Making Tax on Retirement Savings Fair and Efficient

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12 June 2017

Taxation of Retirement Savings WP – Draft Scope

- This working group will look at the taxation (including NI treatment) of savings that are earmarked for retirement and the impact of changes in the system which may be considered.
- The analysis will include a broad definition of savings vehicles, not just pensions, including ISA-style pensions and owner-occupied/buy-to-let property
- The analysis will consider macroeconomic, individual and cross-generational implications including:
  - The financial implications of various taxation regimes for individuals, government and society
  - The motivation for saving for retirement within each taxation regime and the relative attractiveness for various socio-economic groups
  - Likely behavioural implications for individuals and employers of changing to alternative systems
- The group will develop a model for the individual impact of different tax systems

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A manifesto issue?

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Agenda

- Context for pensions tax review
- Implications of change
- Intergenerational fairness
- Questions and comments

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Principles for designing an ideal tax system

Adam Smith's original canons

- Equity
- Certainty
- Convenience
- Economy

Later additions…

- Simplicity
- Productivity
- Elasticity

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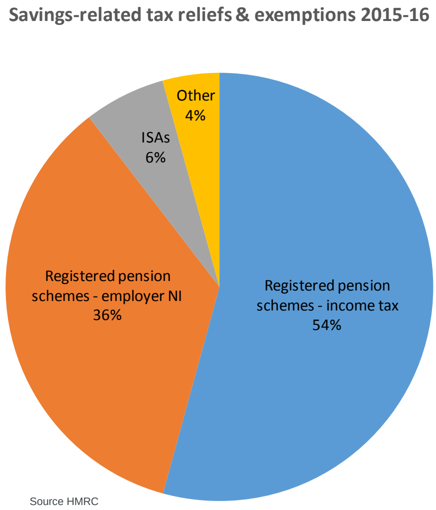
Why is the taxation of pensions important?

87% of income tax reliefs targeted at savings…

…85% of which at pensions

98% of NICs reliefs for employer pension contributions

Total cost over £40bn a year



Source HMRC

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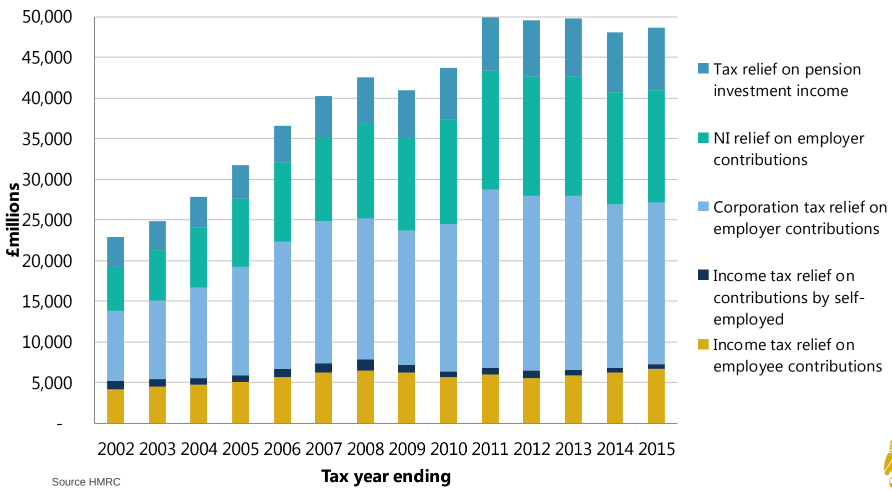
Who gets the relief?



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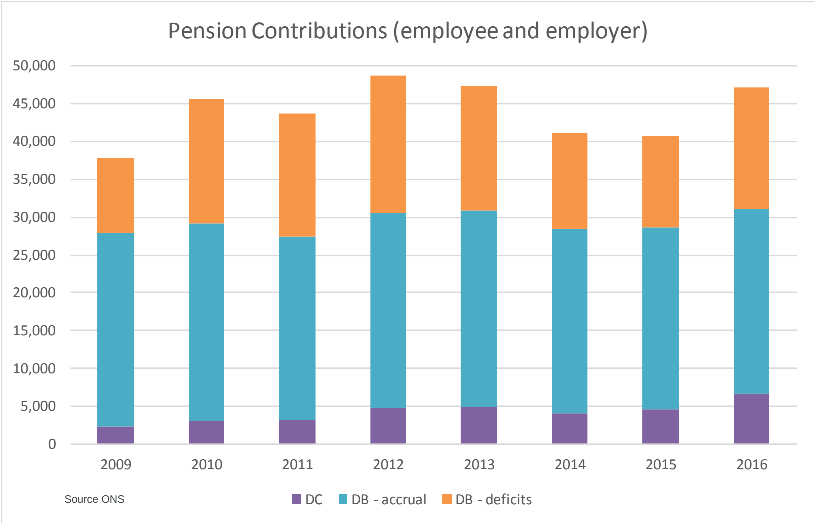

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Current landscape

Our perverse pension rules are driving our best workers out of the labour market

The Telegraph

7 APRIL 2017 • 8:42PM

The Telegraph

Money › Investing › Funds

Six different types of Isa for 2017: which is best for you?

Pensions minister: lifetime allowance is more than enough to retire on

New Model Adviser / 10 Apr, 2017

The £1 million lifetime allowance (LTA) allows people to save four times what they need to reach an average retirement income, according to pensions minister Richard Harrington.

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ISAs as retirement savings

ISA → Help to Buy ISA → Lifetime ISA → Pension ISA?

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Retain current system

Possible amendments?

- Further reductions to Annual Allowance or Lifetime Allowance
- Tax free lump sum
- Address disparity between HMRC value of DC and DB pensions
- National Insurance exemption on employer contributions
- Tax rates on pensions in payment

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Pension ISA

- Long-term saving incentivised with government top-up?
- Unclear if/how TEE fits in with defined benefit schemes
- July 2015 Green Paper and consultation
- Compatible with simplicity and certainty canons?

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Flat rate of tax relief

- Tax relief in region of 20% to 33% (i.e. Government top-up of 25% to 50%)
- Employer DC contribution generates tax charge?
- DB accrual generates tax charge based on Pension Input Amount?
- Breaks link between government relief/top-up and income tax system

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Retirement outcomes from employee contribution

Pre-retirement Post-retirement	Nil Nil	20% Nil	20% 20%	40% 20%	40% 40%	45% 20%	45% 40%	45% 45%
Salary	0%							
Current system	0/25%	25%	6%	42%	17%	55%	27%	20%
LISA	25%							
PISA (no top-up)	0%							
30% flat rate	43%	43%	21%	21%	0%	21%	0%	-5%

- Table shows effective "top-up" relative to taking employment income as cash
- Higher/additional rate payers stepping down to a lower tax band in retirement are current winners

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Retirement outcomes from employer contribution

Pre-retirement Post-retirement	Nil Nil	20% Nil	 20%	40% 20%	 40%	 20%	45% 40%	 45%
Salary	77%	60%		51%		47%		
Current system	100%	100%	85%	85%	70%	85%	70%	66%
LISA	97%	75%		64%		58%		
PISA (no top-up)	77%	60%		51%		47%		
30% flat rate	100%	100%	85%	77%	63%	72%	60%	56%

- Table shows the proportion of employer spend received in retirement
- Pension saving remains tax efficient under flat rate/LISA system even for additional rate taxpayers (marginally)

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Issues of inter-generational equity

The social contract between the generations shows signs of fraying

Millennials are at risk of becoming the first ever generation to record lower lifetime earnings than their predecessors

Lower levels of asset building, and home ownership in particular, generate short-term disappointment and longer-term living standards challenges

Central issues for actuaries

- Trend from large DB to small DC
  - Quantum + risk issues
- Low interest rates / returns relative to history
- Triple lock
- (Lack of) pre-funding for health/social care
  - Pressure on NHS
  - Pressure to relieve retirees of social care costs which are largely means tested

And also

- Access to home ownership
- Student debt – or perception thereof

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Where does tax fit in to the debate?

- Can encourage investment in tangible assets which legitimises claims of retirees on society
- Owner-occupied property CGT exempt + no tax on ‘notional rent
  - Discourages down-sizing + reduces supply?
- DB captures bulk of tax relief?
- Decumulation limits reduce taxpayer risks around subsequent welfare costs
  - 2015 freedoms run counter
- Could targeted investment tax relief help?
  - Currently largely neutral between asset classes
  - But why not incentivise eg infrastructure?
- Buy-to-let taxes increased
- Low returns/low inflation = lower investment tax relief/take

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EET is better in principle if you were starting from scratch?

Technical issues

- EET easier to adjust in payment tax rates to deal with:
  - Experience not in line with expectations
  - Different levels of cost to state (heathcare vs childcare/education)
- It's about reducing risk transfer between generations?

Perception problems

- Discourages down-sizing + reduces supply?
- Should chancellors redefine savings contracts?
- Only if the alternatives are worse?
- Many believe that chancellors cannot be relied upon not to tax TEE savings twice and this is a reason to prefer EET
- However the partial retrospection of pensions tax changes suggests the opposite?
- Do savers trust chancellors not to 'double dip' ISAs?

Does this house believes that a TEE system like the ISA is more likely to engender a long term stable and successful savings culture then an EET system like the current pension model?

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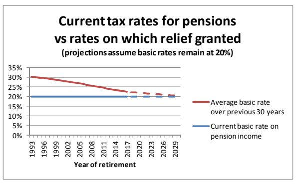
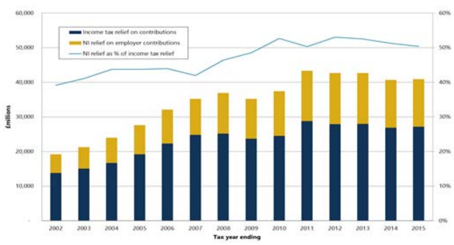
Given where we are, should income taxes on accrued pensions increase?





Source HMRC + WP calculations

Thinking the unthinkable..

- Basic rate generally higher when relief granted to current retired generation
- Before considering material amounts of the relief granted on higher rate tranches to people who will pay basic rate on the pension income
- Without prejudice to the tax-free lump sum – the explicit deal in return for inflexibility
- Applies to all savers inc self-employed and AVCs
- Issue is exacerbated for employer contributions which are NI relieved – 74% of the total in 2014
- If pensions are deferred pay why are they NI exempt?

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Practicalities of change
NI change does not auger well... BUT

Pressure on health/social care extreme will only get worse

- Hard to reconcile this ageing population pressure with favourable tax treatment in the long term
- Young people vote with their feet if not the ballot box – potential serious economic implications if they have to pay?

NI is income tax by another name economically

- But is the emotional link different?
- NI is the means by which income taxes have stayed stable/gone up whilst headline basic rate down....
- People believe NI pays for NHS – opportunity?
- Cutting NI and increasing income taxes could have the same effect
- Alternatives are ‘death taxes’?

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Questions

Comments

- Is change inevitable?
- Is change desirable?
- What is important here?
- What lessons can we learn from the past?
- What are the potential unintended consequences?

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Your turn

What issues are most important for our group to pursue?

[Issue list to be added on the day]

1. aa
2. Bb
3. Cc
4. Dd
5. Ee
6. Ff

You have 3 votes

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Appendix: assumptions for slides 16/17

- No allowance for investment return before retirement
- Contributions are within the Annual Allowance and total benefits are within the Lifetime Allowance
- Flat rate of tax relief
  - employee contributions made by Relief At Source with flat rate relief of 30% i.e. a 43% Government top-up
  - employees subject to higher and additional rate income tax face a tax charge on contributions made by the employer, equal to the difference between the marginal rate of income tax and 30% e.g. a charge of 10% of the employer contribution for a higher rate taxpayer – this charge is assumed to be deducted from the contribution
  - employer contributions are exempt from National Insurance
  - 25% tax-free pension commencement lump sum on payment
- Slide 17 assumes the same employer spend in each wrapper i.e. employees receive a full share of the employer National Insurance saving under the current and flat rate of tax relief system
- Employer National Insurance are due on contributions to Lifetime ISA and Pensions ISA

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