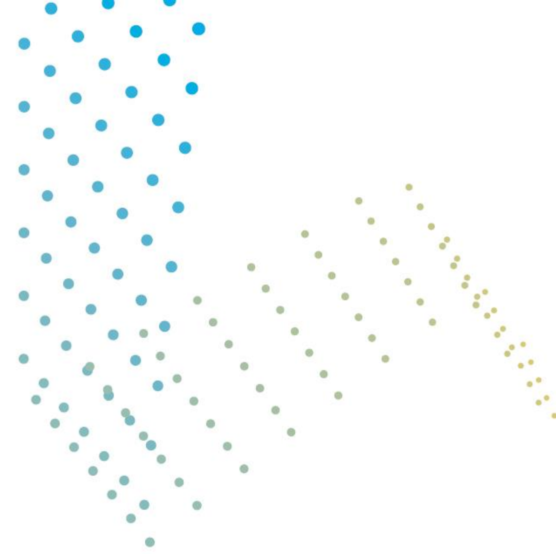
HYMANS ROBERTSON



# Pre-Budget pensions speculations

October 2024

**Old rope, tired tropes, or broken clocks?**

It often seems that the same pensions rumours are dusted off in the run-up to a Budget: the Chancellor of the Exchequer is ruminating on radical changes to taxation; allowances could be slashed; and, of course (a perennial favourite) the end of the tax-free lump sum. This time around, however, those familiar lines have been delivered in front of a backdrop painted by the Chancellor, emphasising '*the worst set of circumstances since the Second World War*', and steeling us to expect '*tough decisions*' and '*difficult choices*'.[1]

OK, she also reiterated Labour's manifesto promise of '*no increases in National Insurance, and the basic, higher, or additional rates of Income Tax'*, but it doesn't take a particularly close examination to realise that those words leave her with considerable wiggle room (the cynical might add, 'especially for a politician').

Moreover, a succession of think tanks, policy wonks and other commentators have been recommending reforms that look a lot like the gossip of the past.

None of us want wants to be the boy who cried 'Wolf!', but neither do we wish to be the ones caught sitting with our slippers on in front of the fire when the carnivorous canid bursts through the door. And you know what they say about broken clocks…

## Contributions tax relief

### Background

The current approach to pension taxation in the UK is described as Exempt, Exempt, Taxed (EET). Within certain annual limits pension contributions receive full tax (and some NIC) relief, investment growth is also tax exempt, but pensions in payment are treated as income and taxed at an individual's marginal rate. The total cost of pension income tax relief in the UK in 2022-23 was £46.8bn, with a further £23.8bn of NIC relief.[2]

In the same year, the total tax revenue from income tax on pensions in payment and annual and lifetime allowance charges was c. £22 bn. A net cost of £48.7bn.

In reality, looking at simple monetary amounts doesn't give the full picture because income tax on pensions is received by the Treasury many years after the tax relief was initially granted.
In one view, the current system also heavily favours higher earners. For example, in 2022-23, basic-rate taxpayers made up just under 82% of all taxpayers and received approximately 37% of the available relief.

[1] *Chancellor Rachel Reeves is taking immediate action to fix the foundations of our economy* (8 July 2024) <www.gov.uk/government/speeches/chancellor-rachel-reeves-is-taking-immediate-action-to-fix-the-foundations-of-our-economy>.

[2] *Private pension statistics commentary: July 2024*, HMRC (31 August 2024) <www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary>.

Higher-rate taxpayers, who represented less than 16% of the total, received around 56% of the relief. Meanwhile, the 1.6% of additional rate taxpayers received around 7%.[3] However, the Institute for Fiscal Studies points out that higher and additional-rate taxpayers also contribute 73% of all income tax on the other side of the coin, so their current cut of contributions relief is already considerably lower than the proportion of the overall tax take for which they're responsible.

At the very least, it's easy to imagine a government constructing a narrative supporting changes to pension tax relief.

### Pension tax relief at a flat rate

One often-discussed proposal would be to limit tax relief to a single rate, for example the basic income tax rate of 20%. One approach to this would be to focus solely on the tax relief given to pension contributions.

For schemes where tax relief is given through the relief at source approach, this change would be straightforward to administer. As is the case now, contributions would be paid after tax and the scheme would claim tax relief at the relevant basic rate. The difference would be that, unlike now, higher and additional-rate taxpayers would not be able to reclaim relief above the basic rate through self-assessment.

Under net pay arrangements contributions are taken before assessment for tax, meaning relief is automatically applied at the marginal rate. There's no easy way to adapt this to flat-rate relief, so it's generally assumed that it would require a switch to relief at source. That would bring upheaval and additional administration burdens for the trustees and sponsors of almost every occupational pension scheme.

Either way, a switch to flat-rate relief would require changes to payroll systems and accounting procedures.

### Advantages

There is an obvious appeal to government. Restricting tax relief to 20% across the board could, on the face of it, raise around £15bn[4], assuming that there are no behavioural changes as a result.

Government may also be drawn to the redistributive nature of the change as it addresses the unequal nature of the current approach and ultimately would have no impact on the 82% of basic rate taxpayers.

Moving to a basic-rate-relief approach would also remove much of the justification for the annual allowance. This is an annual limit on tax-free pension growth, currently set at £60,000. It's designed to address some of the issues around fairness and limit the cost of pensions tax relief. The annual allowance process is a cumbersome and administratively burdensome one, especially for defined benefit schemes.

In 2022/23, tax raised from the annual allowance was £300 million, which suggests a move to basic-rate tax relief would give plenty of scope to scrap it.

The government could also explore applying tax relief at a single rate other than the basic income tax rate. For example, relief at 30% would be more strongly redistributive and could improve retirement outcomes for lower earners.

---

[3] *Income Tax liabilities statistics: tax year 2020 to 2021 to tax year 2023 to 2024*, HMRC (29 June 2024) <www.gov.uk/government/statistics/income-tax-liabilities-statistics-tax-year-2020-to-2021-to-tax-year-2023-to-2024/summary-statistics>.

[4] *Options for increasing taxes*, Institute for Fiscal Studies (21 September 2024) <https://ifs.org.uk/articles/options-increasing-taxes>.

### Disadvantages

As with any change to taxation there will be a change in incentives and disincentives for different groups. A move to basic-rate tax relief would have no impact on the majority of those saving for retirement but the impact on higher and additional-rate taxpayers would be significant and could result in double taxation, ie tax on contributions and on pensions in payment.

The previous government removed the Lifetime Allowance (LTA) because it argued that it was a disincentive to higher earners and that its removal would '*encourage inactive individuals to return to work, in particular those aged 50 and above.*'[5] In 2022/23, only 13,080 LTA charges were reported, a drop in the ocean compared to the number who will be impacted by the removal of higher and additional-rate tax relief. To what extent would an increase in the tax bills of 18% of the workforce act to disincentivise saving and change behaviours? In particular, the Government will be concerned by any measure that would cause senior NHS staff to leave the workforce.

A big problem of this approach is the difficulty in applying fairness between members of DB and DC schemes. Because the increase in value of a DB scheme is not directly linked to the value of contributions paid, in the way it is in a DC scheme, some form of deemed contribution for DB schemes would be required. Trying to measure the deemed contribution fairly would likely lead to more complexity and more disincentives to save.

In order to prevent people circumventing any changes to the tax regime, we can expect any changes to the tax regime to be accompanied by anti-forestalling measures. This would be some form of restriction on pension contribution tax relief effective immediately and designed to prevent a reduction to the increased tax revenue expected by the Treasury.

## Move to Taxed – Exempt – Exempt

Under this approach the current EET approach becomes TEE. There is no tax relief on pension contributions, pensions grow tax-free and all retirement savings can be drawn tax-free.

### Advantages

The appeal to the government of this approach is that the tax take comes potentially many years before the relief is granted. There will also be many workers whose contributions are taxed at 40% while in work but who retire on pensions that would otherwise only be taxed at 20% or not at all.

### Disadvantages

The big disadvantage here is one of extreme complexity. Pension savings already accrued under EET would need to be separated from future TEE saving and tracked, meaning separate taxation regimes for pre- and post-change benefits would be in operation for many decades to come. Moving to TEE will result in higher administration fees being levied on employers.

Moving to TEE would complicate administration, requiring changes to record keeping, benefit calculations, processes, payroll functions, reporting and communications. All of those would require time and cost investment which would be passed on to employers.

---

[5] *Abolition of the Lifetime Allowance (LTA)*, GOV.UK (22 November 2023) <www.gov.uk/government/publications/abolition-of-the-lifetime-allowance-from-6-april-2024/abolition-of-the-lifetime-allowance-lta>.

## National Insurance Contributions on pensions

### Background

National Insurance Contributions (NICs) are paid by employees and employers on earned income. Currently employees pay a rate of 8% on a band of earnings between £242 and £967 per week, and 2% thereafter. Employers pay at a rate of 13.8% on all earnings above £175 per week.

However, where employers provide remuneration in the form of payment into a worker's pension, these contributions are not treated as earnings for NI purposes.

This has encouraged a move towards "salary sacrifice" arrangements, where an employee accepts a lower salary, but in return, the employer pays both the employer and employee pension contributions across as an employer pension contribution. In such arrangements this means that the employer only pays NICs on the employee's lower, post-sacrifice level of salary.

In some cases, the employer may share some of the NIC saving it makes with the employee, whether by offering more generous employer pension contributions, or through a direct sharing as a proportion of the amount of salary an employee 'sacrifices'.

### Possible change

The government could remove or reduce NI relief on employer contributions.

Although this could be a very substantial revenue raiser - current NIC relief equates to a cost of £23.8bn[6] - it might generate considerable opposition from employers who use the NIC savings to offer more generous pension contributions.

We've seen changes to employee NICs being introduced at relatively short notice, so this change if implemented could be made effective within short timescales.

***Thoughts for pension schemes:***

- Costs for employers will go up if NIC savings on pensions are reduced or removed, which may lead them to review their contribution structures and rates.
- In particular, employers may need to review the level of NIC savings (if any) that they share back with employees.
- Employers may consider reviewing the attractiveness (to employers) of offering remuneration in the form of pensions, and may consider if better offered in take-home pay. This could however result in employers contributing less into pension which would reduce member outcomes.

There are also rumours circulating about possibility of making pension income NI-able (in addition to being taxed as income). That is easier said than done, and the proposals need to become quite elaborate to avoid double taxation and disincentivising employer support for pensions. It would mean major changes for the specialist software that is used for pensioner payrolls.

## Inheritance tax

There are two main respects in which wealth held in the form of pensions receives favourable treatment in the event of the death of the owner. These are:

---

[6] See footnote 2.

1) Where a person dies under the age of 75 and leaves behind a defined contribution (DC) pension pot, their heirs can generally draw from this pot free of any income tax.
2) Pension savings are generally not included as part of an estate for Inheritance Tax (IHT) purposes.

**Possible change (1)**

It's been suggested that the Government could apply the income-tax treatment which currently applies for deaths at age 75 or over to all deaths.

This would mean that when someone age under 75 dies with a balance in their DC pot, the remaining funds can be passed to their nominees, but income tax is due as and when the money is withdrawn.

Given increasing life expectancies, if this change were introduced, it's unlikely that many savers, particularly younger ones, would be affected, so this may not generate a lot of revenue for the Government either in the short or longer term.

**Possible change (2)**

The Government may look to include money from DC pensions as part of the estate for IHT purposes. Possible reasoning for this is that the current exclusion of DC pensions is inconsistent with other savings eg ISAs which are included in the estate for IHT purposes.

However, there would be other considerations:

- Bringing DC pension pots into IHT would create an inconsistency with pensions paid to dependants from DB pension schemes, and lump sum benefits from both DB pension schemes and life assurance schemes, all of which currently fall outside IHT.
- Whilst generally a transfer to a spouse on death is exempt from IHT, bringing pension pots within IHT for other transfers could have the unintended consequence of penalising unmarried partners.

***Thoughts for pension schemes:***

Who would be responsible for paying IHT bills in respect of pensions? Scheme administrators don't know the total value of a deceased member's estate, or their other IHT details, so it would probably continue to be a responsibility that falls upon personal representatives. However, there would need to be additional disclosures to enable settlement of the member's tax affairs.

## Restricting tax-free cash

Tax-free cash lump sums are an incredibly popular option with members, with very high take up rates. This impacts both members' retirement planning and the cashflow profile of schemes. Members find the option attractive both because of the tax-free status but also the short-term financial flexibility created by a large cash injection. A key question will be how a reduction, or removal, of the tax-free status will influence members' take up of the option.

The method by which the Government might introduce the change is also critical:

- An immediate change on the day of the Budget could lead to a rush of members changing their short-term retirement plans, either altering their lump sum decision or, in the extreme, deferring their planned retirement.
- Conversely, signposting a future change in the tax-free status could lead to a rush of retirement requests, as members accelerate their plans so that they still benefit from the tax-free payment. Would a surge create short-term liquidity issues for some schemes?

Either way, administrators could expect a swell of member questions and benefit requests over a very short period of time.

In defined benefit (DB) schemes, changes in member behaviour could impact cashflow profiles, which in turn could impact investment hedging strategies. If member behaviours change, there could also be knock-on implications for DB schemes that make allowance for members taking cash when setting their funding and accounting assumptions.
In defined contribution (DC) schemes, it could lead to a change in default investment strategies, members' saving behaviours or post-retirement strategies, in particular approaches to drawdown.

If you have any questions, or if you'd like to discuss potential implications in more detail, please get in touch.

London | Birmingham | Glasgow | Edinburgh T 020 7082 6000 | www.hymans.co.uk

This communication has been compiled by Hymans Robertson LLP® (HR) as a general information summary and is based on its understanding of events as at the date of publication, which may be subject to change. It is not to be relied upon for investment or financial decisions and is not a substitute for professional advice (including for legal, investment or tax advice) on specific circumstances. HR accepts no liability for errors or omissions or reliance on any statement or opinion. Where we have relied upon data provided by third parties, reasonable care has been taken to assess its accuracy however we provide no guarantee and accept no liability in respect of any errors made by any third party.

Hymans Robertson LLP is a limited liability partnership registered in England and Wales with registered number OC310282. Authorised and regulated by the Financial Conduct Authority and licensed by the Institute and Faculty of Actuaries for a range of investment business activities.

© Hymans Robertson LLP 2024. All rights reserved.