3º SEMINÁRIO INTERNACIONAL DE
PREVIDÊNCIA COMPLEMENTAR

Principles for pension taxation

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Realização: SPREV Secretaria de Previdência

Patrocínio: ABRAPP

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Presentation structure

Pension taxation UK

- UK taxation
- UK reforms
- International perspective

Principles for pension taxation

- General principles of taxation
- PLSA principles for pension tax reform

A more progressive approach?

- Flat rate of tax relief
- Impact on savers
- Implications for schemes and employers

Pension taxation – UK

UK private pension taxation takes the form of EET

- saver’s own contributions are exempt from income tax but not national insurance
- employer’s contributions are not a taxable benefit for the saver and are exempt from income and corporation tax and national insurance
- investment returns are (mainly) exempt from tax within the fund
- 75% of payments in retirement are subject to income tax (since 1947)
- some tax relief available to beneficiaries on death before age 75

Employed and self-employed receive same relief on contributions

The main ‘incentive to save’ comes from the 25% tax free payments in retirement

Incentive and pension taxation in general not widely understood

However, general perception that saving for retirement is ‘a good thing’

Automatic enrolment has significantly increased the number and proportion of workers with pension savings, although many of lowest earners still excluded

Pension taxation – UK current limits

Nominal limits for tax-free contributions (since 2006)

- if no earned income, can contribute £2,880 and receive 'tax rebate' on contribution boosting to £3,600
- low earners can also get 'tax rebate' on own contributions even if not paying tax (recently extended to all schemes)
- for those with earned income, limit is £40,000 pa or 100% earned income if lower (3 years' carry forward)
- limit tapers for highest earners who earn in excess of £200,000 to £4,000 pa (since 2016)
- once taking benefits from pension, contribution limit set at £4,000 to minimise recycling
- contributions in excess of limits subject to tax charge
- very few savers affected by contribution limits– less than 1% of earners affected by taper, less than 15% earn in excess of £40,000

Further limit on total fund that can be accumulated

- lifetime allowance of £1.073 million, frozen until 2026
- once value of all pensions exceeds this amount, subject to 55% tax charge on lump sum withdrawals
- lifetime allowance has led to many high earners ceasing to be active members of pension schemes towards end of career
- 1.25 million people currently estimated to exceed lifetime allowance by retirement (3% of working age population)

Maximum tax free pension contributions

Pension taxation – UK reforms

Current basis for tax relief dates back to 2006 (A-day)

- Before A-Day, different rules applied to different types of pensions
- Contribution limits were % of earnings for many pensions with no lifetime limits

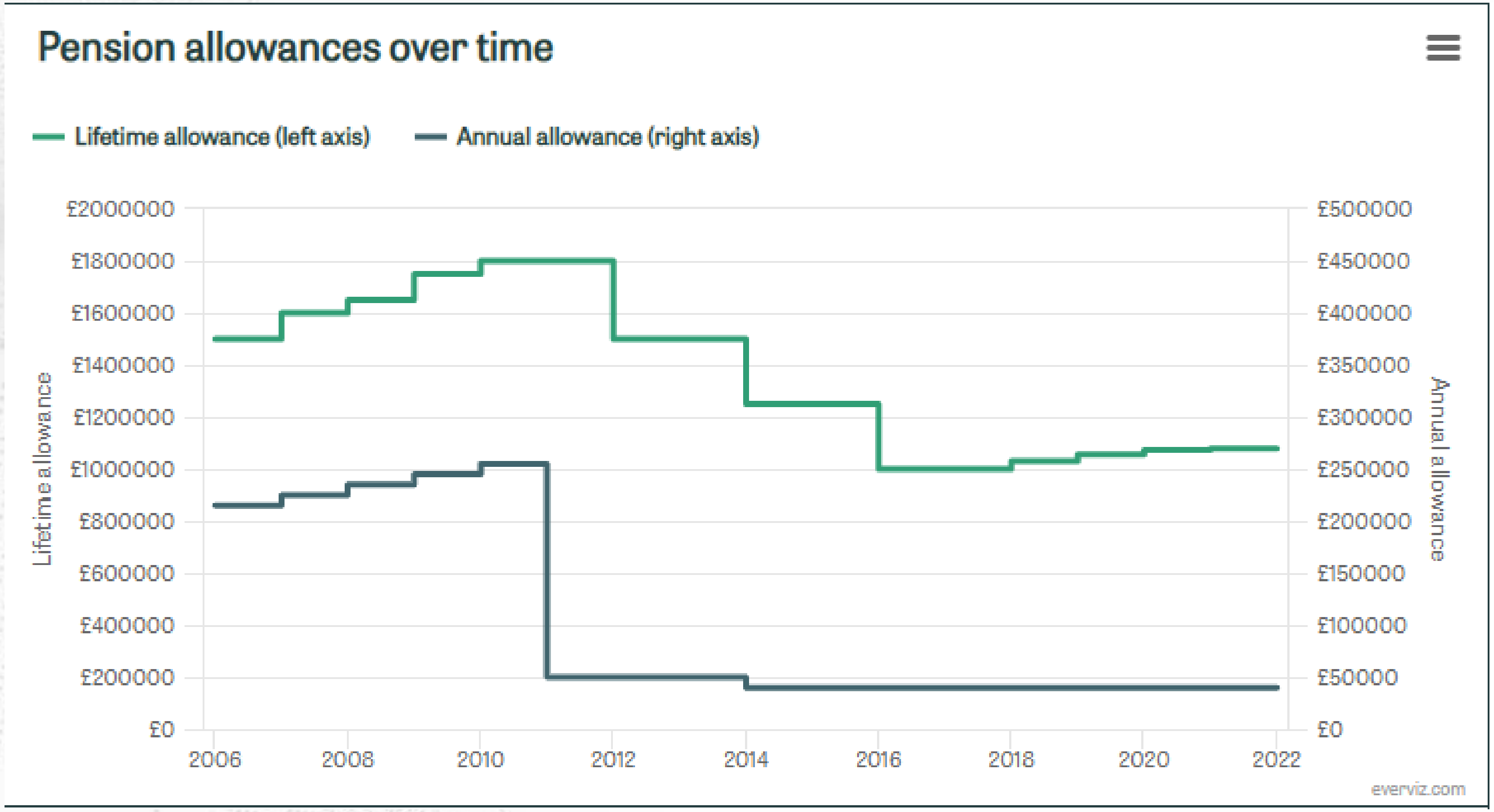
Drivers of change included desire to simplify regime and cap ‘costs’

Original A-day limits were extremely generous

- £215,000 contribution limit
- £1.8m lifetime allowance

Limits have gradually become more progressive but driven largely by desire to limit the cost of tax relief / increase tax revenues

Allowances have fallen over time



Source: IFS TaxLab

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Principles of tax relief / reforms

OECD principles of taxation

- Neutrality: same tax relief is available to all workers in all types of scheme
- Efficiency: EET works well with the existing income tax and payroll systems
- Certainty and simplicity: EET as applied in the UK is neither
- Effectiveness and fairness: EET taxes when income is hands of the saver and avoids double taxation
- Flexibility: Government has been able to flex the system, for example by varying the annual and lifetime allowances
- Equity: main challenge for EET is that it benefits higher earners more than lower earners

PLSA principles for pension tax reform

- **Promotes adequacy:** provides financial support and incentivises saving for retirement
- **Easier to understand**: 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 not require repeated change and so builds confidence in long-term saving

A more progressive approach?

Long running debates about pension tax relief in the UK

- Perceived 'unfairness' or lack of equity in current system
- Current system does not incentivise savings
- Some argue that current system is fair as it smooths taxation over lifetime

Suggestions for change include:

- Changing to a TEE system (possibly with a system of tax credits)
- Limiting the tax free cash to a nominal amount
- Applying different rules for DB and DC
- Limiting tax relief to basic rate tax (flat rate relief)

All reforms come with degree of cost, complexity and uncertainty

- TEE would remove the incentive to lock money away until retirement
- Limiting the tax free cash would add considerable complexity and reduce attractiveness of pensions
- Different regimes for DB and DC would be perceived widely as unfair / inequitable
- Flat rate relief only would be complex for schemes and employers and would result in some double taxation

PLSA analysis of reforms

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	✗	✗	-	✓	✓
Removing NI relief on the Employer Contribution	✗	✗	-	✓	✓
Capping the tax free lump sum at £75k (retrospectively)	-	✗	✗	✓	-
Splitting DB and DC regime	✓	-	✗	✗	✗
Single Rate at 20%	✗	✗	-	✗	✓
TEE	✗	✗	-	✗	✗

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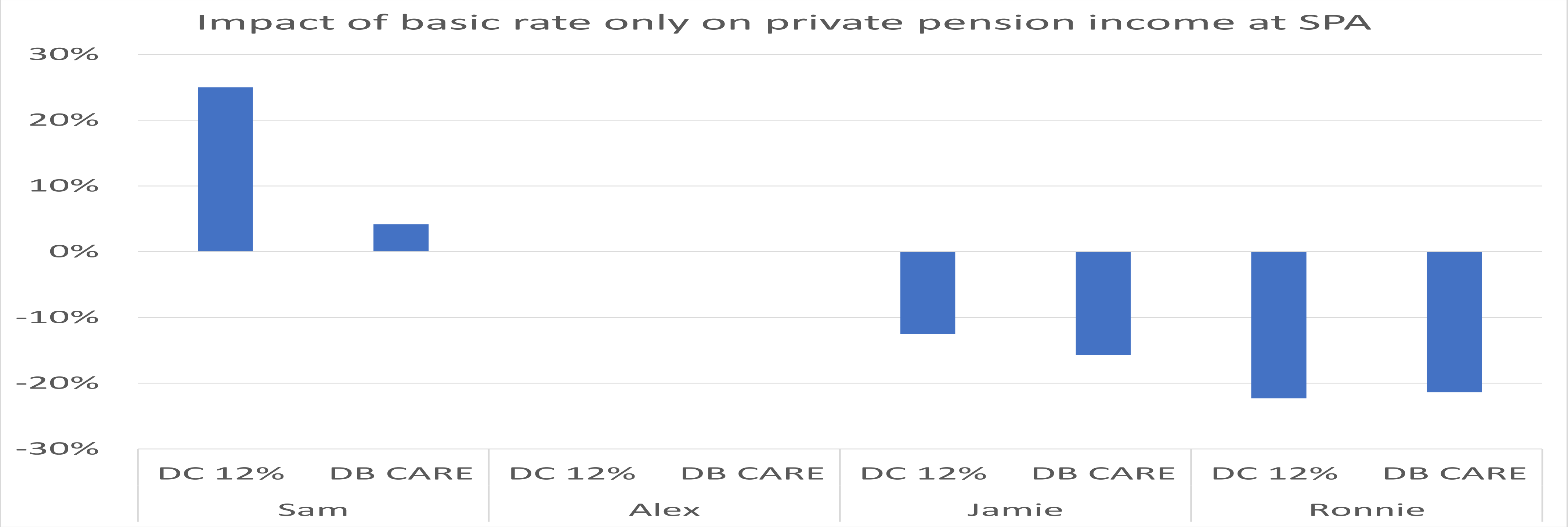
Flat rate relief: impact on savers

- Moving to flat rate tax relief creates winners and losers
- Clearest winners are non-taxpayer savers who benefit from a boost to their pension contributions
- Clearest losers are those who are higher rate taxpayers
- Those close to the higher rate or sometimes higher rate may also lose out



Source: PLSA analysis of PPI modelling

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Flat rate relief: Implications for schemes and employers

For schemes:

- Significant changes to systems to accommodate change
- More complex and frequent calculations for higher earners in DB schemes
- Potential loss of higher earners (and contributions) in scheme

For employers:

- Changes to payroll systems
- More complex communications with staff
- Staff discontent (particularly among higher earners in public sector)

Summary

UK system of pension tax relief is claimed by some to be regressive

However, several mitigations in place:

- Non-earners and lowest earners can attract 'tax relief' in spite of not paying tax (EET made to work)
- Contribution limits severely capped for highest earners
- Lifetime allowance limits can affect moderate to highest earners
- Automatic-enrolment has enabled many more lower earners to benefit from tax relief

Change is possible but would bring:

- significant costs for employers and pension schemes
- significant costs for some members of pension schemes
- potential for claims of intergenerational unfairness
- potential behavioural change which could affect pension adequacy in later life

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Thanks!

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