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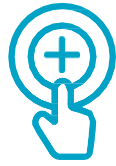

Pensions, Tax and the Budget

September 2024

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01 Introduction

It is widely expected that the October 2024 Budget will include a mix of spending cuts and tax rises to improve the overall state of the public finances. On the revenue-raising side, the Labour Manifesto of 2024 ruled out a number of options as follows:

> *"Labour will not increase taxes on working people, which is why we will not increase National Insurance, the basic, higher, or additional rates of Income Tax, or VAT."*[1]

It also said:

> *"Labour will cap corporation tax at the current level of 25 per cent."*[2]

Given that income tax, VAT, National Insurance and corporation tax account for nearly two thirds of all tax revenues, this suggests that the Government will be looking hard for other potential sources of revenue.

One frequently discussed way in which the Government could raise extra revenue would be through changes to tax relief (and related reliefs) on pension contributions, given that the Government estimates that this system cost around £48.7bn in 2022-23.

The purpose of this paper is to examine what changes might be made.

There are many elements of the system which the Chancellor could change but this paper looks at some of the more likely areas.

We aim to explore for each:

- How the current system works
- What could be changed
- Implementation issues
- How much could be raised
- What impact the change could have on behaviour (eg incentive to save etc)

[1] Labour Party Manifesto 2024, pg 19
[2] Labour Party Manifesto 2024, pg 28

The cost of pension tax relief

Before looking at specific policy proposals, it is worth understanding where the headline figure for the cost of pension tax relief comes from, and how it is broken down.

The key elements of the pension tax relief system relevant here are:

- Subject to various limits, individuals can make personal contributions to a pension and receive tax relief on those contributions, usually at their marginal rate of income tax.
- Money paid by employers into the pensions of their employees is not taxed, nor is it subject to employer or employee NI contributions.
- Investment returns within a pension are generally not subject to direct taxation.[3]
- Money taken out of pensions is generally subject to income tax. However, 25% of the value of withdrawals can typically be taken in the form of a tax-free lump sum, up to a lifetime limit of £268,275.
- Wealth held in the form of pensions is often not counted as part of someone's estate for the purpose of inheritance tax, whilst pension pots passed on when someone dies aged under 75 are also often not subject to income tax in the hands of the recipient.

In order to estimate the cost of pension tax relief, HMRC looks at how much tax (and NI) revenue is foregone as a result of the rules as set out above. It then nets off the tax currently paid by today's retirees and certain tax charges which arise when people do (or did) exceed annual or lifetime limits on tax relief.

The headline result of this analysis is that in 2022-23, pension tax relief cost the Government £48.7bn. The key elements of this figure are shown in Table 1.

[3] The main exception to this is that where dividends are paid into a pension scheme, pension schemes are no longer able to reclaim the associated dividend tax credit.

Table 1. Government costings of elements of the pension tax relief system

	Cost (+)/Revenue (-)
Income tax relief on employee/self-employed contributions	£10.3bn
Income tax relief on employer contributions[4]	£32.2bn
Income tax relief on investment income of pension funds	£4.3bn
National Insurance relief on employer contributions	£23.8bn
Less	
Income tax due on pensions in payment	(£21.2bn)
Other tax charges (annual allowance/ lifetime allowance)	(£0.8bn)
Net cost of pension tax relief	**£48.7bn**

Source: Authors' calculations based on Table 6, Private Pension Statistics (Private pension statistics - GOV.UK)

If the Government could save even a small percentage of this total cost, it could make a meaningful contribution to the Treasury's overall tax and spending plans.

It should be noted, however, that this way of measuring the cost of pension tax relief has a number of flaws. One is that it scores as a cost of the tax relief given to today's contributors but nets off the tax paid by today's retirees. This could overstate the cost of relief as today's cohort of workers is larger than today's cohort of retirees, and today's workers will eventually pay more tax on their pension savings than the amount paid by today's pensioners.

Despite this and other flaws the short-term costs of pension tax relief are significant, so the Treasury will be looking for measures which would encounter the least political resistance, and which also tick some or all of the following boxes:

- Would generate significant revenue.
- Would primarily affect the better off.
- Could be implemented relatively quickly.
- Would not significantly worsen incentives to invest for retirement.

[4] Note that this also includes the NI revenue lost where employees sacrifice part of their salary, and in return, their employer makes contributions into a pension on their behalf.

Naturally, there are very few changes which tick all of these boxes, but we have identified three types of reform to pension tax relief which the Chancellor might initially judge score reasonably well on at least some of these criteria:

- The tax treatment of pension lump sums
- The NI advantages of remuneration in the form of employer pension contributions
- The tax advantages at death of pensions

These are clearly just a subset of the many options which are often discussed in this context. Chief among other options include offering tax relief at a standard rate of relief rather than giving higher earners who pay tax at a higher rate relief at that higher rate. Our judgement is that flat-rate tax relief would be hugely complex to implement and could potentially create millions of losers, notably in the public sector. This could be seen to breach the commitment not to increase taxes on working people and might be sufficiently politically challenging not to be taken further by the present Government. On this basis, we have not included an analysis of such a measure in this paper.

02 Tax-free lump sums

The current rules

Where an individual builds up a Defined Contribution (pot of money) pension fund and reaches the normal minimum pension age (currently 55), they can take a quarter of the value of the pot out free of tax. When this is done at the time the money is accessed for the first time, this is normally[5] known as a Pension Commencement Lump Sum (PCLS) or, more colloquially, a tax-free lump sum. Similar provisions apply to those in more traditional Defined Benefit ('income for life') pensions, although, as discussed later, the way the 25% tax-free share is defined works in a slightly different way.

Until 2024-25, the maximum amount of tax-free cash was in effect, governed by the existence of a Lifetime Allowance (LTA) on the total amount of tax-privileged pension wealth which someone could build up over their lifetime. With an LTA in 2023-24 of £1,073,100, this implied for most people a maximum tax-free lump sum of 25% of this figure or £268,275. This means that broadly speaking, only those with pension wealth worth more than a million pounds are affected by this cap.

With the abolition of the LTA in 2024-25, the Government was keen to ensure that this did not lift the lid on tax-free cash, so they created a new lifetime limit on tax-free cash of £268,275.[6]

If the Chancellor is looking to raise revenue from the tax relief system, reducing the limit on tax-free cash could be a focus of attention.

One reason why the Government might consider scaling back tax-free cash is that relatively few ordinary pension savers get near this sort of figure. So, it might be a way of raising money without alienating the wider electorate. Of course, the counterpoint is that if not many people have pension savings at the necessary level, the potential gain may not be that great, and those who would be affected would include senior public servants such as doctors who have in the past been very vocal about limits in pension tax relief.

Notably, no separate figures have been published on the Exchequer cost of the existing system of tax-free lump sums. However, the Institute for Fiscal Studies say[7] that in the long-term the annual revenue foregone from the system of tax-free lump sums and based on unchanged saving behaviour, is around £5.5bn.

[5] The main exception to this is where the whole pension pot is taken as an Uncrystallised Funds Pension Lump Sum (UFPLS) where each subsequent withdrawal comprises 25% tax-free cash and is 75% taxed.
[6] There are also new lifetime limits on lump sums arising from death benefits as well as on pension commencement.
[7] Adam, S, et al, A blueprint for a better tax treatment of pensions, IFS, 2023

What could be changed?

There are several ways in which the value of tax-free cash could be reduced, but the two simplest ones would probably be:

- Instead of allowing relief on 25% of any pension pot, the percentage could be reduced or
- The cap of £268,275 could be reduced.

The first of these options would create smaller average losses amongst those who lose out but would spread them much more widely.

Allowing a smaller percentage of pensions to be taken tax-free would, in principle, cause losses amongst everyone who was likely to draw a pension and take a lump sum, including millions of low earners with modest pots because of automatic enrolment. This would rather undermine any goal of avoiding upsetting too many people.

It is more likely therefore that the Government might consider simply reducing the lifetime cap on tax-free cash. For example, the Fabian Society has recently published a report[8] suggesting a £100,000 limit on lifetime tax-free cash.

Implementation issues

The amount of revenue raised by such a measure would depend crucially on the extent to which it was accompanied by some form of transitional protection for those whose pension savings already implied tax-free cash above the new limit and potentially also those who had planned on this basis and were close to retirement. It would also depend on how savings behaviour changed in response to the new regime.

In the past, when limits on tax-advantaged pension savings were reduced (such as successive reductions in the Lifetime Allowance), the Government of the day introduced protection regimes for those who were already over the new limits or did not make further pension savings. Something similar could potentially be expected in the event of a lower cap for tax-free lump sums.

Alternatively, the Chancellor could give notice that the new limits will apply at a date in the future, though she would need to be sure that this did not lead to something of a gold rush (and loss of short-term tax revenue) as people sought to maximise the relief before it was more heavily capped.

Potential protection regimes

One way of protecting people from what could be seen as the retrospective application of this change would be to value everyone's pension saving to date – either on the date of the Budget or, perhaps more practically, at the end of the financial year.

They could then be allowed to take 25% of that pot, up to the old cap of £268,275[9] or alternatively keep the old allowance if they made no further pension savings.

This protection is broadly how the Lifetime Allowance protections worked.

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[8] See: Expensive and Unequal | Fabian Society
[9] Or such higher amount as they already had a protection for.

However, there would be a risk that in the window between a Budget on October 30th and a valuation date of (say) 5th April the next year, people would have an incentive to invest heavily into pensions to maximise their level of tax-free lump sum. If they did so, the Treasury could find itself actually losing money in the short-term because of the additional tax relief costs of people bumping up their pension savings.

A wider issue might be those who were below the proposed limit at the time of the Budget, but were expected to be above it by retirement, either because of contributions they planned to pay, or investment returns they expected to receive which would have taken them above. If, for example, they had planned to use their tax-free lump sum to pay off a mortgage and suddenly faced tax on a chunk of it, they might feel aggrieved that the rules had been changed at the last minute.

This group could be much wider than those who had previously been affected by reductions in the Lifetime Allowance and could include long-serving public servants with future entitlement to significant Defined Benefit pensions, part of which they were planning to take as tax-free lump sums.

The Government may well consider that this argument could be used against any change of any sort, and that they have the right to change the rules of pension tax relief. But it is possible that there could be some graduation in the implementation of the change, such as a phased reduction in the limit, or a higher limit for those within a certain number of years of retirement.[10]

The Government might also consider whether it would still give individuals the chance to take larger lump sums than the new cap and simply pay tax on the rest, which the tax rules currently allow for those affected by the current limit. If the lump sum was intended for a specific purpose (such as paying off a mortgage or to support another family member), the ability to take a significant part of their pension as a lump sum – even if partially taxed – could remain important. However, even if this was the Government’s intention, the specifics of some pension scheme rules could prohibit any lump sum over the tax-free amount, as they do currently. This could create significant (and unintended) inequality between pension savers based on the exact wording in their scheme rules. Care would be needed in this area.

How much would this raise?

In this section we consider the potential impact of a significant cut in the lifetime limit for tax-free lump sums to £100,000.

The scale and nature of the impact would be different for Defined Contribution (DC) and Defined Benefit (DB) pensions, noting that a number of people will have pensions under both regimes. We consider each in turn.

[10] The Government would however need to be careful that it did not fall foul of the laws on Age Discrimination which led to the famous McCloud judgment on public sector pensions. In that case, the Government had planned to exempt those within ten years of retirement from changes to public service schemes, but this was ruled discriminatory. The resultant ‘McCloud remedy’ has more than wiped out the planned savings from the changes for a seven year period.

A. DC Pensions

In principle, anyone with total DC pots at retirement of over £400,000 could lose out if they were in future only able to take £100,000 in tax-free cash.

But the amount raised per person would depend on how they responded. It is possible to identify two extreme scenarios:

- They still take exactly the same lump sum as previously planned, paying tax on anything in excess of £100k; or
- They only take the tax-free amount, and put the rest into drawdown or annuity, taking it in broadly equal (taxable) chunks for the rest of their life.

If we ignore the fact that a large taxable lump sum up front could push someone into a higher tax bracket, these two scenarios would in principle both generate the same amount of income tax for the Government. However, in the first case all of the additional tax would flow into the Treasury up-front, whereas in the latter case the extra tax would flow in over a period of potentially a couple of decades or more.

There is a more indirect and intangible effect on other taxes – for example to the extent people currently spend lump sums on items which are subject to VAT or stamp duty, these revenues could actually be reduced in the short-term.

From a political point of view, any cut to tax-free cash will be challenging and will only be worth the political hit if it generates significant extra revenue in the relatively short term. There is clearly a risk that, in the case of DC pensions, the initial extra revenue could be relatively low.

In addition, the number of people at present reaching retirement with DC pension pots in excess of £400,000 is relatively small.

For example, the FCA's annual retirement income market data[11] gives some breakdowns by pot size for DC pension pots accessed for the first time in each six-month period.

Taking the latest six-month period and annualising it, the FCA data suggests that around 60,000 pots were accessed with a value, after taking tax-free cash, of £250,000 or more, corresponding to an original gross pot size of £312,500.

Unfortunately, we do not have a breakdown which would allow us to know how many of these are over £400,000 and therefore potentially affected, but it is likely to be significantly less than the 60,000 with a gross pot over £312,500. We are therefore still talking about relatively small amounts in the scheme of Government finances.

There is however one additional source of revenue from this measure, and this would be through any change in savings behaviour. If we ignore any transitional protection, someone of working age now who expected to reach a DC pot in excess of £400,000 might decide to stop saving (or save less) into a pension, given that the attraction of further tax-free cash had been taken away. Depending on what else they did with the money, this would be likely to generate a net benefit to the Treasury as it would lower the cost today of pension tax relief on those contributions that would no longer be made. However, it is very difficult to quantify this effect.

[11] See: Retirement income market data 2021-22 | FCA

Finally – a point on the long-term effects. If some people choose to restrict their pension savings to stay under £400,000 in total savings, it will initially appear that such individuals would have broadly moderate retirements (the PLSA estimate a £300k - £500k pot required for a single person[12]) and not need to rely on Government financial support beyond the state pension in retirement. However, over decades, this may depend on the confidence that younger individuals have that the £100,000 limit will be inflation-linked. Furthermore, future investment returns are unpredictable so people may be unclear how much they wish to save. The result might well, therefore, be inadequate pension savings for future generations.

B. DB Pensions

In most DB pensions, members can take a scheme pension and a tax-free lump sum. In some cases – such as many public sector schemes – the amount of pension foregone to secure the lump sum can be relatively large. This factor may be important when we consider the potential Exchequer effect of capping tax-free cash.

The concept of a 25% tax-free lump sum needs a little explaining in the context of a Defined Benefit pension scheme, as there is not a pot of cash as such.

Instead, a notional cash pot is calculated for tax purposes on the basis of 20x the annual pension at retirement, plus the value of any lump sum taken. The 25% limit applies to this total notional pot.

For example, consider the case of someone who has earned a DB pension of £15,000 per year after taking tax-free cash. Multiplying the regular pension by twenty gives £300,000. A lump sum of £100,000 would give a total notional pot of £400,000, of which 25% can be taken tax-free. This arithmetic would suggest that anyone with an annual pension of over £15,000 after taking tax-free cash could be affected by a £100k limit.

Or consider a public service scheme where someone can draw 3x of their final salary at retirement as a lump sum in addition to their regular scheme pension. With a £100,000 cap on tax-free cash, anyone whose final salary was anything over £33,333 would be caught by the cap.

As with DC pensions, the amount which individuals would lose would depend on how they responded. If they simply took a 25% lump sum in any case, then the extra tax due would flow to the Treasury immediately. But – assuming this was an option – if they only took a lump sum up to the new tax-free cap, then the rest would flow into scheme pensions for the rest of their life, with a corresponding elongation to the flow of extra tax to the Government.

It is worth noting that reforms over the years have changed the way in which public sector pensions provide for a lump sum option. In the past, in many scheme members would have accrued a scheme pension (as some percentage of their salary) and the right to a lump sum (also a percentage of their salary). However more recently, public sector schemes have mainly moved to simply providing a scheme pension, but with the option to commute part of that pension into a lump sum.[13]

[12] See: How to estimate likely retirement living standards

[13] There could also be an added complication for public sector schemes, which relates to the McCloud judgment. In simple terms, many members of public service schemes will be given a choice at retirement as to whether, for the period from 2015 to 2022, they wish to be treated as having been a member of the old pre-reform pension scheme or the new scheme. As the 2015 reforms restructured the way in which rights to lump sum benefits are built up, changes to the tax treatment of lump sums at retirement could result in some members now making a different McCloud decision than the one which has been assumed to date.

The importance of this distinction is that the impact of a cap on tax-free cash may vary according to the section of the scheme in which rights were accrued.

Where rights are purely to a scheme pension, part of which can be commuted, the impact of a new cap on tax-free cash may simply be that people convert less of their regular pension into a lump sum. But in older sections, where there was an explicit right to a lump sum of a minimum level, it may depend on scheme rules whether part of this lump sum can be converted back into scheme pension.

In cases where people have to give up a scheme pension to secure a lump sum, a different group of people may be affected. The threshold to hit the cap over a 40-year career may be a final salary of around c£30,000 or a career average salary of around c£25,000 in today's money. This is a huge number of workers, for whom a changed tax regime is highly likely to result in people taking smaller lump sums.

The issue of a switch from taking larger lump sums to smaller lump sums plus a higher scheme pension may be especially prevalent in the public sector. This is because the amount of scheme pension foregone is large relative to the amount of lump sum secured.[14] One potential impact on Government finances over the long term is that the cost of public sector pensions would rise as fewer people commute their regular pension on relatively unfavourable terms but instead draw a larger ongoing pension.

Across the two slightly differing benefit structures, the IFS estimate[15] that almost half of public sector retirees could be in this position.

Some of the affected public servants may even be more likely to retire early for two reasons:

- They may realise future work will cease to accrue any further tax-free lump sum and/or feel that the £100k will not be increased over time.
- By retiring early, both their pension and lump sum often receive a reduction to offset the fact they are expected to receive the pension element for more years. One of the reasons some employees may currently choose not to retire early is the tax-free lump sum element can continue to grow while they delay. Capping the tax-free lump sum will curtail this growth in the lump sum for some – and the changed incentives could precipitate a reduction in the public sector workforce.

In summary, a £100k cap on tax-free cash could ultimately affect millions of long serving public servants, some on relatively modest wages, so might be politically challenging. And as there are likely to be far more DB members than DC members caught by such a change, the additional revenue is in most cases likely to flow over a period of decades rather than immediately – and this is even before allowing for any form of transitional protection.

[14] Many public service schemes commute scheme pension into a lump sum at a rate of 1:12 – that is, a member has to give up £1 per year of pension for their entire retirement to secure £12 of a lump sum. Without the tax advantage on the final slice above £100k, this deal may look even less attractive.
[15] See: Raising revenue from reforms to pensions taxation | Institute for Fiscal Studies (ifs.org.uk)

How many people could be caught?

To give a sense of rough orders of magnitude of how many people may be affected, we have looked at the Family Resources Survey, which provides information by age on how many people are drawing DB pensions at different levels. We find that roughly 400,000 people aged 65-69 are currently drawing DB occupational pensions of £15,000 per year or more, which would suggest that perhaps around 80,000 people per year commence such pensions. This could be a very broad-brush guide to the number of potential losers each year from a new cap, assuming that the vast majority of these choose to take a tax-free lump sum.

In terms of the potential loss per person, the data suggests that this group with annual pensions over £15,000 are on average drawing around £28,000 per year. This would imply a lump sum of roughly £180,000, an excess over a new cap of £80,000 and a tax bill if the full amount was taken of up to £32,000 (on the assumption that most or all of this would fall within the 40% tax bracket).

All of this means that, in the unlikely event that 80,000 people per year chose to continue taking a full lump sum averaging £180,000, and incurring a tax bill of up to £32,000, the Treasury could raise up to £2.5bn through the DB element of such a change.

In reality, it is more likely that most people (perhaps except those who had a specific need to take a significant part of their pension as a lump sum, regardless of tax) would instead take a lump sum up to the tax-free limit and then convert the rest back into scheme pension. The total tax take would be lower if most of this was taxed gradually at 20% rather than 40% in a lump (potentially half as much) and would presumably be spread over a couple of decades.

As a result, the extra revenue to the Treasury – though ultimately substantial – would take many years to reach a significant level.[16]

It is worth mentioning that there may also be 'second round' behavioural consequences of a change of this sort.

If it turned out that public servants at a wide range of earnings levels no longer saw pensions as quite so attractive (because of the capped ability to build up a tax-free lump sum) it might tilt their negotiations with their employers away from pensions and towards pay.

Change in the structure of public sector pensions is generally a slow process, but eventually, we could end up in a situation where more of the remuneration of public sector workers was in the form of pay now rather than pay later (ie pensions). In a world of (largely) unfunded public sector pension schemes, this would mean higher upfront costs for the Government (in the form of higher pay) but lower costs for future Governments (in the form of lower pensions). It would also reduce the flow of current contributions, which are used to pay for today's retirees, and therefore provide a short-term cashflow pressure to the Government.

[16] The IFS note cited earlier suggests that the 'long-run' revenue from a £100k cap on lump sums could be around £2 billion per year.

03 National Insurance

A second area likely to attract the attention of the Chancellor is the NI advantages of employer contributions to pension schemes.

National Insurance Contributions (NICs) are paid by employees and employers on earned income.

At present:

- Employees pay a rate of 8% on a band of earnings between £242 and £967 per week, and 2% thereafter.
- Employers pay at a rate of 13.8% on all earnings above £175 per week.

However, where employers provide remuneration in the form of payment into a worker's pension, these contributions are not treated as earnings for NI purposes.

As well as generally encouraging workplace pension provision, in recent years, this has encouraged a move towards "salary sacrifice" arrangements, where an employee accepts a lower salary, but in return, the employer pays all the pension contributions rather than the employer and employee each paying a proportion. Such arrangements are now commonplace, though not universal.

One point worth noting about 'salary sacrifice' arrangements is that in some cases the employee shares some or all of the NI saving which the employer makes through this arrangement. In the event that this incentive for employers were to be reduced or eliminated, this could have a direct knock-on effect on employees.

What could be changed?

An idea proposed by both the Resolution Foundation[17] and the Institute for Fiscal Studies[18] is for the Government to remove the NI relief on employer contributions. According to Table 1 above, the notional cost to the taxpayer of not levying NI contributions on employer pension contributions is a little under £24 billion per year. However, this includes the contributions made by many public sector employers (e.g. schools, hospitals and central and local Government), and if NI relief was withdrawn, it would no doubt be necessary for the Treasury to make up the resultant shortfall in the budgets of schools, hospitals, etc. On that basis, a more realistic estimate of the potential revenue would focus on private sector employers and would be more like £16 billion per year.[19]

In terms of the politics of such a measure, there are several attractions:

- Such a change could almost certainly be introduced relatively quickly, without the need for years of phasing or transitional rules.
- There is the potential to raise billions of pounds.

[17] See: Revenue and reform • Resolution Foundation
[18] See: Raising revenue from reforms to pensions taxation | Institute for Fiscal Studies (ifs.org.uk)
[19] HMRC estimates that employer NI relief in public sector schemes costs around £5.3bn per year compared with around £10bn for private sector schemes, including those operating 'salary sacrifice' arrangements. We assume, therefore, that roughly one-third of the savings from imposing full NI on employers would have to be refunded to public sector employers. (Source: Table 6.2 Private pension statistics - GOV.UK)

- The immediate hit would not be on employees (voters) but on employers (though employees could ultimately lose out in a variety of ways if employers adjusted their behaviour in response to the change).
- It could be argued that this is simply closing a loophole where remuneration packages are explicitly structured to minimise NI liabilities and would remove an unfairness between employees in firms which offer salary sacrifice and those which do not.

There are, however, some obvious challenges which such a measure would face:

- One of the Government's key missions is to promote economic growth, and a multi-billion-pound tax increase on businesses might not sit well with that priority.
- In general, Government s seek to tax activities which they want to discourage such as smoking, drinking alcohol or polluting the environment, whereas in this case they would be taxing something which (presumably) they want employers to do – namely, put money into their employees' pension schemes.
- In particular, where contributions are to clear deficits which have arisen in Defined Benefit pension schemes, Government policy has historically been to encourage such payments, not to tax them; if such payments are being made by struggling employers, this new levy could further undermine the position of both the company and the pension scheme; more generally, 'top-up' payments by employers to get their DB pension schemes funded to the level of a buyout with an insurance company would become more expensive and this would also potentially reduce the number of schemes able to secure member benefits in this way.
- Linked to the above two points, it might seem odd to have a 'pro-business' manifesto pledge not to raise Corporation Tax rates, but then to raise taxes but only on the businesses which pay into pensions for their workers.
- As noted above, where a salary sacrifice scheme is in place, a new tax on employers for paying pension contributions might be passed on to employees in the form of a less favourable 'salary sacrifice' package; this might be regarded by some as breaching the Labour manifesto pledge that the party "…will not increase taxes on working people". Even if the costs are not passed on, it could also be seen to break the promise in the second half of that pledge, namely "…which is why we will not increase National Insurance…"
- Many employers might respond with lower future pay rises or in putting up prices.

Of course, there is no particular reason why, if the Chancellor was minded to make a change, the full employer rate of NI contributions needs to apply to pension contributions. We consider some variations in the next section.

Could this be done in another way?

If the Chancellor wanted to reduce the NI advantage to employers of paying pension contributions rather than wages, the simplest option would be to simply apply the full 13.8% employer NI rate on pension contributions. Although this could be a very substantial revenue raiser, it might generate considerable opposition from employers and could also be seen to undermine, in particular, those employers who are the most generous in terms of workplace pension provision.

If this was felt to be going too far, there are several more modest options:

- The Chancellor could create a new rate of NI specifically for employer pension contributions; this would allow the Chancellor to implement the change gradually, but perhaps increase the rate over time having monitored the impact of the original change; or
- The Chancellor could say that a percentage of employer spend on pension contributions would be subject to the full rate of NI; whilst this is a slightly convoluted idea, it would enable the Government to say that it was not actually increasing the rate of NI at all but simply widening the 'tax base'; it would also allow for a phased introduction of the change, with the percentage of contributions subject to full rate NI being increased over time; or
- The Government could announce that it was 'abolishing salary sacrifice' for pensions. Salary sacrifice is already ineffective for things like company cars or private medical insurance so, in principle pensions could be added to this list[20]. Given the wide prevalence of salary sacrifice, particularly amongst larger employers, this could still raise several billion pounds to the extent that employers went on with current rates of pension contributions. One practical problem with this is that some firms currently offer non-contributory pension arrangements, which are presumably a very attractive benefit to workers and not something that the Government would wish to discourage. It may not be straightforward to draw a legal distinction between arrangements where all the pension contributions are paid by the employer because of a salary sacrifice 'device' as against ones where employers have always (possibly in part for the same reasons) paid all the contributions. But if this problem could be overcome, there would be considerable presentational attractions to the Chancellor of announcing a measure which few people would understand, which raised billions of pounds, which did not immediately fall on the pay packets of employees, and which did not require an increase in any tax rates.

The downside is that this would presumably need to be an 'all-or-nothing' change, with the full 13.8% NICs applying as salary sacrifice schemes were unwound, whereas simply creating a new tax rate on employer pension contributions could be done gradually and at a much lower rate.

In the next section, we deal with some practical implementation issues that the Government may need to consider.

[20] Note, however, that if employer pension contributions were simply to be treated as a 'benefit in kind', they would not only be subject to NI but also to income tax and this might be regarded as a step too far.

What would be taxed?

Contributions to the scheme as a whole rather than with respect to named individuals?

In theory, it should be straightforward to tax the pension contributions that employers pay into the pensions of today's employees. For DC pensions, that is indeed the case, but for Defined Benefit pension schemes, where some such schemes have a deficit, employers may be making deficit repair contributions to make sure that all historic pension promises made to past and present employees can be met. Some employer payments into pension schemes do not directly translate into member benefits but are simply to meet the administration and investment expenses that fall on schemes. Neither of these types of payments directly map onto the remuneration package of current employees.

However, given that separating out these different elements of employer pension contributions might not be straightforward, it seems likely that any new NI rate would include all of these payments by employers, even though they do not directly relate to the pension rights of any specific individual. One reason for this would be to avoid 'arbitrage' if some forms of employer payments attracted NI but others did not.

Contributions with respect to low-paid workers where no employer NICs are due?

A related issue is that for lower-paid employees, no employer NICs are currently payable. To the extent that employer contributions into a scheme are with respect to such workers, you could be in a situation where the pension element of their remuneration attracted NI at (say) 13.8%, but their wages attracted no employer NICs. However, it would probably complicate matters too much to try to exclude contributions in respect of such workers from any new levy.

A. Treatment of pension fund surpluses

If money paid into a Defined Benefit pension scheme was subject to employer NICs but turned out not to have been needed (ie the scheme winds up with a surplus,) then employers might reasonably feel that they should have a refund on the NI which has been paid.

However, this would be far from straightforward. If a scheme was close to winding up at the point of policy implementation, then the large bulk of contributions would have benefited from employer NIC relief and only the most recent would have been subject to the new levy. It would presumably only be appropriate to offer an NI refund on wind-up to the extent that NI had been paid 'on the way in', and this could require some careful calculations and record-keeping as to the 'correct' figure.

B. Timing issues

If the change is effective from 6 April 2025 (or later), some employers may accelerate their planned DB contributions to before that date in order to pre-empt the change – though this will depend on affordability.

A more extreme version of this would be for employers with DC arrangements to front load contributions before the new tax came in, perhaps putting the money into some sort of general pension fund, and then allocating funds from that vehicle to individual employees year by year.

Whilst the latter response in particular may not be very likely – and could probably be prohibited by law – these points are a reminder that a large tax change which raises billions of pounds from businesses is likely to spark a lot of activity to minimise that new liability.

C. Impact on incentives for workplace pension provision

One obvious risk if NICs were levied on employer contributions, and especially if at the full 13.8% rate, is that it would reduce the relative attractiveness to employers of offering remuneration in the form of pensions.

For example, we could see far more employers offering a total compensation package in the form of a higher salary than at present, but with only a 3% employer contribution if mandated by auto-enrolment minima. Employees would then be left to their own devices if they wanted to use some of their additional take-home pay to top-up their pension beyond AE minimum levels. The obvious concern is that employees would not do so – or at least not to the extent that their employer currently contributes – and that overall retirement outcomes would deteriorate.

04 Pensions, death and taxes

There are two main respects in which wealth held in the form of pensions receives favourable treatment in the event of the death of the owner, and either or both of these could receive attention from the Chancellor.

These are:

- Where a person dies under the age of 75 and leaves behind a pension pot, their heirs can generally draw from this pot free of any income tax
- Pension savings are generally not included as part of an estate for Inheritance Tax purposes

We consider each in turn.

A. Income tax exemption where owner dies under 75

In cases where someone with a balance in their DC pot dies aged 75 or over, the remaining funds can be passed to their nominees, but income tax is due as and when the money is withdrawn. However, where the death occurs before the age of 75, the beneficiaries can take the money out free of income tax subject to being below the former Lifetime Allowance of £1,073,100. This system was introduced as part of a set of reforms in April 2015 designed to be 'pro inheritance' and refined when the Lifetime Allowance was abolished this year.

This rule is primarily relevant to those who have built up DC pensions and who die before those pots have been exhausted. At present, the large majority of pension wealth is held in the form of DB pension rights where the benefit is generally formed of a continuing pension to spouses and other partners. This benefit is taxed at the recipient's income tax whatever the age of the death (and so perhaps DC currently has more favourable treatment than DB in this regard). However, that balance will shift over time as more and more people build up DC pots.

One reform option would simply be to apply the income tax treatment which currently applies for deaths at age 75 or over to all deaths. It is understandable that the age 75 threshold could be felt to be an arbitrary cut-off.[21]

It is unclear exactly how much extra tax such a change would raise. The decision to allow all pensions (including those in drawdown) to be passed on, tax-free, for deaths under 75 was part of a wider package of reforms, including abolishing a 55% tax charge on certain other inherited pensions. This 2015 reform package as a whole was costed at around £150m[22], but the Government at the time did not separately cost the expanded exemption for deaths under 75.

If we assume that removing income tax for deaths under 75 was only a relatively small part of the overall costing, reinstating it would probably only raise tens of millions of pounds for the Chancellor. It may well be that the revenue relative to the likely political criticism would not be an attractive trade-off.

[21] The use of age 75 as a cut-off mirrors other provisions in the pensions tax system, notably that pension tax relief is no longer available on contributions beyond that age.
[22] See: Chancellor abolishes 55% tax on pension funds at death - GOV.UK (www.gov.uk)

It is also notable that around 85% of pension wealth held by 40-year-old men and around 90% of pension wealth held by 40-year-old women is projected to have its owner survive to age 75[23] - which are higher survival rates than the general population owing to the correlation between wealth and life expectancy. This feature will also reduce revenues.

B. Exclusion of pension assets from estates

Pension wealth currently receives favourable treatment when it comes to Inheritance Tax (IHT) compared with some other forms of wealth. In general, money held in the form of a DC pension pot is simply excluded when estates are valued for IHT purposes. This contrasts with the treatment of, for example, ISAs, whose value counts in full as part of the estate when money is passed on between the generations.

The Government may take the view that it is hard to see why investments held in an ISA should count for IHT purposes, but investments held inside a pension should not, and could simply legislate to count pension wealth in future.

As ever, there would be some implementation issues to consider. These include:

- Whether there would be a need for any form of transitional protection for those who had made plans on the basis that pension assets would not be included in their estate.
- Whether Personal Representatives would have to pay the IHT bill arising from the inherited pension before they had actually received the money – either in the form of a lump sum or even a series of payments. This could create considerable cashflow problems; would it be necessary to create some new ‘scheme pays’ mechanism to cover cases like this? This would not be straightforward as the trustees of the scheme would not know how much IHT to deduct unless notified by the Personal Representative.

A further consideration would be that bringing DC pension pots into IHT would create an inconsistency with pensions paid to dependants from DB pension schemes and lump sum benefits from both DB pension schemes and life assurance schemes, all of which currently fall outside IHT. Whilst generally a transfer to a spouse on death is exempt from IHT, bringing pension pots within IHT for other transfers could have the unintended consequence of penalising unmarried partners.

How much could be raised?

The potential revenue from such a measure is difficult to assess. Only a relatively small proportion of estates currently pay IHT at all[24], so for those with modest estates, adding in any unspent pension wealth might still leave them below the current IHT allowances.

It would also be necessary to think through the potential behavioural consequences of counting pensions towards estates.

For someone who anticipated being within the IHT scope, the fact that IHT is levied at a rate of 40% might lead them to consider minimising their unspent pension on death. For example, if the pension holder paid income tax at the basic rate, they might seek to take money out of their pension for as long as they remained within the basic rate band, so as to pay 20% tax on withdrawals and then gift as much as possible to their intended heirs.

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[23] Continuous Mortality Investigation, S3PA tables with CMI 2023 projections, long-term rate of 1.25% (also in line with Statutory Money Purchase Illustration guidance)
[24] According to HMRC, just 4.39% of deaths in 2021-22 resulted in an IHT liability – see: [Inheritance Tax liabilities statistics: commentary - GOV.UK (www.gov.uk)]

This would obviously be subject to IHT considerations, including that gifts may only be wholly exempt if the donor survives for seven years after the gift is made, but coupled with a possible normal expenditure out of income exemption on some gifts, it is just one example of many that creative advisers might come up with to reduce any potential IHT liability.

Once again, we may be looking at a measure which could no doubt raise some money and could be said to be aimed at those with the broadest shoulders, but where behavioural responses could limit the potential tax take and where any political flak might not be proportionate to the amount raised, at least in the short term.[25]

[25] We note that the IFS say: "Ending this inequitable treatment [excluding pensions from IHT] could raise several hundred million pounds a year in the short term, rising quickly thereafter (potentially to as much as £2 billion a year, though probably less)." See: [Raising revenue from reforms to pensions taxation | Institute for Fiscal Studies (ifs.org.uk)]

05 Conclusion

A headline cost of nearly £50 billion per year for the pension tax relief system will not have gone unnoticed in the Treasury, especially given the Government 's limited ability to raise revenue through raising taxes or borrowing more. However, as this report shows, there are few easy wins when it comes to raiding the pension tax relief 'pot' to improve the public finances.

We find that:

- Capping tax-free lump sums might be attractive as it could clearly be presented as affecting only the very wealthiest. However, assuming that an extensive system of transitional protection had to be introduced, the upfront revenue could be limited. The main group of losers, at least for now, is likely to be long-serving public servants, including some who are not on especially high wages, who would either face a tax bill on their pension lump sum or would have to take a lower lump sum. Furthermore, if people respond by taking lower lump sums and increased regular pensions, the extra tax take would take many years to accumulate. Given the huge political sensitivity around tax-free cash, the revenue versus controversy trade-off may be judged to be unattractive.
- Removing or reducing the NI advantages to employers of paying pension contributions rather than wages could raise substantial sums. It would do so in a way which would not immediately impact on the take-home pay of employees (which would make it more politically attractive) though for salary sacrifice schemes it is likely that they may end up being redrawn, with workers seeing less favourable terms, or even scrapped. But critics would argue that taxing businesses is at odds with the Government's pro-growth agenda, results in costs being passed on indirectly to workers and consumers and in particular that it is wrong to raise the tax burden on employers who are 'doing the right thing' by paying into pensions for their workers.
- As an alternative, the Chancellor could simply announce that she was abolishing salary sacrifice for pensions. Although there would be practical challenges in defining what this meant, and firms would need time to adjust to the new rules, this could still be a major revenue raiser and with potentially less political saliency for many voters.[26] It would, however, still affect millions of workers in workplaces where a salary sacrifice scheme was in place, and it seems highly likely that many of these workers would lose out in due course as new arrangements were put in place.

[26] There is limited information on the extent of use of salary sacrifice, but research cited by Aegon suggests that 50% of workplaces use salary sacrifice for pensions, and it seems highly likely that larger employers, with better access to advice and economies of scale, would be more likely to use it than smaller firms. See: Salary sacrifice for employers – what you need to know | Employer | Aegon

- Pensions benefit from favourable tax treatment when it comes to death. The Chancellor could (re)introduce income taxation of inherited pension pots for deaths under 75 and could include DC pension wealth in estates for IHT purposes. But in both cases the short-term revenue raised could be limited, especially if any transitional protection was put in place, and increasing taxes on death carries its own political challenges.

  In considering these reliefs it is important that the Chancellor looks holistically at what the pensions system (including the pensions tax regime) is trying to achieve and how far the primary focus is on individuals and their own retirement relative to the potential use of (unspent) pension saving as a source of bequests. She would also need to consider how any change affected the relative advantages of DB and DC pensions.

In all of these examples, a less favourable tax treatment of pension contributions or pension wealth would make saving in a pension less attractive for individuals and providing a (good) pension less attractive for employers. Given the Government 's own estimates[27] that around 12 million people in the UK are currently under-saving for their retirement, the Chancellor will need to assure herself that any Budget measures designed to improve the public finances at the expense of support for pension saving do not make that problem worse.

[27] See: Analysis of future pension incomes - GOV.UK (www.gov.uk)

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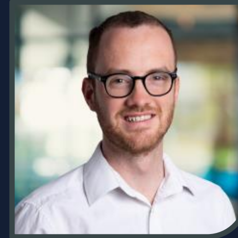

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