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Pensions tax and high earning employees

31 March 2023

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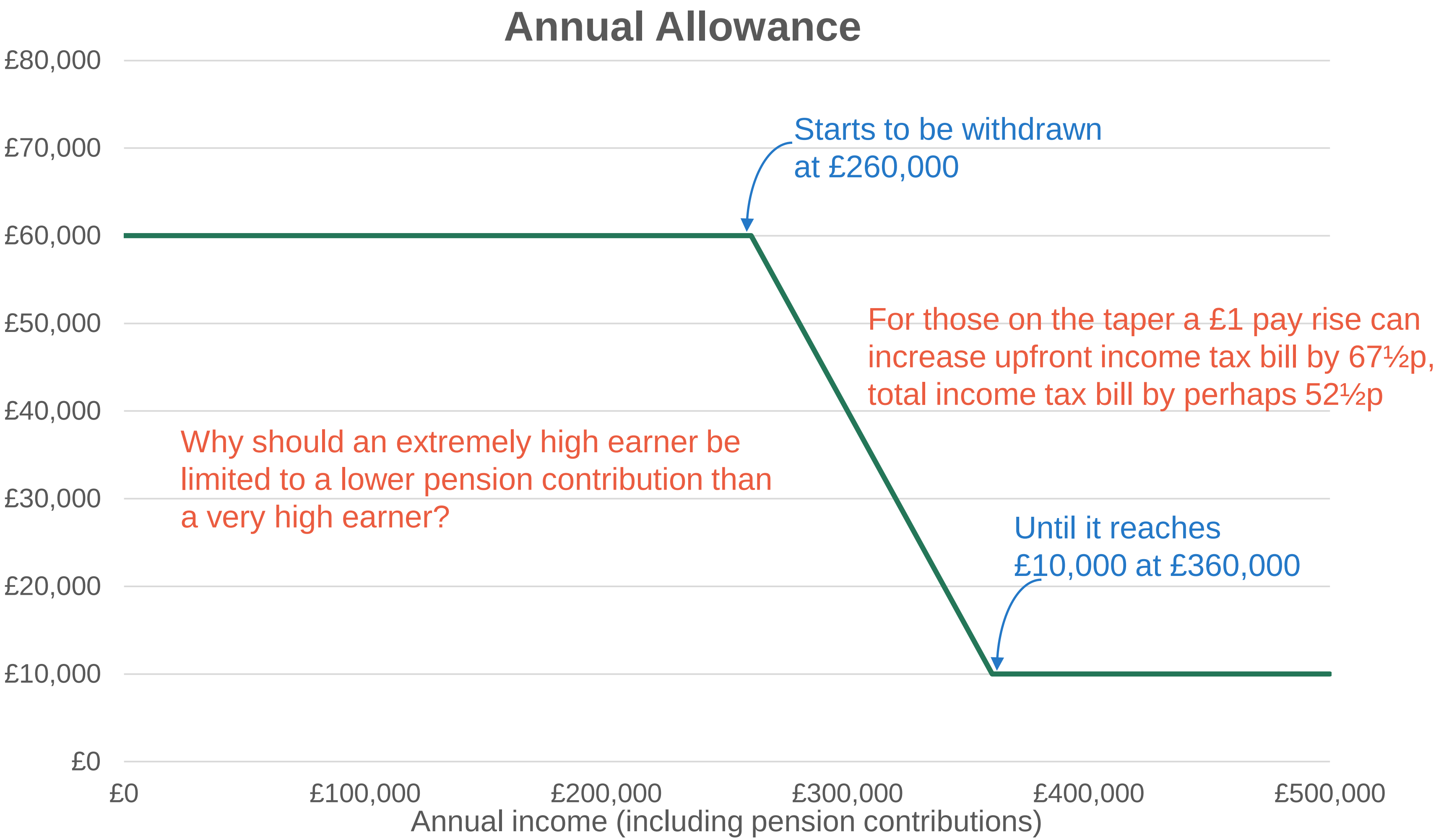
Upfront income tax relief and additional-rate taxpayers

- In 2020–21 £2.3 billion of upfront income tax relief was given at the additional rate
  - 6% of all relief going to 3.5% of pension contributions
  - but their average rate of income tax is 38%, compared to 17% among taxpayers as a whole
- Their pension withdrawals typically taxed more highly than others
- We might think deferred taxation, which allows taxable income to be smoothed, is appropriate
  - reduces the extent to which annual income tax penalises those with variable incomes
- Hard to do anything different with defined benefit arrangements

Where is the system overly generous?

- Income tax
  - 25% of accumulated pension pot, up to 25% of £1,073,000, can be taken free of income tax
  - twice as valuable to higher-rate than basic-rate retirees
- National Insurance contributions
  - employer pension contributions escape NICs entirely
- Treatment of pensions at death
  - no income tax on withdrawals if die before age 75
  - typically pension pots exempt from inheritance tax

… and where is it ungenerous?



Note: Assumes income excluding pensions contributions exceeds £200,000. 52½p assumes higher-rate taxpayer in retirement who is not constrained by cap on the 25% tax-free component and that the rate of return on pension saving is the same as the discount rate.

So what to do?

- Income tax
  - limit on tax-free component sensible, but £268,275 too high
  - for example £100,000 would affect richest fifth; even better if combined with move to a flat-rate top-up on pension withdrawals
- Employee National Insurance contributions
  - move to deferred taxation
  - would hit high earners: 2% upfront relief but would charge 12% on some pension withdrawals
- Tax treatment of pensions at death
  - income tax: apply income tax regardless of age of death
  - inheritance tax: phase in including pensions in taxable estate

Conclusions

- Deferred taxation of remuneration via pensions perfectly reasonable
- Good reasons to have well-targeted subsidies for pension saving

- Don’t provide additional tax subsidies to those with big pension pots
- Don’t treat pensions more favourably as a vehicle for bequests than as a vehicle for retirement income

- Having eliminated unjustified subsidies
  - abolition of lifetime allowance more justified
  - could consider a much more generous annual allowance and certainly get rid of the annual allowance taper