

PENSIONS

BRIEFING

THE QUEST FOR THE OPTIMAL TAX REGIME FOR PENSION PLANS VIEWS FROM THE UK

AN OPTIMAL TAX REGIME FOR PENSION PLANS?

The quest for the optimal tax regime for pension plans is of course highly subjective. For the purposes of this note, it is assumed that the better tax regime will be the one that most encourages behaviour that supports reliable income streams in the post-retirement period. It could also be the one that is most favourable to the employee or the one that is most favourable to pension plans as opposed to other forms of saving or post-retirement income provision.

The following is a commented description of the UK regime and of recent changes made to it.

The note refers to the individual saver as the “worker”. This is partly to be consistent with concepts used in the European Union but also because the tax advantages of pension saving in the UK apply principally in relation to income earned through employment or self-employment or funding provided by an employer.

EET

Broadly, tax-advantaged saving for retirement in the UK has for more than half a century operated principally on an “EET” basis i.e. contributions into the pension arrangement have been tax exempt, investment returns within the pension arrangement during the accumulation phase have been tax exempt and benefits paid out of the scheme in the retirement phase have been taxed.

This treatment has always been subject to limits: the amount of contributions or benefit accumulation that is permitted in the pension arrangement on an exempt basis has always been subject to limits. Exceed those limits and tax is payable or, under previous regimes, the scheme might itself lose its tax-favoured status.

Tax will be payable by the pension plan if its investment activities are in the nature of trading activities. Dividends on equity investments in UK companies are taxed before payment¹ to the pension plan and relief previously available is withdrawn.

At the other end, not all of the benefit payable by the pension plan is taxed. Up to 25 per cent of the value of benefits being drawn can be taken as a tax free lump sum.

A key attraction of an EET regime is that it is effectively a tax deferral system and matches the worker's deferral of spending. After all, there are downsides to saving for retirement: in the UK, the funds cannot be accessed, or not without a penal level of tax until a certain age, generally 55 except in cases of ill-health. It would generally be unacceptable for the worker to pay tax on what they cannot enjoy and might never enjoy. Some reward in the form of a tax break is required to encourage saving.

The tiered structure of the UK income tax regime enhances the value of this tax deferral for moderate to high earners: the vast majority of workers will have lower incomes in retirement than during their working lives; they will either find themselves in a lower tax band or find that more of their income is within a lower tax band. Only the lowest earners, for whom pension saving may in any event be unaffordable and who pay little tax, do not benefit from the lower rate.

The EET structure makes it possible for workers to save the significant sums required for a reasonable standard of living in retirement. The value of the tax relief is effectively compounded by the investment return on the relief during the entire accumulation phase. Taxation on investments would significantly erode the value of those investments. In this regard, there has been significant criticism of the effective withdrawal of tax relief on dividends from UK companies.

The EET structure also ensures that there is broad parity of treatment between retirees and workers in relation to tax paid on income actually drawn. A pension income of £50,000 will be subject to the same rate of income tax as a salary of £50,000.

A downside of EET is that the employee has to trust that the income tax payable later in life will not have increased above the rate currently payable. Given the desire of anyone with sufficient surplus income to provide for themselves in later life, this downside may not be material.

It is more likely that the merits of EET are outweighed by the attractions of other options for wealth accumulation, such as residential property, or other downsides of pension savings, such as the compulsory lock-up, i.e. the requirement in the UK tax regime that pension plan assets can only be accessed after age 55 (with few exceptions).

SHAPING BENEFITS THROUGH LIMITS AND CONDITIONS TO TAX RELIEF

Generous tax breaks have long been provided in the UK to encourage pension saving. Limits and restrictions have been applied as conditions for the tax advantages to ensure that the

¹ The tax is paid as “advance corporation tax” (ACT) by the company paying the dividend.

wealth accumulated in pension funds is not excessive and that it is used for the intended purpose.

The UK has explored several strategies.

Earlier tax regimes applied before April 2006 focused on capping the benefits that could be drawn from each plan. A key limit was a pension of two thirds of a generously defined final remuneration. Plan design often targeted this level of benefit over a typical career span, commonly leading to final salary designs providing a pension of one sixtieth of final pensionable earnings for each year of pensionable service subject to a limit of 40 years of pensionable service. This illustrates how the tax regime influences pension plan design.

To prevent individuals from accumulating a greater share of tax relieved pension, individuals were not permitted to participate in more than one arrangement in respect of the same employment and benefits from one arrangement would be netted off the limits available within another.

Successive governments modified strategies so that tax advantaged pension saving in the UK has been subject to changing regimes. Different regimes existed in parallel for occupational and personal pension plans. For instance, an employee could not save more than 15 per cent of pay into an occupational pension plan (although their employer could add to that within other limits). In a personal pension plan, an employee could save a higher proportion of pay with graduated limits according to age.

A practice of grandfathering existing arrangements on the introduction of a new regime led to the UK having no fewer than eight concurrent regimes by 2004. The reasons for the grandfathering are simple: as workers, employers and pension fund providers have made commitments or set aside funds in expectation of particular benefits, any changes made by tax legislation to the terms and conditions between the time of the engagement and the receipt of the benefit would undermine confidence in the system. The downside of grandfathering is equally clear: it leads to complexity and complexity of itself discourages pension saving. It also had the socially anomalous effect that workers from one generation who had commenced pension saving at a certain date might be allowed a larger amount of tax advantaged pension than younger workers, even in respect of employment in the same period.

THE ANNUAL ALLOWANCE AND THE LIFETIME ALLOWANCE

In an effort to simplify the system and address the various disparities, the UK government redesigned the fundamental

limits under the Finance Act 2004 which came into force on 6 April 2006. This time, the new regime was superimposed on all existing arrangements that had had tax approval under previous regimes. Payments permitted under old regimes that did not fit within the new were not prohibited but simply became taxable. Transitional arrangements which expired in April 2011 also allowed pension plans to continue to enforce limits applicable under earlier regimes.

The Finance Act 2004 regime uses two key limits: the annual allowance and the lifetime allowance. The annual allowance limits the amount an individual can save into tax advantaged pension arrangements in any year. The lifetime allowance limits the total amount of such saving an individual can benefit from in their lifetime. The limits apply equally to savings set aside by the worker and savings provided for their benefit by their employer.

Unlike previous limits the annual allowance and the lifetime allowance are not scheme specific but apply to the individual across all tax advantaged pension arrangements they may have. One advantage has been to dispense with the rule restricting workers to a single scheme in respect of any single source of income. This rule had anti-competitive effects and also put pressure on employers to facilitate personal saving within the employer sponsored fund which might better be provided by commercial providers.

Originally, the lifetime allowance was set at £1.4m and was then increased annually to £1.8m. It is now to be reduced to £1.5m with effect from 6 April 2012. A prescribed conversion factor is used to measure defined benefit pensions and lump sums against the lifetime allowance. The retirement income that may be secured for a capital value of £1.5m may in practice further reduce for defined contribution arrangements if annuity costs increase.

The annual allowance was originally set at £215,000 for 2006-7 and increased to £255,000 in 2010-11. Set at this high level (about one sixth of the lifetime allowance), the annual allowance enabled workers to choose the pace of pension funding and had very little relevance to employment pension benefits. It facilitated pension saving by the self-employed and those with irregular earnings. With effect from 6 April 2011, it has been reduced to £50,000.

Exceeding the limits is not prohibited but tax charges will apply which effectively negate the effect of the tax relief. There are transitional arrangements relating to both changes to the lifetime allowance and the annual allowance.

Tax relief by definition tends to favour the wealthiest as they are those who otherwise pay the most tax. The lowering of the lifetime allowance effectively limits tax advantaged pension saving to provision of a comfortable retirement income, not out of proportion with average incomes. The lowering of the annual allowance has the effect of spreading the relief by forcing the highest earners to spread their pension saving over several years.

The new tax structure has advantages and disadvantages:

Advantages

- ♦ it achieves a measure of fairness for workers of different generations and in different industries (with or without access to occupational pension plans); and
- ♦ it is simple to understand.

Disadvantages

- ♦ because the annual allowance and lifetime allowance apply to aggregate pension accrual across all arrangements for each worker, employers may not have visibility on when the limits are exceeded; and
- ♦ the lower annual allowance rarely affects normal saving in occupational plans but can affect sudden enhancements to benefits which accrue in a single year such as generous ill-health and redundancy pensions which were common features under previous regimes and attractive to both employers and employees.

FURTHER CONDITIONS FOR TAX RELIEF

Other key principles of the UK pension tax regime introduced by the Finance Act 2004 intended to ensure tax advantaged saving is applied only for the purpose of providing income in the post-retirement phase are as follows:

- ♦ a standard minimum pension age prevents access to pension funds before age 55 save in cases of ill-health (and limited other exceptions); the effect is that those of working age are not able to use the tax relief to withdraw from the economy at an early age;
- ♦ pensions for the worker must be payable for life; the tax relief is provided to encourage workers to provide for themselves and this rule is intended to ensure that those who benefit from the tax relief do not later become dependent on the state;
- ♦ pensions for children can only be paid after age 18 if in full time education (and then only until age 23) or if dependent through disability;

- ♦ no loans to the worker or the employer can be provided from pension funds;
- ♦ pension funds cannot be assigned or used as collateral or invested in property used by the worker or the employer; and
- ♦ pensions (or annuities) must be provided generally by a regulated pension fund or a regulated insurance company subject to capital requirements.

With falling annuity rates, the requirement to buy an annuity (in most cases) has been greatly resented and cited as a disincentive to pension saving. Recent changes now allow retirees to drawdown from their fund even after age 75 without tax penalties. Those who cannot demonstrate an annual income of £20,000 are however restricted to an income based on the annuity their fund could have purchased. The objective is again to ensure that the state benefits from the tax relief provided through the pension system by not having to support the workers at end of life.

The UK government is now looking at further proposals to allow early access under limited conditions. This has been prompted by research suggesting that the requirement to lock up financial resources until age 55 discourages many, particularly younger workers, from pension saving.

THE TAX FREE LUMP SUM

One feature of the UK pension tax landscape that has survived many changes is the tax free lump sum. Under the current regime, 25 per cent of the accumulated fund used for pension may be drawn as a tax free lump sum.

It might seem perverse that, if the objective of supporting pension saving is to ensure workers have adequate independent incomes to sustain themselves in the last phase of life, they are permitted and encouraged by a further tax break to use 25 per cent of that income a lump sum at the start of retirement.

Justifications for the benefit could be as follows:

- ♦ other tax advantages of pension saving can seem marginal having regard to the deferral of spending and other restrictions on use of pension capital. The tax free lump sum will tip the balance for many and thus encourage pension saving; and
- ♦ many workers, particularly those on lower or moderate incomes, use the tax free lump sum to pay off mortgage debts and other debts at the start of retirement.

By ensuring people start the non-working phase of their lives with low debts and with their housing needs already met, it is possible for most retirees to live on relatively low incomes.

ENGAGING EMPLOYERS

If the objective of government has been to offer tax relief to encourage people during their working lives for the post-work phase of life so as to relieve the state of the burden of caring for the elderly, a key partner in this strategy has been the employer.

In the UK, tax relief has been targeted at employers to encourage them to provide retirement income for their employees or provide part of their remuneration in the form of pension.

Contributions to tax approved pension arrangements are deductible for corporation tax purposes. Further, where the employer cannot fund the contributions, other group companies may be able to obtain the tax relief for paying contributions in place of the employer.

Limits have been placed on these arrangements to avoid abuse. Under earlier regimes, an occupational pension plan needed to have a complete prohibition on repayments to the employer from the plan. Later this was replaced by a tax charge (at 40 per cent) intended to counter the benefit of deferring tax and any untaxed investment returns by contributing excessive funds to a pension fund and later reclaiming the surplus. A pension plan might also lose its tax approved status if it was overfunded (105 per cent on the measure used by the UK revenue at the time).

The UK experience has been that limiting overfunding and limiting the employers' access to surplus encourages employers to underfund. Underfunding itself has presented a challenge to the state as the state has been under pressure to provide for workers who lose pension benefits through underfunding.

Under arrangements known as "contracting-out", previous UK governments also encouraged employers to assume responsibility for part of the state retirement pension. Under a contracted-out arrangement, the state would make a contribution to the plan (in addition to corporation and income tax relief). In exchange, the plan would provide a certain level of benefit, on a defined contribution or defined benefit basis, which would replace part of the state pension for workers participating in the plan. The greatest challenge with these arrangements has been their complexity and the comparative value for different age groups of the state benefit and the contracted out benefits they replace.

PENSIONS AND STATE BENEFITS

The UK government is introducing auto-enrolment to enhance pension saving. The intention is to harness the power of apathy by requiring workers to opt out of pension saving. Despite the tax relief, too few have opted in and research shows that often the tax relief has principally benefited the most affluent.

A key criticism of auto-enrolment is that it will result in workers on low or moderate incomes and those who take material career breaks subsidising the state or, more accurately, getting no benefit from their pension savings. The reason for this is that the UK currently provides part of the state pension and other benefits to retirees on a means-tested basis.

The UK government has resolved to address this by increasing the basic state pension to a level that will remove the need for most means-tested benefits.

ALTERNATIVES

Not all saving is done through pensions and not all pensions are tax-approved.

A popular alternative in the UK is housing. There is no wealth tax as such payable in the UK on residential property and the increase in value earned on a main home is exempt from capital gains tax.

A more comparable alternative to pension saving is the 'individual savings account' or ISA. This benefits from a TEE regime: the contribution is made on a taxed basis but the investment returns roll up on an exempt basis and the fund can be drawn at any time on an exempt basis. There is no lock-up period and no restrictions on the form in which the funds are spent.

For employers wanting to provide pension income above the levels permitted in the tax approved pension scheme environment (i.e. above the lifetime allowance) for their high earners, pensions can be provided on a basis that provides relief to the employer at the time the employee receives the pension. Any pre-funding however will not benefit from corporation tax relief until the pension is in payment. With effect from April 2011, under new legislation aimed at "disguised remuneration", the worker may also be taxed on the amounts set aside to fund or provide security for employer pension promises (outside the tax-approved environment). In effect the UK government has declared itself opposed to any form of deferred earnings that achieves tax deferral or abatement, except to the limited extent permitted in registered pension schemes, i.e. up to £1.5m per worker.

THE UK QUEST SO FAR

Tax incentives have been used for decades in the UK to encourage both individuals and employers to set aside resources for retirement income.

There has always been a concern about relief being over generous and consequently favouring those who are able to take advantage of it the most, namely the most affluent. The challenge for the state has been in offering tax relief on a basis that:

- ◆ is sufficiently generous to enable average workers to build up adequate funds;
- ◆ is attractive enough to outweigh the sacrifice of deferring spending;
- ◆ ensures funds that have benefited from tax relief serve the objectives of relieving dependency in old age;
- ◆ engages employers; and
- ◆ does not unduly subsidise wealth accumulation by the most affluent.

Challenges have arisen as:

- ◆ means-tested state benefits have been used to fill the income gap for many retirees, further discouraging pension saving by many;
- ◆ periodic changes to the tax regime added complexity and damaged confidence;
- ◆ competing demands on the earnings of average workers have held back saving; and
- ◆ there has been a tendency for only the highest earners to use the pension regime and to do so as part of tax planning.

Successes have included the engagement of employers to widen the uptake of pension saving.

The current strategy is not to rely solely on tax relief to encourage saving but to use auto-enrolment and to limit tax relieved saving strictly to a lifetime allowance for each worker of £1.5m; enough to provide a comfortable retirement but not to subsidise exceptional wealth.

WHERE NEXT?

The introduction of auto-enrolment suggests a move away from the use of tax breaks to influence behaviour and might be seen as a step towards compulsion.

A higher "universal" basic state pension providing an adequate standard of living for retirees also arguably removes the justification for tax relief on pension saving. Such tax relief is a subsidy to those wanting or able to provide an enhanced level of retirement income for themselves.

It is probably unlikely that all tax advantages for pension saving will be withdrawn in the UK. Future UK governments are likely to continue to find benefit in encouraging a savings culture and enabling people to provide a reasonable level of affluence for themselves in old age.

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