Briefing note: Proposals for a flat rate of tax relief on pension contributions

Successive governments have seen changes to the tax treatment of pensions as a means of increasing revenues. Nigel Lawson introduced a tax on pension fund surpluses, Gordon Brown abolished Advance Corporation Tax and George Osborne has reduced the lifetime and annual allowances by 44 and 84 per cent respectively.

Now the chancellor is strongly rumoured to be considering making changes to the current system of tax relief on pension contributions. One option under consideration is a single flat rate of tax relief, most commonly thought to be 30 per cent.

Why is the government considering a flat rate of tax relief?

The "cost" of tax relief on pension contributions and the amount of relief that goes to higher rate taxpayers is the most frequently cited justification for a flat rate of relief. The fact that more relief is given to those who pay more tax is hardly surprising.

However figures used to state the "cost" of tax relief on pension contributions are misleading. The current framework is designed to ensure that income is only taxed once – on receipt of pension income. Unless one believes that income should be taxed twice, figures stating the "costs" of relief are more representative of the amount of tax being **deferred** rather than foregone**.**

The current system

At present, taxpayers contribute who contribute to pension schemes can claim back Income Tax at their marginal rate as illustrated in the below example:

- Mr Taxpayer has an annual income of £50,000
- He has £7,165 of income over the higher rate (40 per cent) threshold of £42,385. Thus he can claim 40 per cent tax relief on the first £7,165 of any pension contribution and 20 per cent tax relief on any further contribution
- He wants to make a pension contribution of £5,000
- He only needs to contribute £3,000 (60 per cent) of his post-tax income. The government will add £2,000, effectively providing tax relief at Mr A's marginal rate

A flat rate of relief would penalise those on volatile incomes – particularly the self-employed

Switching to a flat rate would replace tax relief with an arbitrary subsidy for some savers and an arbitrary penalty for others. There isn't a flat rate of income tax.

Proposals for this are misguided as the tax system should treat pension contributions and income symmetrically. This corrects the unfairness inherent in a progressive tax system.

The worst hit by such a change would be those with volatile incomes, most notably the self-employed of whom there are now 4.7 million.

Consider the following example:

Mr A works for 10 years earning £40,000 every year - a total of £400,000. The table below shows how much income tax he will pay at today's rates and thresholds.

Years	Income (£)	Taxable at 20% (£)	Tax at 20% (£)	Taxable at 40% (£)	Tax at 40% (£)	Total tax paid (£)
10	40,000	29,400	5,880	0	0	5,880
Total	**400,000**	**294,000**	**58,800**	**0**	**0**	**58,800**

He makes contributions equal to 10 per cent of his income each year

Years	Income (£)	Gross pension contribution (£)	Marginal tax rate (%)	Input required (£)
10	40,000	4,000	20	3,200
Total	**400,000**	**40,000**	**20**	**32,000**

Mr B works for 10 years with an income that rises from £20,000 to £60,000. His total income over the period is £400,000

Years	Income (£)	Taxable at 20% (£)	Tax at 20% (£)	Taxable at 40% (£)	Tax at 40% (£)	Total tax paid (£)
2	20,000	9,400	1,880	0	0	1,880
2	30,000	19,400	3,880	0	0	3,880
1	40,000	29,400	5,880	0	0	5,880
4	50,000	31,785	31,785	7,615	3,046	9,403
1	60,000	31,785	31,785	17,615	7,046	13,403
Total	**400,000**	**245,925**	**176,325**	**48,075**	**19,230**	**68,415**

He too makes pension contributions equal to 10 per cent of his income each year

Years	Income (£)	Gross pension contribution (£)	Marginal tax rate (%)	Input required (£)
2	20,000	2,000	20	1,600
2	30,000	3,000	20	2,400
1	40,000	4,000	20	3,200
4	50,000	5,000	40	3,000
1	60,000	6,000	40	3,600
Total	**400,000**	**40,000**	**-**	**26,800**

Summary under current system

Name	10 year Income (£)	Income Tax paid (£)	Gross pension contribution (£)	Input (£)	Income remaining (£)
Mr A	400,000	58,800	40,000	32,000	309,200
Mr B	400,000	68,415	40,000	26,800	304,785
Difference	**0**	**9,615**	**0**	**5,200**	**4,415**

- Despite earning the same amount over a 10 year period, **Mr B has paid £9,615 more in Income Tax** than Mr A
- To partially correct for this unfairness, by providing relief at marginal rates, **Mr B has to put £5,200 less of his post-tax income into his pension than Mr A**
- Mr B is still **£4,415** worse off than Mr A despite earning the same amount over 10 years and making the same pension contributions

Summary under proposed 30% flat rate

Name	10 year Income (£)	Income Tax paid (£)	Gross pension contribution (£)	Input (£)	Income remaining (£)
Mr A	400,000	58,800	40,000	28,000	313,200
Mr B	400,000	68,415	40,000	28,000	303,585
Difference	**0**	**9,615**	**0**	**0**	**9,615**

- Mr B would have to put **a further £1,200** of his post-tax income into his pensions to get the same gross contribution of £40,000 leaving him **£9,615 worse off** than Mr A

Conclusion

Switching to a flat rate of relief would further exacerbate the unfairness of a progressive tax system that sees those on volatile incomes taxed more heavily than those on steady incomes. The biggest losers would most likely be the 4.7 million self-employed who are older and closer to retirement than employees.

Significant reductions to the lifetime allowance and the tapering away of the annual allowance for higher earners have already punished prudent savers and created an uncertain pensions landscape. A flat rate of tax relief on contributions would add further incoherence to what is already a chaotic system and punish those on volatile incomes. Relief should continue to be provided at marginal rates.