

Society of Pension Professionals: Tax Paper: 'Myth-busting'

There has been a lot in the press recently about reforming pension tax. And there are good reasons for improving the pensions tax regime, both political and technical. However, this is a complex and often misunderstood area and it's important that the key issues are well understood when proposing reform.

As this paper explains, the size of the prize isn't what you think? The majority of pensions tax relief relates to employer contributions to fill deficits in their defined benefit pension schemes, rather than contributions made by the member. Further, tax is paid on pensions in payment, so tax relief is largely tax deferral. More tax revenue now means less later.

Without these key issues being clearly understood, there is a risk that any pensions tax reform ultimately discourages people from saving for retirement and makes a complex tax system even more complex. While at the same time not generating the hoped-for revenue for the Treasury.

1. The scope for savings from pensions tax is limited

The gross cost of pension tax relief quoted by HMRC for 2017/18 was £37.2 billion, but most of this relates to employer contributions to DB schemes, including a significant amount of deficit repair contributions. These deficit contributions relate to pensions for historic service, rather than current contributions for particular individuals, and are paid by employers as required by the DB funding legislation.

The figure for individual member contributions to DB and DC schemes, including contributions to personal pensions and payments by the self-employed, is considerably lower at £6.3 billion.

The amount that could be raised by government through amendments to pensions tax relief should be viewed in this context.

2. Pension contributions are still subject to tax

In reality, most of what is quoted as tax 'relief' is simply tax deferral.

Under the current system, relief is provided on pension contributions at an individual's marginal rate of income tax, but the pension is then taxed as income in retirement.

For most savers, this means the only part of pensions that is truly relief from income tax is the 25% lump sum, although there are also national insurance benefits.

3. The true cost of pensions tax relief is significantly less than quoted

The cost of tax relief on pensions is complex to assess, but in reality the true cost is significantly less than the amounts often quoted.

The net cost of pensions tax relief quoted by HMRC for 2017/18 was £19.0 billion, but this figure is arrived at by simply deducting income tax on pensions currently payable. These pensions relate to an entirely different cohort of individuals, and the tax payable on these pensions bears no relation to the reliefs currently being provided.

The income tax eventually paid by the cohort currently receiving relief is likely to be far greater, due to the higher value of the pensions in payment and the increased number of individuals receiving taxable pension benefits.

Therefore, using the current amount of tax received to net off against total costs is not a like for like comparison and overstates the true cost of tax relief. It also risks undermining long-term retirement saving and successfully

establishing auto-enrolment, as any increase in pension saving will increase the quoted cost without an immediate increase in the tax received on pensions payable.

4. 'Flat rate' relief would be difficult to apply and risk unintended consequences

It is important to recognise that any alternative system that does not provide relief at an individual's marginal rate (e.g. a single 'flat rate' of relief) would not be practical for DB schemes.

For the appropriate rate of relief to be determined, the 'deemed contribution' to the DB scheme would need to be calculated for the benefits earned each year. This is problematic for DB, as the true value can only be known during retirement. This makes it virtually impossible to apply a flat rate of relief to DB schemes in a way that is fair and transparent.

Any system that does not provide relief at an individual's marginal rate would also carry a significant risk of unintended consequences when applied to DB.

For example, it could lead to penal taxation (particularly for those in public sector DB schemes where opting-out with a cash alternative is not possible) where the valuation method places a high value on the DB pension in a particular year.

In essence, this is similar to the problems faced by the NHS Pension Scheme under the Tapered Annual Allowance, except that it would apply to all DB members, regardless of their income.

5. The tax regime for DB and DC cannot be easily separated

In theory, an alternative system could be applied more easily to defined contribution (DC) pensions. For example, tax relief for DB could continue to be given at marginal rate, whereas DC could switch to a flat rate approach.

However, it may not be possible to deliver a split approach that is fair to both DB members and DC members.

Another challenge with this approach is that many people have both DB and DC rights. Any split tax structure would need to take into account the 'other' type of benefit, and there is no easy way of doing this without undermining the tax savings that the government might achieve.

A further important consideration is that some benefit structures do not fit neatly into the category of DB or DC.

6. Pensions tax changes would be detrimental to long-term retirement saving

It is important to continue to support automatic enrolment and avoid any changes that risk undermining or reversing its progress. There also need to be clear incentives if greater levels of savings are to be achieved.

Any change to tax relief which results in reduced take home pay would risk increased 'opt-outs', and the creation of a culture where opting-out is justifiable in the minds of individuals. This issue might especially arise if workers suffer immediate tax consequences on employer pension contributions.

The low savings rate means there is already an issue with employees unable to afford to retire. Any reduction in tax relief is likely to exacerbate this.

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