

*LCP on point* 

# *Pension tax relief, the new Chancellor and the 2020 Budget*

February 2020



## Contents

<i>01. Introduction</i>	<i>2</i>
<i>02. Changes to the annual allowance for higher earners</i>	<i>4</i>
<i>03. Addressing the ‘net pay’ issue for lower earners</i>	<i>11</i>
<i>04. Radical structural reform</i>	<i>14</i>
<i>05. What can we expect in Budget 2020 on pension tax relief?</i>	<i>17</i>

# 01 Introduction

*The subject of potential changes to pension tax relief comes up in the run-up to nearly every Budget, and the 2020 Budget has been no exception. Indeed, with a manifesto commitment not to raise headline rates of income tax, VAT or national insurance, a new government looking for extra revenue for priority areas is particularly likely to give serious scrutiny to big ticket tax reliefs.*

The Government's latest estimate<sup>1</sup> for the gross cost of pension tax relief in 2017/18 was £37.2 billion, with a further £16.5 billion in National Insurance relief on employer pension contributions. Even allowing for the £19 billion a year collected in tax on current pensions in payment, the government puts the net cost of pension tax relief at £35.4 billion – a figure once described by former Chancellor Philip Hammond as 'eye-wateringly expensive'<sup>2</sup> Even though today's tax-relieved contributions will turn into tomorrow's taxable pension payments, and with some arguments about the validity of some of the numbers, pension tax relief still has a substantial impact on the exchequer's cash flows which makes it hard for the Treasury to ignore.

But as well as looking at ways of dipping into pension tax relief purely as a revenue-raiser, this year we are likely to see the government bringing forward proposals to tackle some of the anomalies in the existing system. These include issues around limits on pension tax relief for higher earners, especially in the NHS, and issues around lower-paid workers missing out on tax credits where the Conservative manifesto promised 'a comprehensive review to look at how to fix this issue'.<sup>3</sup>

---

*But as well as looking at ways of dipping into pension tax relief purely as a revenue-raiser, this year we are likely to see the government bringing forward proposals to tackle some of the anomalies in the existing systems*

---

In this document we seek to set out the main issues which the Government may look to address around pension tax relief and to explain the main options they may be considering. We start with tax issues for higher earners where the government has given the clearest indication that a Budget announcement is to be expected, not least to deal with serious workforce issues in the NHS. Next, we look at the 'net pay' issue affecting lower earners where, at the very least, we could expect a Budget announcement of a review. Finally, we touch relatively briefly on some of the more radical options for reform which have been floated again in recent weeks. Some of these changes – such as a move to 'flat rate' relief on pension savings – would be so radical that there appears to be virtually no chance of a change that could be implemented for 6<sup>th</sup> April 2020. But it is possible that a new government could decide that there will never be a better time to change things and so the Budget could signal a potential direction of travel.

---

<sup>1</sup> See:

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/833859/Table\\_6\\_Cost\\_of\\_Pension\\_Tax\\_and\\_NICs\\_Relief\\_2012-13\\_to\\_2017-18.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/833859/Table_6_Cost_of_Pension_Tax_and_NICs_Relief_2012-13_to_2017-18.pdf)

<sup>2</sup> <https://www.telegraph.co.uk/politics/2018/10/12/philip-hammond-says-pensions-tax-relief-eye-wateringly-expensive/>

<sup>3</sup> [https://assets-global.website-files.com/5da42e2cae7ebd3f8bde353c5dda924905da587992a064ba\\_Conservative%202019%20Manifesto.pdf](https://assets-global.website-files.com/5da42e2cae7ebd3f8bde353c5dda924905da587992a064ba_Conservative%202019%20Manifesto.pdf)

Assuming that the most that the government could do for a radical change is signal a potential change in a future tax year, the government will have to consider very carefully how people's behaviour might change in the period between the announcement of the plans and their implementation. For example, if it was expected that pension tax relief was going to be cut in 2021/22, this could trigger a big increase in pension saving – and associated loss of Treasury tax revenues – in 2020/21 as people sought to 'max out' on available reliefs. The Treasury would therefore be likely to implement interim measures – known technically as 'anti-forestalling' provisions – to try to prevent this from happening.

It should be noted that there are other issues with the system of pension tax relief which are in need of reform but which are not covered by manifesto commitments, and where we are unlikely to see any Budget changes. These include:

- The Lifetime Allowance (LTA), which provides an upper limit on the value of lifetime pension savings which can be accrued with the benefit of pension tax relief, and currently stands at £1.055m. The LTA (as it applies for defined contribution savings) is often criticised for being a tax on investment outcomes, as those who invest successfully are more likely to exceed the LTA than those who achieve lower returns; repeated reductions in the LTA have also resulted in growing numbers of people who have now opted out of pension saving altogether, partly in order to retain access to historically higher rates of LTA;
- Annual Allowance limits do not work well for the self-employed; for example, someone who is lifetime self-employed might use all their spare cash to build up their business earlier in their working life and then look to make good for a shortfall in pension saving later on once they have built up a successful business; strict annual limits makes this process of 'catching up' very limited;
- The relative treatment of Defined Benefit and Defined Contribution pensions is increasingly seen as unfair; because of the rules around how DB pensions are tested against annual and lifetime allowances, a given level of pension will eat up much more of the AA and the LTA if it is delivered through a Defined Contribution arrangement than through a Defined Benefit arrangement;
- The basic application of the Annual Allowance limits to DB benefits involve some complex calculations that give unintuitive results and that can block reasonable options.

## 02 Changes to the annual allowance for higher earners

*By far the most likely Budget announcement relating to pension tax relief affects the way in which relief is limited for those on higher earnings. Standard annual allowance limits have been substantially cut in recent years and a complex ‘tapered’ limit was introduced in 2016 which has caused further complications. With stories of NHS doctors and consultants cutting back on their hours and responsibilities to avoid large tax bills, the political pressure for action has become irresistible. In this section we briefly outline the problem of the taper aspect before considering what the Chancellor might do about it.*

### What is the problem?

In 2019/20, most individuals are allowed (together with their employer) to save £40,000 into a pension each tax year with the benefit of pension tax relief. In the case of traditional ‘defined benefit’ pensions, the test is not how much was contributed during the year but how much the value of the pension increased in the year. But the basic principle, regardless of the type of pension, is that there is an overall limit on how much pension tax relief an individual can enjoy in any given year. Whilst it is not illegal to save in excess of the annual allowance, any such contributions will attract a tax charge which is designed to claw back the tax relief that has been awarded beyond the annual maximum.<sup>4</sup>

Although £40,000 is a relatively large sum, even at this level some people can find that they have gone over the limit and face a tax bill. A typical example might be someone whose pension is linked to their ‘final salary’ at the end of their working life and who gets a promotion. In such cases all their years of service get the benefit of their enhanced post-promotion salary and the value of their pension wealth can rise by more than £40,000. They have obviously benefited from a better paid job and a larger expected lifetime pension, but they can find they also get a tax bill which they did not expect on money they have not yet received.

The situation is made more complex by the fact that not everyone qualifies for the full £40,000 limit. The main exception of relevance to the Budget is those who are affected by the ‘tapered’ annual allowance.<sup>5</sup>

The rules around this are complex – which is part of the problem – but the gist is that those who have ‘threshold income’ (roughly speaking this is total pay and income before tax, net of the individual’s pension contributions) above £110,000 can see their £40,000 limit reduced on a sliding scale. The amount by which their limit is reduced depends on how far their adjusted income (roughly speaking this is threshold income plus the gross value of pension savings made by or for the individual in the year – which, effectively, boils down to the individual’s income plus the value of pensions savings paid for by their employer) exceeds

<sup>4</sup> Where there are savings above the annual allowance on which no tax relief is awarded, but where the resulting pension is subject to income tax in retirement, this is in effect a form of double taxation.

<sup>5</sup> What follows is a relatively plain English explanation of how the system works, but the precise rules can be found on the gov.uk website at: <https://www.gov.uk/guidance/pension-schemes-work-out-your-tapered-annual-allowance>

£150,000. For every two pounds above £150,000, the annual allowance is reduced by one pound, with a floor of £10,000 for those with adjusted income of £210,000 or more.

As will be apparent from this brief description, there are several problems with this system which the Chancellor may wish to address:

- The system has a 'cliff edge' at £110,000; those with threshold income of exactly £110,000 or less can ignore the tapered annual allowance (i.e. have the full £40,000 allowance) even if their employer-sponsored pension grew dramatically during the year; but for those with just one pound more, the whole system switches on in full; that one pound can mean a lot of extra tax; in extreme cases, people at or around £110,000 can find that their earnings from additional work are more than wiped out by an increased tax bill;
- The calculations are extremely complex which makes it very difficult for people to know where they stand; as set out above, there are two different thresholds at work (£110,000 and £150,000) and two different income definitions (threshold income and adjusted income); the way in which Defined Benefit pension rights are included can make it even harder for people to understand what their tapered annual allowance is and whether or not they have exceeded it;
- Pension schemes/employers will not know enough about the total income (earnings and other) of individual members to know their tapered allowance, and they also will not know if an individual has been making savings in another scheme. So, it is up to the individual to collect the information and do the calculations to see if they are in breach of their tapered allowance in any given year;
- The annual allowance for the current year is determined by income in the current year – which will not be known with certainty until the end of the year, particularly for those with variable or unpredictable incomes (including senior doctors);
- Time lag – because the level of the tapered annual allowance can only be calculated well after the end of the relevant tax year (and information about DB savings in the tax year does not need to be issued to members until the 6 October following the end of the tax year) members may only discover that they have large, unexpected (and, if around that cliff-edge, perhaps avoidable) tax bills many months after the tax year. This in turn can make them very 'risk averse' with respect to taking on discretionary work or responsibilities in the current year.
- The time lag, and other features particular to the tapered annual allowance, may cause problems in members accessing "scheme pays". This is the mechanism by which, when a member identifies that they have a pensions relief (AA) tax charge, they can ask their scheme to pay it in return for a benefit reduction – rather than have to meet the charge out of take home pay.

### Proposed 'solutions' to date

As the political pressure to address this issue has grown, the Government has proposed a number of measures to ameliorate the problem, with particular reference to the impact of annual allowance limits on senior doctors. These have included:

- A simple change to the NHS Pension scheme – under current rules, membership of the NHS pension scheme is broadly speaking an all-or-nothing choice; this is relatively inflexible in a situation where each individual member can have their own individual level of annual allowance; in response to this some doctors have been adopting their own 'DIY' strategy of opting out of the scheme part-way through the year in order to cap their pension growth before opting back in again at the start of the next year; in order to formalise this, the NHS initially proposed offering doctors a single '50-50' option (similar to that offered in other schemes such as the local government pension scheme) whereby doctors could contribute at half the rate and accrue half the pension; this option was quickly rejected both because of the inflexibility and because it meant that doctors would 'lose' the other half of their employer pension contribution and this was therefore in effect a pay cut;

- A menu of options within the NHS Pension scheme<sup>6</sup> – following the negative reaction to its original proposals, the Government then came up with a revised proposal that would allow doctors to choose from a range of reduced contribution levels (starting at 10%, 20%, 30% etc of the full contribution rate); doctors would also be able to review this decision towards the end of the financial year in the light of their actual earnings during that year; and, if the employing trust was willing, get cash in hand in lieu of what the employer would otherwise have paid into the trust. Although this option gave greater flexibility it was still criticised principally on grounds of not resolving the fundamental complexity of the regime;
- A Treasury review – at the same time as the more flexible options on the NHS pension scheme were set out, the Treasury also promised<sup>7</sup> in August 2019 to “review how the tapered annual allowance supports the delivery of public services such as the NHS”. It is possible that the outcome of that review could have been announced in an Autumn 2019 Budget but the calling of the General Election meant that there was no Budget in 2019.
- A one-off patch offer to pay doctors’ pension tax charges for 2019/20 – as concerns grew during 2019/20 about the impact of the pension tax issue on the NHS, a short-term measure was announced<sup>8</sup> during the 2019 General Election campaign; this was to say to doctors that if they incurred a pension tax relief tax charge in respect of 2019/20 this would be ‘made good’; in practice the way this would work in most cases would be that the NHS pension scheme would pay the tax bill via the existing ‘scheme pays’ process, and that the resulting pension deduction in the NHS pension scheme would be made good by the doctor’s local NHS employer in retirement outside the NHS pension scheme (with the government acting as payer of last resort); this (complex to manage) offer was met with some scepticism at the time by Doctors’ leaders, partly because the delivery of the promise could lie potentially decades in the future (at retirement) and partly because of the legal uncertainty as to whether this could constitute tax avoidance<sup>9</sup>;

In its 2019 General Election manifesto the Conservative Party said simply:

---

*‘We also want to make sure that doctors spend as much time as possible treating patients, so we will address the ‘taper problem’ in doctors’ pensions, which causes many to turn down extra shifts for fear of high tax bills. Within our first 30 days, we will hold an urgent review... to solve the problem’. (Source: Conservative Party Manifesto 2019, p10);*

---

<sup>6</sup> <https://www.gov.uk/government/consultations/nhs-pension-scheme-increased-flexibility>

<sup>7</sup> <https://www.gov.uk/government/news/nhs-pensions-for-senior-clinicians-new-changes-announced-to-improve-care>

<sup>8</sup> See <https://www.england.nhs.uk/pensions/>

<sup>9</sup> See [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/847925/matt-hancock-pensions-directions-letter-nov-2019.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/847925/matt-hancock-pensions-directions-letter-nov-2019.pdf)



## What might the Chancellor do?

Given the Conservative manifesto pledge set out above, as well as the Treasury review announced last summer, it is now widely expected that the 2020 Budget will contain substantive measures to address this issue. Despite the government's initial stance, it now seems to be accepted that changes will need to be made for all schemes and perhaps to the system of pension tax relief as a whole, and that any Budget changes are unlikely to be 'NHS-only'.

In this section we consider some of the main options likely to be under consideration<sup>10</sup>. Some of these options could be implemented individually or in combination with each other.

### Option 1. Abolishing the tapered annual allowance

The tapering of the annual allowance was only introduced a few years ago and there is little doubt that it has added greatly to the complexity and unpredictability of an already complex system of pension tax relief. A new Chancellor could make his mark by sweeping away this added complexity by abolishing the tapering of the annual allowance outright. It may be that a bold gesture of this sort is what it would take to restore the confidence of doctors (and others) that they can work their desired hours without risk of large and unpredictable tax bills.

However, the tapered annual allowance was introduced to reduce the cost of pension tax relief especially to the extent that it benefits higher earners. A change which simply increased the tax relief limit of some of the highest earners by up to £30,000 could easily be criticised as unduly favouring the rich and would also cost the Treasury significant sums. When the taper was first introduced it was expected to raise around £4 billion in total over the period 2015/16 to 2019/20, with annual savings of around £1 billion once the measure was fully implemented. But it is worth noting that in October 2016 the Office of Budget Responsibility published a report<sup>11</sup> which described these estimates as having a 'very high uncertainty' rating.

What is known is that in the DC world many employers allow individuals to avoid the whole complexity of the taper by having pensions contributions capped at £10,000 with cash in lieu of what otherwise would have been paid – and so saving the government significant sums in pension tax relief. Assuming that HM Treasury would not want to significantly raise the overall cost of pension tax relief as part of any reform package, it seems likely that the quid pro quo for abolition of the tapered annual allowance might be a reduction in the generosity of another aspect of the system. This might, for example, include an across-the-board reduction in the £40,000 standard annual allowance.

**Advantages:** This would certainly reduce a whole area of complexity. It is possible that anything less than this will fail to lead to a change in behaviour amongst senior doctors who have reacted negatively to suggestions of more incremental changes.

**Disadvantages:** if the quid pro quo was a reduction in the general annual allowance, that means some people not currently affected by a £40,000 limit – including some doctors – would start to face the complexity of the annual allowance and the possibility of tax charges.

---

<sup>10</sup> There are other more detailed options which we do not consider here but which could help to dampen the impact of annual allowance tax charges. In particular, improvements to the mechanisms for cases where the 'scheme pays' the tax bill could help to reduce the pain associated with this issue.

<sup>11</sup>[https://obr.uk/docs/dlm\\_uploads/FSAP-pensions-and-savings-1.pdf](https://obr.uk/docs/dlm_uploads/FSAP-pensions-and-savings-1.pdf) - see Table 2.1



## Option 2. Increasing the thresholds for the tapered annual allowance

When the tapered annual allowance was introduced in April 2016 the thresholds for ‘threshold income’ and ‘adjusted income’ were set at £110,000 and £150,000 and they have remained unchanged since. As nominal incomes have increased over the period this means that more people are being brought into the scope of the tapered annual allowance. In addition, the ability to ‘carry forward’ unused tax allowances from a year when the taper did not exist ran out in 2019/20 and this has undoubtedly contributed to the much greater awareness of this issue during 2019/20.

One idea trailed in the press in the run up to the Budget<sup>12</sup> has been to increase the threshold income to £150,000 (and presumably the threshold for adjusted income to £190,000).

**Advantages:** Substantially raising the income levels at which the tapered annual allowance applies would take many people out of the scope of the taper.

**Disadvantages:** Raising the taper thresholds would not tackle the underlying complexity of the tax regime and would still leave some higher earners at risk. In addition, if the Treasury sought to recover the resultant loss in tax revenue by an across-the-board reduction in the Annual Allowance, this would again result in some people starting to have annual allowance issues for the first time.

## Option 3. Excluding growth in Defined Benefit pension rights from the Annual Allowance calculation

There are a number of criticisms of the way in which the growth in pension rights are tested against the Annual Allowance under current rules. These include:

- **Cash flow problems** – individuals incur a tax bill now in respect of a pension they will not enjoy for many years. Although the option to have the ‘scheme pay’ the tax bill helps with this issue there are various features of the design of ‘scheme pays’ which means that this may not always be a complete mitigation;
- **Is it necessary when there is already a lifetime allowance limit?** – Whereas the purpose of an annual allowance is (presumably) to limit the extent to which individuals ‘max out’ on the potential to benefit from tax relief as they accrue benefits, those who accrue significant amounts of DB benefits have rarely exercised much discretion in terms of their pension saving. They have mostly simply paid into the scheme at the stipulated rate and accrued benefits in line with the rules of the scheme. It could be argued that it is inappropriate to levy a tax penalty on those who build up pension in this way during any given year, especially as they will still be subject to a lifetime cap (the ‘lifetime allowance’) on the size of tax privileged pension saving they can enjoy at retirement;
- **Fair valuation, complexity and timing** – whereas it is relatively straightforward to measure how much an individual and their employer has contributed to a Defined Contribution pension scheme, the HMRC rules on working out the growth in DB rights which is to be tested against the Annual Allowance are much more complex; although pension schemes can supply members with the figures this is sometimes very late in the day and it is hard for individuals to know during the year in question how much of their Annual Allowance they have used up by being a member of their DB scheme;

One response to this would be to exclude DB accruals from the annual allowance calculation and simply rely on the Lifetime Allowance to cap tax relief for those with large DB pensions.<sup>13</sup>

**Advantages:** This would be a clean, bold reform for those still earning benefits in DB schemes. Anything which results in fewer complex calculations has to be a step in the right direction. This would also reduce administration costs for pension schemes. This is the option favoured by the British Medical Association, whilst the Office for Tax Simplification has also expressed its support for this approach.<sup>14</sup>

<sup>12</sup> See, for example: <https://www.ft.com/content/d0175d2e-9ad4-4568-bcd8-1cac231e7f23>

<sup>13</sup> Conversely, in the world of Defined Contributions, the lifetime allowance is seen as an unfair tax measure penalising an individual's good investment decisions – with the annual allowance a much easier and more sensible tax measure.

<sup>14</sup> See, for example: <https://www.gov.uk/government/publications/ots-life-events-review-simplifying-tax-for-individuals>

**Disadvantages:** HMRC might be concerned about the potential for those with DB pensions to obtain a disproportionate amount of pension tax relief by also contributing heavily into DC pensions. For example, someone who had accrued substantial DB rights during a year could still have a further £40,000 of DC pension contributions without being in breach of the Annual Allowance if their DB accrual was simply ignored. It is likely that there would need to be more complex rules such as DB accruals not triggering a tax charge in themselves but being taken into account in assessing whether a tax charge should be paid by those that have also made DC contributions. But this in turn would cause complications for those accruing rights in 'hybrid' pension arrangements where both DB and DC benefits are being built up.

#### Option 4. Allow 'lumpy' DB accruals to be smoothed rather than all counting in a single tax year

One of the situations in which large tax bills can arise is where someone has a sudden surge in the value of their DB pension. This can happen where, for example, someone is building up rights in a final salary arrangement and enjoys a promotion. The whole of their service in the final salary scheme would benefit from the rise to the new salary level, creating a jump in pension rights resulting in a huge value to test against the annual allowance. Although technically this accrual all happened at a single point in time, the benefits of that accrual may not be felt for many years (and will be spread over a long retirement). It might be thought unfair therefore to treat this as generating a large lump sum tax liability in a single year (especially if subsequent years' accruals are well below the maximum allowance allowed).

The system already allows carry-forward of unused Annual Allowance for the past. An additional option mooted by the government in its September 2019 consultation document on changes to the NHS scheme<sup>15</sup>, would be to treat the increased pension as building up over several years. The consultation document puts it like this:

---

*“One-off substantial increases in pensionable pay can create a spike in pension growth and a higher annual allowance tax charge that is not replicated in the subsequent years. The NHS Pension Scheme Advisory Board have suggested that the amount by which the new pay level contributes towards member pensions could be gradually increased over a number of years to smooth such spikes. The Department proposes to consult on the principle of phasing the 'pensionability' of large pay increases for high-earners and invites views on potential ways to give effect to this” (p9).*

---

It should be noted that smoothing of this sort is already offered by some private sector pension schemes in line with their scheme rules. It tends to work well for those who are approaching retirement and experience a large one-off growth in the value of their pension.

**Advantages:** Anything which allows 'lumpy' accruals of pension rights to be smoothed over a number of years could, in principle, be seen as fair and could reduce the number of people who are affected by tax charges. This might be particularly useful in cases where the lumpy accrual arises from a one-off event such as a promotion.

**Disadvantages:** Although smoothing of this sort will reduce potential tax charges in the short-term, it will effectively 'carry forward' some of the accrual into future years where the impact is uncertain. The future pension tax relief system is not known and the level of future accruals (e.g. from further promotions) cannot be known, so it could turn out after the event that the member would have fared better if they had not

---

<sup>15</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/830862/NHSPS\\_flexibility\\_consultation\\_document.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/830862/NHSPS_flexibility_consultation_document.pdf)

smoothed their accrual. This will also create new complexity (especially in a tapered AA world) and an even greater need for doctors and others to seek expert financial advice.

## **CONCLUSION**

We are very likely to see a Budget announcement in this area, given manifesto promises and the need to address staffing issues in the NHS. The Chancellor may prefer incremental and technical changes which are easy to implement. But with the huge suspicion amongst senior doctors (and the BMA) it may be that only a more radical reform will have the desired effect.

## 03 Addressing the ‘net pay’ issue for lower earners

*At the other end of the income spectrum, the Conservative manifesto mentions a second problem area in the pension tax relief system, one that predominantly affects lower earners. This relates to the way in which some lower paid workers may not get the benefit of pension tax credits of up to £65 pa depending on whether their scheme delivers tax relief through the ‘relief at source’ route or the ‘net pay arrangement’. In this section we explain the issue and consider what the government might do to address it.*

### What is the problem?

Where an individual contributes their own money into a personal pension they do so out of their take-home pay. The pension provider then makes a claim for tax relief at the basic rate (currently 20% in England, Wales and Northern Ireland) which is added to the individual’s pension fund. Those who pay tax at higher rates are able to claim further tax relief (as cash in hand) through the tax return process. This method of delivering tax relief is known as ‘Relief at Source’ (RAS) and it is used by personal pension providers and also a small number of occupational pension schemes, notably the National Employment Savings Trust (NEST), a scheme that was partly designed to work for lower paid workers. The basic rate relief is added in respect of all scheme members, including those who are earning below the tax threshold of £12,500 and so did not actually pay any income tax.

The alternative way of delivering tax relief is known as the ‘Net Pay Arrangement’ (NPA). This is the method used by most occupational pension schemes. Under this arrangement, pension contributions are deducted before the individual’s tax liability is calculated. An advantage of this is that it gives taxpayers the immediate benefit of full tax relief at their marginal rate. But the downside is that for those who are non-taxpayers, no tax credit is gained.

So, it costs a non-taxpayer £1 to get £1 in their pension if the scheme uses the NPA, but only 80p if the scheme uses RAS – the remaining 20p is contributed by the Treasury (effectively redistribution from other taxpayers).

---

*“When automatic enrolment was first implemented there was alignment between the income tax threshold and the trigger point for automatic enrolment. This meant that (broadly speaking) most people who were enrolled into workplace pensions were also taxpayers so it made little difference how that tax relief was delivered.”*

---

The advent of automatic enrolment into workplace pensions has brought this issue into sharper focus. When automatic enrolment was first implemented there was alignment between the income tax threshold and the trigger point for automatic enrolment. This meant that (broadly speaking) most people who were enrolled into workplace pensions were also taxpayers so it made little difference how that tax relief was delivered.

However, in 2015/16 the automatic enrolment trigger and the personal tax allowance started to diverge. The AE trigger was frozen at £10,000 whilst the tax threshold was increased to £10,600.<sup>16</sup> Since then the personal tax allowance has continued to rise, currently standing at £12,500, whilst the AE trigger remains at £10,000. This has created a growing band of workers who are paying into a pension (because they earn more than £10,000 and have been automatically enrolled) but are not taxpayers (because they earn less than £12,500). For these workers, if their pension scheme delivers tax relief through the NPA method they will lose out relative to a scheme that uses the RAS method.

The exact number of workers losing out is not known, but in a letter to the Work and Pensions Committee in April 2019<sup>17</sup>, Treasury Minister John Glen said that in 2016/17 there were around 1.33m workers earning below the tax threshold and contributing to a pension using the NPA approach. This number is likely to have risen since then because of the rising gap between the tax threshold and the AE trigger, and also because of the further rollout of automatic enrolment, including the completion of phasing of DC contributions by April 2019. According to HM Treasury the maximum loss per head in 2019/20 for someone paying minimum contributions under automatic enrolment was around £65.

This issue has been raised on a number of occasions, especially as the gap between the tax threshold and the AE trigger has risen, and an industry wide 'net pay action group' has been formed to press for change.<sup>18</sup>

### What might the government do?

The Conservative manifesto mentioned this topic explicitly but did not offer a specific solution. Instead it committed a future Conservative government to launch 'a comprehensive review to look at how to fix this issue'.<sup>19</sup> There are several barriers to reform:

- Fixing the issue in a way which added to people's pension entitlements would require an occupational pension scheme to be able to claim a tax credit on behalf of the right low paid individuals. The amount to claim will vary depending on each individual's income level (from all sources) and this could create considerable complexity. Any 'fix' could therefore be administratively or technically complex; it might not be practical to allocate tax relief to the pension funds of the individuals affected, so they may need to receive cash reimbursement of the amount lost;
- From a government accounting point of view, pension tax relief largely counts as 'negative revenue' (that is, it reduces the reported tax burden on individuals by reducing measured income tax receipts), but compensation for missed tax credits that was delivered as a cash payment would count as public expenditure; the figures quoted earlier suggest that this would be of the order of £100m per year; although it should make no difference whether this is treated as spending or 'negative tax', governments tend to be far more amenable to measures which reduce the reported tax burden rather than those which increase it;
- These workers are, by definition, relatively low paid and many may come within the scope of the means-tested benefit system; if compensation payments increased the disposable income of these workers they could find that some or all of the gain was clawed back through reductions in Universal Credit or other benefits which seriously undermine the cost-effectiveness of the whole exercise;

<sup>16</sup> See: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/484972/review-of-ae-earnings-trigger-2016-2017.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/484972/review-of-ae-earnings-trigger-2016-2017.pdf) for discussion

<sup>17</sup> <https://www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/Letter-from-John-Glen-MP-to-the-Treasury-and-Guy-Opperman-MP-Minister-re-follow-up-of-evidence-session-3-April.pdf>

<sup>18</sup> See for example: <https://www.litrg.org.uk/latest-news/news/191220-net-pay-action-group-press-release-campaigners-urge-government-act-quickly>

<sup>19</sup> The issues are akin to some of the problems the government faces in giving appropriate relief to those in Scotland and Wales (effectively that of identifying individual tax positions) who may be paying a different rate of income tax, and ideally they would be addressed holistically.

- If part of the idea of fixing this problem was to improve the attractiveness of pension saving for low earners, there would ideally be a link between the payment of the pension contribution and the receipt of the tax relief; but in this case it would probably not be possible to identify those who had lost out until well after the end of the relevant tax year, and any compensation payments might then take months to process; although a payment of up to £65 per year would no doubt be welcomed by recipients, the connection between that payment and membership of an occupational pension scheme would be tenuous to say the least.

The Net Pay Action Group has proposed a solution based on existing HMRC ‘real-time information’ on earnings levels. The Group says<sup>20</sup> of its proposals that:

“It requires HMRC to use the data it already collects via PAYE real-time information (RTI) to identify, after the year end, those who have contributed to an NPA scheme and who have not earned enough to obtain taxpayer incentive. HMRC could then provide that sum via the informal P800 process (or those in Self Assessment could claim relief via their return). This would result in the extra money paid into the pension by these low earners being refunded to them, or that refund being offset against a tax liability”.

More details of this proposal can be found at: <https://www.litrq.org.uk/sites/default/files/190509-LITRG-briefing-Net-Pay-Arrangements-lower-paid-workers-FINAL.pdf>

## CONCLUSION

The complexity of this issue, and the limited nature of the Conservative manifesto pledge, suggests that the March 2020 Budget is unlikely to bring forward a solution to this problem. In addition, the government may prefer to defer resolving the issue until it can be fitted into more holistic changes to the tax regime. It is however reasonable to expect more details of the review proposed in the manifesto, and campaigners will be looking for a timeline over which this longstanding concern will be addressed.

---

<sup>20</sup> <https://www.litrq.org.uk/latest-news/news/191220-net-pay-action-group-press-release-campaigners-urge-government-act-quickly>

## 04 Radical structural reform

*The last fundamental reform of pension tax relief was in 2006 in a set of changes generally referred to as ‘pension simplification’. Since then, however, there have been a series of piecemeal changes which are largely regarded as having moved away from simplification. Far more people are now affected by lifetime and annual allowances than was originally envisaged and a number of new complications (such as the money purchase annual allowance and the tapered annual allowance) have been introduced, as well as flexibilities changing the landscape. For reasons of complexity alone, a more fundamental review beyond the narrow issues discussed so far in this paper might be welcomed.*

### A single ‘flat rate’ of tax relief

A more fundamental case which is often advanced for structural reform of pension tax relief is the extent to which the bulk of the relief goes to the highest earners. Higher earners tend, not surprisingly, to put more money in to pensions than their lower-earning counterparts, and they benefit from tax relief at their (higher) marginal rate of tax. Although tax relief is to some extent only a matter of tax deferral rather than outright subsidy, there are several respects in which the current system is more generous than this:

- In most cases, up to 25% of any pension pot can be taken as tax-free cash at retirement; those who are higher rate/additional rate tax payers and those able to put more money in to their pensions get proportionately more benefit from this subsidy;
- Although individuals get tax relief at their marginal rate, and pay tax in retirement on their pension income, it is quite common to pay a higher marginal rate of tax in work than in retirement; for example, an individual could receive tax relief at 40% (if they earn more than £50,000 pa) or 45% on contributions made whilst in work but pay tax only at 20% on their pension in retirement, or might receive basic rate relief on contributions when in work but be a non-taxpayer in retirement;
- Employer contributions into pensions are not subject to National Insurance contributions;

As well as the distributional impact of pension tax relief, the overall cost of the relief, at least in terms of short-term government revenues, has often led it to be a potential target for reform. The most recent example of this was in the summer of 2015 when the former Chancellor, George Osborne, launched a consultation on possible changes including replacing the current system of tax relief with an ‘ISA-style’ treatment where contributions go into pensions out of post-tax income (with an explicit incentive added, to compensate for locking up savings) but where pensions are then tax free in retirement. This proposal met with a range of objections and was eventually dropped.

Against this backdrop, one reform option which is regularly canvassed, and which has attracted support from political parties and industry groups such as the Association of British Insurers, is the suggestion of a so-called ‘flat rate’ of tax relief of say 30% (while continuing with the model of the outcome pension being taxed



at retirement with a tax free element). Indeed, such a proposal (albeit with a much lower flat rate of 20%) has recently been floated in the media with the suggestion that this could feature in the forthcoming Budget.

In this section we set out some of the problems which such a proposal could make and why we think it unlikely that a firm commitment to implement flat rate relief is on the cards.

### Why not give everyone tax relief at the same rate?

On the face of it, giving tax relief to all savers at the same rate would have much to commend it. Those who are currently saving modest amounts arguably need the most help to build up a decent pension pot and a higher rate of tax relief would help them to do so more quickly. Whilst this would entail less tax relief for higher earners many will still enjoy good wages now and have good pension prospects for the future. However, there are a number of political and practical problems with this idea:

- Large losses for millions of people – latest HMRC statistics<sup>21</sup> suggest that well over four million people are paying tax at the higher or additional rate (entry points currently at c£50,000 and £150,000 of earnings in most of the UK), and the large majority of these will be making contributions into a pension or having employer-sponsored pension provision made for them; for someone with gross pension contributions of £40,000, basic rate relief is worth £8,000 and a further £8,000 could be claimed in tax relief by a 40% rate payer; this latter figure would be lost if all tax relief was standardised at 20%; even if a standard rate of relief of (say) 30% was applied, the losses for higher earners could easily run into thousands of pounds; however, those who previously benefited from relief at the 20% rate would gain from a new (higher) uniform rate of relief; gainers would include most of the ten million people who have recently been enrolled into workplace pensions under the ‘automatic enrolment’ programme, most of whom pay income tax at the basic rate;
- Disconnecting the higher earners from pension savings - for some individuals the change could mean that saving for pensions was no longer tax advantaged; for example, consider the case of someone who paid tax at the 40% rate whilst in work and expected to do so in retirement, and suppose there was a flat rate of relief 30%; on putting money in to a pension, and locking it up until at least age 55, they would get relief at 30%; on taking money out they would pay no tax on the first quarter (the ‘tax free lump sum’) and 40% tax on the remainder, giving a weighted average of 30%; getting relief at 30% only to pay tax at 30%, and losing access to the cash in the meantime may not represent much of an incentive to save via a pension compared with other tax-privileged forms of investment;
- Complexity with Defined Benefit pensions<sup>22</sup> – there are various ways in which moving away from tax relief at the individual’s marginal rate would cause huge complexity for members of DB schemes, including millions of workers in ‘unfunded’ public sector schemes.
- It is unclear from what has been said so far how exactly a restriction to 20% (or some other flat rate) would work in practice; the rumoured revenue savings of £10 billion from a 20% flat rate would imply a tax charge on higher rate taxpayers to claw back the higher tax relief not only on their personal contribution to the pension but also to clawback deemed tax relief on the employer contribution; valuing the employer contribution to tax would be complex and hard for members to understand;
- Tax has to be paid in respect of a pension which may not be drawn for many years; this is currently (for Annual Allowance charges) dealt with by the ‘scheme pays’ process where the pension scheme pays the tax bill and then reduces member pensions at retirement through an often rather complex mechanism; if large numbers of higher rate taxpayers faced tax charges and had to rely on ‘scheme pays’, this would considerably increase the complexity of pension scheme administration; to the extent that these were unfunded public sector schemes it would also do little for the public sector’s short-term cash flow, as one arm of government (e.g the NHS) would effectively be funding the ‘scheme pays’ tax bills back to the Treasury, with any savings not coming until years later (in the form of lower public sector pension payments.) Parallel issues apply if (e.g with a 30% relief) a credit needed to be granted to some;

<sup>21</sup> <https://www.gov.uk/government/statistics/number-of-individual-income-taxpayers-by-marginal-rate-gender-and-age>

<sup>22</sup> A fuller account of the complexities of combining flat rate relief with DB pensions was produced by the Association of Consulting Actuaries in 2015 and can be found at: <https://aca.org.uk/aca-responds-to-pension-tax-consultation/>

## Possible packages of reform

Simply abolishing higher rate relief in isolation would lead to millions of people potentially losing thousands of pounds a year. Implementing such a change in isolation therefore seems unlikely. But it might be possible to implement a more radical package of reform that might be more politically appealing:

- Exclude Defined Benefit accruals from the Annual Allowance limit, as requested by the British Medical Association, relying on the lifetime limit to cap tax relief on larger DB pensions;
- Exclude Defined Contribution pensions from the Lifetime Allowance limit, thereby improving the relative attractiveness of saving in a DC arrangement;
- Abolish the tapered annual allowance;
- Apply a standard rate of tax relief to Defined Contribution saving, between the current basic rate of 20% and higher rate of 40%;
- Make adjustments to income tax rates and bands to reduce the maximum losses suffered by those who currently enjoy higher rate relief;

This package would address the pressing issues of the tapered annual allowance for higher earners and create millions of gainers amongst those on lower incomes, particularly benefiting many of those who have recently been automatically enrolled into such pensions for the first time, whilst at the same time providing some mitigation for those that would otherwise be hit hardest.

Some of these measures would greatly simplify the system, though others would bring in new complications. One issue that would need to be addressed would be that many older workers have past DB rights but are now building up DC pensions. If DC pensions were now excluded from the Lifetime Allowance this could create a tax windfall for this group. As is so often the case, pension reform would be much easier starting with a blank sheet of paper rather than having to deal with the complex and diverse history of individuals' accrued pension rights.

## CONCLUSION

The big attraction to the Government is, of course, the large price tag attached to the current system of pension tax relief. But the above issues help to explain why having a single rate of tax relief, though often discussed, has not so far been implemented. It may be that a new government with a sizeable majority is more able than most to consider a big shake-up of this sort. But there would be formidable political and practical problems facing any Chancellor who decided to down this route.

## 05 What can we expect in Budget 2020 on pension tax relief?

*Although recent Budgets have generally had little to say on the subject of pension tax, there are strong reasons to think that Budget 2020 will be an exception. The Conservative manifesto raised two specific areas of concern around pension tax, whilst the overall fiscal position means that larger scale reform may be considered given the large and growing cost of the pension tax relief system as a whole.*

Our view is that:

- The most likely announcement is action to address the problems faced by higher earners – notably but not exclusively in the NHS – arising from the annual allowance and the tapered annual allowance for pension tax relief. Recent history suggests that the Treasury’s instinct tends to be to tinker with rates and thresholds rather than adopt more fundamental changes. A simple adjustment to the thresholds for the tapered annual allowance cannot therefore be ruled out. But a more sweeping change which removed the taper altogether would be a welcome simplification. This could be accompanied by other changes, including reviewing the appropriateness of counting DB pension accruals against the annual allowance.
- A review of the problems caused for low paid workers by the two different methods of delivering tax relief is likely to be announced; but any solution could be complex and relatively costly unless part of wider reform.
- Immediate structural reform such as the introduction of flat rate relief would be very difficult in the short-term, not least because of the list of practical obstacles which we have set out; but it is possible that a newly elected government, emboldened by a large Parliamentary majority, might seek to ‘test the waters’ for reform by launching a consultation on wider changes to the system.<sup>23</sup> Given that we expect 2020 to be a year of two Budgets (one in the Spring and a second one reverting to the regular pattern of Autumn budgets), one possibility would be an announcement in the Spring of plans to consult on major reforms with a final decision taken in the Autumn budget with a view to implementation in 2021/22. However, the practical difficulties of implementing major changes in terms of HMRC systems, pension scheme administration etc. should not be under-estimated. A final decision taken in November/December 2020 might simply not leave enough time for implementation a few months later at the start of the next tax year.

<sup>23</sup> As noted earlier, if the possibility of major changes to pension tax relief was mooted in this year’s Budget, it might be necessary to introduce what are known as ‘anti-forestalling’ measures; these are temporary arrangements to prevent people changing their behaviour to maximise pension tax relief before any more complex long-term cuts were implemented; without such measures, the Treasury could suffer a significant drop in short-term revenues.

## Contact us

If you would like more information please contact your usual LCP adviser or one of our specialists below.



*Steve Webb,  
Partner*

**+44 07875494184**  
**steve.webb@lcp.uk.com**



*Alasdair Mayes,  
Partner*

**+44(0)1962 872725**  
**alasdair.mayes@lcp.uk.com**

*At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in pensions, investment, insurance, energy and financial wellbeing.*

Lane Clark & Peacock LLP  
London, UK  
Tel: +44 (0)20 7439 2266  
enquiries@lcp.uk.com

Lane Clark & Peacock LLP  
Winchester, UK  
Tel: +44 (0)1962 870060  
enquiries@lcp.uk.com

Lane Clark & Peacock Ireland Limited  
Dublin, Ireland  
Tel: +353 (0)1 614 43 93  
enquiries@lcpireland.com

Lane Clark & Peacock Netherlands  
B.V. (operating under licence)  
Utrecht, Netherlands  
Tel: +31 (0)30 256 76 30  
info@lcpnl.com

All rights to this document are reserved to Lane Clark & Peacock LLP. We accept no liability to anyone to whom this document has been provided (with or without our consent). Nothing in this document constitutes advice. The contents of this document and any questionnaires or supporting material provided as part of this tender submission are confidential.

Lane Clark & Peacock LLP is a limited liability partnership registered in England and Wales with registered number OC301436. All partners are members of Lane Clark & Peacock LLP. A list of members' names is available for inspection at 95 Wigmore Street, London W1U 1DQ, the firm's principal place of business and registered office. The firm is regulated by the Institute and Faculty of Actuaries in respect of a range of investment business activities. The firm is not authorised under the Financial Services and Markets Act 2000 but we are able in certain circumstances to offer a limited range of investment services to clients because we are licensed by the Institute and Faculty of Actuaries. We can provide these investment services if they are an incidental part of the professional services we have been engaged to provide.