

Summary

The tax relief permitted on pension lump sums disproportionately benefits the wealthy at taxpayers' expense. The result is a regressive system where those with the most generous entitlements also receive the highest rate of tax relief. At a time when the public finances are under strain wealthy individuals are able to shelter considerable amounts of pension income from the tax system.

This paper proposes that those individuals taking lump sums above the higher rate tax threshold (£42,475) should have to pay tax analogous to income tax at the higher rate. This would mitigate the regressive outputs of the current pension system whilst ensuring that the average pensioner can still benefit from the flexibility that a tax-free lump sum provides at retirement.

Making this change would prevent those with the greatest means from gaining disproportionately via a taxpayer subsidy of their pension income. It would also raise additional revenue for the Treasury. We estimate that the proposed changes would contribute an extra five per cent to annual income tax revenues from future pensions in payment.

Introduction

A recent survey suggests that around eight out of ten pensioners drawing private or company pensions opt to take a tax-free lump sum at retirement. For many pensioners the payment is not particularly large, with the average paid amounting to around £21,000.¹ However for some wealthier pensioners with large pension pots the amount they are able to withdraw as a tax-free lump sum can be considerable – up to £450,000 in 2011/12.² Whilst tax relief on pension contributions has been the subject of considerable policy debate (the Liberal Democrats have, for example, proposed removing higher rate tax relief on contributions) the issue of tax-free lump sums has received relatively little or no attention. This paper aims to redress this.

Pension tax relief has traditionally been a difficult and controversial area for policy-makers; Gordon Brown's removal of generous tax credits for pension

1 Survey by Research Plus on behalf of The Prudential, 15th June 2011.

2 This limit will fall to £375,000 in 2012/13.

A relief for some: how to stop lump sum tax relief favouring the wealthy

Mark Lloyd
with Chris Nicholson
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CENTRE:FORUM

The system as it stands is both expensive for the taxpayer and benefits the wealthy disproportionately

fund returns on investment in 1997 was criticised heavily, despite raising billions of pounds in extra tax revenue.³ However, with the government looking to reduce the fiscal deficit and many workers nearing retirement, we believe a reassessment of tax relief on lump sums is needed.

The current pension tax system

At present a number of different sorts of pension schemes exist which can be split into two broad sub-sets: 'defined contribution' and 'defined benefit' schemes.

- *Defined contribution schemes* make no guarantee as to the final level of retirement income a contributor will receive, rather the level of income gained, will depend on the performance of the pension scheme's investments and market conditions. An employer may guarantee to match an employee's pension contributions up to a certain level, such as four per cent of salary, so as to contribute to the pension fund's value. The individual is then able to use the money accrued at retirement to buy an annuity (yearly retirement income) from a pension provider at prevailing market rates. This kind of provision places the risk of poor investment performance, or increased liabilities due to rising life expectancies, on the employee and pension provider. To illustrate; a 65-year-old male non-smoker retiring today, who had saved £100,000 over his working life, could buy an index-linked annuity of around £4,400 per annum (see Table 2 in Appendix 1).
- *Defined benefit schemes*, in contrast, place the financial risk in the employer's hands. This is a form of pension provision whereby an employer guarantees an employee a particular rate of retirement income *ex ante* in return for a fixed contribution from the employee, such as four per cent of annual income. Prior to the recent

pension reforms a typical public sector defined benefit scheme might offer a pension of 1/80th of an individual's final salary for every year's service, plus a tax-free lump sum of around 1.5 times final salary. Due to the potential costs and risks involved in guaranteeing such provision, defined benefit schemes are becoming increasingly rare in the private sector.

UK tax law encourages individuals to save for a pension by offering tax relief in the first two stages of the three-stage pension 'lifecycle':

- 1) Contribution stage (cash paid into pension scheme)
- 2) Investment stage (funds invested for capital growth)
- 3) Withdrawal stage (funds paid out as cash in retirement)

In the contribution stage, where money is paid into a pension scheme, any deposits are subject to tax relief up to a certain level. This level has varied substantially over time but is currently set at £50,000 per annum. This means that whatever amount of income, up to £50,000, an individual pays from their salary into their pension pot is discounted as taxable income and can be invested in a pension fund free of income tax today.⁴ Currently, individuals are allowed to accrue a lifetime total of £1.8m in their pension pot before they are liable to any tax charge on these contributions. The measure is designed to prevent people being taxed twice on the same income; once when earned today, and again when the money is paid as a pension annuity in retirement.

Tax relief on contributions is therefore a deferral of tax. The amount of tax relief actually received depends on the amount of income tax that would have been paid on the initial contributions relative to the rate of income tax paid when the money is withdrawn as a pension in retirement. Wealthier individuals are often able to benefit from 'tax arbitrage' on pension assets, as they gain tax relief at a higher marginal rate on contributions than they are eventually taxed at when their pension income is drawn in retirement (see inset box, page four).

Pension funds also benefit from tax relief on their investment income (capital gains

³ See: L Halligan, 'Brown's raid on pensions costs Britain £100 billion' The Telegraph, 15th October 2006; and A Murray-Watson, 'Revealed: How Gordon Brown has cost you £100,000', The Independent, 8th April 2007.

⁴ In the case of defined benefit schemes, the £50,000 limit applies to growth in value of the pension over a year, beyond this amount additional increases in value may be subject to tax.

and interest payments) and national insurance tax relief on employer pension contributions. All this makes pension saving more tax-efficient than other forms of retirement investment.

Income tax bands (exclusive of personal allowances)

2011-12	£ a year
Basic ^{5,6} rate (20%)	0-35,000
Higher rate (40%)	35,001 - 150,000
Additional rate (50%)	Over 150,000

Note: For tax-free personal allowances see Table 3 (page 15).

Tax-free lump sums

As a further inducement towards pensions saving, individuals have traditionally been allowed to carry out a 'commutation' of some of their pension entitlements. This means reallocating some pensions wealth from being paid out as annuities to being withdrawn as a single cash lump sum.⁷ Data from a 2007 report suggests that in the region of 400,000 people draw on a lump sum payment from their pension each year.⁸

Under rules for the tax year 2011/12 individuals over 55 years of age may qualify for a tax-free lump sum up to the value of £450,000.⁹ Those in defined contribution schemes are able to take up to 25 per cent of their total pension pot tax-free, and those with defined benefit schemes (where there is no fixed pension pot) are broadly able to take up to 25 per cent of the 'capital value' of their pension rights. The capital value is usually defined as 20 times the value of their first annuity.¹⁰

For those who take a lump sum, a portion of their income has benefited from tax relief on a number of levels: upon contribution,

If the government agrees on the principle of progressive taxation, it would appear perverse to continue to allow the wealthy to benefit the most from tax relief on pension lump sums.

upon payment of investment income, and again upon withdrawal of their lump sum. It is the sustainability and fairness of this extensive system of pension tax relief that CentreForum questions as part of a wider focus on making UK taxation fairer.

The system as it stands is both expensive for the taxpayer and benefits the wealthy disproportionately. We analyse some options below for how tax policy can be adjusted to correct this distortion and ensure that the wealthy do not benefit disproportionately from lump sum tax relief at the taxpayer's expense.

The pension tax relief problem

A fundamental problem with pension tax relief is that the progressive nature of the UK tax system, whereby an individual's marginal tax rate rises as their income increases, is mirrored in a regressive system of tax relief. An individual will therefore benefit from a greater marginal rate of tax relief on pension contributions as their income increases.

This is a symptom of the UK's 'exempt/exempt/taxed' (EET) structure where pensions are largely taxed only in the payment stage. An individual can accumulate a pension pot from income that would be taxed at high marginal rates, then withdraw that income in retirement and be taxed at a much lower rate on their annuity. In 2008-09 individuals with income over £150,000 represented only 1.5 per cent of pension savers, yet received a quarter of all tax relief on contributions (£6.1 billion). This amounted to an average of £27,000 per person for higher earners, an amount in excess of the median wage, and compares with an average of £1,000 for people who pay income tax at the basic rate.¹¹

In the 2009 Budget the then chancellor, Alistair Darling, announced that higher rate tax relief on pensions contributions would be tapered down to 20 per cent for

5 Since 2008/09 there is a 10% starting rate for savings income only. The starting rate limit for savings was £2,440 for 2010/11 which increased in line with RPI to £2,560 for 2011/12. If an individual's taxable non-savings income exceeds the starting rate limit, then the 10% starting rate for savings will not be available for savings income.

6 The rates available for dividends for the 2010/11 tax year are the 10 per cent dividend ordinary rate, 32.5 per cent dividend upper rate and the 42.5 per cent dividend additional rate. These rates will stay the same for the 2011/12 tax year.

7 In the case of total pension pots below £18,000 individuals are permitted to carry out a 'trivial commutation' allowing them to access their full pension pot subject to income tax on 75 per cent of the total value.

8 See: CentreForum, 'Setting pensions free' by Steve Webb and Jo Holland, April 2009.

9 The amount that can be taken as a tax-free lump sum will be reduced to £375,000 from 2012/13 onwards as the lifetime allowance is reduced from £1.8m to £1.5m.

10 HM Customs and Revenue, 'Guide to changes in lifetime allowance', December 2010.

11 HM Treasury, Budget 2009, HC 407, 22nd April 2009, para 5.88 and 5.91.

A simple overview of tax relief for the wealthy individual

The government has recently taken steps to reduce the level of taxpayer subsidy given to pension savings by capping tax-free contributions at £50,000 per year. From 2012/13 the individual tax-free 'lifetime allowance' on pension savings will also fall from £1.8m to £1.5m. However, despite these changes wealthy pensioners will still benefit from generous tax relief throughout the pension lifecycle. To illustrate this, consider the simplified example of 'Person A'.

Person A starts saving from the age of 25 in April 2012, contributing to his pension at the maximum tax-free rate of £50,000 annually from his £300,000 salary, on which he would have paid 50 per cent tax under current rules.

Person A's contribution rate and investment growth means that he will reach the maximum lifetime allowance, equal to £1.5m at today's prices, relatively early and will have considerable wealth by the time he retires.

Choosing to take the full £375,000 tax-free lump sum allowed under the new rules, Person A is

left with £1,125,000 at today's prices with which to buy an annuity. That would currently buy him an annuity of around £41,400 per year, on top of a state pension of £5,312. On a combined income of £46,712 he would pay £9,125 in income tax.

Having received tax relief at 50 per cent (equal to £750,000 on his contributions over his lifetime, minus any returns on investment, which are also untaxed), he now pays a much lower tax rate on his pension income, equal to just 19.5 per cent per year. He was able to take a sum equal to nine times his annuity completely tax-free. Person A has therefore benefited considerably from tax arbitrage by diverting salaried income towards pensions savings.

Over the course of a twenty year pension Person A will pay just £182,500 in income tax from £1.5m in income. This amounts to an average tax rate of just 12 per cent on his total pension assets.

individuals with incomes above £150,000. However, following widespread criticism that the reform was unworkable it was scrapped by the current government who proposed instead to make similar levels of tax gains (around £3.5bn) by lowering the annual cap on tax-free contributions to £50,000.¹²

The current government's changes have limited the Treasury's total exposure to relief on contributions, but they have not solved the fundamental problem of fairness in pension tax relief.

Writing for CentreForum recently, Co-Chair of the Liberal Democrat Parliamentary Treasury Policy Committee, Lord Newby, proposed that tax relief on contributions be limited to the lower rate to avoid unfair tax gains in relief on contributions.

Tax-free lump sums exacerbate the tax relief problem by preserving the existing tax advantages for the rich in the withdrawal stage, effectively allowing a quarter of pension assets to receive triple exempt (EEE) treatment, rather than EET treatment.

If an individual has accrued the full 'lifetime allowance' in their pension pot, currently set at £1.8m, they are able to withdraw up to 25 per cent of this as tax-free income, amounting to £450,000.¹³ If this one-off

payment were to be taxed as yearly income at standard income tax rates then £203,000 would have gone to the Treasury.¹⁴ The individual is therefore receiving tax relief to the tune of around 45 per cent of their lump sum.

Using the same basis for calculation, an individual with a private or company scheme taking the average lump sum of around £21,000 would receive £2,212 of tax relief, or just 11 per cent of their lump sum. Even a thrifty full-time earner, finishing their career on a salary of around £39,000, who had paid into an average private sector pension scheme all their lives would see considerably less tax benefit from a pension lump sum. With a final pot in the region of £240,000 they could take around £60,000 as a tax-free payment, equating to £15,505 of tax relief, or 25 per cent of the total lump sum payout.¹⁵

As Carl Emmerson, Deputy Director at the Institute for Fiscal Studies, has commented:

"The [current] pension system is inappropriately generous to the wealthy. The most obvious anomaly is the fact that individuals can take up to 25% of their pension as a lump sum free of income tax [...] A reform

¹² See: Djina Thurley, House of Commons Library Note SN/BT 5901, 'Restricting pension tax relief', March 2011.

¹³ The lifetime allowance is due to fall to £1.5m from April 2012 onwards.

¹⁴ Assuming that the payment was the individual's only income for the year. If not, even more would have been taxed.

¹⁵ See CentreForum's previous publication, 'Setting our pensions free', Steve Webb and Jo Holland, April 2009.

that placed a much smaller cap on the amount that can be taken as a lump-sum would improve value for money for the public purse as there is no obvious justification for providing such a generous amount tax-free.”¹⁶

Whilst wholesale reform of the UK pensions system is a complex task, altering tax-free lump sums to correct for the current distortions is achievable. If the government agrees on the principle of progressive taxation of income it would appear perverse to continue with a system that allows the wealthy to benefit the most from tax relief on pension lump sums.

The scale of pension tax relief

The public discourse surrounding unsustainable conditions in pension provision tends to focus on the future cost to the taxpayer of state pension liabilities and unfunded public sector pension schemes. However the level of taxpayer subsidy directed at pensions through tax relief amounts to an enormous amount of revenue foregone for the Treasury today, exacerbating an already daunting funding requirement.

HMRC figures show that the net value of tax revenue foregone through the contribution and investment stages of the pension lifecycle amounted to at least £26bn in 2009/10.¹⁷ Around 60 per cent of pension tax relief each year is estimated to go to higher rate tax payers as opposed to those on lower incomes.¹⁸

In the withdrawal stage the value of tax-free lump sum payments as a proportion of total pension fund outflow has risen sharply in recent years. In 2004 lump sums totalled £3bn or around 10 per cent of outflow for funded self-administered pension schemes (which make up the majority of pension assets), but by 2010 they had increased to £8.6bn, or roughly 15 per cent.¹⁹

There are no detailed calculations available on the full extent of revenue forgone through tax relief on lump sums. HMRC estimates that tax relief on lump sum payments from registered pension schemes totalled £2.5bn

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in 2008/9.²⁰ This figure assumes tax relief at 20 per cent on total lump sum expenditure by pension funds, and that consumers would not change their behaviour in response to a tax . This is therefore only a ‘ballpark’ estimate. Given that in the region of 400,000 lump sums are drawn each year, averaging around £21,000, the true figure is likely to be similarly significant.

Should we get rid of lump sums?

Some have argued that the lump sum entitlement creates perverse incentives for pensioners to withdraw their savings early, resulting in smaller annuity incomes. The IFS’s Mirrlees review suggests that an incentive towards pensions saving which was roughly equivalent to the current lump sum entitlement could be achieved through a 5 per cent government top-up of pension pots at conversion, roughly matching the net gains made from the tax-free allowance.²¹ This idea has its advantages. It could be argued that allowing people to draw down a quarter of their pension assets runs counter to the aim of creating stable and comfortable retirement incomes.

However, pensions are a highly illiquid form of saving – more illiquid than long-term bonds or physical assets – and therefore a relatively unattractive investment, even when compared to other tax-free vehicles. For many the appeal of having a retirement ‘bonus’ they can access and use for purchases or holidays at the end of their careers compensates for the restrictive nature of pension saving, acting as an incentive to save. Over three quarters of

16 Institute for Fiscal Studies Press Release, ‘A response to the Treasury consultation on restricting pensions tax relief’, 1st March 2010.

17 The real figure will be larger as the ONS does not have data for the extra relief given on capital gains made by pension funds investments. See ONS, Pension Trends April 2011, Table 14.8, p14-8

18 Answer to parliamentary question: Ian Pearson, House of Commons, Hansard, 9th October 2008, Column 796W

19 ONS, Pension Trends, April 2011, Figure 9.7, p9-7

20 Assuming lump sums represent the same proportion of total expenditure for funded and unfunded schemes, and that tax relief has been given at 20 per cent: HMRC, ‘Revenue-based taxes and benefits’, Table 7.9, September 2010

21 The IFS’s Mirrlees Review suggests a top-up equivalent to the tax efficiencies gained by a lower rate taxpayer on their lump sum (i.e. a value equal to 20 percent of their 25 per cent lump sum). See: J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, ‘Tax by Design: the Mirrlees Review’, 2011, Chapter 14, p340-341

those who do take a lump sum at retirement deposit some or all of the cash in savings or investment vehicles, suggesting those individuals value having flexible access to their retirement savings.²² If the tax-free lump sum were to disappear altogether then some savers may choose to divert their income into more accessible and liquid vehicles, increasing the likelihood that the cash might be depleted prior to retirement.

Keeping the tax-free lump sum entitlement is also important for maintaining continuity. People may have made financial decisions premised on receiving a lump sum at retirement, such as paying off the principal on a mortgage or consumer loan. For many, the amount of tax relief gained on lump sum payments is relatively small but potentially important, thus removing those rights could be difficult for policymakers.

We therefore maintain that preserving the tax-free lump sum entitlement is desirable in terms of saving incentives and continuity. However we suggest that lowering the tax-free threshold to a suitable level and introducing fairer tax measures above this threshold would help to reduce the regressive outputs of the current regime and save money.

In the following sections we consider the options open to policymakers and some of their likely effects before turning to the recommendations.

Lowering the tax-free threshold on lump sums

The current effective tax-free threshold for lump sums is £450,000. This is equal to 25 per cent of the current pension lifetime allowance of £1.8m above which any lump sum withdrawals would be taxed at a penalty rate (55 per cent). Ultimately the level at which the lump sum tax threshold is set is arbitrary but there are several potential guidelines that could be used. The strengths and weaknesses of these options are discussed in more detail in the Appendix 2 (page 15).

Grounding taxation in mean or median income figures:

One option for taxing lump sums would be to set a tax-free threshold equal to a multiple of mean or median earnings and taxing them progressively above that level. According to ONS figures for 2010, UK gross mean income for full-time workers was £26,510 and gross

The most rational and straightforward way to remedy the problem is to apply existing income tax bands to pension lump sums

median income was £21,221.²³ Using some multiple of these figures would be a way of 'grounding' taxation in prevailing wage levels in the same way that the current government wishes to do with benefit entitlements.

Setting the tax-free limit at the 'trivial commutation' limit

For pensioners with smaller pension endowments current rules allow 100 per cent of pension savings below a combined total of £18,000 to be commuted as a lump sum payout rather than converted to an annuity. If commuted in this way then 25 per cent of the total commuted sum is tax-free and 75 per cent is counted as taxable income.²⁴ Provided that the government wishes to keep the option to carry out trivial commutations in place, this might be seen as a suitable place to set the tax-free limit.

In order to avoid inequalities in levels of relief the government is likely to have to allow all trivial commutations to be paid out tax-free so no differences in tax-free allowance exist between wealthy and less well-off pensioners. Payouts above £18,000 could then be taxed at a decided rate.

Linking taxation to existing income tax bands

A third option for taxing lump sums is to tie them to existing bands and tax them progressively, with larger lump sums attracting higher marginal rates. To achieve this, pension lump sums would have to be treated as 'one-off' sources of income with their own tax-free allowances and scaled tax bands, just as other forms of earnings, such as capital gains and savings income, are treated.

If we were to imitate the income tax system precisely this could mean pensioners being taxed at different marginal rates according to the size of their lump sum: zero, 20, 40, or 50 per cent respectively.

²³ ONS, Annual Survey of Hours and Earnings 2010.

²⁴ Or, if the commutation is taken after the pension is already in payment, then it is all counted taxable as income for that year.

With the necessary incentives an individual with the maximum pension pot of £1.8m who decides to take only the tax-free portion of the lump sum would place £407,525 back into the income tax system

Given that the regressive system of tax relief on pension lump sums is a direct result of progressive income tax bands, remedying the problem in this way would appear to tackle the problem at source, and would have a credible precedent in the existing income tax system. This paper proposes a variation on this option below.

Our recommendation: linking lump sums to tax bands

The regressive system of tax relief for pensions is a mirror-image of the progressive income tax system. Therefore we propose that the most rational and straightforward way to remedy the problem is to apply existing income tax bands to pension lump sums. Using the existing conventions and thresholds for taxation removes the need to set new (arbitrary) limits on lump sums or introduce new tax rates and further complicate the pensions system.

There are several ways this could be achieved, with differing outcomes for pensioners and the Treasury. Because we believe that the tax-free lump sum entitlement is a beneficial arrangement which encourages pensions saving, our proposal aims to ensure that the tax-free entitlement remains for the average UK pensioner, whilst eliminating tax advantages for the wealthy.

Given that the current higher rate threshold of £42,475 is the point at which a wealthy individual will begin to receive a higher marginal rate of tax relief than a less wealthy individual, we propose that this is the most suitable point at which to place the tax-free limit. Lump sum income above this threshold should be taxed in line with current income tax rates; 40 per cent up to £150,000, and 50 per cent above that level. In practice this is likely to mean that few people will take lump sums above £42,475. This will ensure that more pension income is drawn as annuities rather than as lump sums and permanently raise income tax revenues from pensions in payment.

Under this scheme a pensioner taking the average lump sum of £21,000 would not be taxed. Indeed those with total pension assets below £170,000 would be entirely unaffected by the change.

In contrast a very wealthy individual drawing the maximum lump sum of £450,000 would no longer receive tax relief at 'higher' and 'additional' rates. If that individual chose to withdraw their full lump sum entitlement they would pay £196,000 in tax on income above the £42,475 threshold.

Withdrawing tax relief in this way would solve the problem of wealthier individuals getting a higher average rate of tax relief per £1 than poorer individuals. Marginal rates of tax relief would begin to fall on sums above £42,475, rather than rising as they do currently (see graph back page). Average tax relief per £1 would be lower for those who took very large lump sums, preserving progressivity in the withdrawal stage.

With the necessary incentives in place an individual with the maximum pension pot of £1.8m who decides to take only the tax-free portion of their lump sum would place £407,525 back into the income tax system. The remaining pension pot, totalling £1,757,525, and used to buy an annuity at prevailing rates would result in an extra £112,000 in income tax going to HM Treasury over a 20 year period.²⁵

This system would then retain the incentive of a discrete tax-free lump sum payment at retirement without simultaneously biasing the proportion of relief given in favour of the wealthiest. Furthermore, by avoiding placing any further limits on the size of lump sums or introducing new tax rates for pensions this proposal avoids unnecessarily complicating the pension system or limiting people's retirement options; individuals can choose to take a large lump sum if they wish, but they will be taxed on that portion where they would otherwise have gained a tax advantage over less wealthy individuals.

The impact on pensioners

Using figures from the Association of British Insurers we estimate that our recommendations would still allow around 98 per cent of defined contribution schemes

²⁵ This figure is based on the tax paid at current rates on a pension pot totalling £1,757,525 used to buy an annuity of £61,752 at today's prices versus a pension pot of £1,350,000 used to buy an annuity of £47,760 at today's prices. Prices checked on FSA Money Advice Service annuity comparison tables, www.moneyadviceservice.org.uk, 25th July 2011.

Our model suggests that the proposed lump sum tax changes would permanently raise total income tax revenue on newly annuitised pensions in payment by about five per cent per year

to be drawn upon tax-free, and would not affect people with total assets below £170,000.²⁶ Survey data from the English Longitudinal Survey of Ageing (Wave One) suggest around 29 per cent of individuals with a defined contribution scheme have more than one scheme²⁷, and around 1.6 per cent of people have both a Defined Benefit (DB) and a Defined Contribution (DC) scheme.²⁸ For some people with multiple schemes, then, the sum of their schemes may push them towards the tax-free threshold. However, given that the average size of DC funds under our model was only around £35,000, individuals with multiple DC funds would still have to possess pension wealth considerably above average to be affected by this change.

For defined benefit schemes, the changes are likely to have a wider impact. This is largely because DB schemes tend to be more generous than DC schemes. For instance, a civil servant with 40 years' service could typically have accrued pension rights at the rate of 1/80th of final salary, plus a lump sum entitlement of 3/80^{ths}, for every year's service. This would mean that a civil servant finishing on a salary of around £30,000 per annum may be entitled to a lump sum of £45,000.

The recent Hutton review recognised that current public sector pension arrangements are out of line with their private sector equivalents. The report recommended changes to make public sector pensions more affordable to the taxpayer, such as moving to career average rather than final salary entitlements. The coalition

government is currently in the process of reforming public sector pensions along similar lines. We suggest, therefore, that a tax-free limit of £42,475 on lump sum entitlements is both fair and in line with current trends in reducing taxpayer exposure to costs associated with pension provision.

The impact on tax revenues

Predicting the likely revenue gains to be made from taxing lump sums is difficult for many reasons. One reason is that none of the public bodies that deal with pensions collect national figures which express pension lump sum payments by size and frequency. Another is that it is difficult confidently to predict changes in individuals' behaviour when faced with different tax incentives. A third reason is that estimating future pension tax revenues requires detailed projections about demographic change over time with unknown margins of error.

The figures we have used to provide the estimates below are illustrative only and are therefore subject to considerable margins of error. The estimates are based on data collected by the Association of British Insurers (ABI) which records the number of pension annuities purchased from private insurers each year by the size of the pension pot used to buy them.

The ABI figures include defined contribution pensions (where annuities are purchased from insurers) but not defined benefit schemes (where annuities are based on pre-existing contracts). As such these figures only represent a proportion of the total pensions converted each year and do not account for the possibility that some individuals may purchase multiple annuities with multiple pension schemes. There are several important reasons why the figures we used are likely to under-estimate the net effect on tax revenues under our proposals. These are discussed in detail in Appendix 1.

Assuming that pensioners will try to minimise their tax liabilities, removing tax relief on lump sums above £42,475 would cause those with entitlements above this level to divert their remaining entitlement towards annuities, effectively reducing the amount of tax relief given to lump sum income every year. According to our model this would have the effect of reducing the amount of tax forgone on pension lump sums by around seven per cent annually. Based on HMRC estimates of total lump sum tax relief per year (£2.5bn), this would

26 Researcher's calculations made from source: Association of British Insurers, Quarterly Annuity Sales figures, Q1 2011, 20th May 2011.

27 See: Institute for Fiscal Studies, Prepared for retirement? The adequacy and distribution of retirement resources in England, October 2005, Section 3.

28 See Institute for Fiscal Studies, Estimating pension wealth of ELSA respondents, May 2005, p20.

mean a reduction in overall tax relief of around £175m annually.²⁹

However, this does not translate directly into extra tax revenues of £175m, rather the diversion of funds away from lump sums and towards annuities would raise future income tax take from pensions in payment as more funds are paid out as taxable annuity income. Our model suggests that the proposed lump sum tax changes would permanently raise total income tax revenue on newly annuitised pensions-in-payment by about five per cent per year from the date of implementation.

The net nominal effect of this increase would grow each year as more pension pots are converted to annuities. Within 20 years from implementation it can reasonably be assumed that these changes would add around five percent to total income tax take from pensions-in-payment.

The likely value of this income is difficult to quantify owing to the number of variables involved, but a crude estimate based on current yearly tax take on pensions in payment suggests this would raise an extra £0.5bn per year at today's prices.

These are conservative estimates of potential tax gains. The figures above are based on the assumption that the number of annuity purchases remains stable over time and that income tax receipts from pensions in payment remain at current levels. However, the UK has an ageing population so, with the number of pensioners increasing in the coming decades, the real value of implementing these changes is likely to be greater over time as the changes affect the withdrawal behaviour of a growing number of people, and a larger proportion of the tax base.³⁰

Softening the blow; some options for transition arrangements

Though the ABI figures suggest only a small minority of pensioners would be affected by our proposals, some of those approaching pension age may find that the

As the number of pensioners increases in the coming decades, the real value of implementing these changes is likely to be much greater over time

sudden curtailing of their tax-free allowance at a late stage in their working life may disrupt well-laid plans. In this section we therefore consider options for transition arrangements:

Option One: Immediate introduction

The first, and least generous, option would be simply to introduce pension lump sum taxes in the next tax year with no recourse to the effect this may have on the plans of those approaching pension age. This is likely to draw opposition from wealthier sections of the population as, for some, this could mean losing out on a substantial amount of retirement income that they had planned to withdraw and spend. A couple, for instance, who had taken out an interest-only mortgage on their home in expectation that they could use their combined lump sum to pay off the principal might suddenly find themselves unable to afford the home or needing to pay off the remainder with annuity income thereby increasing the likelihood they may require financial assistance from the state.

This option could also lead to mass lump sum withdrawals as people rush to beat the deadline.

As with all pension reform, changes affecting individuals' long-held retirement plans run the risk of being presented as 'pulling the rug' from underneath people who have worked hard all their lives to save for retirement and, for those currently aged in their fifties or sixties, this could seem like an unfair way to change the terms of their retirement.

Option Two: 'Fixed protection' rights

When the government announced the reduction of the tax-free lifetime allowance from £1.8m to £1.5m from 2012/13 they put in place fixed protection rights for those who had already accrued, or expected to accrue, more than £1.5m in their pension pots by the

²⁹ Note: HMRC's estimates of tax revenue foregone on pension lump sums is based on a crude assumption of 20 per cent tax levied on the total value of all funded and unfunded schemes. This estimate is subject to considerable error owing to the fact that some individuals' lump sums may not be taxed at all and others' would be taxed at higher rates.

³⁰ See: ONS, Pension Trends, April 2011, Chapter 2. The ratio of pensioners to working age population is due to rise from 310 to every 1,000 in 2008 to 343 to every 1,000 by 2051 – an increase of 10 per cent. This assumes net immigration (which tends to work against demographic ageing) remains at around 180,000 per annum. However, under current Home Office plans net immigration is expected to fall in the coming years, meaning the rise in the pensioner ratio could be much higher than this.

5th April 2012. Fixed protection allowed those individuals to continue to claim the portion of their pension pot above £1.5m (i.e. up to £300,000) without tax after the new lifetime allowance is introduced, provided they cease to contribute any further income to their pension after 5th April 2012.³¹

A similar arrangement could be considered for tax-free lumps sums. For instance, those who have reached the age of 55 by 5th April 2012, and were therefore eligible under current rules, could be allowed to retain their right to take a tax-free lump sum above £42,475 as they choose. This would avoid a rush from those of pensionable age to withdraw their lump sums before the changes take effect in the next tax year. Whether these individuals would be allowed to continue to add to their pension pot after 2012 and claim 25 per cent of their final pot, or were only permitted to take 25 per cent of the pot they had accrued by April 2012 would be a further issue.

Whilst this option would result in less financial disruption for those who had already passed the age of 55 by April 2012, it would not solve the problem for those who fell marginally under that age. The age limit could, of course, be lowered, but this would just defer the problem; the line would have to be drawn somewhere and some people would feel hard done by.

This option would also result in a substantial period of time elapsing before the Treasury begins to see any positive impact on tax revenues from the changes, as those under the age of 55 may not begin to take their pension until a decade later. We believe a scheme with the potential to raise revenue sooner would be preferable to one whereby the Treasury will see little difference in revenues for a decade or more.

Option Three: A balanced penalty/incentive arrangement

A transition arrangement that might be considered fairer than either of the two above options, and less disruptive, would need to structure incentives for early withdrawal carefully. This means ensuring that for the vast majority of individuals there is little net benefit to be gained from withdrawing their lump sum early before the changes come into force.

We suggest allowing a transitional period of one to two years from the introduction of taxation measures during which all pension

savers are given the option of withdrawing their current lump sum entitlement subject to a penalty tax. Anyone, of any age, who has accrued pension rights at the beginning of the transition period should be given the option of withdrawing up to 25 per cent of those rights up to £450,000.³² This would give those with very large lump sum entitlements the option of restructuring their retirement savings to take into account the new tax changes.

In order to dissuade those with lump sum entitlements above the £42,475 from disrupting pension funds' operations by taking early withdrawals it is proposed that a 20 per cent penalty tax is levied *on the whole of the amount* taken as an early withdrawal lump sum.

This arrangement would deter someone who, for instance, was entitled to a £50,000 lump sum in three years' time from making an early lump sum withdrawal as they would pay £10,000 tax, wiping out any tax advantages. Those who had very large lump sums could choose to withdraw their entitlements early in order to avoid marginal rates of 40 or 50 percent later, but would have to consider whether they stood to benefit more from removing a large amount as a lump sum taxed at 20 per cent, or leaving it in their pension pots to be paid out as an annuity where the tax rate it attracted may actually be lower, depending on the full value of their annuity.

Generally, this would mean early withdrawal would only be attractive to those whose lump sum entitlement was larger than around £60-70,000 and who were particularly predisposed to taking a large lump sum rather than opting for a larger annuity.

This option is likely to mean a greater tax take for the Treasury in the short run than Option Two as some wealthy individuals choose to make early withdrawals and pay 20 per cent tax. It would, however, still mean fewer early withdrawals overall than Option One, minimising the likelihood of a financial disruption as a result of mass withdrawals.

Given the challenges currently facing UK public finances we suggest that a change in policy which both raises revenue in the short run, and helps contribute to a more solid pensions tax base in the long run is the right choice at this time.

³¹ HMRC, 'Fixed protection for pension savings', www.hmrc.gov.uk

³² These rights could consist of either a defined contribution pension pot or the final capital value of a defined benefit scheme adjusted to take into account early withdrawal.

Conclusion

This paper proposes that limiting tax-free lump sums would correct distortions in a regressive system of tax relief for pension lump sums.

Individuals wishing to take lump sums above the higher rate income tax threshold, currently £42,475, should pay tax at the higher rate on lump sum income above that level. This change would ensure that wealthier pensioners do not receive a higher percentage rate of tax relief on lump sums than poorer ones and would raise extra revenue for the Treasury, reducing the burden on taxpayers into the future.

Taxing large lump sums at the same rates as income is a simple and straightforward way of changing the system that could raise yearly tax revenues from pensions in

payment by around 5 per cent per annum. This change would have an increasingly large effect on net tax revenues as the UK population ages and pensioners make up a larger proportion of the tax base.

The proposed changes would only affect those with larger than average endowments and would preserve much needed incentives for the majority of pensions savers.

As a transition arrangement we suggest giving individuals the option of reducing their overall tax exposure by choosing to take an early withdrawal, subject to a penalty tax charge. This would deter mass withdrawals of pension funds whilst ensuring that the Treasury benefits from the changes in both the short run and the longer term.

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About the authors

Mark Lloyd is the author of 'Tier 4 fears: why government student visa proposals are unfair' and a former intern at CentreForum. He studied PPE and Security Studies and joined CentreForum after working as an incident manager with the police.

Chris Nicholson, Director and Chief Executive of CentreForum. Formerly, he was a government economist and Partner and Head of the Public Sector practice at KPMG.

Appendix 1:

Notes on tax estimates

Our estimate is that a tax on lump sums above the threshold for higher rate income tax would provide 4.52 per cent extra tax revenue on newly annuitised pension pots per year. This estimate is based on figures collected by the ABI. The ABI collects quarterly figures on the number of purchases of pension annuities broken down by the total size of the pension pot used for the purchase. These figures are collected from the insurance companies who sell annuities to British pensioners and include approximately 95 per cent of the market for defined contribution schemes.

The raw data included in Table 1 (page 14) presents the number of annuities purchased from pension providers in 2010 by the size of fund used for the purchase. Importantly these figures represent the size of the fund used to purchase an annuity *after* any lump sum entitlement had been drawn, where the lump sum, if taken, is not recorded. In order to correct for this distortion we applied survey data from The Prudential suggesting that around 80 per cent of individuals in private or company schemes take a lump sum before annuitisation which allowed us to create a weighted average pot size for each individual annuity purchase. The weighted average assumed that 80 per cent of people had taken the maximum 25 per cent lump sum from their pot, and that lump sum withdrawals were evenly distributed across the sample. This weighted average pot size was then used to calculate the rough level of taxation to be gained based on current tax rates from placing a tax-free limit of £42,475 on lump sums.

In order to make these calculations possible we made a simplifying assumption about people's behaviour; that individuals will always choose to allocate their assets in the most tax-efficient way.

Following this assumption through to its conclusion we modelled the tax revenue take on the basis of two important stylised principles:

1. The 80 per cent of individuals who take a tax-free lump sum will always take their maximum tax-free allowance, as this will always be more tax efficient than leaving assets to be paid out as annuities.
2. Given the 40 per cent marginal rate on sums above £42,475, no individual would take a lump sum above this

level as they would always pay an equal or higher marginal tax rate on that portion of income than they would if taken as an annuity.

All remaining lump sum entitlement above £42,475, therefore, would be converted to annuity income to be paid out annually, in addition to state pension entitlements, and taxed at current tax rates.

Margins of error

As mentioned earlier, the method we have used is likely to underestimate the overall effects on tax take. There are several reasons why this is the case:

1. Figures only include defined contribution (DC) schemes which tend to be less generous than an equivalent defined benefit (DB) scheme, meaning the pot sizes used in the analysis may not be fully representative of the pensions market as a whole: there are likely to be a greater proportion of larger pension pots. ONS figures from 2007 suggest that members of defined contribution schemes (occupational and personal) represent around 50 per cent of active pension scheme members. The remaining 50 per cent are members of funded or unfunded defined benefit schemes.³³ According to ONS figures from 2008, the percentage of salary paid into individuals' pots by the average employer was almost three times bigger for DB pensions meaning that, for the same levels of employee contribution, DB members will receive a much larger final benefit.³⁴ NAPF figures from 2010 show that the mean annual value of a DB pension was £7,467, representing a final pot of around £200,000.³⁵ As Table 1 shows, very few DC pots reach anywhere near this size. The absence of DB schemes from the data used could therefore significantly under-represent the true tax gains to be made from the proposed changes.
2. Because the raw data in Table 1 does not measure the size of pension pots after £500,000 we had to assume a normal distribution of pension wealth that approached zero at the upper limit of

³³ ONS Pension Trends, April 2011, Figure 6.3, p 6-5.

³⁴ Kathy Newman and Patrick Worrall, 'Why Cameron's right on public sector pensions', Factcheck Blog for Channel Four News, 28th June 2011.

³⁵ NAPF, National Survey, 2010.

£1.8m meaning that, of the 493 recorded pension pots above the £500,000 level, our model only postulated one scheme that fell within the £1.7-1.8m category. In reality this is very unlikely to be the case. It is far more likely that pension wealth is of non-normal distribution where there are a relatively high number of schemes that have accrued the full lifetime allowance of £1.8m belonging to very wealthy individuals. The annuities on such schemes would pay higher rates of tax than is accounted for in our model. This means our yearly tax estimate is likely to be low.

3. We assumed that all pensioners are equally likely to take a lump sum payment at retirement and created a weighted average for each individual pension pot based on this. In reality those with very large pension pots are more likely to take a lump sum than those with modest pots. This is because the net marginal effect on their annuity income is smaller (see Table 2) and their other wealth is likely to be more considerable, meaning they are less reliant on annuities. The relative tax gain to be made from taking the tax-free lump sum allowance is also larger for those who pay higher rates of income tax, making tax-free lump sums a useful way to 'tax-smooth' lifetime income. If we conclude that a higher proportion of wealthy people take a tax-free lump sum than at the lower end of the scale then our estimation of wealth at the upper end of the scale should have been higher. More people at the upper end would be paying higher marginal tax rates leading to a higher final tax take.
4. Because the ABI figures measure pension schemes rather than pensioners they risk under-estimating net individual personal pension wealth. Some individuals have more than one pension pot and will thus appear, in our model, to pay a lower average rate of tax than is the case. For instance a person with two pots of £30,000 and a £50,000 respectively would pay a higher average tax rate on their annuity income than if the pots were owned by two individuals.

Survey data from the English Longitudinal Survey of Ageing (Wave One) suggest around 1.6 per cent of people have both a defined benefit and a defined contribution scheme³⁶ and around 29 per cent of individuals

with a defined contribution scheme have more than one scheme.³⁷ This may have a considerable bearing on the total amount of tax revenues to be gained.

Equally, there are some factors that may inflate our estimates of tax take which should also be considered:

1. Because we have assumed that anyone who took a tax-free lump sum from their pension scheme took the full 25 per cent entitlement our initial estimate of the full value of pension schemes (based on weighted averages) may be high. This is due to the possibility that some individuals may have only taken 20 or 15 per cent. This bias, however, will be at least partially corrected in our assumption that anyone able to do so in our model will withdraw the maximum permitted tax-free lump sum before buying an annuity, which balances against the initial bias in the weighted average pot sizes.
2. In postulating that people entitled to lump sums higher than the tax-free limit of £42,475 will divert all the rest of their pension annuity to income we are also discounting the effects of behavioural changes whereby those who will lose a large proportion of their tax-free lump sum in retirement may stop saving as much in their pension and divert income towards other investments. This would reduce overall pensions tax take (though it would raise tax take elsewhere in the system).
3. We based our model on the assumption that 80% of pensioners withdraw a lump sum prior to conversion. The survey data on which this was founded covered UK private and company schemes (DB and DC) but did not cover public sector schemes. If public sector workers were significantly less likely to withdraw a lump sum than others, then this would affect the final tax take so that the net effect of the changes was smaller.

In sum, the statistics we have used have several shortcomings and the assumptions we employed have the potential both to over-state and under-state the potential tax take, though the likelihood is that they would under-state the overall gains from the proposed changes. The figures used should be treated as a general guide only.

³⁶ See Institute for Fiscal Studies, Estimating pension wealth of ELSA respondents, May 2005, p20.

³⁷ See: Institute for Fiscal Studies, Prepared for retirement? The adequacy and distribution of retirement resources in England, October 2005, Section 3.

Table 1: Annuity purchase data

Size of fund	2010
Less than £5,000	93,502
£5,000 - £9,999	70,354
£10,000 - £19,999	103,931
£20,000 - £29,999	60,830
£30,000 - £39,999	35,720
£40,000 - £49,999	22,162
£50,000 - £59,999	14,218
£60,000 - £69,999	9,734
£70,000 - £79,999	7,190
£80,000 - £89,999	5,336
£90,000 - £99,999	3,920
£100,000 - £124,999	6,800
£125,000 - £149,999	3,687
£150,000 - £174,999	2,226
£175,000 - £199,999	1,440
£200,000 - £249,999	1,674
£250,000 - £299,999	890
£300,000 - £349,999	549
£350,000 - £399,999	350
£400,000 - £449,999	219
£450,000 - £499,999	147
£500,000 and above	493
Total	445,372

Table 2: Current market annuity purchase rates

Size of fund	Size of annuity	Marginal conversion rate	Conversion rate
£5,000	£192	-	£26.04
£7,500	£288	£26.04	£26.04
£10,000	£408	£20.83	£24.51
£15,000	£636	£21.93	£23.58
£25,000	£1,080	£22.52	£23.15
£50,000	£2,172	£22.89	£23.02
£75,000	£3,264	£22.89	£22.98
£100,000	£4,356	£22.89	£22.96
£125,000	£5,436	£23.15	£22.99
£150,000	£6,528	£23.89	£22.98
£200,000	£8,712	£22.89	£22.96
£300,000	£13,068	£22.96	£22.96
£400,000	£17,424	£22.96	£22.96
£500,000	£21,780	£22.96	£22.96
£750,000	£32,676	£22.96	£22.95
£1,000,000	£37,580	£42.34	£25.92
£1,250,000	£44,220	£44.33	£28.27
£1,500,000	£52,692	£29.51	£28.47
£1,800,000	£63,240	£28.44	£28.46

NOTE:

Table 2 is based on a 65-year-old male, non-smoker, purchasing an RPI-linked annuity with no guaranteed term. The conversion rate illustrates the number of pounds in a pension pot needed to buy every extra pound of annuity income. The marginal conversion rate illustrates the annuity purchasing power of each additional pound held in a pension pot. It can be clearly seen from the table that pension savings above around £1m suffer lower marginal returns which means taking a lump sum from pension pots above this level is relatively more attractive than taking a lump sum from pots below this level.

Source: FSA Money Advice Service annuity comparison tables, www.moneymadeclear.org.uk, checked on 8th August 2011

Appendix 2:

The strengths and weaknesses of alternative lump sum taxation options

Grounding taxation in mean or median income figures:

This option appears reasonable in the first instance, but the proposal faces several obstacles.

First there are problems to do with measurement bias in mean and median figures, particularly the possibility that they over or under-state incomes through their composition.

Second, there are problems surrounding which median or mean figure to choose. It may be the case that a more appropriate guide figure for taxation would be mean or median incomes at retirement age (£20,895 and £16,305 respectively). Or perhaps it would be more appropriate to use mean or median salaries for full-time workers? The figures would then be £29,631 and £23,565 respectively.

Even if we resolve the above debate satisfactorily there remain questions about the structure of taxation above that level. If we were to introduce a lump sum tax, what should the rate be? If we are using mean/median figures for the lower thresholds, should we use multiples of these for higher thresholds? Addressing these questions through the introduction of new unique limits and tax rates based on figures that have never been used before will add new layers of complexity to what is already a fiendishly complicated area.

It is our view, therefore, that linking taxation to mean or median incomes, whilst intuitively appealing, is likely to raise more issues than necessary and may result in undesirable added complexity.

Setting the tax-free limit at the 'trivial commutation' limit:

In using this option the government may wish to tax lump sums above £18,000 at the individual's highest marginal income tax rate, the basic income tax rate (20 per cent), or some other rate as desired.

This option has the potential to solve the equity problem whereby some people receive more tax relief than others on their lump sum. Depending on how the government decided to tax lump sums above £18,000 it could structure incentives towards different outcomes. For instance, a

very high tax rate above that threshold, like the current 55 per cent rate above £450,000, could deter many from taking lump sums above £18,000 level altogether, ensuring more money was paid out as annuities. This would mean a higher income tax yield in future years, with relatively little change in revenue in the short run.

Conversely if the government wanted to raise money more quickly it could choose to have a low, flat 20 per cent tax rate (or similar) on sums above £18,000 which would mean those whose entitlements were very large may still wish to take large lump sums. This would, for example, raise £86,400 in tax revenue from a lump sum of £450,000. However, having a low flat tax rate would still benefit the rich disproportionately and lead to differential levels of tax relief being gained; therefore a progressive system would be fairer.

Table 3: Personal income tax allowances

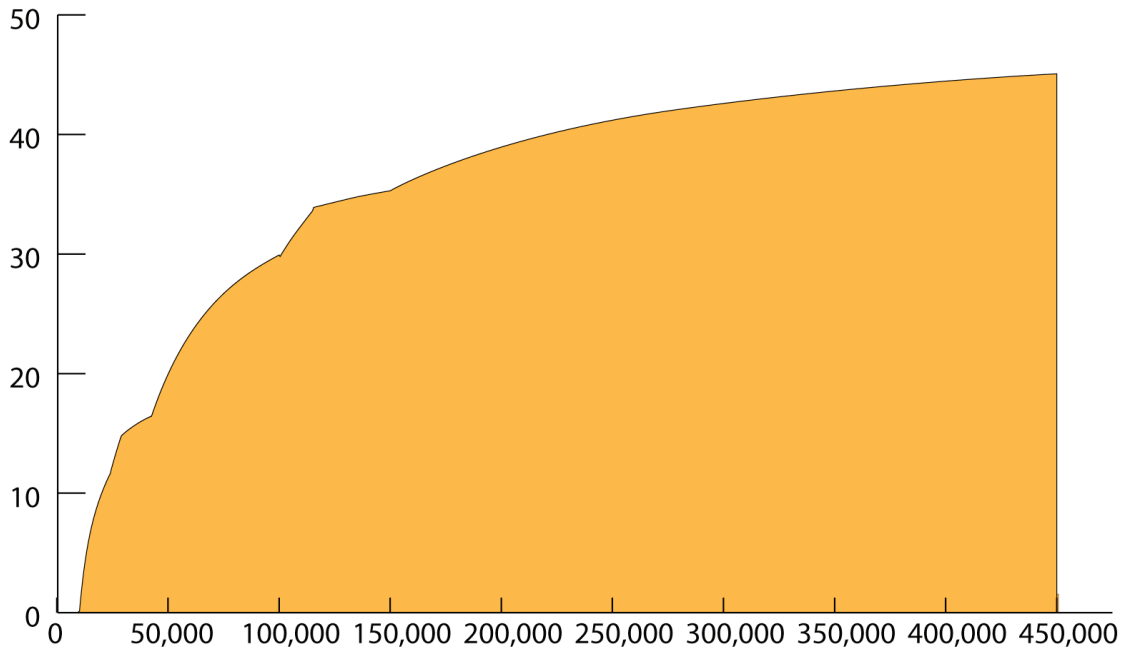
	£ per year		
	2010-11	2011-12	Change
Personal allowance			
age under 65	6,475	7,475	1,000
age 65-74	9,490	9,940	450
age 75 and over	9,640	10,090	450
Married couples allowance*			
maximum amount	6,965	7,295	330
minimum amount	2,670	2,800	130
Income limit for under 65 personal allowance	100,000	100,000	0
Income limit for age-related allowances	22,900	24,000	1,100
Blind person's allowance	1,890	1,980	90

*Available to people born before April 6, 1935. Tax relief for this allowance is restricted to 10 per cent. This is also the maximum relief for maintenance payments where at least one of the parties is born before 6 April 1935.

NOTE:

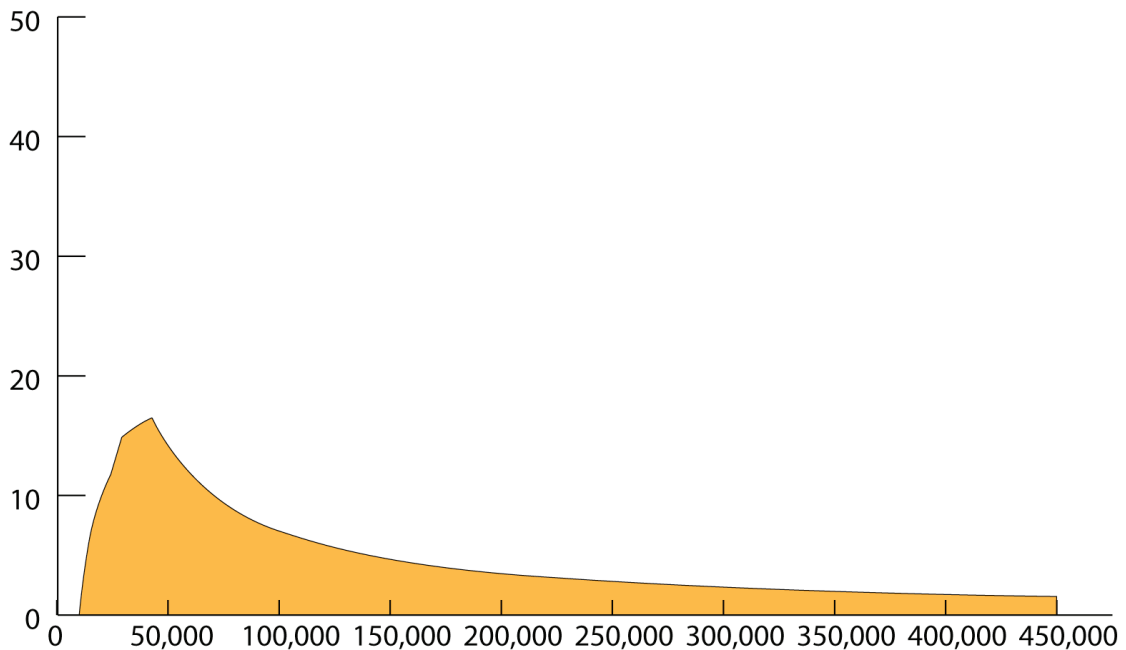
Age-related allowances are tapered down at the rate of £1 for every £2 of income above £24,000 for those aged 65 and over. The same taper rate is applied to the personal allowances of all individuals earning over £100,000 per annum.

Figure 1: Tax relief gained on pension lump sums as a percentage of total payment – the existing system



Assuming a personal allowance of £9,940 for 65-74 year olds.

Figure 2: Tax relief on pension lump sums as a percentage of total payment – the proposed system



Assuming a personal allowance of £9,940 for 65-74 year olds.