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Creating a sustainable Pensions Tax Framework

A careful review after the General Election is needed so the framework's purposes are clear and pension saving is incentivised at all levels

A policy paper by the Association of Consulting Actuaries

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FOREWORD BY THE CHAIRMAN OF THE ASSOCIATION OF CONSULTING ACTUARIES

As we approach the general election, pension tax relief has become increasingly topical with the amount of tax relief and its focus being debated. The Association of Consulting Actuaries (ACA) has significant concerns that further reductions will be made to pensions' tax relief and also that the changes will be placed on an already overly complex system. This paper sets out our concerns and calls for a collaboration between the political parties, Government and the Pensions Industry to create a sustainable pension taxation system that can be readily understood and can properly incentivise retirement savings.

The Association has provided assistance and comment to HM Treasury and HMRC around the detailed operation of pension taxation rules over many years. Its approach has been to help the Government of the day understand the implications for scheme members and pensions practitioners (and given the wide range of scheme designs and employment/retirement issues that exist) of different approaches to the taxation of pensions.

Pension tax relief gives employees and employers an incentive to lock away their money, potentially for many years, to make suitable provision for retirement in preference to other forms of saving or immediate consumption. We believe it is critically important that there are meaningful incentives to employees and employers to encourage retirement saving and to cover potential costs of long term care. Reaching old age with adequate retirement savings provides employees and employers with choices which are not otherwise available. There have been various indications that relief might be reduced – we would ask the political parties and the next Government to think very carefully about current reliefs and the long term impact of any reduction. In particular, it is important to understand fully the extent of the current reliefs, and how they are distributed, before making any changes.

Constant chipping away of tax relief undermines faith in the system and erodes the belief that saving for old age is appropriate. It is inconsistent with the Pension Schemes Act which is intended to be the foundation structure for future pension savings.

Furthermore, the ACA has been concerned for some time about the complexity of the current system and believes that very few people, even those working in the pensions industry, fully understand the many nuances of the pension tax system. Our members intervene in many cases where pension benefits and the tax paid would otherwise not be determined in accordance with the law – and it is clear that there are many similar cases which go by unnoticed.

This complexity results in individuals being put off saving for retirement, employers are deterred from establishing and maintaining pension schemes beyond the minimum enforced by auto-enrolment; and, for individuals who do save diligently (and for employers supporting this), the costs of ensuring compliance with current tax law means ultimately that there is less money available for retirement savings.

We hope the paper will spark debate and encourage suggestions on how pension taxation could be reformed. Our hope is that the Government after the next election will establish a formal review of pension taxation, working with all interested parties involved in pension provision to make it an easier system to understand and operate within but, more importantly, that there is a clear and unequivocal incentive to save for retirement.

David Fairs
Chairman of the Association of Consulting Actuaries

INTRODUCTION

The Pensions Tax Simplification Regime introduced in 2006 did, for the most part, simplify pension taxation for the majority of people. Whilst there were aspects of the regime introduced in 2006 that were complex, the complexity applied to a relatively small proportion of the working population and arguably to a group who could bear more easily the cost of professional advice to help with that complexity. Administrators of pension arrangements could establish systems to filter out these more complex cases for greater scrutiny by senior pension experts.

The significant reductions that have subsequently taken place in the Annual Allowance and Lifetime Allowance have meant that this complexity is being felt by an increasing number of individuals and anomalies are emerging as these complex rules combine with a wider variety of individual circumstances. Furthermore, the speed at which subsequent changes to pension taxation have been introduced has led to legislation that contains anomalies and applications which are counterintuitive.

Yet further changes are being introduced as a result of the Budget announcement in 2014 and with the potential for further consequent future measures in respect of those over age 55 – whether high or low pensioned. There will also be the need to deal with risk sharing schemes introduced as part of the Pension Schemes Act.

We believe that a point of inflexion has already been reached where the current system of pension taxation is incapable of being understood at some very basic and necessary levels by the general public and indeed by many pension professionals.

As more cases fall into the areas of complexity needing more scrutiny, the costs of compliance increase and act as a drag on the amounts available for pension savings.

How much tax relief is given and to whom is a political decision by the government of the day – but this needs to be thought through very carefully, making sure that there is clear understanding of what reliefs are actually being given at the moment.

We believe that a fundamental review of pension taxation is necessary, rather than further tinkering with the existing system.

Clearly, any meaningful change to pension taxation would require detailed analysis and consultation. It may well be that radical change will not be welcomed by all but we hope to stimulate a debate on moving to a more easily understood tax regime without anomalies which, in the long term, will encourage and facilitate greater pension saving amongst those who currently save far too little for later life. If the paper stimulates others to promote a simpler and better model then we will have achieved our aim.

Before changes can be made to the operation of pension tax relief, consideration needs to be given to two separate questions:

1. How much tax relief is to be granted in total?
2. How is that tax relief to be allocated amongst the various constituencies (high earners vs low earners, defined benefit vs defined contribution, old vs young etc.)

HOW MUCH TAX RELIEF?

The basis of pension tax relief currently provided in the UK is that (within complex limits) contributions are not subject to the income tax that would apply if taken as salary instead; investment income and gains are largely not subject to tax and, at retirement, broadly one quarter of the fund can be drawn tax free. The balance is subject to the individual's marginal income tax rate as it is drawn. Different arrangements apply for death benefits.

Employer pension contributions are also not subject to National Insurance Contributions (compared with the employer paying salary which would attract National Insurance payable by employer and employee) leading to some employers operating salary sacrifice arrangements to, in effect, pass employees' contributions to a pension scheme without being subject to National Insurance.

The size of reliefs (in income tax and national insurance) provided towards retirement savings is significant, with a figure often quoted of between £30bn and £40bn. The challenge presented by various parties is whether such a subsidy is justifiable and whether it is appropriately targeted at those most deserving of incentives.

However, we believe this figure is misleading if it is being used to judge the incentives being given for year-by-year pension saving.

First, it counts the tax relief provided on pension input but ignores the tax collected on pensions once they come into payment. Government figures based on **current pensioner** payments suggest that this would reduce the above headline figure by around £12bn - but more tax than that would be expected to be collected from **current savers** in the future.

Secondly the figure above is inappropriate as a measure of relief for year-by-year savings because it includes the tax relief on "deficit contributions" now being paid by employers into Defined Benefit Schemes ie contributions paid to make up funding gaps from past benefit accrual. There are no easily available statistics but our estimate is that this "catch-up" could account for perhaps £5bn of the relief figure quoted.

Once these features have been accounted for, the real level of tax incentivisation is much lower.

Any significant reduction to the amount of tax relief granted on contributions could lead to a withdrawal from pension savings which is counter to recent Government policies, such as auto-enrolment, which are designed to encourage greater participation. So, we would hope that pensions are not deemed a soft target for raising revenue in the short term and, if any reduction in tax relief is to be made, that it is carefully thought through in both short- and long-term impact.

WHY THE NEED FOR CHANGE TO HOW THE RELIEF IS CONSTRAINED/SHARED OUT?

Aside from the tax free lump sum and National Insurance relief on employer contributions, individuals who retire with the same marginal tax rate in retirement as when they were in work, are in reality just deferring tax (with tax efficient investment) rather than saving tax. The current system benefits most those who have a higher marginal rate of income tax whilst working compared with that in retirement (so that the rate of relief granted at the contribution phase is higher than the rate of tax charged when benefits are received). And with the changes announced in the Budget 2014, it might be argued that it will become easier for individuals who can afford to delay withdrawals to organise their affairs to achieve this.

The nature of the existing regime has resulted in extremely complex rules to limit the advantage that can be taken of this and to try to ensure tax relief is provided in line with the policy intent of the day. However, the complexity of the rules is now so great that very few understand the full nuances of the existing tax regime; the likelihood of errors is high and increasing, there are cases which result in counter-intuitive issues interfering with sensible retirement provision and practice. The significant reductions in the Annual Allowance and in the Lifetime Allowance (with no prospect of indexation) have brought those complexities to bear on a significantly greater proportion of the population.

The changes announced in the Budget 2014, whilst bringing welcome freedoms, also present challenges to ensure that the new freedoms are not manipulated and do not lead to more tax relief being granted than was intended. Unfortunately, this has already introduced further complexity on top of an overly complex system and further anti-abuse measures may be introduced. As we note above, the cost of monitoring and administering the current system is significant and growing all the time, with much of the cost being borne by the employer, and money spent on compliance costs is money that is not invested for individuals' retirement (or indeed for business growth).

We also have the potential for Shared Risk schemes as set out in the Pension Schemes Bill, which the existing taxation system is not designed to cope with.

We believe therefore that the time has come to look again at the basis of tax relief.

GUIDING PRINCIPLES

In terms of developing a new regime, we believe that there are a number of guiding principles that should shape future pension tax relief:

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

We anticipate that there should be no change to the tax treatment of assets held within a pension fund or to the tax treatment of emerging benefits. Changes to either of these would (if the pensions tax regime is to remain credible) require the existing treatment to be grandfathered for existing assets and benefits and therefore require two regimes to run in parallel – so that old complexities would be maintained.

As such, we suggest that the focus should primarily be on changes to the tax treatment of contributions into pension funds.

NEW REGIME FOR DEFINED CONTRIBUTION ARRANGEMENTS

Much of the complexity around pension arrangements arises because of designs made to cap savings in a system where relief is awarded at a person's highest marginal rate, so that the greatest incentive to save is directed at those with the highest earnings and hence marginal tax rate (and greatest scope to "band shift" down to a lower income tax rate when drawing their pension).

We have considered the merits of replacing relief with a matching contribution from government and think that is worth an exploration of an explicit incentive such as a direct match. (It would be akin to an extension of Relief at Source.) A structure involving a match fits well with the communications used for Auto-Enrolment, where the member sees an element contributed by himself, his employer and the government.

However, care would need to be taken to ensure equitable treatment between different types of pension arrangements and methods of paying contributions.

NEW REGIME FOR DEFINED BENEFIT SCHEMES

The current Annual Allowance system suffers from a number of flaws, many of which reflect the nature of Defined Benefit arrangements and the difficulty of expressing a year's additional pension as a single monetary amount.

We have considered whether a simplified system such as a matching contribution could be equally applied to Defined Benefit Schemes. However, the nature of Defined Benefit arrangements is very different from that of Defined Contribution. Under a Defined Benefit arrangement (all other things being equal) the capital value of each year's accrual increases as retirement approaches and the member's age increases.

This highlights three issues with the current approach to measuring Defined Benefit accrual for tax purposes.

First, the method to value accrual is very simplistic (in particular using a flat annuity rate of £16 per £1pa) and was designed to ease the process of valuing accrual when determining the point at which additional taxes applied. This simplistic approach was originally introduced in the context of an Annual Allowance at inception of £215,000 and might have been appropriate even at £50,000 in 2010. With the Annual Allowance at £40,000 from 2014, the weaknesses of the approach are more significant.

Where tax is actually to be paid by an individual on a valuation of his/her accrual (rather than as a measure beyond which additional tax will apply), we believe it is essential to use a more accurate method than the current one to make that valuation, albeit that this will increase the burden on pensions administration.

Secondly, as the accrual of benefits increases with age, the "flat" approach used for the Annual Allowance will tend to mean that young members will be well within the Annual Allowance whereas older members with long service might, even on moderate incomes, run a higher risk of breaching the Annual Allowance if they receive a promotion or sudden pay increase.

Thirdly, the flat factors used for Annual Allowance and Lifetime Allowance purposes lead to significant anomalies in valuation between different ways of drawing Defined Benefits that are in true life cost-neutral, as well as between Defined Contribution and Defined Benefit arrangements.

As such, we believe the current AA valuation methodology is increasingly not fit for purpose.

RISK SHARING SCHEMES

The Pension Schemes Bill introduces a new type of arrangement called a risk sharing arrangement or Defined Ambition Scheme.

Risk sharing arrangements create particular challenges because the build-up of benefits may be irregular. In many ways, it would be preferable just to measure the benefits emerging from risk sharing schemes at retirement but a mechanism that does not regulate the year on year build-up of benefits potentially opens the opportunity for manipulation.

RECOMMENDATIONS

The ACA recommends:

- **There should be no "knee jerk" changes to the pension taxation system after the General Election. We note that even a reduction in LTA might look a simple change – but it brings a new range of individuals into a potentially complex net and creates a new "protected case" for schemes to have to deal with – so its impact should not be underestimated.**

- **The next Government should initiate a fundamental cross-party review of the Pension Taxation system working closely with employers, pension providers, consultants and administration providers to ensure the new system is practical.**

- **The review should ensure that full details of the current reliefs, and their distribution between various constituencies, are understood.**

- **Changes to Pension Taxation should have cross-party support so that any new framework can endure.**

- **Any new framework should be given an appropriate lead time so that those who manage schemes can change systems appropriately and employers and individuals can plan properly for any new change.**

- **Once in place the new framework should not have any changes made to it for many years.**

The Association of Consulting Actuaries (ACA) is the representative body for UK consulting actuaries and is the largest national grouping of consulting actuaries in the world.

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