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TAXATION TREATMENT OF RETIREMENT BENEFITS

FOR some years there has been a general feeling of disquiet that the treatment of retirement benefits for purposes of taxation should be so complicated and should lead to such different consequences according to the particular approach to the problem.

A joint committee of the Federation of British Industries, the Association of British Chambers of Commerce, the Life Offices' Association and the Association of Superannuation Funds drew up a report entitled *The tax treatment of retirement benefits*, which reviewed the problem as a whole and included recommendations for the design of future legislation in the United Kingdom. The report included the comment:

> It has long been the opinion of employers and of representative bodies of those who are interested in retirement provisions for employees that the present state of the law is illogical and that it is warping the natural development of retirement schemes....

Subject to certain reservations, the report was endorsed by the four associations and forwarded to the Chairman of the Board of Inland Revenue in February 1948.

In 1950, following an announcement made in his Budget Speech, the Chancellor appointed a Committee to review the income-tax treatment of superannuation and pension schemes, and of contributions made under such schemes. The Committee was also to consider, among other things, whether further income-tax relief should be given for other kinds of payments which individuals might make during their lives for the purpose of providing for their retirement or old age, and for their dependants after death. In this connexion the Committee was to pay special attention to the position of self-employed persons and of others not subject to any pensions scheme.

The exact terms of reference of the Committee are as follows:

> (1) To review the income tax law relating to superannuation funds and other arrangements, whether contractual or voluntary, for the provision, on retirement or death of persons holding an office or employment, of pensions or other benefits for those persons or their dependants.
>
> (2) Generally, to review the law governing the treatment for income tax purposes of payments made by, or for the benefit of, individuals with a view to providing for the individual in his retirement or old age, or for his dependants after his death, and the treatment for income tax purposes of sums received by way of such provision.
>
> (3) To consider whether any amendment of the law in regard to these matters is necessary or desirable; and, in particular, to consider whether the scope of income tax relief in respect of payments of that nature should be extended and, if so, in what circumstances and subject to what conditions, having special regard to the fact that contributory pensions schemes on the lines of those commonly adopted by industrial concerns are not at present available to all persons holding an office or employment, and are not applicable to an individual carrying on a profession or business.

The members of the Committee are:

Mr J. Millard Tucker, K.C. (*Chairman*).
Mr W. S. Carrington, F.C.A. — Mr H. Weston Howard, C.B.E.
Sir John J. Cater. — Mr R. C. Simmonds, F.I.A.
Mr George Woodcock, M.A.

The Committee is commonly known as the Millard Tucker (No. 2) Committee to distinguish it from the earlier Committee, appointed in 1949, on the computation of net trade profits for income tax purposes, which was also presided over by Mr Millard Tucker.

The Councils of the Institute and the Faculty of Actuaries both decided to submit evidence to the Committee and gave independent consideration to the subjects mentioned in the terms of reference. The Institute recommendations were embodied in a Memorandum which was prepared by a sub-committee of the General Purposes Committee. When these recommendations were compared with those of the Faculty Memorandum it was found that they were closely similar, with one major exception—the treatment of life assurance and endowment assurance policies, which are dealt with in paragraphs 15 to 19 of the Institute Memorandum and sections II(*f*) and III(*b*) of the Faculty Memorandum.

The two Councils decided to submit evidence jointly on behalf of the actuarial profession, and to send both memoranda to the Committee, there being insufficient time to weld the two documents into one memorandum. It was hoped that the recommendations might gain in importance through having been prepared independently by the separate Councils. Messrs. A. E. Bromfield, J. H. Gunlake, J. H. Kitton and D. A. B. Scrimgeour have been appointed as the joint delegation to give oral evidence before the Committee.

The Institute Memorandum is printed on p. 452 and the Faculty Memorandum on p. 463.

MEMORANDUM SUBMITTED BY THE COUNCIL OF THE INSTITUTE OF ACTUARIES

1. Provision for retirement or old age, or for dependants, by means of pensions or other benefits—whether made out of National, Local Authority or Statutory funds and revenues, or through the medium of the life assurance companies, or of privately established funds or schemes—is a subject with which actuaries are concerned in their professional capacity, in many cases intimately. The Council of the Institute of Actuaries accordingly desires to submit the following memorandum upon the taxation treatment of such benefits to the Committee appointed, under the chairmanship of Mr J. Millard Tucker, K.C., to consider that subject.

2. For the purpose of this memorandum it has been assumed (though it is not intended that the assumption should be taken to imply approval) that there will be no alteration in the present taxation treatment of immediate annuities. If any such alterations are contemplated, the Council might wish to modify the following recommendations.

3. The Council has had the opportunity of studying the Report dealing with retirement benefits to the Chairman of the Board of Inland Revenue prepared in February, 1948 (hereinafter referred to as 'the 1948 Report') jointly by the Federation of British Industries, the Association of British Chambers of Commerce, the Life Offices' Association, and the Association of Superannuation and Pension Funds (which Report it is understood has now been placed before the Committee), and is in broad agreement with the general principles set out therein, subject to the modifications recommended below.

4. In considering the taxation treatment of retirement and similar benefits, it is important to bear in mind the total cost of providing them—whether this be met wholly by the employer (as in a non-contributory pension scheme), or partly by the employer and partly by the employee (as in a contributory pension scheme), or wholly by the individual. In this connexion, the attention of the Committee is drawn to the undesirability of differences in the treatment of contributions payable by employees and employers. If, for instance, more favourable treatment is accorded to an employer's contributions, the simple expedient can be, and is, adopted of arranging the scheme entirely at his cost, a reduction being then made in the employees' salaries so as to transfer an agreed share of the cost to them.

GENERAL PRINCIPLES AND LIMITS

5. The authors of the 1948 Report were clearly of the opinion that, on the whole, the most satisfactory principle to adopt in designing suitable tax regulations is to exempt from taxation the cost of building up pensions and similar benefits, and to tax the benefits when they become payable. The Council concurs in this view. Theoretically such an arrangement, being designed to protect the tax-payer from double taxation, should be universally applied without any particular limits, but bearing in mind the progressive scale which constitutes so prominent a feature of our taxation system, it would seem necessary in practice to impose some restrictions.

6. As regards the provision of a pension payable on retirement at the specified age (or earlier on grounds of ill-health), the limit of two-thirds of retiring salary applied in the case of schemes approved in accordance with the 1921 and 1947 Finance Acts does not appear to the Council to call for revision, though an alternative is recommended (see later) in the case of self-employed persons. It is suggested, however, that the second limitation—of the pension to £2000 per annum—which has in recent years been prescribed in some cases by the Inland Revenue authorities has added greatly to the complications of the subject, is anomalous (in that it is normally applied to 1921-Act schemes if they are contributory, but not if they are non-contributory, and is not applied to schemes which are subject to the 1918 Act or the 1947 Act), and should be abolished. A suggestion is made later regarding the taxation of withdrawal benefits which should facilitate the removal of this limit. The present high level of taxation would, in any case, seem likely to preclude pensions of unreasonably large amounts being arranged.

CONTROL

7. The Council is satisfied that it is in the public interest that special taxation arrangements should not be applied to retirement benefits without appropriate official control, but desires to draw the Committee's attention to the fact that at present many of the requirements with which a pension scheme must comply in order to secure approval are determined departmentally. It is suggested that the greater part, at all events, of any revised regulations resulting from the Committee's findings should be suitably codified and imposed by Statutory Instrument. Anomalies which at present arise as between the provisions of the relevant 1918, 1921, 1922 and 1947 Acts, and the regulations made thereunder, could then be removed.

TAXATION TREATMENT OF EMPLOYERS' CONTRIBUTIONS

8. Under present legislation, ordinary annual contributions made by an employer to an approved scheme or fund are, in all cases, allowed as an expense for tax purposes. The treatment of payments other than ordinary annual contributions (such, for instance, as lump-sum payments made to cover liability for past service) is, however, anomalous in that,

(*a*) in the case of a fund approved under the 1921 Act, such payments are allowed as an expense, provided that the relief is spread over a period (usually ten years or less) determined by the Inland Revenue authorities;

(*b*) in the case of a scheme recognized or approved under the 1918 or 1947 Acts, no payments made towards future pensions other than ordinary annual contributions are allowed as an expense, although since the decision in *Hancock* v. *General Reversionary and Investment Company Ltd.* a lump-sum payment may be allowable if it is made either to commute a pension or to replace a pension by an annuity purchased from a life office.

9. The Council considers that all payments made by an employer should be treated as an expense, but recognizes that it may be desirable for the Inland Revenue authorities to retain the right to spread the relief for abnormally large payments over several years.

INTEREST EARNINGS

10. As superannuation benefits are built up not only from the premiums or contributions payable, but also from the interest earned upon them, the principle of exempting the cost of such benefits from tax raises the question of the taxation treatment of the interest earnings—a matter which was fully considered by the members of the Royal Commission of 1920 on the Income Tax. In the case of an approved fund, privately established under the 1921 Act, interest earnings are (except as mentioned below under 'Lump sums') mainly exempt from tax, but if the pension scheme is based upon deferred annuities issued by a life assurance company some tax may be payable, under the special regulations governing the taxation of an annuity fund, depending upon whether the particular item of interest income is or is not matched by current annuity payments.

11. It is suggested that this arrangement, the effect of which is to introduce extraneous tax considerations into the actuarial calculation of the premiums payable for deferred and immediate annuities, should be terminated, and that the annuity fund held by an assurance company in connexion with approved pension schemes should, like the corresponding private fund, be exempted from tax in respect of its interest income (subject to appropriate provisions, as suggested later, regarding withdrawal benefits).* The maintenance by an assurance company of a separate account for business of this type would not appear to present any insuperable difficulty.

LUMP SUMS ON RETIREMENT

12. The authors of the 1948 Report contemplated that the principle 'exempt the build-up, tax the benefit' would be applied to lump-sum benefits as well as to pensions, and suggested a method, which in the opinion of the Council is reasonable, for calculating the rate at which lump sums should be taxed. Reference was made in the Report, however, to the difficulty presented by the fact that there were already in existence a number (which has since increased) of schemes providing tax-exempt lump sums, the premiums or contributions for which are tax-exempt, the interest earnings being sometimes, but not in all cases, taxable. The exemption of any part of a lump-sum retirement benefit from taxation would be in direct conflict with the general principles advocated, and on grounds of logic the Council cannot support it. If, however, for practical reasons the concession is maintained, and, for reasons of equity is extended to additional classes of persons, a limit must clearly be imposed.

13. It seems to the Council that the present regulations, which in effect permit not more than one-quarter of the whole retirement benefit to be taken in the form of a tax-exempt lump sum, certainly go as far in this connexion as is reasonable. It is further suggested that the limitation, mentioned earlier in this Memorandum, of the pension to two-thirds of retiring salary should be inclusive of the pension equivalent of any lump sum forming part of the retirement benefit. If the concession were, subject to permitted limits, to be maintained and extended in its application, approval would, presumably, no

* It is noted that the Committee on the Taxation of Trading Profits has made a recommendation to this effect.

longer be witheld (as it is at present) from such part of a privately established pension scheme as relates to the provision of lump sums.

14. The Committee may, however, take the view that, whilst a tax-exempt lump sum of 25% should continue to be permitted, the interest earnings relating thereto should be taxed. Alterations in the taxation treatment of contributions, whether payable by employees or employers, do not involve any specifically actuarial considerations, but the Council feels that it ought to remind the Committee that adverse changes in the taxation treatment of interest earnings relating to existing retirement benefits schemes might invalidate the actuarial basis of the premiums (or contributions) and the reserves, and might give rise to grave difficulties.

PROVISION FOR DEPENDANTS

15. The addition of widows' and children's pensions to a 1921-Act retirement benefits scheme is generally allowed nowadays, provided that they do not increase the cost, on the average, by more than one-third. There is no special necessity for a limitation in this particular form, and it is suggested that it might with advantage be replaced by a limitation of the cost of death benefits to a contribution of, say, 5% of the individual's income. It is suggested, however, that the contributions for death benefits, which would be additional to any contributions payable to provide retirement benefits, should secure exemption from tax on the same lines as the latter, not only (as at present) where membership of the widows' scheme is voluntary, but also where membership is compulsory (in which event the tax relief at present allowed is nearly always smaller).

16. Schemes which do not include pensions for widows and children usually provide lump-sum payments on death. In practice, these take a variety of forms, but are generally not less than the premiums or contributions paid (often with interest added). It is suggested that, if it is to be permissible to take one quarter of a retirement benefit in the form of a tax-exempt lump sum, it would be consistent to allow one-quarter of any lump sum payable on death to be similarly exempt, provided that the cost of the total death benefit is limited as suggested above. The remainder of the lump sum should be taxed at source.

17. Similar provisions could be applied to the self-employed man, or to the case of a widows' or orphans' benefit scheme which is not associated with retirement pensions, subject as regards the former to the same right of carry-forward in respect of tax relief as is suggested later in this Memorandum.

18. If a capital sum payable on death, or an annuity commencing on death, is subject to both income tax and estate duty, double taxation arises. In practice most widows' annuities have a value of less than £2000 and are payable under such conditions that they are treated as separate estates. The loss to the Revenue if all such payments—whether of a capital or income nature—were free of estate duty would be relatively small; moreover, the structure of retirement benefits and the relative taxation suggested in this Memorandum is self-contained and self-consistent. For both reasons it would seem better, therefore, to levy income tax on such benefits and free them completely of estate duty.

19. At the present time, a privately-established scheme which includes a death benefit in excess of the refund of contributions (for example where the

benefit is subject to a minimum of, say, twice the rate of annual salary current at the time of death) can only secure approval in certain conditions and subject to the production of a special actuarial certificate of a rather complex nature. The taxation arrangements suggested would make this restriction of the permitted death benefit, and the formality of a special certificate, unnecessary.

20. It is convenient to refer here to ordinary whole life and endowment assurances. Although these form a means by which provision for retirement, or for dependants, can be made, the Council associates itself with the view that they are clearly distinguishable from assurances relating to pension and death benefit schemes, in that they can be freely effected for purposes other than retirement and for any selected amount or maturity age, and that the policy-holder is not obliged to take any part of the benefit in the form of a pension, and is able to assign, alter or discontinue the policy at any time. There is, therefore, in the opinion of the Council no need to disturb the long-established taxation treatment of the premiums payable for individual assurances. It is, however, suggested that in any extension of tax relief in respect of provision for retirement to persons for whom facilities do not at present exist (a subject dealt with in a later section) it should be made possible for such persons to utilize any suitable assurance policies they already possess; revised taxation provisions would then apply to these assurances from the date of the introduction of new legislation.

WITHDRAWAL BENEFITS

21. In the elimination of the differences of taxation procedure affecting schemes subject to the provisions of the 1918 and 1921 Acts, the Council would desire to see uniformity in the treatment of benefits arising on the withdrawal of members. Whilst it might be argued, by analogy with lump sums payable on retirement, that at least a proportion of these payments should be free of tax, it would seem more in line with the general principle that the whole of a withdrawal benefit should bear the rate of taxation actually suffered by the member withdrawing. The Council accordingly recommends this, and suggests that the most convenient administrative procedure would consist in the deduction of tax at the standard rate at source, with the right of suitable recovery by the recipient.

22. Apart from the question of taxation, it is desirable to refer to the fact that, particularly in the case of a 1921-Act scheme, no portion of the contributions made by an employer can be returned in cash to a withdrawing member, although the grant of deferred pensions based upon the total contributions already paid is generally permitted. If the suggestion made as to taxation is accepted, consideration might be given by the Committee to the granting of suitable discretionary powers to make such cash payments, particularly when a member has to leave the service through no fault of his own. This concession would meet the wishes of the 'good employer' anxious to mitigate the hardship of dismissal for redundancy.

SELF-EMPLOYED PERSONS, AND PERSONS FOR WHOM PENSION SCHEMES ARE NOT AVAILABLE

23. The Council has considered the representations made to the Chancellor of the Exchequer by the Councils of the Law Society and of the Institute of Chartered Accountants, in a Memorandum dated 1 March 1949, regarding the

serious obstacles presented by the present taxation provisions to the retirement and recruitment of persons engaged in private practice, either individually or in partnership, and desires to associate itself with those representations, both in their general application to self-employed persons and employees for whom pensions schemes are not available, and in their particular application to those actuaries who are engaged as full-time consultants.

24. It is suggested that if the privileges at present available to some employed persons are to be extended, they should be extended in respect of all earned income (except possibly pensions themselves) arising under any Schedule. No further refinement seems to be desirable.

25. One way to extend the privileges might be to repeal the provisions allowing relief in respect of contributions to schemes approved under the 1921 or 1947 Acts, and to make a general and corresponding increase in the earned income allowance. This, however, would not necessarily encourage thrift for the particular purpose in view. Relief from tax should be related to money actually saved, and if savings securing tax-exemption are to be set aside for old age or incapacity, it is reasonable for the person who saves to accept restrictions, analogous to those imposed in the case of 1921-Act funds, on his power to dispose of his property; the nature of suitable restrictions is discussed below.

26. Certain large groups of self-employed persons could set up funds for themselves, or be brought into existing funds for employed persons; for example, partners in firms of Chartered Accountants might join a new scheme to be sponsored by their Institute, or the schemes (if any) for the employees of their own firms. Smaller groups might join together, or might join a larger scheme. But there is certain to be a large number of people, self-employed or in non-pensionable employment, who must make their own individual arrangements.

27. If the use of sums of money which may be large in the aggregate (though derived from many varying sources) is to be restricted, the administrative machinery of existing financial institutions must be expected to take a part, or the process of securing approval will be too cumbrous. The recommendations below may therefore be considered as relating to saving through all or any of life assurance offices, the National Debt Office (by the sale of deferred annuities which would, it is thought, be a new development), friendly societies and funds similar to those now approvable under section 32 of the 1921 Finance Act.

28. The main difficulty in extending present reliefs to self-employed persons is that their earnings generally vary from year to year. The second difficulty is that the 'specified' pension age, which is necessary in a 1921-Act fund, seems much less relevant to them; if it is considered important to specify a retirement age, it might perhaps be one not before 65 (60 for females). Both these difficulties suggest that conditions and limitations to concessions should be related to earnings rather than to benefits. It is, in any case, more natural to relate tax concessions for a particular year to payments in that year than to payments at some future date.

29. In considering limitations of the concessions which could be granted to self-employed persons, or persons in employment carrying no rights to retirement benefits (called for convenience 'non-pensionable'), it is helpful to consider a male aged 20–25 who makes level earnings throughout a long working life. To secure a pension for life from 65 of two-thirds of his annual earnings he should set aside at least $7\frac{1}{2}\%$ of his income. He will, it is true, be entitled to

the State pension, but bearing in mind that his earnings will probably increase, perhaps substantially, during his life, 10% (plus 5% previously suggested for death benefits) would seem to be a reasonable maximum allowance to be deducted from gross earned income (with the modifications mentioned below), provided that the money is actually utilized in providing for old age or incapacity.

30. If the present restriction of concessions to 'regular annual contributions' is retained, there is no obvious reason for any absolute upper limit. But if the restriction is removed, a person with a large but fluctuating income would be able to make large payments when his marginal sur-tax rate is high, but none at all in other years; an absolute limit to the amount to be set aside in any one year might therefore be imposed.

31. Though some of the organizations suggested for accepting these savings could readily handle fluctuating payments, not all could. For this reason it is recommended that the allowance should be limited in principle to sums actually paid, but that to remove hardship in cases where income fluctuates considerably, a non-pensionable person who has paid more than the admissible amount in one year should be allowed to carry forward the excess to any future year in which his payment is less than the admissible percentage of a higher income. For example, a man may effect a policy at £100 per annum premium when his earned income is £1000 per annum. If his earnings fall to £800 for three years, he will have paid an amount which exceeds his allowance by 3 × (£100–£80), or £60. If his earnings rise to £1500 in the next year, he would be allowed not only his £100 payment but £50 of the £60 credit, and £10 credit would be carried forward. It might be impracticable to permit such carry-forwards indefinitely, and a limit of five or seven years (say) might be imposed, though only for practical reasons. To relate the allowance to a 3- or 5-year average of earnings would only diminish without removing the difficulty of a fluctuating allowance.

32. There is a sound actuarial case for granting females a higher allowance because they normally retire earlier (the National Insurance Act accepts this principle) and in general live longer. The 10% limit suggested above might be increased to 15% for them.

33. The problem presented by the older men and women is a difficult one. If the case for extending the present concessions rests on the arguments of hardship and damage to important professions there is equally a case for rectifying past inequities, but precise actuarial calculations are impracticable.

34. The following suggestion takes account of these facts:

(i) The difficulties of the non-pensionable vis-à-vis the pensionable person became acute during and immediately after the 1939–45 war, when the cost of living and taxation rose steeply and simultaneously.

(ii) The non-pensionable person has always been able to obtain the life assurance premium rebate on endowment assurance policies.

(iii) Some upper age limit to increased concessions must in practice be imposed.

(iv) The National Insurance pension is a higher percentage of the normally lower earnings of females.

The suggestion is that, for people who begin to make savings under the proposed new arrangements within, say, two years of the passing of any Finance Act in which these proposals are incorporated, the improved percentages shown in the Table should be allowed. In all other cases (except possibly pensionable persons becoming non-pensionable in circumstances in which they have no accrued retirement benefits) the maximum allowance in respect of retirement benefits should be 10% for males, ceasing at age 65, and 15% for females, ceasing at age 60.

Age attained on passing of Act	Percentage of earnings to be allowed	Maximum number of years for which allowance may be granted
	MALES	
25 and under	10	40
26	11	39
27	11	38
28	12	37
29	12	36
	Increasing by 1% for each 2 years of age	Decreasing by 1 year for each year of age
53	24	12
54	25	11
55	25	11
56	25	10
57	25	10
	Remaining level at 25%	Decreasing by 1 year for each 2 years of age
74	25	1
75	25	1
over 75	Nil	—
	FEMALES	
25 and under	15	35
26	16	34
27	16	33
	Increasing by 1% for each 2 years of age	Decreasing by 1 year for each year of age
43	24	17
44	25	16
45	25	15
46	25	14
47	25	13
48	25	12
49	25	11
50	25	11
51	25	10
52	25	10
	Remaining level at 25%	Decreasing by 1 year for each 2 years of age
69	25	1
70	25	1
over 70	Nil	—

35. If concessions of the sort discussed are to be made, the Inland Revenue should be entitled to require that the contributions are in fact used for the purpose for which they are intended. Restrictions in this connexion similar to those in employed persons' schemes should be imposed. The safeguards

against the misuse of moneys paid out of a fund approved under the 1921 Act are now well established, but the practice under the 1947 Act is not yet well established or properly tested. It is understood that there is at present some doubt about the legal enforceability of a clause purporting to prevent assignments, surrenders and other transactions of which the main object is the avoidance of tax on the proceeds of policies intended to provide an annual pension and/or a limited lump sum, but that such powers could be provided by a special clause in a Finance Act. Alternatively, if the suggestion is accepted that all sums received on the surrender of an approved retirement benefit should be taxed at source at the standard rate, there should be no need for the Inland Revenue to have such powers: a suitable clause in the policy or rules of the scheme would be required in order that the premiums would qualify for relief, and payments under the policy (or out of the fund) would suffer deduction of tax at source.

36. The foregoing remarks apply mainly to the self-employed person. There are, however, also many non-pensionable employed persons (see paragraph 29), and the Council considers that they should be granted the same reliefs as are suggested for self-employed persons. It is further suggested that an employed person who is entitled to a retirement benefit which is expected to fall short of the two-thirds standard (or less for shorter service) should be allowed to set aside premiums or contributions on the 'self-employed' basis in respect of an appropriate part of his income—although it is appreciated that this might involve some administrative difficulties in practice.

COMPANIES WITH EMPLOYEES OVERSEAS

37. It is suggested that consideration should be given to the special problems arising in respect of persons, some of whose working life is spent overseas, generally with retirement subsequently in this country. Whilst abroad, these persons are subject to local taxation, so that approval of their fund has to be sought from the local authorities. This situation is met by the creation of separate funds covering respectively employment in and out of the United Kingdom. Under present procedure, moneys cannot be transferred between the funds without loss by taxation, but it may be that no solution, compatible with suitable taxation safeguards, can be found for this problem.

38. Another matter to which reference might perhaps be made at this point is the situation which arises if funds are invested in securities the yield from which is within the scope of 'Dominion taxation' agreements. In such cases tax is deducted at source and cannot be recovered.

39. The Council mentions these two matters in order that the Committee may consider whether, in view of the growth of the pension scheme structure in all countries, suitable reciprocal agreements could be reached which would enable schemes to have more general approval across frontiers.

GROUPS OF COMPANIES

40. The limitations at present set to approval under the 1921 Act restrict the scope of a fund to companies whose relationship is that of principal and subsidiary. As a result, separate funds often have to be created when similarity of benefits and actuarial considerations would indicate the desirability of the

inclusion of the employees of a whole group in the same fund thereby reducing transfers to a minimum. Much more latitude is, however, given in respect of recognition under the 1918 Act.

41. The Council would suggest that consideration be given to a wider outlook in this matter, particularly as the creation of funds for self-employed persons will need to cover professional or trade groups if they are to be firmly established. It is submitted that persons in a loosely-knit group of companies, or serving a common trading interest in their employment, should be eligible for an inclusive fund. The formation of pension companies might be considered as an alternative to trusts operated under the 1921 Act, or for the purpose of covering groups of persons linked by a common interest or similar employment.

TRANSFERS BETWEEN SCHEMES

42. Whilst advocating the taxation of withdrawal benefits, the Council would desire to see every facility given to transfer arrangements which in the event of a change of occupation would preserve, to the greatest extent possible, accrued pension rights without loss by taxation. At present the Board of Inland Revenue have to restrict their approval to transfers between pension schemes created under the aegis of the same Act, but this limitation should vanish with the introduction of new legislation. Appropriate certificates of transfer might be accepted either as exempting transfer values from taxation or as providing a right of recovery.

RETIREMENT AT A SPECIFIED AGE

43. Approval of a fund under the 1921 Act can only be granted if the main benefit is the grant of a pension from a specified age. Although provision can be made for early and late retirement, the Council submits that this requirement tends to a rigidity which is undesirable and will, as already indicated, be quite unsuitable in any case for self-employed persons. Further, with increasing longevity, the suitability of a particular age can have no permanence. It would, therefore, seem desirable to modify this requirement in any new legislation to permit normal retirement not earlier than a specified age.

44. It is also suggested that the prohibition (which has been relaxed to some extent recently) upon the receipt of a pension whilst continuing at work in the same employment should be abandoned.

TAXATION OF CAPITAL SUMS

45. It has been suggested above that capital sums should be taxed at source as if they were income (subject in certain cases to 25% being allowed tax-exemption). In order to determine the rate of tax to be applied it would be fair to 'spread forward' the lump sum by dividing it by the present value of a life annuity of £1 per annum, which might be taken, for example, from the published tables of annuities purchasable through the Post Office. As a simple, rough-and-ready approximation, however, it would be reasonable to adopt the method suggested in the 1948 Report, namely to divide by 10. It is pointed out, however, that there is nothing to prevent arrangements being made for the receipt of a long sequence of capital sums. To divide each one of such a sequence

of sums by 10 would be inappropriate, and, moreover, it may be difficult to determine in borderline cases whether the sequence is one of capital sums or an annual income. The council therefore suggests that if, after a person has received one capital sum which has been divided by 10 for the purpose of computing the rate of tax, another retirement benefit is received within ten years, the Inland Revenue should have the right to make a revised assessment in respect of the previous capital sum as if it had only been divided by the number of tax years elapsed since it was received.

TRANSITIONAL ARRANGEMENTS

46. The long-term nature of pension arrangements militates against an easy solution of the problems which arise when new conditions are introduced, and the actuarial profession is obviously anxious to ensure that no change shall jeopardize the solvency of schemes based on assumptions which might not hold good under the new conditions. Equally, members who have joined schemes on the basis that taxation of benefits will be in accordance with existing legislation may feel a grievance if adverse changes are made.

47. Consequently, it may be necessary to differentiate between the situation previous and subsequent to any important alteration. An example is the change which has been suggested in the basis of taxation of benefits on withdrawal. Thus, the existing provisions as to tax deduction might continue to be applied to contributions paid prior to the introduction of new legislation, whilst the new provisions might be applied to subsequent contributions.

48. It is evident that very careful consideration will have to be given to transitional arrangements, and their effect upon the different circumstances of existing schemes established under the Acts at present governing approval.

April 1951

MEMORANDUM SUBMITTED BY THE COUNCIL OF THE FACULTY OF ACTUARIES IN SCOTLAND

I. FUNDAMENTAL PRINCIPLES

It is obviously desirable that, underlying any practical recommendations regarding the taxation of retirement and dependants' benefits, there should, if possible, be a consistent theoretical basis, and it is therefore proposed to consider the theoretical side first.

(*a*) Tax treatment should be based broadly on one of the two following principles:

Principle (1) To tax the benefits and to allow full tax relief in respect of contributions and interest accumulation. Essentially this permits a respreading of earned income, and taxes remuneration when it is actually received.

Principle (2) To allow the benefits to be paid free of tax, but not to grant tax relief in respect of contributions and interest accumulation.

Principle (1) underlies the Finance Act, 1921, and we recommend that it should be generally adopted.

(*b*) The employer's contribution should be regarded as remuneration of the employee, and accordingly, in so far as the employer's contribution is not deemed to be taxable income of the employee, it may be regarded as a contribution by the employee receiving full tax relief.

This principle is referred to in our recommendations under Section III(*b*). It has already been accepted by the Inland Revenue Authorities when they agreed that an employee, instead of contributing towards a scheme, can accept a reduction in salary and have the scheme maintained entirely by employer's contributions.

(*c*) In theory, if Principle (1) is accepted, no limits are required on the amounts of the deferred benefits to be provided, the remuneration deferred being considered as not having been received until it is actually paid in the form of benefit. In practice, however, since the principle involves a respreading of earned income, it is necessary to adopt some limitations in order to avoid abuses, e.g. where an unreasonable proportion of income attracting a high rate of tax is diverted and subsequently charged to tax at a substantially lower rate.

II. RETIREMENT BENEFITS SCHEMES—EMPLOYED PERSONS

There are many conflicting rules in the present taxation treatment of these schemes, arising partly out of law (e.g. the different provisions of the 1918 and 1921 Acts) and partly out of practice (e.g. the £2000 limiting pension under contributory but not under non-contributory 1921-Act funds). It seems illogical that these inconsistencies should continue, and we therefore recommend that Principle (1) be applied to all purely retirement benefits arrangements whether contributory or non-contributory, whether administered privately or through an assurance company, and whether covering a group of employees or only a single employee—subject, however, to the following points:

(*a*) *Limits.* We feel that the existing maximum pension limit of two-thirds of earnings at retirement, or of average earnings over a period before retirement, is reasonable and should be continued. We also recommend that other limits, such as an over-all maximum pension of £2000, should not be applied. Special limits will probably be required for employees with less than twenty years' total service.

(*b*) *Lump-sum benefits on retirement.* We recommend that these should be fully taxable in accordance with Principle (1), but that it would be unnecessarily severe to tax them as income arising entirely in the year of receipt. The suggestion made in the 1948 Report by the Federation of British Industries, etc., seems reasonable, i.e. to charge as tax on the lump sum ten times the tax payable on an addition to income *after retirement* of one-tenth of the lump sum. It is noted that a concession was given under the Finance Act, 1947, as regards certain lump-sum benefits. No recommendation is made on this point.

(*c*) *Withdrawals.* Any lump-sum payments should be taxable as suggested in (*b*). It is recommended that even if any tax concession were made regarding lump-sum payments on retirement (such as the exemption from tax of a payment equivalent in value to one-quarter of the total benefits) it should not be extended to withdrawals, since it is desirable that employees should elect to retain accrued pension benefits rather than to take cash returns.

(*d*) *Death: return of contributions.* Life assurance benefits are discussed in (*f*) of this section and in section III (*b*), but separate comment is required where there is a death payment under a retirement benefits scheme of a return of contributions. It would, we feel, be impracticable to segregate this part of the scheme for tax relief purposes, and on the other hand, for reasons given in the other sections, we do not recommend that tax should be levied on the death benefit. Fortunately, however, the contributions and reserves involved are very small, and it has always been the practice under 1921-Act funds to allow these death returns tax free, coupled with full relief on contributions and interest. We therefore recommend that this practice be continued and extended to all retirement benefit schemes where the payment on death is restricted to a return of contributions.

(*e*) *Lump-sum contributions.* We recommend that these be allowed for tax relief to the employer, spread over a period of ten years. This more or less conforms with current practice under the 1921 Act. Employees are not at present granted tax rebate on lump-sum contributions, and no special recommendation is made that this restriction be altered.

(*f*) *Endowment assurances.* Life assurance benefits are more fully dealt with in section III (*b*), but some reference to them must be made under the present section as regards retirement benefits schemes provided by means of endowment assurance policies, since these necessarily include life assurance cover.

Under such schemes, if the retirement benefit part were confined to a non-commutable pension, and if the death benefit were taxed, Principle (1) could be strictly applied. This, however, would seem to us to involve two serious disadvantages. Firstly, taxation of the death benefit would be a strong deterrent to the institution of life assurance schemes, whereas it has always been considered beneficial to encourage life assurance. Secondly, a segregation of the life assurance funds of insurance companies would be required, the part relating to schemes being untaxed and the part relating to ordinary policyholders being taxed. This would involve considerable practical complications.

For these reasons we recommend that alternative arrangements be made involving two departures from theory. In Section III(*b*) it is suggested that the life assurance benefit should not be taxed and reasons are given for proposing that, despite this, the contributions should rank for full tax relief. This would be the first departure from theory and would require a concession from the Inland Revenue Authorities.

On the other hand, we recommend a second departure which would mean a gain to the Authorities, i.e. that tax according to the tax legislation for Life Assurance Companies should be levied on the whole interest accumulation for schemes administered by means of endowment assurance policies even where the retirement benefit is confined to a non-commutable pension. Our reasons for this recommendation are as follows. In theory, if the death benefit is not taxed, then tax should be levied on the corresponding interest accumulation, whereas if the retirement benefit is confined to a taxable pension, then the corresponding interest accumulation should be tax free. Theory, therefore, would require a division of reserves for each individual policy, which would in our opinion be unsatisfactory.

Tax relief in excess of the normal two-fifths allowed on contributions to the death benefit part of the policies (i.e. the concession required from the Inland Revenue Authorities) would in total be smaller than the tax charged on the interest relative to the retirement benefit part of the policies (i.e. the gain to the Inland Revenue Authorities). In addition, the over-all treatment of endowment assurance schemes would be simple, i.e. the whole contribution would rank for full tax relief; tax would be levied on all the interest accumulation; the life assurance benefit would be paid free of tax.

Note. Even if the above suggestions for endowment assurances were adopted, the treatment proposed in this Memorandum for pension benefits and dependants' benefits arranged separately might be expected to allow more favourable terms to be offered to the employed or self-employed person, in that tax would be levied on interest in respect of the pension benefits. The result might well be, therefore, that endowment assurances would cease to be of importance in this connexion, but in so far as they might be used, we feel that the regulations suggested in the foregoing sub-section (*f*) are appropriate.

III. WIDOWS' AND DEPENDANTS' BENEFITS SCHEMES— EMPLOYED PERSONS

(*a*) *Pension benefits*

At present the benefits under widows' and dependants' pension funds attract tax in the hands of the beneficiary, but there is considerable difference in practice regarding the reliefs allowed.

As regards contributions, compulsory schemes and special schemes set up by Act of Parliament (e.g. for law societies) come under the Income Tax Act, 1918, and relief is granted at half rate, three-quarter rate or full rate of tax payable by the employee for incomes up to £1000, between £1000 and £2000, and over £2000 respectively. Voluntary schemes come under the Finance Act, 1921, and contributions are treated for tax purposes as a deduction from income. As regards interest accumulation, all schemes except the special ones referred to above come under the Finance Act, 1921, and do not suffer tax. The special schemes are taxed on the interest of the fund, less tax deducted from pensions, with no offset for management expenses.

Since there seems to be no logical reason for the difference in tax treatment, it is recommended that Principle (1) be applied to all such schemes, subject to some limitation of the pension benefit, as suggested in section I(*c*). Such limitation must be arbitrary, but bearing in mind the normal maximum of two-thirds of retiring salary approved for retirement pensions, we suggest that a maximum of one-third of salary at death before retirement, or one-third of retiring salary in the event of death after retirement, is reasonable and consistent. It would be inadvisable to relate the limit to years of service, since the intention is to give protection to dependants from the outset.

(*b*) *Other benefits*

These are normally life assurance benefits, payable in one sum or over a fixed period of years, on the death of the employee. They may be arranged quite separately from a retirement benefits scheme (e.g. a group life assurance scheme combined with a pension fund), or they may be more closely connected with the retirement benefits scheme (e.g. endowment assurance schemes), which causes a certain amount of overlapping between this section and section II.

Life assurance schemes are obviously related to widows' pension funds in that the benefit provided is for the widow or dependants of a deceased employee. There is, however, the essential difference that the benefit, being a capital payment, is not normally subject to income tax. As stated above, we feel that it would be inadvisable to tax life assurance benefits, which are in any case subject to estate duty, and Principle (2) would therefore be applicable. Interest accumulation would be taxed, and it is important to note that this would fit in with present practice regarding the assurance funds of life assurance companies; the majority of these life assurance schemes will necessarily be administered through assurance companies.

As regards contributions, Principle (2) requires that no rebate be allowed on employees' contributions and that employers' contributions be assessed as income in the hands of the employees. There is no doubt, however, that this also would be a strong deterrent to the institution of life assurance schemes, and we recommend that, if possible, a concession be made on this point and contributions be allowed to rank for full tax relief. Such concessional treatment is strongly established in current practice, because an employer has always been allowed to contribute to a life assurance scheme without the employees having to pay tax on the contributions. As suggested in section I(*b*) above, this treatment of employers' contributions is the same as granting full tax rebate in respect of employees' contributions, and no real extension of current concessional treatment is involved. It should also be noted that the Inland Revenue Authorities have already adopted the practice of approving pension funds under the 1921 Act where a death benefit is included up to a maximum of at least one year's salary.

Bearing in mind (i) the administrative convenience of having a uniform rule regarding tax relief on all contributions to schemes, (ii) the deterrent effect on life assurance provision of taxing contributions, and (iii) the fact that the concession has been freely given in the past, we therefore recommend that full tax relief should be allowed in respect of contributions to life assurance schemes, even although the benefit is not taxable, provided the sum assured is limited as suggested below.

As regards limits, the suggested maximum widow's pension of one-third of salary would require a sum assured of, say, seven years' salary for a young widow, reducing to, say, four years' salary for a widow aged sixty-five. It is suggested that a limit of five or six years' salary might be allowed.

Note. It is considered that dependants' pension or other benefits up to the maximum amount should be permitted in addition to retirement benefits up to the maximum amount.

IV. SELF-EMPLOYED PERSONS

It appears that in equity any regulations for self-employed persons should apply also to employees who are not members of a pension/life assurance scheme. References to self-employed persons in this section are therefore intended to include them. Similar regulations should also apply to employed persons covered by a pension/life assurance scheme in so far as the scheme does not provide the maximum benefits.

The previous sections refer to the tax position of schemes for employed persons, and it seems clear that in equity it should be possible for a self-employed person to put himself in a similar tax position, bearing in mind always that he must meet the whole cost of benefits himself. Although the object to be attained is therefore self-evident, the practical application of the fundamental principles is difficult for the following reasons, among others:

(i) The income of a self-employed person is more subject to fluctuation than the income of an employed person, and it may not therefore be possible for him in practice to commit himself to a regular annual payment.

(ii) It has not been the practice of the Inland Revenue Authorities in the past to allow random payments by employees to rank for tax rebate.

(iii) Control of the accumulated contributions must not be left with the beneficiary. Under schemes, the benefits are strictly controlled by the rules, and some corresponding restrictions must be devised for self-employed persons.

(iv) Fixed retirement ages are unusual.

We recommend that the tax treatment of pension and other future benefit arrangements for self-employed persons should be the same as for schemes covering employed persons, subject to the following special regulations:

(*a*) Since a fluctuating income makes it difficult for many self-employed persons to contract to make regular payments, the Inland Revenue Authorities should relax in such cases their insistence that tax rebate be allowed only on regular annual contributions. Rebate should be allowed on any contribution made by a self-employed person within the limits set out below.

(*b*) To avoid tax evasion resulting from (*a*), it will not be enough to fix a maximum pension at retirement, and this appears to be a purely empirical problem. It is a problem of some complexity since, for example, the benefits secured by a given contribution vary greatly with age, and since both fluctuating incomes and increasing incomes must be provided for.

After full consideration of the various alternatives available, we are of the opinion that the most practical method is to limit the allowable contribution each year to a proportion of earnings, and that no additional limits can be introduced without considerable practical difficulties. We also feel that it would be unsatisfactory to fix limiting contributions separately for retirement benefits and dependants' benefits, although the method suggested above for schemes for employed persons involves this separation.

Having regard to a male self-employed person beginning contributions at age thirty, with retirement age sixty-five, a contribution of 15% of earnings would provide life assurance and retirement benefits comparable with those suggested for employed persons, assuming a moderate increase of earnings throughout working life. Persons whose earnings increase considerably, or at relatively later ages, would not be able to secure such adequate benefits, but no simple working rule can achieve more than rough justice. For females there might be reason for a higher limit because they normally retire earlier and their pensions cost more. On the other hand, they do not have to provide dependants' benefits to the same extent, and their earnings do not normally increase so much. It may therefore be considered sufficiently equitable to have the same percentage for both males and females.

(*c*) The proposed maximum contribution would not be sufficient to allow present self-employed persons at the older ages to build up adequate pensions, and it is hoped that some measure of relief may be possible for them. It cannot be expected that they should be enabled in their future working life to make up fully for their previous service, and as a compromise it is recommended that past service provisions be limited to a maximum of ten years, i.e. the period during which high income tax has made saving difficult.

It is essential to have a simple working rule, and we therefore recommend that for self-employed persons at the date when any new legislation of this nature is introduced, who are then over age thirty-five, the normal maximum allowable contribution in any year be increased by an additional 1% of earnings for each year of age over thirty-five, but with an over-all maximum of 25% of earnings.

(*d*) We recommend that if in any year a self-employed person makes a contribution in excess of the limiting amount, this additional payment should be carried forward and allowed as a deduction for tax purposes in any future year when the person makes a contribution of less than the limiting amount. It will be noted that this would not allow a self-employed person to escape tax on unreasonably large amounts in years of high earnings. It is merely an administrative convenience to allow him to set aside reserves, as it were, out of taxed income from which to pay contributions in future lean years.

(*e*) The Act introducing legislation for self-employed persons defining the conditions under which tax relief will be given should make provision that all policies which are written within the terms of the Act should be endorsed to record this, and the benefits should by that token be non-commutable and non-assignable and capable of being surrendered only on the policyholder ceasing to be a self-employed person and with the consent of the Inland Revenue Authorities. Where such consent is given, the surrender value should be subject to deduction of tax as suggested in section II(*c*).

V. FEE-PAID DIRECTORS AND CONTROLLING DIRECTORS

We recommend that whole-time or part-time directors remunerated by fees, and controlling directors, should have the same privileges as employees, or alternatively as self-employed persons where no scheme is in force. Thus these directors should be permitted to enter existing schemes in force for employees of their companies, and in general it should be permissible for the companies to provide pensions of not more than two-thirds of the actual fees and salary payable in these cases. Past service credit for present directors, however, should be limited to ten years. Alternatively, where no scheme is in force, the directors should be subject to the regulations regarding self-employed persons.

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