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Research Briefing

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Reform of pension tax relief

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Contents

Summary

How are pensions taxed in the UK?

In the UK, private pension saving is taxed on an "exempt, exempt, taxed" model. This means:

- When people and their employers pay into a pension the contributions are **exempt** from taxation. Both the saver and any contributing employer receive tax relief, up to set limits.
- If the pension savings grow through investments this is **exempt** from taxation.
- When the savings are withdrawn as pension payments these are **taxed** like other income. People are allowed access up to 25% of their pension savings tax free.

What are the limits on pensions tax relief?

There are three main limits on the amount of tax relief someone can receive when they are contributing to their pension. In 2022/23 these were:

- A person earning more than £3,600 a year in the UK cannot receive tax relief on pension savings worth more than those earnings.
- An annual allowance which limits the amount someone can save into a pension pot before they pay tax. This is £40,000 a year for most people.
- A lifetime allowance is the amount which someone can usually build up in pension pots without paying tax. This is currently £1,073,100.

What changes have been announced?

For employees there are two ways to administer tax relief on pension contributions:

- Net pay: pension contributions are deducted from earnings before any tax has been paid. This means that tax relief is automatically given at the person's rate of income tax.

- Relief at source: pension contributions are made after tax has been paid. Tax relief is claimed by the pension scheme at the relevant basic rate of income tax (20%).

People paying below the basic rate of income tax will receive more tax relief if they contribute to their pension through relief at source than through net pay.

The Government announced in October 2021 that it will "resolve the anomaly by introducing a system to make top-up payments directly to low-earning individuals saving in pension schemes using a net pay arrangement from 2024-25 onwards."

What are the options for reform?

Two allowances or one?

There have been questions about whether both an annual and lifetime allowance are needed when they both have the same aim, to limit the amount of tax relief someone can receive.

In July 2018, the Treasury Committee recommended that "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." In response, the Government said that "no consensus" for reform had emerged since it consulted on the issue in 2015.

A single rate of pensions tax relief

One option for reform is a single rate of tax relief, rather than relief being given at someone's marginal rate of tax. Those in favour of a single rate of pensions tax relief often argue that it would be fairer for all taxpayers to receive the same rate of relief. Under the current system higher rate income taxpayers receive a higher rate of pensions tax relief. Those opposed to a single rate of tax relief argue that it would be expensive to administer, unfair and inappropriately distort behaviour.

Taxing pension contributions

In the UK, private pension saving is taxed on an "exempt, exempt, taxed" model (EET). This means that tax is not paid on contributions and investment growth, but tax is paid when savings are used to make pension payments. A different approach which has been considered is a "taxed, exempt, exempt" model (TEE). In this system contributions are taxed like other salary and no tax is paid on investment growth and payments from savings.

Those in favour have said that the current system is expensive. Opponents however have argued that the transition to a new system would be complex and taxing contributions would disincentivise pension saving.

Limiting tax-free lump sums

People are allowed to receive up to 25% of their pension savings as a tax free lump sum when they access their pension. Whether this is possible in a particular case will depend on the rules of the specific pension scheme. Several bodies have suggested that the amount which can be withdrawn tax free should be capped at a level below 25% of the lifetime allowance.

1 Background

1.1 How are pensions taxed in the UK?

In the UK, private pension saving is taxed on an "exempt, exempt, taxed" model (EET). This means:

- When people and their employers pay into a pension the contributions are **exempt** from taxation. Both the saver and any contributing employer receive tax relief, up to set limits.
- If the pension savings grow through investments this is **exempt** from taxation.
- When the savings are withdrawn as pension payments these are **taxed** like other income. People are allowed access up to 25% of their pension savings tax free.[1]

The main pension tax legislation is set out in Part 4 of the Finance Act 2004 and the Income Tax (Earnings and Pensions) Act 2003.

1.2 What are the limits on pensions tax relief?

There are three main limits on the amount of tax relief someone can receive when they are contributing to their pension:

- A person earning more than £3,600 a year in the UK cannot receive tax relief on pension savings worth more than those earnings.[2] Someone earning less that £3,600 a year can receive relief on contributions up to this amount.[3]
- An annual allowance which limits the amount someone can save into a pension pot before they pay tax. This is £40,000 a year for most people.[4]

1 Pensions Tax Manual, PTM024100 – General principles: overview of pensions taxation: the basics, HMRC, 28 February 2022
2 Finance Act 2004, section 190
3 Finance Act 2004, section 190
4 Finance Act 2004, section 228

- A lifetime allowance is the amount which someone can usually build up in pension pots without paying tax. This is currently £1,073,100.[5]

Earnings limit and annual allowance

In any given tax year, a person can save the lower of 100% of their annual earnings or the annual allowance into a pension without paying tax. Someone earning less that £3,600 a year can receive relief on contributions up to this amount.[6]

The annual allowance was introduced in 2006 and set at £215,000 by the Finance Act 2004. It increased by £10,000 a year, reaching £255,000 in 2010/11. Since then there have been reductions to the annual allowance:

- The Finance Act 2011 reduced the annual allowance from £255,000 in 2010/11 to £50,000 in 2011/12.
- The annual allowance was further reduced to £40,000 in 2014/15 by the Finance Act 2013.
- Since 2016/17, the annual allowance has been tapered, reducing for higher earners.

In 2021/22, a person's annual allowance is tapered (reduced), if their threshold (taxed) income is above £200,000 and their adjusted (total including pension contributions) income is above £240,000.[7] For every £2 of adjusted income someone receives above £240,000 their annual allowance is reduced by £1.[8] Tapering stops at £312,000, meaning everyone retains an annual allowance of at least £4,000.[9] Between 6 April 2016 and 5 April 2020, the threshold income was £110,000, adjusted income was £150,000 and people could retain an annual allowance of at least £10,000.[10]

If someone contributes more than their annual allowance into pension schemes, then they will need to pay tax on those contributions. The number of people exceeding the annual allowance has increased significantly as the allowance has been reduced. [11] In 2010/11, when the allowance was at its highest at £255,000, there were 140 people reporting contributions exceeding their annual allowance. The following year, when the allowance was reduced to £50,000 there were 5,570 people reporting contributions exceeding their annual allowance. In the most recent year 2019/20, with an annual allowance

5 Finance Act 2021, section 28
6 Finance Act 2004, section 190
7 Pensions Tax Manual, PTM051100 – Annual allowance: essential principles, HMRC, 28 February 2022
8 Finance Act 2020, part 1 section 22
9 As above
10 Finance Act 2015, schedule 4
11 Personal and stakeholder pensions statistics, table 7, HMRC, 23 March 2022

of £40,000 there were 42,350 people reporting contributions in excess of this and a further 21,410 charges reported by pension schemes.[12]

Money purchase annual allowance

In the 2014 Budget the Coalition Government announced a major reform in the tax rules for some pensions known as the pension freedoms.[13] Defined contribution schemes, or as they are sometimes called money purchase schemes, provide a pension pot based on the value of which depends on factors such as the level of contribution paid and investment returns. The pension freedoms meant that, from 6 April 2015, people aged 55 and over would be able to make withdrawals from their defined contribution pension pot "at a time of their choosing, subject to their marginal rate of income tax."[14] A money purchase allowance is intended to prevent people using the pension freedoms to avoid tax on their employment income by paying it into a pension before immediately withdrawing it with 25% tax free.[15] Once someone accesses a defined contribution pension the amount that they can contribute to defined contribution schemes in future is reduced to the money purchase annual allowance of £4,000. [16]

Lifetime allowance

The lifetime allowance was introduced in 2006, alongside the annual allowance by the Finance Act 2004.[17] It was set at £1.5 million when it was introduced and increased to £1.8 million by 2010/11.[18] Since then it reduced to £1.5 million in 2012/13, to £1.25 million in 2014/15, and to £1 million in 2016/17.[19]

Between 2018/19 and 2021/22 the lifetime allowance was increased in line with inflation as measured by CPI.[20] The Finance Act 2021 froze the lifetime allowance at its current level of £1,073,000 until April 2026.[21]

1.3 How much does pension tax relief cost?

In 2019/20, an estimated £41.3 billion in tax relief was provided on pension contributions. In the same year, £19.2 billion was collected on private

12 As above
13 Budget 2014, HM Treasury, 19 March 2014
14 As above
15 HM Treasury, Freedom and choice in pensions: Government response to consultation, Cm 8901, July 2014, para 2.27
16 Reducing the money purchase annual allowance, HM Treasury, 23 November 2016
17 Finance Act 2004, part 4
18 The Registered Pension Schemes (Standard Lifetime and Annual Allowances) Order 2007, SI 2007/494
19 Finance Act 2011, schedule 18; Finance Act 2013, part 1, section 48; and Finance Act 2016, part 1, section 19
20 Finance Act 2016, section 19
21 Finance Act 2021, section 28

pensions in payment. National Insurance relief on employer contributions was £19.7 billion.[22]

Table 1: Cost of pensions tax relief

£billion

	16/17	17/18	18/19p	19/20p
Income tax relief on:				
Occupational scheme contributions				
By employees	4.0	4.5	5.0	5.4
By employers	18.0	19.8	19.2	21.1
Personal Pension Scheme Contributions				
By employees	1.3	1.4	1.6	1.8
By employers	4.2	4.3	4.8	5.5
Contributions by self employed	0.4	0.3	0.3	0.2
Investment income of pension funds	6.5	6.7	7.4	7.3
Total tax relief	**34.4**	**36.9**	**38.2**	**41.3**
Less tax liable on:				
Pension payments	17.8	18.3	18.7	19.2
Total net tax relief	**16.7**	**18.7**	**19.5**	**22.1**
NICs relief on employer contributions	15.0	16.6	17.4	19.7
Net tax and NIC relief	**31.7**	**35.2**	**36.8**	**41.8**

Notes: p provisional figures

NICs relief for employer contributions is a combination of National Insurance relief on pension contributions, as well as the saving for individuals from the employers contributions not being treated as part of their gross income and subject to employee NICS contributions

Source: HMRC, Personal and stakeholder pensions statistics, Table 6

Using a net cost of tax relief figure of £22.1 billion (£41.3 billion minus £19.2 billion) may misrepresent the actual cost to the government. The Treasury explained in 2015 that the measure may not be appropriate because of the gap in time between tax relief on contributions and tax collected on pensions in payment:

> 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 net cost. Second, tax rates of individuals may change over their lifetime and therefore the rate of

22 Personal and stakeholder pensions statistics, Table 6, HMRC, 23 March 2022

> relief they receive may not correspond to the amount of tax they ultimately pay on their pension.[23]

It is also worth noting that removing tax relief through reforms is not guaranteed to result in savings of the same amount. In 2004 the Pensions Policy Institute said:

> 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.[24]

Gross pensions tax relief has increased each year since 2016/17 according to provisional data. In their most recent statistical survey of pension schemes, HMRC said:

> There has been strong growth in contributions to both occupational and personal pension schemes. This is expected to be largely as a result of automatic enrolment, which has increased the number of individuals saving and thus the total amount saved and partly due to increases in employer contribution rates.[25]

It added that public sector employer contributions had increased after increases to contribution rates in many public sector schemes in April 2019.

1.4 Who receives pension tax relief?

According data from HMRC in 2019/20:

- People with annual incomes over £50,000 accounted for 14.4% of income taxpayers, but 41% of private pension contributions attracting tax relief.
- The 1.4% of income taxpayers with incomes of £150,000 and above, accounted for 7% pension contributions attracting tax relief.
- The 30% of people earning less than £20,000 account for 9% of tax relief on personal pension contributions.[26]

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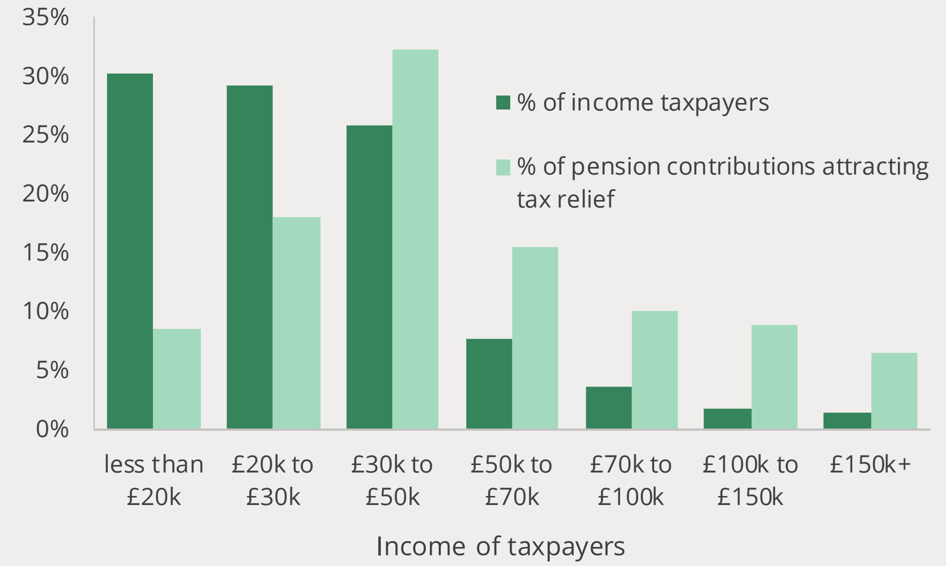
23 HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July 2015, para 2.4

24 Tax Relief and Incentives for Pension Saving (PDF), Pensions Policy Institute, October 2004

25 Commentary for Personal and Stakeholder Pension Statistics: September 2021, HMRC, 23 March 2022

26 Table 3.3. Distribution of total income before and after tax by gender: 2019 to 2020, HMRC; Table 3.8. Deductions and reliefs: 2019 to 2020, HMRC

Income taxpayers and pension contributions attracting relief, 2019/20



Sources: HMRC. Table 3.3. Distribution of total income before and after tax by gender: 2019 to 2020; Table 3.8. Deductions and reliefs: 2019 to 2020

In 2015, the Government estimated that reductions in the annual and lifetime allowances since 2010:

> …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.[27]

At the time, the Institute for Fiscal Studies said that 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 argued that the tax system should treat pension contributions and income in a symmetric way.[28]

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27 HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July 2015, para 2.6

28 Green Budget 2014, Institute for Fiscal Studies Chapter 10, p231; Green Budget 2015, Institute for Fiscal Studies, p260

1.5 Why do pensions receive tax relief?

Broadly, tax relief on pensions is intended to encourage private saving for later life.

In the 2014 Budget the Coalition Government announced a major reform in the tax rules for some pensions known as the pension freedoms.[29] Introducing the reforms, the Government explained that "tax relief is given so that the funds are used to provide benefits later in life for the member and their dependants."[30] The Coalition Government had previously set out its tax principles for retirement as:

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 given, unless they are used to provide a pension for a dependant.[31]

In July 2015, the Conservative Government proposed reforming its principles to strengthen incentives to save and ensure sustainability:

- 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.

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29 For more detail, see Pension flexibilities: the freedom and choice reforms, Commons Library Briefing, CBP-6891

30 Explanatory Notes to the Taxation of Pensions Act 2014, para 8

31 Removing the requirement to annuitise by age 75, HM Treasury, July 2010, para 2.10

- It should be **sustainable**. Any proposal for reform should also be in line with the government's long-term fiscal strategy.[32]

In July 2020, the Treasury launched a consultation on the administration of pensions tax relief which focussed on the relief for low earners (covered in section 5.4). In its call for evidence it set out three principles for making changes, simplicity, deliverability and proportionality.[33]

In response to a Treasury Select Committee report on the prospect for future tax reform, the Government said in 2021:

> the 2015 consultation on pensions tax indicated no clear consensus for reform. Changes to pensions tax relief in recent years have aimed to strike a balance between allowing the vast majority of savers to make significant tax-free pension savings and targeting incentives to save on those who most need Government support to save for retirement. Altering this balance could have profound and far-reaching impacts, and so while all tax reliefs are kept under review, more radical changes to pensions tax relief would require careful consideration.[34]

Comment

A range of organisations have commented on the objectives of pension tax relief. The Pensions Policy Institute said in 2016 that the "two main reasons why tax relief is given on pensions are to encourage people to save for their retirement, and to make the tax system for pension saving neutral by ensuring that people do not pay tax twice on the same income."[35]

In 2014, The Institute for Fiscal Studies said that some incentive needs to be provided to encourage people to save for retirement. [36] It said that the pensions tax relief system – while not flawless - achieves two objectives. It ensures that there is no tax on normal returns to saving, but where there are higher returns more tax will be paid on pension income. [37] The system also means that people "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."[38]

The Institute for Fiscal Studies has subsequently said that incentives should be well targeted, depending on the government's aim:

> Any such incentives should be well targeted, the meaning of which depends on whether the government's aim is to incentivise all pension saving equally or,

32 HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July 2015, para 3.4
33 Pensions tax relief administration: Call for Evidence, HM Treasury, July 2020, para 1.19
34 Treasury Committee, Tax after coronavirus: The Government's response, HC 144 2021-22, page 11
35 Future trends in pensions tax relief, Pensions Policy Institute, July 2016
36 Green Budget 2014, Institute for Fiscal Studies, chapter 10
37 As above
38 As above

> for example, to give incentives only, or especially, for certain groups – most obviously those who would otherwise be most at risk of under-saving for retirement – or up to certain limits. Whether any incentives are effective will also depend on how well people understand the incentives and on whether they respond by saving more and using those savings appropriately in retirement. Many arguments for pensions tax reform reflect concerns that the current tax incentives are not well designed.[39]

In July 2021, the Pensions and Lifetime Savings Association published a discussion paper outlining five principles for pension taxation. It suggested:

> Promotes adequacy: provides financial support and incentivises saving for retirement.
>
> Encourages the right behaviours: helps savers make the right decisions about retirement saving.
>
> Fair: helps everyone – the employed and the self-employed- save for retirement.
>
> Simple to adopt & administer: avoids unreasonable transition and on-going costs for employers and schemes.
>
> Enduring & sustainable: designed to avoid repeated change and so builds confidence in long-term saving.[40]

39 What are the options for reforming pensions taxation?, Institute for Fiscal Studies, (accessed 29 March 2022)

40 Five Principles for Pension Taxation: Discussion Paper – Second Edition, Pensions and Lifetime Savings Association, July 2021

2 Administering pensions tax relief

2.1 What are net pay and relief at source arrangements?

For employees there are two ways to administer tax relief on pension contributions:

- Net pay: pension contributions are deducted from earnings before any tax has been paid. This means that tax relief is automatically given at the person's rate of income tax.[41]
- Relief at source: pension contributions are made after tax has been paid. Tax relief is claimed by the pension scheme at the relevant basic rate of income tax (20%).[42]

2.2 How do the arrangements affect different taxpayers?

Broadly, people paying the basic rate of income tax (20%) will receive the same tax relief under both arrangements. However, depending on the arrangement they are in people who do not pay income tax and people who pay a higher rate of income tax may receive less tax relief than they are entitled to receive.

People who pay more than 20% income tax still receive 20% tax relief in a relief at source arrangement. The additional tax relief they are entitled to can be claimed through a self assessment tax return.[43] In a net pay arrangement, people who pay more than 20% income tax automatically receive tax relief at the correct rate of income tax.

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41 Tax will be paid at the marginal rate, which is the rate of tax which would be paid on an additional pound of earnings.

42 The relevant rate of income tax is either the basic rate, the Scottish basic rate or the Welsh basic rate, all of which were 20% in 2022/23. For Scottish taxpayers paying no more than the Scottish starter rate HMRC does not recover the difference between the rate of income tax they pay (19%) and the relief they receive (20%). This is covered further in Pensions Tax Manual, PTM044220 – Contributions: tax relief for members: methods: relief at source, HMRC, 28 February 2022

43 Tax on your private pension contributions, Gov.uk (accessed 29 March 2022)

In a relief at source arrangement, someone who pays below the basic rate of income tax will still receive 20% tax relief on their pension contributions, up to the higher of £3,600 or their UK earnings.[44] For example, to contribute £100 to a pension scheme through relief at source, a person who does not pay income tax would contribute £80 from their earnings ant the scheme would claim £20 from HMRC. In a net pay arrangement, someone who does not pay income tax would receive no tax relief. To contribute £100 to a pension scheme through a net pay arrangement, a person who does not pay income tax would contribute £100 from their salary.

In a 2019 report the Work and Pensions Committee recommended resolving the net pay and relief at source tax relief arrangements as "a matter or urgency" explaining that nor doing so "risks damaging faith in the system, by perpetuating arrangements which cause individuals to lose significant sums through decisions they did not make."[45]

2.3 How will the administration of tax relief for low earners change?

Government proposals on pensions tax relief administration

The 2019 Conservative manifesto included a commitment to conduct a comprehensive review of how net pay arrangements affect "people missing out on pension benefits".[46]

In July 2020, the Treasury launched a call for evidence on pensions tax relief administration which said that:

> This discrepancy in outcomes has led to some calls to reform the system so that the 1.5m lower earners in net pay schemes have the same outcomes as the 1.3m lower earners in [relief at source] schemes.[47]

In its July 2020 call for evidence the Treasury considered four approaches:

- Paying a bonus based on HMRC's Real Time Information data. HMRC would use its current end of year process to identify those eligible for a bonus. The Government said that this "would require significant and costly administrative charges".[48]

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44 Finance Act 2004, section 190 and section 192

45 Work and Pensions Committee, Pension costs and transparency, 24 July 2019, HC 1476 2017-19, paras 134-135

46 The Conservative and Unionist Party Manifesto 2019, Conservatives, November 2019

47 Pensions tax relief administration: Call for Evidence, HM Treasury, July 2020, para 3.9

48 Pensions tax relief administration: Call for Evidence, HM Treasury, July 2020, para 5.15

- A standalone charge on relief at source schemes to recover tax relief paid to people who do not pay income tax. The Government said this "would mean taking money from some of those on lower incomes" and would not fully equalise outcomes.[49]

- Employers operating a net pay and a relief at source scheme, with the scheme an employee contributed to depending on whether or not they are expected to pay income tax. The Government felt that the solution was only likely to be feasible for large employers with a high proportion of low-earning employees.[50]

- Mandating the use of relief at source for defined contribution schemes. The Government said this "would be a significant change for providers who currently operate net pay."[51]

In its call for evidence the Government said that paying a bonus and a standalone charge did not meet its principles for change.[52] It also said that it was "not currently convinced" of the case for employers operating multiple schemes.[53]

The Treasury published a response to the call for evidence in October 2021. It found that the approach set out to paying a bonus was unworkable and responses "clearly suggest" that the other three proposals would not meet the Government's principles for change.[54] It instead said it would proceed with "a variant of the bonus proposal".[55] It outlined the proposal for claiming top-ups as follows:

> 1. There will be no changes to how individuals save into pension schemes using [net pay arrangements] in 2024-25, with no change to take-home pay or pension contributions.
>
> 2. HMRC will make the necessary systems changes to enable identification of low earners in [net pay arrangement] schemes from April 2025, in respect of the 2024-25 tax year.
>
> 3. HMRC will calculate the amount of top-up any individual is entitled to, based on their pension contributions in 2024-25. This process will then continue each year from April 2026 onwards.
>
> 4. HMRC will notify individuals that they are eligible for a top-up and individuals will be invited to provide the necessary details for HMRC to be able to make the payment to them. For those individuals that are digitally

49 The outcomes would not be fully equalised because people in net pay schemes pay pension contributions before they pay income tax, they can effectively earn more than people in relief at source schemes before they reach their personal allowance and have to pay tax. Pensions tax relief administration: Call for Evidence, HM Treasury, July 2020, para 5.24

50 As above, para 5.31

51 As above, para 5.39

52 As above, paras 5.20 and 5.27

53 As above, para 5.36

54 Pensions tax relief administration: Call for Evidence Response, HM Treasury, October 2021, para 2.30

55 As above, para 2.31

> excluded, HMRC will provide additional support services to enable them to receive payment.[56]

An estimated 1.2m low earners in net pay arrangements would receive an average top-up worth £53 in 2025-26.[57] The Government has said primary legislation will be required and it intends to publish a draft in 2022 to be legislated for in a subsequent Finance Bill.[58]

The proposal has broadly been welcomed, though concerns have been raised about take up and the earliest claims being made in April 2025. The Low Incomes Tax Reform group (LITRG), which is a member of the Net Pay Action Group and has campaigned on the issue for a number of years said:

> LITRG has been asking Government to take action to address this pension inequality for a number of years. Today's announcement, which will see a top-up payment made to those affected, is therefore welcome. However, it is disappointing that this will only apply from the 2024/25 tax year and there will be no remedial action for historic tax years.
>
> While today's publication is light on the full detail of how the new process will operate in all cases, it does suggest that those affected will need to take some sort of action to secure a top-up payment. This may well discourage people from accessing the top-up and we urge HMRC to ensure the process is accessible, simple and automated as far as possible. It is concerning that the Government's estimates of the cost of this measure in its first two years is just a fraction of what it would be if there were full take up.[59]

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56 Pensions tax relief administration: Call for Evidence Response, HM Treasury, October 2021, para 2.33

57 As above, para 2.34

58 As above, para 2.36

59 Press Release: LITRG welcomes solution to pension inequality for low-income workers, Low Incomes Tax Reform Group, 27 October 2021

3 What do devolved rates of income tax mean for pension tax relief?

The Scotland Act 2012 introduced the Scottish rate of income tax from April 2016 and the Wales Act 2014 introduced the Welsh rate of income tax from 6 April 2019.[60] In Scotland, income tax rates now differ to the rest of the UK, which means that the tax relief received by Scottish taxpayers may also differ. The table below sets out the rates of income tax in 2022/23:

Table 2: Income tax rates

2022/23

Scotland			England, Wales and Northern Ireland		
	Band	Rate		Band	Rate
Starter Rate	£12,570 to £14,732	19%	Basic	£12,571 to £50,270	20%
Basic Rate	£14,733 to £25,688	20%	Higher	£50,271 to £150,000	40%
Intermediate	£25,689 to £43,662	21%	Additional	Over £150,000	45%
Higher	£43,663 to £150,000	41%			
Additional	Over £150,000	46%			

Source: Income tax policy proposal: Scottish Budget 2022-23, Scottish Government

Income tax personal allowance and the basic rate limit from 6 April 2022 to 5 April 2026, HMRC

This means there are additional differences between the tax relief provided through net pay arrangements and relief at source arrangements in Scotland.

Scottish taxpayers paying no more than the Scottish starter rate would receive 19% tax relief in a net pay arrangement and 20% in a relief at source scheme. For those in relief at source schemes HMRC has said it does not recover the 1% difference between the rate of income tax (19%) and the rate of relief (20%).[61]

Like other people who pay more than 20% income tax, people paying the Scottish intermediate rate still receive 20% tax relief in a relief at source arrangement. They are able to claim the additional 1% they are entitled to through a self assessment tax return.[62] In a net pay arrangement, people paying the Scottish intermediate rate automatically receive tax relief at the correct rate.

60 Scotland Act 2012, sections 25-27, and Wales Act 2014, sections 8-11

61 Pensions Tax Manual, PTM044220 – Contributions: tax relief for members: methods: relief at source, HMRC, 28 February 2022

62 Tax on your private pension contributions, Gov.uk (accessed 29 March 2022)

In its response to the call for evidence on pension tax relief administration the Treasury said:

> The government recognises that income tax is a devolved matter, and that Scotland currently has different income tax rates compared with the rest of the UK. A complication thus arises in relation to tax relief in [relief at source] schemes, since Scotland has a starter rate tax band of 19% that is below the 20% basic rate on which tax relief calculations are based. The government is open to discussing the implications of this issue with the Scottish Government.[63]

63 Pensions tax relief administration: Call for Evidence Response, HM Treasury, October 2021, para 2.35

4 How have the annual and lifetime allowances changed?

Section 1.2 covers the limits on pensions tax relief placed by the annual and lifetime allowances.

4.1 Reducing the allowances

As covered in Section 1.2 both the annual allowance and lifetime allowances have been reduced since they were introduced. Measures were introduced to mitigate some of the impact of these reductions. For example, people at risk of breaching the annual in a particular year can 'carry forward' unused allowances from the previous three years.[64] In certain circumstances, people can apply for protection against a lifetime allowance being reduced.[65]

In 2015 the Government said that the reductions had reduced Exchequer costs and the share of pensions tax relief going to additional rate taxpayers.[66]

4.2 Impact of the tapered annual allowance

Since 2016/17, the annual allowance has been tapered. This means the annual allowance reduces for earners with an income above both a taxed threshold and an adjusted amount including pension contributions. [67] For every £2 of income someone receives above their adjusted income their annual allowance is reduced by £1. [68]

Between 6 April 2016 and 5 April 2020, the threshold income for tapering the annual allowance was £110,000, adjusted income was £150,000 and people could retain an annual allowance of at least £10,000.[69]

Although these rules applied across all schemes, the nature of many doctors' work meant there was a particular impact on the NHS (for example, consultants taking on additional work often at short notice to cover service

64 Finance Act 2004, section 228A
65 Finance Act 2004, section 218
66 HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July 2015, para 1.5 and 2.6
67 Finance Act 2015, schedule 4
68 Finance Act 2020, part 1 section 22
69 Finance Act 2015, schedule 4

pressures). This was particularly felt in 2019/20 when the capacity to bring forward unused annual allowances from the previous three years was largely exhausted.[70]

In October 2019, the Office of Tax Simplification said:

> The government should continue to review the annual allowance and lifetime allowances and how, in combination, they deliver against their policy objectives, taking account of the distortions (such as those affecting the National Health Service) they sometimes produce.[71]

In the March 2020 Budget, the Government announced increases of £90,000 in the income thresholds for the tapered annual allowance ('adjusted income' increased to £240,000, 'threshold income' to £200,000) and a decrease in the minimum annual allowance to £4,000.[72] The British Medical Association welcomed the announcement – which would mean that the "vast majority of doctors are now removed from the effect of the taper" – but said it was long overdue and that further reform was needed.[73] The British Medical Association said that it:

> ...remains firmly of the view that the annual allowance is unsuited to defined benefit pensions schemes such as the NHS. Many doctors with incomes below the new threshold income will face tax bills as a result of exceeding the standard annual allowance which remains at £40,000 - this can happen following a modest rise in pensionable pay.[74]

The Minister for Health said in April 2022 that following the change an "estimated 96% of general practitioners and 98% of consultants are out of scope of the taper based on National Health Service earnings."[75]

4.3 Money Purchase Annual Allowance

In the 2014 Budget the Coalition Government announced a major reform in the tax rules for some pensions known as the pension freedoms.[76] Defined contribution schemes, or as they are sometimes called money purchase schemes, provide a pension pot the value of which depends on factors such as the level of contribution paid and investment returns. The pension freedoms meant that, from 6 April 2015, people aged 55 and over would be able to

70 NHS Pension Scheme: proposed flexibility, Department of Health and Social Care, 22 July 2019, para 1.11

71 Taxation and Life Events: Simplifying tax for individuals, Office of Tax Simplification, October 2019, recommendation 8

72 Budget 2020, HM Treasury, 11 March 2020

73 BMA says Government has 'finally listened' to months of lobbying to fix pension taxation crisis and improve patient care, British Medical Association, 11 March 2020

74 Annual allowance – what does the 2020 budget announcement mean?, British Medical Association, 13 March 2020

75 PQ 153887 [on NHS: Workplace Pensions], 14 April 2022

76 Budget 2014, HM Treasury, 19 March 2014

make withdrawals from their defined contribution pension pot "at a time of their choosing, subject to their marginal rate of income tax."[77]

A money purchase allowance is intended to prevent people using the pension freedoms to avoid tax on their employment income by paying it into a pension before immediately withdrawing it with 25% tax free.[78] Once someone accesses a defined contribution pension the amount that they can contribute to defined contribution schemes in future is reduced to the money purchase annual allowance of £4,000.[79]

People with defined benefit schemes receive a regular pension income, guaranteed by a sponsor, which is usually an employer. Contributions to defined benefit schemes do not count towards the money purchase annual allowance.

Since the money purchase annual allowance was introduced in April 2015 there have been calls for it to be reformed. In October 2019, the Office of Tax Simplification said:

> The reduction in the level of the money-purchase annual allowance in 2017 has increased concern that those withdrawing small amounts, perhaps from a small pension savings scheme they have, can unwittingly and disproportionately limit their capacity to maintain their main pension saving through another scheme.[80]

The Office of Tax Simplification recommended that:

> The government should review the operation of the Money Purchase Annual Allowance, gathering better evidence, considering whether it meets its policy objectives, is set at the right level and is sufficiently understood, given the present potential for disproportionate outcomes.[81]

These concerns increased during the early stages of the Covid-19 pandemic when there were concerns that people accessing their pensions in response to a temporary drop in income would permanently reduce the amount they were able to save with tax relief in future. In February 2021, Yvonne Braun, the Director of Policy for Long-Term Savings and Protection at the Association of British Insurers said:

> Covid-19 has shown that households' financial resilience can be fragile and addressing that should be a central part of the nation's Covid-19 recovery. Our data suggests that pension withdrawals have not yet substantially increased but the continued uncertainty and insecure job market could mean more people dipping into their retirement savings to get by. Removing or increasing the Money Purchase Annual Allowance will help incentivise older workers to save. This will improve their financial resilience and also make sure people are

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77 As above

78 HM Treasury, Freedom and choice in pensions: Government response to consultation, Cm 8901, July 2014, para 2.27

79 Reducing the money purchase annual allowance, HM Treasury, 23 November 2016

80 Taxation and Life Events: Simplifying tax for individuals, Office of Tax Simplification, October 2019, p12

81 As above, recommendation 9

> not penalised for doing the right thing by paying money back into their pension when they can afford to.[82]

In February 2020, the Association of British Insurers also called on the Government to review the Money Purchase Annual Allowance, explaining:

> The MPAA, which effectively limits the amount of tax relief that can be received on contributions once the pot has been accessed, has also been a cause for concern. Its reduction to £4,000 means it affects individuals who continue to work but have accessed their pension, particularly as retirement is no longer a cliff edge. The MPAA disincentivises future saving permanently as the impact of a previous withdrawal cannot be reversed.[83]

Similarly, the Pensions and Lifetime Savings Association said in February 2021 that:

> At its current level of £4,000 per annum the PLSA feels that the MPAA has unintended consequences of limiting contributions from people who are in their 50s. For example, those people who may have been out of work though redundancy and found it necessary to dip into their pensions, who then go back into the workforce and are wanting to rebuild their pension pot rather than people who are purposefully 'recycling' their pension (which is the policy's intention). HMRC does not collect data on the number of people affected by the MPAA which makes it hard to evaluate its impact and to see if it is targeting the right people. The government should review the MPAA to ensure it is working as appropriately and is affecting the right people.[84]

Although HMRC does collect data on people contributing more than their annual allowance, it does not collect data on which annual allowance has been applies.[85]

4.4 Two allowances or one?

There have been questions about whether both an annual and lifetime allowance are needed when they both have the same aim, to limit the amount of tax relief someone can receive.

In July 2018, the Treasury Committee recommended that:

> 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

82 Scrap the Money Purchase Annual Allowance to help financial resilience, Association of British Insurers, 26 February 2021
83 Five years on: Future-proofing the freedoms, Association of British Insurers, p23
84 Five principles for pension taxation, The Pensions and Lifetime Savings Association, February 2021
85 Personal and stakeholder pensions statistics, HMRC, 23 March 2022, notes to Table 7 and 8

> allowance, introducing a flat rate of relief, and promoting understanding of tax relief as a bonus or additional contribution."[86]

In its response to the Treasury Committee's report, the Government said that "no consensus for either incremental or more radical reform of pension tax relief has emerged since the consultation in 2015."[87]

People in defined contribution schemes build up pension savings differently to people in defined benefit schemes. People in a defined contribution scheme build up a pension pot, the value of which depends on the amount of money contributed by the person and their employer and on the performance of investments. Unlike defined contribution schemes, defined benefit pensions offer a regular pension income, guaranteed by a sponsor which is usually an employer. The amount paid by a defined benefit pension is linked to salary and length of service. The way the lifetime and annual allowances are calculated depends on whether the type of pension someone has:

- For people in defined contribution schemes the amount they, their employer and anyone else contributes to their pension counts towards the annual and lifetime allowances.
- For people in defined benefit schemes the increase in the value of their promised benefits counts towards their annual allowance. Normally, twenty times the annual pension provided through a defined benefit scheme is counted towards the lifetime allowance.[88]

In October 2019, the Office of Tax Simplification said that lifetime and annual allowance charges could present significant complexities for pension savers in different circumstances. It questioned whether both should apply:

> Given the policy aim of limiting the overall amount of pensions savings tax relief available to any one individual, applying both the [annual allowance] and [lifetime allowance] charges to pensions may be unnecessary.
>
> One possibility would be for the [annual allowance] to apply in relation to [defined contribution] schemes and the [lifetime allowance] in relation to [defined benefit] schemes, reflecting the most natural operational and administrative fit between the two approaches and the type of scheme involved.[89]

There has been no official response to this report. In January 2020, the then Financial Secretary to the Treasury said that "Officials will continue to

86 Treasury Committee, Household finances: income, saving and debt, 18 July 2018, HC 565 2017-19, para 117

87 Treasury Committee, Household finances: income, saving and debt: Government Response to the Committee's Nineteenth Report, 9 October 2018, HC 1627 2017-19

88 PTM088100 - The lifetime allowance and the lifetime allowance charge: benefit crystallisation events: benefit crystallisation events overview, HMRC, 28 February 2022; PTM053100 - Annual allowance: pension input amounts: valuing for different types of arrangement, HMRC, 28 February 2022

89 Taxation and Life Events, Office of Tax Simplification, October 2019

consider the recommendations made in ‘Taxation and Life Events’ carefully.”[90]

[90] PQ 10421 [on Taxation], 4 February 2020

5 What are the options for reform?

5.1 Single rate of pensions tax relief

One option for reform is a single rate of tax relief, rather than relief being given at someone's marginal rate of tax. Those in favour of a single rate of pensions tax relief often argue that it would be fairer for all taxpayers to receive the same rate of relief. Under the current system higher rate income taxpayers receive a higher rate of pensions tax relief. Those opposed to a single rate of tax relief argue that it would be expensive to administer, unfair and inappropriately distort behaviour.

Advantages of a single rate of pensions tax relief

In 2005, the Pensions Commission, which was established to look at the adequacy of pension savings, said that a single rate of relief, described 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.[91]

A report by the Pensions Policy Institute in June 2020 found that a flat rate of tax relief on defined contribution pension contributions would increase the proportion of tax relief going to basic rate taxpayers from 26% to 42%.[92] The Association of British Insurers, which sponsored the work, said that the pensions system needed to be changed so that it is "simpler, fairer to all earners and encourages saving for retirement.[93] In 2015, the Association of British Insurer's 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

91 A New Pension Settlement for the Twenty-First Century; The Second Report of the Pensions Commission ,Pensions Commission, November 2005, p318

92 Tax relief on Defined Contribution pension contributions: PPI Briefing Note number 122, Pensions Policy Institute, June 2020

93 Low earners missing out on vital tax relief despite more saving for a pension, Association of British Insurers, 23 June 2020

> Automatic Enrolment advertising to make the Savers' Bonus as visible at the matched employer's contribution could therefore have a powerful impact.[94]

This approach was supported by the Low Incomes Tax Reform Group, which argued that a single rate of tax relief would improve incentives for those on low incomes:

> [The Low Incomes Tax Reform Group] 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.[95]

And that 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 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.[96]

Issues with a single rate of tax relief

A single rate of tax relief, unless accompanied by further measures, could mean double taxation for higher rate taxpayers. Higher rate taxpayers might first be expected to pay tax on the difference between their marginal rate of income tax and the flat rate of tax when making contributions. When those savings are withdrawn as a pension, under the current system, income tax would again need to be paid.

The Pensions and Lifetime Savings Association looked at three options for a single rate of relief in a July 2021 report. It found that:

- A single rate at 20% would reduce result in double taxation for higher earners who pay a reduced rate of tax when they make pension contributions and income tax when they withdraw their savings.
- A single rate at 25-30% would "improve adequacy" for basic rate taxpayers though there would be a negative impact on higher rate taxpayers who could still be double taxed on their pensions.

94 A Savers Bonus (PDF), Association of British Insurers, October 2015
95 Strengthening incentives to save for pensions, The Low Incomes Tax Reform Group, 29 October 2015
96 Strengthening incentives to save for pensions, The Low Incomes Tax Reform Group, 29 October 2015

- Continuing the current regime for defined benefit schemes and introducing a single rate for defined contribution schemes would improve adequacy for basic rate taxpayers but have a negative impact on higher rate taxpayers.

The Pensions and Lifetime Savings Association found that none of the three single rate options it considered were simple to adopt and administer.[97] It also said that there would be additional complexities for defined benefit schemes where contributions are more complicated to measure which would involve annual calculations and repayments for every higher rate taxpayer.[98]

The Institute for Fiscal Studies said that one option could be for there to be a uniform rate of relief on contributions and uniform rate of tax on pension income. However, it said it was debatable whether this would be an improvement and there would be a "major practical difficulty in restricting the rate of relief".[99]

Cost to the Government

The level a flat rate of pensions tax relief was set would determine how much it would cost the government compared to the current system. In June 2020, the Pensions Policy Institute estimated that a 20% flat rate would cost £5.8 billion and a 33% flat rate would cost £9.6 billion, compared to a cost of the current system of £9.3 billion.[100]

In its 2016 Green Budget, the Institute for Fiscal Studies said that 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.[101]

5.2 Taxing pension contributions

In the UK, private pension saving is taxed on an "exempt, exempt, taxed" model (EET). This means that tax is not paid on contributions and investment growth, but tax is paid when savings are used to make pension payments. A

97 Five principles for pension taxation, The Pensions and Lifetime Savings Association, February 2021
98 As above
99 What are the options for reforming pensions taxation?, Institute for Fiscal Studies [accessed 6 May 2022]
100 Tax relief on Defined Contribution pension contributions: PPI Briefing Note number 122, Pensions Policy Institute, June 2020
101 Green Budget 2016, Institute for Fiscal Studies, February 2016, p119

different approach which has been considered is a "taxed, exempt, exempt" model (TEE). In this system contributions are taxed like other salary and no tax is paid on investment growth and payments from savings. In 2020, the OECD reported that Costa Rica, Czech Republic, Hungary, Israel, Lithuania, Luxembourg, and Mexico, were all using variants of a taxed, exempt, exempt model.[102]

In 2015, the Treasury described a system where contributions are taxed upfront and then topped up by the government. The Treasury 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.[103]

Reform along these lines had been proposed by the Centre for Policy Studies in 2014, which said 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". The Centre for Policy studies proposals include replacing tax relief with a Treasury contribution of 50p per £1 saved up to an annual allowance.[104]

Impact of moving to a new system

In July 2021, the Pensions and Lifetime Savings Association published a discussion paper outlining five principles for pension taxation. It looked at a system where "income tax is full applied to all contributions but investment returns and income in retirement are both exempt from tax". It found that this would not promote adequacy or encourage the right behaviours, because it disincentives pension savings and that changing the current system would mean "a two-track system will have to be supported potentially for decades."[105]

The Association of British Insurers was concerned that 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".[106] In 2015 it said:

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102 Financial incentives for funded private pension plans: OECD country profiles 2021, OECD, 3 December 2021

103 HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July 2015, para 3.12

104 Retirement savings incentives: the end of tax relief and a new beginning, Centre for Policy Studies, 2014

105 Five principles for pension taxation, The Pensions and Lifetime Savings Association, February 2021, p14-15

106 A Savers' Bonus, Association of British Insurers, October 2015

5. 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.

6. 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.[107]

Impact on retirement incomes

The impact on pension incomes would depend on the details of a new system and whether or not the government makes payments to top up pension saving. In 2015, analysis by the Pensions Policy Institute found that:

> 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.[108]

In July 2021, the Pensions and Lifetime Savings Association said that a move from EET to TEE would "negatively impact adequacy as it removes all tax benefits, disincentives saving into pensions, reduces the amount being saved and, will result in lower incomes in retirement."[109]

The Association of British Insurers argued that the change would undermine responsible saving, saying that:

> 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.[110]

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107 A Savers' Bonus, Association of British Insurers, October 2015

108 PPI, Comparison of pension outcomes under EET and TEE tax treatment, October 2015

109 Five principles for pension taxation, The Pensions and Lifetime Savings Association, February 2021

110 A Savers' Bonus, Association of British Insurers, October 2015

Impact on tax and Government spending

In its 2016 Green Budget, the Institute for Fiscal Studies argued that moving to TEE tax treatment has "much more dramatic consequences for the profile of tax revenues and poses significant political risks". It said that:

> 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. [111]

It explained that the longer run cost would depend on the size of any new tax incentives and explained:

> 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.[112]

In July 2021, the Pensions and Lifetime Savings Association said that a move from EET to TEE "could lead to an upfront positive fiscal flow for [the Government], the revenue gain would fall over time as income from pensions in payment fall and then stop."[113]

5.3 Capping the tax-free lump sum

People are allowed to receive up to 25% of their pension savings as a tax free lump sum when they access their pension. Whether this is possible in a particular case will depend on the rules of the specific pension scheme.

In July 2021, the Pensions and Lifetime Savings Association looked at capping the tax-free lump sum at £75,000. It said around 25% of people aged 55-64 would be affected and may disincentivise pension saving. It also said that "This would be a major retrospective change and so could be considered unfair for those who saved in the belief they would get 25% [tax-free lump sum] without it being capped".[114]

111 Green Budget 2016, Institute for Fiscal Studies p119-20
112 As above
113 Five principles for pension taxation, The Pensions and Lifetime Savings Association, February 2021
114 Five principles for pension taxation, The Pensions and Lifetime Savings Association, February 2021

In its 2014 Green Budget, the Institute for Fiscal Studies had also argued for a limit but said that there is no reliable estimate of how much tax revenue this would raise.[115] More recently, the Institute for Fiscal Studies said an option for reforming the tax-free lump sum could be replacing it with a bonus top-up. It explained:

> At the moment, for every £1 taken from a pension, 25p is tax-free if taken as a lump sum, saving a basic-rate taxpayer 5p (20% of 25p) and a higher-rate taxpayer 10p (40% of 25p) in income tax. Instead, the government could top up pension savings by, say, 5%, and then charge income tax on the full amount taken from the pension. For a basic-rate taxpayer, a 5p top-up for every £1 of pension savings would be broadly equivalent in value to the tax-free lump sum. [116]

In 2013, the Pensions Policy Institute 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.[117]

5.4 2015 Treasury consultation on reforming pension tax relief

The case for change

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

> 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.
>
> […]
>
> 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. [118]

115 Green Budget 2014, Institute for Fiscal Studies, Chapter 10,

116 What are the options for reforming pensions taxation?, Institute for Fiscal Studies [accessed 6 May 2022]

117 Tax Relief for Pension Saving in the UK, Pensions Policy Institute, July 2013; For more on the background to this, see Pension lump sums, Commons Library Briefing SN02181

118 HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July 2015, Foreword

On incentives, the Government cited research by the Pensions Policy Institute 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 scheme, increasing the importance of ensuring they are contributing enough to achieve an adequate income in retirement. [119] DWP analysis in 2014 suggested that almost half of adults below State Pension age are not saving enough for their retirement.[120]

A 2013 report from the Pensions Policy Institute 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.
> - 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.[121]

In its response to the 2015 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

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119 HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July 2015, para 1.24; Scenario analysis of future pension incomes, Department for Work and Pensions, August 2014

120 Scenario analysis of future pension incomes, Department for Work and Pensions, August 2014

121 As above, p24

to it. There was some evidence that matching contributions affected behaviour:

> 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.
>
> 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.
>
> 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.[122]

The Pensions and Lifetime Savings Association, previously the National Association of Pension Funds (NAPF), argued 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.
>
> 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**

122 Response to HM Treasury consultation: strengthening the incentive to save, Pension Policy Institute, October 2015

> **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.**[123]

Response - Budget 2016

In Budget 2016, the then Chancellor did not announce any fundamental change to the tax treatment of pension on the grounds that there was 'no consensus'.[124]

The then Chancellor did announce the introduction of the Lifetime ISA to encourage saving into for house purchase or retirement, discussed in Library Briefing Paper Lifetime ISA and pensions, CBP-07724.

Response were mixed. The Pension and Lifetime Savings Association, for example, described "no change" as the right decision.[125] 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."[126] 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".[127]

On the prospect of future tax reform, the Government said in June 2021:

> the 2015 consultation on pensions tax indicated no clear consensus for reform. Changes to pensions tax relief in recent years have aimed to strike a balance between allowing the vast majority of savers to make significant tax-free pension savings and targeting incentives to save on those who most need Government support to save for retirement. Altering this balance could have profound and far-reaching impacts, and so while all tax reliefs are kept under review, more radical changes to pensions tax relief would require careful consideration.[128]

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123 Strengthening the incentive to save: a consultation response on tax relief, Pensions and Lifetime Savings Association, October 2015

124 HC Deb 16 March 2016 c96

125 Pensions and Lifetime Savings Association comments on Budget 2016, Pensions and Lifetime Savings Association, 16 March 2016

126 'Osborne scraps pension tax relief shake-up', Financial Times, 6 March 2016

127 Pensions: George Osborne drops plans to cut tax relief, BBC News, 5 March 2016

128 Treasury Committee, Tax after coronavirus: The Government's response, HC 144 2021-22, page 11