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Tax relief for pension saving in the UK

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Tax relief for pension savings in the UK

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- Current system of pension tax relief
- Does the pension tax relief system work?
- Alternatives to the current system

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Rationale for pension tax relief

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- Support retirement saving by encouraging individuals to save for their retirement and employers to contribute to pension schemes
- Compensate people for the fact that they cannot access their money before a particular date
- Ensure that people do not pay tax twice on the same income

How pension tax relief works

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Three stages where tax is applied or relieved

1. Contributions to the pension (**E**xempt)
2. Investment returns on the fund (**E**xempt)*
3. Payments out of the pension scheme (**T**axed)**

Recent changes include reductions of Lifetime and Annual Allowances, and phasing out of the age-related allowance.

* except ACT on dividend payments can no longer be reclaimed
** except tax free lump sum up to 25% pension fund

Pension saving is tax-advantaged compared to ISAs

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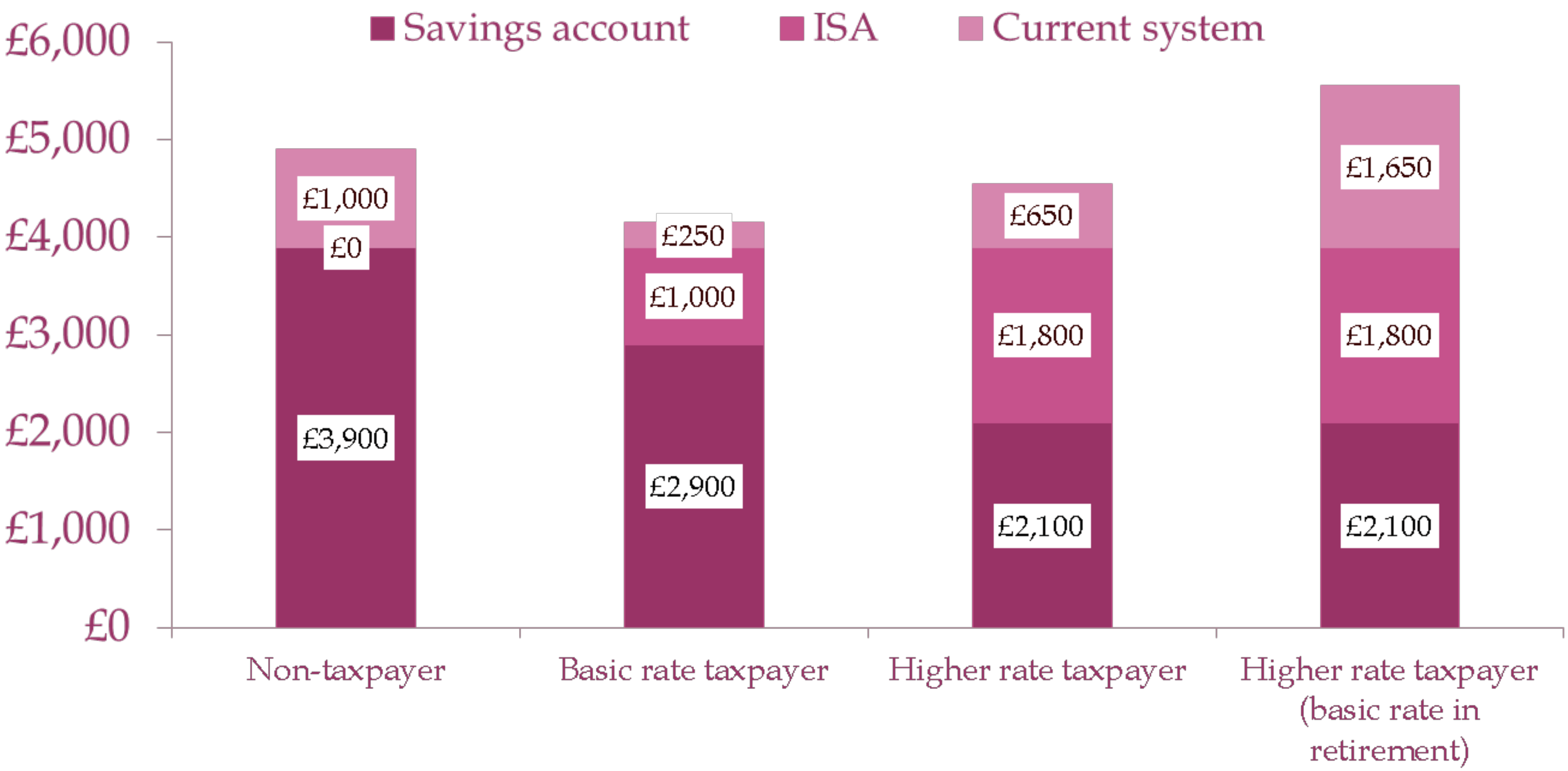
Capitalised value of income and lump sum for a £1,000 payment into a pension fund at age 40 which remains invested until State Pension Age



How much does pension tax relief cost?

	£ millions
Total tax relief on pension contributions	£28,500
Relief paid on investment returns	£6,500
Total tax relief on contributions	£35,000
Tax liable on private pensions	£11,300
NET TAX RELIEF COST	**£23,900**

HMRC figures for 2010/11

Tax relief goes disproportionately to higher earners

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Contributions and tax relief on pensions at each earnings band in 2010/11

Under auto-enrolment a larger proportion of tax relief goes to lower and mid-range earners

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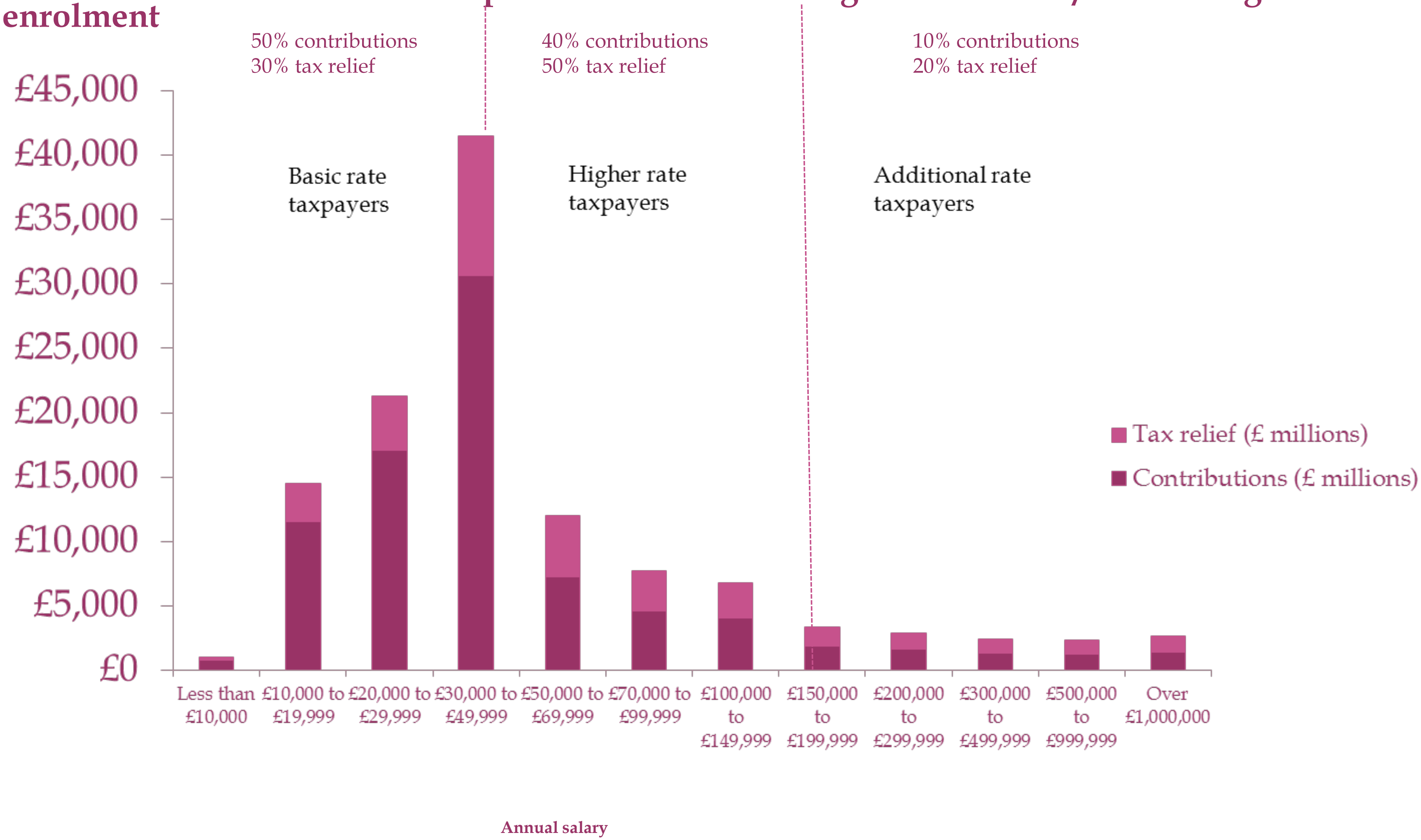
Contributions and tax relief on pensions at each earnings band in 2010/11 allowing for auto-enrolment



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Reasons for ineffectiveness directly related to tax system

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- Low levels of understanding around tax treatment of pensions
- Tax incentives have redirected money from other savings rather than incentivising saving overall
- A 'Savings Gap' remains

General barriers to pension saving

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- People have insufficient income to make pension savings
- Lack of understanding around pensions
- Issues related to the current design and delivery of pensions

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Alternatives to the current system

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- Recent adjustments to the current system
- Restrictions to the tax-free lump sum
- Single rate of tax relief

Recent adjustments to the current system

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- From 2014/15 Annual Allowance reduced from £50,000 to £40,000

- Lifetime Allowance reduced from £1.5 to £1.25 million

Carry-forward rules mean that much larger pay rises are required to breach the Annual Allowance

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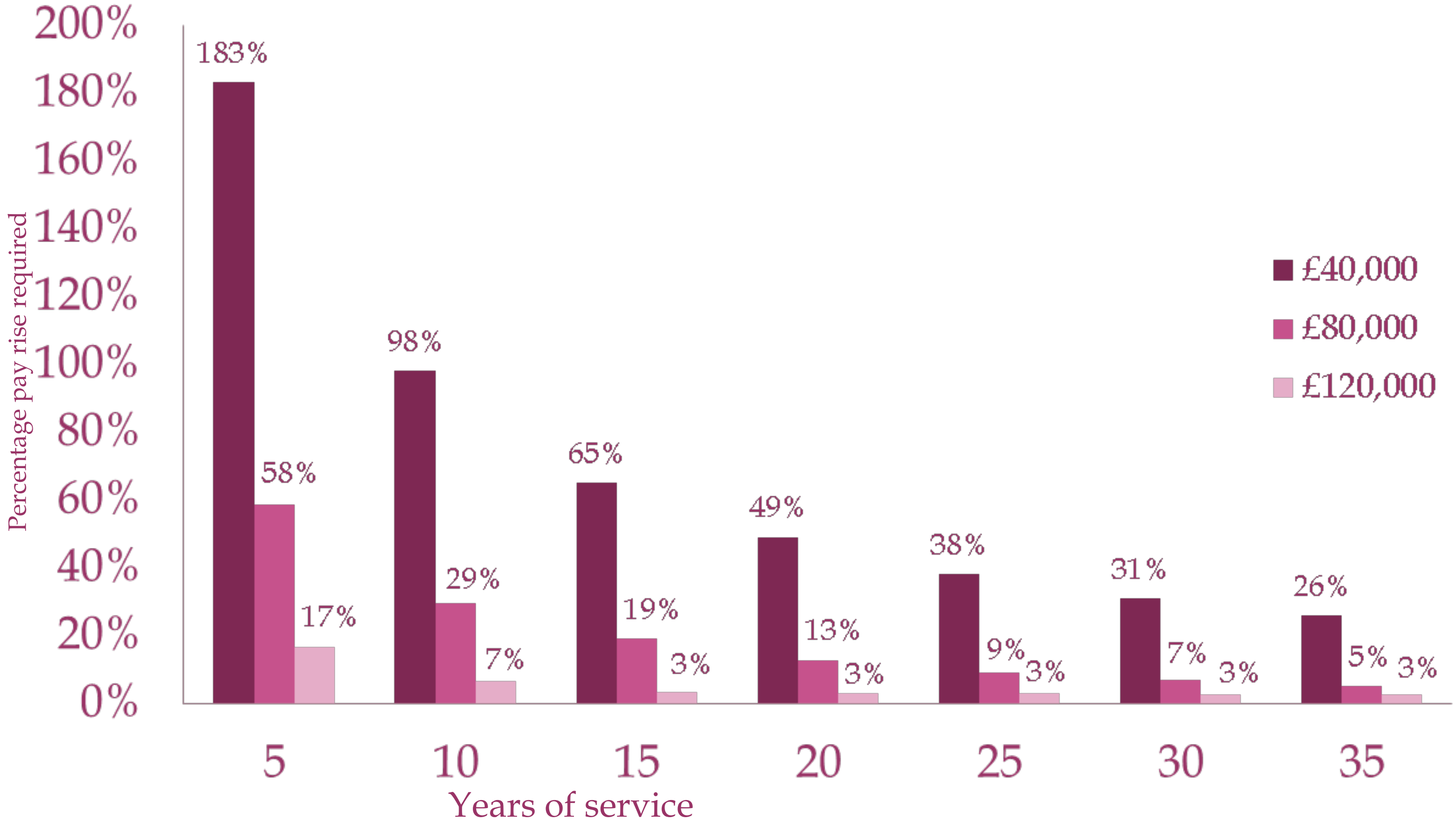
Percentage pay rise that would be required to breach the £40,000 Annual Allowance with 3 year carry-forward



Reducing contributions to keep below the annual allowance would reduce the value of pension funds

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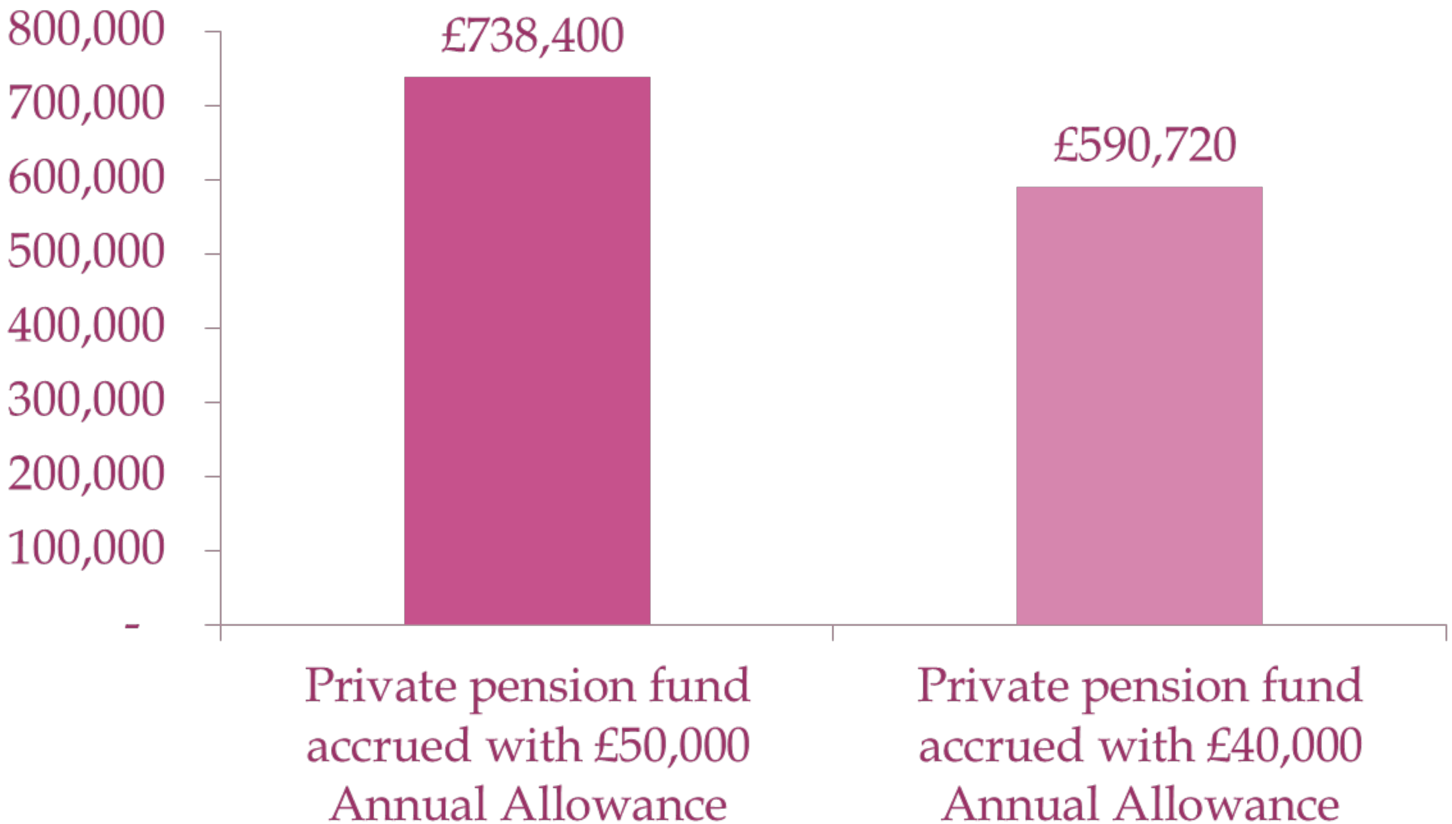
Annual private pension income for a high earning DC pension scheme member



Restrictions to the tax-free lump

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- Current distribution of tax relief on lump sums
- Option 1: limiting tax-free portion of lump sum to 20% pension fund
- Option 2: capping tax-free portion of lump sums at £36,000

A third of tax relief goes to individuals with lump sums worth more than £150,000

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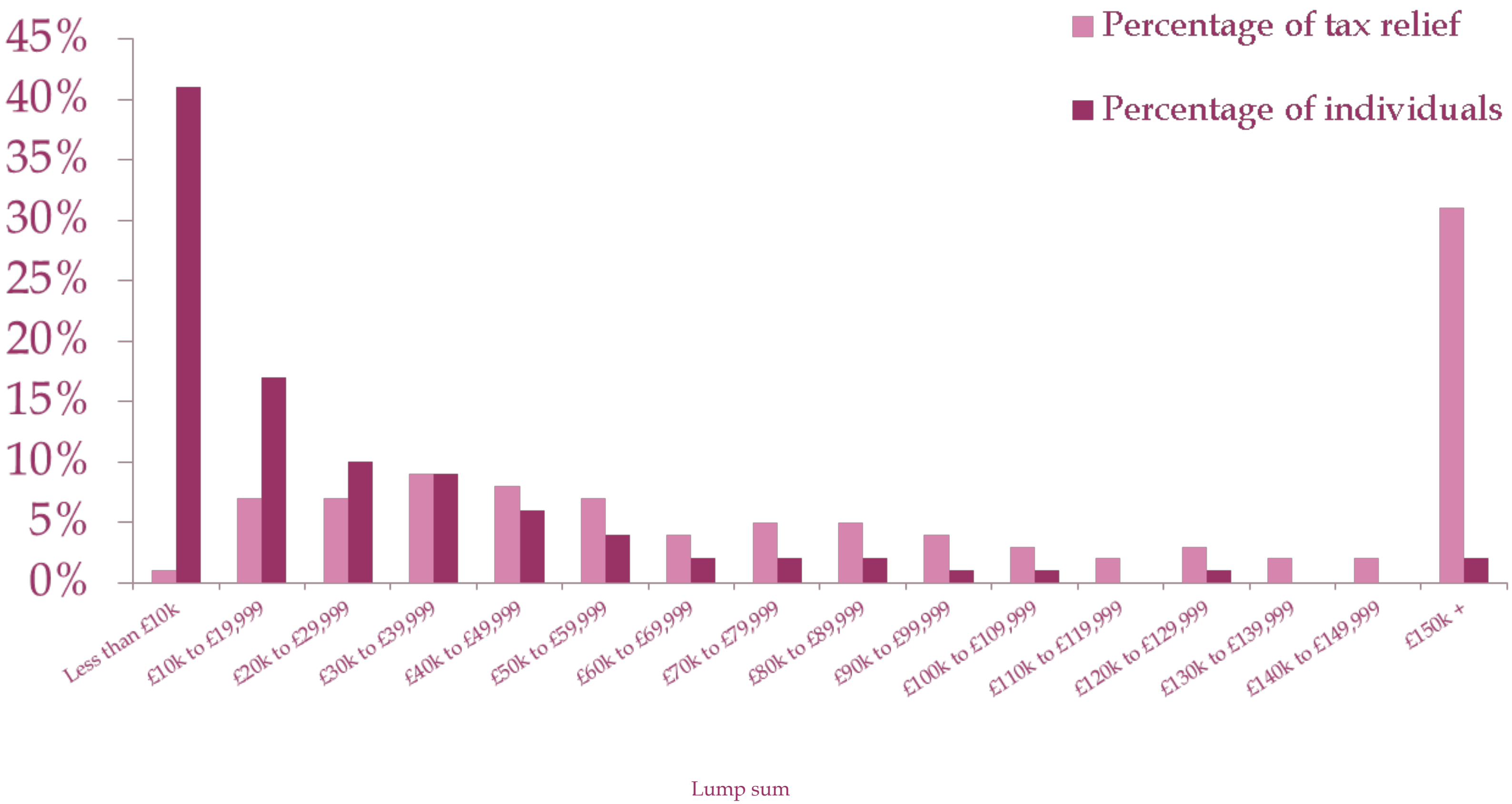
Percentage of individuals and percentage tax relief by size of lump sum



Limiting tax-free portion of lump sum to 20%

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- Reduction in tax relief received would be proportionately the same for all taxpayers
- If applied to current lump sums, cost of tax relief could decrease from £4 billion to £3.5 billion

Capping tax-free portion of lump sum at £36,000

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- Proportion of tax relief going to lump sums of £150,000 and over would reduce from 32% to 7%
- If applied to current lump sums, cost of tax relief could halve from £4 billion to £2 billion

Single rate of tax relief

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- At basic rate (20%)
- 30%
- At higher rate (40%)

Single rate of tax relief

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Basic rate – higher earners would lose out relative to current system

30% - Low and mid-range earners would gain while higher earners would lose out

Higher rate – Low and mid-range earners would benefit

Under all single rate options – between 45%and 50% of tax relief would go to higher and additional rate taxpayers compared to 70% in current system

A single rate of tax relief would have a high impact on the cost of tax relief on contributions

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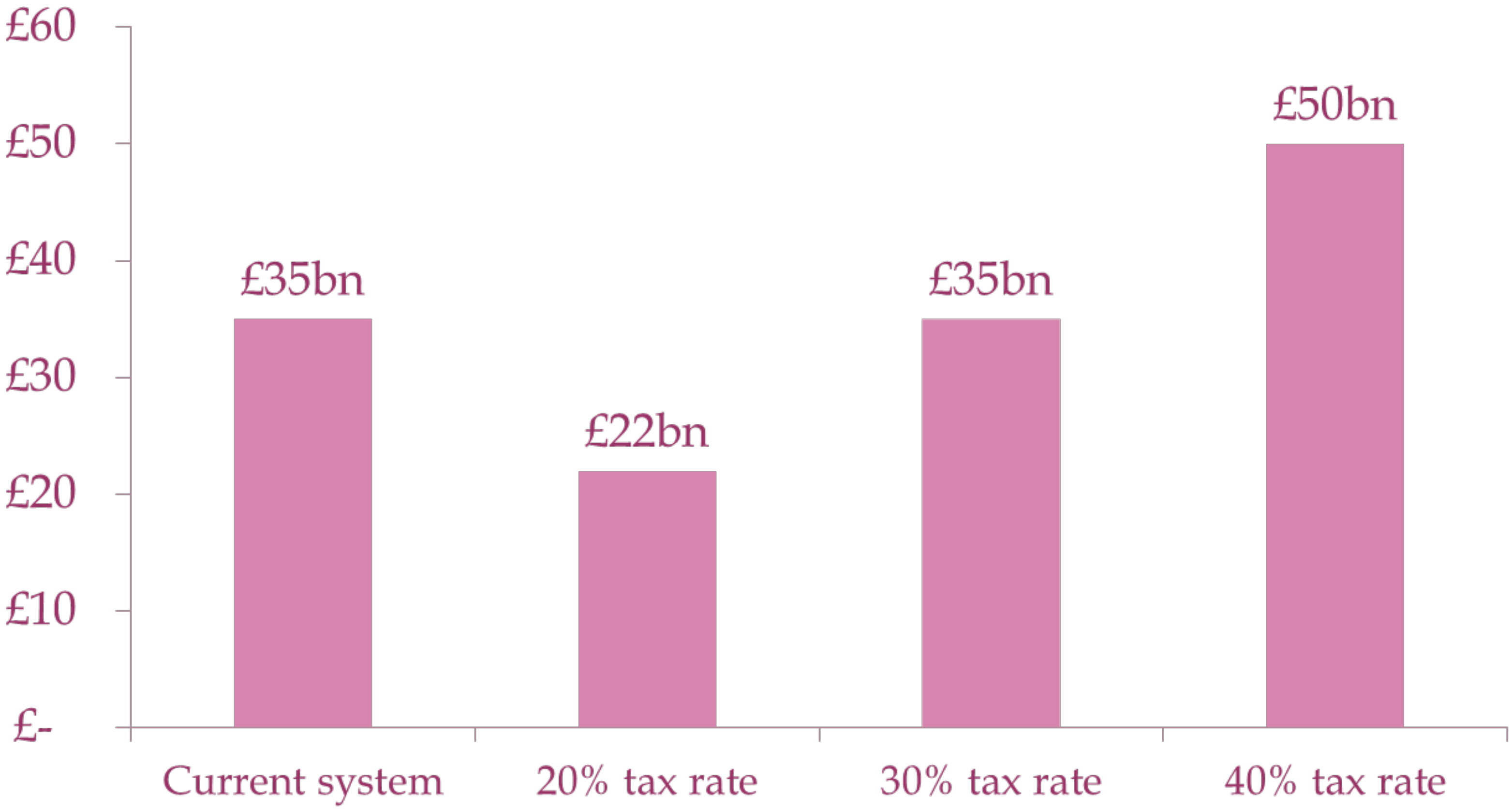
The gross cost of tax relief on contributions at the marginal rate and at a single rate of 20%, 30% and 40%, £bn.



Single rate of tax relief – practical considerations

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- More difficult to give tax relief at a single rate, as it would be difficult to operate Net Pay Arrangements.
- System may appear less transparent to members of Defined Benefit pension schemes
- It may be more difficult to understand. However, presenting tax relief as matching contributions may be easier to understand and may further incentivise pension saving

Behaviour might change in a number of ways

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- Return on individual's own contributions would change, leading to individuals changing their behaviour – if they understand the change
- It may affect perceptions and ease of use of the pension tax relief system
- If may affect employers through administrative complexity and cost

The impact of behaviour change is uncertain

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- Estimates of the extent of behaviour change are limited
- But even with wide sensitivity testing (+/- 50%), ranges of outcomes are reasonably narrow
- Basic rate tax relief - £19 bn to £22 bn
- 30% tax relief - £34 bn to £35 bn
- Higher rate tax relief - £50 bn - £57 bn

Summary

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- The current system of tax relief gives a tax advantage to pension savers, but the advantage is more valuable for higher earners
- There is little evidence that tax relief encourages saving, particularly for lower earners
- Recent reforms have focussed on reducing rather than re-shaping tax reliefs
- A single rate of tax relief would distribute tax relief evenly, but be difficult to implement and may change behaviour