A blueprint for a better tax treatment of pensions

6 February 2023

One Great George Street, Westminster

Wifi Network:
OneGreatGeorgeStreet

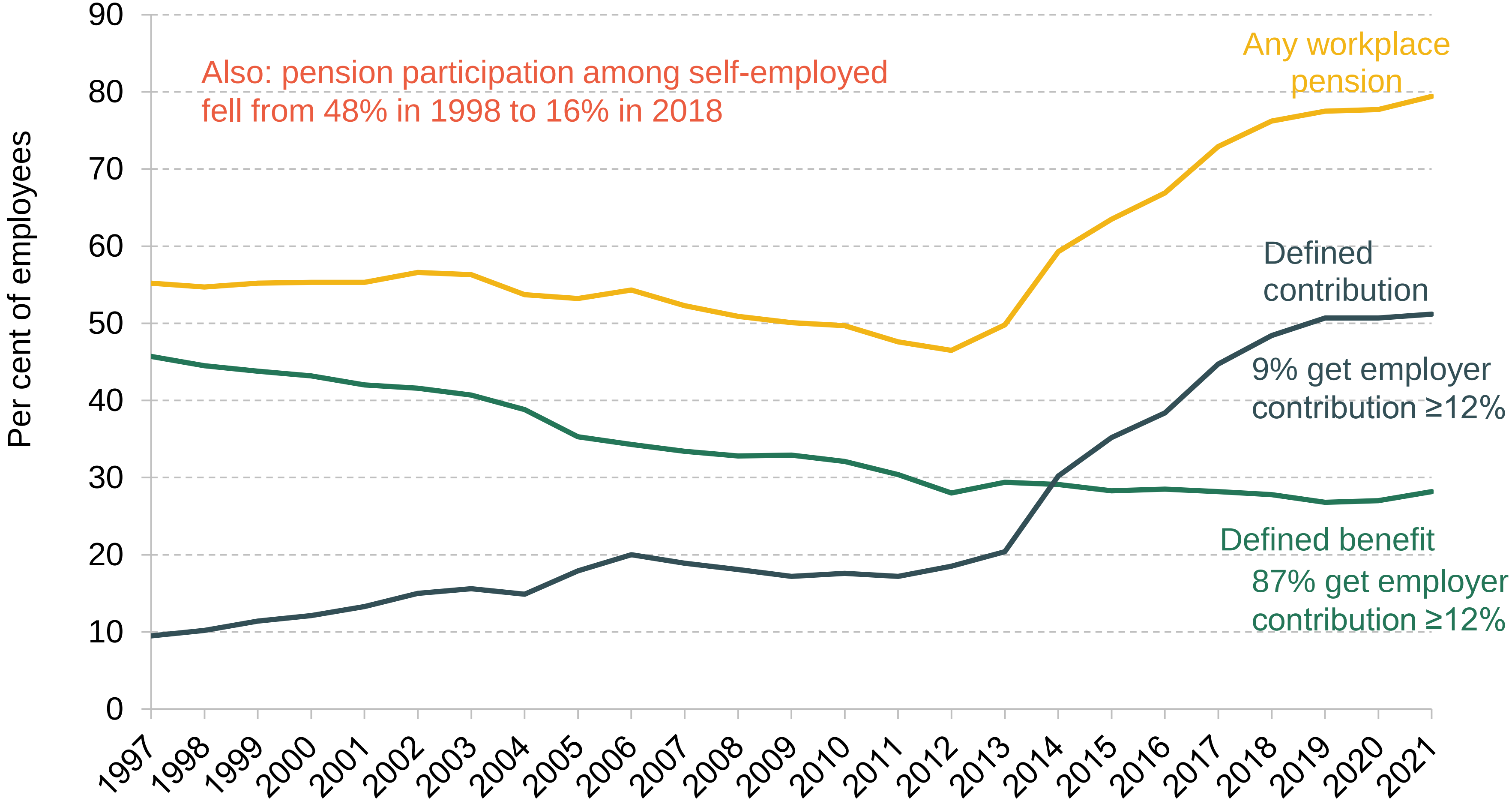
@TheIFS

UKRI Economic and Social Research Council

abrdn Financial Fairness Trust

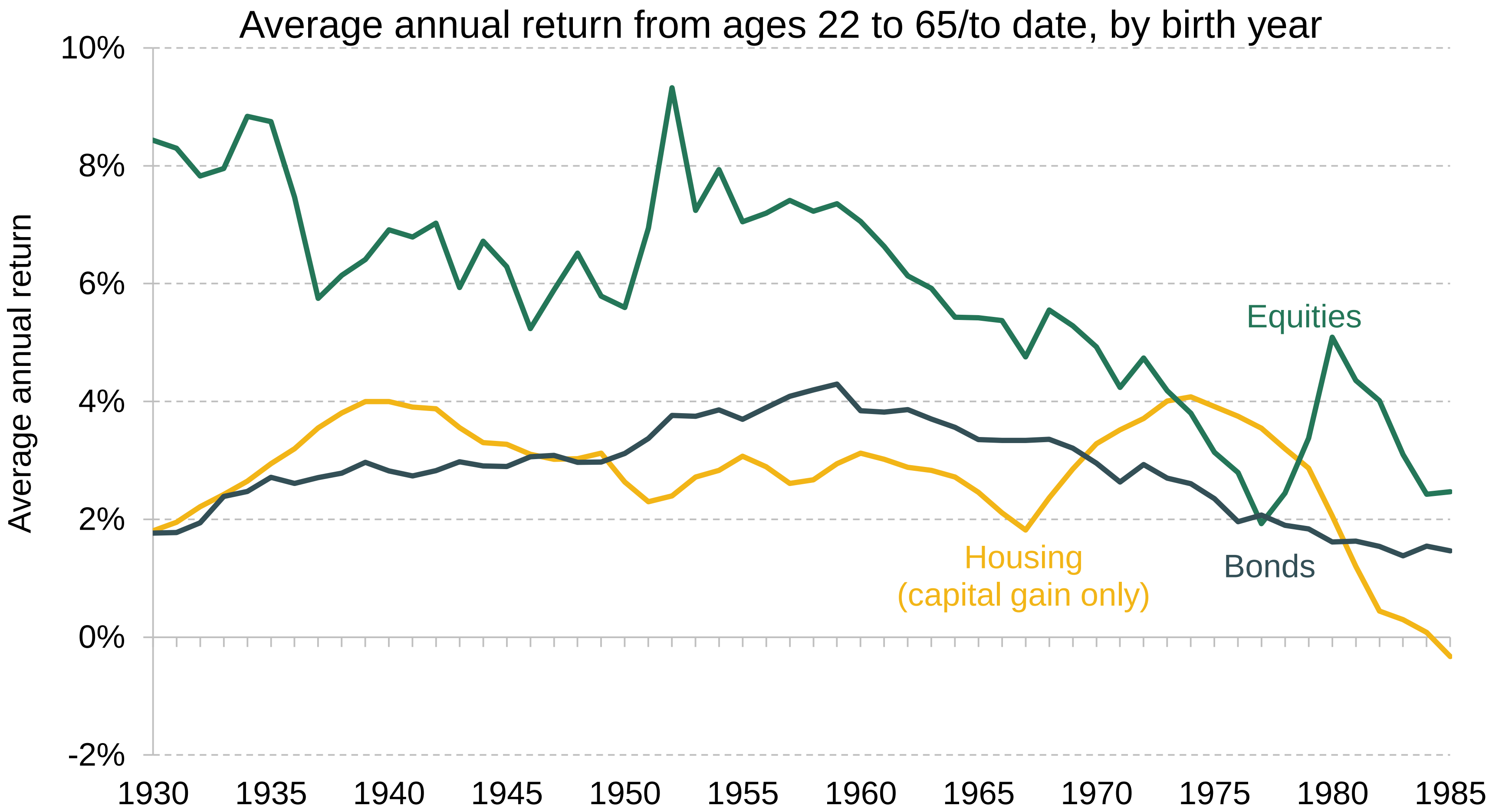
Context

Workplace pension membership



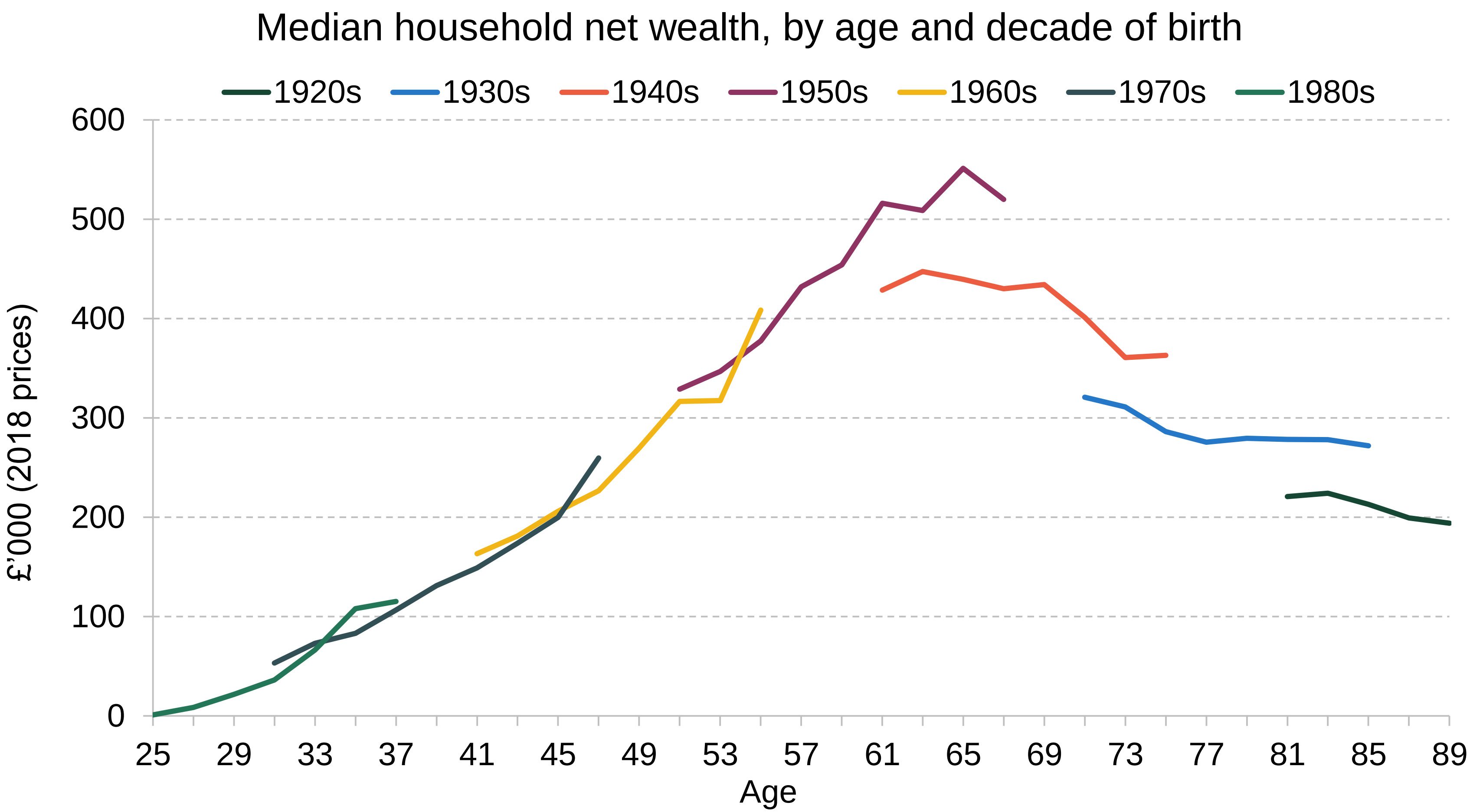
Notes and sources: see Figure 2.1.

Returns lower



Notes and sources: see Figure 2.4.

Wealth accumulation by generation



Notes and sources: see Figure 2.3.

Approach & Principles

Approach & Principles (1/2)

- We don’t take a stance on
  - the right overall level of support for pension saving
  - the degree to which the overall tax system should redistribute
- We assess where current tax subsidies are:
  - ungenerous to those at more risk of undersaving for retirement
  - overly generous to those at least risk
- Propose reforms
  - to even out those subsidies
  - ensure pension incentives not oddly linked to specific tax rates
  - give policymakers better tools to make subsequent adjustments

Approach & Principles (2/2)

- Proposed reforms are practical, including for defined benefit and defined contribution arrangements

- Transitional issues would require careful consideration, and we set out ways to deal with these

- Retrospective taxation never ideal, but when increasing tax on withdrawals impossible to avoid without extremely long transitions
- Often a trade-off with allowing an overly generous element to linger for longer to the benefit of older generations at expense of others

Support under the current system

Savings tax regimes compared

Contributions made → Returns that accrue → Funds withdrawn

- ISAs and owner-occupied housing subject to TEE treatment
- Income tax treatment of pensions closest to EET treatment
- Both can be considered reasonable benchmarks
- Three key differences
  - timing of tax payments
  - those who see tax rate fall at retirement do better under EET
  - those achieving bigger returns do better under TEE

Current system compared to EET

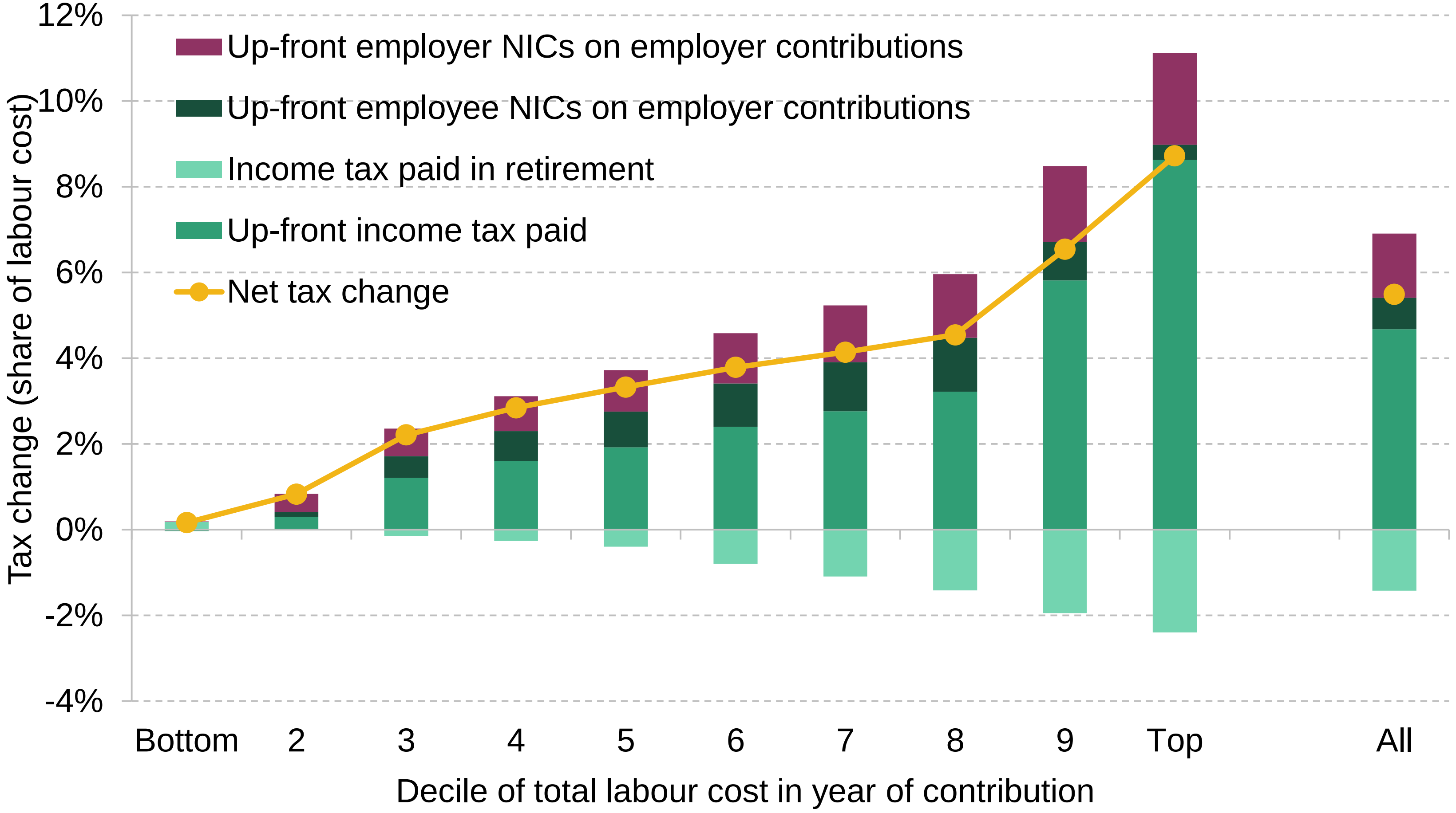
1. Up to 25% of a pension can be withdrawn free of income tax
2. NICs provides TEE treatment of individual pension contributions
3. Employer pension contributions escape NICs entirely
4. Pension pots bequeathed can escape both inheritance tax and, for deaths before age 75, income tax
5. Annual and lifetime limits on pension saving

- First four are of more benefit to those with big pension pots, high retirement incomes and big employer contributions

Empirical analysis

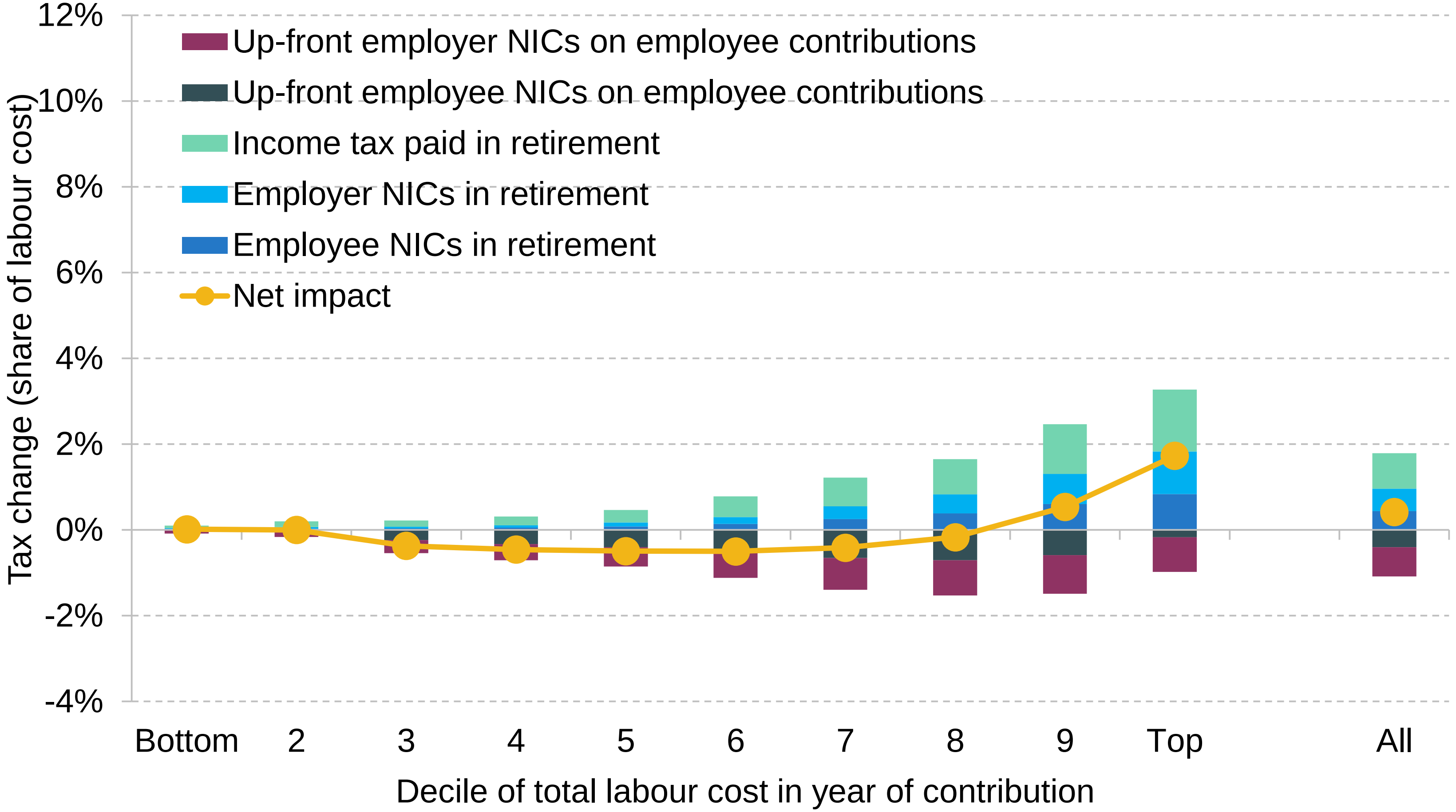
- Estimate long-run impact of systems on different individuals
- Done by examining current workers, along with a model of the tax rate they will face in retirement
- Novel and provides lots of new insights
  - relies on lots of assumptions set out in the report
  - ignores behavioural responses

TEE compared to current system



Notes and sources: see Figure 6.1.

EET compared to current system



Notes and sources: see Figure 6.2.

What we are not recommending

Upfront income tax relief

- Should consider relief on contributions alongside tax on withdrawals
- Allowing smoothing of taxable income reduces the extent to which annual income tax penalises those with variable incomes
  - although not everyone can smooth; so competing inequities
- Not just higher and additional rate taxpayers benefit: far more get basic rate relief and pay no income tax on pension withdrawals
  - argument for flat-rate relief also implies flat tax on withdrawals
- Practical difficulty with assigning employer DB contributions
  - suppose retired members living longer: who should pay tax on the resulting increase in employer contributions?

Our proposed reforms

Areas of reform

Our report proposes reform in five areas:

1. 25% tax-free component
2. Employee National Insurance contributions
3. Employer National Insurance contributions
4. Tax treatment at death
5. Pension limits

25% tax free component

25% tax-free component

A long-standing and high-profile element of the system.

Serious design flaws:

- Do those with £800k pension pots really need a tax subsidy to contribute more?
- Most generous to those paying higher/additional rate in retirement…
- … and of no benefit to non-taxpaying pensioners.

25% tax-free component

1. **Reform the tax-free component**
   - ‘Top up’ all pension pots by the same proportion, equivalent to 25% tax-free for basic-rate taxpayers
   - Levels out subsidy, increasing the value of all pensions by the same proportion – higher-rate and non-taxpayers alike

2. **Cap the reformed tax-free component**
   - A cap of £400k, for example, would leave 80% unaffected

National Insurance

National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs		
Employer NICs		

National Insurance

	Employee pension contribution	**Employer pension contribution**
Employee NICs		
Employer NICs		

- Current system draws a distinction between the treatment of employee and employer pension contributions

National Insurance

	Employee pension contribution	**Employer pension contribution**
Employee NICs	TEE	
Employer NICs	TEE	

- NICs charged up front on all employee pension contributions

National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs	TEE	EEE
Employer NICs	TEE	EEE

- NICs charged up front on all employee pension contributions
- Employer pension contributions – exempt from NICs

National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs	TEE	EEE
Employer NICs	TEE	EEE

- NICs exemption from employer pension contributions is a **£19 billion** tax break (relative to TEE)
- Roughly the cost of cutting main employee NICs rate from 12% to 8%

National Insurance

Current NICs treatment of employer pension contributions is flawed:

- Subsidy goes up when the NICs rate goes up…
- …and falls with NICs discounts (e.g. employment allowance)
- Subsidises employer but not employee pension contributions (leading to arrangements like salary sacrifice)
- Not available to ~4 million self-employed

National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs	TEE	EEE
Employer NICs	TEE	EEE

National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs	TEE	EEE
Employer NICs	TEE	EEE

National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs	TEE → EET	EEE → EET
Employer NICs	TEE	EEE

National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs	TEE → EET	EEE → EET
Employer NICs	TEE	EEE

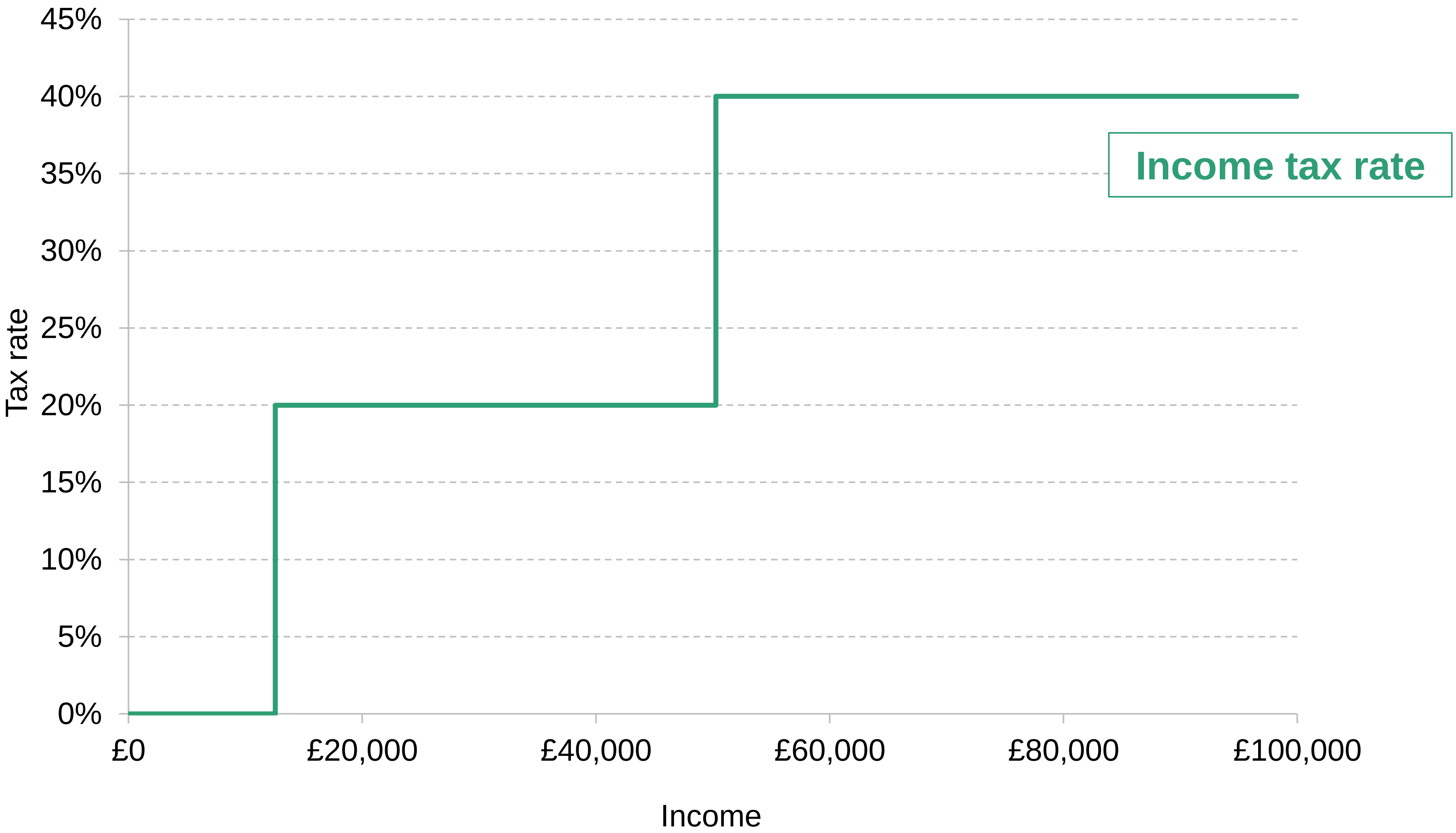
- Introduce upfront NICs relief on employee pension contributions
- Gradually bring in employee NICs on pension income (by DOB)

National Insurance

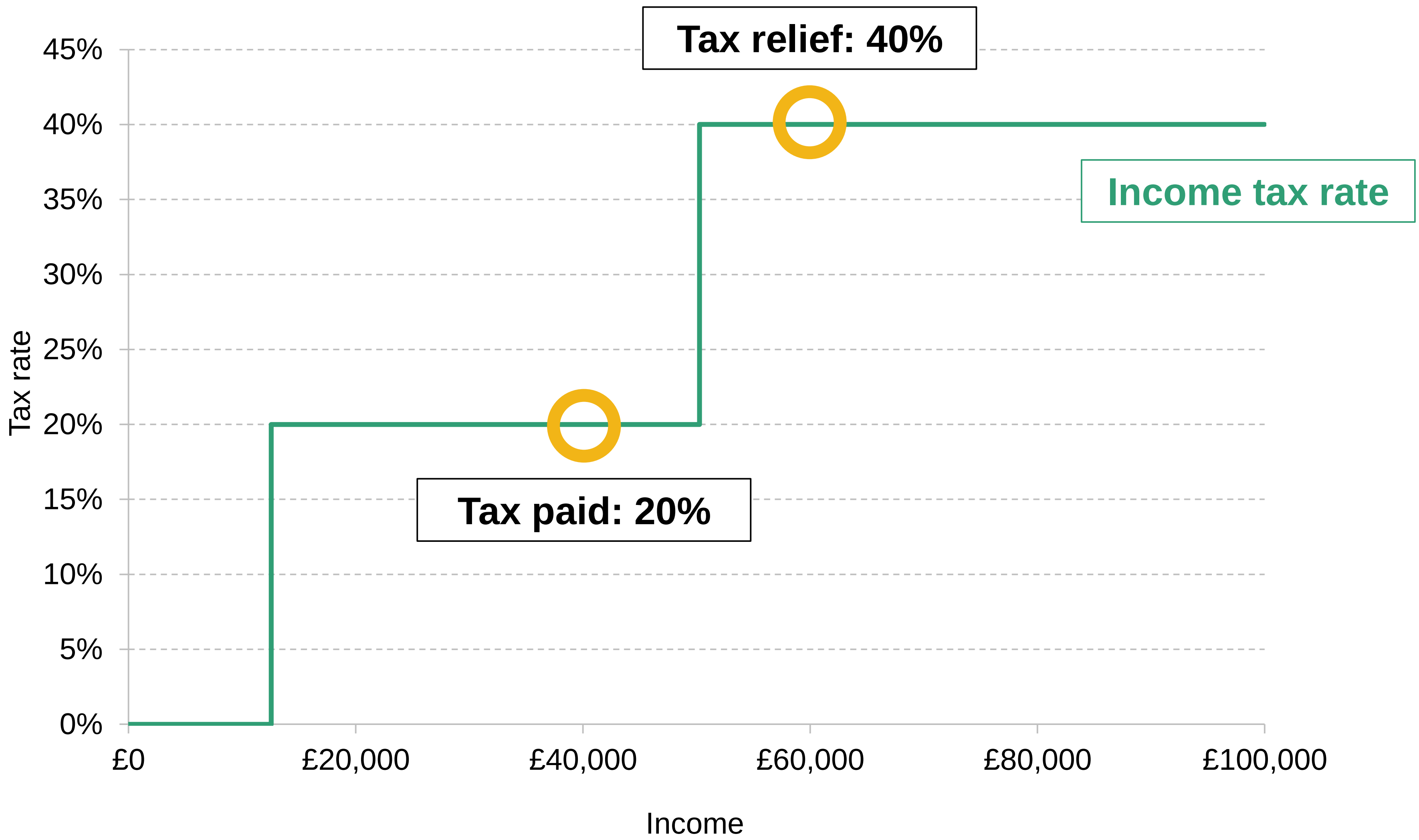
	Employee pension contribution	Employer pension contribution
Employee NICs	TEE ↓ EET	EEE ↓ EET
Employer NICs	TEE	EEE

- Aligns treatment with income tax
- Brings in revenue when it's needed
- Ensures high investment returns don't escape tax

NICs and tax base smoothing

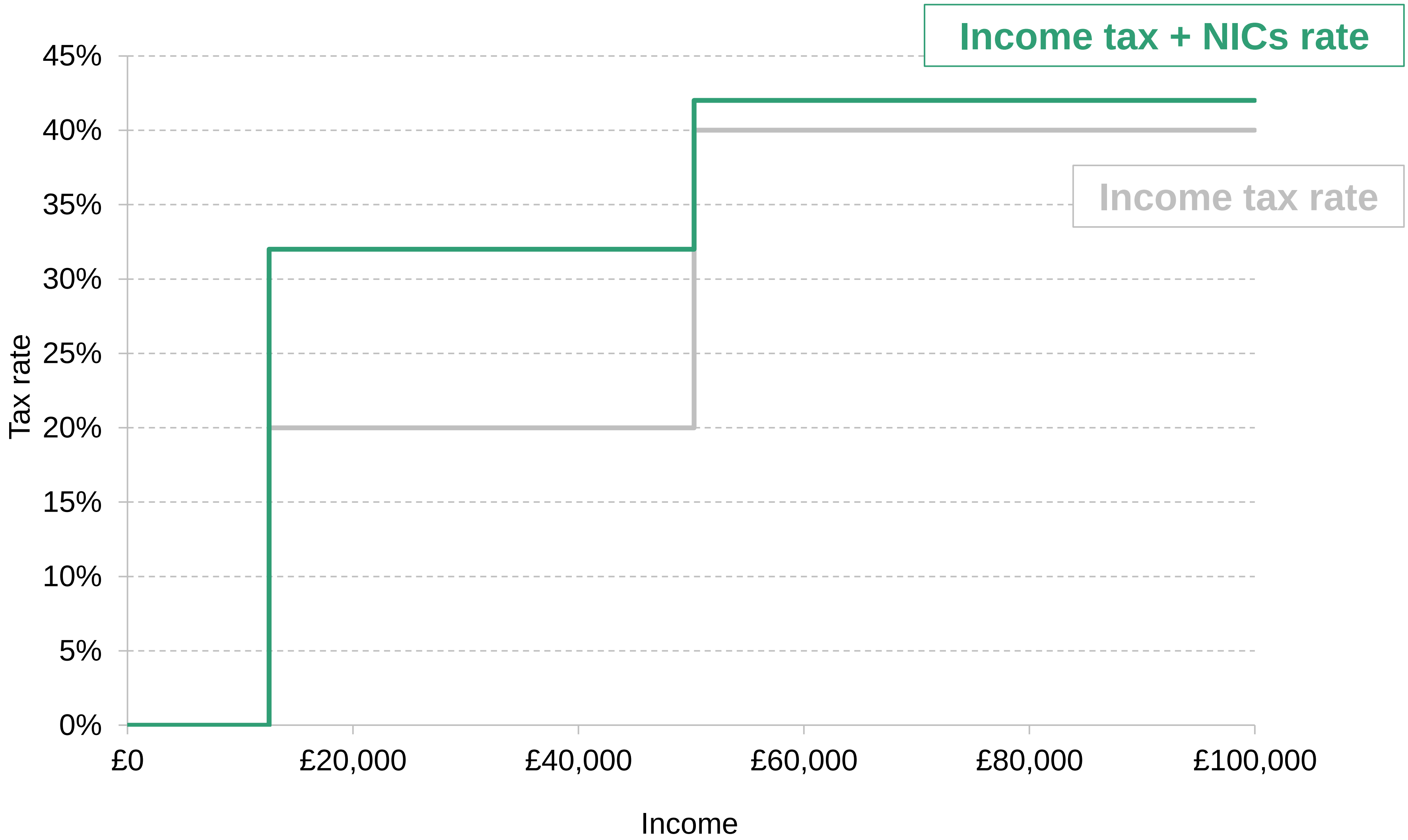


NICs and tax base smoothing

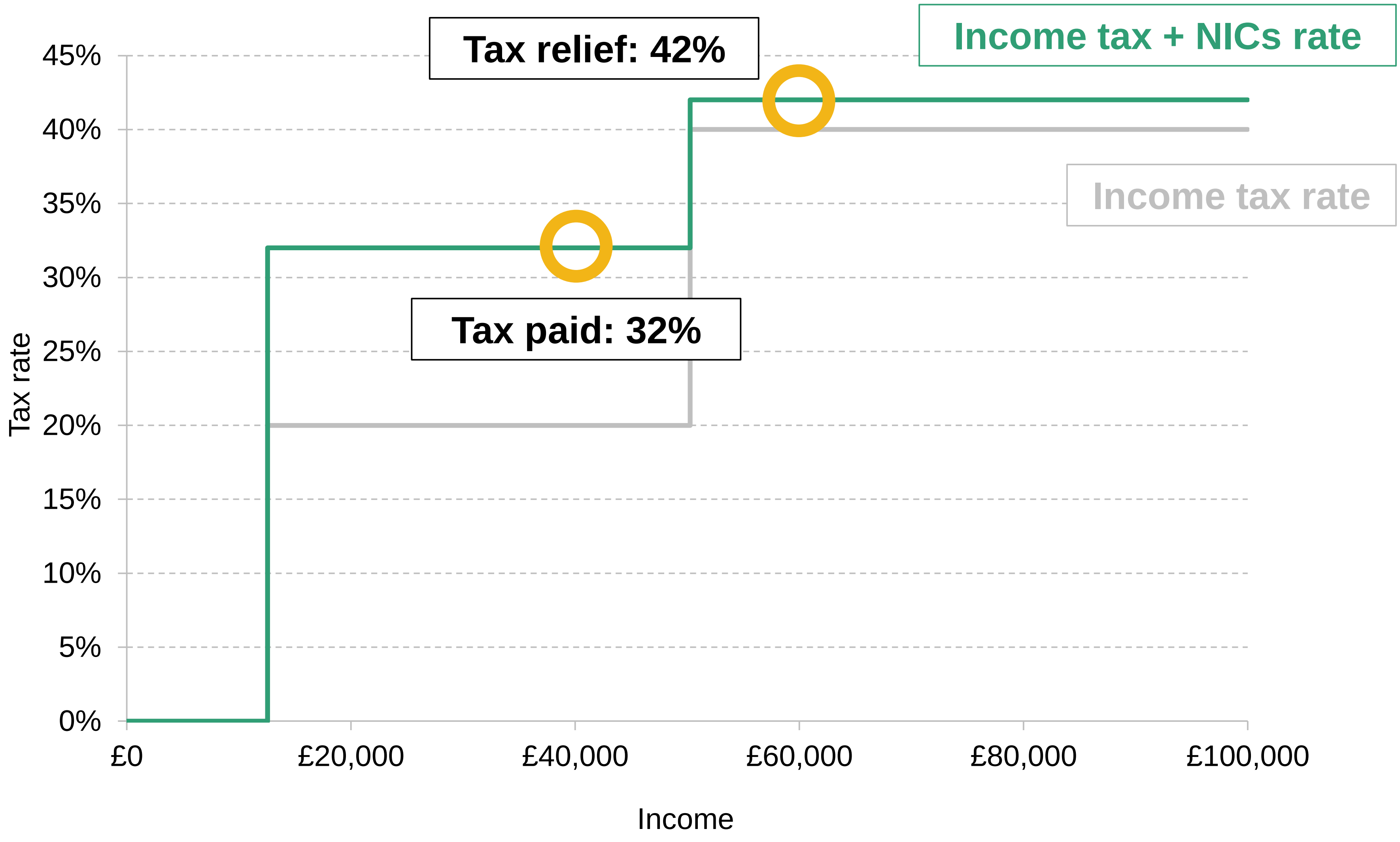


NICs and tax base smoothing

NICs and tax base smoothing



NICs and tax base smoothing



National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs	TEE ↓ EET	EEE ↓ EET
Employer NICs	TEE	EEE

National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs	TEE EET	EEE EET
Employer NICs	TEE	EEE

- Charging employer NICs on withdrawals not an option – employer might no longer exist!

National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs	TEE ↓ EET	EEE ↓ EET
Employer NICs	TEE ↓ TEE (unchanged)	EEE ↓ TEE

National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs	TEE → EET	EEE → EET
Employer NICs	TEE → TEE (unchanged)	EEE → TEE

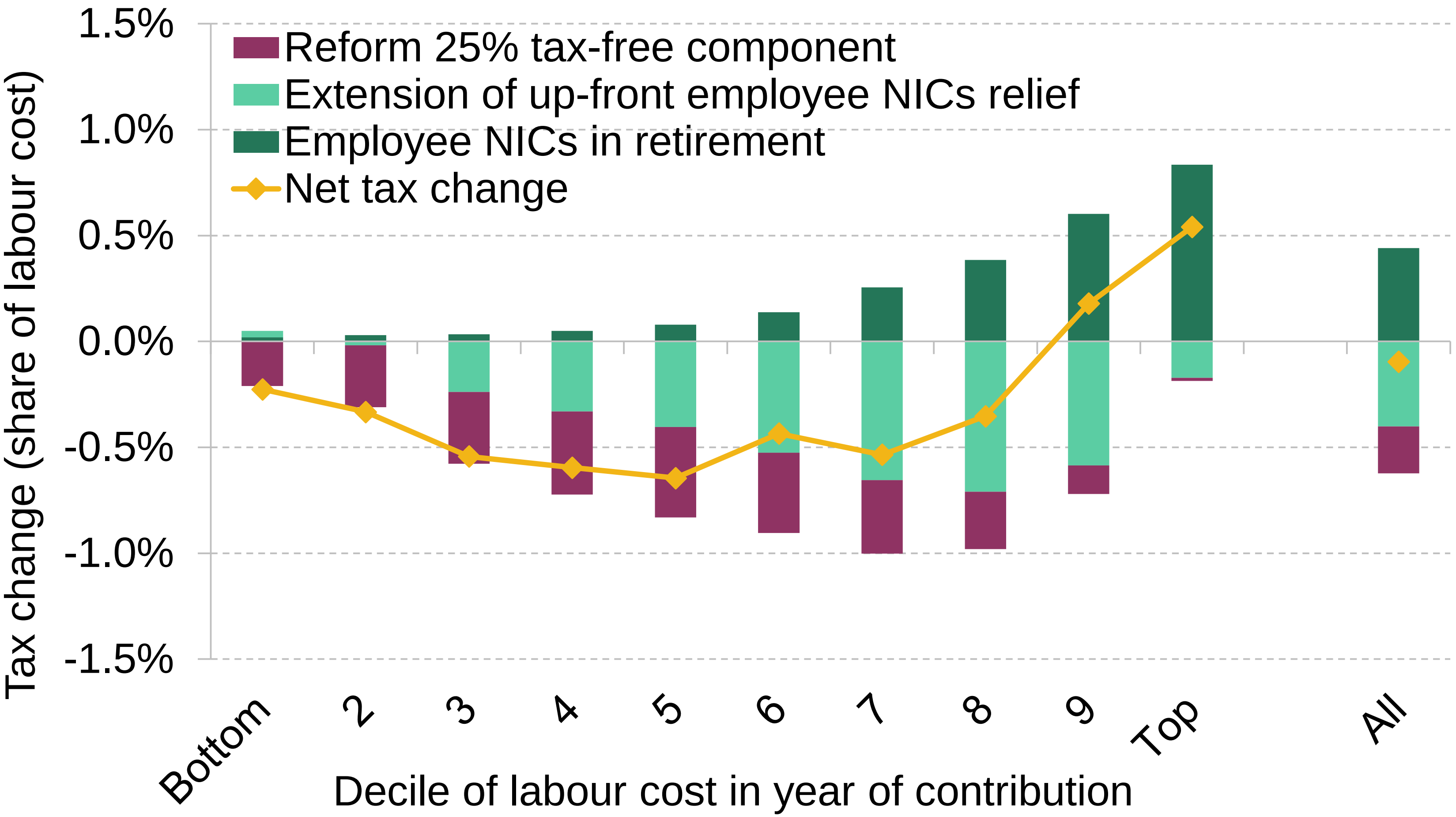
- Proposal would be a big reduction in the pension subsidy for employer contributions

National Insurance

	Employee pension contribution	Employer pension contribution
Employee NICs	TEE → EET	EEE → EET
Employer NICs	TEE → TEE (unchanged)	EEE → TEE

- Could introduce a new subsidy on *all* employer pension contributions
- If set at 13.8% would compensate for employer NICs increase
- Could be adjusted independently to fine-tune incentives

Proposed reform package



Notes and sources: see Figure 7.7.

Taking back control

Our proposals would create three new parameters:

- A uniform top-up rate for the reformed 25% tax-free component
- Cap on reformed tax-free component
- Direct subsidy on employer pension contributions

Allow policymakers to explicitly choose the level of subsidy, relative subsidy for employee/employer contributions, etc.

Taxation at death

Taxation at death

Growth of DC and introduction of pension freedoms has made this issue increasingly urgent.

Two aspects of treatment at death particularly undesirable:

(1) Pensions inherited from someone who dies before 75 are entirely free of income tax

- Dying at 74 rather than 75 can have tax implications for heirs, running into the tens of thousands
- **We recommend ending this anomaly**

Taxation at death

(2) Pensions are exempt from inheritance tax

- Bizarre incentives post-freedoms: more favourably treated as bequest vehicle than as retirement income
- **Pensions should be included in the taxable estate**
- Could use the revenue to increase IHT thresholds or reduce rate

Pension limits

Pension limits

Current limits suffer from several design flaws:

- More generous to DB than DC
- Annual allowance taper for high earners
- Creates uncertainty and complexity

We recommend the following reforms:

- Lifetime allowance should **cap benefits for DB** schemes while **capping contributions for DC** schemes
- The annual allowance **taper should be scrapped**.
- Both allowances (annual and lifetime) **could be made more generous**.

Conclusions

Conclusions

- Current system is full of strange incentives and often too generous to those at little risk of under saving
- Our practical package of reforms would:
  - Even out incentives to save in a pension
  - Allow subsidies to be explicitly determined by policymakers
  - End the bizarre incentives created by tax treatment at death
  - And do so in a way that rationalises the system

The Institute for Fiscal Studies
7 Ridgmount Street
London
WC1E 7AE

www.ifs.org.uk