Pensions Tax Relief: ‘Time to end the salami slicing’
**ROYAL LONDON POLICY PAPER**  
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Executive Summary

In recent years, the HMRC’s limits on pensions tax relief have been repeatedly reduced. The Lifetime Allowance (LTA) is the maximum amount of tax relieved pension saving that an individual can build up over their lifetime. This has fallen from a peak of £1.8m in 2011/12 to £1m in 2016/17. The Annual Allowance for contributions into tax privileged pension saving was cut from a peak of £255,000 in 2010/11 to £40,000 in 2014/15. This was followed in 2016/17 by the introduction of a complex tapering system, with a reduction from £40,000 per year to £10,000 per year for the highest earners.

In addition to the fall in the value of these HMRC limits, annuity rates have fallen sharply, particularly since the financial crash of 2008, and again following the referendum on the UK’s membership of the European Union. This means that the value of a pension that can be purchased by someone who stays within the HMRC limits has fallen sharply in the last decade, particularly when account is taken of inflation.

Calculations by Royal London show:

- In 2006/07, a £1.5 million pension pot and a typical annuity rate of just over 7% would have generated an annual pension of just under £106,000; in 2016/17, a £1 million pension pot and a typical annuity rate of around 4.5% would generate an annual pension of just £45,400; this is a reduction of around 57% in a decade;

- The largest pension that could have been bought in the last decade would have been in 2008/09 when a lifetime allowance of £1.65m and an annuity rate of 7.34% would have generated an annual pension of around £121,000; relative to this peak, the figure of £45,000 represents a reduction of 62%;

- Taking account of CPI inflation, the falls are more stark still; the real terms fall over a decade is 66% (from around £133,000 in 2006/07 to £45,000 in 2016/17, both in 2016/17 prices), whilst the fall from the peak on this measure in 2007/08 is 69% (from around £145,000 in 2007/08 to £45,400 in 2016/17);

- The position is more favourable for DB pensions because the amount you can receive is not affected by the fall in annuity rates; in addition, the way that DB pension pots are measured against the lifetime limit allows individuals to draw a larger DB pension and stay within the limit than for a DC pension; however, there have still been sharp falls even for DB pensioners:
In 2006/07 a DB pension of £75,000 would have been allowable within the lifetime limit of £1.5m; in 2016/17 the maximum is £50,000 with a limit of £1m; this represents a fall in nominal terms of one third;

Measured in 2016/17 prices, the fall is from around £94,000 to £50,000, a real terms decline of 47%;

For someone with a DC pension pot wanting to buy an annuity that broadly mirrors DB style benefits (with 3% inflation protection and a fifty per cent survivor pension) an annuity rate of 2.71% and a lifetime limit of £1m generates an income at retirement in 2016 of just £27,100, not much more than half the corresponding figure for a DB pensioner; if the million pound pot was used to buy a more comprehensive annuity, providing full RPI protection and a two thirds survivor’s pension, the starting value would be just £20,860 per year;

With an Autumn Statement due on November 23rd, the new Chancellor will be considering his options for revenue raising, and with a challenging fiscal position, he will no doubt be tempted to look once again at the scope for raising revenue from cuts to pensions tax relief.

We believe that the Chancellor should resist the temptation to go for further salami-slicing of pensions tax relief. This is for two main reasons:

a) As our analysis shows, the sorts of pensions now available to those who reach the lifetime allowance are no longer the preserve of the super-rich; and if the previously announced policy of annual price indexation of the lifetime limit is implemented, many more individuals who have worked hard and saved hard will have to start making sure that they avoid saving too much in their pension;

b) Constant changes to pension taxation create uncertainty and instability for savers, advisers and for pension providers; pension planning is about the long-term, but the twice-yearly cycle of Budgets and Autumn Statements means that every six months there is fresh uncertainty about potential changes to tax relief limits or to other features of the system such as the future of the tax-free lump sum; last year’s Green Paper floating the idea of a pensions ISA and the subsequent introduction of the Lifetime ISA have also added uncertainty about the Government’s long-term plans for tax relief;

We believe that the very existence of a lifetime limit creates great complexity, and this is reinforced by the constant changes to the limit and the various schemes of transitional protection associated with each change. It surely undermines a savings culture to put more and more people in a position where they have to actively ensure that their pension pot does not exceed an arbitrary limit. With a sensible system of annual limits we can see no justification for the existence of a separate lifetime limit.
But in the absence of fundamental structural reform, the Chancellor should resist the temptation to dip once again into the pensions tax relief pot. During the General Election campaign of 2015 the current governing party undertook to make no further changes to pensions tax relief. If the Chancellor were to reassert that promise in his Autumn Statement, the resultant period of stability would be hugely welcomed by pension savers.
1. **Limits to Tax Relief on Pension Contributions in 2016/17**

Under the current system of tax relief on pension contributions, individuals are allowed to accumulate a tax-privileged pension pot of up to £1 million. Beyond this amount, withdrawals are taxed at a penal tax rate. The gov.uk website says:

*The rate of tax you pay on pension savings above your lifetime allowance depends on how the money is paid to you - the rate is:*

- 55% if you get it as a lump sum
- 25% if you get it any other way, for example pension payments or cash withdrawals

[https://www.gov.uk/tax-on-your-private-pension/lifetime-allowance](https://www.gov.uk/tax-on-your-private-pension/lifetime-allowance)

For Defined Contribution pensions it is the size of the pension pot which is tested against the lifetime limit. For Defined Benefit contributions the value of the lifetime entitlement is generally calculated as twenty times the annual pension you get in the first year plus the value of any additional lump sum.

In addition to the lifetime limit, there is an annual allowance which has become significantly more complex since April 2016.

In the simplest cases, individuals are able to contribute up to £40,000 per year into a pension and receive full tax relief. However, since April 2016, those who have gross income plus employer pension contributions in excess of £150,000 per year are subject to a tapered reduction in the value of their annual allowance. The taper operates at a rate of fifty pence in the pound on total income in excess of £150,000, up to a ceiling of £210,000. Those with a total income of £210,000 per year therefore have their annual allowance tapered down to £10,000.

The annual allowance can also be reduced for those who exercise their post 55 ‘pension freedoms’ and who draw taxable cash from a defined contribution pension scheme and then continue to make pension contributions. This reduced allowance is known as the ‘Money Purchase Annual Allowance’ and stands at £10,000. More complex rules apply to those who draw taxable cash from a DB pension.

Unused annual allowances for up to three previous tax years can be carried forward into the current tax year.

Where an individual exceeds the annual allowance and has a tax bill of £2,000 or more, they may be able to ask their pension provider to pay the tax directly from their pension pot.
2. **Changes to Tax Relief limits in the last decade**

   a) **Lifetime Allowance**

The current system of lifetime allowances was introduced in 2006/07. Table 1 shows the rates of lifetime allowance in each year since then:

*Table 1: Lifetime Allowance rates 2006/07 to 2016/17*

<table>
<thead>
<tr>
<th>Year</th>
<th>Lifetime Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006/07</td>
<td>£1,500,000</td>
</tr>
<tr>
<td>2007/08</td>
<td>£1,600,000</td>
</tr>
<tr>
<td>2008/09</td>
<td>£1,650,000</td>
</tr>
<tr>
<td>2009/10</td>
<td>£1,750,000</td>
</tr>
<tr>
<td>2010/11</td>
<td>£1,800,000</td>
</tr>
<tr>
<td>2011/12</td>
<td>£1,800,000</td>
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<tr>
<td>2012/13</td>
<td>£1,500,000</td>
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<tr>
<td>2013/14</td>
<td>£1,500,000</td>
</tr>
<tr>
<td>2014/15</td>
<td>£1,250,000</td>
</tr>
<tr>
<td>2015/16</td>
<td>£1,250,000</td>
</tr>
<tr>
<td>2016/17</td>
<td>£1,000,000</td>
</tr>
</tbody>
</table>

As will be clear from Table 1, lifetime limits were increased on an annual basis between 2006/07 and 2010/11. After the General Election of 2010 it was announced that the Lifetime Limit would be cut from £1.8m to £1.5m in 2012/13. In 2012 it was announced that the limit would be cut to £1.25m in 2014/15, and in the 2015 Budget it was announced that the limit would be reduced to £1m in 2016/17. However, the pledge was also made that the limit would be indexed by the CPI from 2018/19 onwards.

When the changes were made to Lifetime Limits in 2012, 2014 and 2016, complex transitional arrangements were put in place to provide a measure of protection for those who had already built up significant pension rights. For example, with regard to the 2016 changes, individuals can apply for:

- “Fixed Protection 2016” – in essence, for those who were not covered by protection against previous changes, this allows people who expect to have a pension pot above the pre-2016 level (ie £1.25m) to
freeze their lifetime allowance at the £1.25m level; however, they have to make no further contributions to their pension;

- “Individual Protection 2016” – those whose pension pot lies between the old limit (£1.25m) and the new limit (£1m), can apply to retain a limit in line with the value of their own individual pension pot as at 5th April 2016.

The above two paragraphs are a very brief summary of pages and pages of complex tax legislation and do not deal with the protection arrangements put in place when earlier reductions were made. It is therefore not only the lifetime limit itself which creates complexity but the fact that each time it changes there has to be a complex new system of transitional protection to help those who might feel that the changes affected them in a particularly unfair way.

Some indication of the scale of this complexity is shown in the numbers of people who have applied to date for the various forms of protection. Available data is shown in Table 2.

### Table 2: Applications for Fixed and Individual Protection against increases in the Lifetime Allowance

<table>
<thead>
<tr>
<th>Type of Protection</th>
<th>Number of people</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Protection 2012</td>
<td>28,664</td>
</tr>
<tr>
<td>Individual Protection 2014</td>
<td>13,468</td>
</tr>
<tr>
<td>Fixed Protection 2014</td>
<td>49,482</td>
</tr>
<tr>
<td>Individual Protection 2016 (to date)</td>
<td>4,867</td>
</tr>
<tr>
<td>Fixed Protection 2016 (to date)</td>
<td>11,969</td>
</tr>
</tbody>
</table>

Sources: The data on Fixed Protection 2012 and 2014 comes from an HMRC reply to a Freedom of Information request by Royal London; data on the other forms of protection comes from the September 2016 edition of the HMRC pension schemes newsletter.

Whilst it is possible to be covered by more than one of these categories at the same time, it seems likely that around 100,000 people are now covered by one of these complex transitional schemes. In addition, the table does not include some of those with the highest amounts of lifetime pension saving who were covered by ‘primary protection’ or ‘enhanced protection’ against the initial introduction of a Lifetime Allowance, for which applications had to be received by 6th April 2009. Given that the deadline for applying for Individual
Protection for 2014 has not yet been reached, let alone the deadlines for the most recent changes, the numbers affected are set to rise even further.

b) Lifetime Allowance

Table 3 shows the rates of Annual Allowance which have applied since 2006/07.

**Table 3: Annual Allowance rates since 2006/07**

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006/07</td>
<td>£215,000</td>
</tr>
<tr>
<td>2007/08</td>
<td>£225,000</td>
</tr>
<tr>
<td>2008/09</td>
<td>£235,000</td>
</tr>
<tr>
<td>2009/10</td>
<td>£245,000</td>
</tr>
<tr>
<td>2010/11</td>
<td>£255,000</td>
</tr>
<tr>
<td>2011/12</td>
<td>£50,000</td>
</tr>
<tr>
<td>2012/13</td>
<td>£50,000</td>
</tr>
<tr>
<td>2013/14</td>
<td>£50,000</td>
</tr>
<tr>
<td>2014/15</td>
<td>£40,000</td>
</tr>
<tr>
<td>2015/16</td>
<td>£40,000 *</td>
</tr>
<tr>
<td>2016/17</td>
<td>£40,000</td>
</tr>
</tbody>
</table>

Note: The annual allowance for 2015/16 is calculated in a more complex way because of the changes to pensions tax relief announced in July 2015.

The most striking change shown in Table 3 is the dramatic fall in the value of the annual allowance between 2010/11 and 2011/12, as well as the further reduction with effect from 2014/15.

As noted earlier, since 2015/16 the £40,000 limit can be reduced for those who take taxable cash from a pension but continue to save into a pension, under the ‘Money Purchase Annual Allowance’ rules.
Since 2016/17, the annual limit can be tapered down to a minimum of £10,000 for those with combined income and pension contributions in excess of £150,000 per year. This change in particular has added huge complexity to the system, not least because at the start of a tax year an individual cannot know with certainty what their annual allowance will be, because they do not know what their income will be. This is a particular issue for higher-earning self-employed people and for those for whom unpredictable bonuses are a significant part of their remuneration.
3. **How much pension can you get and stay within the HMRC limits?**

One way of measuring the progressive tightening of the limits on pensions tax relief is to look at the size of pension which an individual can draw whilst staying within the lifetime limit.

To illustrate this point we make the assumption that the individual uses the whole of their pension pot to buy a level (ie unindexed) annuity from the age of 65, based on average annuity rates prevailing at the time. Because annuity rates have been falling, particularly since the financial crash of 2008, this reinforces the squeeze on pensions affordable within the lifetime limit from a DC pension pot, as shown in Figure 1.

**Figure 1: Level of annual income which could be bought with a DC pension pot equal to the lifetime allowance 2006/07 to 2016/17**

![Graph showing the decline in pension amounts](image)

*Source: Royal London calculations based on HMRC Lifetime Allowance rates and level annuity rates at age 65 supplied by [www.williamburrows.com](http://www.williamburrows.com)*

Figure 1 illustrates the very substantial decline in the amount of pension which can be bought with a pot equal to the lifetime limit over the last decade or so. In the earlier part of the period, the figure was relatively flat because falling annuity rates were being offset by annual increases in the lifetime allowance. But after 2010/11 the picture changes dramatically, with a combination of big cuts to the lifetime limit being reinforced by falls in annuity rates. The cash value of the annuity that could be bought in 2006/07 is just under £106,000, rising to a peak of £121,000 in 2008/09 and then plunging to just £45,400 in 2016/17 based on the latest annuity rates.

However, Figure 1 does not tell the full story because we have had a decade of inflation since the lifetime allowance was first introduced. Figure 2 therefore repeats the analysis but adds a second line which shows pension values in constant 2016/17 prices.
Figure 2: Level of annual income which could be bought with a DC pension pot equal to the lifetime allowance 2006/07 to 2016/17 a) in cash terms and b) in 2016/17 prices

Source: Royal London calculations based on HMRC Lifetime Allowance rates, CPI index and level annuity rates at age 65 supplied by www.williamburrows.com

Figure 2 shows that the real terms decline in the size of pension which can be bought with a DC pot at the limit for tax purposes is even sharper. Someone in 2006/07 with a pension pot at the lifetime limit could have bought a pension worth £133,000 in today’s money, peaking at £145,000 in 2007/08 before slumping to £45,400 this year. This is a real terms fall of 66% since 2006/07 and a fall of 69% from the peak in 2007/08.

As noted above, the rules for DB pensions are different. In broad terms, a DB pension is allowable within the limit if it is less than one twentieth of the lifetime allowance (because DB pensions in payment at retirement are multiplied by twenty to convert them into a lump sum amount which can be compared with the lifetime limit). Figure 3 shows the amount of DB pension which could be accrued within the overall limit.
Figure 3: DB pension obtainable within the lifetime limit 2006/07 to 2016/17

Source: Royal London calculations based on HMRC Lifetime Allowance rates

Figure 3 indicates that in 2006/07 an individual could receive a DB pension of £75,000 per year (because 20 times £75,000 equals the lifetime limit of £1.5m), rising to a peak of £90,000 in 2010/11, before falling back to £50,000 now. This is a fall of one third since 2006/07 and a fall of 44% since the peak in 2010/11. A DB pensioner can secure a higher annual pension (£50,000 per year) than a DC pensioner who buys an annuity with a £1m pot (£45,400 pension). However, at the start of the period when annuity rates were much higher, it was the DC pensioner who could buy the larger pension within the overall limits.

A final comparison which may be of interest is the position of DC pensioners who wish to use their pension pot to buy DB-style benefits – namely pensions with built-in inflation protection and generous provision for a surviving spouse. Figure 4 repeats the analysis of Figure 3 but adds data for the size of index-linked annuity which could be bought with the maximum DC pension pot allowable without breaching HMRC tax relief limits. The annuity used for this comparison is one where payments are indexed by 3% each year and where a half pension is paid to a surviving spouse.
The striking conclusion of Figure 4 is that those who want inflation protection in retirement combined with a pension for a surviving spouse can now only secure a starting pension of around £27,000 per year from a DC pension pot without breaching HMRC limits, whilst their counterpart in a DB scheme can have a £50,000 per year starting pension. For those wanting an annuity which provided full RPI inflation protection and a two thirds pension for a surviving spouse, the pension available within HMRC limits would be just £20,860 per year.
4. Implications for policy

The foregoing analysis has shown not just the great complexity of the limits on pensions tax relief but also the way in which the system has changed with great regularity. These changes themselves bring greater complexity as transitional arrangements have to be built in for those who are affected at each stage.

Our calculations show that the level of pension obtainable from a DC pension pot at the HMRC limit has fallen in real terms by around two thirds in a decade. With the stated policy of the government being to increase the lifetime allowance only by CPI inflation in the coming years, more and more people will start to be caught within the net of the lifetime limit, with all of its associated complexity, or will have to take steps to avoid being caught.

Given that governments have repeatedly changed the tax relief limits in the recent past, each new ‘fiscal event’ – a Budget or an Autumn Statement – is now routinely surrounded by weeks of speculation about the next potential cut to tax relief. And given the pressurised fiscal position in which the Government finds itself, the Autumn Statement of 2016 is likely to be no exception.

Our view of this situation is best summarised as follows:

- Constant ‘salami slicing’ of the lifetime limit has had a huge cumulative effect, with limits now likely to bite on a much broader swathe of the population beyond the “super-rich”; given the level of under-saving in the UK, a system which will actively discourage growing numbers of workers from putting money into their pension pot is likely to be counterproductive;

- Constant tinkering with the lifetime and annual allowances is layering complexity upon complexity for savers and for pension schemes, and the cost of this complexity has to come from somewhere; if it costs more to run pensions then there will be less money to pay pensions;

- We cannot see any justification for a lifetime limit, and in particular for one based on the size of a saver’s pension pot; whilst a sensible annual limit on contributions into pension schemes helps to manage the fiscal impact of pensions tax relief, a lifetime limit based on the outcome of pension saving penalises those who invest their money well and can lead to savers inadvertently breaching tax relief limits;

In the absence of a more fundamental reform of pensions tax relief which would provide the opportunity for radical simplification of limits, we urge the Chancellor to stick to his party’s pre-election pledge to make no further changes to pensions tax relief in the life-time of this Parliament; this would provide welcome breathing space for pension savers and pension schemes alike