THE SOCIETY OF PENSION PROFESSIONALS

making pensions work

Pensions tax relief:

separating fact from fiction

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Foreword

Changes to pensions tax relief are frequently debated by policymakers and in the media. The new Government have so far refused to rule out any such changes and therefore speculation has increased in recent weeks ahead of the 30 October 2024 Budget.

The Society of Pension Professionals (SPP) understands the potential rationale for reducing pensions tax relief for higher earners, whilst maintaining or increasing relief for basic rate income taxpayers, potentially resulting in savings in the gross cost against a backdrop of challenging financial circumstances for the economy.

However, on further inspection, such changes are unlikely to lead to the savings that some have suggested and may end up costing more in the long term. Changing pensions tax relief will be incredibly complex, time consuming and costly, leading to substantial disruption for savers, employers, the pensions industry and the UK economy. Changes are also likely to give rise to numerous unintended consequences, not least a reduction in saving for retirement at a time when so many are not saving enough[1].

We have set out below the SPP views on some of the options that might be considered, but if the Government decides to explore any of these changes, these must be properly consulted on and implemented in a realistic timeframe. In recent years there have been several occasions when this has not happened. For example, the Tapered Annual Allowance (TAA) had unintended consequences for the NHS Pension Scheme, damaging trust and confidence in pension saving. More recently, the abolition of the Lifetime Allowance (LTA) was undertaken within wholly unrealistic timescales, despite numerous warnings from the industry, leading to the Government being unable to deliver legislation that works correctly. This resulted in benefit payments to members and beneficiaries being delayed on advice from HMRC. Even now, in October 2024, the outstanding amendments are still to be finalised.

Whatever steps policymakers decide to take, we hope this paper proves informative and makes a valuable contribution to ongoing debates around changes to pensions tax relief and the various alternatives.

Steve Hitchiner,
Chair, SPP Tax Group

1 The IFS Pensions Review, 2024:
https://ifs.org.uk/sites/default/files/2024-09/Adequacy-of-future-retirement-incomes-new-evidence-for-private-sector-employees-IFS-Report-R331.pdf

Pensions Tax Relief

For more than 100 years, since the 1921 Finance Act, those saving in a pension in the UK have been granted tax relief on their pension contributions, effectively acting as tax deferral until an individual withdraws their pension savings when the money is taxed as income.

In 2016, HMRC research found that the majority (57%) of those who saved into a pension and were aware of pension tax relief, consider the relief, *"...to have been an important factor in their decision to invest in a pension."* [2]

The impact of pensions tax relief was even more striking amongst those who were not initially aware of the relief, *"...two-thirds (67%) say that having tax-free pension contributions...would encourage them to start saving, or save more into a pension..."*[3]

However, whilst people might be unaware of the effects of tax relief, this does not mean that they would be accepting of significantly higher tax charges reducing their take-home pay if tax relief is reduced.

The true cost of pensions tax relief

The gross cost of pension tax and NIC relief estimated by HMRC for 2022/23 is £70.6bn[4], but a large proportion of this (£25.9bn, or around 37%) relates to employer contributions to DB occupational schemes, including deficit repair contributions and investment income on pension assets. As such, much of the cost quoted relates to pensions for historic service, rather than current contributions for particular individuals.

The figure for tax relief on individual member contributions to DB and DC schemes, including contributions to personal pensions and payments by the self-employed, was considerably lower at £16.1 billion.

The amount that could be raised by the Government through amendments to pensions tax relief needs to be viewed in this context.

The net cost of pensions tax and NIC relief quoted by HMRC for 2022/23 was £48.7 billion, but this is arrived at by simply deducting income tax on pensions currently payable of £21.1 billion from the total above, along with £0.8 billion relating to Annual Allowance (AA) and Lifetime Allowance (LTA) charges.

These pensions relate to an entirely different cohort of individuals, and the tax payable on these pensions bears little or 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 policy decisions to promote pension saving and successfully establishing auto-enrolment, as any increase in pension saving will increase the quoted cost without any immediate increase in the tax received on pensions payable.

The cost of tax relief on employee pension contributions has risen due to the freeze on personal allowances and higher rate income tax thresholds, bringing more pension savers into the higher rate tax bracket whilst the reduction in employee National Insurance to 8% will reduce the "cost" of pension tax relief, as the rate of tax not paid on employer pension contributions has been reduced.

In the interests of transparency and evidence-based policy making, policymakers should consider acknowledging that most of the amounts quoted as pensions tax relief are simply tax deferral. For most savers, the only part of pension income that is genuinely relief from income tax is the 25% tax-free cash lump sum.

Stability and certainty

Given the government is keen to see workers save more for their future and pension schemes invest more in the UK, reducing tax relief on such activities contradicts these objectives. Likewise, it appears counterproductive to have a clearly stated commitment to boosting economic growth via pensions whilst simultaneously discouraging the largest contributors to pension funds.

Substantial tinkering with different elements of the pensions system since A-Day (6 April 2006) has not, overall, boosted confidence in the system. Pensions need to fit within a constant regime that is protected from changes by successive Governments. A consistent approach and greater stability in the pensions tax system would help to aid understanding of the incentives on offer, underpin the importance of saving for later life and, ultimately, improve confidence in pension saving.

Individuals need to understand what they can pay, and what they will receive. For a system to be sustainable, it also needs to be left alone. Although the introduction of AE has achieved its aim of increasing the take-up of workplace pension saving, changes made over the years to pensions tax have had the opposite effect. Constant change can be detrimental, leading to distrust and disengagement with the pensions system.

2 Pension tax relief: awareness, understanding and saving behaviours, July 2016: https://assets.publishing.service.gov.uk/media/62543e43d3bf7f600d405620/Pension_tax_relief_-_awareness__understanding__saving_behaviours.pdf
3 Ibid
4 Private pension statistics commentary, 31 July 2024: https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary#the-estimated-cost-of-pension-relief

A single rate of tax relief

As noted above, whilst the SPP can understand the potential appeal of a flat rate of relief that targets lower earners whilst achieving fiscal savings for HM Treasury, we believe there are numerous risks and challenges associated with such a change.

Timing

Moving away from relief at an individual's marginal rate to a flat rate of relief would be extremely complex, and it would take the Government and the industry considerable time to overcome the challenges associated with this. Acknowledging the Government's desire to address immediate fiscal challenges, it is worth noting that such a change could not be implemented for some time, and certainly not in time for the 2025/2026 tax year.

Administration and costs

Transitioning to a flat rate system would require an overhaul of administrative systems and payroll. Such a change is administratively complex, costly and will be a considerable resource burden. The costs of this will need to be recovered, in all likelihood, from employees and savers. Similarly, pension schemes might need to again adjust their structures or offerings in response to the new tax relief regime, which could lead to disruptions and increased costs for both providers and scheme members.

Defined Benefit (DB) schemes

To an extent, these administration and cost challenges apply to all pension arrangements, but it is important to recognise that any alternative system that does not provide relief at an individual's marginal rate would be extremely difficult to apply to DB schemes. For the appropriate rate of relief to be determined, the 'deemed contribution' 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 and, as such, it is virtually impossible to apply a flat rate to DB schemes in a way that is fair and transparent. The impact would be particularly onerous for the public sector, where DB provision is still common.

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 for whom opting out with a cash alternative is not an option) 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 TAA, except that it would apply to a wider range of DB members including those on lower incomes.

Defined Contribution (DC) schemes

In theory, an alternative system could be applied to DC pensions. For example, tax relief for DB could continue at marginal rate, whereas DC could switch to a flat rate approach. However, this would mean treating DB (largely in the public sector) and DC (largely in the private sector) workers differently, when we assume the underlying policy objective must be to treat individuals consistently.

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

Tax

If a single rate of pensions tax relief is to be applied, some savers who receive 20% tax relief on their contributions will pay 40% tax on their pension income, creating a substantial disincentive to save for retirement. It has been suggested that the numbers affected would be small, but recent research has indicated over 3 million pensioners could be brought into the higher or additional rate tax band by the 2027/28 tax year[5].

Importantly, to raise extra revenue for the Treasury and cover the cost of any increase in relief for basic rate taxpayers, an additional tax charge would fall on higher rate and additional rate taxpayers. This would inevitably impact pension saving, and it is not just low earners who are under-saving for retirement[6].

5 Quilter press release, "Frozen thresholds will see one in five pensioners dragged into paying higher or additional rate tax by 2028", 22 August 2024: https://media.quilter.com/search/2024/frozen-thresholds-will-see-one-in-five-pensioners-dragged-into-paying-higher-or-additional-rate-tax-by-2028/

6 DWP Analysis of future pension incomes, March 2023: https://www.gov.uk/government/statistics/analysis-of-future-pension-incomes/analysis-of-future-pension-incomes#:~:text=The%20current%20analysis%20shows%20there,a%20certain%20standard%20of%20living.&text=higher%20earners%20are%20more%20likely%20to%20be%20undersaving%20relative%20to%20TRRs%20

Any change to the way that tax relief is given which results in reduced take-home pay will disincentivise pension saving. Thus, the opt-out rate from Automatic Enrolment (AE) will likely increase and the number of people who are not saving enough for their retirement will increase too. The Department for Work & Pensions has already found that 38% of working age people (equivalent to 12.5 million people) are not saving enough for retirement[7].

Any reduction in pension saving is also likely to lead to an increase in future welfare costs. Today 1 in 5 of the UK population is over 65, by 2050 this will be 1 in 4. Inadequate retirement saving is already costing the taxpayer £5bn per annum through Pension Credit being paid to 1.5m pensioners[8]. But there are indirect welfare costs to consider too e.g. the failure to deliver Pension Credit to 40% of eligible pensioners has been estimated to cost the taxpayer £4 billion a year in increased NHS and social care spending[9].

If tax relief is reduced, a small number of higher earners may decide, and be able to afford, to increase their pension contributions to make up for that. This is positive for long-term saving, but in the short term (which the Government has stated it is particularly concerned about) this will divert money that might otherwise have been spent in the economy.

Simplified examples

Consider a headteacher earning £80,000 a year with benefit accrual under the Teachers' Pension Scheme of 1/57th of annual earnings. This means the headteacher will accrue £1,403.51 of pension per annum.

Using HMRC's Annual Allowance factor of 16 to value this pension accrual, and ignoring any inflation adjustments, results in a total deemed contribution of £22,456. Limiting tax relief to a flat rate of 25% (say) would mean that a 15% tax charge would apply. Therefore, the total tax charge for a switch to flat-rate relief at 25% for such a headteacher would be £3,368 (or £280 a month). This charge would apply in addition to any contributions that the headteacher is required to pay towards the cost of their pension.

This simplified example uses the existing HMRC Annual Allowance factor of 16 to value a year's pension accrual. However, this will not be an accurate representation of the true actuarial value of pension accrual, which would depend on a very wide range of factors, and it would be very difficult to design an approach that is seen as fair and reasonable in determining the appropriate tax charge.

In theory, the impact could be mitigated by 'scheme pays' options, where the tax charge is met by a reduction in the value of the pension accrual. However, this would be similarly complex to implement in way that is fair, reasonable, and without risk of unintended consequences. Ultimately, it would also still lead to an individual losing money, simply in another format, at a later date.

There are also many aspects of DB pension accrual that could cause a 'spike' in value, such as a large salary increase, resulting in a significant tax charge. Consider a final salary member with benefit accrual of 1/60th of annual earnings and 20 years' service, who receives a promotion which increases their salary from £60,000 to £70,000. Their pension will have increased by £4,500 and, depending on the valuation method, this could result in a deemed contribution of £72,000 (again using the 16 to 1 factor). Limiting tax relief to a flat rate of 25% (say) would mean a 15% tax charge, and therefore a tax charge of £10,800.

7 Analysis of future pension incomes, 3 March 2023:
https://www.gov.uk/government/statistics/analysis-of-future-pension-incomes/analysis-of-future-pension-incomes#:~:text=In%20the%20'all%20income'%20scenario,the%20period%20just%20before%20retirement.

8 House of Commons library research paper, Pension Credit, 2020:
https://researchbriefings.files.parliament.uk/documents/CBP-8135/CBP-8135.pdf

9 Independent Age, 2020:
https://www.independentage.org/sites/default/files/2020-09/Pension%20Credit%20Independent%20And%20and%20Loughborough%20University%20report_0.pdf

National Insurance Contributions (NICs)

Simply reversing the two NIC reductions that have taken effect this year would generate £10.3bn a year[10], but the Labour Government have made a manifesto commitment not to increase NICs.

The fact that NIC employer contributions to pensions are not subject to employer or employee NICs has gained increasing attention, and HMRC figures suggest that the total cost of this NIC relief was £24.0bn for 2022/23 (although again this will include DB deficit contributions that relate to a legacy cohort of savers). Making these contributions liable to NICs may be easier than a change to tax relief (although still not straightforward). However, again, Labour has made a manifesto commitment not to increase NICs, so any decision to do this will effectively mean breaking a manifesto pledge.

In addition:

> The additional cost to employers (whether immediate or phased, the eventual cost would be 13.8% of all pension contributions) would almost certainly be passed on to employees, in the form of lower pension contributions for DC and benefit redesign or closure for DB.

> As for a flat rate of relief, there would be a need to calculate the 'deemed contribution' for DB benefits, so that the appropriate NIC charge can be determined. This would create the same challenges in ensuring that the valuation method is fair and reasonable, although the risk of unintended consequences is arguably reduced, as the outcome is not being used to determine individual taxation.

> If employers make reductions in contributions, they will understandably pass responsibility to the Government and communicate this to their employees.

> Those paying the minimum AE contributions may not be able to reduce contributions, but they are likely to seek savings elsewhere, for example by reducing pay increases or losing jobs.

> This is likely to have a significant negative impact on the adequacy of pension saving in the short term as employers look to reduce their costs and longer term as employers look to offer the most attractive benefits package. From the employer's perspective, there would be no financial advantage in offering pension benefits instead of additional salary, potentially undermining the support of employers for adequate pension packages. This would be a very significant risk, given the importance of the employer within the UK pensions system.

> Based on HMRC figures, £3.9bn of the total NIC relief relates to 'salary sacrifice' contributions (£1.3bn employee, £2.6 employer)[11]. Targeting these contributions might lessen some of the issues described above, but it is not clear how practical this would be. Importantly the extra tax burden in this case would also be hitting members and their savings very selectively. Many in non-contributory schemes, or those schemes whose employer contribution that starts from a higher base, would be better off and not have to shoulder the extra tax burden, while those who receive a lower employer contribution and seek to remedy that with a salary sacrifice will be worse off. More often than not, those whose employer contributions start at a lower amount will be moderate and low earners.

Amend policy relating to death benefits?

Recent reforms have made pensions more attractive for estate planning. Currently, on death before age 75, a lump sum can be paid to an individual's beneficiaries tax-free, up to £1,073,100. This is anomalous to the payment of a dependant's scheme pension, which is taxed as income (noting that beneficiaries annuities / flexi-access drawdown are tax-free where the member died before age 75), and is therefore a potential area to target, especially given this was not part of the original policy intention for providing pensions tax relief.

Such a change could be considered as part of any wider reforms to the Inheritance Tax regime but equally could be progressed in isolation.

Furthermore, beneficiaries can take an unlimited amount of uncrystallised DC pension tax-free if they take it is as drawdown following death before age 75. This circumvents the Lump Sum and Death Benefit Allowance (LSDBA) and is a consequence of the removal of the LTA.

10 Office of Budget Responsibility, March 2024: https://obr.uk/efo/economic-and-fiscal-outlook-march-2024/#chapter-3
11 HMRC Private Pensions Statistics, Table 6, July 2024: https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics

Restrict the tax-free lump sum?

25% of a pension can be taken tax-free, up to a limit of £268,275 (25% of the £1,073,100 LTA).

This is the only element of a pension that is genuinely tax free. Pension tax relief is, for most savers, simply tax deferral, with the exception being this lump sum payment for those who choose to take it.

According to recent IFS analysis, the availability of the 25% tax-free lump sum costs £5.5bn annually[12]. However, removing it would decrease trust and confidence in pension saving. In addition, transitional arrangements are likely to be required, as they have in the past, which would be complex and would significantly reduce the potential amount that could be raised.

For many savers, the idea of a tax-free lump sum serves as a motivational factor, so its removal is likely to act as a disincentive to save in a pension.

Reintroduce the Lifetime Allowance?

As the SPP has previously made clear[13], there is an economic rationale for both having an LTA and not. However, the LTA being abolished (still not completed) and then reinstated will increase complexity and seriously damage trust and confidence, coming so soon after its removal.

Exemptions

Similarly, any move to reinstate the LTA but to then to exclude certain public sector workers, whether NHS doctors or state school head teachers, will be complex and costly. Taking this approach will also create a two-tier pension system that will further reduce consumer confidence at a time when industry and policymakers should be doing more to encourage saving, not less. Uncertainty about this issue previously affected savers' engagement with pensions and any additional uncertainty is likely to do the same.

Costs

The cost of abolishing the LTA for pension schemes was significant - system changes, process changes, updates to member communications, updates to scheme rules and more, which must be passed on to savers. Similarly, the costs of re-instating the LTA should not be underestimated, nor should the inevitable complexity of these changes for both schemes and, importantly, their members who are ultimately likely to directly or indirectly pay for these changes.

Other factors

In addition to the issues of complexity, cost and uncertainty, the LTA penalised strong investment growth and had other well publicised effects on both public and private sector workers e.g. doctors working less hours, headteachers retiring early, which negatively impacted the UK economy.

Reduce the Annual Allowance?

The Annual Allowance (AA) is the most that an individual can save into their pension pots in a single tax year (6 April to 5 April) before having to pay tax.

The AA is currently £60,000 or up to 100 per cent of an individual's annual earnings if they are lower than this. In limited circumstances it may be lower still i.e. if an individual has flexibly accessed their pension pot or earns in excess of 'threshold income' of £200,000 or an 'adjusted income' of over £260,000.

The AA has changed several times in recent years. From 2011-12 until 2013-14 it was £50,000. It was £40,000 from 2014-15 until 2022-23 and has been £60,000 since 2023-24.

In 2021-22, when the allowance was £40,000 per annum, £600m was raised in AA charges[14]. This figure is likely to be reduced by the higher allowance now in effect and so returning to £40,000 or possibly reducing it to an even lower figure, perhaps as low as £30,000, would inevitably raise additional funds for the Exchequer and would do so quicker than many of the alternatives.

Given the AA primarily impacts higher earners, this may be a more attractive option for policymakers. That said, it is worth cautioning that reductions here are likely to significantly impact senior professionals in the public sector such as headteachers, deputy headteachers, senior doctors and nurses. Although the LTA was frequently highlighted as being the cause of early retirements and reduced hours in the public sector, the AA may well have been a bigger factor in those decisions, as highlighted by NHS England last year[15]. As stated above in relation to the LTA, creating exemptions for public sector workers here would be complex, costly and create a two-tier pension system that will further reduce consumer confidence at a time when industry and policymakers should be doing more to encourage saving, not less.

12 IFS Pensions Review, Raising revenue from reforms to pensions taxation, September 2024: https://ifs.org.uk/articles/raising-revenue-reforms-pensions-taxation

13 SPP Paper, "The Lifetime Allowance: a review of options", September 2023: https://the-spp.co.uk/wp-content/uploads/SPP-Paper-The-Life-Time-Allowance-A-review-of-options.fv_.pdf?v=1247

14 HM Revenue & Customs, Private pension statistics, 27 September 2023, Table 6: https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics

15 NHS England submission to the Review Body on Doctors' and Dentists' Remuneration 2023-2024, January 2023: https://www.england.nhs.uk/wp-content/uploads/2023/02/B2025-nhs-england-submission-to-the-review-body-on-doctors-and-dentists-2023-24.pdf

Conclusion

There are no easy solutions to the challenge of improving pensions tax relief arrangements. It is also clear that simplistic calculations relating to the billions of pounds potentially saved by introducing a new pensions tax relief arrangement are far from reliable and instead bring with them substantial costs, complexity and disruption.

That said, there are alternative ways of generating savings for HM Treasury, and SPP hopes our analysis of the opportunities and challenges some of these may bring helps to inform policymakers and wider debates around these issues.

Again, as the SPP set out at the beginning of this document, should policymakers decide to make any changes in this area, it is essential that they are properly consulted on and implemented in a realistic timeframe.

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About The Society of Pension Professionals

Founded in 1958 as the Society of Pension Consultants, today SPP is the representative body for a wide range of providers of pensions advice and services to schemes, trustees and employers. These include actuaries, accountants, lawyers, investment managers, administrators, professional trustees, covenant assessors, consultants and pension specialists.

Thousands of individuals and pension funds use the services of one or more of the SPP's members, including the overwhelming majority of the 500 largest UK pension funds.

The SPP seeks to harness the expertise of its 85 corporate members - who collectively employ over 15,000 pension professionals - to deliver a positive impact for savers, the pensions industry and its stakeholders including policymakers and regulators.

Further information

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