From obscure tax reliefs to clear incentives to save for retirement

Aquila Heywood's response to HM Treasury's consultation on pensions tax relief 'Strengthening the incentive to save'

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1 Introduction

We welcome the opportunity to respond to HM Treasury's consultation on pensions tax relief.

Details of our response are set out in the following sections. To put our response in context, we have provided details about Aquila Heywood and our customers in the Appendix.

2 Summary of our response

We recognise the need to strengthen the incentive for individuals to save for their retirement, especially with people living longer.

We believe that the incentive to save for retirement would be significantly enhanced if the Government introduced clear incentives with which individuals would identify, rather than the current mechanisms of providing tax relief on pension contributions, which are complicated and somewhat obscure.

Our proposal involves introducing 'Government Pension Incentive' payments which:

- Are clearly identified and communicated
- Provide a simple and transparent mechanism
- Are fairer across basic-rate taxpayers, higher-rate taxpayers and non-taxpayers for the employed and self-employed
- Support the progress made with auto-enrolment and incentivise increases in contributions beyond the auto-enrolment minimum contributions
- Facilitate a sustainable approach to promoting pension savings in future

We believe that such an approach should be introduced within this Parliament, but we propose that any such change should be introduced when the auto-enrolment staging dates are complete from April 2018.

We also propose that the Lifetime Allowance should be abolished for DC schemes and the Annual Allowance should be abolished for DB schemes.

Our administration system supports the various tax reliefs and allowances currently in place, but the key issue is whether individuals are appropriately incentivised to save for their retirement. Implementing our proposals will require new interfaces with HMRC, similar to the RTI changes that were successfully implemented in 2013. Automation from the outset would be imperative but, given the success of the RTI implementation, we are confident that implementing our proposals would be relatively straightforward.

3 Key issues and proposals

In this section we will summarise the issues as we see them and propose a new way forward without jeopardising existing pension provision.

3.1 Issues

3.1.1 Eight key issues

Issue 1: Individuals are not engaged with their need for income in retirement through pensions or other savings provision. While we are encouraged by the low volume of opt-outs during the first three years of auto-enrolment, we need to recognise that the next three years will be substantially more challenging.

Issue 2: Individuals in DC pension plans are not saving enough for their retirement. Many are being auto-enrolled into pension plans with the minimum 1% contribution from employers and employees, together with a small amount of tax relief. Experts suggest that contributions should be at least 15% of income to project a viable income in retirement in addition to a full state pension. While we recognise that auto-enrolment has increased the number of people saving for retirement, it is concerning that the average contributions have reduced.

Issue 3: Outside the public sector, there are now relatively few employees who are accruing a defined benefit pension. Members of DC pension plans are exposed to investment, inflation and longevity risks and need to be aware of these risks.

Issue 4: There is little focus on tax relief being a key incentive to save for retirement, especially for basic-rate taxpayers. It is noticeable that about three-quarters of the tax relief goes to employees above the higher-rate tax threshold (around 55% of the pensions tax relief is provided to the 12% of higher-rate taxpayers, and 20% of the pensions tax relief is provided to the 1% of additional-rate taxpayers).

Issue 5: Tax relief on employee contributions is provided by two different mechanisms – 'Net Pay' and 'Relief at Source' – which are described below. Neither of these is both simple and transparent, and neither provides a significant incentive to contribute more.

Issue 6: Under the 'Net Pay' mechanism, employees who do not pay tax do not receive any tax relief. On the face of it, this would appear somewhat unfair.

Issue 7: It is perhaps understandable that HM Treasury does not feel that the current tax relief mechanisms are incentivising individuals to invest for their income in retirement, and that the tax reliefs should be more clearly targeted.

Issue 8: While we understand that the amount of tax relief an individual receives needs to be capped, the Annual Allowance rules have become extremely complicated, especially for high earners. The Lifetime Allowance has become a disincentive for saving and can be a penalty for good investment management. Moreover, it is not appropriate to have a 'collar' and a 'cap'.

3.1.2 Current tax relief mechanisms

The 'Net Pay' mechanism means that employee contributions are taken out of gross earnings before deducting Income Tax. This is efficient in applying the tax relief immediately, but the amount of tax relief is not often quantified or obvious.

The 'Relief at Source' mechanism involves the DC pension provider paying the tax relief at the standard rate on the member's contribution into their pension plan and the money is recouped from HMRC – a process that can take several months before the tax relief is invested. Higher-rate taxpayers then need to reclaim the extra relief via self-assessment.

3.2 Our proposals

There needs to be more clarity about the incentives for individuals to save for their retirement, better engagement and a simpler, clearer and fairer mechanism for incentivising individuals.

Proposal 1: There should be no change in the tax relief on employer's contributions that are treated as a business expense, and should continue to do so. Indeed, employers should be encouraged through a new incentive to match employees' voluntary contributions as part of a strategy to get more individuals saving more for their retirement as part of a future phase of auto-escalation.

Proposal 2: The current mechanisms for pensions tax relief on employees' contributions should be replaced by a 'Government Pension Incentive (GPI)'. This would consist of a Government payment of 50% of an employee's contribution. For example, an employee contributing £100 would get £150 invested into their DC pension plan as a result of their £50 GPI payment.

Such an approach would be equivalent to tax relief at 33% for all contributing members of registered pension schemes. However, we would suggest that an explicit 50% increase would be a greater incentive and a simpler and clearer proposition. To reinforce the incentive, we would propose that the amount of the GPI payments be explicitly shown on annual benefit statements and, potentially, payslips as well.

Proposal 3: For DB members, the GPI payment would be implemented by one third of the employee's contribution rate being paid by the Government. This results in the GPI being 50% of the employee's contribution.

Proposal 4: For DC members, the GPI would be implemented by the employee's contribution being increased by 50% and the full amount including the GPI being invested.

Proposal 5: We would suggest that the pension scheme/pension provider would send a standard electronic message to HMRC providing details of the GPI amounts and HMRC would make the payment soon afterwards (rather than the current waiting time of several months). This process would be similar to HMRC's RTI messaging introduced in 2013, but would need to be extended to include automated payments.

Proposal 6: For DC schemes, the Lifetime Allowance should be abolished, but there should be a maximum contribution per tax year (a revised Annual Allowance) that would qualify for a GPI. Our suggestion would be a maximum of £30,000 including the GPI payment.

Proposal 7: For DB schemes, the Annual Allowance should be abolished, but there should be a Lifetime Allowance (LTA) based on the value of the DB benefits when benefits are crystallised and capitalised using appropriate valuation factors determined by the Government Actuary's Department.

We believe these proposals would incentivise individuals to contribute to their pension schemes (especially those who are basic-rate taxpayers or not paying tax) in a simpler and cost-effective manner without disrupting existing pension provision.

We recognise that, if the GPI for higher-rate tax-payers is 50% (commensurate with 33% tax relief), there is a risk that contributions would be focussed on employer contributions, especially if salary sacrifice is available. There may need to be an adjustment to address this issue.

We do not advocate pension savings accounts where all contributions are taxed in a T-E-E tax environment. We believe that such an approach would lead to significant complications where part of an individual's benefits are taxed on payment of pensions and other pension benefits are not taxed. This would lead to major impacts, especially in DB schemes. Moreover, there is a severe risk that individuals would be concerned that the tax-exempt payment of benefits could be taxed at a later date, which could dis-incentivise individuals saving for their retirement.

4 Our response to the questions posed in the consultation

Q1 – To what extent does the complexity of the current system undermine the incentive for individuals to save into a pension?

Having two different mechanisms for pensions tax relief, both of which are not particularly visible to members, does undermine the incentive to some extent.

Having said that, for many pension savers, especially those new to pension saving through auto-enrolment, the current scheme to which they are saving (and all future schemes) will be a straightforward defined contribution scheme. The auto-enrolment process has been designed to make saving into such pensions simple and easy, with individuals having only to decide to stay in the scheme or not. For these individuals the current system is not that complex at all. Current opt-out rates would suggest that these individuals welcome the opportunity to save for their retirement. In addition, recent press coverage about the new pension freedoms has increased awareness of pensions - not always positive!

If an individual receives tax relief through only one mechanism throughout their working life, the complications are not too onerous, but having exposure to both mechanisms is complicated, and both situations are not very transparent.

We believe that moving to a new T-E-E tax environment would impose greater complications for pension schemes and their members. We accept that it could be simpler for individuals who are saving for retirement for the first time, but that will be a very small minority.

Q2 – Do respondents believe that a simpler system is likely to result in greater engagement with pension saving? If so, how could the system be simplified to strengthen the incentive for individuals to save into a pension?

We believe that the pensions tax relief mechanisms could be simplified by introducing a Government Pension Incentive as set out in our proposals, instead of the current tax relief mechanisms, and would strengthen the incentive to save for retirement.

Q3 – Would an alternative system allow individuals to take greater personal responsibility for saving an adequate amount for retirement, particularly in the context of the shift to defined contribution pensions?

We believe that our proposals would incentivise individuals who are not engaged with pensions to start to contribute or contribute greater amounts.

Q4– Would an alternative system allow individuals to plan better for how they use their savings in retirement?

An alternative system of incentives would not necessarily allow individuals to plan their retirement better. It is more important to ensure that individuals have appropriate access to guidance/advice, including modelling tools and access to details of all their existing pension entitlements in a Pension Dashboard/Register.

It would be more beneficial for them to know that plans put in place now will still be applicable when they retire. Constant changes, such as those experienced in the last ten years, make planning more difficult.

Education and access to affordable guidance/advice would also be more beneficial than an alternative system, in allowing individuals to plan their retirement more adequately.

Q5 – Should the Government consider differential treatment for defined benefit and defined contribution pensions? If so, how should each be treated?

If the Government is going to change the tax treatment for future pension contributions, there should not be differential treatment for employee contributions to defined benefit and defined contribution schemes, as this would cause further confusion to the public and potentially make the annual allowance process more complex.

Q6 – What administrative barriers exist to reforming the system of pensions tax, particularly in the context of automatic enrolment? How could these best be overcome?

If the Government shifts how pensions are taxed, this will require an overhaul of administrative processes, especially in trust-based schemes.

Schemes are currently utilising one of the two tax collection methods outlined above; therefore, removing either or both of these will require a redesign of processes and procedures.

Any change to the tax relief on pension contributions should, ideally, allow for a simple and straightforward collection of contributions and claiming of incentives from the Government. Technology can help play a part in this, but only with simple and clear regulations that allow consistent application across schemes.

The Government may have to consider other regulatory barriers, such as late payment reports to regulators and the application of any charge caps if there are to be changes to the way in which tax relief is granted to pensions.

We believe that replacing the tax relief with a Government Pension Incentive will impact on administration processes for such schemes, but using automated messaging with HMRC will mean that the process should be relatively straightforward to implement.

Q7 – How should employer pension contributions be treated under any reform of pensions tax relief?

The tax treatment of employer contributions should remain unchanged.

The majority of employer contributions in DB schemes are deficit recovery contributions. Removing tax relief on these will only accelerate closure of DB schemes to future accrual, worsening the savings position. Changing the tax position for employer contributions will also increase the costs for employers, which are increasing already through the cessation of contracting out.

One further point is that any threat to increase the net cost of employer contributions to DB schemes could also put employers at threat and increase the likelihood of their pension scheme going to the PPF, potentially reducing the benefits available to individuals with a further knock on effect on faith in pension saving.

Q8 – How can the Government make sure that any reform of pensions tax relief is sustainable for the future?

We believe that introducing a Government Pension Incentive that is not tied directly into the taxation system would allow future governments to change the level of the incentive from time to time or to introduce variances of the approach in the future, such as tiering of the GPI rates.

As such, we believe that the GPI approach is much more sustainable and adaptable for the future.

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5 Appendix - about Aquila Heywood

Aquila Heywood is the leading supplier of life and pensions administration software solutions in the UK. The pension schemes for ten million members in more than 200 major organisations are run using our administration software solutions. These solutions cover the whole range of available schemes including DB, DC, hybrid, career average, cash balance and stakeholder, as well as a full range of other group and individual products including Group Risk, Individual Protection, SIPPs and Wraps, Income Drawdown and Annuities.

Aquila Heywood provides solutions across a diverse range of markets including Financial Services, Third-Party Administration, Corporate and Public Sector pension schemes in the UK, Ireland and the rest of Europe.

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