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How will the evolving retirement landscape impact tax and benefits?

Introduction

This Briefing Note explores the impact that retirement income decisions, which have changed significantly since the introduction of pensions freedom and choice, may have on individual and State finances.

The key questions addressed in this Briefing Note are:

- How might taxation be impacted by evolving retirement income patterns?
- How might means-tested benefits be impacted by evolving retirement income patterns?

These are explored both in terms of the way that they will impact individuals' income in retirement and also how aggregate changes could impact State finances.

This is the third and final output of the Evolving Retirement series, which also includes:

- The evolving retirement landscape, which explored the way that retirement income decisions, savings and assets have evolved in recent years, particularly since the introduction of pension freedoms; and
- Evolving retirement outcomes, which looked at the range of potential outcomes that may be achieved through different retirement income decisions, and the changes that may need to occur within the industry and wider pensions landscape in order to ensure that these outcomes are positive for as many people as possible.

How might taxation be impacted by evolving retirement income patterns?

This section explores the impact that evolving retirement income patterns could have on taxation, both in relation to the individual and how this may impact the money they have to support them during retirement, and in terms of increased tax revenue for the Government.

Estimates surrounding the impact of pension freedoms on state finances are subject to considerable uncertainty

When the pension freedoms were announced in 2014, the Government stated that it expected the policy to result in increased income tax receipts in each year until 2030, peaking in 2018-19 (Table 1).

In the March 2017 Budget, the Government revised its estimate of increased revenue for 2017-18 to £1.6bn (from £910m) as a result of higher than expected anticipated levels of initial withdrawals. However, the tax take from flexible pension withdrawals was subsequently lower than expected by about £0.5 billion less than the revised estimate.[1]

This uncertainty is because individuals will pay different amounts of tax based on the retirement income decisions they make. The extent to which this will impact state finances is dependent on the behaviour of those accessing their pension savings.

In order to estimate the cost, assumptions must be made about the way that people will choose to access their savings over the course of their retirement. In the 2014 Budget, the Government estimated that 30% of people with Defined Contribution (DC) savings would choose to draw down their pension at a faster rate than they would have been able to if they purchased an annuity.

Increased levels of tax revenue in the short-term on drawdown users will lead to decreased levels of tax revenue in the future

If more people choose to withdraw their full pension in the early years of retirement, HMRC

Table 1: Policy costings 2015-2020 impact of pension freedoms on State finances (£m)

	2015-16	2016-17	2017-18	2018-19	2019-20
Original projections	+320	+600	+910	+1,220	+810
Revised projections	-	-	+1,600	+900	+900
Observed outcome	+1,500	+1,100	+1,100	-	-

will receive a higher level of tax in the near future. However, as those people reach older ages at which they would, under the old system, have been paying tax on income from an annuity, they may be paying less tax as they will have less pension savings to draw on.

Individuals may achieve a wide range of tax outcomes which are highly dependent on the way in which they access their savings
The amount of tax an individual will pay on their pension savings, both year-on-year and over the entirety of their retirement, is highly dependent on the way in which they access those savings: whether they withdraw their savings, annuitise or enter drawdown (and the rate at which they draw down).
While annuity income is taxed, tax paid by someone who withdraws their whole DC pot in one go is likely to be higher. This is because an individual who annuitises (or draws down steadily over the course of retirement) will be able to make use of their Annual Allowance for tax exemption each year. This means that a smaller proportion of their money will be subject to tax overall than someone who accesses all of their DC savings in a single withdrawal and so only makes use of their Annual Allowance in one year. Taking large sums from a pension pot may also result in paying tax at a higher rate if the amount that is taken moves them into the higher rate tax bracket (when income exceeds £46,351).

Hypothetical Individual 1: Seb

- Moderate levels of Defined Contribution (DC) savings—£50,000 at State Pension age (SPa)
- Some Defined Benefit (DB) entitlement—£2,000 per year
- Full entitlement to State Pension of £164 per week

Purchasing an annuity would result in Seb paying the least in tax
21% of pots worth between £50,000 and £99,000 that have been accessed since the introduction of pension freedoms have been annuitised. This is higher than the 13% of pots annuitised among all pot sizes.[2]

Payments received from annuities are taxed as income at the individuals' marginal rate. However, income below the Annual Personal Allowance of £11,850 is exempt from tax.

If Seb chooses to purchase an annuity at SPa with the entirety of his savings (after taking a 25% tax-free lump sum), he would pay £27.50 in tax in the first year of his retirement (Charts 1 and 2—tax payments decline year on year because withdrawals are uprated by CPI and the personal allowance is assumed to increase in line with earnings, which decreases the proportion of income which is eligible for tax).

Drawdown options can also be tax efficient but this depends on the withdrawal rate used
If Seb withdrew from his pension at 7% each year (at which rate he has around a 50% probability of his savings lasting throughout the entirety of his retirement), he would pay a total of £1,435 in tax over the course of his retirement (Charts 1 and 3).

Chart 1: Seb would pay significantly more tax if he withdraws his savings fully in the early years of retirement
Cumulative income tax throughout retirement

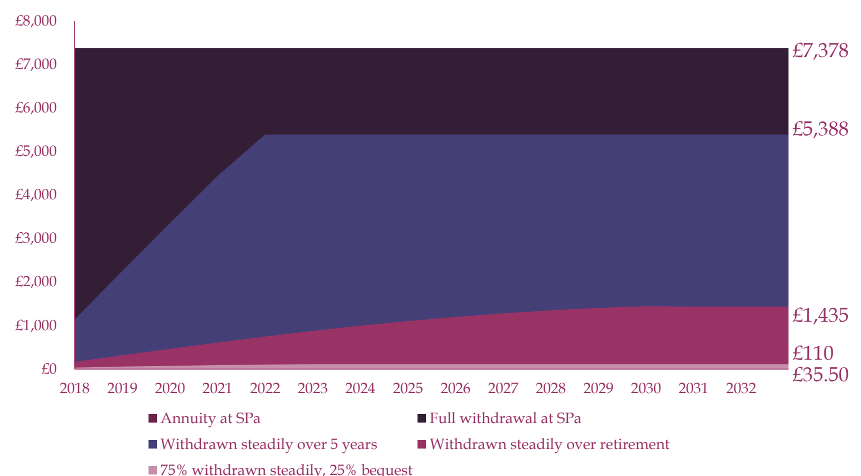
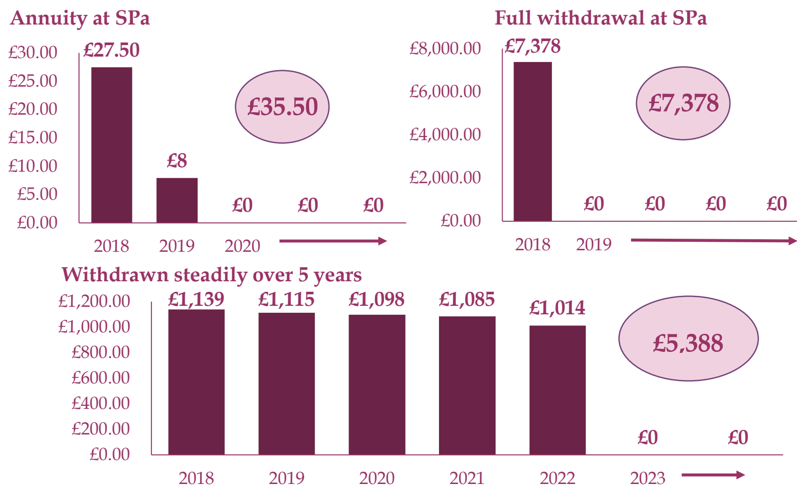


Chart 2: Withdrawing savings quickly results in a much larger tax bill than purchasing an annuity

Annual and total tax payments by retirement income decision



Withdrawing at a lower rate would mean even lower tax payments, however it would also mean a lower level of income, and for many people, particularly those with lower levels of pension savings, adequacy needs may be a more significant consideration than tax efficiency when making retirement income decisions.

Drawing down on a proportion of DC savings while ring-fencing the remainder to leave as a bequest would further reduce the tax payments Seb would have to make

For many people, leaving a bequest behind for family or friends is an important consideration when making retirement income decisions, and one which cannot be provided for if their full savings are annuitised. If Seb ring-fences 25% of his pot to leave as a bequest, while drawing down on the remaining 75%, drawing down at a rate of 7% per year on 75% of his pot, he would pay a total of £110 tax over the course of retirement (Charts 1 and 3).

Compared to purchasing an annuity, Seb would pay significantly more tax if he withdraws his pot in full at SPa

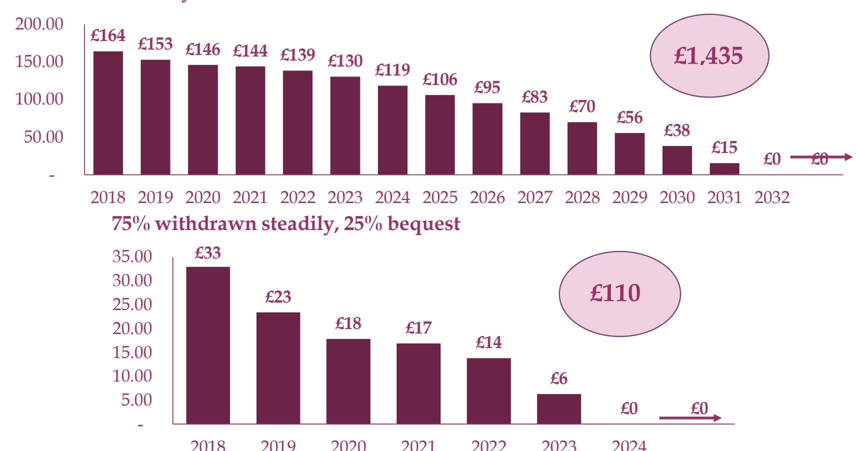
If Seb chose to fully withdraw his DC savings at SPa, he would be entitled to a 25% tax-free lump sum and the remainder (£37,500) would be taxed at his marginal rate. This means that he would pay £7,378 in tax in the first year of his retirement, and no tax in subsequent years (Charts 1 and 2). This means that he only really has access to around £42,600 from his £50,000 DC pot. This loss is equivalent to nearly three years worth of income if he were drawing down at 7%.

Spreading withdrawals over even a short number of years would reduce the total tax payment due compared to withdrawing fully at SPa

When initially estimating the tax revenue that the freedoms could bring in, it was assumed that even those who withdrew their money relatively quickly would do so over the space of four to five years in order to reduce their individual tax burden.

Chart 3: Setting aside a proportion of the pot for inheritance purposes can be tax efficient

Annual and total tax payments by retirement income decision



Higher than anticipated increases in tax take when the policy was introduced were largely justified by a higher number of people withdrawing their whole pot upon access.

If Seb were to withdraw his DC savings steadily over the first five years of his retirement, this would be more tax efficient than withdrawing the pot fully in year one, paying around £2,000 less tax in total (Charts 1 and 2). Although, he would still pay considerably more tax than if he was drawing down steadily over retirement. Even those who are well informed about the tax implications of their retirement income decisions may view this increased payment as an acceptable cost for the flexibility provided by drawdown products over annuities. Advice and guidance could help people to understand the risks and trade-offs associated with accessing their pension savings.

Hypothetical Individual 2: Kirsty

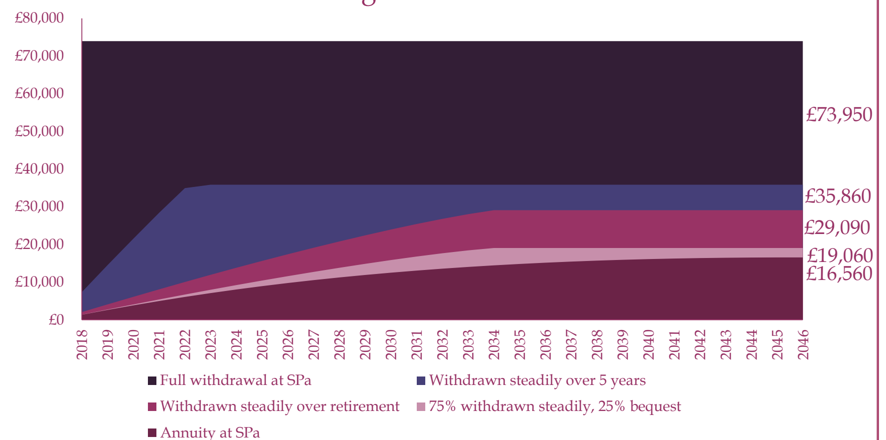
- High levels of DC savings—£260,000 at SPa
- Full entitlement to State Pension of £164 per week

An individual with higher levels of pension savings would see a greater impact on their taxation based on the decisions they make about accessing their savings

Fully withdrawing her pension pot at SPa, Kirsty would pay more than £70,000 in tax (Chart 4). This is equivalent to around 5 years of income if she withdrew at a rate of 7%. However, based on retirement income data since the pension freedoms were introduced, it is unlikely that she would do so. Only 4% of pots over £250,000 that were accessed between October 2016 and September 2017 were fully withdrawn. The vast majority (84%) of accessed pots of this size were moved into drawdown, while 8% were annuitised.[3]

Chart 4: For a higher income individual, the difference in tax paid between full withdrawal and annuitisation would be more substantial

Cumulative income tax throughout retirement



Drawing down at 7%, Kirsty would pay around £29,000 in tax over the course of her retirement. She would pay around half this amount of tax if she chose to annuitise her DC savings (Chart 4). However, for individuals with considerable DC savings like Kirsty, bequest motives may be a significant consideration, which may discourage them from annuitising some or all of their pot.

People reaching retirement in the next ten to fifteen years could pay significantly more tax based on the retirement income decisions they make

Since the pension freedoms were introduced, only 13% of DC pots accessed have been used to purchase an annuity. More than half (54%) have been fully withdrawn, nearly a third (30%) have entered drawdown, and 3% have been accessed through UFPLS (Uncrystallised Fund Pension Lump Sum).[4] While past behaviour is not necessarily a predictor of future behaviour, it may give an indication of the range of impact on tax revenue.

On aggregate, people currently aged between 50 and SPa could pay between £4.6 billion and £13.3 billion more in tax if they choose to withdraw their pots fully at SPa compared to if they

annuitise. If they all drew down steadily over retirement at a rate of 7% per year the impact would be less significant at between £0.1 billion and £0.9 billion. However, based on the way in which people have so far accessed their savings since the pension freedoms were introduced, the impact is likely to be more in the region of £1.1billion to £3.3 billion each year between 2018 and 2028 (Chart 5).

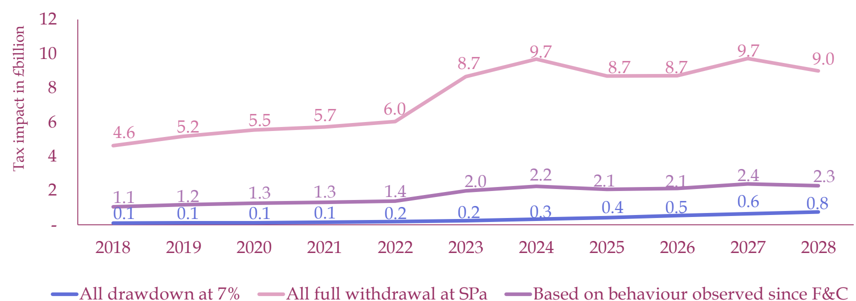
The modelling assumes that people will access their pension savings around SPa, which accounts for the fact that some people will access earlier and some later. However, changes in the age at which people access their savings would impact tax revenue trends. In addition, because the modelling is based on observed past behaviour, this may not be representative of the decisions people will make in the future, particularly those who have chosen not to access their savings yet despite being able to do so, who may make very different access decisions to those who have chosen to access their savings at younger ages.

Aggregate tax revenue increases over the ten year period modelled, despite the fact that individual tax payments reduce over time (Charts 2 and 3) because each year there will be people accessing their pension savings for the first time and incurring tax.

Some of these increases are due to the fact that people are increasingly reaching retirement with higher levels of DC savings. However, this means they may be offset by higher levels of tax relief received during the accumulation phase.

Chart 5: The magnitude of impact that pension freedoms will have on tax revenue is dependent on the retirement income decisions made by individuals

Increase in tax revenue as a result of retirement income decisions of people with pension savings currently aged between 50 and SPa



There have been some issues around the tax treatment of flexible pension withdrawals

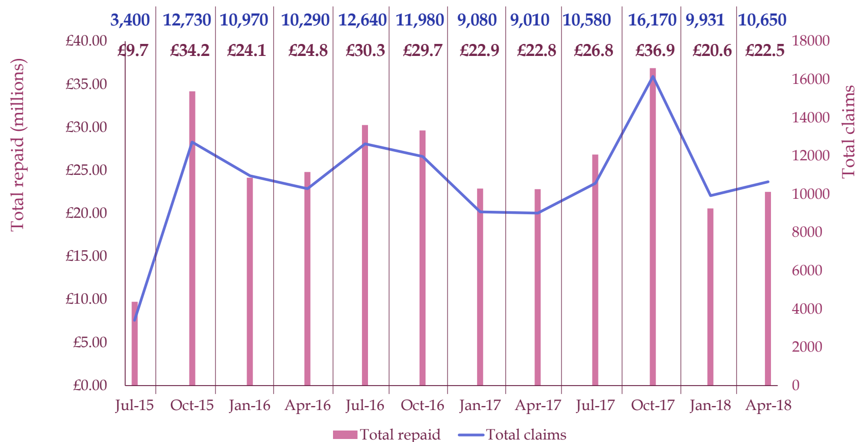
Under the current system, someone who makes a large withdrawal from their pension pot in a single month will be taxed at an 'emergency rate' as it is assumed that they will take the same level of withdrawal from their pension each month as income. This means that they only receive tax exemption on 1/12th of their personal allowance, £988.

In Q1 2018 HMRC refunded £22m of tax payments related to flexible pension withdrawals. Since April 2015, when the freedoms were introduced, HMRC has repaid a total of £305m to more than 127,000 claimants (Chart 6). The total number of people who have been taxed at the emergency rate on their pension withdrawals could potentially be larger still, as these numbers only include those who have reclaimed their money. Those who do not fill out the necessary claim form will be reimbursed but this is likely to take longer than if they actively submit a claim.

For example, Seb withdraws £2,625 (7%) in one go upon entering drawdown, with the intention of spreading this income over the course of the year. For tax purposes he might be treated as if he intended to withdraw this amount monthly. This would lead to a considerably higher tax bill, £4,330 rather than £164. He could, of course, claim this back. However, this will take time and in the meantime he may be losing out on returns which would otherwise have accrued on the money.

There is an ongoing debate about whether the tax system for pen-

Chart 6: Since the freedoms were introduced, HMRC has repaid a total of £305m to more than 127,000 claimants



sion withdrawals should be amended. Those representing low-income taxpayers think it is important to minimise the risk that underpaid tax may result in later demands for payment on people who may have spent the withdrawal shortly after receiving it and have little savings to draw on in order to pay the additional tax.

Representatives from the pensions industry have suggested that where it is not possible to operate the correct tax code for an individual, a default code at the basic rate would mean that basic rate taxpayers would pay the correct amount, while higher rate taxpayers who would need to pay more later are likely to have higher levels of savings to draw upon in order to pay this, as well as being experienced at dealing with self-assessment for tax purposes in many cases.[5]

HMRC, however, will not be amending the system in the foreseeable future, concluding that 'any changes at the current time would not significantly improve the tax position for the majority of recipients of a flexible payment when compared to the process currently in place.'[6]

How might means-tested benefits be impacted by evolving retirement income patterns?

This section explores the impact that retirement income decisions could have on the means-tested benefits individuals are entitled to. It also discusses the potential impact these decisions may have on aggregate on state finances, in particular the complexity of identifying this impact.

In the Autumn Statement in December 2014, the Government announced that it would 'change the notional income rules applied to pension pots which have not been accessed, or have been accessed flexibly, from 150% to 100% of the income an equivalent annuity would offer, or the actual income taken if higher.'[7]

Evolving retirement income patterns resulting from the pension freedoms are likely to have the greatest impact on housing-related benefits, including Housing Benefit and Council Tax Support. This is because eligibility for such benefits extends further up the income distribution (the level of income/assets which an individual can have before becoming ineligible is higher).

Take-up of means-tested benefits among people over SPa tends to be relatively low, which means that the impact of retirement income decisions on means-tested benefits may not be large as those who become eligible or increase eligibility may not necessarily apply for the benefits to which they are now entitled.

There are four segments of pensioners who may not be accessing Pension Credit despite being eligible:

- Those who have low awareness and low self-perceived need of Pension Credit.
- Those who have missed out on automatic triggers that should have notified them about Pension Credit and therefore have low Pension Credit awareness but a high self-perceived need for additional financial support.
- Those who have a high awareness of Pension Credit but feel that it is not meant for them as they think they have enough

money to survive on.
- Those who are too proud to apply for additional support from the Government as they view Pension Credit as a handout. This group is the most vulnerable as they have both a high awareness of Pension Credit and a high level of need, but will nevertheless choose not to access it.[8]

Seb has moderate levels of DC savings and so, provided he withdraws at a sensible rate is unlikely to fall back on means-tested benefits. Those without any private pension savings are likely to be heavily reliant on means-tested benefits regardless of any retirement decisions they make. However, someone who has pension savings at a lower level than Seb could make retirement income decisions that substantially impact their entitlement to means-tested benefits.

Hypothetical Individual 3: Bethany
- Has some DC savings— £15,000 at SPa
- This could provide her with an income of £20 per week if she withdraws at 7%
- She has partial State Pension entitlement, with 26 NIc qualifying years, entitling her to a State Pension of £122 per week
- Rents, rather than owns, her home

Since the pension freedoms were introduced, 61% of people who have accessed pension pots worth between £10,000 and £29,000 have fully withdrawn their pots.[9] If Bethany withdrew her entire pot in one go, she would afterwards, assuming she has no other savings, be entirely reliant on the State Pension and means-tested benefits for income in retirement.

23% of people who have accessed pension pots worth between £10,000 and £29,000 have entered drawdown.[10] In many cases, this is done by people who wish to access their 25% tax-free lump sum and have not subsequently made further withdrawals from their pot. However, even if Bethany made no further withdrawals from her pot after taking her 25% tax-free lump sum, the money saved within her pension could still affect her entitlement to means-tested benefits.

People over SPa with pension savings who choose not to access those savings in order to provide themselves with an income, will be treated as though they are taking an income based on the level of savings they have. This is called ‘deemed income’. Every £500 or part of £500 of savings over £10,000 is treated as a deemed income of £1 per week. Having taken 25% of her pot as a tax-free lump sum, Bethany would have a deemed income of £3 per week. This would reduce the amount of Pension Credit she is entitled to by an equivalent £3 per week.

Because of her small pot size, her deemed income is low and so has only a small impact on her entitlement to means-tested benefits. However, someone who chooses not to access a larger pot could be affected more substantially. For example, if Seb chose not to withdraw from his pension pot, he would have a deemed income of £55 per week. This is higher than the £50 per week income he would take if withdrawing from his fund at a rate of 7% per year.

When calculating benefit entitlement, either deemed income or actual income taken can be used, depending on which of the two is higher. In the case of Seb withdrawing at 7% per year, deemed income of £55 per week would be used in benefit calculations.

Assets and income vary over time as withdrawals are made, meaning that entitlement to means-tested benefits will change over the course of retirement.

Withdrawing her full DC pot in one go, Bethany would pay more tax than she would otherwise have done. If she withdrew £1,000 from her pot each year until it runs out, she would pay no tax as she would never reach the Annual Allowance. If, however, she withdrew the full £15,000 upon reaching SPa, she would pay tax on £5,744 of her withdrawal totalling £1,149.

Bethany could receive an additional £6,000 in means-tested benefits over the course of her retirement if she chose to with-

draw her DC savings in full at SPa rather than drawing them down at a sustainable rate (Chart 7).

The modelling assumes that individuals who fully withdraw their pension savings spend them over a short period, however some may use the withdrawal to support themselves over a longer period in retirement. This would potentially mean that they pay more tax than they need have done (if they had drawn down the money as and when they needed it), as they will be taxed upon withdrawal, not upon spending. This will also impact their entitlement to means-tested benefits as the money will be treated as capital.

Those who do spend the full withdrawal may also see their means-tested benefit entitlement impacted if they are deemed to have deliberately deprived themselves of those assets.

Chart 7: Individual 2 receives nearly £6,000 more in means-tested benefits over her retirement if she withdraws her pot in full at SPa

The 'deliberate deprivation of assets' rule aims to mitigate increased reliance on means-tested benefits resulting from pension freedoms

Following the introduction of the pension freedoms, DWP warned that people who access their pension pots may not be able to claim means-tested benefits if their money runs out. If an individual is deemed to have deliberately spent or given the money away in order to secure or increase entitlement to benefits, they will be treated as though they still have that money and it will be taken into account as income or capital when benefit entitlement is calculated. However, it is not clear what criteria will be used to determine whether someone has 'deliberately' spent or given away money with the intention of receiving a higher level of benefits.

Whether Bethany's entitlement to means-tested benefits would be impacted by her decision to fully withdraw her entire pot would depend on the ways in which she spent the money withdrawn. For example, if she used the money to pay off debts, her decision to make a full withdrawal would not be considered deliberate deprivation.

Support with care costs could also be impacted by retirement income decisions. However, the 'deprivation' rule may be even harder to enforce in relation to long-term care costs because much of the spending down of pension assets may have occurred a significant period of time ago, which would make it more difficult to determine whether it was spent in an appropriate manner.

Estimating the aggregate cost to the state of evolving retirement income decisions is complex

Calculating the impact that this could have on aggregate for state finances is more complex as it is heavily dependent on individual saving levels, retirement income decisions and application of the deprivation rule. The impact could also be reduced by low-levels of take-up of means-tested benefits among people over pension age. The take up rate of Pension Credit is around 60% and the take up of housing benefit is around 80% for pensioners who are entitled to these means-tested benefits.[12] Other benefits that may be impacted include the assessment of support for care needs which are assessed by local councils.

While there is potential for Government benefits spending upon an individual to increase as a result of retirement income decisions, the impact this may have on aggregate may be relatively small. It is estimated that spending on income-related benefits for people above SPa will account for around 0.25% of GDP in 2063-64, so even a 5% increase in caseloads would increase spending by only around 0.01 per cent of GDP.[11]

When an individual accesses their pension savings under freedom and choice they may reduce their entitlement to means-tested benefits through an increased income and increased capital in their assessment. It may be that in future years after they have exhausted their pension pot and any capital drawn from it that they may be entitled to a greater amount of means-tested benefits. This assumes that their retirement income decisions are not assessed as deliberate deprivation of assets.

In aggregate, modelling indicates that any increased means-tested benefit expenditure (excluding support for care needs) upon older pensioners might be more than offset by a reduction in means-tested benefits to younger pensioners (who are reducing their entitlement in the early years of retirement in the same way that previous cohorts may have done). The net impact could be around 1% of the expenditure upon these means-tested benefits. However, the actual impact is highly dependent upon behavioural assumptions, including the spending of capital which has been drawn from pension savings. Any changes to the level of benefits, thresholds and assessment criteria could have a far greater impact upon expenditure.

It has also been suggested that pension freedoms could have a macroeconomic impact

An increase in the number of people entering drawdown at retirement rather than purchasing an annuity may change the way that capital is invested as drawdown gives individuals the flexibility to choose their own investment strategy.

The increased number of pots being fully withdrawn could also have an impact, with just 1 in 5 pots that have been fully withdrawn reinvested. However, 60% of fully withdrawn pots are worth less than £10,000, which means that the magnitude of this impact is likely limited.[13]

It has also been suggested that there may be an increase in the use of pension savings to invest in property, in particular buy-to-let properties which can offer income as well as capital growth. But, again, the macroeconomic impact of this is likely to be limited.

Conclusions

Retirement income decisions that people make under the new pension freedoms are likely to have the greatest impact on tax revenue, although they are also likely to impact means-tested benefits to some degree. In regards to tax, individuals with considerable DC savings and some DB entitlement could end up paying 200 times more based on the retirement income decisions modelled in this Briefing Note (full withdrawal at SPa compared to purchasing an annuity). Based on the way in which people have accessed their pension savings since the pension freedoms were introduced, HMRC could see increased tax revenue of £19.2 billion over the next ten years. However, this is dependent on the retirement income decisions people make in the future, which cannot necessarily be accurately predicted by past behaviour.

The impact of evolving retirement income decisions on means-tested benefits is more difficult to estimate. On an individual level, someone with DC savings of around £15,000 could receive around £6,000 more in benefits over the course of their retirement if they fully withdraw their savings at SPa rather than drawing down steadily. For someone with higher levels of DC savings, the impact could be even more substantial, although those who withdraw their pension savings fully to later fall back upon means-tested benefits for support may receive reduced benefits as a result of the deprivation rule. Calculating the impact that this could have on aggregate for state finances is more complex as it is heavily dependent on individual saving levels, retirement income decisions, application of the deprivation rule and take-up of means-tested benefits.

[1] OBR (2017) *Economic and fiscal outlook – November 2017*
[2] FCA (2018) *Data Bulletin 12 March 2018*
[3] FCA (2018) *Data Bulletin 12 March 2018*
[4] FCA (2018) *Data Bulletin 12 March 2018*
[5] Office for Tax Simplification (2018) *Savings income: routes to simplification*
[6] HMRC (2018) *Pension schemes newsletter 100 – June 2018*
[7] HM Treasury (2014) *Autumn Statement December 2014*
[8] DWP (2012) *Investigating the triggers into claiming Pension Credit*
[9] FCA (2018) *Data Bulletin 12 March 2018*
[10] FCA (2018) *Data Bulletin 12 March 2018*
[11] OBR (2014) *Fiscal sustainability report July 2014*
[12] DWP (2017) *Income-related benefits: estimates of take-up*
[13] FCA (2017) *Retirement Outcomes Review: Interim Report*

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