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The impact of tax policy on employer sponsored pension provision

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Introduction

This report examines the subject of pensions tax policy and explores both the direct and indirect impact that changes in successive Government's tax policy over the past thirty years have had on employer pension provision. This report also looks at the proposals that have been made for the future direction of tax policy for pensions and assesses their potential impact upon individuals and the costs to the Exchequer.

Chapter one explores changes in the taxation of pensions in context of the wider developments that have shaped the pensions landscape over the last three decades. Government policy, regulation, social change and the economy have all left their mark on pension provision and take-up. Some of these changes have led to greater uncertainty, higher costs and lower returns for pension schemes.

Chapter two of this report sets out the current regime of pension taxation and examines how the tax treatment of pensions has changed over the past 30 years. This chapter explores the rationale for changes to pension taxation and the direct and the cumulative impact that changes have had on employers and scheme members. This chapter concludes that whilst the direct and immediate effects have centred on the costs of implementation, and have at times had a beneficial impact on scheme funding, the longer term, indirect and unintended consequences may also have contributed to a 30 year decline in employer provision.

Chapter three considers how the reforms proposed by the Coalition Government in 2010 could affect higher earning individuals, in particular highlighting the different effects for those in Defined Benefit schemes compared to Defined Contribution schemes and the outcomes for different generations of employees. The findings suggest that the tax charge for some high earners in Defined Benefit schemes could lead them to opt-out of employer sponsored pension provision, potentially increasing the pressure on employers with Defined Benefit schemes to restructure pension arrangements.

This report has been compiled using both existing published material as well as input from a small number of employers, trade bodies and other industry influencers. A provider, an industry body and employers, pension schemes and consultancies were interviewed for this project. The views expressed by the individuals interviewed cannot be held to be representative of all of the pensions industry but their observations have been incorporated into this report on an anonymous basis, expressed as quotes, to support more general observations about changes in employer provision.

Executive Summary

This report has been compiled using both existing published material as well as input from a small number of employers, trade bodies and other industry influencers. A provider, an industry body and employers, pension schemes and consultancies were interviewed for this project. The views expressed by the individuals interviewed cannot be held to be representative of all of the pensions industry but their observations have been incorporated into this report on an anonymous basis, expressed as quotes, to support more general observations about changes in employer provision.

The provision of pensions by employers has undergone a series of significant changes since the Second World War. Whilst membership rose in the early years after the war, later years saw a decline in the membership of occupational schemes, starting in the late 1960s.

The forces for change in pension provision have been well-documented and can be broadly grouped into three domains: economic developments; social change and policy and regulatory change.

- Most notable of the social and medical developments has been the very significant shift in life expectancy. More importantly for pension schemes and members, the improvements in life expectancy at age 65 have extended the period over which pensions have to be paid. The knock-on effects have been felt throughout the pension system, whether through the increased liabilities of Defined Benefit pension schemes or through lower annuity rates for defined contribution scheme members.
- Changes in the provision of and engagement with pension schemes have also been affected by changes in society's attitudes to pensions and retirement. People's attitudes to savings in general and pensions in particular have changed, brought about in part by the pension 'scandals' of Maxwell, pension miss-selling and the collapse of Equitable Life. Attitudes towards borrowing have also changed as credit became more readily available in the 1980s until the economic crisis of 2007/08.
- The past three decades have been characterised by very considerable policy changes and interventions in the pensions market, including: the removal of an employer's ability to make pension scheme membership compulsory in 1986; the introduction of personal pensions and the ability to contract out of the State Earnings Related Pension (SERPs) in 1988; and the requirement, since 2001, for most employers to offer access to a pension plan.

- The Government has also responded to a series of well-publicised problems in the pensions market by enhancing the protection for scheme members and increasing the regulation of occupational pension schemes. Changes included:
  - a series of changes in the 1980s and 1990s which gradually removed the discretionary element of pension benefits and replaced them with higher, and more certain, member benefits;
  - the introduction of the Pension Protection Fund in 2005;
  - the introduction of a new statutory funding formula for Defined Benefit pension schemes introduced through the Pensions Act 2004;
  - changes in accounting regulation have also changed the relationship between employers and their Defined Benefit pension schemes.

  Collectively, these changes have improved protection for scheme members but have also increased the burden and cost of pension provision for employers.

Several employers interviewed for this study were critical of a 'dislocated', 'reactive' and 'short termist' approach to pension regulation. Most had closed their final salary schemes to new entrants and some to future accruals.

The current system of taxation of private pensions in the UK follows the broad principle that pensions are a form of deferred pay and that taxation of that pay should also be deferred until retirement. This can be broadly described as contributions being Exempt from tax, Investment returns Exempt from tax, and withdrawal from pensions being Taxed. This is sometimes called an EET system. In a pure EET system, tax is smoothed over a lifetime and this generally avoids any double taxation of income.

Some of the changes made to pension taxation over the past three decades have adapted, and in some cases, eroded the principle of EET. The different changes have all had different impacts, either directly or indirectly, on employer sponsored pension provision.

- In an effort to reduce the scale of surpluses then estimated to exist in pension schemes and to increase exchequer revenue, the Finance Act 1986 introduced restrictions on the size of surpluses and the way in which they should be dealt with. The immediate impact of this change was generally positive for scheme members of Defined Benefit schemes, employers and government, although in the longer term the effect was largely negative for all. Those interviewed for this project were divided about the impact of the change with some arguing that changes to Defined Benefit schemes would have occurred anyway, whilst others argue that the changes were directly responsible for the weakened state of Defined Benefit schemes. The resulting fall in surpluses, whether or not driven by tax changes, left many Defined Benefit schemes and employers less able to cope with the challenges facing them.

- The budget of 1989 introduced an earnings cap to limit the levels of earnings on which pension provision could be made to new entrants to pension schemes. Some of the employers interviewed, typically those with few higher earners, had been largely unaffected by the earnings cap. Other employers felt that the earnings cap was the first step in senior decision makers disengaging from pensions.
- The initial reduction in advance corporation tax (ACT) by the Conservative Government in 1993 and the subsequent abolition of ACT by the Labour Government in 1997 and the ability of pension funds to reclaim this in full led to a short term fall in income for both Defined Benefit and Defined Contribution schemes as well as workplace and individual personal pensions. Individuals interviewed expressed mixed views about ACT removal but in general did not link any changes in provision to the tax changes.
- On A-day 2006, eight different tax regimes for pensions were replaced by a single new regime to be applied to all private pensions, whether occupational schemes or personal pensions and whether Defined Benefit or Defined Contribution. Among employers interviewed for this project, attitudes towards simplification were again mixed but often tinged with disappointment at an opportunity lost. Several commented that simplification did not live up to its promise and that the changes led to increased complexity. However, by far the most common criticism was that the lifetime allowance led to senior management starting to detach from pensions and added complexity to the benefit structure for higher earners through the need to establish unapproved schemes.
- In the 2009 Budget Statement, the then Chancellor announced a fundamental change to the way in which pension contributions attract tax relief for higher earners. The employers, advisers, provider and representative body interviewed for this project criticised the costs and complexity of the proposals, particularly for Defined Benefit schemes, and again raised concerns that most senior people affected would have chosen to leave the pension scheme altogether with further consequences for employer engagement.
- Following the change in UK Government in 2010, the new coalition Government announced changes to the Labour Government proposals in its first budget. The Government proposed to achieve a reduction in the cost of pension tax relief by reducing the AA (annual allowance) from its current level of £255,000 to £50,000 whilst retaining tax relief at an individual's marginal rate of tax. The revised proposals were seen as preferable to the proposals made in 2009 by those interviewed, although a number felt that more employees in their own schemes would be affected by the new change, which could cause them a different set of problems to the 2009 proposals.

- The Coalition Government proposals are targeted on high earners, and will only directly affect a very small minority of pension scheme members (most likely those in the top 1% of UK earners). Even an individual earning enough to put them just in the top 10% of earners in the UK would be highly unlikely to ever have pension contributions in excess of the £50,000 annual allowance.
- The impact of the Coalition Government proposals may increase over time. With the new annual allowances being frozen until 2016 and then potentially indexed at a lower rate than earnings, significantly more individuals could face the prospect of a tax charge on their pension contributions in future, particularly those in public or private sector Defined Benefit schemes. An individual contributing less than £40,000 in 2011 who increases their contributions in line with average earnings growth each year could breach the annual allowance by 2016.
- PPI analysis of hypothetical high earning individuals suggests that:
  - Additional tax charges could lead to high marginal tax rates for very high earners
  - If lower allowances lead to lower contributions, income in retirement will fall
  - The lifetime allowance can still be exceeded even with a lower annual allowance
  - Younger individuals with very high lifetime earnings and prolonged pension scheme membership may see a greater impact over their lifetime than similar older individuals

  As a result very high earning individuals may change their behaviour in order to avoid additional taxation.
- Employers with Defined Benefit schemes face a number of operational and strategic issues, most notably how to deal with the small number of employees who are caught by the rules. Some employers may choose to deal with members on a case by case basis. Others may decide on more radical solutions such as moving to a Defined Contribution arrangement.

It is evident that changes in pension provision have taken place against a backdrop of economic, social and regulatory change. Within this environment, changes to pension taxation have added costs to the operation and funding of pension schemes and have removed some of the benefits of pensions for very high earners and, as with recent proposals, have created a sense of uncertainty. Changes to pension provision cannot be laid at the door of tax changes alone, but the findings from the interviews carried out for this research suggest that it is probable that some of the changes may have accelerated change, or at least failed to stem the tide of employers reducing their commitment to pensions.

Chapter one: what forces have shaped employer sponsored pensions over the last three decades?

Chapter one examines the changes in employer provision of pensions and seeks to describe the forces that have shaped the pensions landscape over the last three decades. Government policy, regulation, social change and the economy have all left their mark on pension provision and take-up. Some of these changes have led to greater uncertainty, higher costs and lower returns for pension schemes.

Employer pension provision has undergone significant change

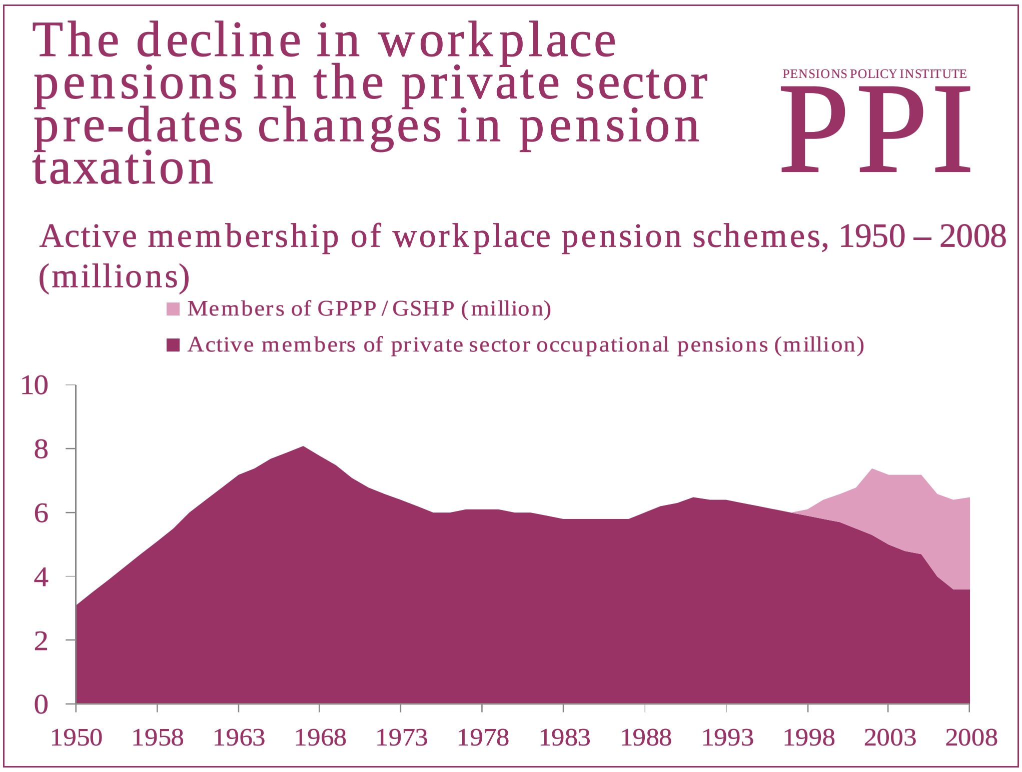
The provision of pensions by employers has undergone a series of significant changes since the Second World War. While membership rose in the early years after the war later years saw a decline in the membership of occupational schemes, starting in the 1960s.

The central shifts are[1]:

- A decline in the number of active members of private sector occupational pension schemes, from a height of over 8 million in the mid-1960s to a low of 3.6 million in 2008. 2006 and 2007 saw the most significant falls in active membership with falls of 15% and 10% respectively.
- A significant shift away from Defined Benefit pension provision towards defined contribution schemes.
- The introduction of Defined Contribution grouped personal pension plans (GPPPs) in 1988 and grouped stakeholder pensions (GSHP) in 2001. GPPP and then GSHP membership have partially offset the decline in membership of occupational schemes during the late 1990s and early 2000s. Some plans may have served as replacements for closed Defined Benefit schemes whilst others have supplemented occupational scheme provision.

[1] ONS (2009/2010), chapter 7

Chart 1[2]



Overall, active membership of workplace plans (that is, including occupational pensions schemes and GPPPs / GSHPs) is estimated to be 6.5 million at the end of 2008. This shows a fall from the mid-1960s peak, but with the growth in GPPPs and GSHPs is higher than much of the 1980s and 1990s (Chart 1). With the rise in unemployment since that date, membership may have fallen again. But it is clear that the decline in occupational pension scheme membership began over 40 years ago.

The number of members of schemes and plans tells only part of the story. Rising employment during the 1990s and 2000s has not resulted in higher numbers of employees with pension provision. ONS data suggests that the proportion of employees with workplace pension provision has fallen since 1997 from 55% to 50% in 2009.[3]

Moreover, the shift from Defined Benefit occupational schemes to defined contribution occupational schemes and contract based plans has led to a fall in per-member contribution rates as active members move from a Defined Benefit to a defined contribution environment. The average employer contribution rate for Defined Benefit pension schemes was 16.6% in 2008

[2] PPI estimates based upon ONS Occupational Pension Scheme Survey and ASHE workplace pension membership data. Change in membership between data points smoothed. Assumes that all members of GPPP and GSHP are employed in private sector.
[3] ONS (2009 / 2010), chapter 7

compared to an average Defined Contribution rate of 6.1%. Furthermore, defined contribution employer contribution rates fell between 2007 and 2008.[4]

The proportion of private sector employers providing access to an open workplace pension scheme fell between 2007 and 2009 from 14% to 10% while the proportion offering any type of pension provision fell from 41% to 28%.[5] Many employers also ceased paying contributions to individual employees personal pensions between 2007 and 2009[6]; a fall from 12% to 5%.

The reforms of private pensions planned by the previous Government are expected to reduce the number and proportion of working individuals without a pension.[7] 2012 is due to see the advent of mandatory auto-enrolment of employees into either a workplace pension scheme or a new scheme called NEST,[8] with contributions made by employer and employee. The underlying principle of the reforms is to give access to employer pension provision (in terms of receiving a contribution from the employer) for nearly all employees.[9]

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Interviewees' comments on changes in pension provision
"Once [Defined Benefit] schemes are closed to existing members, attitudes towards pensions change across the organisation."

[4] ONS (2009/2010), chapter 8. Defined contribution rates are for occupational schemes only. The modal contribution rates for contract-based workplace pensions lies between 3% and 6%.
[5] DWP (2009)
[6] That is, non-group personal and stakeholder arrangements that have been arranged on an individual basis but where the employer makes a contribution
[7] Pensions Act.2008. The Act implemented the reforms to private pensions set out in the Government's White Paper ***Personal Accounts, a new way to save***.
[8] National Employment Savings Trust.
[9] Individuals aged less than 22, or earning less than the income tax personal allowance threshold will not be auto-enrolled

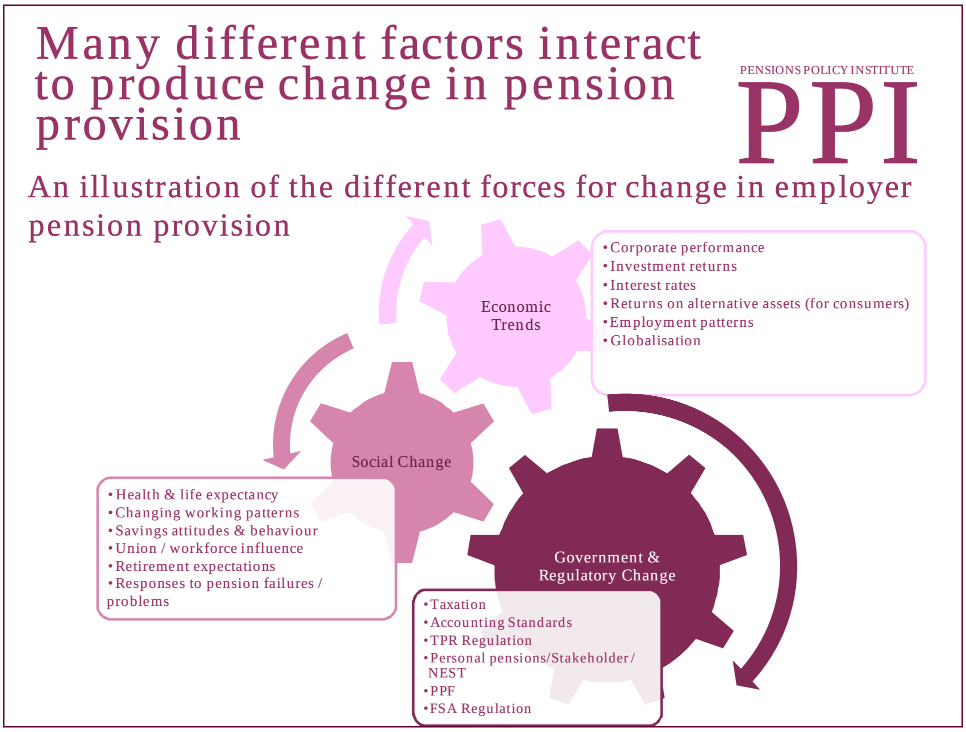
Uncertainty and change

The forces for change in pension provision have been well-documented and can be broadly grouped into three domains (Chart 2):

- policy and regulatory change;
- social change; and,
- the impact of the economy.

However, these are not mutually exclusive, and changes in one can lead to, or impact on, changes in another.

Chart 2



Economic developments

Pension provision has been very significantly affected by a number of economic developments, in particular:

- Many commentators attribute a significant part of the decline in Defined Benefit pensions to the turbulence in stock markets following the ‘dot com’ boom and crash at the end of the 1990s. The effect on Defined Benefit pension schemes was to move many from a position of surplus to one of deficit in the early 2000s, a position from which many have not recovered.
- The economic crisis of the late 2000s is also seen to be having an effect on corporate performance, with pressure to reduce costs being brought to bear on the business in general and pension scheme contributions.
- The property or house price boom of the 1990s and the early part of 2000s has led to many consumers seeing the equity in their homes as an alternative or supplement to private pension saving.[10] Recent volatility in

[10] Pensions Commission (2004)

house prices may have changed this view but may not yet have fed through into a revised view of saving through financial instruments, in part due to the continued volatility of stock markets. For employers, this attitude has, in some cases, contributed to the view that pensions are no longer a desired employee benefit.

- Changing labour market patterns, with increased labour mobility and more emphasis on temporary and short-term contract work has led to the perception that Defined Benefit pension schemes are no longer as suitable for employees as in the past.

Interviewees' comments on economic change

"The combination of pension miss-selling, the rise in home ownership and personal debt has led to a massive lack of trust and interest in pensions"

"The media negative reporting of pensions is the biggest impact on employee attitudes. People simply don't trust pensions. They don't see their parents suffering so don't see why they have to do anything about pensions."

"It's been a perfect storm. Tax changes, the tech bubble, accounting changes and the current economic crisis. Pensions are just so much more visible to the finance people these days."

Social and medical developments

Most notable of the social and medical developments has been the very significant shift in life expectancy brought about by, among other things, improved diet, reductions in smoking and medical advances. More importantly for pension schemes and members, the improvements in life expectancy at age 65 have extended the period over which pensions have to be paid.

The knock-on effects have been felt throughout the pension system, whether through the increased liabilities of Defined Benefit pension schemes or through lower annuity rates for defined contribution scheme members.

Defined Benefit pension costs are particularly sensitive to longevity assumptions. The costs of providing for each 65 year old pensioner in a DB scheme would increase by 3% if mortality assumptions are off by just one year, rising to 8% if assumptions are off by three years and 13% if off by five years.[11]

Changes in the provision of and engagement with pension schemes have also been affected by:

- Changing expectations of retirement. Changes in longevity have not yet been fully factored into individuals' expectations, although employment rates among older people have risen since the 1990s and the average age of withdrawal from the labour market has been rising steadily since the early

[11] PPI (2007), drawing on figures from the Prudential quoted in TPR (2007) ***The purple book*** page 48

2000s.[12] The attitudes of today's workers to retirement are being framed by the experiences of their parents. Two of the employers interviewed noted a somewhat contradictory attitude among their employees. Whilst they could see their parents enjoying retirement and having a comfortable lifestyle, they did not see this as a reason for joining a pension scheme; even where their parents' retirement incomes were supported by savings and private pension arrangements.

- Changing attitudes to savings in general and pensions in particular brought about, in part by the pension 'scandals' of Maxwell, pension miss-selling and the collapse of Equitable Life. Several organisations interviewed expressed the view that employee attitudes towards pensions had been affected by media reporting of events and by the on-going negative focus on pensions that the media is seen to have. For some employers, this was making enrolment into their schemes difficult.
- Changing attitudes towards borrowing as credit became more readily available in the 1980s until the economic crisis of 2007/08. This has fuelled a 'spend today' consumer mindset that is well documented by the behavioural economists.

Interviewees' comments on social change

"The most important influences on employer provision have been longevity, which actuaries ignored for so long."

"One of the biggest changes has been cultural. We have a spending culture and paternalism has changed, especially in London and the South. There has been a shift to personal responsibility and people have opted out of pensions. There is a massive lack of trust in pensions and people love ISAs."

"The media started to become aware of the closure of DB schemes in the 2000s and it then became much more difficult to close schemes."

Policy and regulation

The past three decades have been characterised by very considerable policy changes and interventions in the pensions market, including the four major changes to pension taxation which are discussed in detail below.

The most significant policy changes that have affected employer engagement with pensions include:

- The removal of an employer's ability to make pension scheme membership compulsory in 1986.[13] Whilst not all employers had previously imposed compulsory membership, the Government Actuary Department did report a small decline in coverage of employees in the private sector between their 1983 and 1987 surveys.[14]

[12] ONS (2009/2010) , chapter 4
[13] Social Security Act 1986
[14] GAD (1991)

- The introduction of personal pensions in 1988 and the ability to contract out of the State Earnings Related Pension (SERPs). This change led to some individuals being encouraged to transfer out of workplace schemes and into personal pensions. In some cases, this led to a loss of employer contributions or other scheme benefits. A subsequent review and intervention by the FSA led to remedial action or compensation for miss-selling of personal pensions.[15] Whilst the impact of Personal Pension miss-selling was felt largely by the individuals affected, it is possible that the change also contributed to lower levels of employer engagement with workplace pensions.
- Since 2001, all employers with 5 or more employees, who do not already have comprehensive pension provision,[16] have been required to designate a stakeholder provider but they are not required to make any contribution. Research in 2003[17] revealed that most employers had provided access to a stakeholder scheme, however far fewer were providing a contribution. It is evident from the number of individuals covered by workplace schemes shown above, that the change had little long-term impact on the overall level of provision of workplace pensions.
- Stakeholder pensions also contributed to downward pressure on the pricing of personal pensions, including the charges associated with GPPPs. GPPPs and GSHPs provided employers with an alternative to occupational schemes. With GPPPs and GSHPs, the administration and regulation of workplace provision was in the hands of the provider, removing cost and burden from the employer.
- Changes in the regulation of the marketing, sales and advice of packaged pension products (personal and stakeholder pensions) during the 1990s and 2000s, contributed towards marked changes in the availability and cost of advice for individuals and employers.

The Government has also responded to a series of well-publicised problems in the pensions market by enhancing the protection for scheme members and increasing the regulation of occupational pension schemes:

- A series of changes in the 1980s and 1990s gradually removed the discretionary element of pension benefits and replaced them with higher, and more certain, member benefits. Examples include: the protection for early leavers afforded by the Social Security Acts of 1973 and 1985; equal access to pensions for women and men introduced under the same legislation; the statutory increase to pensions in payment introduced in the Pensions Act 1995; and the revaluation of Guaranteed Minimum Pension at retirement, introduced in 1988.
- The introduction of the Pensions Protection Fund in 2005, designed to afford members of Defined Benefit pension schemes greater security should an employer with an underfunded pension scheme become

[15] FSA (2002)
[16] An occupational pension scheme or a GPP with a minimum 3% contribution, or some combination, open to all employees
[17] DWP (2003)

insolvent. The scheme works by imposing a levy upon all Defined Benefit pension schemes which results in well-funded schemes subsidising weaker schemes.

- The introduction of a new statutory funding formula for Defined Benefit pension schemes introduced through the Pensions Act 2004. This requires schemes to have sufficient assets to cover an actuarial estimate of the amount needed to pay benefits when due. Trustees are required to set out either a statement of funding principles and schedule of contributions to cover the funding requirements, or a recovery plan which corrects any shortfall in funding. The position on the application of Solvency II requirements to Defined Benefit pension schemes remains on the agenda with a Green Paper issued by the EU in July 2010. The application of Solvency II is not an agreed policy, and is actively opposed by the UK Government.
- Accounting regulation has also changed the relationship between employers and their Defined Benefit pension schemes. FRS 17, an accounting standard which became fully operational from 2002/3, introduced the requirement for employers to disclose any discrepancy between the value of the assets and liabilities of their Defined Benefit pension schemes on their balance sheets. Prior to the rule, employers were better able to 'smooth out' the volatility in the schemes assets and liabilities whereas FRS 17 makes any deficits more apparent to shareholders. As a result, the price of a company's shares can be more directly affected by the state of funding of the pension scheme. [18]

Finally, successive Governments have introduced changes in pension tax relief which have had a number of direct effects on the costs of pension provision. The effects of these changes are examined in more detail in the following chapter.

Several employers interviewed for this study were critical of a 'dislocated', 'reactive' and 'short-termist' approach to pension regulation. Most of these had closed their final salary schemes to new entrants and some to future accruals.

Looked at together, the changes in policy and regulation paint a picture of increasing costs and uncertainty for employers operating occupational pension schemes in general and Defined Benefit schemes in particular.

[18] More recently a new accounting standard, IAS19, has been introduced which does allow for smoothing to be incorporated in estimates of liabilities. However, having adjusted accounting procedures already many employers continue to use FRS17.

Interviewees' comments on regulatory change

"We have gone back to the 1980s and looked at the statutory changes and have calculated that they have added 60% to the cost of providing a pension."

"The changes to accounting standards and poor stock market performance have been the most influential."

"Compulsory membership has gone and employers are finding it hard to engage with employees on pensions."

"FRS 17 brought the funding position to the fore and it had to be explained to analysts. Employers could no longer just pretend that it was a snapshot. The accounting standards being introduced in 2011 are a big deal."

"Solvency II is also a potential problem; there is still talk of convergence. Employers are increasingly running their pensions as an insurance company."

Chapter two: how have changes in pension tax policy affected employer sponsored pensions?

Chapter two sets out the current regime of pension taxation and examines how the tax treatment of pensions has changed over the past 30 years. This chapter explores the rationale for changes to pension taxation and the impact that changes have had on government, employers and scheme members. Some changes have resulted in moderate or high costs of implementation for schemes and employers; others have changed the funding costs for employers. Some have proved beneficial to members, although the benefit has not always been sustained. The long term effects of the changes in taxation have to be considered in the light of other environmental changes, but, whether causal or not, a negative relationship can be seen between some tax changes and employer provision. This appears to be particularly true where tax changes personally affect the pension decision makers in businesses.

What is the role of pensions tax relief?
There are many different views as to the appropriate role of tax relief for pensions. Many see pensions as a deferred salary, and so argue that that the role of tax relief is to avoid the 'salary' being taxed twice – once when paid initially as part of current salary and then again when providing a 'salary' in later life. Others see the role of tax relief as encouraging beneficial behaviour that is for the good of the individual and society – giving an incentive to an individual to defer income so that they do not end up with a low income or reliant on the state in retirement.

Of course these two views are not mutually exclusive – avoiding double taxation may also incentivise pension saving over other forms of saving. But the difference in emphasis can lead to different ideas about the best structure for tax relief, and who should receive it. Avoiding double taxation could mean that high earning individuals with high marginal tax rates could receive large amounts of tax relief. However, an emphasis on incentives might suggest that over-incentivising low income individuals to save would be beneficial for the state in the long-run, with less need to incentivise saving for high earners. The UK system as outlined in this chapter combines a mixture of both approaches.

Current UK tax position

The current system of taxation of private pensions in the UK follows the broad principle that pensions are a form of deferred pay and that taxation of that pay should also be deferred until retirement. Tax is thus smoothed over a lifetime and generally avoids any double taxation of income.[19]

Since 1921, the UK has broadly adopted the principle of contributions being Exempt from tax, Investment returns Exempt from tax, and withdrawal from pensions being Taxed (or EET - Exempt, Exempt, Taxed) for the taxation of savings when placed into a regulated pension.

Essentially, individuals agree to lock their savings away until retirement in return for tax deferral and some tax benefits. The tax position of pensions has been seen by the Government as a key part of the incentivisation of long-term savings and, in turn, a key part of reducing dependency on state benefits in retirement.

"The generous tax relief provided by the Exchequer raises incentives to save in a pension relative to other products, encourages employer engagement and sits alongside Government's wider objectives to tackle pensioner poverty and to enable low and moderate earners to have access to low cost saving for their retirement."[20]

However, many changes have been made to the precise basis of taxation since 1921.

Early developments in pension scheme taxation

Two different schemes for pension taxation were introduced in 1921. The first and closest to today's system was based on the system of Friendly Society taxation in force at the time. Although subject to tax, benefits paid out were subject only to a composite rate equal to one third or one quarter of the standard rate of tax of the time. The alternative tax regime based on life insurance taxation was broadly ETE (Exempt, Taxed, Exempt). Under this regime, employer contributions were free of tax, employee contributions were taxed at half of the then standard rate of tax, the fund was taxed but benefits could be paid tax free and as a lump sum.[21]

The pure EET approach allows for:

- Contributions made by the employee or self-employed individual to be paid from gross pay and not subject to income tax or national insurance, thus providing tax relief at the individual's marginal rate of income tax;
- Contributions paid by the employer to be free of national insurance (NI) and to be offset against corporation tax;
- Growth and income within the pension fund to be free of capital gains tax (CGT) and income taxes;

[19] Dilnot A & Johnson P (1993)
[20] HM Treasury (2007)
[21] Dilnot & Johnson (1993)

- Benefits to those taking retirement income from a private pension to be taxed at the individual's marginal rate of income tax.

In practice, the application of the EET approach to pensions has been subject to limitations and anomalies. Specifically:

- Tax free contributions have been subject to successive limits: age-related formulae have allowed an individual to contribute up to 40% of income; the Finance Act 1987 introduced the concept of an earnings cap on pensionable earnings; more recently the annual cap on contributions was introduced in April 2006 with the simplification of pension taxation (see below for a more detailed discussion); and from April 2011, by the proposed limits placed on annual allowances.
- Since 1986 the tax free nature of surpluses in Defined Benefit pension schemes has been restricted leading to the potential for taxation of surpluses.
- Whilst the roll-up of funds invested directly in bonds, property or cash is completely tax-free, since 1997, dividend income received by pension funds from equities is taxed at source at corporation tax rates.
- Individuals are able to take a tax-free lump sum at retirement of 25% of the accumulated fund. Prior to 2006 (A-Day), different rules on tax free cash existed and varied according to the type of pension and the date of joining.
- Funds which exceed the lifetime limit of £1.8 million (in the tax year 2010/2011) are subject to tax at a rate of 55% when payable.

As a result, today's system is perhaps better referred to as Eet, with the second two letters in lower case in order to reflect the taxation of some fund income and the availability of some tax-free benefits.[22] The mix of exemption and taxation for individuals will depend upon:

- The individual's marginal rate of tax during working life and in retirement;
- The extent to which they choose to take the tax-free lump sum; and,
- The fund's mix of assets and the balance between capital growth and income within the UK equity portfolio.

Today's tax regime for pensions is largely a continuation of the Eet principle and a reflection of the simplification regime set down by the Government in the Finance Act 2004. The tax position for UK private pensions prior to the changes made in the Finance Act 2009 (see below) is summarised in Table 1 below.

[22] The initial 'E' holds until annual allowance and lifetime allowances are met, so for high earners with potentially large pension contributions even this 'E' could be described as 'e'.

Table 1: UK Pension Taxation 1st May 2010

Individual's Contributions	Employer Contributions	Fund	Benefits
Contributions exempt at marginal rate subject to the annual allowance (AA) or 100% of pay. Employee contributions paid out of income which has been subject to employee NI. No employee NI is payable on employer contributions.	Contributions deductible for corporation tax purposes. Contributions exempt from employer NI contributions.	Fund income exempt from income tax other than income from UK equities. Growth of assets in the fund not subject to capital gains tax.	Subject to income tax at individual's marginal rate, other than tax-free lump sum of 25% of fund. Any residual funds left upon death are subject to tax (varies according to timing of death).

For the individual, an important benefit of pension taxation afforded by the pure EET system is the smoothing of taxation over a lifetime. Whilst contributions and fund growth are largely tax-free during a working life, many of the benefits of this may be later reclaimed through the taxation of private pension income, though often at a lower rate of taxation. In the context of the broader current UK taxations system, deferred taxation through EET also gives rise to a higher net benefit to the individual than a TEE system.[23]

Although personal taxation is in theory smoothed over a lifetime, there have, in practice, always been some irregularities in the UK system, arising mainly from timing issues and fiscal policy.

Over a typical working and retirement lifetime, individuals can expect to experience several changes in personal taxation, both as a result of government changes to allowances and tax rates and due to changing levels of personal income. In recent years, income tax rates have generally been low when compared to the 1970s when the top rate of tax was in excess of 83%.[24] In recent times, it has generally been expected that people will experience lower rates of income tax in retirement than during their working life. The combination of higher tax allowances for those aged over 65 and the generally lower levels of income in retirement make it feasible for many individuals to move from being higher rate taxpayers during a working life to a basic rate taxpayer in retirement. However, this is by no means a certainty. In periods where tax rates are rising, the opposite could be true.

[23] Dilnot A & Johnson P. (1993).
[24] Clark T & Dilnot A (2002)

Overall, most people are thought to experience a lower overall lifetime tax burden on income as a result of the EET system. An earlier report by the PPI[25] highlighted the enhanced levels of income experienced by those who were either non-taxpayers throughout their lives or who were higher rate taxpayers during their working lives and basic rate taxpayers when retired. The study concluded that, at the time:

- the regime of tax relief benefited higher earners more than lower earners;
- there was little evidence that tax incentives increase the overall level of saving;
- tax incentives encouraged pension savings rather than other types of savings.

For employers, the taxation of pension contributions allows those wishing to support employees in their retirement saving to reduce the annual tax burden for the company. While there is no benefit in terms of corporation tax between paying a pound in salary and a pound in pension contribution, pension contributions do not attract national insurance contributions. This reduces the cost to the employer by 12.8%.

The Pensions Commission suggested that tax relief on pension contributions in periods of higher marginal tax rates (both personal and corporate) made workplace pensions a tax-efficient way of paying people, particularly senior managers.[26]

For the state, the taxation of pensions results in a delay, and potentially a net loss, in tax revenue. The EET regime essentially favours long-term saving, particularly retirement saving, over consumption today. Savings that might otherwise have been made from taxed income and subject to taxation of income and growth are instead not taxed until they are drawn down in retirement. Without pensions and ISAs, government revenue today would be higher but future revenue could be lower. In the UK, most other savings vehicles available to the ordinary saver are taxed on a TTE basis – contributions are made from taxed income, income and growth are taxed but money withdrawn from the taxed fund is not then taxed again.

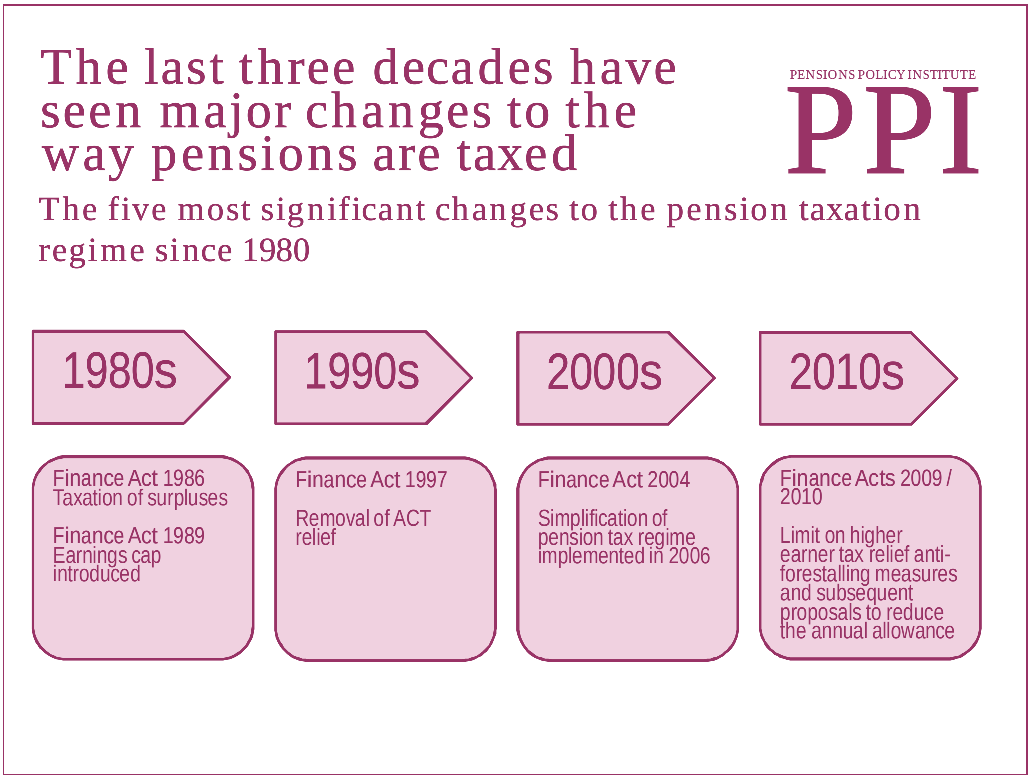
[25] PPI (2004)
[26] Pensions Commission (2004)

Three decades of change

Some of the changes made to pension taxation over the past three decades have adapted, and in some cases, eroded the principle of EET. This report focuses on five major events in order to assess their impact on employers and the schemes they support as well as the individuals in those schemes and the wider consumer population. The five events we consider in detail below are:

- the taxation of estimated surpluses;
- the introduction of the earnings cap;
- the removal of the ability of pension schemes to claim advanced corporation tax (ACT) relief on the dividend growth in pension funds;
- pension simplification in 2006; and
- the recent proposals to further limit tax-free contributions.

Chart 3



Taxation of surpluses

During the 1980s, many Defined Benefit pension schemes began to build up substantial surpluses.[27] Some companies were seeking refunds from what were perceived to be extremely healthy pension funds while Government were concerned that excess surpluses were being used as a form of tax avoidance.

It is important to note that the surpluses were estimated, and were point-in-time estimates – that is, only valid at a given date. The calculation of surpluses were based on a comparison of the actual assets held in pension

[27] HMRC PSI4.11

schemes against an estimate of the potential liabilities (how much would be needed to guarantee the payment of all future pensions that had been earned up to that date). Liability estimates are sensitive to the assumptions used to calculate them, in particular concerning future life expectancy and discount rates.

In an effort to reduce the scale of estimated surpluses and increase exchequer revenue, the Finance Act 1986 introduced restrictions on the size of estimated surpluses and the way in which they should be dealt with. In order to avoid losing tax relief, schemes with surpluses estimated as in excess of 105% of the liabilities[28] were required to reduce the surplus over a five year period by:

- reducing or suspending further contributions from the employer and/or employee, and/or
- improving the benefits available from the scheme, and/or
- refunding contributions to the employer subject to a tax charge of 35%.

The immediate impact of this change was generally positive for scheme members of Defined Benefit schemes, employers and government, although in the longer term the effect was largely negative for all. Members often received enhanced benefits, employers reduced their pension scheme contributions and for the Government, the cost of pension tax relief was reduced and, all other things being equal, corporation tax revenues increased.

The longer term consequences presented all stakeholders with challenges.

Many employers opted to take contribution holidays, thus improving their short-term profits, reducing the cost of tax relief and improving corporation tax revenues for the Government. Those in receipt of refunds also generated additional revenue for the Government. Some schemes introduced enhancements in benefits for all, or some, employees, sometimes in the form of enhanced early retirement packages.

Those interviewed for this project were divided about the impact of the change with some arguing that changes to Defined Benefit schemes would have occurred anyway, whilst others argue that the changes were directly responsible for the weakened state of Defined Benefit schemes.

[28] The rules for the measurement of surpluses was prescribed and less than the solvency requirement.

Interviewees' comments on taxation of surpluses

"I'm not sure that they had that much effect. Contribution holidays would have happened anyway. Employers were just responding to the economic cycle."

"It had little effect because companies had already started to split the surpluses by reducing contributions and improving benefits. Surpluses had already slipped away before the rule could have any impact."

"The change was very short-sighted. It was clear that surpluses would not last, even at the time. When the storm came, some schemes had enhanced benefits which eroded the surplus and they went into deficit"

"It led to an increase in benefits which was a shame because that created problems which can't be undone."

"Employers who got close to the limit sometimes improved benefits which when economic conditions changed they could not afford which in turn led to the demise of schemes"

"Many people had their benefits improved to reflect the high inflation of the 1970s."

"The change did lead employers to see the pension scheme as a piggy bank. When the contribution holiday ran out, management started to think about why they were paying the contributions."

It is impossible to say whether surpluses would have continued at pre-1986 levels in the absence of legislation. The Pensions Commission notes that the tax changes and employers responses were taking place during periods of higher than average returns on equities.[29] The fall in surpluses, whether or not driven by tax changes, left many schemes and employers less able to cope with the challenges facing them, in particular:

- the collapse in equity prices in the early 2000s;
- substantial improvements in member longevity;
- increased regulation and enhanced funding requirements.

In addition, the introduction of financial reporting standards (FRS17) increased the visibility of pension scheme funding to employers, even if it did not change the cost of providing pensions.

It is very difficult to measure the impact of tax changes on consumer sentiment, however tax changes alone are unlikely to have had any immediate impact on attitudes towards pensions. Indeed, in the early 1980s consumers may have been supportive of the changes introduced if they were seen as leading to better pay outs – or lower contributions – for consumers. However, the much later headlines about deficits and closure or collapse of schemes may

[29] Pensions Commission (2004)

have contributed to uncertainty about pensions in general; a view held by a significant proportion of the adult population.[30]

Table 2: Summary of the direct effects of changes to the taxation of surpluses

Taxation of surpluses (Finance Act 1986)	
Employers	Pension contributions reduced for some in the short term / profits enhanced, for those with Defined Benefit schemes.
Schemes	Defined Benefit scheme surpluses reduced. No change for Defined Contribution schemes or plans.
Scheme members	Some Defined Benefit scheme members' benefits maintained or enhanced but, over time, resilience of schemes reduced. Defined Contribution scheme and plan members unaffected by changes.
Consumers in general	Largely unaware of changes at the time. Defined Benefit pensions start to be seen as more attractive as benefits rise but later headlines have contributed to wariness about pensions.
Government	Positive effect on tax revenues where contribution holidays led to higher profits and reduced the cost of tax relief. Effect short-lived due to move from surplus to deficit.

Earnings cap

The budget of 1989 included a surprise change to the taxation of pension benefits and contributions. It was announced that the Finance Act of that year would limit the levels of earnings on which pension provision could be made for new pension scheme members.

The rationale for the change was to reduce the cost of tax relief and to limit the benefit for higher earners. The change limited the contributions which could be paid into tax-approved Defined Contribution pension schemes or the benefits payable under a Defined Benefit scheme. The earnings cap for contributions was set at £60,000 and was subsequently increased in line with retail prices.

The change was not retrospective, as it did not affect any existing scheme members, but did limit benefits (or tax free contributions) for those joining occupational pension schemes after 1st June 1989 and those contributing to personal pensions.

For the majority of members, the cap had little immediate effect; either because their incomes were lower than the cap or because they joined the scheme before June 1989 and were not capped. For schemes, new rules and processes had to be employed, with associated costs. For employers, on the one hand, future pension costs could be reduced but on the other, some

[30] DWP (2006)

employers found themselves having to compensate higher earners who joined the company after June 1989 for lower tax-approved pension benefits, or offering different types of benefits.

The majority of consumers would have been unaware of the changes and the changes would have had little impact on consumer sentiment at the time of implementation. Higher earners may have become more aware of changes when changing jobs later in their careers.

Whilst the earnings cap was replaced, in 2006, by the annual and lifetime allowances (see below), some schemes have continued to apply the earnings cap under transitional arrangements which must cease by 2010/11. The current notional value of the earnings cap calculated by HM Treasury is £123,600.

In the 1989 budget, the Chancellor also announced that employers could establish unapproved schemes which would not attract the same tax relief but which would enable employers to pay more generous pensions to higher earners. These schemes are used by some employers to top up tax-advantaged benefits for senior staff. Some schemes are funded and may be set up offshore or in the UK, whilst others are unfunded or secured against assets of the company.

Some of the employers interviewed, typically those with few higher earners, had been largely unaffected by the earnings cap. Other employers felt that the earnings cap was the first step in senior decision makers disengaging from pensions.

Interviewees' comments on earnings cap

"It affected very few people at the time because the cap was quite high. We found our way around it with an unapproved scheme."

"We had very few senior people capped so it hadn't bitten by A-day."

"The start of the end for pensions and led to the closure of DB schemes. Some [employers] saw the change as an opportunity to limit liabilities but it diluted the benefits for senior and long-serving people."

Table 3: Summary of the direct effects of introducing the earnings cap for tax-relieved pensions contributions

Earnings Cap (Finance Act 1989)	
Employers	For some employers, future pension contributions were, in theory, reduced by the imposition of the cap, a benefit often outweighed by increasing costs elsewhere. However, some employers needed to compensate new senior entrants for less generous pension provision. Some opted for cash allowance whilst others established unapproved schemes with deferred corporation tax relief.
Schemes	New processes for ensuring cap not exceeded for all schemes.
Scheme members	For the majority no change to benefits. For uncapped high earners, decision to leave existing scheme is made more complex. New entrants on high earnings face reduced pension benefits.
Consumers in general	Largely unaware of changes.
Government	Over time, cost of tax relief for high earners falls where cash replaces pension benefit. Where unapproved schemes employed, corporation tax relief delayed from time of contribution to time of benefits.

Changes to and removal of advance corporation tax

Between 1973, when advance corporation tax (ACT) was first introduced, to 1997, pension funds (and charities and non-taxpaying individuals) were able to recover the tax paid by companies on their dividends to shareholders. When first introduced, ACT was set at 30% with pension schemes able to reclaim this in full. The rate was linked to the rate of basic rate income tax between 1973 and 1993 but was reduced by the Conservative Government in 1993 to 22.5% immediately and 20% the following year, resulting in a fall in income for pension schemes.

This reduction was continued by the Labour Government in 1997, which abolished ACT and replaced it with a quarterly instalment scheme for corporation tax for large companies and a reduced rate of corporation tax. The rationale of the reforms was to alter the balance between dividend payments and company re-investment, and so to stimulate growth in the economy. However, it is not clear whether the companies benefiting from the changes were also those whose pension schemes were affected.

Pension schemes were no longer able to reclaim corporation tax paid on dividends and the exempt nature of fund taxation had been altered. The short term impact on pension schemes was a fall in income for both Defined Benefit and Defined Contribution schemes as well as workplace and individual personal pensions.

The impact on employers varied according to the type of workplace pensions offered:

- For employers with Defined Benefit schemes the change led to an increase in the contributions required to meet existing commitments. These higher costs may in turn have contributed towards scheme closures, although identifying specific reasons for closure is difficult.
- The impact on employers with defined contribution schemes was minimal since the costs were borne by employees, in the form of lower returns and retirement benefits.
- Members of Defined Benefit schemes were not directly affected by the change but may have been affected by any knock-on effect of scheme closures to future accrual.

Individuals interviewed expressed mixed views about ACT removal but in general did not link any changes in provision to the tax changes. Several felt that the headlines were more impactful than the change itself whilst others felt that the shock had been absorbed by the time its effect was visible in scheme valuations.

Interviewees' comments on ACT removal

"Not a major issue, employers pretty much carried on as before. The actuarial methods used at the time disguised the impact."

"It wasn't discussed in the boardroom... with hindsight, an irritation but not the death of pensions"

"It had a powerful external effect with lots of media headlines. Management got very wound up about it but in practice, coped. And anyway, dividends were high at the time."

"Irritating but its effect has been dwarfed by other changes."

"We were annoyed about ACT removal but it was two years before our next valuation and people just got on with things."

"Bit of a stealth tax. People didn't understand the implications. We estimated that it added 7% to our annual pension costs. We also ended up investing more outside of the UK because we could recover withholding tax. Minimal impact but it did suck money out of the business and out of employing people."

"People are still angry about it – its effect was totemic."

The perception of the cost of pension schemes was affected by this change. Media headlines around the time of the changes frequently referred to a '£5 billion raid on pension funds', and subsequent headlines have continued to criticise the decision.

However, although the cost is uncertain, the initial cost was less than £5 billion per year, and probably more in the region of between £2.5bn and £3.5bn per year[31] as around £1.5 billion of the £5 billion in extra taxes came from removing tax relief from other investors (such as some individuals and charities). The lower corporation tax rates also gave companies who make profits more scope to increase their pension contributions, without being worse off. An estimate is that the offsetting gain to pension schemes could be as much as £1 billion per year.[32]

The longer term impact on pension scheme income depended upon the investment mix of funds, and the impact on the balance between dividend payments and re-investment within UK companies.

The prevalence of the headlines in mainstream media and the tone of the messages conveyed may have affected consumer sentiment; reinforcing the belief held by some that pensions are no longer good value.

Table 4: Summary of the direct effects of ACT changes and removal

Changes to and removal of ACT (Finance Act 1997)	
Employers	Pension costs increased for those with Defined Benefit schemes. No effect for those with Defined Contribution schemes.
Schemes	Fund income reduced for some, leading to the need for restructuring of investments for Defined Benefit schemes.
Scheme members	Loss of income and reduction in value for those in Defined Contribution schemes. No change in benefits for those in Defined Benefit.
Consumers in general	Sentiment towards pensions may have been affected by tone and volume of headlines.
Government	Cost of pension tax relief reduced (but revenue from corporation tax also reduced)

Pension Simplification

Prior to the implementation of pension simplification provisions on A-day 2006,[33] eight different regimes had applied to the taxation of pensions.[34] The eight regimes were replaced by a single new regime to be applied to all private pensions, whether occupational schemes or personal pensions and whether Defined Benefit or Defined Contribution.

The Government's policy objectives were stated as:[35]

- improved choice and flexibility for pension providers, employers and individuals saving in pensions;

[31] PPI (2005)
[32] IFS (2005)
[33] 6th April 2006
[34] Inland Revenue (2004)
[35] HMT (2004b)

- improved competition among financial services firms providing pensions;
- greater encouragement for individuals to save for retirement; and
- reduced administration and compliance costs for sponsoring employers, pension scheme administrators, providers and advisers.

At the heart of the new regime were radical changes to the level of contributions that would qualify for tax relief; a single set of rules for the provision of tax free lump sums; and the introduction of a lifetime allowance that set a single allowance on the amount of pension savings that can benefit from tax relief. Other key changes included:

- the introduction of greater flexibility in drawing retirement benefits,
- raising the age when most people could access their pension savings to 55 (from 50),
- the introduction of Alternatively Secured Pensions at age 75, and
- a new approval process for all pension schemes.

The changes were made in response to market-wide calls for the Government to address the complexity of pension taxation and were widely welcomed across the pensions market. Particularly attractive to employers was the implied promise that the changes would form the basis of a long-term sustainable solution.

The Government's regulatory impact assessment,[36] calculated that the following groups would be affected by the changes: 100,000 pension schemes; 250 providers of personal and stakeholder pensions; IFAs advising on pensions; 10 million members of occupational schemes; and 5.5 million contributors to personal and stakeholder pensions and retirement annuity contracts.

The Government anticipated that almost all stakeholders would benefit from the changes. A survey by the Inland Revenue,[37] ahead of the changes and subsequent consultation, suggested that administrative cost savings across the pensions industry would amount to £80 million a year, a saving that would feed through either to lower costs for employers or scheme / plan members. It was also held that smaller companies would find the setting up and running of a pension scheme for employees less expensive as a result of the changes. The assessment also anticipated lower advice costs for individuals, in part due to the need for less detailed knowledge of different tax regimes among IFAs.

For employers and/or schemes the changes gave rise to some transitional costs, although not all were related to the changes in pension taxation but rather, changes to retirement flexibility. The research available does not split the costs incurred between pension taxation and other costs. However, research conducted among employers by HMRC in 2008,[38] found that 76% of

[36] HMT (2004a)
[37] Inland Revenue (2001)
[38] HMRC(2008)

employers with a pension scheme incurred no costs of transition, 14% were not aware of what costs were incurred. A small minority (5%) incurred costs in excess of £50,000 (mainly larger employers). The Government estimated a one-off government cost of implementation of £30 million and post-implementation costs of £9 million.

Estimates of the transitional costs made by various parts of the industry put the transitional costs in the range of £250 - £350 million.[39] Once again, the changes introduced differential impacts on Defined Benefit and Defined Contribution schemes:

- Employers with Defined Benefit schemes or employers who bear the costs of administration of Defined Contribution schemes themselves will have experienced an increase in costs in transitioning into the new environment.
- Employers with Defined Contribution schemes where members bear all of the costs will have been sheltered from any immediate increased costs to the scheme but may have incurred HR costs in dealing with employee queries and employee communication.

Among employers interviewed for this project, attitudes towards simplification were again mixed, but often tinged with disappointment at an opportunity lost. Several commented that simplification did not live up to its promise and that the changes led to increased complexity (see page 30). However, by far the most common criticism was that the lifetime allowance led to senior management starting to detach from pensions and added complexity to the benefit structure for higher earners through the need to establish unapproved schemes. Some interviewees felt that they could link the decline in interest in pensions among senior people to subsequent decisions made about reduced pension provision, although they acknowledged that other factors also played a part.

[39] HMT (2004b),The estimate for larger schemes made by Association of Consulting Actuaries; estimate for small self-administered schemes by the Association of Pensioneer Trustees; SIPP provider group estimate and Insurance Company estimate.

Interviewees' comments on simplification

"It was good for our higher earners. Contributions did rise post A-day."

"We were glad to see 2/3rd and the earnings cap go. The company went down the UURB route."

"Overall a good thing but disappointed that the Government did not stick to the promise. They unpicked some of the simplification within 2-3 years of implementation."

"It wasn't simplification – 1000 pages of regulation which introduced huge complexity. The lifetime allowance was a problem since it diluted the benefits that some received. Some gave some senior people cash and it accelerated the shift to Defined Contribution."

"It wasn't left alone long enough to bed in."

"At least this was a more proactive change but the industry tinkered afterwards and decision makers affected by 1989 had already lost interest."

"The lifetime allowance was disappointing. Some senior people have had less interest [in pensions] now they are not personally benefiting."

The main benefits for individuals were held to be greater flexibility, the opportunity to save more and gain more tax relief. However, a small number of between 5,000 and 10,000 individuals were estimated to be affected by the introduction of the lifetime allowance.

Qualitative research carried out for HMRC in 2008[40] to track attitudes to pensions following A-day changes revealed:

- a widespread lack of awareness and understanding of pensions tax relief and A-day among the general public,
- higher levels of awareness of both tax relief and A-day changes among wealthy individuals,
- generally positive attitudes towards tax relief and simplification among those who were aware and among those who were made aware through the research,
- employer contributions tended to be seen as higher incentive to save than tax relief, particularly among those who were not higher earners,
- little impact upon pension contributions even among most higher earners, since most respondents to the survey had not been maximising contributions before A-day.
- Some evidence of reductions in contributions to keep within annual limit and small number of higher earners increasing contributions.

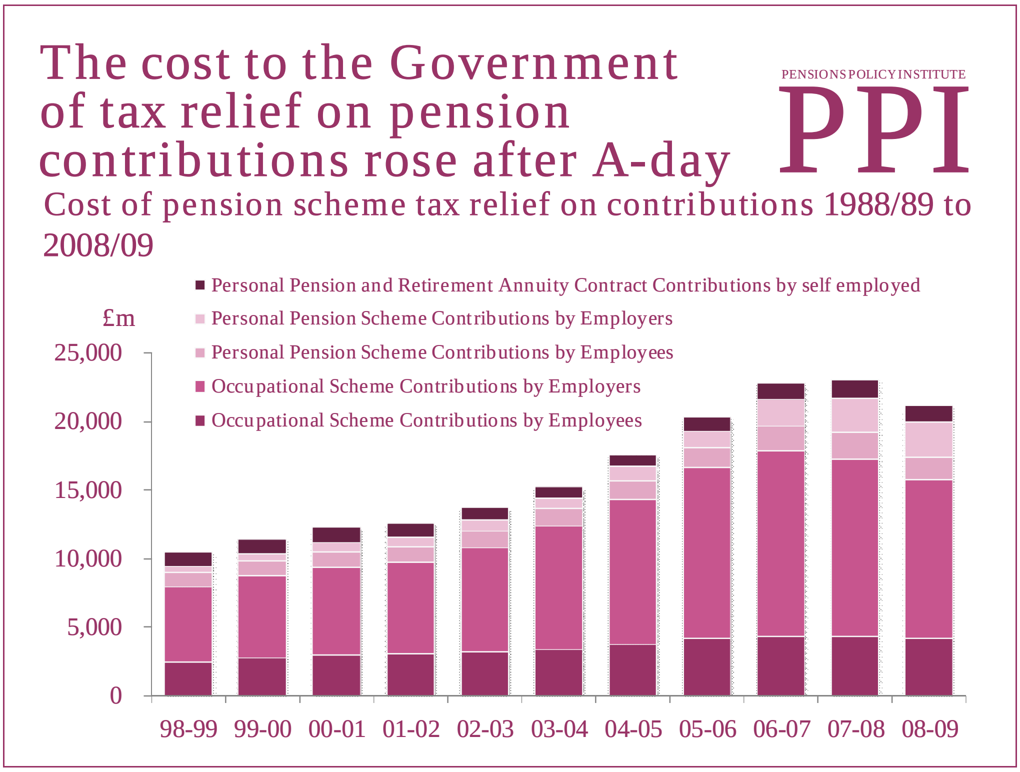
[40] Opinion Leader (2008)

- The lifetime allowance appeared to be making the most difference to a small number of higher earners' behaviour as they tracked the value of their fund to ensure that the limit was not exceeded.

The principle long-term effect for the Government stems from the increased flexibility for individuals. The Government estimated that tax relief on pensions would grow as a result of the reforms. The Exchequer costs were estimated to be £25 million of additional tax relief in 2006-07, rising to £165 million in 2008-09. However, the Government acknowledged in its own impact assessment that the actual costs would depend upon behavioural change among pension savers and could be higher still.

It is impossible to isolate the impact of the A-day changes, and too soon to see any significant behavioural change in published Government data. However, the cost of tax relief on contributions rose from around £20 billion prior to the change to around £23 billion in 2006/07 and 2007/08 but falling back in 2008/09 to just above £21 billion. It is not possible to say what the corresponding figures would have been in the absence of the A-day reforms.

Chart 4[41]



[41] HMRC Statistics, Table 7.9, Registered Pension Schemes, Cost of Tax Relief

Table 5: Summary of the direct effects of pension simplification

Pension Simplification (Finance Act 2004)	
Employers	Some transitional costs for employers with Defined Benefit schemes or where admin costs borne by employer. Added complexity to Defined Benefit schemes and through the need to establish unapproved schemes for senior staff.
Schemes	Some one-off costs incurred in system changes and communication. On-going costs increased due to monitoring contributions and reporting to HMRC.
Scheme members	Contribution limit provided greater flexibility of contribution over working lifetime. Small minority of higher earners adversely affected by lifetime cap whilst others benefited from the removal of the limits on the tax free lump sum.
Consumers	Pension rules simpler to understand and non-taxpayers able to benefit from pensions for first time.
Government	Limited effect on overall bill for tax relief.

Limits on higher earner tax relief (Labour Government proposals)
In the 2009 Budget Statement, the then Chancellor announced a fundamental change to the way in which pension contributions attract tax relief for higher earners. The Finance Act 2009 introduced a number of anti-forestalling measures designed to limit an individual's ability to side-step the changes which were due to be implemented from April 2011.

The proposed changes that were due to be implemented in 2011 would have reduced the tax relief available on pension contributions to basic rate tax for those with total income in excess of £150,000 but would have allowed those below this threshold to continue to attract tax relief at their marginal rate. The mechanism for ensuring that tax relief was reduced relied on disclosure of contributions (or deemed contributions for Defined Benefit schemes) in an individual's tax return and a subsequent tax charge (a tax bill) being applied to reclaim the tax relief given at source. It was proposed that, where an individual's tax charge exceeded £15,000, the individual could request that their pension scheme pay the tax for them, with a consequent revaluation of benefits (known as 'scheme pays').

The rationale for making the changes to higher earner taxation were summarised by the Government in its own consultation on the changes put forward in the 2009 Budget[42]. These centred on the themes of fairness and the sustainability of public finances. In particular it highlighted that:

- those earning over £150,000, who represent 1% of earners, were in receipt of 25% of the total tax relief given.
- the changes would have contributed at least £3 billion per annum to public finances through the reduction in higher earner tax relief. This would represent a reduction in pension tax relief of over 10% of 2008-09 levels of

[42] HM Treasury (2009)

£28.4 billion and an average loss of tax relief of £10,000 for each of the 300,000 individuals estimated to be affected.[43]

Following consultation, the Government's impact assessment issued in March 2010,[44] estimated the compliance costs for pension schemes, employers and individuals to be £900 million of one-off costs and £115 million of on-going costs. Taken together, the costs amount to more than 1/3rd of the 'year one' assumed savings to the Exchequer and would have been borne by shareholders, employees and members of pension schemes. Most of the direct costs of implementation would have been carried by employers and pension schemes (and in some cases, their members), with a small amount, £3m per annum, borne by HMRC (and in turn by the taxpayer).

The vast majority of members of a pension scheme or plan would have been unaffected directly by the proposed changes, although several organisations suggested that the number affected would be greater than government estimates. However, given that the pension schemes and plans of which they are members would have incurred additional costs, there may have been some knock-on effects even for basic rate tax-payers in defined contribution schemes through increased charges or costs deducted from the scheme.

A small, well-advised and influential number of higher earners would have found themselves facing a decision on whether to stay in their pension scheme and pay the higher rate tax charge or leave the scheme. The decision for some may have hinged on whether they expected to be higher rate taxpayers once retired. Those that did may have decided to leave schemes rather than face paying higher rate tax on pensions where they have received only basic rate tax relief on some contributions.

Those employers with members in Defined Benefit schemes (other than those closed to further accruals) faced the most complex set of issues and the highest costs due to the proposals to introduce a new formula for valuing Defined Benefit accruals and to permit 'scheme pays'.

The employers, advisers, provider and representative body interviewed for this project spoke with one voice in criticising the costs and complexity of the proposals. Many also expressed the view that, faced with the prospect of a tax bill on employer pension contributions, most senior people affected would have chosen to leave the pension scheme altogether with further consequences for employer engagement. One or two went on to suggest that, when combined with the forthcoming auto-enrolment, it could lead to a decision by their employer to withdraw in part or wholly from providing pensions.

[43] HM Treasury (2010b)
[44] HM Treasury (2010a)

Interviewees' comments on the Labour Government proposals

"HR departments will not be calling for pensions to be part of the benefit package for higher earners."

"Sadly self-interest reigns and if pensions don't suit senior management, they won't consider them important. Employers will have to move to cash deals."

"Senior managers questioned whether we should continue with the scheme. We have a meritocracy where benefits should be applied consistently. People on modest salaries would have been caught because of relocation benefits."

"We oppose the change in principle because of its effect on decision makers in the pension market. Employers will become less sympathetic to pensions. If the directors are no longer in the scheme, they won't support it. "

"People will feel wronged that they did the right thing by saving and then they get a tax bill. Employees will leave the scheme rather than face a tax charge."

"This would have affected 550 people in our business in year one and 4000 people by year 20. It's important, not just because of the people affected today but because it affects future board members and decision makers. It has important implications for the long term."

"18% of our staff would have been affected. Not all of them would have left the scheme."

Table 6: Summary of anticipated direct effects of higher earner tax relief changes

Higher earner tax relief (Finance Act 2009)	
Employers	Costs associated with dealing with higher earner queries and restructuring benefit packages for higher earners. Increase in contributions to Defined Benefit schemes to cover increased scheme costs.
Schemes	Both one-off and on-going implementation costs. Particularly high for Defined Benefit schemes and schemes with high proportion of higher earners.
Scheme members	Pensions no longer efficient for higher earners caught by the changes. Some lower earners risk getting caught through ad-hoc payments such as redundancy.
Consumers in general	Initial impact limited due to focus on higher earners but impact of headlines could affect attitudes and behaviour in due course. Could also have been seen in positive light as a move against 'fat cats'.
Government	An estimated reduction in Exchequer costs of approximately £3billion if no behavioural changes among employers and employee.

Coalition Government Proposals
Following the change in UK Government in 2010, the new coalition Government announced changes to the Labour Government proposals in its first budget.

Although the Government acknowledged the concerns of employers and the pensions industry, it announced that it would continue with the overall policy of reducing the cost of pension tax relief as part of its 'commitment to tackling the fiscal deficit'.

In July 2010, the Government issued a discussion document on its proposals to raise at least the same amount of revenue as the Labour Government proposals but through a reduction in the annual allowance. Following discussion, the proposals are expected to form part of the Finance Bill 2011 and to take effect in April 2011.

In reviewing the proposals, the Government has set down three driving principles behind the proposed reforms:

- that tax relief and tax-free lump sums are designed to encourage people to take responsibility for their retirement planning;
- that the Government's overriding concern in developing proposals has been to reduce the Government deficit; and
- that any reforms should be fair, simple and sustainable.

The Government's discussion document published in July 2010,[45] proposed to achieve a reduction in the cost of pension tax relief by reducing the AA (annual allowance) from its current level of £255,000 to a level in the region of £30,000 to £45,000 whilst retaining tax relief at an individual's marginal rate of tax. Following 238 responses to the discussion document, the Government published its final proposals in October 2010.[46] The key proposals included:

- A reduction in the AA from £255,000 (2010-2011) to £50,000 from April 2011 (with no indexation of the index until 2016). Individuals will be able to offset any contributions in excess of the AA against unused allowances from the previous 3 years (known as carry forward). The latter element of the proposals is expected to exclude those who experience a sudden and temporary increase in contribution levels as a result of early retirement and redundancy.
- The exemption of ill health benefits from the AA regime.
- Deemed contributions from Defined Benefit schemes will be valued using a flat factor of 16.[47]
- The LTA will be reduced from £1.8 million to £1.5 million from April 2012.

[45] HMT (2010c)
[46] HMT (2010d)
[47] In the GAD recommendations used to set this factor, the Government Actuary states that he has been instructed to recommend a factor suitable '***for use over the medium term, for say the next 5 to 10 years***' GAD (2010)

- The intention to clamp down on the use of EFRBs as a mechanism for rewarding some employees.[48]

Where contributions exceed the new AA, a tax charge will be applied in cases other than ill-health or death, through the individual's tax assessment. This will ensure that individuals receive no tax relief on the excess. Any existing exemptions from the annual allowance charge will be removed.

The proposals continue the theme of differential impacts on Defined Benefit and defined contribution schemes:

- Defined Contribution pension schemes or individuals with personal pensions are expected to find it easy to cope with a lower annual allowance (by limiting contributions and thus removing the need for a tax charge),
- Some Defined Benefit scheme members will either continue to face a potential tax charge where the deemed value of their accrual exceeds the annual allowance or schemes will face the prospect of redesigns if they wish to avoid members being subject to a tax charge. The proposals encourage Defined Benefit schemes to consider whether they could redesign their benefit structures to meet the new AA.

The decision to use a single valuation factor of 16 for valuing Defined Benefit contributions was taken following criticism of the complexity and administrative burden that would be imposed by an age-related factor, as proposed by the previous Government. A single valuation factor follows the approach to valuing Defined Benefit pensions under the previous rules and will be relatively simple for schemes to adopt. However, the Government Actuary's Department, in recommending the valuation factor,[49] acknowledges that a single factor favours some individuals over others, in particular, older workers over younger workers and married members over those who are single at retirement.

A further important change was contained in the GAD report on the valuation of Defined Benefit contributions. Whereas the previous valuation formula applied the multiplier of 10 to the whole of the increase in accrued benefits arising from increases in pensionable salary, the revised formula reduces the increase by a revaluation factor, which it is expected will be based on the Consumer Price Index (CPI). This means that if the value of benefits is increased because of high inflation, this would not count towards the annual allowance.

It is proposed that the reporting of contributions against the annual allowance will be through the individual self-assessment tax return. Individuals will

[48] Employer-Financed Retirement Benefit Schemes (EFRBs) are unapproved pension schemes set up by employers for higher earners, in response to limits on tax relief for approved schemes
[49] GAD (2010)

need to collect the relevant information from their pension schemes, and may need help and / or specialist advice.

The method of payment of the additional tax due has yet to be finalised. One option still under consideration is for the payment to be made through the scheme in cases where employees are exposed to a significant tax charge. Such a mechanism is expected to add further complexity and cost to Defined Benefit schemes.

The Government's proposals are explicitly targeted at those individuals who are higher earners and able to save consistently large amounts in pensions. The Government estimates that around 100,000 individuals will be affected by the new rules, 70% of who would be on incomes of £130,000 per year or more and 20% on incomes of less than £100,000 per year. The Government anticipates that employers and trustees will find ways of adapting schemes / contributions to avoid individual's incurring a tax charge.

However, estimates are necessarily subject to a degree of uncertainty, as there is limited data available about the individuals who will be affected, and the estimates require a number of assumptions to be made. The estimates of the numbers affected also only covers the first year of implementation, and the announced freeze in the annual allowance could increase the numbers of people affected in future years. However, providing any independent corroboration of these estimates is problematic. Chapter 3 considers further the difficulties in identifying who might be affected by the latest change, and provides more detail of the possible impact on individual members.

The proposals are estimated to save the Exchequer £4 billion per annum by 2016. However, given the uncertainties and lack of estimates as to how many individuals are likely to be affected by then, there is also a high degree of uncertainty surrounding this estimate. It is not clear from published information what behavioural assumptions have been made in arriving at the estimated saving (such as how many pay the tax charges, how many reduce contributions, whether schemes themselves are changed, where else individuals may switch saving and which tax regimes these may fall under).

The new policy also reduces and freezes the lifetime allowance at £1.5 million. This reduction and freeze will mean that potentially a larger number of individuals could be caught, or be close to and have to consider, the lifetime allowance, and potentially to reach the limit earlier in their working life than under the previous regime. This increases the scope for individuals to request information and valuations from schemes, albeit still high net worth individuals.

Most of the interviews for this project were conducted just after the initial budget announcements but before the HMT discussion document. The revised proposals were broadly welcomed as an alternative to the Labour proposals, although a number of employers felt that more employees would be affected by the change than the earlier proposals which could cause them a different set of problems. However, the proposals were recognised to be less of a cliff-edge and left room for senior people to engage with pensions, albeit that the benefits would be reduced.

Interviewees comments on Coalition proposals

"We have no new DB accrual but the impact might still be felt. However, we might see a reversal in the 'no more pensions' mindset [that the Labour proposals introduced."

"Be careful what you wish for – these proposals could be worse and affect more people."

"These proposals will affect about 25% of our staff [compared to 18% for Labour Government proposals]. It's much easier for the people in Defined Contribution [but many people still in DB]."

"Our employer takes a thoughtful approach to the process [of pension decisions]... it feels as though these tax changes are the last nail in the coffin [of DB].

"[Our response] will depend on the valuation factors. Valuing the benefits becomes an industry of administration. The current formula of 10 times seems fair."

Table 7: Summary of anticipated direct effects of the reduced annual allowance

Reduced annual allowance (Emergency budget 2010)	
Employers	Some costs associated with dealing with higher earner queries, restructuring benefit packages for higher earners. Extra costs for Defined Benefit schemes passed on to employer but potential for lower contributions to Defined Benefit schemes where redesigned to avoid exceeding the annual allowance.
Schemes	Both one-off and on-going implementation costs (but lower than under previous proposals). Higher for Defined Benefit schemes.
Members	Ability to build up significant pension reduced. Some flexibility of funding removed for Defined Contribution members, particularly the self-employed. Some costs of implementation carried by Defined Contribution scheme members.
Consumers	Limited immediate effect. May be seen as a positive move to limit pensions of high earners.
Government	A reduction in Exchequer costs of between £2.9 – £4.8 billion by 2012-13.

Pension tax changes and employer provision

It is evident that changes in pension provision have taken place against a backdrop of economic, social and regulatory change. Within this environment, changes to pension taxation have added costs to the operation and funding of pension schemes and have removed some of the benefits of pensions for very high earners and, as with recent proposals, have created a sense of uncertainty. Although changes to pension provision cannot be laid at the door of tax changes alone, some of the changes may have accelerated change or at least failed to stem the tide of employers reducing their commitment to pensions.

There is a view that tax changes that affect senior management as individuals have a greater impact on employers' support for pension provision than changes that affect the pension fund more generally. Changes to fund taxation appear to cause irritation but do not directly bring about change. By contrast, changes which reduce the ability to receive tax relief for senior individuals are reported to have a greater effect.

In some occupational pension schemes decision makers' attitudes to provision for their staff may have been influenced as much, if not more, by their own arrangements as by the needs of their employees. Most of those interviewed for this project believed that they could trace a decline in board room support and engagement with pensions to the imposition of the earnings cap in 1989 through to the lifetime allowance changes in 2006. However it is not clear how this has been transformed into the availability of schemes, and how much of the change seen in employer sponsored provision would have occurred even without any changes in the taxations.

The Labour Government proposals to impose a tax charge on higher earner contributions was seen by some to be the final nail in the coffin of Defined Benefit pensions. Many of those interviewed expected senior staff and other high earners to choose to leave their pension schemes rather than face a tax charge. This could have further reduced the connection between senior staff and employer pension provision for other employees. To some extent, the very existence of the transitional arrangements may already have damaged the confidence senior staff place in their own pension provision.

Whilst the revised proposals suggested in the 2010 emergency budget potentially draw in more employees, they are thought to be less likely to have an immediate impact on provision. All members of pension schemes, even the highest earners, will continue to receive full tax relief on some contributions. The costs to schemes and employers are expected to be lower, particularly for Defined Contribution schemes and higher earners will continue to receive full tax relief on contributions, albeit lower contributions for some. The remaining unknown is what effect the changes will have on Defined Benefit schemes that could face the prospect of redesigning benefits to avoid exceeding the new annual allowance.

There is also the scope for further requests to schemes and employers for requests for information and advice, from those who breach the lower limits and those who think they may, who are likely to increase in number over time as the limits are frozen.

Over time, the disconnection between pension provision for decision makers and their employees might be expected to have an effect on wider pension decisions. A small number of employers with a high proportion of higher earners such as accountants and solicitors, investment banks and fund managers, may all find themselves with a significant number of employees and, perhaps more importantly, management, whose perception of pensions changes with the reduced value of tax relief. More workplace schemes may become limited to lower paid workers, or eventually close to be replaced by alternative, potentially less generous, arrangements. However, the underlying trends in longevity and the economy suggest that this may continue even without reform of tax relief. It is hard to isolate the size of the potential impact of policy changes in tax relief, even if the direction of change is clear.

Across the range of tax changes reviewed, the impact on Defined Benefit schemes, their sponsors and, sometimes, their members has generally been greater than the impact on Defined Contribution schemes.

- The restriction of tax relief on surpluses affected only Defined Benefit schemes and their employers. Employers with Defined Contribution schemes could, subject to limits, continue to pay contributions.
- The removal of ACT relief was felt equally by schemes but whereas sponsors of Defined Benefit schemes picked up the bill, members of Defined Contribution schemes carried the costs. Employers with Defined Benefit will therefore have been more focused on the impact.
- Pension simplification led to greater complexity for Defined Benefit schemes and their sponsors, although the lifetime limit applies equally across Defined Benefit and Defined Contribution.
- The Labour Government proposals could have led, and the more recent Government proposals could still lead, to Defined Benefit schemes facing a more complex set of calculations to value accruals than is in place today. Furthermore Defined Benefit members with higher incomes and/or long service may continue to face tax charges. Defined Contribution schemes do not face the same issue and members are likely to be able to cap their contributions as they go along in order to avoid a tax charge being applied.

The differential impact on employers with Defined Benefit schemes may have contributed to the decline of Defined Benefit schemes. The latest proposals have the potential to accelerate further the closure of Defined Benefit schemes with a further shift to Defined Contribution likely.

Interviewees' comments on the long term impact of tax changes.

"Changes to taxation, up to the recent changes, haven't been the driving force behind the decline in employer provision but they certainly haven't helped stem the flow."

"Some directors will become disengaged from pensions and pension arrangements for their employees will be lower down on the agenda as a result"

"Sadly self-interest reigns and if pensions don't suit senior management, they won't consider them to be important"

"Employers change DB schemes, not because DB is bad but because the rules [including the tax rules] change."

Chapter three: what impact could future changes have on employer sponsored pensions?

Chapter three considers how the reforms proposed by the Coalition Government in 2010 could affect higher earning individuals, in particular highlighting the different effects for those in Defined Benefit schemes compared to Defined Contribution and the outcomes for different generations of employee. The findings suggest that the tax charge for those in Defined Benefit schemes could lead to employers with Defined Benefit schemes facing the prospect of restructuring or closing their schemes, resulting in a further shift towards Defined Contribution schemes.

Who is affected?

The proposals put forward by the Coalition Government will affect those individuals with pension contributions or deemed contributions (for Defined Benefit) in excess of £50,000. The Government has proposed that the new Annual Allowance will not be indexed until 2016, when the position will be reviewed. The number of individuals affected could therefore increase due to earnings growth.

The Government has estimated that in the first year approximately 100,000 individuals could be affected by the reduction in the annual allowance.

However, it is difficult for independent commentators to verify or dispute these estimates due to the poor coverage of official publicly available data sources in relation to the earnings and pension contributions of very high earners.

The Government estimates that 70% of those individuals affected in 2011 will be earning over £100,000, which is comfortably within the top 5% of earners, and for the majority affected probably in the top 1%, of all earners in the UK.[50]

Those most affected by the change, even by 2016, will generally be very high earners:

- in Defined Contribution schemes who face limiting their contributions and receiving a lower income in retirement than they would have under A-day rules. In practice, the number in Defined Contribution schemes with contributions regularly in excess of £50,000 is likely to be low.
- in Defined Benefit schemes who face either paying a tax charge or negotiating reduced benefits under their scheme. The income threshold for those in Defined Benefit schemes caught by the new rules will vary according to income, scheme design, length of time spent in a scheme and future earnings growth.

[50] Based on figures from the Survey of Personal Incomes 2007/8

With the new annual allowances being frozen until 2016 and then potentially indexed at a lower rate than earnings, significantly more individuals could face the prospect of a tax charge on their pension contributions, particularly those in public or private sector Defined Benefit schemes.

Over that 5 year period, average earnings are expected to increase by 28%.[51]
So compared to average earnings growth between 2011 and 2016, the annual allowance will be reducing. One way of illustrating this is to adjust the £50,000 limit in future years to show what level of contribution in 2011 would breach the annual allowance in each year, assuming that the contribution grew each year in line with average earnings growth (as, for example, a fixed percentage contribution to a DC fund where pensionable earnings increases in line with average earnings would do). On this basis, the annual allowance will be worth only £39,180 in 2016 (Table 8). This relative fall compared to earnings means that the number of individuals likely to be caught by the threshold will increase, particularly if earnings grow faster than average for very high earners.

Table 8: Annual allowance in 2011 earnings terms, 2011 to 2016[52]

	2011	2012	2013	2014	2015	2016
Annual allowance adjusted for earnings growth	£50,000	£48,310	£45,880	£43,530	£41,300	£39,180

The effect on very high earning individuals
It is possible to use hypothetical examples to illustrate the types of impact that individuals who are affected might face.

PPI would normally model individuals who have a range of different career histories and earnings levels, covering low, median and high earners (often taken as having earnings high enough to put them just within the top 10% of full-time employees). Using these types of individuals would be informative in one sense, as none of the individuals would be directly affected by the changes. Even an individual earning enough to put them just in the top 10% of earners in the UK would be highly unlikely to ever have pension contributions in excess of the £50,000 annual allowance.

This analysis considers the impact of the Coalition Government proposals for pension tax relief on four very high earnings individuals. Since the changes are unlikely to affect the majority of lower and medium earners, the individuals are high earners over their working lifetimes. The four case studies are based on:

[51] PPI estimate based on estimated average earnings growth as projected by the OBR for the June 2010 Budget, rounded to the nearest 1%. OBR (2010)
[52] PPI estimates based on estimated average earnings growth as projected by the OBR for the June 2010 Budget, rounded to the nearest £10. OBR (2010)

- Two individuals aged 50 and earning £100,000 in 2010. The first, Helen, is a member of a Defined Benefit scheme, the second, Stephen, is a member of a Defined Contribution scheme. Stephen's contributions have been set so that he could expect a broadly similar pension income to Helen's (given the assumptions used in the model).
- Two individuals aged 30 and earning £50,000 in 2010 (and projected to earn £100,000 in 2010 terms by age 50). The first, Emma, is a member of a Defined Benefit scheme, the second, John, a member of a Defined Contribution scheme. John's contributions have been set so that he could expect a broadly similar pension income to Emma's (given the assumptions used in the model).

These individuals are not representative at all of the wider population of pension scheme members, with combinations of very high earnings and long histories of pension scheme membership. However, they are useful to illustrate specific issues that might arise as a result of the changes being made.

For each individual, the proposed Coalition changes are compared with the outcome had the A-day rules on contributions and lifetime allowance been maintained for the remainder of their career. The analysis allows for the three-year carry forward facility as proposed by the Coalition. The allowances are assumed to be increased in line with prices[53] after 2016.

The changes to the tax regime are assumed to affect the Defined Benefit and Defined Contribution pensions differently. Individuals in Defined Contribution schemes are assumed to be able to reduce their contributions so as to avoid breaching the annual allowance. Individuals in Defined Benefit schemes are assumed not to be able to reduce contributions, and so when they breach the annual allowance they will face an additional tax charge. In reality some DB scheme members will change their pension arrangements to avoid the tax charge, and some DC members may not reduce contributions but pay the tax charge, so these assumptions are a simplification. Further details of the models and assumptions used are given in the appendix to this report.

Analysis of these hypothetical individuals suggests that:

- Additional tax charges could lead to high marginal tax rates for very high earners
- If lower allowances lead to lower contributions, income in retirement will fall
- The lifetime allowance can still be exceeded even with a lower annual allowance
- Younger individuals with very high lifetime earnings and prolonged pension scheme membership may see a greater impact over their lifetime than similar older individuals

As a result very high earning individuals may change their behaviour in order to avoid additional taxation.

[53] Using the Retail Prices Index (RPI)

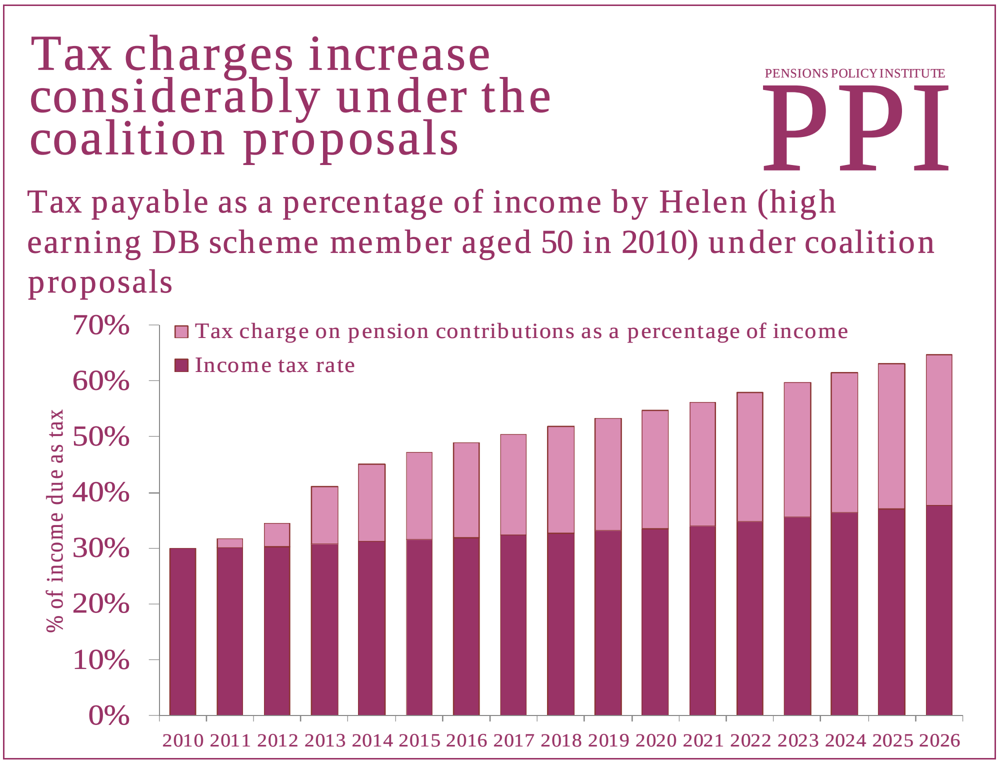
Additional tax charges could lead to high marginal tax rates for very high earners

Helen, as a very high earning and long serving member of Defined Benefit scheme, breaches the annual allowance when it is reduced to £50,000 in 2011 (even after allowing for the carry-forward rules). Helen's tax charge increases each year from 2011 until she reaches her state pension age of 66 in 2027. This is because her earnings and hence her pension contributions are assumed to grow faster than the annual tax allowance, which is frozen in cash terms until 2016 and then increased in line with prices. [54]

Combining Helen's income tax and pension contribution tax charge, she could face paying up to 65% of her income in tax by the time she retires. In the year before her retirement, when the impact of the reduced annual allowance is at its most extreme, Helen faces a tax charge on her deemed contributions equivalent to 28% of her gross income under the new regime (Chart 5). Very few individuals are likely to face tax charges at this extreme level, which result as a combination of very high earnings and very long (and continuing) membership of a DB scheme.

Helen, as a very high earner with long membership of a DB pension scheme, also has a very high retirement income (high enough to be in the top 5% of individual incomes in the UK) and so also faces the prospect of then paying tax again on most of the pension when it is paid.

Chart 5[55]



[54] Using the Retail Prices Index (RPI)
[55] PPI modelling, see appendix for further details

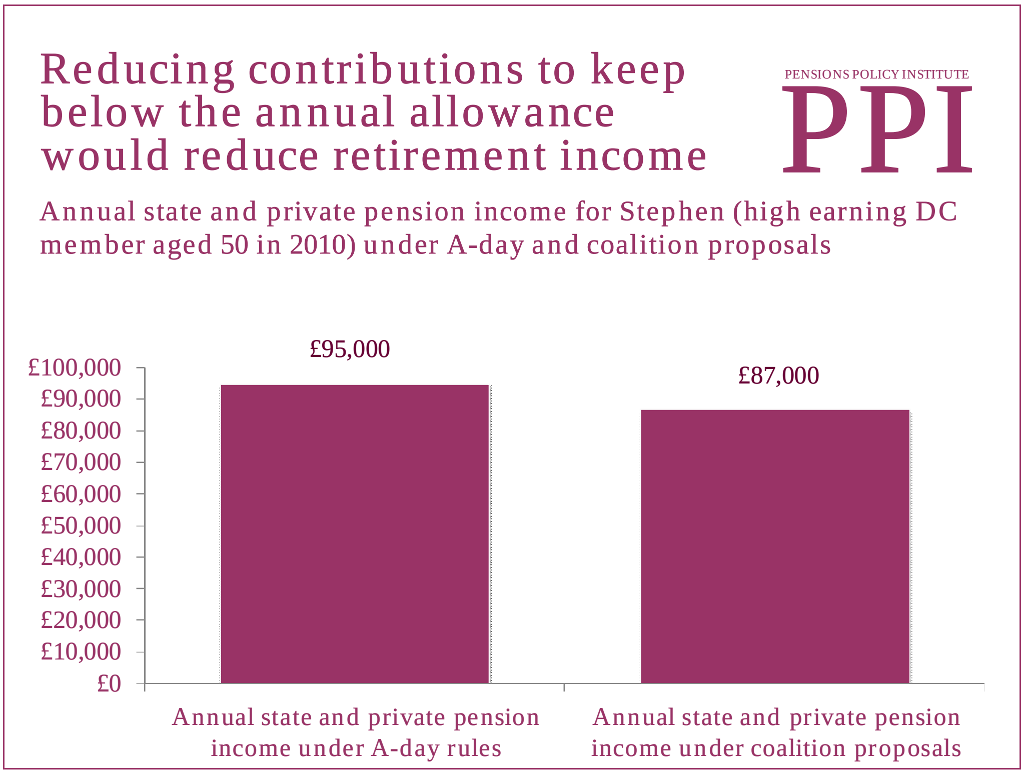
Under the previous (A-day) rules, Helen would not have breached the annual allowance.

If lower allowances lead to lower contributions, income in retirement will fall

Stephen has a similar very high earnings profile and career path to Helen but is a member of a Defined Contribution pension scheme. The scheme has generous levels of contribution designed to match the benefits of Helen's Defined Benefit scheme.

Under the A-day rules, Stephen's contributions never exceed the annual allowance. Under the proposed new rules, his contributions exceed the annual allowance (after allowing for the three years carry forward) at age 54. Rather than pay a tax charge on his contributions, Stephen's contributions are reduced to the level of the annual allowance. As a result, Stephen's eventual pension is reduced under the revised proposals (Chart 6).

Chart 6[56]



As Stephen is a very high earner and has been contributing to a pension scheme throughout his life, Stephen has a very high pension income – high enough to still be in the top 5% of all individual incomes in the UK.[57]

56 PPI modelling, see appendix for further details
57 Based on figures form the Survey of Personal Incomes 2007/8

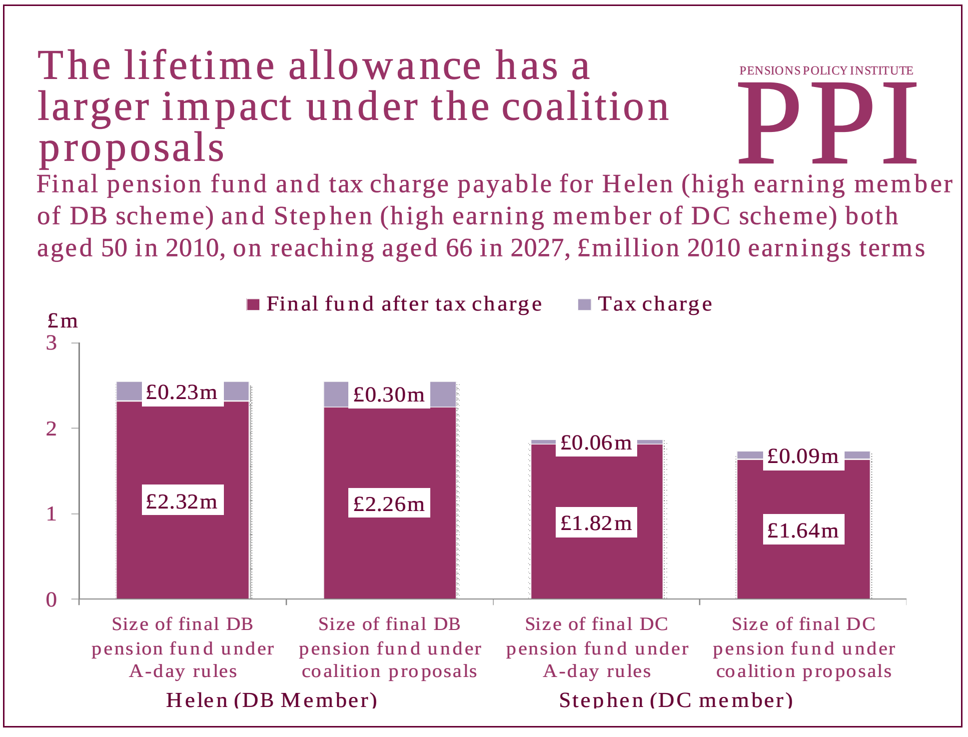
Under the A-day rules Stephen is able to retire at age 66 with a 25% tax free lump sum and an annual pension of around £95,000 (including state pension), a replacement rate of 55%. However, his annual pension is reduced by 8% to around £87,000 under the £50,000 annual allowance changes, a replacement rate of 50%. However, as a result of reducing his contributions, Stephen will not suffer any double taxation on his pension savings.

The lifetime allowance can still be exceeded even with a lower annual allowance
Both Helen and Stephen also face paying more tax on their pension funds at retirement due to the changes in the lifetime allowance.

Tax on the fund over and above the value of the lifetime allowance would reduce Helen's fund by 11%. Under the A-day rules, Helen's fund would have been reduced by 9% (Chart 7).

However, Stephen reduces his contribution in the new regime when his contributions would otherwise exceed the annual allowance. But despite building up a smaller pension fund, Stephen still faces a higher tax charge under the lifetime allowance in the new regime than he would have done under the A-day system. Under the new rules, Stephen's fund at retirement is reduced by 5% as a result of the lifetime allowance, whereas under the A-day rules, the fund is reduced by 3%.

Chart 7[58]



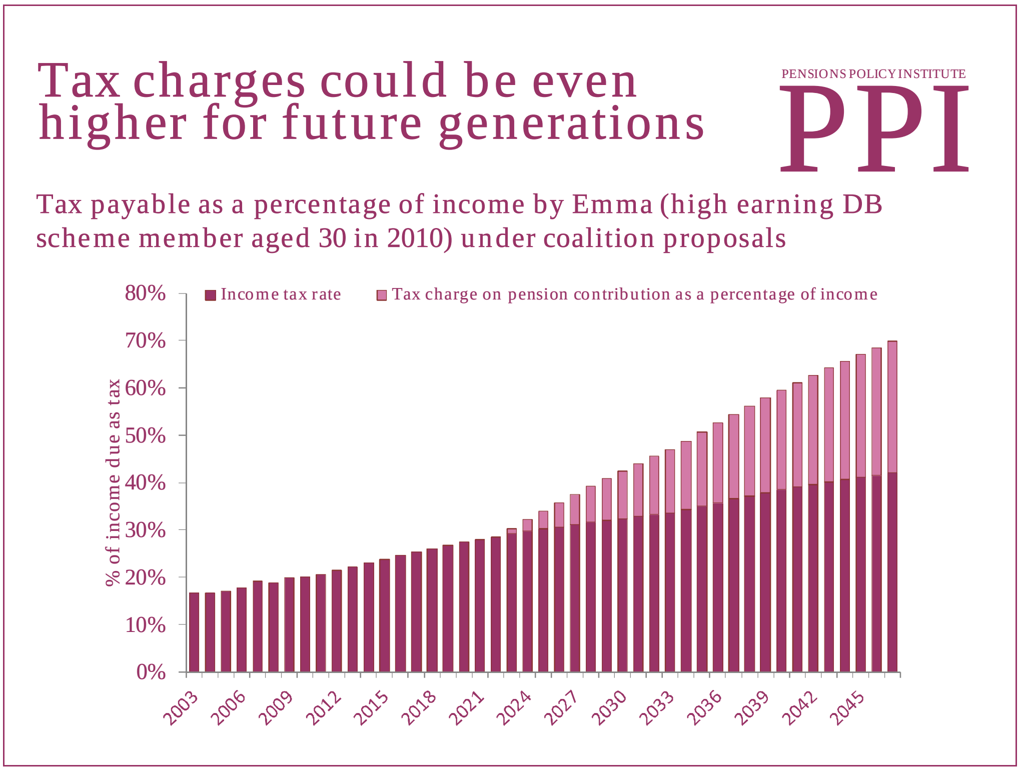
58 PPI modelling, see appendix for further details

Younger individuals with very high lifetime earnings and prolonged pension scheme membership may see a greater impact over their lifetime than similar older individuals

Emma and John are younger versions of Helen and Stephen, with very high earnings (eventually earning enough to have incomes in the top 1% of UK incomes) and with long pension schemes membership. As Emma and John are earlier in their careers than Helen and Stephen, they are not immediately affected by the changes in the annual allowance. Under the A-day rules, neither Emma nor John would have breached the annual allowance.

However, under the new proposals, Emma (the younger member of a DB scheme) breaches the reduced annual allowance at age 42 (Chart 8), much earlier than her older counterpart Helen (Chart 5)

Chart 8[59]



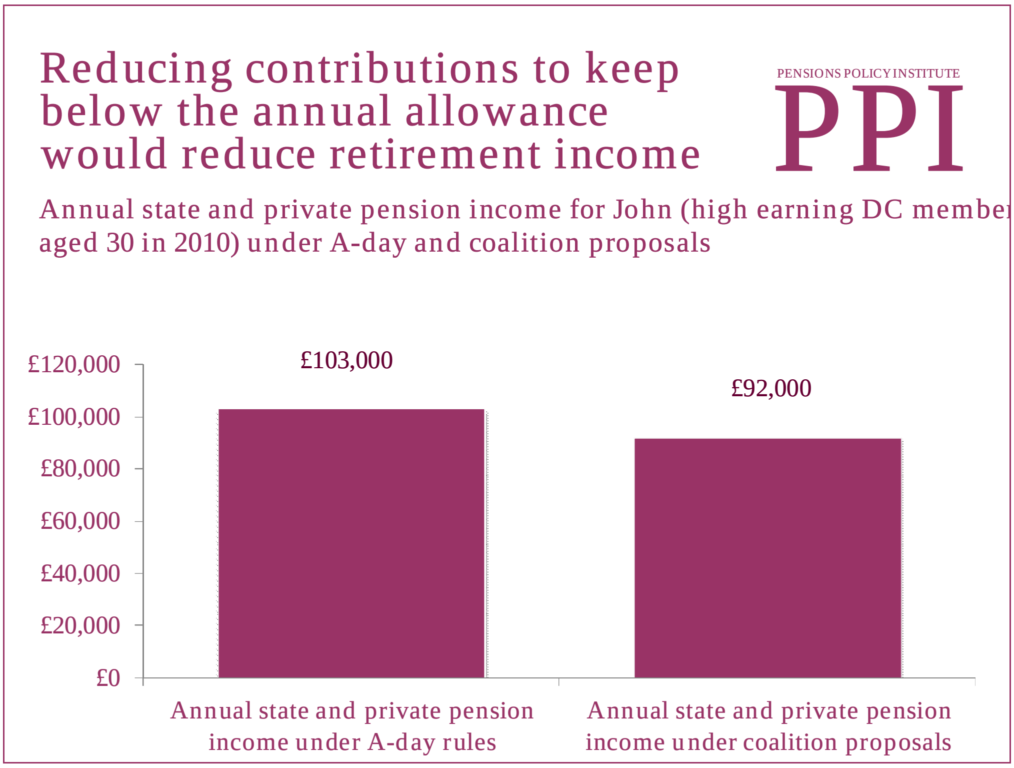
Combining Emma's income tax and pension contribution tax charge, she could face paying up to 70% of her income in tax under the new proposals by the time she retires. In the year before her retirement, when the impact of the reduced annual allowance is at its most extreme, Emma faces a tax charge on her deemed pension contributions equivalent to 28% of her gross income. Very few individuals are likely to face tax charges at this extreme level, which result as a combination of very high earnings and very long (and continuing) membership of a DB scheme.

[59] PPI modelling, see appendix for further details

John (the younger DC scheme member) has contributions in excess of the annual allowance at age 56, which is in fact 2 years later than Stephen. [60] At this point John reduces his contributions to avoid any additional tax charges.

As a result of this reduction in contributions, John would receive a lower pension income in retirement than under the A-day rules (Chart 9). His replacement rate is reduced from 55% under the A-day rules to 50% under the new policy proposals. This is a similar change to that seen by the older DC member, Stephen. Also like Stephen, John's pension income is still very high and high enough to put him in the top 5% of all incomes in the UK.

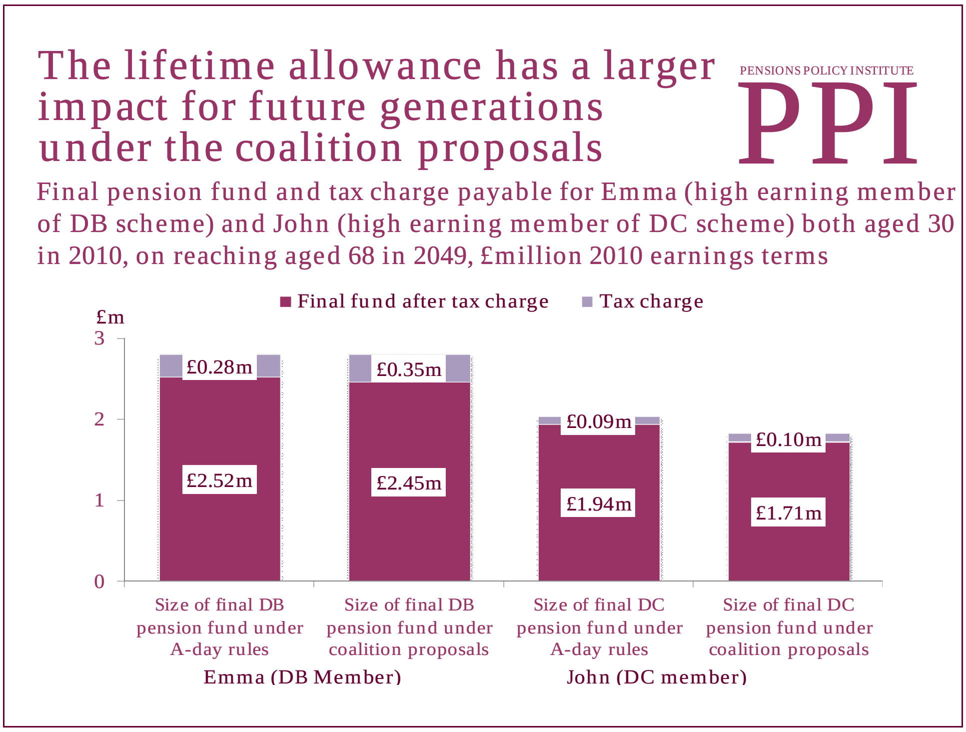
Chart 9[61]



[60] This is as a result of the assumption that after 2010 the annual and lifetime allowances are assumed to be increased in line with prices.
[61] PPI modelling, see appendix for further details

The lifetime allowance also has a greater impact for both Emma and John under the new proposals than in the A-day regime (Chart 10).

Chart 10[62]



Tax on her fund over and above the value of the Lifetime allowance would reduce Emma's fund by more than 12% under the new proposals, compared to 10% under A-day Rules. Under the proposed new rules, John's fund at retirement is reduced by 6% as a result of the lifetime allowance, whereas under A-day rules, the fund is reduced by 4%.

Many individuals may change behaviour to avoid additional taxation

The examples described above illustrate the different prospects facing those in Defined Contribution schemes compared to those in Defined Benefit. For high earners with Defined Contribution schemes, limiting contributions to the £50,000 cap will result in a reduced pension in retirement but will not lead to a tax charge.

However, for higher earners who are long-term members of Defined Benefit schemes, a significant tax charge after the end of the tax year is possible. For many, this could be an uncomfortable amount to find, particularly in a lump sum and even more so if the tax charge increases year on year. They may feel that the changes undermine the fairness of pension taxation. The Government is currently consulting on a range of options to allow individuals to meet potentially high tax charges.[63]

62 PPI modelling, see appendix for further details
63 HMT (2010e)

The higher paid Defined Benefit member will almost certainly wish to consider alternative strategies which may include reduced benefits from the Defined Benefit scheme, a switch to contributing to a Defined Contribution scheme or ceasing to be a member of a pension scheme altogether.

However, individuals are unlikely to be able to make these decisions alone. They are likely to need advice, both individually about their own contributions and from their employers if changes to pension arrangements are required. This could cover advice on contributions levels if individuals are at or close to the annual allowance as well as advice for those individuals getting close to the lifetime limit who may want to avoid additional tax, particularly DC scheme members who may wish to devise a strategy to get as close as possible to the lifetime limit without running the risk of undershooting the limit as a result of poor returns in the years immediately before drawing income from the pension fund.

This is however still only likely to affect a very small minority of pension scheme members, although an increasing number as the limits affect increasing numbers as they fall relative to earnings levels.

Potential impact on employers and Government

Employers with Defined Benefit schemes face a number of operational and strategic issues, most notably how to deal with employees who are caught by the rules. Some may choose to deal with members on a case by case basis. Others may decide on more radical solutions such as modifying the scheme rules or moving to a Defined Contribution arrangement. In either case this will increase the costs of running the scheme, and the cost of advice as to how to deal with individuals or how to re-structure. If schemes are re-structured, this could be very expensive in administrative terms for specific schemes and employers.

The changes proposed by the Coalition Government (the reductions in both the annual allowance and lifetime allowance) have been calculated to save £4bn per year in a steady state. However, behavioural changes among employers and employees could increase the level of savings further. A further shift from Defined Benefit to defined contribution schemes combined with lower overall contribution rates could lead to lower costs of pension tax relief.

Over the long term, the reduction in benefits in retirement among higher earners and other members of Defined Benefit schemes may counteract some of this short term saving and lead to reduced tax revenues for future governments.

While most employer and pension groups have welcomed the proposals as preferable to those proposed by the previous Labour Government, there remains uncertainty about the number of people likely to be affected by the proposals over the longer term and the impact upon both private and public sector Defined Benefit schemes. Whilst the proposals seem less likely to reduce employer engagement with pensions to the extent envisaged with the previous proposals, one consequence of the changes could be a further shift away from Defined Benefit towards Defined Contribution pension schemes.

Appendix: Modelling assumptions and methodology

This appendix describes the modelling assumptions used in chapter 3 of this report. The modelling in this report uses the PPI's Individual Model that was developed with a grant from the Nuffield Foundation. The Individual Model is the PPI's tool for modelling illustrative individual's income during retirement. It can model income for different individuals under current policy, or look at how an individual's income would be affected by policy changes. This income includes benefits from the state pension system and private pension arrangements, and can also include income from earnings and equity release. It is useful to see how changes in policy can affect individuals' incomes in the future.

In this analysis, the following assumptions have been made in the Individual Model:

- CPI Inflation of 2%
- RPI Inflation of 2.87%
- Average earnings growth of 4.5% in nominal terms
- Investment returns of 6% in nominal terms corresponding to a mixed equity / bond fund
- Annual management charges (AMCs) of 1% of assets under management
- Increases in the Basic State Pension in line with the 'Triple Lock' at 4.76% in nominal terms
- For the very high earners modelled, salary increases by broadly 4% per year in excess of average earnings growth. This is much higher than usual earnings growth assumptions and is constructed to hit target earnings levels at specific ages. However, there is evidence to suggest that pay for the top 1% of earners grows much more rapidly than for the rest of the population.[64]
- In DC pensions, a 37% contributions rate is used to be broadly equivalent to the DB pension examples, which are assumed to be based on a 1/60 accrual rate
- Where individuals breach the annual allowance, for the new regime 3 years carry forward is allowed (that is any unused annual allowance from previous years can be used to increase the annual allowance in the first years that the allowance is breached).
- After 2016, the annual allowance and lifetime allowance are assumed to be increased each year in line with prices (that is, the Retail Prices Index)

This analysis considers the impact of the Coalition Government proposals for pension tax relief on four individuals. Since the changes are unlikely to affect the majority of lower and medium earners, the individuals are high earners over their working lifetimes. The four case studies are based on:

- Two individuals aged 50 and earning £100,000 in 2010. The first, Helen, is a member of a Defined Benefit scheme, the second, Stephen, is a member of a

[64] See for example Chapter 2, and Chart 2.E of Hutton (2010)

Defined Contribution scheme. Stephen's contributions have been set so that he could expect a broadly similar pension income to Helen's (given the assumptions used in the model).

- Two individuals aged 30 and earning £50,000 in 2010 (and projected to earn £100,000 in 2010 terms by age 50). The first, Emma, is a member of a Defined Benefit scheme, the second, John, a member of a Defined Contribution scheme. John's contributions have been set so that he could expect a broadly similar pension income to Emma's (given the assumptions used in the model).

For each individual, the proposed Coalition changes are compared with the outcome had the A-day rules on contributions and lifetime allowance been maintained for the remainder of their career. The analysis allows for the three-year carry forward facility as proposed by the Coalition.

The changes to the tax regime are assumed to affect the Defined Benefit and Defined Contribution examples differently. Individuals in Defined Contribution schemes are assumed to be able to reduce their contributions so as to avoid breaching the annual allowance. Individuals in Defined Benefit schemes are assumed not to be able to reduce contributions, and so when they breach the annual allowance they will face an additional tax charge.

The modelling carried out for this project was designed to compare:

- The age at which pension contributions exceed the revised annual allowance, triggering a tax charge for members of Defined Benefit schemes or a reduced contribution rate for Defined Contribution scheme members.
- For members of Defined Benefit schemes, the amount of tax charge due each year once the annual allowance has been breached.
- The impact that the tax charge has on the individual's lifetime average tax rate.
- For members of Defined Contribution schemes, the amount by which pensions in retirement are reduced as a result of keeping contributions below the annual allowance and the effect that this has on the pension in retirement.
- The extent by which the fund, at retirement, exceeds the lifetime allowance and the tax charge payable at that point.

Further details and modelling results are available on request.

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- A major oil company
- A large US investment bank
- A large business support company
- A large Industry-wide scheme

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