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TAXATION OF PRIVATE PENSIONS IN THE UK¹

CARL EMMERSON²

Introduction

Private pension saving is a key component of retirement saving in the UK. The most recent data available shows that four-tenths of private household wealth is held in private pensions. Among those aged 55 to 64 nearly 73 percent had accumulated some private pension rights, with the median holding among those with some pension rights being £149,300 (Office for National Statistics 2015).³ This is partly explained by the fact that holding savings in pensions is, on average, tax favoured relative to other saving vehicles. The fact that large amounts are placed in private pensions also makes it important that the tax treatment of such savings is well-designed.

This paper starts by briefly setting out the economic principles of what a neutral tax treatment of saving would look like. The following section describes current UK practice, and particularly highlights where it departs from a neutral system. The subsequent section considers some reform options, and the last section offers some conclusions.

Principles

There are, in general, three obvious points where pension saving could be subject to personal taxation: firstly, before income is paid into a pension; secondly, as any returns accrue; and thirdly, when the pension is drawn.⁴

One option, which has been advocated by (among others) Meade (1978) and Mirrlees (2011), is to give tax relief on contributions to pensions, to levy no personal tax on returns as they accrue, and for income from pensions to be subject to tax. This is known as an EET (Exempt, Exempt, Taxed) regime. This type of treatment neatly achieves two objectives:

Firstly, it ensures that, at the personal level, only excess returns to savings are subject to tax: if higher returns are generated, a greater amount of tax will be paid on the eventual pension income.

Secondly, it means that individuals who are subject to a higher rate of income tax during part of their working life, but subject to a lower rate of income tax in 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.

An EET regime is not, however, flawless. Those who expect to face a lower marginal rate of income tax in retirement than they do at the moment will have their incentive to save distorted by the tax system: they will be incentivised to spend less today and to spend more in retirement than they otherwise would do.

The starting point for the tax treatment of savings should be not to cause any distortion between spending today instead of saving and spending in future. But if all savings were taxed in such a way, the tax system would provide no incentive to save in a private pension. Therefore if public policy wants individuals to choose to lock away their savings until they retire, then it could be appropriate to have a more generous tax treatment of private pension savings than the benchmark EET system. Any such bonus should be tailored to the problem it is trying to solve. There seem to be two main concerns discussed that such a bonus might seek to address. Firstly, there is a potential concern that individuals would otherwise actively choose to save too little from society's point of view because of the presence of means-tested benefits. If this were a problem, then it would make sense to target the incentive towards those who would otherwise be likely to end up on means-tested benefits in retirement.

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² Institute for Fiscal Studies.

³ Data from the 2012 to 2014 wave of the Wealth and Assets Survey (Office for National Statistics 2015).

⁴ Other taxes – such as corporation tax, inheritance tax, stamp duties on purchases of shares and property – might affect pension returns, but are beyond the scope of this paper.

A second potential concern is that individuals might be saving too little from their own point of view. If this were the case, then it would make sense to target any incentive towards potential undersavers. In both cases, the incentive should be designed in a way that encourages individuals to respond to it and it should potentially only be targeted towards those who are actually likely to respond.

Current UK practice

The UK's income tax and capital gains tax regime for pensions closely resembles the EET regime described above. Contributions are made free of income tax, investment returns accumulate free of income tax and capital gains tax, and the pension in payment is subject to income tax. There are three obvious ways in which UK practice deviates from a pure EET treatment: limits on the amounts that can be contributed to and held in private pensions, the presence of a tax-free lump sum and the treatment of pension savings by the system of National Insurance contributions (NICs).

Limits

There are two limits that apply to private pension contributions. Firstly, individual contributions (i.e. not including those formally made by an employer) in a single year are not allowed to exceed the greater of 100 percent of an individual's earnings in that year, or £3,600 if their earnings are below this level. Secondly, tax relief is given on private pension contributions (both individual and employer) up to an annual limit, known as the annual allowance. In 2016–17 for most individuals this is set at £40,000 (lower than the £255,000 annual limit that was in place in 2010–11). Rather oddly, the small number of individuals with an annual income (including pension contributions) in excess of £150,000 (and a taxable income above £110,000) have a lower annual limit of just £10,000 for those with an income in excess of £210,000 (those who have accessed their pension also have a reduced annual allowance). Individuals are allowed to make use of any unused allowance from the previous three years, as long as they were a member of a scheme in those years. This means that, for many, the annual allowance will eventually effectively become a £160,000 limit over a rolling four-year window.

There is also a cap on the total amount that can be accumulated in a private pension, known as the lifetime limit. In 2016–17 this is set at £1 million (down from £1.8

million in 2010–11). To get a feel for how big a £1 million pension pot is, it is worth noting that a single man aged 65 with a pension pot that size could, at current annuity rates, take a tax-free lump sum of £250,000 and receive an annual pension pegged to inflation (as measured by the RPI) of about £28,500 (or an annual pension fixed in cash terms of about £44,000).⁵ On their own, these caps on contributions mean that some retirement savings are less generously treated than the benchmark EET treatment.

Tax-free lump sum

A quarter of the accumulated pension balance can be withdrawn as a lump sum free of income tax. The result is that a quarter of contributions are effectively subject to a very generous EEE treatment for income tax purposes. This means that someone who accumulated £1 million in a private pension would be able to receive £250,000 that had escaped income tax altogether: it would be taxed neither when it was earned nor when it was withdrawn from the pension.

National Insurance contributions

The NICs regime for pensions is quite different from the income tax regime. With employee contributions there is no relief on contributions for NICs and no NICs are payable on pension income (TEE treatment). However, employer pension contributions are treated extremely generously: they are excluded from earnings for both employer and employee NICs – total NICs relief of 22.7 percent for those earning below the upper earnings limit (£827 per week from April 2016) – while the pension income they generate is not subject to NICs either (EEE treatment). Employer pension contributions are the only major form of employee remuneration that escapes NICs entirely and make up roughly three-quarters of all pension contributions.

Cost of UK pensions tax relief and who benefits

The figures produced by the UK government suggest that the net cost of pension relief provided by income tax and NICs in 2013–14 was £35.2 billion. However, this takes the total cost of upfront tax relief, adds the cost of not taxing returns, and nets off the amount of tax

⁵ For someone in a defined benefit pension arrangement, a £250,000 lump sum and an annual RPI-linked pension of £37,500 – almost one-third higher than the maximum defined contribution pension – is deemed to be equivalent to a pension pot of £1 million (since defined benefit pension schemes are deemed to have a pot size 20 times the annual pension).

paid on pension income. In other words, it is an attempt to estimate the cost relative to a TTE tax regime, which is one in which individuals are not able to benefit from tax-rate smoothing and where the system encourages individuals to spend rather than to save.⁶ A better estimate (i.e. relative to a benchmark EET regime) would be the cost of NICs relief – estimated at £14.0 billion – plus the cost of the tax-free lump sum, which might be around £2.5 billion a year.⁷ This suggests that the true cost of income tax and NICs relief could be less than half the official estimate.

In addition, official estimates offer no analysis of how pension tax relief is distributed relative to the EET benchmark, although the tax-free lump sum and the lack of NICs on employer contributions will probably mean that the lifetime rich will, on average, see their pension contributions more generously treated than lower-income individuals will.

Options for reform

The starting point for those looking to reform the tax treatment of pensions in the UK should be to look at the elements that depart from the benchmark EET system and consider whether those departures are well-designed.

Bearing this in mind, a coherent reform of the current system could move in the following direction:

First: Increase the contribution limits. This would extend the amount of savings that could receive the benchmark EET tax treatment. A sensible priority would be to increase the annual allowances (or to extend the four year period of roll-over) since, for a given amount of lifetime contributions, this disproportionately falls on those who happen to want to make lump-sum pension contributions over their working lives, which is difficult to justify. Furthermore, just as all individuals have the same lifetime limit, it would also be sensible for most to have the same annual limit – i.e. not to limit individual contributions to the greater of £3,600 or 100 percent of

earnings, and not to have a lower annual limit for those with an annual income over £150,000.⁸

Second: Cap the tax-free lump sum. The tax-free lump sum means that individuals can get EEE income tax treatment on up to one-quarter of their pension fund (which can be up to £250,000). While the tax-free lump sum may be relatively transparent and well-understood, it is far from clear why those with, for example, almost £1 million already accumulated in a pension pot, should receive a subsidy on additional pension saving: they will not be reliant on means-tested benefits in retirement and they are relatively unlikely to be undersaving. Limiting the size of the tax-free lump sum would be an obvious improvement.

Third: Levy NICs on employer contributions. This is an opaque subsidy that is difficult to justify. The lack of employer NICs on employer pension contributions is forecast to cost £10.0 billion in 2015–16. Even if this were ended, it would still leave employer contributions free of employee NICs (and charging these on employer contributions would be more complicated in defined benefit arrangements). Therefore it might be better to move towards providing NICs relief on all pension contributions (i.e. employee as well as employer) and levying NICs on all pension income. This would move the NIC system towards EET treatment and help harmonise the operation of NICs and income tax. Implementing this reform slowly over time would help reduce the extent to which it represented retrospective double taxation (that is, by levying NICs on pension income, despite having already levied NICs on employee contributions to that pension, undermining the legitimate expectations of those who have saved up to now).

The UK government is currently considering how to respond to a consultation on reform to the tax treatment of pension saving (HM Treasury 2015). A response is expected in the March 2016 budget. Unfortunately, none of the reforms suggested above appear to be likely outcomes: if a major reform is implemented, it seems likely to take one of two forms (Cumbo and Barret 2015):

First: Moving to a system whereby individuals all receive the same rate of up-front relief on their contributions (i.e. regardless of whether they are a basic, higher or additional rate income taxpayer). Such a reform

⁶ In addition, rather than deduct the income tax that is expected to be paid on the pensions of today's working age population, the calculation deducts the income tax raised on pensions currently in payment. The former is likely to be significantly greater not least due to growth in the number of pensioners.

⁷ The government previously estimated the total cost of the tax-free lump sum at around £2.5 billion (in 2009–10), but no longer produces an estimate.

⁸ A reduced limit for those who have already started to draw their pension might still be appropriate in order to limit the ability of individuals to recycle pension income back through a pension in order to qualify for more tax-relief.

would be misguided, as it considers the tax treatment of pension contributions in isolation from the tax treatment of the pension income they finance. It is hard to see how it can be unfair for higher-rate taxpayers to receive 40 percent relief when basic-rate taxpayers receive 20 percent relief, yet at the same time not be unfair for higher-rate taxpayers to pay 40 percent tax on their pension income when basic-rate taxpayers pay only 20 percent. It is, of course, true that many of those receiving relief at the higher rate will only pay basic-rate tax in retirement. However, such individuals are simply smoothing their taxable income between high-income and low-income periods, undoing the ‘unfairness’ that an annually-assessed progressive tax schedule creates by taking more tax from people whose incomes are volatile than from people whose incomes are stable.⁹

Second: Moving to a system where up-front relief is not given on any pension contributions, but pension income is completely untaxed when received (a TEE regime, equivalent to what the UK has for saving in Individual Savings Accounts and owner-occupied housing). While this regime (like a pure EET regime) would have the desirable feature of leaving the normal return to saving untaxed, it would have the undesirable feature of also leaving any returns in excess of this untaxed. Furthermore, it would not allow individuals to benefit from tax-rate smoothing.¹⁰

It is also possible that the current system will be retained. This option has explicitly been left open by the government and, while not the best possible option, it could be preferable to the two options set out above. However, one significant risk with retaining the current system is that it has not proved to be particularly durable, and the direction of recent reforms might suggest that the pension contribution limits could be further reduced in the future. Such a change would continue to be a move in the wrong direction.

Conclusions

The UK’s income tax and capital gains tax regime for pensions is closest to an EET regime that has many attractions. Deviations from this regime include the presence of a tax-free lump sum and the fact that employer contributions escape NICs entirely. These come at a considerable cost in terms of foregone tax revenues.

There may be good reasons for using the tax system to encourage people to save a certain amount in a private pension. However, a reform package that included restrictions of the size of the tax-free lump sum, and placing at least some NICs on employer pension contributions, would be very welcome. It would reduce the subsidy to pension saving and ensure it was better targeted at encouraging individuals to save sufficiently, so they are not reliant on means-tested benefits in retirement and getting those who would otherwise undersave for retirement to save more. Raising the annual allowance – which penalises those who would otherwise like to make lump-sum pension contributions – and setting it at the same level for all individuals would also be a step in the right direction. Unfortunately, reforms of this kind do not appear to be on the agenda.

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⁹ Even if receiving higher-rate relief and then paying basic-rate tax is seen as unfair, that does not diminish the case for accompanying any restriction of tax relief on contributions with a restriction of the tax on pension income. The tax system should treat pension contributions and pension income in a symmetric way.

¹⁰ In addition, it would bring forward in time a substantial amount of income tax receipts (£27.0 billion extra would have been raised in 2013–14), but at least half of this would represent revenue being brought forward, rather than genuinely additional revenue (in the same year income tax levied on pension income raised £13.1 billion and growth in the pensioner population would be expected to increase this over time). This raises a concern that, with a tendency to focus on the short-term indicators of the health of the public finances, the Chancellor – or one of his successors – might inappropriately spend rather than bank this temporary windfall.