomes

Analysis by the PPI found that the impact on individuals depended on the detail:

A pure TEE system without matching contributions is likely to reduce pension outcomes, because, with tax being paid up front, none of the pension is received tax free, and the tax paid is at the individual's marginal rate in work, rather than an average rate after retirement.

Giving a matching contribution on a TEE system is similar to a flat rate EET system in the accumulation phase.

A TEE system with significant matching contributions could increase the outcomes for individuals.<sup>79</sup>

The ABI argued that the change would undermine responsible saving:

- Few people trust future governments to leave their pension savings untouched. In our survey carried out by Populus, only 19% thought future governments could be trusted not to tax future pensions. This lack of trust would undermine their incentive to save on the promise that there will not be tax when they access their pension.
- The current system acts as a brake against people spending their entire pot early in retirement. This is because there is an incentive to spread income over multiple years to reduce the amount of tax payable. Without such a brake, people will be tempted to withdraw all their money as soon as they can, to keep it 'safe', risking poor investment decisions that will reduce the value of their pension and make them more reliant on state support in later life. This tendency will be exacerbated if people perceive the need to keep their money safe from future administrations that might decide to tax pensions in payment.<sup>80</sup>

The PLSA modelled the effect on retirement funds and found that:

The non-taxpayer and the basic rate taxpayer who moves to being a non-taxpayer in retirement are worse off under the TEE system than the current system, assuming no major changes to the tax system. Only people who would pay basic rate tax on their contributions under TEE or basic rate tax on their fund in retirement (after taking the tax free cash) would receive the same outcomes under both systems.<sup>81</sup>

It was also concerned about the behavioural response, which would depend on a number of factors – such as how the change was reported and how employers and pension schemes respond. The outcome of its modelling led it to conclude that:

[...] a change to TEE will lead to lower levels of retirement saving. The scale of this change is difficult to predict but it is feasible that savings will gravitate towards the statutory minimum for automatic enrolment.<sup>82</sup>

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<sup>79</sup> PPI, [Comparison of pension outcomes under EET and TEE tax treatment](#), October 2015

<sup>80</sup> ABI, [A Savers' Bonus](#), October 2015

<sup>81</sup> NAPF, [Strengthening the incentive to save: a consultation on pension tax relief – A response by the National Association of Pension Funds](#), September 2015

<sup>82</sup> Ibid

### Fiscal impact

The IFS argued that moving to TEE tax treatment has “much more dramatic consequences for the profile of tax revenues and poses significant political risks”:

Moving to a system in which contributions are taxed up front rather than on receipt would dramatically boost tax revenues in the near term. But levying this income tax up front would come at the expense of a reduction in revenues in the future, as the government will no longer collect income tax on these pensions in payment.

The extent to which the net increase in tax is permanent rather than temporary would depend on a number of factors, including the extent to which people face lower marginal tax rates in retirement than when they make their pension contributions and future investment returns. If the tax rates some individuals face in retirement are lower than those they faced when their pension contributions were made and if there were no excess returns, then at least part of the higher revenues raised in the short term from a move to TEE would be a permanent gain. If there were excess returns (but no tax-rate smoothing), then a move to TEE would lose the government revenue over the longer run.

The longer-run cost would also depend on the size of any new tax incentives offered to all those saving in pensions compared with what is currently available. Under the current EET income tax system, the incentive offered takes the form of the tax-free lump sum. Under a TEE income tax system, the incentive could take the form of an up-front government top-up. If the new incentive is less generous than the old one, then part of the additional revenues raised in the short run would be permanent.

The government estimates that up-front income tax relief on pension contributions totalled £27.0 billion (£6.8 billion on individual contributions and £20.2 billion on employer contributions) in 2013–14. However, much of this will be recouped in future from income tax received when private pension incomes are drawn. In 2013–14, £13.1 billion of income tax was paid on income received from private pensions. This figure gives some feel for how much of the up-front tax relief might be only temporary, though in practice future growth in the pensioner population is likely to push this number up. If the government also wanted to introduce a significant up-front top-up, then it would be quite possible that the vast majority of any additional income tax revenues raised in the short term would be temporary rather than permanent.<sup>83</sup>

The ABI argued that there would be a negative fiscal impact:

- Independent modelling conducted by the National Institute of Economic and Social Research (NIESR) for the ABI predicts that the negative macroeconomic consequences of moving to a TEE system would be significant, with a reduction in GDP, savings, productivity and real wages, while real interest rates would be expected to increase.
- This is because a TEE system shifts the tax burden away from pensioners and onto the working age population whose budget constraints are tightest, meaning they have fewer resources to split between consumption and saving,

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<sup>83</sup> IFS [Green Budget 2016](#), p119-20

which lowers saving and affects the whole economy. Unsurprisingly, EET systems are the norm in OECD countries.<sup>84</sup>

## The existing system with modifications

Another option was to retain the existing system, with some adjustments.

### Changes to the annual and lifetime allowances

Pensions for Professionals (representing mainly public sector professionals) called for the existing system to be maintained as “the most effective method” of fostering a culture of saving and providing “all working people with a satisfactory standard of living in retirement.” They argue that the AA should be removed for DB schemes and the LTA removed or decreased for DC schemes.” It also argued for more detailed analysis before final decisions were taken.<sup>85</sup>

**For more detail, see**

Library Briefing Paper  
CBP-5901 [Restricting pension tax relief](#)

The ABI, for example, has argued that the existing system could be simplified by removing the lifetime allowance (LTA) for defined contribution pensions and the annual allowance (AA) for defined benefit schemes. Costs to the Exchequer could be reduced by reducing the annual allowance for DC pensions and keeping DB pensions broadly in line by reducing the LTA. Implementation costs would be “the lowest of the options we have considered, meaning reform could be delivered quickly and with minimal risk.” It says the “most important component would again be re-framing tax relief as the Savers’ Bonus to make the incentive visible to people.”<sup>86</sup>

The Institute for Fiscal Studies (IFS) argued that:

Reducing the annual allowance or the lifetime limits, or restricting income tax relief on pension contributions in any other way, would be expensive to administer and arguably unfair and would inappropriately distort behaviour. Better ways to boost revenues would be to tackle the two elements of the system that look generous relative to a reasonable benchmark – i.e. the tax-free lump sum and the generous NICs treatment of employer pension contributions.<sup>87</sup>

In its 2016 Green Budget it argued that in deciding how to proceed, the Government should be “careful to distinguish between what is genuinely a permanent increase in revenues and what is only a temporary windfall.”<sup>88</sup>

The CBI said eight out of ten respondents to an industry-wide survey were against further changes in pension taxation.<sup>89</sup>

<sup>84</sup> ABI, [A Savers’ Bonus](#), October 2015

<sup>85</sup> Pensions for Professionals, [Response to Green Paper, “Strengthening the incentive to save: a consultation on pensions tax relief”](#)

<sup>86</sup> ABI, [A Saver’s Bonus](#), October 2015; NIESR, [An economic analysis of the existing taxation of pensions \(EET\) versus an alternative regime \(TEE\)](#), September 2015

<sup>87</sup> IFS, [2014 Green Budget](#)

<sup>88</sup> IFS, [Green Budget 2016](#), p97

<sup>89</sup> CBI, [Business warn Government not to tinker with pensions tax – CBI/Mercer Pensions Survey 2015](#)



### **Capping the tax-free lump sum**

The pension tax legislation provided for lump sum payments to be made from a pension scheme in certain circumstances. In particular, individuals could opt to receive up to 25% of their pension fund as a tax free lump sum on retirement. Whether this is possible in a particular case will depend on what the pension scheme rules say.<sup>90</sup>

In its 2014 Green Budget, the IFS argued that:

[...] there is a powerful case for introducing a cash limit on the amount that can be withdrawn from a pension tax-free, at a level considerably below £312,500 (the current level, simply 25% of the £1.25 million lifetime limit on registered pension saving). Unfortunately, no reliable current estimate exists of the revenue that this would raise.<sup>91</sup>

The PPI found that changes to the 25% tax-free lump sum would mean pension tax relief was more evenly distributed. However, it did not think it would improve incentives to save.<sup>92</sup>

The IFS also argued that the NICs treatment of employer pension contributions could be reformed.<sup>93</sup>

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<sup>90</sup> See also Library Note SN 2181 [Pension lump sums](#).

<sup>91</sup> IFS [Green Budget 2014](#), Chapter 10,

<sup>92</sup> PPI, [Tax Relief for Pension Saving in the UK](#), July 2013; For more on the background to this, see Library Note SN 2181 [Pension lump sums](#)

<sup>93</sup> IFS [Green Budget 2015](#), Chapter 10, p253-4; IFS [Green Budget 2014](#), Chapter 10, p239

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