THE MEMBER BACKING
PENSIONS AND LIFETIME SAVINGS ASSOCIATION

FIVE PRINCIPLES FOR PENSION TAXATION

DISCUSSION PAPER - SECOND EDITION

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EXECUTIVE SUMMARY

- There has been a raft of speculation over the last year that Government plans to reduce the level of financial support for pension saving. In response, the PLSA has sought to identify the principles against which any reform should be assessed and has considered whether the range of reforms most frequently discussed satisfy them.
- The current tax treatment for pensions in the UK is described as EET: exempt on contributions, exempt on investment returns and taxed when taken in retirement. Restrictions are placed on the amount of pensions tax relief an individual can receive, in particular through the Annual Allowance and the Lifetime Allowance.
- People are currently not saving enough to have an adequate income in retirement, so it is essential that any changes to pensions tax relief make the situation better not worse.
- Today, on average a pensioner household has an income of just over £17,000 after housing costs, which is around two-thirds of the median household income (after housing costs) of £24,752 per year However, there are differences between households; for example the bottom fifth of single pensioners have a net income of only £5,824 per year, and the next fifth only £8,736.
- While many current retirees achieve the Moderate and Comfortable levels of the Retirement Living Standards (with 20% of single pensioners and 40% of pensioner couples achieving the Moderate level or above), as many as 40% of single pensioners and 20% of pensioner couples do not achieve the Minimum level. Whilst wider workplace pension participation through AE means that three quarters of employees are likely to achieve at least the Minimum, the shift in the private sector from DB to DC pensions means that only around 25% of pensioners will achieve the Moderate or Comfortable levels in the future.
- A similar picture of declining pension adequacy is seen when looking at future pension incomes using the Target Replacement Rates (TRRs) of the Pensions Commission. In 2016, Hymans Robertson undertook modelling for the PLSA on this issue. The findings showed that of the 25.5 million people then in employment, just over 50%, or 13.6 million people, were at high risk of failing to meet their TRR. When looking at the pension savings of people who have only DC pension savings, who are generally in the private sector and often younger people, only 3% could be expected to achieve their target replacement rate.[1]
- Tax relief provides a crucial support for savers by boosting their savings over the long term. In 2017/18, HMRC estimated the gross cost of fiscal support for pensions as £53.7bn but, in reality, the picture is more complicated. Once income from taxation of

[1] PLSA, Retirement Income Adequacy: Generation By Generation (2016) https://www.plsa.co.uk/portals/0/Documents/0605-Retirement-income-adequacy-Generation-by-Generation.pdf

pensions in payment and non-application of National Insurance on Employer Contributions is accounted for, the net annual cost is estimated as being £18.9bn. The total government public sector spending in 2017/18 was £852bn.[2] Therefore, the net annual cost of pensions tax relief accounts for 2% of total public sector spending. Since Covid-19, the percentage is likely to be even lower. This money contributes to the "social good" of pension saving and helps people live when they can no longer work. It also helps to reduce the number of pensioners who must rely on welfare payments from the tax payer.

- The PLSA supports maintaining the core elements of the current approach to pension tax relief, in particular the EET system, and the level of fiscal support given to pension saving. However, we recognise that the UK is facing a very severe economic and fiscal environment. If the Government chooses to undertake a reform of pensions tax relief, we propose that it should be based on the five principles set out below:

Principles for Pension Taxation

- ***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.

- There are many ways in which the fiscal support for pension saving could be altered or reformed. However, in this report, we have picked out seven that have been frequently discussed by Government, the pension sector, consumer groups, and the media over the last five years. We have compared these against the principles for reform. These reform options are TEE[3], a single rate of income tax relief at 20% for all pensions, a single rate

[2] Based on 2018/19 prices. https://www.instituteforgovernment.org.uk/publication/whitehall-monitor-2020/finances
[3] This is where income tax is fully applied to all contributions but investment returns and income in retirement are both exempt from tax.

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at 25 or 30%, a reduction in the Annual Allowance and Lifetime Allowance, removing NI relief on employer contributions, capping of the tax-free lump sum at £75,000 (retrospectively) and splitting DB and DC tax regimes with changes to DC only.

- Our assessment suggests that neither the current system, nor any of the seven options for reform widely discussed, meet all of our five Principles for Pension Taxation. However, the current system satisfies more of the principles than any other option. The lowest scoring option is TEE; it meets only one of the five principles for reform and fails four of them. The other options only satisfy one or two of the principles, although some do also achieve some neutral scores.
- The outcome of our assessment is set out in the table below:

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Current System	✓	✓	-	✓	-
Single rate at 25 or 30%	✓	✓	-	×	-
Reduction in AA and LTA	×	×	-	✓	✓
Removing NI relief on the Employer Contribution	×	×	-	✓	✓
Capping the tax free lump sum at £75k (retrospectively)	-	×	×	✓	-
Splitting DB and DC regime	✓	-	×	×	×
Single Rate at 20%	×	×	-	×	✓
TEE	×	×	-	×	×

- Rather than embarking on a major reform of pensions tax relief, we think there is more value in addressing some of the more specific and technical shortcomings of the current system. For example, the inequalities created for low income savers due to the differences in tax administration systems used by different pension schemes - the net pay / RAS issue.

INTRODUCTION

Government support for pension saving is a societal good and is beneficial to government in the longer term. Reducing government spending now may mean higher spending on benefit payments in the future due to inadequate saving. Helping individuals to support themselves in retirement is a positive government intervention.

People, however, are currently not saving enough to have an adequate income in retirement (as seen in PLSA research[4]), so it is essential that any changes to pensions tax relief make the situation better not worse.

One way to improve retirement income adequacy is through the tax relief that people receive on their pension contributions. This particularly helps to improve outcomes for automatic enrolment; as savers are being automatically enrolled and not making the decision to opt out. Tax relief boosts their saving capability over the long term as part of the 5% contribution paid by the saver and 3% paid by the employer includes tax relief). Having tax relief at the start and with each contribution is likely to result in larger pot sizes over time.

Over the last year, there has been regular speculation that the Government plans to reduce the level of fiscal support for pension saving. The PLSA has sought to identify the principles on which any reform should take place and consider whether the range of reforms most frequently discussed satisfy them.

This report starts by providing some background information on the nature and scale of fiscal support for pension saving. It then sets out the PLSA's principles for reform, and an assessment of seven often discussed reforms, before drawing conclusions on how the Government should approach this issue.

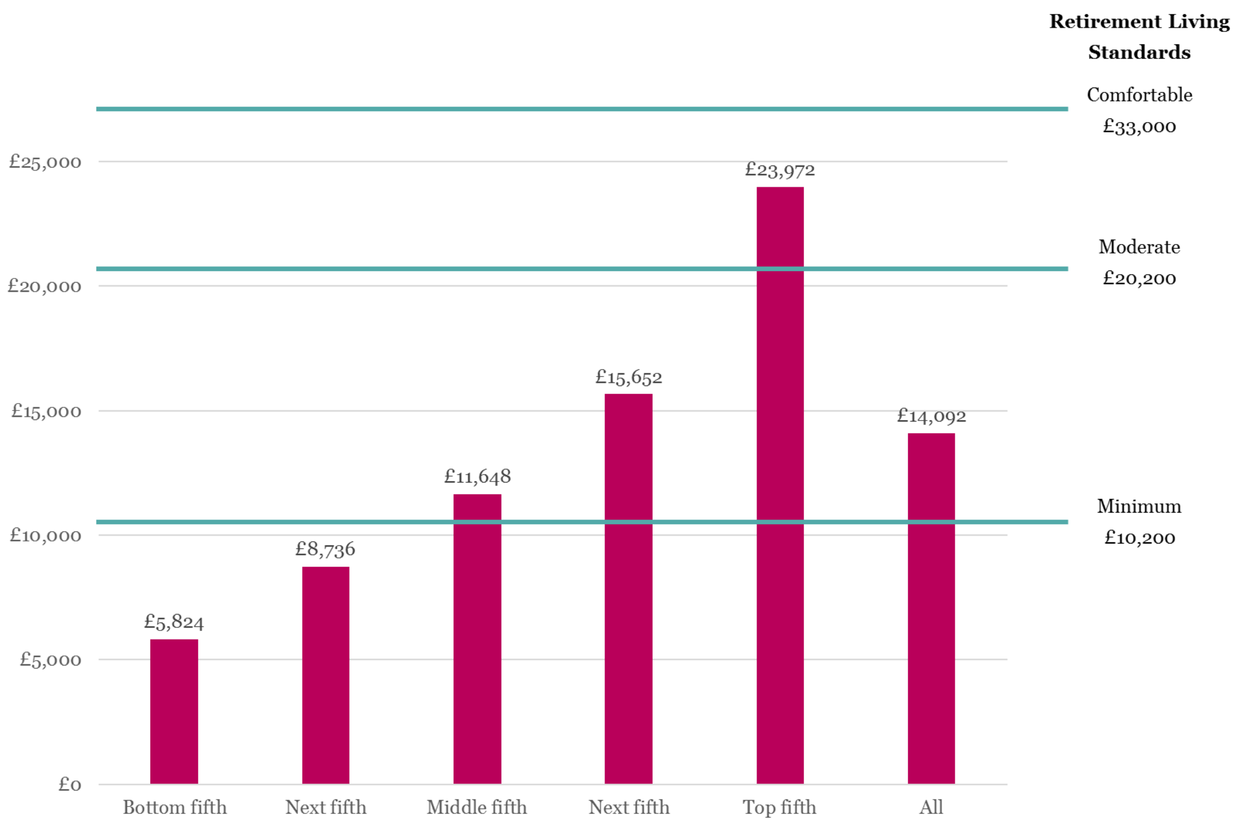
[4] PLSA, Retirement Income Adequacy: Generation By Generation (2016) https://www.plsa.co.uk/portals/0/Documents/0605-Retirement-income-adequacy-Generation-by-Generation.pdf

BACKGROUND

PENSIONS ADEQUACY: ARE PEOPLE SAVING ENOUGH?

Looking at current pensioners, the average pension income[5] (after tax and housing costs[6]) for pensioner households is just over £17,000[7]. This is around two-thirds of the median household income (after housing costs) of £24,752 per year[8]. Many people's pension income is far lower than this level and pension incomes are likely to be worse not better in the future. The bottom fifth of single pensioners have a net income of only £5,824 per year, and the next fifth only £8,736 (see Figure 1 below).

FIGURE 1: SINGLE PENSIONER NET INCOME PER YEAR (AFTER HOUSING COSTS)



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5 Income sources include income from earnings, investment income, personal pension income, occupational pension income and state pension. Income after housing costs is derived by subtracting rent, water rates and charges, structural insurance premiums, mortgage interest payments and ground rent, and service charges from income BHC.

6 After the deduction of direct taxes, other payments such as pension contributions, and housing costs.

7 DWP, Pensioner Income Series: Financial Year 2019 to 2020, March 2021, https://www.gov.uk/government/statistics/pensioners-incomes-series-financial-year-2019-to-2020

8 ONS, Households below average income: an analysis of the income distribution FYE 1995 to FYE 2020, March 2021: https://www.gov.uk/government/statistics/households-below-average-income-for-financial-years-ending-1995-to-2020/households-below-average-income-an-analysis-of-the-income-distribution-fye-1995-to-fye-2020#:~:text=In%20FYE%202020%2C%20the%20average,around%20%C2%A324%2C900%20per%20year).

When current single pensioner incomes are assessed against the Retirement Living Standards, three definitions of retirement lifestyles identified by the PLSA on the basis of independent research with the UK population, it is concerning to note that 40% (the two bottom quartiles) fall below the Minimum level standard[9], and only 20% (the top quartile) achieves the moderate level. Looking at single pensioners as a whole, the average sits just above the Minimum level (see Figure 1 above).

PLSA Retirement Living Standards

Minimum

This lifestyle covers all a person's needs, with some left over for fun and social occasions. It envisages people being able to holiday in the UK, eat out about once a month and do some affordable leisure activities about twice a week.

Moderate

This lifestyle provides more financial security and more flexibility. It envisages people have one foreign holiday per year and eating out a few times a month. It provides opportunities for people to do more of the things they want to do.

Comfortable

This lifestyle enables people to be more spontaneous with their money. It includes things like a subscription to a streaming service, regular beauty treatments and two foreign holidays a year.

The total cost of each Retirement Living Standard is as follows:

	SINGLE	COUPLE
Minimum	£10,200	£15,700
Moderate	£20,200	£29,100
Comfortable	£33,000	£47,500

A similar picture emerges when looking at the incomes of pensioner couples. In the middle quintile, the net income for a pensioner couple is just under £25,000. The bottom fifth of

[9] The minimum level is based on Loughborough University research for the Joseph Rowntree Foundation (JRF), https://www.jrf.org.uk/income-benefits/minimum-income-standards.

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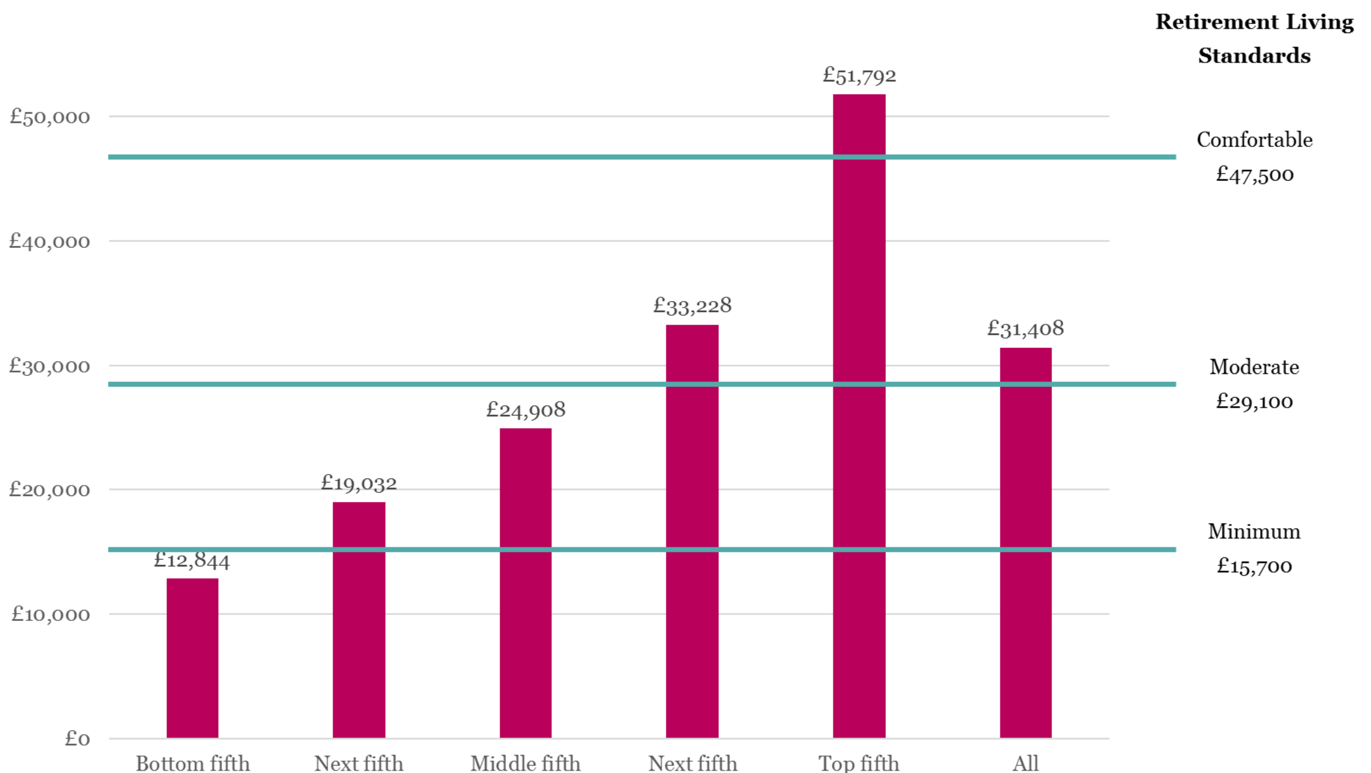
pensioner couple net incomes is only £12,844 and of the next fifth only £19,032 (see Figure 2 below).

FIGURE 2: PENSIONER COUPLE[10] NET INCOME PER YEAR (AFTER HOUSING COSTS)



When current pensioner couple incomes are assessed against the Retirement Living Standards, we find that 20% (the bottom quintile) fall below the Minimum level standard, and 20% (the top quintile) achieve the highest, Comfortable level. Looking at pensioner couples on average their income level is just over the Moderate level (see figure 2 above).

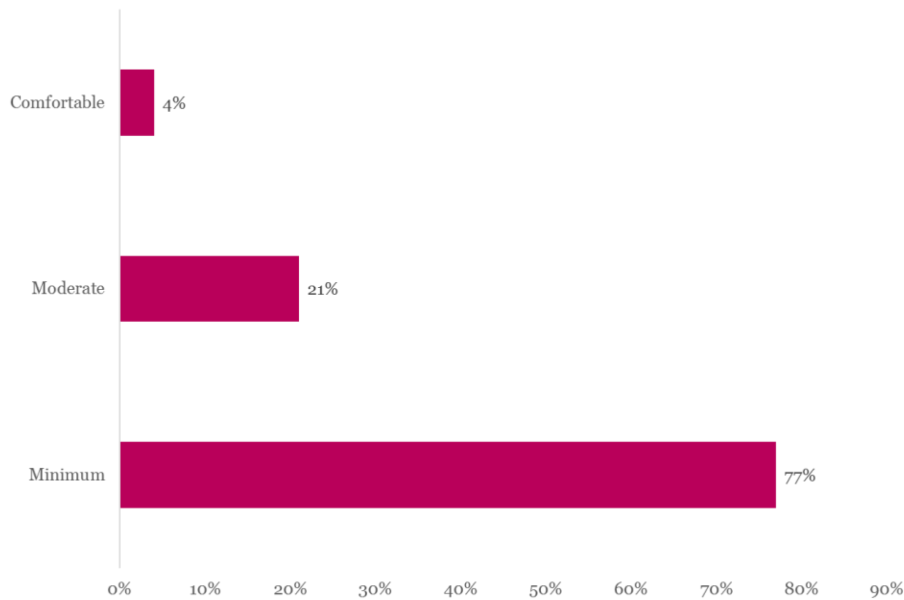
Overall, this assessment shows that when looking at current pensioners, while many do achieve the Moderate level, and some the Comfortable level, 20% of pensioner couples and 40% of single pensioners fall below the Minimum standard.

Unfortunately, this situation is not likely to improve in the future. According to PLSA analysis, if we look at all of today's workers, our modelling tells us that at an automatic enrolment contribution rate of 8% of band earnings (with the lower band removed as Government has promised from the mid-2020s) and assuming an annuity is purchased at

[10] DWP, Pensioner Income Series: Financial Year 2019 to 2020, https://www.gov.uk/government/statistics/pensioners-incomes-series-financial-year-2019-to-2020

retirement, far fewer future pensioners will achieve each of the Retirement Living Standards than is currently the case. Looking at the working population, only around a quarter will achieve the Moderate or Comfortable levels:

FIGURE 3: PROPORTION OF THE WORKING POPULATION PROJECTED TO ACHIEVE A MINIMUM, MODERATE AND COMFORTABLE RETIREMENT LIVING STANDARD



We have found a similarly unpromising picture when we use a different assessment of pension income – the Target Replacement Rates (TRR) used by the 2006 Pensions Commission. This independent body identified targets for pension saving for people of different income levels such that they would be able to maintain their pre-retirement lifestyle in retirement. In its 2004 report[11], the Pensions Commission proposed target replacement rates for different levels of earnings.

FIGURE 4: PENSIONS COMMISSION TARGET REPLACEMENT RATES

OVERALL 2004 INCOME BAND	INCOME BAND IN 2021 EARNINGS TERMS	TARGET REPLACEMENT RATE
Up to £9,500	Up to £15,000	80%
£9,500-£17,500	£15,000-£27,500	70%
£17,500-£25,000	£27,500-£39,300	67%
£25,000-£40,000	£39,300-£62,800	60%
Over £40,000	Over £62,800	50%

In 2016, Hymans Robertson undertook modelling for the PLSA that examined the likelihood that workers would have a pension equivalent to the Pensions Commission's

[11] Pensions Commission 2004, Pensions: Challenges and Choices, The First Report of the Pensions Commission

target replacement rate.[12] The findings showed that, of the 25.5 million people then in employment, just over 50%, or 13.6 million people, were at high risk of failing to meet their TRR.[13]

Moreover, recent LCP analysis shows that private sector DB rights at retirement are close to their peak and will decline precipitously in the next 25 years. At the same time, DC rights will only grow slowly over the same time period to replace the loss of DB rights.[14] This means that the next generations of people who have not had time to build up DC entitlements under AE and do not have DB rights are likely to have lower pension income. PLSA and Hymans Robertson analysis found that where people only have a defined contribution pension, 97% were likely to fall short of the savings targets.[15]

This was also borne out by recent analysis of the ONS Wealth and Assets Survey by the Resolution Foundation which found that within the bottom half of the income distribution, 42% of those employees reported having no private pension wealth.[16]

WHAT IS PENSIONS TAX RELIEF?

Pensions tax relief is made up of two main components: income tax relief on employer and employee contributions and relief on investment income of pensions funds. For most people, the main benefit of pension tax relief is gained at retirement through the 25% tax free lump sum. Pensions also receive fiscal support through the exemption of National Insurance payments on employer contributions (pension NICs relief).

The current tax treatment for pensions in the UK is described as EET: exempt on contributions, exempt on investment returns and taxed when taken in retirement. Therefore, it is more accurate to describe pensions income tax relief as tax deferred rather than relief – *as tax is paid* on 75% of the pension fund when it is withdrawn after age 55.

Restrictions are placed on the amount of pensions tax relief an individual can receive, through the Annual Allowances and the Lifetime Allowance. The standard Annual Allowance (AA) provides a limit on how much tax relief an individual can receive in a given

[12] The TRR for someone with pre-retirement gross earnings of less than £9,500 is 80%, between £9,500 to £17,499 is 70%, between £17,500 to £24,999 is 67%, between £35,000 to £39,999 is 60% and is 50% for those earning £40,000 or more (2005 figures).

[13] PLSA, Retirement Income Adequacy: Generation By Generation (2016) https://www.plsa.co.uk/portals/0/Documents/0605-Retirement-income-adequacy-Generation-by-Generation.pdf

[14] LCP, "The Ski-Slope of Doom" – is this the most worrying chart in pensions, April 2021, https://insight.lcp.uk.com/acton/attachment/20628/f-186c6faa-226c-4946-b5a6-24422e12dfc8/1/-/-/-/-/%E2%80%9CThe%20Ski-Slope%20of%20Doom%E2%80%9D%20%E2%80%93%20is%20this%20the%20most%20worrying%20chart%20in%20pensions%3F.pdf

[15] PLSA, Retirement Income Adequacy: Generation By Generation (2016) https://www.plsa.co.uk/portals/0/Documents/0605-Retirement-income-adequacy-Generation-by-Generation.pdf

[16] Resolution Foundation (2021), Building a Living Pension, https://www.resolutionfoundation.org/publications/building-a-living-pension/

year (e.g. through DC contributions or DB entitlement changes). The Annual Allowance is currently set at £40,000. However, for those with a threshold income in excess of £200,000, the AA is reduced gradually to £4,000 (called the AA taper).

The Money Purchase Annual Allowance (MPAA) restricts the amount of tax relief an individual can receive on pension contributions once they start taking money from a DC pension. This is to prevent people from 'recycling' their pension. Once the MPAA is triggered, tax relief is only given on contributions up to £4,000 per annum.

The Lifetime Allowance (LTA) provides for any contributions made above the limit (once benefits have been crystallised) to be taxed. The LTA is currently set at £1,073,100.

Employers can choose from two ways to apply tax relief to members' pension contributions: Net pay arrangements and Relief at Source (RAS) arrangements. Trust-based[17] pension schemes tend to operate net pay arrangements, while contract-based providers ordinarily use RAS arrangements. Each arrangement has its pros and cons and neither works well for all schemes or all savers.

[17] A trust-based scheme is run through an appointed board of trustees who have a fiduciary duty to act in members' best interests. Contract-based schemes are run on a contract between members and the pension provider.

Two current issues with pensions tax relief

Net pay / relief at source (RAS) Anomaly

The operation of net pay and RAS regimes has created some anomalies, mainly, on savers earning below the minimum tax threshold (i.e. the personal income tax allowance). Those who contribute to a scheme operating a RAS arrangement receive a tax rebate of 20% on their own contributions, however an equivalent worker in a net pay scheme does not receive a tax rebate on their own pension contributions. Similarly, higher rate taxpayers in RAS schemes only receive tax relief equivalent to 20%, if they do not claim the higher rate back from HMRC. The PLSA believe that the best solution to overcome this anomaly and ensure that savers are getting the tax relief they are entitled to is through changes to HMRC's P800 process. Urgent consideration and action of this issue is needed to resolve the net pay / RAS anomaly.

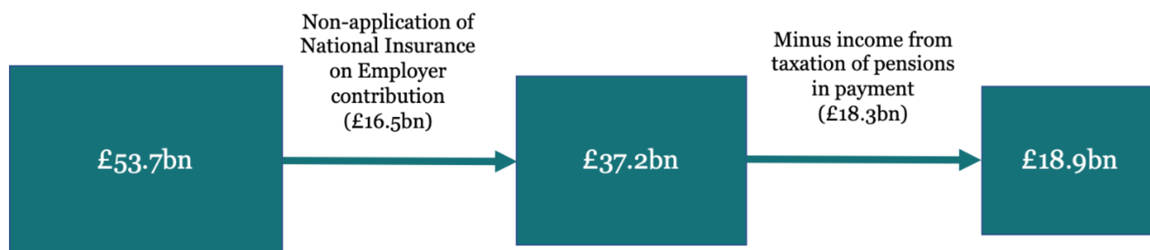
Money Purchase Annual Allowance (MPAA)

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 may be limited in their ability to rebuild their pension pot due to the £4,000pa limit. These people are not purposefully 'recycling' their pension, which is the behaviour the policy is intended to prevent. 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.

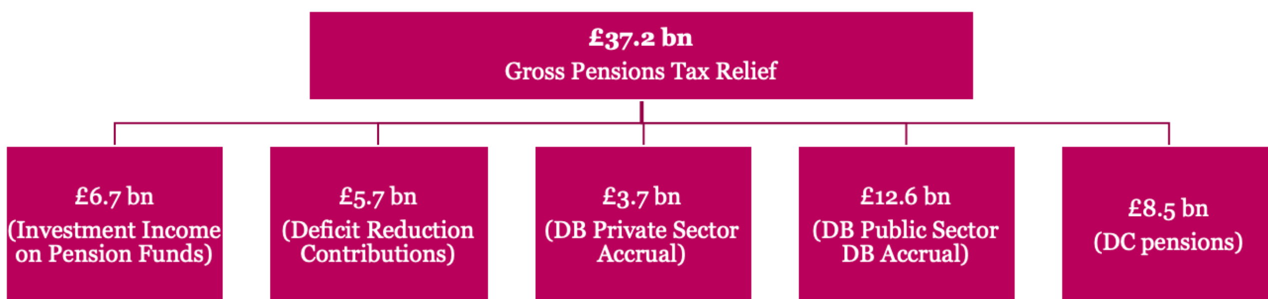
HOW MUCH IS SPENT ON PENSIONS TAX RELIEF?

In 2017/18 HMRC estimated the gross cost of fiscal support for pensions as £53.7bn but, in reality, the picture is more complicated.

Once income from taxation of pensions in payment and non-application of National Insurance on Employer Contributions is accounted for, the net annual cost is estimated as being £18.9bn. The total government public sector spending in 2017/18 was £852bn.[18] So the net annual cost of pensions tax relief accounts for 2% of total public sector spending. Since Covid 19, the percentage is likely to be even lower. This money contributes to the "social good" of pension saving and helps people live when they can no longer work. It also helps reduce the number of pensioners who must rely on welfare payments from the tax payer.



The £37.2bn figure can be further broken down into different areas.[19]



Savings that can be made through reforms to pensions tax relief are likely to be far lower than widely quoted in the media. Removing tax relief from the investment income on pension funds would negatively impact investment growth. Collecting tax from members related to Deficit Reduction Contributions (DRCs) would be complex and controversial.

[18] Based on 2018/19 prices. https://www.instituteforgovernment.org.uk/publication/whitehall-monitor-2020/finances
[19] Based on PLSA estimates.

DRCs cannot easily be attributed to individuals within the scheme and, even if they could, many would not be active members and would include pensioner members.

If we set aside altering the exemption from taxation of investment income and DRCs as undesirable or impractical, it leaves £24.8bn of potential revenue for the Exchequer. However, this would only be achieved if both DB and DC pensions lost all income tax relief. Taxing active members of DB pension schemes, most of whom work in the public sector, including senior NHS and social care workers, would also be complex and controversial. If DB schemes were to be left untouched by reform, it would reduce the potential tax relief saving to £8.5bn. Only a small part of this would be recovered by moving to a single rate of tax relief for DC.

Introducing major change to the system of fiscal support for pensions risks undermining hard-won confidence in pensions. This, in turn, could undermine the gains made in recent years, particularly through the advent of automatic enrolment and systemic improvements in governance and value for money. Therefore, any potential reforms should be fully thought-through and assessed, taking account of both the obvious direct effects and the scope for behavioural change.

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FIVE PRINCIPLES FOR PENSION TAXATION

The PLSA supports maintaining the main elements of the current approach to pension tax relief, in particular the EET system, and the level of fiscal support given to pension saving. However, due to Covid-19 we recognise that the UK is facing a very severe economic and fiscal environment. If the Government chooses to undertake a reform of pension tax relief, we believe that it should be based on the five principles set out below.

These principles have been developed through careful discussion with the PLSA Policy Board and with a senior-level Steering Group[20] looking at the issue of pension tax relief. Our principles for pension taxation are:

Principles for Pension Taxation

- ***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.

The principles have also been tested via research with our wider PLSA membership, in particular with the PLSA Reference Groups.[21] Among our members there were high levels of support for the PLSA principles, with most support for "promoting adequacy", "enduring and sustainable" and "encourages the right behaviours". If the five principles are used as a basis for reform we believe it should result in an effective system of pension tax relief.

[20] Members of the Steering Group included the Policy Board Chair, the PLSA Chair and the Chairs of the PLSA's main Policy Committees. See Annex 1.

[21] PLSA Reference Groups provide a channel of extra insight from PLSA members on policy issues. There are four reference groups, covering DB, DC, Master Trusts and Local Authority pensions. There are around 100 members on each group.

SEVEN OPTIONS FOR REFORM

There are many ways in which the fiscal support for pension saving could be altered or reformed. However, in this report, we have picked out seven that have been frequently discussed by Government, the pension sector, consumer groups, and the media over the last five years.

The reform options considered in this report are:

- **TEE**: This is where income tax is fully applied to all contributions but investment returns and income in retirement are both exempt from tax.

And modifications to EET through:

- **Single rate at 20%**: The same rate of tax relief at 20% is applied to all pension contributions, rather than at a saver's marginal rate of income tax as is currently the case.

- **Single rate at 25 or 30%**: The same rate of tax relief at 25 or 30% is applied to all pension contributions, rather than at a saver's marginal rate of income tax.

- **Reduction in the Annual Allowance (AA) and Lifetime Allowance (LTA)**: The AA is currently set at £40,000, under this reform option it is assumed to have been reduced to £30,000. The LTA is currently set at £1.07 million, under this reform it is assumed that it is reduced to £750k.

- **Capping the tax-free lump sum at £75k (retrospectively)**: Currently, savers can take 25% of their pension without being eligible to pay tax. Under this reform option, the amount that could be withdrawn would be 25% up to the value of £75k[22].

- **Removing NI Relief on Employer Contribution:** Currently National Insurance is not payable on the employer pension contribution; whereas, National Insurance is payable on the employee contribution. Under this scenario employer pension contributions would be subject to National Insurance – same as the employee contribution.

- **Splitting the DB and DC tax regime:** The regime for DB would not be changed but DC contributions would be subject to a single rate of income tax relief of 25%.

[22] Based on Wealth and Assets Survey from 2016-18, at the 75th percentile the tax free cash on pensions already accumulated is £73,750 for those aged 55-64.

ASSESSMENT OF REFORM OPTIONS

We have examined the current approach to pension tax relief and the reform options outlined in the previous section.

TEE

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
TEE	×	×	-	×	×

- *Promotes adequacy:* 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. Under TEE, a basic rate tax payer would have a 20% reduction in their private pension income before tax and for a higher rate tax payer it would lead to a 37% reduction.[23] It would completely undermine the concept of pensions as distinct from other forms of tax-incentivised savings, such as ISAs.

- *Encourages the right behaviours:* TEE removes much of the incentive to save for the long term. Besides discouraging pension saving in general, TEE would remove an important brake on withdrawals under pension freedoms as the money taken out would not be taxed. People might be more likely to take all of their pension saving in one lump sum rather than as a yearly income. In the long run this may mean that more government support is needed to ensure pensioners do not end up in poverty, if their resources have been used too quickly.

- *Fair:* Under TEE, everyone would pay tax on their pension contributions at their marginal rate of tax when working. However, a number of groups would lose out compared to the current system, e.g. non-taxpayers who currently gain from the relief at source system would lose that benefit altogether.

- *Simple to adopt and administer:* TEE would create complexity and significant additional cost for employers through necessary changes to payroll systems – something which may cost millions of pounds for larger employers. It would also

[23] PPI modelling undertaken for the PLSA January 2021. Figures relate to a median earner and higher rate tax payer throughout most of their career in a DC scheme contributing at the minimum for automatic enrolment.

require two accounts for every current active member of every scheme, meaning a two-track system will have to be supported potentially for decades.

- *Enduring and sustainable:* TEE would mean that, rather than currently where government receives tax revenue from pensions at the point when people retire and are most likely to need health and welfare support, government will instead receive it much earlier. Given that the UK has an ageing society, with associated costs rising to government as society ages, this is a fiscally high-risk strategy. Few people will believe that a future government will not be tempted to also tax pensions at the point of withdrawal – thereby making the system not TEE but TET. While such a system could lead to an upfront positive fiscal flow for HMT, the revenue gain would fall over time as income from pensions in payment fall and then stop.

SINGLE RATE AT 20%

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Single rate at 20%	×	×	-	×	✓

- *Promotes adequacy:* A single rate at 20% would not improve the retirement income adequacy of basic rate tax payers, as they would receive the same level of government support as in the current system. However, unless they save even more than today, it will reduce adequacy for higher rate tax payers as they will receive a reduction in the amount of tax relief. This will worsen the position of many higher rate tax payers, as we know that many, particularly those earning between £50,000 and £100,000, are already saving inadequately for retirement. A higher rate tax payer could see a reduction of 22% in their private pension income before tax.[24] Under a single rate, we believe the employer pension contribution would have to become a taxable benefit and included in payroll (with the scheme reclaiming the single rate relief) (see Annex 2). This could also have implications for those basic rate taxpayers close to the higher rate tax threshold by tipping them into a higher rate tax bracket. For some, this could have additional implications for claiming benefits or tax credits e.g. childcare tax credits. Someone on the cusp of paying higher rate may see a reduction of 7% in their private pension income before tax.[25]

[24] PPI modelling undertaken for the PLSA January 2021. Figures relate to a higher rate tax payer throughout most of their career in a DC scheme contributing at the minimum for automatic enrolment.

[25] Figures relate to a person on the cusp of paying higher rate tax throughout most of their career in a DC scheme at the minimum for automatic enrolment.

- *Encourages the right behaviours:* A single rate of tax relief would involve the "double taxation" of some income for some people, in contradiction of one the key principles of fair taxation.[26] The very threat of double taxation may inhibit some from continuing to make pension contributions, particularly if the option of taking cash instead of an employer contribution is made available.

- *Fair:* While it might seem reasonable to reduce tax relief for the 13% of the working population who pay higher rate income tax, i.e. those earning above £50,000 per year, it should be remembered that many more than 13% of tax payers will earn this amount at some time, and many only for a short number of years towards the end of their careers – when pension saving is often at its highest. We estimate that the removal of higher rate tax relief on pension contributions could result in around 3-4 million taxpayers each paying an average of £2,000 more tax each year; money that would otherwise have gone into their pensions. Higher earners in DB schemes would either find themselves paying a lot more tax or having benefits reduced significantly every year in order for the scheme to pay the tax.

- *Simple to adopt and administer:* A single rate would create complexity and significant additional cost for employers because of changes to payroll systems and the need to explain the change to their workforce. This would be particularly the case as employer contributions need to be taxed through payroll before being paid into the scheme. This is because the single rate would also need to apply to the employer contributions to remove avoidance. Updates to payroll systems would take time, potentially 2-3 years, and changes are likely to cost in the millions of pounds for employers. A single rate will introduce considerable process and system changes for all pension schemes and pension providers, potentially leading to a new form of relief at source (see Annex 3).

- *Enduring and sustainable:* The rate of relief would be anchored to the basic rate tax relief. Keeping the single rate linked to income tax should limit any further reductions in fiscal support. The PLSA estimates that the Treasury would gain around £8bn - £10bn from a single rate at 20% if people carry on with the same level of pension saving as now.[27]

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[26] OECD (2014), Addressing the Tax Challenges of the Digital Economy, https://www.oecd-ilibrary.org/docserver/9789264218789-en.pdf?expires=1612793211&id=id&accname=guest&checksum=F42FBFD9B06DF3F992DEDD339B3B85C1

[27] Model based on contributions and assumes between 34 and 60% of DB contributions are from higher rate taxpayers (T3.8 Survey of Personal Incomes 2017/18).

SINGLE RATE AT 25 OR 30%

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Single rate at 25 or 30%	✓	✓	-	×	-

- *Promotes adequacy:* A single rate at 25 or 30% would improve adequacy of basic rate tax payers in DC, as they would receive a higher rate of relief into their pension, boosting private pension income before tax by 5-14% for basic rate taxpayers.[28] However, when combined with state pension and subject to tax, the percentage increase on total take-home retirement income drops to a more limited 1-9%%. It would have a negative impact on adequacy for higher rate tax payers, as there will be a reduction in the amount of support they receive, however, the loss will be smaller than at a single rate of 20%. A higher rate tax payer would see a reduction of 10-17% in their private pension at retirement, depending on whether the rate was 25 or 30%.[29] Again, there may be implications for those close to paying the higher rate; including employer contributions as a taxable benefit could push some into the higher rate for some or all of their contribution (see Annex 2).

- *Encourages the right behaviours:* Although, it is hard to assess behavioural effects, the increased level of government support may encourage basic rate taxpayers to increase their level of contributions. The messaging from Government, media and employers will be critical to ensure that people contribute to their pensions. Clearly, higher rate income tax payers unless they increase their contribution rate will pay less into their pensions and, all other things being equal will have a lower income in retirement. The prospect of double taxation may cause some to cease paying pension contributions altogether.

- *Fair*: A single rate above basic rate will provide a boost in savings to basic rate taxpayers. However, people who pay higher rate income tax (or are on the cusp of a higher rate), will lose out, although by less than is the case if the Government moves to a single rate set at 20%.

- *Simple to adopt and administer*: Complex and significant system changes would be needed to implement a single rate at 25 or 30% in order to claim the additional bonus

[28] PPI modelling undertaken for the PLSA January 2021. Figures relate to a median earner in a DC scheme contributing at the minimum for automatic enrolment.

[29] Figures relate to a higher rate tax payer throughout most of their career in a DC scheme contributing at the minimum for automatic enrolment.

for basic rate taxpayers and to pay tax on higher rate taxpayers' contributions (as outlined in Annex 3). Moving to a single rate could lead to the closure of many of the remaining defined benefit schemes in the private sector.

- *Enduring and sustainable*: Once the rate of pensions tax relief is decoupled from the rate of income tax, we believe it will be easier in the future for governments to further reduce relief. The PLSA estimates that the Treasury would gain around £3.5bn-£4.8bn from a single rate at 25%. If set at 30%, the amount raised is a more mixed picture - our estimates show that the Treasury could gain £1.5bn or they could lose an additional £1bn in revenue.[30]

REDUCTION IN THE ANNUAL ALLOWANCE (AA) AND LIFETIME ALLOWANCE (LTA)

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Reduction in the Annual Allowance (AA) and Lifetime Allowance (LTA)	×	×	-	✓	✓

- *Promotes adequacy:* Clearly, a reduction in the Lifetime Allowance will reduce pensions adequacy among those who are affected, i.e. people with or hoping to have substantial pension savings. Reductions in the Annual Allowance could reduce adequacy among people who make contributions on an irregular or "lumpy" basis such as the self-employed, someone with peak earnings late in life, or someone selling their business or receiving an inheritance.

- *Encourages the right behaviours:* A lower AA may disadvantage some people who have held off pension saving later into their career and inhibit them from making pension contributions when they are better able to afford it. Similarly, it may inhibit saving among self-employed people who wish to a make a larger contribution to their pensions, for example, due to a short period of higher earnings or upon selling their business.

[30] Model based on contributions and assumes 34-60% of DB contributions are from higher rate taxpayers (T3.8 Survey of Personal Incomes 2017/18).

- *Fair:* A reduction in the allowances will not affect most DC savers. However, it is likely to affect people in defined benefit pension schemes, often catching senior public sector workers such as doctors, also those, such as the self-employed, who are likely to save in lump sums.

- *Simple to adopt and administer:* Compared to other reform options discussed it is relatively simple to adopt and administer, as it is a change to the current system rather than a complete overhaul. However, the AA and the LTA are a large administrative burden for schemes, especially for defined benefit ones, and for individuals. Lowering the AA and LTA would lead to a very substantial increase in the number of DB calculations which schemes need to undertake, and increase the number of savers affected.

- *Enduring and sustainable:* It is hard to estimate how much revenue would increase through a reduction in the AA and LTA. However, given that only a minority of people save close to either allowance, it is likely to be relatively small and it would take some time for the impact of a lower LTA to be felt by the Treasury.

CAPPING THE TAX FREE LUMP SUM (TFLS) AT £75K (RETROSPECTIVELY)

REFORM OPTION	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Capping the tax free lump sum at £75k (retrospectively)	-	×	×	✓	-

- *Promotes adequacy:* A cap of £75,000 would mean that around 25% of people aged 55-64 would be affected, based on current Wealth and Assets data[31]. Those with DB pensions would be disproportionately affected. More than 25% of DB members aged 45 or over have already accrued more than £50,000 of tax-free cash. Over time a fixed sum will affect a greater proportion of savers.

- *Encourages the right behaviours:* It may be a disincentive to people saving into a pension to contribute beyond the point where they can no longer get additional tax free cash. For example, if the TFLS is set at £75k, someone in a DC pension might cease to save in a pension over £300,000 (therefore, especially affecting higher earners) or to leave their DB scheme once £15,000 per annum of retirement income is accumulated. Savers may worry about additional cuts to the tax-free lump sum and therefore move to

[31] Based on value of pension wealth in 2016-2018 Wealth and Assets survey.

other saving vehicles, even they are not affected. Unless changes come into effect immediately, it may increase risky behaviour as those who are able to access their pension might try and take their tax-free lump sum earlier. This could potentially make them more susceptible to, and increase the risk of, scams.

- *Fair:* This would be a major retrospective change and so could be considered unfair for those who saved in the belief they would get 25% TFLS without it being capped (outside of the lifetime allowance). This means that it could potentially lead to a legal challenge through the courts. Capping the amount would further limit the tax relief available to higher earners or those who make higher pension contributions. Most larger TFLS are in DB pensions so it would affect the public sector, e.g. senior clinicians in the NHS, more than the private sector. Changing the tax free lump sum also has significant intergenerational fairness issues. Younger generations will not have access to the same benefits as previous generations.

- *Simple to adopt and administer:* A cap would add cost and complexity for schemes if expressed as a pound figure but it would be less complex if cast as a smaller percentage (e.g. 20% rather than the current rule of 25%). If a nominal amount is used as the cap e.g. £75k, each scheme would have to provide evidence to the member of the tax-free cash already taken so that this could be provided to other schemes in order for the limit to be regulated. Each time an individual wanted to cash in some of their pension, they would have to supply evidence from their other pension schemes on how much they had already taken in tax free cash. If they had already taken £75,000 then the scheme would have to subject the whole amount to tax using the individual's tax code. However, if a percentage figure rather than a nominal amount is used, it would be less complex for the scheme but wider in impact because it would affect all savers and not just those with larger pots.

- *Enduring and sustainable:* In order for HMT to raise significant funds from the change, it would have to be implemented retrospectively and not only on future accrual. If the amount was set at the 75th percentile of pension wealth held by those approaching retirement this would mean the amount would have to vary in the future to avoid fiscal drag. This would add a further layer of complexity for schemes and may make it harder for people to plan. Governments are also unlikely to uprate the amount so more and more people would be captured over time. In 2013, PPI predicted that limiting tax free cash to £36,000 would raise £2bn p.a. at the outset. In order to raise this amount it would need to be applied to all existing pensions. If only applied to future accrual it would raise far less in the short term.

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REMOVING NI RELIEF ON THE EMPLOYER CONTRIBUTION

REFORM OPTION	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Removing NI relief on the Employer Contribution	×	×	-	✓	✓

- *Promotes adequacy:* Both employers and members would have to pay more in NI on the employer contribution. For employers it will increase pension-related costs by 13.8% and for members it could add up to 12% to the cost of saving. For the employer, removing NI Relief will increase payroll costs, and for the employee would lead to a reduction in pension contributions or take-home pay.

- *Encourages the right behaviours:* It is very likely to be a disincentive for employers to contribute above AE minimum contributions – as they do not benefit from a lower NI bill. It would likely result in DB closures and lower DC contributions.

- *Fair:* It would affect everyone in more or less the same way. However, arguably, the negative implications for DB would be even worse than for those in DC because total contributions are typically that much higher than for DC. Due to the way NI is applied on employees, median earners are likely to be hit most.

- *Simple to adopt and administer:* Compared to other reforms this could be simpler to adopt (for DC) but will require some changes to payroll systems in order to calculate the NI payable by the member on the employer contribution. However, no administrative changes would be required by DC pension schemes. On the other hand, for DB pension schemes, there may need to be a calculation on the value of the employer contribution to calculate the amount of NI due, that would then be fed into payroll.

- *Enduring and sustainable:* Absent of behavioural change by employers and members, the Treasury would raise considerable revenue from removing NI relief. In 2017/18, the non-application of NI on the employer contribution cost £16.5bn. However, if we are right to assume this reform would result in the closure of DB schemes and lower levels of pension contributions, the actual savings to HMT would be much lower. And, if to avoid the negative effects on DB pensions, the change was only applied to DC pensions, the savings for Government would be considerably less.

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SPLITTING DB AND DC REGIME

The assessment below is based upon the tax regime for DB members remaining as it is now and the regime for DC members changing to a single rate of tax relief in excess of the basic rate of income tax (i.e. 25% rather than the basic rate of 20%).

REFORM OPTION	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Splitting DB and DC regime	✓	-	✗	✗	✗

- *Promotes adequacy*: It would improve adequacy of basic rate tax payers in DC but would have a negative impact on adequacy for higher rate tax payers in DC. There would be no change for DB savers. On balance, it could be argued this is overall positive.

- *Encourages the right behaviours*: It may encourage basic rate taxpayers to increase their level of contributions in DC schemes. However, having two different systems could cause confusion for savers who contribute to both DB and DC pension savings; and particularly complex for those in hybrid schemes.

- *Fair:* A single rate above basic rate will provide a boost in savings to basic rate taxpayers in DC. However, people in DC who pay higher rate income tax (or are on the cusp of a higher rate) will lose out. Having a difference between DB and DC, where there is no change to DB, is likely to be seen as unfair, especially as the total tax supported saving in a DB pension (£50k pa approx.) already provides more than for a DC pension (£30k pa approx.). Compared to DC, basic rate taxpayers in DB may lose out by not having the 25% rate relief, whilst there would be no impact for higher earners in DB, who would not be losing out on marginal rate relief.

- *Simple to adopt and administer*: Complex and significant system changes would be needed in DC to implement a single rate at 25% in order to claim the additional bonus for basic rate taxpayers and to pay tax on higher rate taxpayers' contributions. It would also create arbitrage between DB and DC which would need to be resolved and there would be complexities for converting DB to DC (and vice versa). There would also be issues for hybrid open schemes, e.g. DB with DC top ups and schemes that may come with characteristics of both, such as CDCs.

- *Enduring and sustainable*: For DC, once the rate of pensions tax relief is decoupled from the rate of income tax, we believe it will be easier in the future for governments to further reduce relief. The only new revenue for the government comes from the single rate on DC, which, at 25%, is only likely to raise about £0.6bn in additional revenue for the exchequer.

CURRENT SYSTEM

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Current System	✓	✓	-	✓	-

- *Promotes adequacy:* The current system provides a high level of fiscal support for pension saving. Under many of the reforms we have assessed, the result would be less government support for pensions, which would therefore have a detrimental effect on adequacy.

- *Encourages the right behaviours:* The current system supports the right behaviours by encouraging people to contribute into their pensions in two ways. One, an awareness that the Government "make a contribution" to pension saving and, secondly, the existence of the 25% tax-free bonus at withdrawal makes pensions an attractive savings-vehicle.

- *Fair:* It treats pension contributions as deferred income and provides savers with relief at the point of contribution. However, as those on higher incomes save more in pensions, it does mean that a substantial share of this fiscal support is received by people earning over £50,000 in any given year. Many people argue if reforms are to be made, they should benefit those on low to median incomes.

- *Simple to adopt and administer:* Although the current system can be complex and would benefit from some simplification, e.g. a solution to the net pay / RAS issue or to the Money Purchase Annual Allowance, having no change would be the simplest option of those considered; from an administrative perspective.

- *Enduring and sustainable:* The system of EET for pensions has been in place for around a century and, despite some reductions in the allowances (since the "simplification reforms" of 2006), it has demonstrated its durability. That said there are

questions about the sustainability of the current system given the current levels of government debt and budget deficit.

OVERALL ASSESSMENT

The assessment set out suggests that neither the current system, nor any of the seven options for reform widely discussed, meet all of the five principles for pension taxation. The current system satisfies more of the principles than any other option. The lowest scoring option is TEE; it meets only one of the five principles for reform and fails four of them. The other options only satisfy one or two of the principles, although some do also achieve some neutral scores.

The outcome of our assessment is set out in the table below:

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Current System	✓	✓	-	✓	-
Single rate at 25 or 30%	✓	✓	-	×	-
Reduction in the AA and LTA	×	×	-	✓	✓
Removing NI relief on the Employer Contribution	×	×	-	✓	✓
Capping the tax free lump sum at £75k	-	×	×	✓	-
Splitting DB and DC regime	✓	-	×	×	×
Single Rate at 20%	×	×	-	×	✓
TEE	×	×	-	×	×

CONCLUSION

On the basis of our assessment against the five principles for pension taxation, none of the reforms set out in this report, as discussed by Government, the pensions sector, consumer groups or the media, should be adopted. Therefore, we believe that the current approach to pensions tax relief, in particular, the EET system should be maintained.

However, we appreciate that in the very challenging fiscal climate, Government will be reviewing all options to relieve pressure on the public purse. Therefore, if reform does happen we believe it should be in line with the principles set out in this report. The implications of reform and how it can be implemented should be fully thought through to ensure there are no unintended consequences. It is essential that the impacts of any changes are assessed, especially with regard to savers, schemes and employers.

The time-scales for any reform should be realistic and practical. Depending on the type of reform, it may take significant amounts of time, and investment, to implement. This would need to be recognised in both the time allowed for consultation and for implementation.

Rather than embarking on a major reform of pensions tax relief, we think there is more value in addressing some of the more specific and technical shortcomings of the current system. For example, the inequalities created for low income savers due to the differences in tax administration systems used by different pension schemes – the net pay / RAS issue.

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ANNEX 1: PLSA PENSIONS TAX RELIEF STEERING GROUP MEMBERS

NAME	ORGANISATION
Emma Douglas (Chair)	Legal & General Investment Mgt
Carol Young	Natwest
Jackie Peel	Mars
Laura Myers	LCP
Rachel Brothwood	West Midlands Pension Fund
Richard Butcher	PTL
Zoe Alexander	NEST
Nigel Peaple	PLSA
Kate Boulden	PLSA
Nicky Day	PLSA
Jackie Wells	Jackie Wells Consulting

ANNEX 2: TAXATION OF EMPLOYER AND MEMBER CONTRIBUTIONS UNDER A SINGLE RATE

- Employer and member contributions are currently subject to the same rate of income tax relief in the hands of the member of the pension scheme (although this is accounted for in a different way according to whether the pension scheme is a net pay scheme or relief at source).
- Employer contributions are effectively treated as deferred pay, tax on which is collected when the money is eventually received in retirement (barring the 25% tax free lump sum). Member contributions are also allowed tax relief on the same basis.
- Under a single rate of income tax relief, the PLSA believes that it will be necessary to subject both employer and member contributions to the same rate of relief. There are two principal reasons for this:
  - Maintaining full tax relief on employer contributions while applying the single rate to member contributions would unfairly favour those with proportionately higher employer contributions than member contributions. For example, higher earners in a scheme with, say, 10% employer contributions and 5% member contributions would benefit more from tax relief than those in a scheme with 7.5% employer contributions and 7.5% member contributions.
  - To not do so would open up a loophole through which higher earners in DC schemes could continue to receive full tax relief. If employer contributions were still subject to full tax relief, it would be possible, irrespective of salary sacrifice, for employment contracts to be reconfigured such that all contributions were made employer contributions in return for an appropriate cut in pay. This would go against the intent of moving to a single rate and would also deny HMT the income that they would expect to receive from higher earners.

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ANNEX 3: IMPLEMENTING A SINGLE RATE ADMINISTRATIVE IMPLICATIONS

- The PLSA believes that two things will have to change for all DC schemes:
    - Higher earners will need to pay tax on their employer and own contributions at the difference between their marginal rate and the single rate, and
    - If the single rate is set above the basic rate, all DC schemes will need to claim the additional relief for non and basic rate tax payers on both employer and employee contributions.
- DC schemes operating on a net pay basis, i.e. most occupational pension schemes, will face considerable changes. It might be feasible for higher rate tax payers to complete a self- assessment tax return each year and the higher rates of relief that they have received to be repaid by themselves or by the scheme (with an equivalent reduction in benefits). Another option would be for HMRC to adjust individual's tax codes. If the single rate is higher than the basic rate, the scheme will still need to find a way to reclaim the excess of the single rate over the basic rate for basic rate and non-taxpayers.
- Having considered the options available to effect the changes required, the PLSA considers that it may be necessary for all DC pension schemes to move to a new form of relief at source (RAS) for both employer and member contributions. This would involve both employer and member contributions passing through payroll and being taxed; with the single rate of tax relief then collected by the scheme on both contributions. A move to new RAS for pension schemes would have significant challenges:
    - *Communication issues* – explanation of why contributions are now taxed with a rebate claimed by the scheme, why payslips have changed, and why for some pension contributions are lower than they were.
    - *Administrator capacity* – many third-party administrators do not provide RAS services. This raises questions about the capacity of the market to service all schemes unless a very considerable time period is allowed for transition.
    - *Cost of system changes* - significant additional systems and process changes would need to be introduced by both schemes and employers. These would take considerable time, probably a period of years to implement.
- While the position of DC schemes is relatively clear, the reforms, if applied to DB schemes would bring different and additional complexities. For funding purposes, we believe that it would be necessary for DB contributions to continue to be paid at the same level as at present and that adjustments to tax would need to be made at an individual level for members of the scheme.
- In order to provide some form of equity with members of DC schemes, a new calculation and mechanism would need to be introduced for all DB members to collect tax on their deemed contributions at the difference between their marginal rate and the new single rate; and to work out, if needed, the rebate to be paid. This method could be

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similar to the current Pension Input Amount used for Annual Allowance calculations. This would have significant cost and time implications for schemes and employers. It would involve additional tax payments by the member (or through scheme pays) every year for every higher rate taxpayer.

- Where the single rate exceeds basic rate, there would also need to be a way of reclaiming tax relief for basic rate taxpayers. This might need to be paid to the individual, rather than boosting benefits in the scheme, although the latter would in theory be feasible. However, it would require the scheme to claim back the amount from HMRC each year and to allocate it to the individual's benefits. Operationalising scheme pays / scheme boosts in this way would not only create complexity for schemes but would also make the projection of income at retirement much more difficult.

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