THE MEMBER BACKING
PENSIONS AND LIFETIME SAVINGS ASSOCIATION

FIVE PRINCIPLES FOR PENSION TAXATION

DISCUSSION PAPER

FEBRUARY 2021

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.

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EXECUTIVE SUMMARY

- There has been a raft of speculation over the last year that Government plans to reduce the level of financial support for pension saving. In response, the PLSA has sought to identify the principles against which any reform should be assessed and has considered whether the range of reforms most frequently discussed satisfy them.
- The current tax treatment for pensions in the UK is described as EET: exempt on contributions, exempt on investment returns and taxed when taken in retirement – apart from 25% which is tax free. Restrictions are placed on the amount of pensions tax relief an individual can receive, in particular through the Annual Allowance and the Lifetime Allowance.
- In 2017/18, HMRC estimated the gross cost of fiscal support for pensions as £53.7bn but, in reality, the picture is more complicated. Once income from taxation of pensions in payment and non-application of National Insurance on Employer Contributions is accounted for, the net annual cost is estimated as being £18.9bn. The total government public sector spending in 2017/18 was £852bn.[1] So the net annual cost of pensions tax relief accounts for 2% of total public sector spending. Since Covid 19, the percentage is likely to be even lower. This money contributes to the "social good" of pension saving and helps people live when they can no longer work. It also helps to reduce the number of pensioners who must rely on welfare payments from the tax payer.

[1] Based on 2018/19 prices. https://www.instituteforgovernment.org.uk/publication/whitehall-monitor-2020/finances

- The PLSA supports maintaining the core elements of the current approach to pension tax relief, in particular the EET system, and the level of fiscal support given to pension saving. However, we recognise that the UK is facing a very severe economic and fiscal environment. If the Government chooses to undertake a reform of pensions tax relief, we propose that it should be based on the five principles set out below:

Principles for Pension Taxation

- ***Promotes adequacy***: provides financial support and incentivises saving for retirement.
- ***Encourages the right behaviours***: helps savers make the right decisions about retirement saving.
- ***Fair***: helps everyone – the employed, the self-employed, and non-workers - save for retirement.
- ***Simple to adopt and administer***: avoids unreasonable transition and on-going costs for employers and schemes.
- ***Enduring & sustainable***: designed to avoid repeated change and so builds confidence in long-term saving.

- There are many ways in which the fiscal support for pension saving could be altered or reformed. However, in this report, we have picked out four that have been frequently discussed by Government, the pension sector, consumer groups, and the media over the last five years. We have compared these against the principles for reform. These reform options are TEE, single rate at 20%, and single rate at 25 or 30%, and a reduction in the Annual Allowance and Lifetime Allowance.
- Our assessment suggests that neither the current system, nor any of the four options for reform widely discussed, meet all of our five Principles for Pension Taxation. However, the current system satisfies more of the principles than any other option. The lowest scoring option is TEE; it meets only one of the five principles for reform and fails four of them. The other options only satisfy one or two of the principles, although some do also achieve some neutral scores.

- The outcome of our assessment is set out in the table below:

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Current System	✓	✓	-	✓	-
Single rate at 25 or 30%	✓	✓	-	×	-
Reduction in AA and LTA	×	×	-	✓	✓
Single Rate at 20%	×	×	-	×	✓
TEE	×	×	-	×	×

- Rather than embarking on a major reform of pensions tax relief, we think there is more value in addressing some of the more specific and technical shortcomings of the current system. For example, the inequalities created for low income savers due to the differences in tax administration systems used by different pension schemes - the net pay / RAS issue.

INTRODUCTION

People are currently not saving enough to have an adequate income in retirement. In 2016, the PLSA undertook a major research project that examined the likelihood that workers would have a pension equivalent to the Pensions Commission's target replacement rate (TRR).[2] The findings showed that, of the 25.5 million people then in employment, just over 50%, or 13.6 million people, were at high risk of failing to meet their TRR. Additionally, where people only have a defined contribution pension, 97% were likely to fall short of the savings targets.[3] Recent analysis of the ONS Wealth and Assets Survey by the Resolution Foundation found that across the bottom half of the income distribution, 42% of employees reported having no pension wealth.[4]

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 automatic enrolment; as savers are being automatically enrolled and staying in the system through inertia. Tax relief boosts their saving capability over the long term with 5% paid by the saver and 3% paid by the employer (part of each contribution includes tax relief). Having tax relief at the start and with each contribution is likely to result in larger pot sizes over time.

Pensions tax relief provides crucial support for savers in a number of ways. It means that they don't pay income tax on contributions to a pension, instead paying it when they access their savings in later life. In addition, one quarter of their savings (up to set limits) will be income tax-free in retirement. There can be an additional tax benefit for those people that pay a lower tax rate in retirement than they do when working.

Over the last year, there has been regular speculation that the Government plans to reduce the level of fiscal support for pension saving. The PLSA has sought to identify the principles on which any reform should take place and consider whether the range of reforms most frequently discussed satisfy them.

This report starts by providing some background information on the nature and scale of fiscal support for pension saving. It then sets out the PLSA's principles for reform, and an assessment of four often discussed reforms, before drawing conclusions on how the Government should approach this issue.

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[2] 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 (2005 figures).

[3] PLSA, Retirement Income Adequacy: Generation By Generation (2016) https://www.plsa.co.uk/portals/0/Documents/0605-Retirement-income-adequacy-Generation-by-Generation.pdf

[4] Resolution Foundation (2021), Building a Living Pension, https://www.resolutionfoundation.org/publications/building-a-living-pension/

BACKGROUND

WHAT IS PENSIONS TAX RELIEF?

Pensions tax relief is made up of two main components: income tax relief on employer and employee contributions and relief on investment income of pensions funds. For most people, the main benefit of pension tax relief is gained at retirement through the 25% tax free lump sum. Pensions also receive fiscal support through the exemption of National Insurance on employer contributions (pension NICs relief).

The current tax treatment for pensions in the UK is described as EET: exempt on contributions, exempt on investment returns and taxed when taken in retirement. Therefore, it is more accurate to describe pensions income tax relief as tax deferred rather than relief – *as tax is paid* on 75% of the pension fund when it is withdrawn after age 55.

Restrictions are placed on the amount of pensions tax relief an individual can receive, through the Annual Allowances and the Lifetime Allowance. The standard Annual Allowance (AA) provides a limit on how much tax relief an individual can receive in a given year (e.g. through DC contributions or DB entitlement changes). The Annual allowance is currently set at £40,000. However, for those with a threshold income in excess of £200,000, the AA is reduced gradually to £4,000 (called the AA taper).

The Money Purchase Annual Allowance (MPAA) restricts the amount of tax relief an individual can receive on pension contributions once they start taking money from a DC pension. This is to prevent people from 'recycling' their pension. Once the MPAA is triggered, tax relief is only given on contributions up to £4,000 per annum.

The Lifetime Allowance (LTA) provides for any contributions made above the limit (once benefits have been crystallised) to be taxed. The LTA is currently set at £1,073,100.

Employers can choose a number of ways to apply tax relief to members' pension contributions: Net Pay arrangements and Relief at Source (RAS) arrangements. Trust-based[5] pension schemes tend to operate net pay arrangements, while contract-based providers ordinarily use RAS arrangements. Each arrangement has its pros and cons and neither works well for all schemes or all savers.

[5] A trust-based scheme is run through an appointed board of trustees 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.

Two current issues with pensions tax relief

Net pay / relief at source (RAS) Anomaly

The operation of net pay and RAS regimes has created some anomalies, mainly, a saver earning below the minimum tax threshold (i.e. the personal income tax allowance) who contributes to a scheme operating a RAS arrangement receives a tax rebate of 20% on their own contributions, however an equivalent worker in a net pay scheme does not receive a tax rebate on their own pension contributions. Similarly, higher rate taxpayers in RAS schemes only receive tax relief equivalent to 20%, if they do not claim the higher rate back from HMRC. 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. Urgent consideration and action of this issue is needed to resolve the net pay / RAS anomaly.

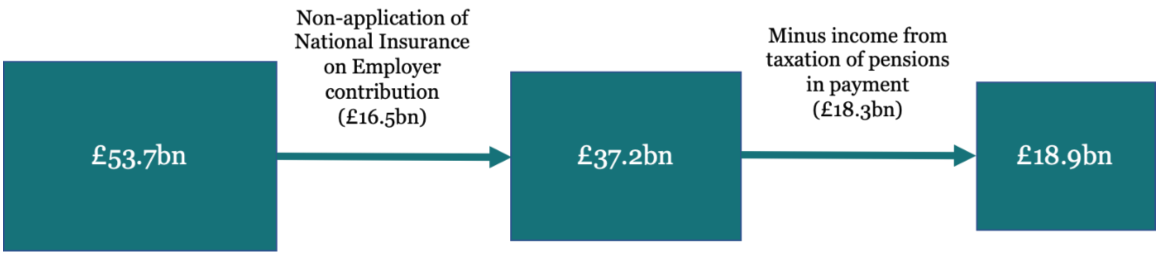
Money Purchase Annual Allowance (MPAA)

At its current level of £4,000 per annum the PLSA feels that the MPAA has unintended consequences of limiting contributions from people who are in their 50s. For example, those people who may have been out of work though redundancy and found it necessary to dip into their pensions, who then 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). 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. The government should review the MPAA to ensure it is working as appropriately and is affecting the right people.

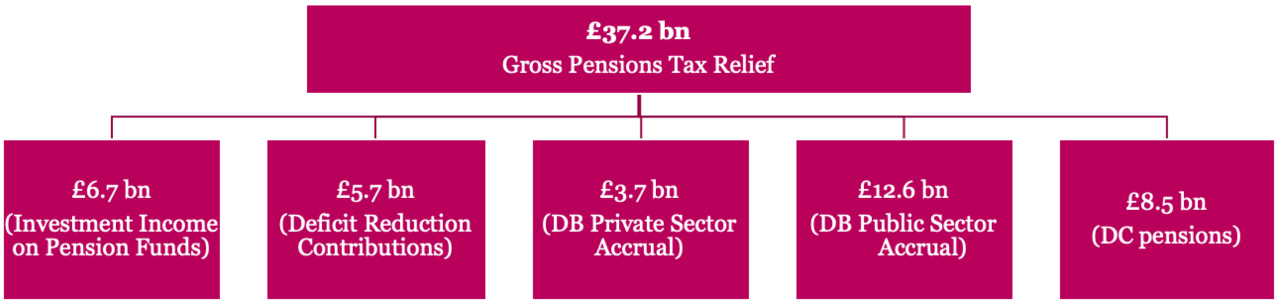
HOW MUCH IS SPENT ON PENSIONS TAX RELIEF?

In 2017/18 HMRC estimated the gross cost of fiscal support for pensions as £53.7bn but, in reality, the picture is more complicated.

Once income from taxation of pensions in payment and non-application of National Insurance on Employer Contributions is accounted for, the net annual cost is estimated as being £18.9bn. The total government public sector spending in 2017/18 was £852bn.[6] So the net annual cost of pensions tax relief accounts for 2% of total public sector spending. Since Covid 19, the percentage is likely to be even lower. This money contributes to the "social good" of pension saving and helps people live when they can no longer work. It also helps reduce the number of pensioners who must rely on welfare payments from the tax payer.



The £37.2bn figure can be further broken down into different areas.[7]



Savings that can be made through reforms to pensions tax relief are likely to be far lower than widely quoted in the media. Removing tax relief from the investment income on pension funds would negatively impact investment growth. Collecting tax from members related to Deficit Reduction Contributions (DRCs) would be complex and controversial.

[6] Based on 2018/19 prices. https://www.instituteforgovernment.org.uk/publication/whitehall-monitor-2020/finances
[7] Based on PLSA estimates.

DRCs cannot easily be attributed to individuals within the scheme and, even if they could, many would not be active members and would include pensioner members.

If we set aside altering the exemption from taxation of investment income and DRCs as undesirable or impractical, it leaves £24.8bn of potential revenue for the Exchequer. However, this would only be achieved if both DB and DC pensions lost all income tax relief. Taxing active members of DB pension schemes, most of whom work in the public sector, including senior NHS and social care workers, would also be complex and controversial. If DB schemes were to be left untouched by reform, it would reduce the potential tax relief saving to £8.5bn. Only a small part of this would be recovered by moving to a single rate of tax relief for DC.

Introducing major change to the system of fiscal support for pensions risks undermining hard-won confidence in pensions. This, in turn, could undermine the gains made in recent years, particularly through the advent of automatic enrolment and systemic improvements in governance and value for money. Therefore, any potential reforms should be fully thought-through and assessed, taking account of both the obvious direct effects and the scope for behavioural change.

FIVE PRINCIPLES FOR PENSION TAXATION

The PLSA supports maintaining the main elements of the current approach to pension tax relief, in particular the EET system, and the level of fiscal support given to pension saving. However, due to Covid-19 we recognise that the UK is facing a very severe economic and fiscal environment. If the Government chooses to undertake a reform of pension tax relief, we believe that it should be based on the five principles set out below.

These principles have been developed through careful discussion with the PLSA Policy Board and with a senior-level Steering Group[8] looking at the issue of pension tax relief. Our principles for pension taxation are:

Principles for Pension Taxation

- ***Promotes adequacy***: provides financial support and incentivises saving for retirement.
- ***Encourages the right behaviours***: helps savers make the right decisions about retirement saving.
- ***Fair***: helps everyone – the employed, the self-employed, and non-workers - save for retirement.
- ***Simple to adopt and administer***: avoids unreasonable transition and on-going costs for employers and schemes.
- ***Enduring & sustainable***: designed to avoid repeated change and so builds confidence in long-term saving.

The principles have also been tested via research with our wider PLSA membership, in particular with the PLSA Reference Groups.[9] Among our members there were high levels of support for the PLSA principles, with most support for "promoting adequacy", "enduring and sustainable" and "encourages the right behaviours". If the five principles are used as basis for reform we believe it should result in an effective system of pension tax relief.

[8] Members of the Steering Group included the Policy Board Chair, the PLSA Chair and the Chairs of the PLSA's main Policy Committees. See Annex 1.

[9] PLSA Reference Groups provide a channel of extra insight from PLSA members on policy issues. There are four reference groups, covering DB, DC, Master Trusts and Local Authority pensions. There are around 100 members on each group.

FOUR OPTIONS FOR REFORM

There are many ways in which the fiscal support for pension saving could be altered or reformed. However, in this report, we have picked out four that have been frequently discussed by Government, the pension sector, consumer groups, and the media over the last five years.

The reform options considered in this report are:

- **TEE**: This is where income tax is fully applied to all contributions but investment returns and income in retirement are both exempt from tax.

And modifications to EET through:

- **Single rate at 20%**: The same rate of tax relief at 20% is applied to all pension contributions, rather than at a saver's marginal rate of income tax as is currently the case.
- **Single rate at 25 or 30%**: The same rate of tax relief at 25 or 30% is applied to all pension contributions, rather than at a saver's marginal rate of income tax.
- **Reduction in the Annual Allowance (AA) and Lifetime Allowance (LTA)**: The AA is currently set at £40,000, under this reform option it is assumed to have been reduced to £30,000. The LTA is currently set at £1.07 million, under this reform it is assumed that it is reduced to £750k.

ASSESSMENT OF REFORM OPTIONS

We have examined the current approach to pension tax relief and the reform options outlined in the previous section.

TEE

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
TEE	×	×	-	×	×

- *Promotes adequacy:* A move from EET to TEE would negatively impact adequacy as it removes all tax benefits, disincentives saving into pensions, reduces the amount being saved and, will result in lower incomes in retirement. Under TEE, a basic rate tax payer would have a 20% reduction in their private pension income before tax and for a higher rate tax payer it would lead to a 37% reduction.[10] It would completely undermine the concept of pensions as distinct from other forms of tax-incentivised savings, such as ISAs.

- *Encourages the right behaviours:* TEE removes much of the incentive to save for the long term. Besides discouraging pension saving in general, TEE would remove an important brake on withdrawals under pension freedoms as the money taken out would not be taxed. People might be more likely to take all of their pension saving in one lump sum rather than as a yearly income. In the long run this may mean that more government support is needed to ensure pensioners do not end up in poverty, if their resources have been used too quickly.

- *Fair:* Under TEE, everyone would pay tax on their pension contributions at their marginal rate of tax when working. However, a number of groups would lose out compared to the current system, e.g. non-taxpayers who currently gain from the relief at source system would lose that benefit altogether.

- *Simple to adopt and administer:* TEE would create complexity and significant additional cost for employers through necessary changes to payroll systems – something which may cost millions of pounds for larger employers. It would also

[10] PPI modelling undertaken for the PLSA January 2021. Figures relate to a median earner and higher rate tax payer throughout most of their career in a DC scheme contributing at the minimum for automatic enrolment. See Annex 2.

require two accounts for every current active member of every scheme, meaning a two-track system will have to be supported potentially for decades.

- *Enduring and sustainable:* TEE would mean that, rather than currently where government receives tax revenue from pensions at the point when people retire and are most likely to need health and welfare support, government will instead receive it much earlier. Given that the UK has an ageing society, with associated costs rising to government as society ages, this is a fiscally high-risk strategy. Few people will believe that a future government will not be tempted to also tax pensions at the point of withdrawal – thereby making the system not TEE but TET. While such a system could lead to an upfront positive fiscal flow for HMT, the revenue gain would fall over time as income from pensions in payment fall and then stop.

SINGLE RATE AT 20%

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Single rate at 20%	×	×	-	×	✓

- *Promotes adequacy:* A single rate at 20% would not improve the retirement income adequacy of basic rate tax payers, as they would receive the same level of government support as in the current system. However, unless they save even more than today, it will reduce adequacy for higher rate tax payers as they will receive a reduction in the amount of tax relief. This will worsen the position of many higher rate tax payers, as we know that many, particularly those earning between £50,000 and £100,000, are already saving inadequately for retirement. A higher rate tax payer would see a reduction of 21% in their private pension income before tax.[11] As we believe both employer and employee contributions would need to be taxed (see Annex 3) it may also have implications for those Basic Rate taxpayers close to paying the higher rate tax threshold, by tipping them into a higher rate tax bracket. For some, this could have additional implications for claiming benefits or tax credits e.g. childcare tax credits. Someone on the cusp of paying higher rate may see a reduction of 7% in their private pension income before tax.[12]

[11] PPI modelling undertaken for the PLSA January 2021. Figures relate to a higher rate tax payer throughout most of their career in a DC scheme contributing at the minimum for automatic enrolment. See Annex 2.

[12] Figures relate to a person on the cusp of paying higher rate tax throughout most of their career in a DC scheme at the minimum for automatic enrolment.

- *Encourages the right behaviours:* A single rate of tax relief would involve the "double taxation" of some income for some people, in contradiction of one of the key principles of fair taxation.[13] The very threat of double taxation may inhibit some from continuing to make pension contributions, particularly if the option of taking cash instead of an employer contribution is made available.

- *Fair:* While it might seem reasonable to reduce tax relief for the 13% of the working population who pay higher rate income tax, i.e. those earning above £50,000 per year, it should be remembered that many more than 13% of tax payers will earn this amount at some time, and many only for a short number of years towards the end of their careers – when pension saving is often at its highest. We estimate that the removal of higher rate tax relief on pension contributions could result in around 3-4 million taxpayers each paying an average of £2,000 more tax each year; money that would otherwise have gone into their pensions.

- *Simple to adopt and administer:* A single rate would create complexity and significant additional cost for employers because of changes to payroll systems and the need to explain the change to their workforce. This would be particularly the case if employer contributions need to be taxed through payroll before being paid into the scheme. Updates to payroll systems would take time, potentially 2-3 years, and changes are likely to cost in the millions of pounds for employers. A single rate will introduce considerable process and system changes for all pension schemes and pension providers, potentially leading to a new form of relief at source (see Annex 4). It is likely that moving to a single rate would lead to the closure of many of the remaining defined benefit schemes in the private sector.

- *Enduring and sustainable:* The rate of relief would be anchored to the basic rate tax relief. Keeping the single rate linked to income tax should limit any further reductions in fiscal support. The PLSA estimates that the Treasury would gain around £8bn - £10bn from a single rate at 20% if people carry on with the same level of pension saving as now.[14]

[13] OECD (2014), Addressing the Tax Challenges of the Digital Economy, https://www.oecd-ilibrary.org/docserver/9789264218789-en.pdf?expires=1612793211&id=id&accname=guest&checksum=F42FBFD9B06DF3F992DEDD339B3B85C1

[14] Model based on contributions and assumes between 34 and 60% of DB contributions are from higher rate taxpayers (T3.8 Survey of Personal Incomes 2017/18).

SINGLE RATE AT 25 OR 30%

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Single rate at 25 or 30%	✓	✓	-	×	-

- *Promotes adequacy:* A single rate at 25 or 30% would improve adequacy of basic rate tax payers in DC, as they would receive a higher rate of relief into their pension, boosting private pension income before tax by 7-14%.[15] However, when combined with state pension and subject to tax, the percentage increase on total take-home retirement income drops to a more limited 2-3%. It would have a negative impact on adequacy for higher rate tax payers, as there will be a reduction in the amount of support they receive, however, the loss will be smaller than at a single rate of 20%. A higher rate tax payer would see a reduction of 10-16% depending on whether the rate was 25 or 30%.[16] Again, there may be implications for those close to paying the higher rate; including employer contributions as a taxable benefit could push some into the higher rate for some or all of their contribution (see Annex 3).

- *Encourages the right behaviours:* Although, it is hard to assess behavioural effects, the increased level of government support may encourage basic rate taxpayers to increase their level of contributions. The messaging from Government, media and employers will be critical to ensure that people contribute to their pensions. Clearly, higher rate income tax payers unless they increase their contribution rate will pay less into their pensions and, all other things being equal will have a lower income in retirement. The prospect of double taxation may cause some to cease paying pension contributions altogether.

- *Fair*: A single rate above basic rate will provide a boost in savings to basic rate taxpayers. However, people who pay higher rate income tax (or are on the cusp of a higher rate), will lose out, although by less than is the case if the Government moves to a single rate set at 20%.

- *Simple to adopt and administer*: Complex and significant system changes would be needed to implement a single rate at 25 or 30% in order to claim the additional bonus for basic rate taxpayers and to pay tax on higher rate taxpayers' contributions (as

[15] PPI modelling undertaken for the PLSA January 2021. Figures relate to a median earner in a DC scheme contributing at the minimum for automatic enrolment. See Annex 2.

[16] Figures relate to a higher rate tax payer throughout most of their career in a DC scheme contributing at the minimum for automatic enrolment.

outlined in Annex 4). Moving to a single rate could lead to the closure of many of the remaining defined benefit schemes in the private sector.

- *Enduring and sustainable*: Once the rate of pensions tax relief is decoupled from the rate of income tax, we believe it will be easier in the future for governments to further reduce relief. The PLSA estimates that the Treasury would gain around £3.5bn-£4.8bn from a single rate at 25%. If set at 30%, the amount raised is a more mixed picture - our estimates show that the Treasury could gain £1.5bn or they could lose an additional £1bn in revenue.[17]

REDUCTION IN THE ANNUAL ALLOWANCE (AA) AND LIFETIME ALLOWANCE (LTA)

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Reduction in the Annual Allowance (AA) and Lifetime Allowance (LTA)	×	×	-	✓	✓

- *Promotes adequacy:* Clearly, a reduction in the Lifetime Allowance will reduce pensions adequacy among those who are affected, i.e. people with or hoping to have substantial pension savings. Reductions in the Annual Allowance could reduce adequacy among people who make contributions on an irregular or "lumpy" basis such as the self-employed, someone with peak earnings late in life, or someone selling their business or receiving an inheritance.

- *Encourages the right behaviours:* A lower AA may disadvantage some people who have held off pension saving later into their career and inhibit them from making pension contributions when they are better able to afford it. Similarly, it may inhibit saving among self-employed people who wish to a make a larger contribution to their pensions, for example, due to a short period of higher earnings or upon selling their business.

- *Fair:* A reduction in the allowances will not affect most DC savers. However, it is likely to affect people in defined benefit pension schemes, often catching senior public sector

[17] Model based on contributions and assumes 34-60% of DB contributions are from higher rate taxpayers (T3.8 Survey of Personal Incomes 2017/18).

workers such as doctors, also those, such as the self-employed, who are likely to save in lump sums.

- *Simple to adopt and administer:* Compared to other reform options discussed it is relatively simple to adopt and administer, as it is a change to the current system rather than a complete overhaul. However, the AA and the LTA are a large administrative burden for schemes, especially for defined benefit ones, and for individuals. Lowering the AA and LTA would lead to a very substantial increase in the number of DB calculations which schemes need to undertake, and increase the number of savers affected.

- *Enduring and sustainable:* It is hard to estimate how much revenue would increase through a reduction in the AA and LTA. However, given that only a minority of people save close to either allowance, it is likely to be relatively small and it would take some time for the impact of a lower LTA to be felt by the Treasury.

CURRENT SYSTEM

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Current System	✓	✓	-	✓	-

- *Promotes adequacy:* The current system provides a high level of fiscal support for pension saving. Under many of the reforms we have assessed, the result would be less government support for pensions, which would therefore have a detrimental effect on adequacy.

- *Encourages the right behaviours:* The current system supports the right behaviours by encouraging people to contribute into their pensions in two ways. One, an awareness that the Government “make a contribution” to pension saving and, secondly, the existence of the 25% tax-free bonus at withdrawal makes pensions an attractive savings-vehicle.

- *Fair:* It treats pension contributions as deferred income and provides savers with relief at the point of contribution. However, as those on higher incomes save more in pensions, it does mean that a substantial share of this fiscal support is received by people earning over £50,000 in any given year. Many people argue if reforms are to be made, they should benefit those on low to median incomes.

- *Simple to adopt and administer:* Although the current system can be complex and would benefit from some simplification, e.g. a solution to the net pay / RAS issue or to the Money Purchase Annual Allowance, having no change would be the simplest option of those considered; from an administrative perspective.

- *Enduring and sustainable:* The system of EET for pensions has been in place for around a century and, despite some reductions in the allowances (since the "simplification reforms" of 2006), it has demonstrated its durability. That said there are questions about the sustainability of the current system given the current levels of government debt and budget deficit.

OVERALL ASSESSMENT

The assessment set out suggests that neither the current system, nor any of the four options for reform widely discussed, meet all of the five principles for pension taxation. The current system satisfies more of the principles than any other option. The lowest scoring option is TEE; it meets only one of the five principles for reform and fails four of them. The other options only satisfy one or two of the principles, although some do also achieve some neutral scores.

The outcome of our assessment is set out in the table below:

REFORM OPTIONS	PROMOTES ADEQUACY	ENCOURAGES THE RIGHT BEHAVIOURS	FAIR	SIMPLE TO ADOPT & ADMINISTER	ENDURING & SUSTAINABLE
Current System	✓	✓	-	✓	-
Single rate at 25 or 30%	✓	✓	-	×	-
Reduction in the AA and LTA	×	×	-	✓	✓
Single Rate at 20%	×	×	-	×	✓
TEE	×	×	-	×	×

CONCLUSION

On the basis of our assessment against the five principles for pension taxation, none of the reforms set out in this report, as discussed by Government, the pensions sector, consumer groups or the media, should be adopted. Therefore, we believe that the core elements of the current approach to pensions tax relief, in particular, the EET system should be maintained.

However, we appreciate that in the very challenging fiscal climate, Government will be reviewing all options to relieve pressure on the public purse. Therefore, if reform does happen we believe it should be in line with the principles set out in this report. The implications of reform and how it can be implemented should be fully thought through to ensure there are no unintended consequences. It is essential that the impacts of any changes are assessed, especially with regard to savers, schemes and employers.

The time-scales for any reform should be realistic and practical. Depending on the type of reform, it may take significant amounts of time, and investment, to implement. This would need to be recognised in both the time allowed for consultation and for implementation.

Rather than embarking on a major reform of pensions tax relief, we think there is more value in addressing some of the more specific and technical shortcomings of the current system. For example, the inequalities created for low income savers due to the differences in tax administration systems used by different pension schemes – the net pay / RAS issue.

ANNEX 1: PLSA PENSIONS TAX RELIEF STEERING GROUP MEMBERS

NAME	ORGANISATION
Emma Douglas (Chair)	Legal & General Investment Mgt
Carol Young	Natwest
Jackie Peel	Mars
Laura Myers	LCP
Rachel Brothwood	West Midlands Pension Fund
Richard Butcher	PTL
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ANNEX 2: INDICATIONS FROM PPI MODELLING

- In January 2021, PLSA commissioned PPI to undertake some modelling work around the impact of potential pension tax reforms on different individuals in different schemes. The full results of this work and detailed modelling assumptions will be published by PLSA at a later date alongside a technical paper from PPI. We have included some initial analysis below to support the findings in this paper.
- The results of the modelling illustrate the impact of different reform options on a range of individuals with different earning and tax profiles and who are members of different pension schemes.
- Summarised below are some of the outputs for five individuals modelled from age 21 in 2021 to age 100, with a state pension age (SPA) of 68 when they begin to take their private pension:
    - A non-taxpayer with career-long salary just below the personal allowance threshold (£12,000 in today's money);
    - A median earner with career-long salary that attracts basic rate tax (peak income £35,000 in today's money);
    - A higher than median earner but basic rate taxpayer with career-long salary just below the higher rate threshold (£50,000 in today's money);
    - A higher than median earner whose earnings for 10 years are just above the higher rate tax threshold (peaking at £50,800 in today's money);
    - A 90th percentile earner who is a higher rate taxpayer from age 29 until SPA (earnings peak at £77,000 in today's money).

- For each individual, we show the results if they are in:
    - a DC pension with contributions at the automatic enrolment minimum (8% of AE band earnings); and
    - a career average DB pension with 1/80th accrual rate (based on the NHS pension scheme).
- The results illustrate the potential impact for all of these individuals against a number of potential tax reforms:
    - A move to TEE from EET where all contributions are taxed through payroll and are passed to the pension scheme net of tax, contributions roll-up free of tax and withdrawals in retirement are free of tax. This option is not modelled for membership of DB.
    - A flat rate of 20% tax relief where both employer and member gross contributions are subject to tax at the individual's marginal rate and the scheme claims back the equivalent of basic rate tax on all contributions. For higher rate taxpayers or those on the cusp of higher rate, the effect is that their contributions

are reduced by 20%. For non-taxpayers this results in a boost to their contributions equivalent to basic rate relief on contributions (including employer contributions). For basic rate taxpayers, the effect is neutral compared to current net pay and relief at source arrangements.

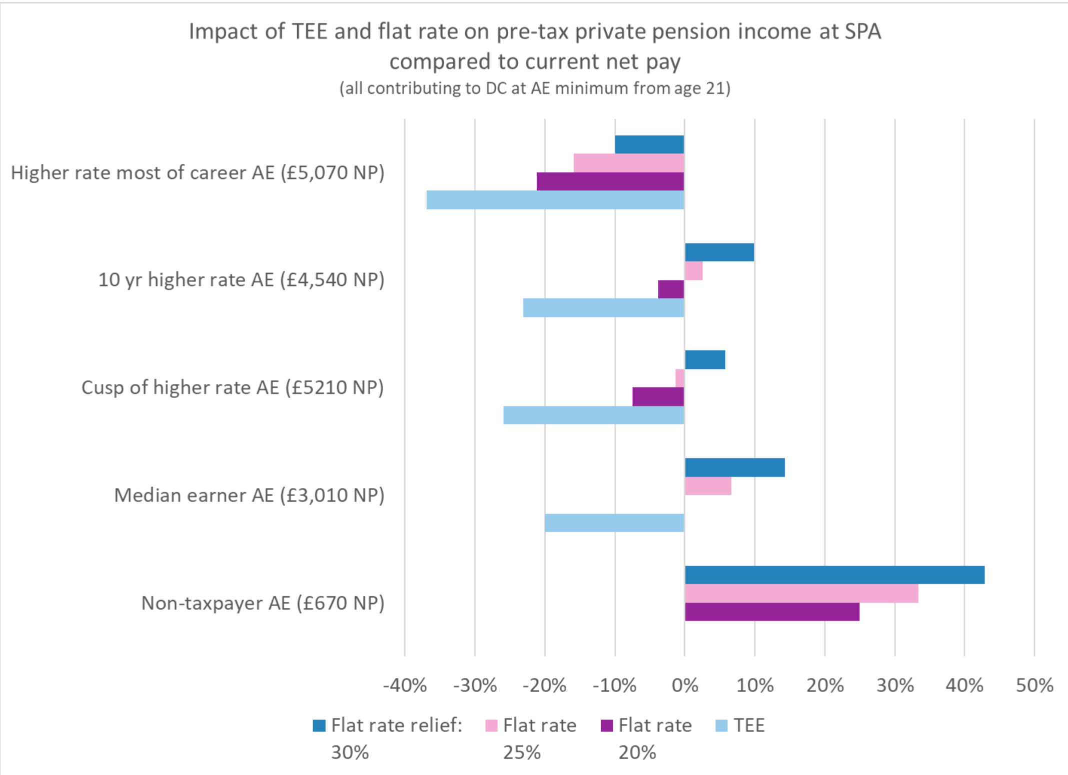
- Flat rates of 25% and 30% applying the same principle as above but providing a boost to those who are basic rate taxpayers as well as a higher boost to non-taxpayers. The negative impact on higher rate taxpayers is lower than either TEE or a 20% flat rate.

- In all of the data shown below it is assumed that individuals take their 25% tax free lump sum and do not use this to generate an additional income.

IMPACT OF PENSION REFORMS ON INDIVIDUALS IN A DC PENSION (A/E MINIMUM)

The chart below summarises the impact in percentage terms of four different pension tax reforms. It compares the pre-tax private pension income at SPA for five individuals under each of four reforms with the level of private pension income that would have been achieved under a net pay (NP) arrangement.

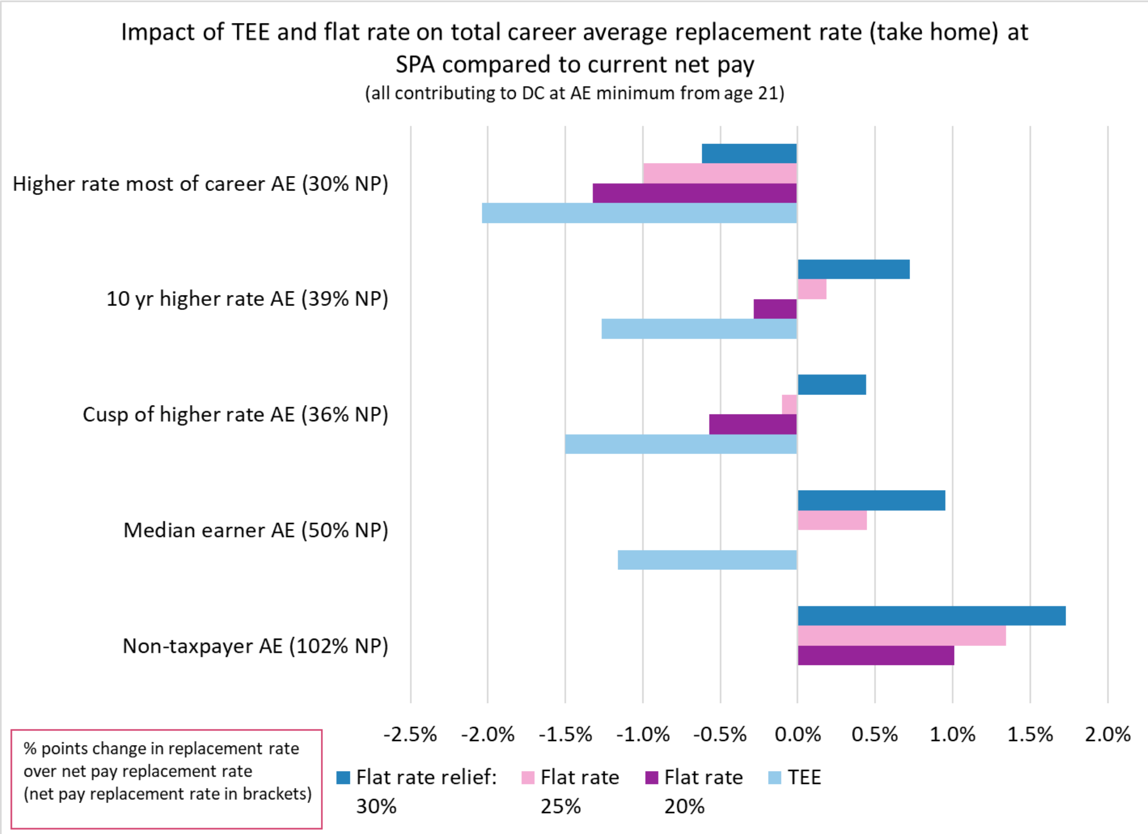
FIGURE 1: IMPACT OF REFORMS ON DC PRE-TAX PRIVATE PENSION INCOME AT SPA IN TODAY'S MONEY (PLSA ANALYSIS OF PPI MODELLING)



- There are clear winners and losers from changes to pension tax relief in terms of looking at private pension before tax at SPA.
    - The biggest winners across all but TEE are non-taxpayers in DC who benefit from a significant boost to private pension income (a 43% increase on £670 under a flat rate of 30%)
    - The biggest losers are those on higher rate tax for much of their career, seeing up to a 38% fall in private pension income under TEE and 22% under basic rate relief only.
    - There are mixed results for:
        - those with a short period as a higher rate taxpayer who lose out under TEE and basic rate relief, but benefit under a flat rate of 25% or more; and
        - those who spend their career at the cusp of being a higher rate taxpayer who lose out under TEE, basic rate and 25% flat rate but gain a little under 30%.

- However, when we combine the private pension with the state pension and subject both to tax, and look at the impact on the average replacement rate that individuals achieve in retirement, the scale of the impact is diminished by two elements:
    - the inclusion of the state pension which for the lower paid dominates their retirement income, and
    - for some, by different amounts of tax paid in retirement (less for those losing income and more for most of those gaining).

FIGURE 2: IMPACT OF REFORMS ON AVERAGE REPLACEMENT RATE - POST TAX PRIVATE AND STATE PENSION INCOME AS % CAREER AVERAGE TAKE-HOME PAY (PLSA ANALYSIS OF PPI MODELLING).

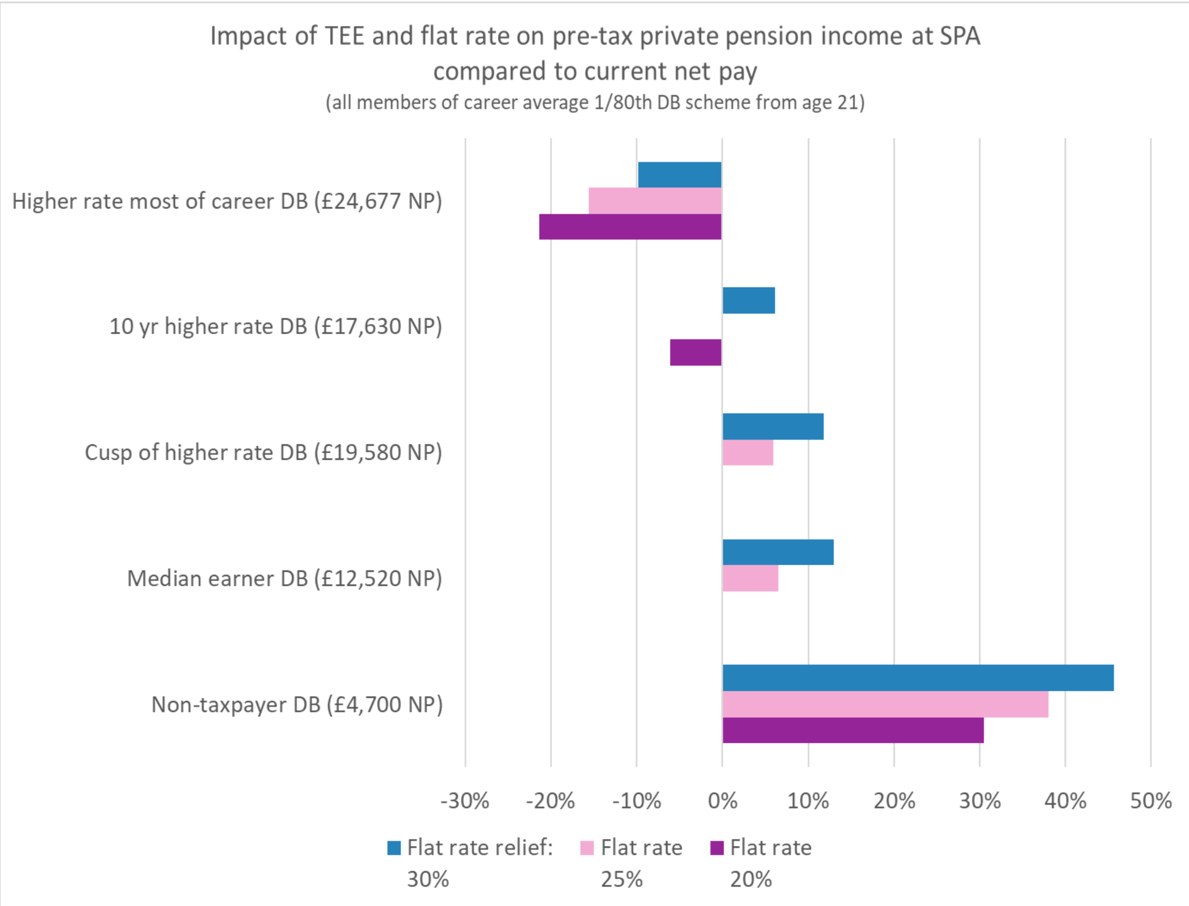


- In none of the tax reform scenarios shown here do any of our individuals gain more than 1.8 percentage points on their take-home pay in retirement, despite the non-taxpayer seeing a 43% increase in their private pension under a 30% flat rate.
- The worst-case scenario is for the higher rate taxpayer under TEE who will see their private pension drop by 38% but their take-home replacement rate drop by 2%.
- Non-taxpayers have high replacement rates under all scenario but benefit by small percentage increases under flat rate because the state pension dominates their retirement income (90+% in each of these scenario).
- Basic rate taxpayers have considerably lower average replacement rates than non-taxpayers. They lose out under TEE and but make a small gain under flat rates. State pension represent around 75-80% of their average net retirement income across the scenarios.
- Those who are higher rate taxpayers for most of their career have the lowest replacement rates and lose more than others under flat rate scenarios. Even here the impact is lessened by the inclusion of the state pension which accounts for between 44% and 78% depending upon the scenario.

IMPACT OF PENSION REFORMS ON INDIVIDUALS IN A DB CAREER AVERAGE PENSION (1/80TH)

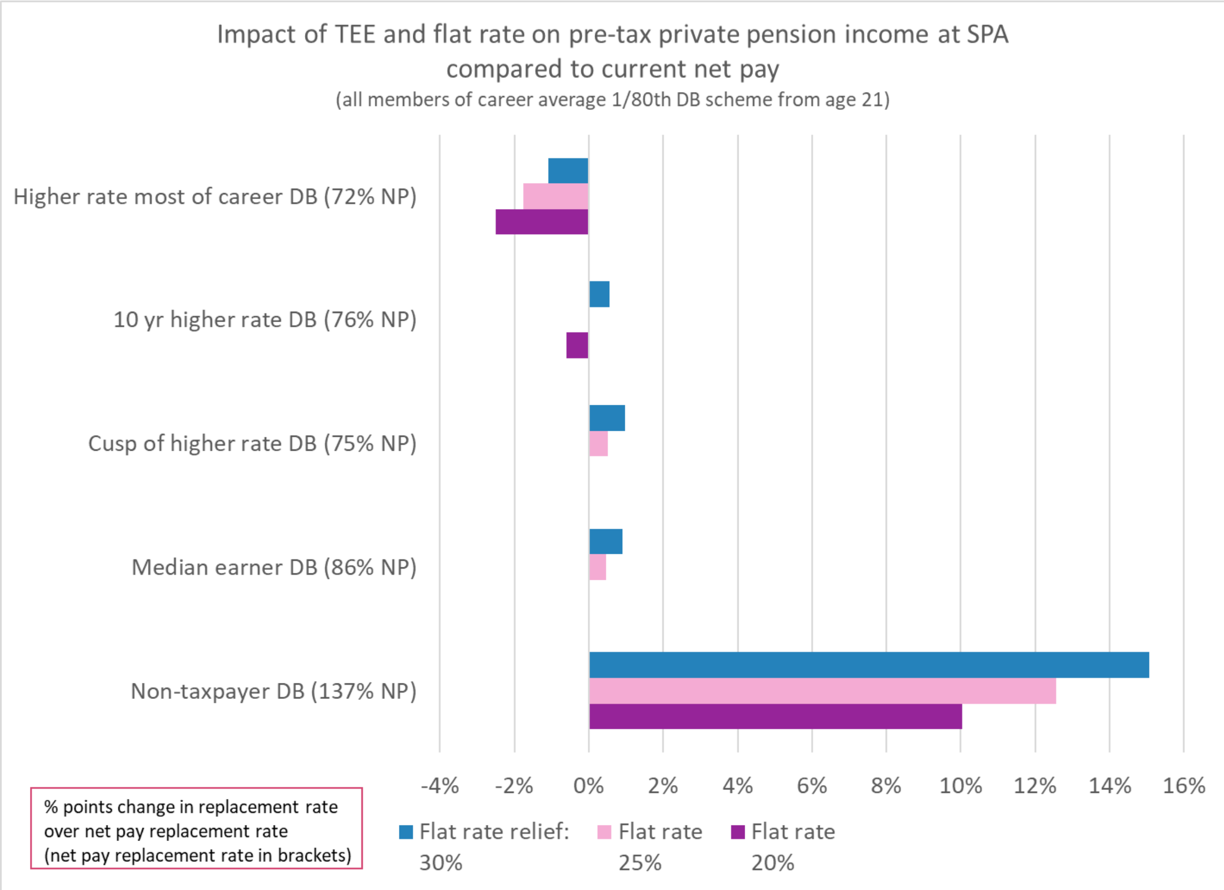
- In order to demonstrate the equivalent effect on those in a DB pension, the same individuals were modelled to show the possible effect of boosting or reducing their scheme benefits in retirement.
- In this chart we have sought to show the equivalent picture for members of a career average DB scheme (PPI used the NHS scheme as the basis for the modelling). We have had to make a number of important assumptions about the way in which reforms could work for active members of DB schemes. The modelling assumes that the annual allowance pension input amount formula is used to calculate a deemed value of the contributions to DB rather than the actual or average contributions. This is then subjected to the different tax regimes (excluding TEE) and, either the tax due to be paid or the tax rebate to be received, is then translated into a reduction in benefits (scheme pays) or a boost to benefits (scheme receives).

FIGURE 3: IMPACT OF REFORMS ON PRE-TAX DB PRIVATE PENSION INCOME AT SPA IN TODAY'S MONEY (PLSA ANALYSIS OF PPI MODELLING)



- In terms of private pensions in retirement, members of DB career average schemes do considerably better in all scenarios than a DC member on automatic enrolment minimum contributions. On the same earnings profiles, individuals generate a private pension that is between 5-7 times that generated by AE minimum contributions. As a result, replacement rates are also much higher (ranging from 72% for the highest earners to 137% for the lowest).
- Improvements and reductions in private pension income arising from tax reform scenarios while similar in degree of percentage change have a much more significant impact on the £ in the pocket.
- Under a 30% flat rate a non-taxpayer would see an increase in private pension from £4,700 to £6,850 and a 15 percentage point increase in their take-home replacement rate to 152%.
- By contrast, under a 20% flat rate a higher rate taxpayer (90th percentile for career) would see a 21% reduction in their private pension from £24,677 to £19,400 and a 2.5 percentage point reduction in their replacement rate to 69.5%.

FIGURE 4: IMPACT OF REFORMS ON AVERAGE REPLACEMENT RATE - POST TAX DB PRIVATE AND STATE PENSION INCOME AS % CAREER AVERAGE TAKE-HOME PAY (PLSA ANALYSIS OF PPI MODELLING)



ANNEX 3: TAXATION OF EMPLOYER AND MEMBER CONTRIBUTIONS UNDER A SINGLE RATE

- Employer and member contributions are currently subject to the same rate of income tax relief in the hands of the member of the pension scheme (although this is accounted for in a different way according to whether the pension scheme is a net pay scheme or relief at source).
- Employer contributions are effectively treated as deferred pay, tax on which is collected when the money is eventually received in retirement (barring the 25% tax free lump sum). Member contributions are also allowed tax relief on the same basis.
- Under a single rate of income tax relief, the PLSA believes that it will be necessary to subject both employer and member contributions to the same rate of relief. There are two principal reasons for this:
  - Maintaining full tax relief on employer contributions while applying the single rate to member contributions would unfairly favour those with proportionately higher employer contributions than member contributions. For example, higher earners in a scheme with, say, 10% employer contributions and 5% member contributions would benefit more from tax relief than those in a scheme with 7.5% employer contributions and 7.5% member contributions.
  - To not do so would open up a loophole through which higher earners in DC schemes could continue to receive full tax relief. If employer contributions were still subject to full tax relief, it would be possible, irrespective of salary sacrifice, for employment contracts to be reconfigured such that all contributions were made employer contributions in return for an appropriate cut in pay. This would go against the intent of moving to a single rate and would also deny HMT the income that they would expect to receive from higher earners.

ANNEX 4: IMPLEMENTING A SINGLE RATE ADMINISTRATIVE IMPLICATIONS

- The PLSA believes that two things will have to change for all DC schemes:
  - Higher earners will need to pay tax on their employer and own contributions at the difference between their marginal rate and the single rate, and
  - If the single rate is set above the basic rate, all DC schemes will need to claim the additional relief for non and basic rate tax payers on both employer and employee contributions.
- DC schemes operating on a net pay basis, i.e. most occupational pension schemes, will face considerable changes. It might be feasible for higher rate tax payers to complete a self- assessment tax return each year and the higher rates of relief that they have received to be repaid by themselves or by the scheme (with an equivalent reduction in benefits). Another option would be for HMRC to adjust individual's tax codes. If the single rate is higher than the basic rate, the scheme will still need to find a way to reclaim the excess of the single rate over the basic rate for basic rate and non-taxpayers.
- Having considered the options available to effect the changes required, the PLSA considers that it may be necessary for all DC pension schemes to move to a new form of relief at source (RAS) for both employer and member contributions. This would involve both employer and member contributions passing through payroll and being taxed; with the single rate of tax relief then collected by the scheme on both contributions. A move to new RAS for pension schemes would have significant challenges:
  - *Communication issues* – explanation of why contributions are now taxed with a rebate claimed by the scheme, why payslips have changed, and why for some pension contributions are lower than they were.
  - *Administrator capacity* – many third-party administrators do not provide RAS services. This raises questions about the capacity of the market to service all schemes unless a very considerable time period is allowed for transition.
  - *Cost of system changes* - significant additional systems and process changes would need to be introduced by both schemes and employers. These would take considerable time, probably a period of years to implement.
- While the position of DC schemes is relatively clear, the reforms, if applied to DB schemes would bring different and additional complexities. For funding purposes, we believe that it would be necessary for DB contributions to continue to be paid at the same level as at present and that adjustments to tax would need to be made at an individual level for members of the scheme.
- In order to provide some form of equity with members of DC schemes, a new calculation and mechanism would need to be introduced for all DB members to collect tax on their deemed contributions at the difference between their marginal rate and the new single rate; and to work out, if needed, the rebate to be paid. This method could be

similar to the current Pension Input Amount used for Annual Allowance calculations. This would have significant cost and time implications for schemes and employers. It would involve additional tax payments by the member (or through scheme pays) every year for every higher rate taxpayer.

- Where the single rate exceeds basic rate, there would also need to be a way of reclaiming tax relief for basic rate taxpayers. This might need to be paid to the individual, rather than boosting benefits in the scheme, although the latter would in theory be feasible. However, it would require the scheme to claim back the amount from HMRC each year and to allocate it to the individual's benefits. Operationalising scheme pays / scheme boosts in this way would not only create complexity for schemes but would also make the projection of income at retirement much more difficult.

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