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AJBell Investcentre

News & Views

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Welcome

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Pensions tax relief consultation

I was asked recently by one of the trade newspapers to write an article on the pensions tax relief consultation, a request which normally I would have acceded to. However, the news editor attached a condition to this request – that the article wasn't to be one of my self-interested rants. How very dare he?!

It did, however, make me stop and think about the motivation behind the views that would inform such an article.

I seem to be in a small minority that believes the current system works well, and that there would be little to be achieved by making wholesale changes. In fact, I believe that wholesale changes will further undermine pension savers' confidence in the stability, longevity and integrity of the pensions legislative framework.

Is a desire for simplicity motivated by self-interest? Maybe partly, as my brain is full of stupid pension rules and there isn't room for any more. I also remember well the discussions with the powers that be in the run-up to pensions simplification and these so-called 'new' ideas for pension reform were considered then and discounted for very good reasons.

Is a desire for the retention of upfront tax relief at marginal rates borne out of self-interest? After all, many of our clients are higher and additional rate tax payers and so they would be net losers if we moved to a flat rate of tax relief or to an ISA styled pension regime. Hopefully the arguments I make below will persuade that this is not the case.

Most commentators are still scratching the surface of the technical debate and I have tried to highlight a few of the challenges with the options being put forward, and to demonstrate that the alternatives are, in all likelihood, more complex than the existing regime.

Regular readers may remember that my initial reaction to the announcement of the consultation in the Chancellor's Summer Budget was that the Government would struggle to transform pensions tax relief in a coherent, simple and fair way and certainly not in such a short window. Remember, it took four years to implement pension simplification, so whether the outcome has already been decided we can only speculate.

If getting people to save more into pensions is the real objective then I doubt that the changes being discussed are likely to deliver this. However, if the agenda is to save a few quid in tax relief then that is a different matter. The

amount of money at stake in this consultation is massive, as are the consequences for this and future generations. It is not hard to conclude that decisions as momentous as these should be wrested away from politicians who do no more than doff their cap to the long-term implications that stretch beyond their typically short tenure in office.

In our dealings with the Treasury it has certainly given a perception of being genuinely open to each of the options being proposed, namely:

- To maintain the current system of pensions tax relief without policy changes;
- To keep the Exempt, Exempt, Taxed (EET) structure and marginal relief but make further changes to it, for example adjusting the annual allowance, lifetime allowance or tax-free cash;
- To keep the EET structure but provide tax relief on contributions at a flat rate; or
- To move to an ISA-style Taxed, Exempt, Exempt (TEE) model but with some type of Government match to encourage saving that will be locked away until savers are at or approaching retirement.

It has also been clear that those managing the consultation are open to suggestions as to how the problems linked with each can be dealt with. Of course, Treasury officials being open to ideas during the consultation may not have any impact on the outcome if Ministers have already decided on the outcome!

The Taxed, Exempt, Exempt solution

If we ignore The Centre for Policy Studies, who have long advocated this approach, I've seen virtually no outright support for the Taxed, Exempt, Exempt 'Pension ISA' solution. I suspect I'm more open to the TEE system than many in the pensions industry, but my support for its introduction would be conditional on a number of factors, some of which I think the Government would struggle to achieve.

Those advocating the TEE system argue that it is simpler for pension savers to understand, and that it will make pensions more like ISAs. ISAs have seen huge growth in the rate of subscriptions in recent years, partly because they are simpler; so if we make pensions more like ISAs, people will save more into pensions.

This is a great argument when you're looking to grab headlines, but things very quickly become a lot less simple as soon as you look beyond the basics.

A big complication is that a huge amount of pensions have accrued under the existing EET system. What do we do with those?

At one end of the spectrum of options, the Government could leave the accrued benefits alone. This would result in two separate pension frameworks operating side by side for accrued and new savings until accrued EET benefits are phased out. This would take decades, and in the meantime the one thing we won't have is simplicity.

At the opposite end, the Government could force the accrued EET pension savings into the TEE model by imposing a compulsory upfront tax on accrued pension savings in return for a promise that the benefits would not be taxed in the future. This deals with the problem of running two systems side-by-side for many years, but it comes with just a few 'minor' issues – it would probably be illegal, it would be virtually impossible to achieve for those pensions which don't have the liquidity to pay the tax, stock markets would plummet as a result of the required level of disinvestment, several insurers would probably go out of business, and absolutely no-one would trust the Government's promise of zero future taxation – other than that, forced conversion to TEE looks great and would go a long way to clearing the Government's debt mountain! Thankfully, the whispers I've heard indicate that the Treasury has ruled out forced conversion, primarily because of the question mark over its legality.

That leaves the middle option of voluntary conversion from EET to TEE. This wouldn't solve the problem of needing to maintain two frameworks, as not everyone would convert. I'm also sure that the choice to convert would not only sit with clients, but providers would have the choice of whether they offered conversion. We would end up in a similar position to the one we have with pension freedoms, where some savers will not be able to convert because their provider has chosen not to offer the option and because they face significant penalties to transfer to a scheme that does offer the opportunity to convert.

The Government would also need to consider the level of tax to impose at the point of voluntary conversion. Too high and no-one will take up the option, too low and not enough tax will be raised. Even if the Government finds what it considers a sweet spot, we will quickly see guides explaining who will be better off converting and who will benefit from staying in the current system. The majority of people who choose to convert will be those for whom the initial tax hit will be lower than the tax they would have paid in the long run. This doesn't sound very positive for the country's long-term finances, although perhaps the immediate financial needs of the Government outweigh concerns about the long term.

There is talk of there being an upfront incentive to invest in this TEE model which is somewhat contradictory. Even if the Government included an upfront incentive, people would still need to engage with pensions in order to understand this incentive in the same way as they need to engage to understand the tax relief they currently receive. The upfront incentive would be necessary because, without it, people will just choose not to lock their money away into a pension. A 'pure' TEE system with no incentive would, I believe, have a hugely negative impact on pension savings.

Also under consideration is the introduction of an incentive for savers to keep their funds in the pension beyond the minimum pension age of 55. Since pension freedoms were introduced the level of withdrawals has been widely reported. One of the main brakes on withdrawals has been the amount of tax that needs to be paid. If a TEE system sees the removal of this tax, there will be very little incentive for most savers to keep funds in their pensions. The Inheritance Tax benefit helps, but will be irrelevant to most pension savers, and will be outweighed for many by a concern that the Government will introduce a withdrawal tax.

What this incentive to keep funds in a pension until State Pension Age looks like is still up for grabs, but it is clear that if TEE does need to come with both upfront and backend incentives in order to succeed, it is unlikely to be much simpler than what is already in place.
Defined benefit accrual and employer contributions are additional significant complications when considering TEE, but I'll leave delving into those until I move on to the proposals for a flat rate of relief.

Having demonstrated that TEE isn't quite as simple as the headline writers would have us believe, we also need to remember that the vast majority of people don't choose to save into an ISA rather than a pension because it is simpler. I could list half a dozen reasons why ISAs are chosen by some savers over pensions before I reached the simplicity of the tax framework. The most important is that they have immediate access to the funds they've invested – this makes the investment less risky from an affordability standpoint because the funds are immediately available.

Also, there are many who claim – with some justification – that the perception of the tax breaks for a basic rate tax payer investing in an ISA is far more attractive than the reality.

Likelihood of moving to a TEE system – 1/10.

Keep EET, but move to a flat rate of relief

A flat rate of relief is the option which has found favour with many within financial services. Several pension providers have directly called for its introduction – as, it seems, have many industry bodies. I have to admit that this has left me scratching my head a little. If it is better than the current system, why haven't they all been calling for it before? It was discounted quite early in the simplification process that ran between 2002 and A-Day in 2006.

Much of the support for the merits of a flat rate of pension tax relief has focussed on its simplicity in comparison to both the existing EET system and the alternative of TEE, and the hypothesis that a simpler system would encourage people to save more.

The problem with this argument is that virtually all of the complexities surrounding a TEE system also exist with a flat rate of relief. I do wonder whether many of those arguing for a flat rate of relief are doing so because they don't believe the Government has any intention of retaining the current EET system – even with further changes to make it more sustainable. I suspect that they view a flat rate of relief as the least worst of the options that are genuinely on the table and this is why we are seeing support for a system that very few had advocated in the past. I think a flat rate of relief could turn out to be fool's gold.

One CEO of a major investment house told me they had backed the flat rate option in their consultation response because they felt change was inevitable and therefore this was the best of the remaining horses to back. I posed a few quick-fire questions on some of the technicalities associated with this approach and I got the distinct impression that, like many consultees, they had formed their view on the sizzle rather than the sausage.

The problem is that the pension system is inherently complex. There are many facets to it and simplification in one area often leads to complications in another.

The proposal for a flat rate of tax relief is a perfect example. For personal contributions to a personal pension it would indeed be simpler. However, if you look at HMRC's own estimates, about three quarters, or £20 billion, of the £27 billion of the pension tax relief applied each year relates to employer contributions and defined benefit accrual rather than personal contributions.

A flat rate becomes considerably less simple when employer contributions and defined benefit accrual are considered. If we assume the flat rate is 30%, basic rate tax payers would have to claim the additional 10% relief somehow and higher and additional rate tax payers would be hit with an additional tax charge. Of course, mechanisms could be put in place to achieve this but I'm not sure you could argue that a system requiring payroll adjustments or the completion of tax returns to cope with three quarters of contributions would be simpler than the current system.

The simplicity of a flat rate or a new matching system could encourage personal contributions from new savers into pensions. However, the complexity of employer contributions and defined benefit accrual could discourage many employers.

When considering whether an increase in personal savings would outweigh the complexity that would be introduced elsewhere, we also need to consider that simplicity is not the only, or most important, factor that determines whether people use their own money to save. Affordability is equally, if not more, important.

With debt levels at record highs, if someone simply cannot afford to save it will not matter how simple the system is. Before making a decision on a flat rate of pension tax relief there needs to be a detailed analysis of whether it will genuinely encourage more people to save via DC pensions

and, crucially, what impact it would have on DB schemes and employer DC contributions. The worst outcome would be to see an increase in personal contributions to DC schemes but a reduction in employer contributions which is where the vast majority of pension savings currently occur.

Likelihood of moving to an EET system with a flat rate of tax relief – 4/10.

My response to the tax relief consultation

Having set out many, but by no means all, of the issues with both the TEE and EET flat rate of relief proposals, I feel obligated to put an alternative view forward.

I have told the Government that I could support a change to either of the main alternative options. However, that support is contingent on the new framework genuinely being simpler.

As I have set out above, I have doubts that this aim can be achieved with either of the alternative options. If it cannot, then we will also fail to achieve the other principles that sit behind the consultation – individuals will not take personal responsibility for their savings, we will not build on the early success of automatic enrolment (in fact, we might reverse it) and the system will not prove sustainable.

The Government must demonstrate that an alternative system is simpler. If it cannot do this then it should look to achieve its aims by making changes within the confines of the current EET system.

My three simple, but key, proposals are set out below. Whether we end up with a TEE system, flat rate, or we retain marginal rate relief in some form, the changes below will achieve the outcome of making pensions simpler.

- Separating the DC and DB regimes. In introducing the pension freedoms to DC only, the Government has finally accepted that the two frameworks work better when considered in isolation. This principle must now be applied to accumulation in the same way it has to decumulation.
- Limit tax relief on DC schemes at the point of contribution, not at the point benefits are taken. So an annual allowance, but no lifetime allowance for DC.
- Limit tax relief on DB schemes at the point benefits are taken, not at the point benefits are accrued. A lifetime allowance, but no annual allowance for DB.

The initial reaction to my focus on ensuring the foundations of each of the three options are sound, rather than throwing my support behind one of the alternatives, has been interesting, notwithstanding the condition of the new regime being more simple than the existing.

I have not analysed the option of doing very little as this is the benchmark against which other alternatives must be measured. I do think it is the most likely option and if we could secure my long-suggested changes to do with separating DB & DC along with the changes to the annual and lifetime allowance as highlighted above, the consultation will be a well worthwhile exercise. I would score the likelihood of this option at 6/10 (4/10 with my suggested changes).

So, self-interested rant or a sore backside full of splinters from sitting on the fence? I will leave you to decide. As for the politicians, Just Keep It Simple, Stupid.

Applications for fixed and individual protection

I'll end with a short note covering a topic about which we have received numerous enquiries: the process through which it will be possible to apply for protection against the drop in the lifetime allowance from £1.25 million to £1 million in April 2016.

HMRC had previously confirmed that it would introduce two new forms of protection, namely fixed protection 2016 and individual protection 2016. Once protection has been obtained it is expected that these will operate in broadly the same fashion as their 2012 and 2014 equivalents.

In a Pension Schemes Newsletter released in the last few weeks, HMRC has confirmed a couple of areas in which these forms of protection will differ from earlier versions.

Firstly, it will not be possible to apply for either form of protection until after the lifetime allowance has dropped. Secondly, HMRC does not intend to issue certificates confirming that protection is in place. Instead it will provide clients with a protection reference number.

Looking at the timing for protection applications, I'm sure readers will be aware that it has been possible, or more accurately it has been a requirement, for clients to apply for both previous versions of fixed protection before the date upon which the protection takes effect. On this occasion, clients are going to need to wait until after the start of the new tax year to apply. At best, this will bring complication for those clients who wish both to apply for fixed protection 2016 and to take benefits shortly after the start of the new tax year – they will be told they are crystallising a particular percentage of the £1 million standard lifetime allowance, and once protection has been confirmed will receive updated documentation from their provider showing a different percentage. At worst, they will have to choose between a lifetime allowance charge and delaying the commencement of benefits.

Part of me does wonder whether the delay in opening applications is linked to the Treasury's tax relief consultation. It doesn't make much sense to go to the

trouble of allowing individuals to apply for fixed protection if the lifetime allowance is going to be scrapped, or significantly amended, in coming months. One can but hope!

The lack of a protection certificate may also cause problems. For individual protection we are going to need access to more information than just a reference number, as this won't tell us the value of an individual's protected lifetime allowance. This would indicate that some form of electronic access will be granted to confirm the value of the protection. It doesn't make a great deal of sense for five forms of protection to operate using a paper certificate, but for the two new versions to operate electronically. I hope HMRC intends to bring the earlier forms of protection in line, but I have a feeling my wishes won't be met here either.