PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

TREASURY SELECT COMMITTEE: TAX AFTER CORONAVIRUS

8 SEPTEMBER 2020

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ABOUT THE PLSA

Our mission is to help everyone achieve a better income in retirement. We work to get more people and money into retirement savings, to get more value out of those savings and to build the confidence and understanding of savers.

We represent the defined benefit, defined contribution, master trust and local authority pension schemes that together provide a retirement income to 20 million savers in the UK and invest £1 trillion in the UK and abroad. Our members also include asset managers, consultants, law firms, fintechs and others who play an influential role in the governance, investment, administration and management of people's financial futures.

EXECUTIVE SUMMARY

- Pensions tax relief is integral to supporting adequate incomes in retirement and we believe that it is essential that government continues to provide support and incentives to help people save enough for retirement.
- The headline figures about the money spent on tax relief are misleading as much of the £35.4bn quoted is simply tax deferred. For most savers, the only part of pensions that is truly tax relief is the 25 per cent of the income that is exempt from taxation once you are able to start accessing it from age 55.[1]
- People are not saving enough for retirement when measured against the targets set by the independent 2006 Pensions Commission and as demonstrated by our Retirement Income Adequacy Report[2] so this is not the time to remove fiscal support.
- However, at this time when government is looking for ways to rebalance the books and amid speculation of changes to pensions tax relief, we believe that any changes must be clearly thought through and it is essential that the impacts are assessed across a range of actors in the system including savers, schemes and employers and Government.
- Due to current talk of Government reform of pension tax relief, PLSA is currently considering on what principles a reform could be based.
- Nevertheless, there are areas where urgent reform is necessary; the net pay / Relief at Source anomaly which means that some low earners do not receive tax relief on their pension contributions. We believe this should be done through changes to HMRC's P800 process.

[1] There are some exceptions to this rule, for example, savers who receive higher rate relief while working and then pay basic rate income tax in retirement.

[2] PLSA, Retirement Income Adequacy: Generation By Generation (2016)

INTRODUCTION

1. The Pensions and Lifetime Savings Association (PLSA) welcomes the opportunity to respond to the Treasury Select Committee's Call for Evidence looking at tax after coronavirus. This submission sets out why pensions tax relief is needed to support saving for retirement and how one area of immediate reform is needed to help those on low incomes. Some background information on the operation of pensions tax relief in the UK is provided in the annex.

PENSIONS TAX RELIEF – A NECESSARY SUPPORT FOR SAVERS

2. Unprecedented policies in the last few months aimed at combating the negative effects of the Coronavirus pandemic on the economy, has led to a substantial increase in government spending and debt. One of the ways that government can help to rebalance the books is through reform to the tax system. There has been speculation in the media that the government is likely to make cuts to pensions tax relief, however, we believe that pensions tax relief plays an important role in encouraging and supporting saving for retirement and therefore any changes or cuts should be fully considered before being implemented.

3. We believe it is essential that government continues to provide support and incentives to help people save enough for retirement. The PLSA is clear that the core objective of tax support for pension saving is that everyone should have an adequate income in retirement. However, due to current talk of Government reform of pension tax relief, we are currently considering on what principles a reform could be based.

4. The main form of tax support to pensions is the deferral of tax until the time of consumption. For most people, the only part of pensions that is truly tax relief is the 25 per cent of the income that is exempt from taxation once you are able to start accessing it from age 55. Other tax support arises due to discrepancies in the rate at which tax is relieved when contributing into a pension and the tax paid on income when receiving it.[3] Another area that is wholly tax exempt is employer exemption from NI contributions, which is an important incentivising element to encourage employers to stay engaged in the pensions system.

5. In 2017/18 HMRC estimated the cost of tax relief as £35.4 billion[4] but, in reality, the picture is more complicated. For example, the figure quoted is only a snapshot of the difference between tax foregone on current savings now and tax raised on pension income (that has

[3] For example, someone may be a higher rate tax payer when contributing into their pension, and therefore receiving higher rate tax relief, but in retirement will be a basic rate tax payer.
[4] For year 2017/18: https://www.gov.uk/government/statistics/registered-pension-schemes-cost-of-tax-relief

been earned at some point in the past). The real figure of the cost of pensions tax relief is hard to calculate but, as noted above, is mainly due to 25 per cent of the pot being tax free.

6. Almost three-quarters (72%) of tax relief is attributable to Defined Benefit schemes, with 19% for deficit reduction contributions (£6.7bn), 41% going to public sector DB future accrual (£14.5bn) and 12% to private sector DB future accrual (£4.2bn).[5] As deficit reduction contributions are not assigned to individuals it would be difficult to calculate a different rate of relief. Therefore, the actual amount of money that could be saved by the Government from amending pensions tax relief is likely to be much lower than estimated.

7. The current tax treatment for pensions is EET (exempt on contributions, exempt on investment returns and taxed when taken as income in retirement). This is by far the best method of treating pensions. As supported by the fact that half of OECD countries use the EET system for pensions[6] and their recommendation that countries currently operating under EET should maintain the deferred taxation structure.[7] Having an EET system makes pension contributions more attractive than other savings vehicles and provides a tax advantage to the saver as they benefit through growth of untaxed contributions and investment growth.

8. The PLSA believe that moving to a TEE system would have a detrimental effect for schemes, sponsors, savers and the Exchequer for a number of reasons as stated in our response[8] to the 2015 consultation on Strengthening the Incentive to Save. Key among them is that although in the short term it will increase tax revenues for Government, in the long term it is likely to reduce future revenue for Governments due to the loss of tax receipts on investment growth. The UK's population is ageing, with a gradually higher proportion of older people, as the years pass. A switch to TEE would reduce the availability of tax revenue in the future just when it will be most needed. By keeping pensions taxation as EET, it also avoids double taxation of the money people are saving and using for retirement. Therefore, any potential changes to tax relief should not involve a move to a TEE system.

9. The majority of employees (77%) are enrolled into a workplace pension,[9] which equates to around 21.3 million people, many of them through Automatic Enrolment (AE) – and a key part of the case for staying opted in is that people will receive a contribution from the employer and support, in the form of pensions tax relief, from the Government. Opt out rates are low and have remained relatively consistent at 9 per cent for the financial year

[5] Calculations based on PLSA estimates.
[6] OECD, The tax treatment of retirement savings in private pensions plans (December 2018)
[7] OECD, OECD Pensions Outlook 2018 (2018)
[8] NAPF, Strengthening the incentive to save: A response by the National Association of Pensions Funds (2015)
[9] ONS, Employee workplace pensions in the UK: 2019 provisional and 2018 final results (March 2020)

2018/19[10]. Many other adults (e.g. the 5 million self-employed[11]) who are not under AE, do not get a pension contribution from an employer so the only support for them comes from the government in the form of pensions tax relief.[12]

10. One of the primary purposes of pensions is to ensure people have an adequate income in retirement. In 2016, the PLSA undertook a major research project that examined the likelihood that current workers would have a pension equivalent to the Pensions Commission's target replacement rate (TRR).[13] The findings showed that, of the 25.5 million people presently in employment, just over 50%, or 13.6 million people, are at high risk of failing to meet their TRR.[14]

11. The report also had a strong generational finding, i.e. while just under half (45%) of working baby boomers (55 – 64) and 51% of Generation X (35-54) are likely to achieve their TRR, the outlook is worse for Millennials (22-34). Our report concluded that AE contributions need to rise to at least 12% if younger generations are to benefit from retirement pensions closer to the Pension Commission's standards. In a later 2018 report, we proposed that this increase in automatic contributions could be phased in gradually, in the latter part of the 2020s so to be fully in place by 2030.[15]

12. One way to improve retirement income adequacy is through the tax relief that people receive on their pension contributions. This particularly helps to improve outcomes for AE as savers are being automatically enrolled and staying in the system through semi-compliant inertia. Tax relief boosts their saving capability over the long term with 4% paid by the savers, 3% paid by the employer and 1% paid by the government for basic tax payers. Having tax relief at the start and with each contribution is also likely to result in larger pot sizes over time. Therefore, now is not the time to remove fiscal support for pension saving.

13. Setting aside the issue of whether a major reform of pension tax relief is desirable, the PLSA would like to raise the important issue of the Net Pay/Relief at Source (RAS) anomaly that occurs in pensions tax relief that needs urgent consideration.

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[10] DWP, Automatic Enrolment evaluation report 2019 (February 2020)

[11] Fourth quarter (Oct to Dec 2019). ONS, Coronavirus and self-employment in the UK (April 2020)

[12] Money Advice Service, Pensions for the self-employed, https://www.moneyadviceservice.org.uk/en/articles/pensions-for-the-self-employed

[13] The TRR for someone with pre-retirement gross earnings of less than £9,500 is 80%, between £9,500 to £17,499 is 70%, between £17,500 to £24,999 is 67%, between £35,000 to £39,999 is 60% and is 50% for those earning £40,000 or more.

[14] PLSA, Retirement Income Adequacy: Generation By Generation (2016)

[15] PLSA, Hitting the Target: A vision of retirement income adequacy: Final recommendations (July 2018)

ONE AREA IN NEED OF IMMEDIATE REFORM – NET PAY / RAS

14. Employers can choose a number of ways to apply tax relief to members' pension contributions: Net Pay arrangements; RAS arrangements; and Salary Sacrifice arrangements. Trust-based[16] pension schemes tend to operate Net Pay arrangements, whilst contract-based providers ordinarily use RAS arrangements.[17] The vast majority of master trusts operate Net Pay arrangements, though a small number are RAS-based, and some offer both arrangements.

15. The operation of the Net Pay/RAS regimes has created some anomalous results, namely:

    a. Savers earning below the minimum tax threshold (i.e. the personal income tax allowance) who contribute to a net pay scheme do not receive tax relief on their pension contributions. An equivalent worker in a scheme operating RAS arrangement receives tax relief at the rate of 20 per cent. At present, a worker in a Net Pay scheme who is affected by the anomaly has no means of reclaiming the foregone tax relief.

    b. Savers who contribute to a RAS scheme and pay income tax at rates higher than 20 per cent do not automatically receive the full amount of tax relief they are entitled to given their tax bracket. They only receive tax relief equivalent to 20 per cent of their savings. The additional relief they are due must be claimed separately; if they do not claim it, they will not receive it. An equivalent worker whose employer operates a Net Pay scheme receives the right amount of relief automatically.

16. Employers are unable to choose both Net Pay and RAS in the same pension scheme and are forced either to make a choice between the two – potentially creating winners and losers amongst their employees – or divide employees between two different schemes (i.e. a Net Pay scheme and a RAS scheme), which is not feasible for most if setting up a new scheme.

17. Net Pay schemes have the benefit that employers and/or schemes do not have to claim back the money from HMRC (which can take time for schemes to receive). Higher earners also do not need to fill out a self-assessment forms in order to claim back tax relief at their higher rate.

[16] A trust-based scheme is run through an appointed board of trusts who have a fiduciary duty to act in members' best interests. Contract-based schemes are run on a contract between members and the pension provider.
[17] A small number of schemes and providers utilise salary sacrifice arrangements for the purpose of administering pensions tax relief.

18. HMRC estimates that 1.5 million people are affected by the Net Pay anomaly.[18]

19. This includes many savers in AE schemes and workers in occupational schemes that predate AE. These people could miss out on tax relief equivalent to a maximum of £64 each in 2019/2020.[19] In total, savers will forego up to £78 million in tax relief for the 2019/2020 tax year.[20] If and when the Lower Earnings Limit is removed, these savers could be missing out on as much as £125 per annum in tax relief.[21]

20. The PLSA believe that the best solution to overcome this anomaly and ensure that savers are getting the tax relief they are entitled to is through changes to HMRC's P800 process.

21. Throughout the tax year, HMRC automatically collects data on earnings from employers via Real Time Information (RTI), data on pension contributions made from Net Pay schemes via the same RTI return, data on pension contributions made from RAS schemes via the monthly and end of year RAS returns from pension providers, and data on interest and dividends from banks, building societies and large savings platforms.

22. After the end of the tax year, HMRC has a complete picture of what tax bracket people fall into, what pension contributions they have paid and what pensions tax relief they have received. All that is required to solve the Net Pay/RAS issue is to integrate HMRC's systems to enable them to carry out an end of year 'sweep up' that could give tax relief to non-taxpayers who missed out in Net Pay schemes and higher rate taxpayers who missed out under RAS schemes.

23. Research by the Low Incomes Tax Reform Group (LITRG) has shown that HMRC's existing end of year P800 process is very close to being able to do this. P800 is the process that HMRC currently uses to check that those who do not complete annual tax returns are in fact paying the right amount of tax. It calculates over or underpayments at year end and collects/refunds these via adjustments to a worker's tax code – unless the worker specifically requests immediate cash settlement.

24. Various operational issues would need to be resolved prior to the introduction of the P800 solution, including:

[18] HM Treasury, Pensions tax relief administration: Call for evidence, July 2020

[19] LITRG, Net Pay Arrangements for Lower Paid Workers – A Proposed Solution (April, 2019).

[20] A. Boulding, Net Pay/Relief at Source – A Technical Note (February, 2019).

[21] This figure is based this on the tax free allowance being £12,500 (in 2019-20), the saver earning £12,500, and making contributions at 5% of salary.

i. A small legislative change is required to operationalise the P800 solution for pensions. Whilst those in RAS schemes can claim the money they are missing out on, the law does not allow those in Net Pay schemes to claim the foregone tax relief. A small change in the next Finance Act is required to enable this.

ii. Clarity is required on the means by which savers would receive the foregone pensions tax relief. The PLSA's current understanding is that it would be refunded through pay packets on an annual basis and not directly into the saver's pension scheme. This could affect a saver's eligibility for Universal Credit payments.

iii. HMRC would need to invest in building the capacity to deliver this solution centrally. We do not yet have an estimate of the scale of investment that would be required.

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ANNEX

BACKGROUND ON THE OPERATION OF PENSIONS TAX RELIEF IN THE UK

1. The pensions landscape is complex. One of the main areas of complication is around the allowances which place limits on the amount of tax relief an individual can receive. These are the Annual Allowance (AA), Lifetime Allowance (LTA) and the Money Purchase Annual Allowance (MPAA).

Annual Allowance

2. The Annual Allowance (AA) provides a limit on how much tax relief an individual can receive in a given year, based on their pension pot growth (e.g. through contributions or entitlement changes). If the limit is breached, they will have to pay a free-standing income charge (an Annual Allowance Charge) at their highest rate of income tax. This is either paid by the individual or through the scheme. However, unused AA can be carried forward for up to three years.

3. The Annual Allowance is calculated differently for Defined Benefit (DB) and Defined Contribution (DC) schemes[22] which throws up different issues for different schemes. For DB, the AA is calculated based on the growth in the pensions entitlement, whereas, for DC it is the amount saved into a fund in a given year. The AA is particularly complicated for DB schemes as it is easy for members to breach the threshold if receiving a wage increase that affects previous years benefit accrual. This is particularly true for members of traditional final salary schemes such as are used often in the public sector.

4. Both the AA and LTA have been reduced radically since they were introduced in 2006 and the number of people they impact has therefore increased. In 2010-11 when the AA was set at £255,000, only 140 people were affected, however, in 2014-15 when the AA was reduced to £40,000, 7,280 were affected.[23] The main purpose of these reductions has been to reduce the amount of fiscal support available to pension saving.

5. In 2017-18, 26,550 people were affected by the AA. This increase in the number affected is likely due to the AA taper, which applies to high earners such as senior clinicians, and is another source of complication for savers and schemes.

[22] A defined benefit scheme provides a set benefit/income for life each year after a person retires. A defined contribution scheme is based on how much has been contributed into a pension pot and any investment growth over time.

[23] https://www.gov.uk/government/statistics/personal-pensions-pensions-annual-allowance-statistics

6. The taper was introduced in 2016-17 and reduces the AA on a sliding scale to a minimum of £10,000 a year once a threshold of £150,000 is exceeded, depending on the individual's level of income and pension saving.[24] It is important to note that everyone, including those on high earnings affected here, are subject to the Lifetime Allowance, so applying the taper means it penalises those who wish to do a lot of saving in a short period, compared to people who do the same amount of saving but at a lower rate over a longer period.

7. However, following public concern regarding the impact of the taper on the availability of senior and experienced NHS staff, in March 2020 Budget the government increased the threshold to £240,000. By increasing the taper in this way, the number of people affected will be significantly reduced.

Lifetime Allowance

8. The Lifetime Allowance (LTA) provides a limit on how much tax relief an individual can receive over their lifetime. Unlike the AA, investment growth, as well as the value of contributions, is considered when calculating whether a person has reached the LTA for DC pensions. However, the value of DB pensions is calculated by multiplying the expected pension by 20. If the limit is breached, then a charge is paid by the scheme and the individual will receive a smaller payment

9. Whereas the AA can cause more issues for people saving in DB pensions, the LTA can be harder to calculate for people in DC pensions as it is hard to predict how the value of pensions will grow with the performance of investments. Growth is impossible to predict and therefore savers may unintentionally breach the LTA.

Money Purchase Annual Allowance

10. The MPAA restricts the amount of tax relief you can receive on pension contributions once you start taking money from a DC pension to prevent people from 'recycling' their pension. Once the MPAA is triggered, from then on tax relief is only given on contributions up to £4,000 per annum. HMRC does not collect data on the number of people affected by the MPAA which makes it hard to evaluate its impact and to see if it is targeting the right people.

11. At its current level of £4,000 per annum the PLSA feels that it has unintended consequences of capturing people who are in their 50s, who may have been out of work though redundancy, who go back into the workforce and are wanting to rebuild their pension pot rather than people who are purposefully 'recycling' their pension (which is the policy's intention).

[24] This also includes rental income, savings and investment income (sources that are not pensionable in themselves).

12. The Coronavirus pandemic is likely to accelerate the trend of people working for longer into retirement and entering flexible retirement.[25] It is therefore crucial to create an environment where people can continue to be rewarded for contributing to the workforce and paying into their pension as well.

[25] The employment rate of people aged 65 and over increased from 4.6% in Q1 2001 to 11.8% in Q1 2020. (ONS, Labour market statistics time series)

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