Spotlight on Pensions
PRESENTS
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Taxing times

Recent publicity on the plight of senior NHS staff whose pension scheme membership landed them with significant and largely unexpected income tax bills highlights yet again problems with the UK's pensions taxation system.

The latest issue – the tapering provisions of the annual allowance - of course potentially applies to all higher earners and long service DB scheme members, both in the public and private sectors since its introduction in 2016. The armed forces are also struggling with the problem, and at surprisingly low rank levels, demonstrating that the effects impact a broader group than just the high earners that was the stated target.

The practical impact of the issue on the ability of the NHS to deliver healthcare has brought it to wider public attention. Changes originally proposed for NHS staff were effectively only a sticking plaster, when arguably the prognosis requires nothing less than a full transplant to return the patient to health. A newly-published consultation on the NHS scheme may bring a solution, but focusing on one scheme in isolation will not address broader deficiencies in the pensions taxation system.

Pensions tax rules are difficult for non-experts to understand. This constantly mitigates against attempts to improve members' confidence in, understanding of, and engagement with, their own retirement income provision. Private sector employers (and, it now appears, some NHS Trusts unofficially) have introduced work-arounds for affected staff which, whilst perhaps not ideal, do at least provide a means of avoiding the penal tax bills that doing nothing can generate.

But the real issue is much broader. It goes to the heart of the pensions taxation dilemma – how to devise a system that is affordable and equitable for all pension scheme members, whilst avoiding Machiavellian devices targeting particular groups to meet political objectives.

The NHS issue

Senior NHS staff are affected by the tapering rules of the annual allowance. They are complicated but, essentially, provide that the annual allowance is reduced by £1 for each £2 that income exceeds £150,000, reversing the tax reliefs for this group. DC scheme members can avoid a tax charge by ceasing contributions in any year at the point their earnings are about to trigger the tapering provisions. However, it is more difficult for DB scheme members to do so, not least because it is difficult to judge when the increase in value of their accrued benefits (the test for DB) driven by their pensionable service and income is about to trigger tapering.

This is in addition to the existing issue of GPs in particular with a generous NHS pension tripping over the lifetime allowance if they continue working. As a result, and encouraged by the tax-based freedom and choice reforms, many are understandably taking the opportunity to retire early with a full pension.

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Wider concerns

Pensions tax shortcomings appear across the piece, with growing numbers of members at all income levels discovering first-hand how inequities are impacting them. At the lower end of the wages spectrum members whose earnings are within the income tax personal allowance arbitrarily lose out on tax relief on pension contributions where the arrangement offered by their employer operates under the net pay basis. That cannot be equitable.

Then there is the tax deducted from pension drawdown payments, which it falls to the member to reclaim where it is too much. Unless the member has detailed tax/pensions knowledge (which most do not) or buys financial advice (which most do not) there is a real risk of a member outside of the self-assessment regime failing to reclaim the tax, leaving them not only out of pocket, but gifting an undeserved windfall to the Treasury. Similarly, the tax charge on the drawdown of an entire pensions pot in one transaction (which, in the absence of any restrictions, provides an understandable temptation particularly for poorer members) is apparently not understood by many members until it is too late to avoid.

Even if a law is logical on one level, it fails as an effective measure if its complexity results in a lack of understanding amongst those it affects.

A mess

A reasonable conclusion is that the whole system is overdue fundamental reform. Rarely-understood tax complications and their practical implications for individual members undermine the pensions brand. The effects of the shortcomings – even if not the technicalities of how they arise – are more widely noticed as the number of people impacted grows. Consequently, the tax system threatens the gains achieved by automatic enrolment.

New approach

It is time for a new system, based upon first principles – the state's moral duty to provide financial assistance to its citizens in retirement. Encouraging citizens to help themselves is desirable, whether through tax relief or by making payments directly from the state purse.

Whatever the system, for the sake both of equity and longevity it should be designed to cost the Treasury no more than the aggregate of an amount per head of the population that is deemed at outset to be affordable and appropriate. That figure should be protected from future erosion by overzealous Chancellors seeking to use pensions tax relief reductions as a way to balance their books in times of leaner tax receipts. There is no way of legally binding the hands of future Chancellors, but a simple system will bring transparency, reducing the room for ministerial sleight of hand to slip in largely unnoticed (and unchallenged) provisions.

The benefit of assistance should be applied equitably amongst pension savers. A fundamental requirement for a law is that those likely to be affected should be able to understand it. The fact that so many people appear to be caught out by unexpected tax consequences demonstrates that the current system comprehensively fails that test.

The complexity of the overall tax system might suggest that a simplified pensions tax system should no longer be integrated with the income tax regime. The "state contribution" to a person's retirement savings could then be the same for each pound contributed to an arrangement, regardless of that person's income. This would also remove the need for a separate restriction on tax relief according to the overall value of a member's fund, as currently applies through the lifetime allowance.

That system would be simpler and more transparent for defined contribution arrangements than for defined benefit, where determining a value for each pound "contributed" is complex. With simplicity as the overriding priority, a broad-brush approach using a standard calculation for "contributions" would apply. Any by-product of winners and losers relative to comparable DC contributions may have to be swallowed, for the greater prize.

A warning from history...

The pensions industry is well acquainted with the problems caused by protecting expectations through grandfathering existing provisions. The complexities this brings bedevil attempts at simplification and must therefore be avoided.

Aspects of the current pensions tax system are being looked at. A fresh, bold approach is required, with simplicity at its heart. Who will embrace the challenge?

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