CHASM | Centre on Household Assets and Savings Management

**Briefing Paper**

**The debate about pension commencement lump-sums**

For nearly a century, UK governments have encouraged individuals to supplement their state retirement benefits by saving through private (occupational and, more recently, personal) pension plans. Their primary inducement has been tax incentives (exemptions and/or relief) which currently apply to all three stages of the pensions' lifecycle: contributions, investment and withdrawals. Employee and employer contributions up to an annual limit of £50,000 and a lifetime allowance (LTA) of £1.5 million are exempt from tax[1] (with employers' contributions also excluded for National Insurance purposes). There is relief on pension fund investment returns (capital gains and interest)[2] and, while retirees pay income tax on their pensions at marginal rates, they can withdraw 25% of their total pension savings (up to the LTA) as a tax-free, commencement, lump-sum (PCLS).

Provisional data for 2011/2012 indicates that these incentives cost the Treasury £28 billion in tax relief on occupational and personal plan contributions, £7 billion in fund investment returns, £14 billion in exemptions from National Insurance contributions,[3] and £4 billion in PCLS relief.[4] When offset against the £11.5 billion income tax collected from pensions in

[1] The government is planning to reduce these to £40,000 and £1.5 million respectively from 2014/2015.
[2] Stamp duty is however paid on share purchases and corporation tax on profits from equity investments.
[3] HMRC (2013) 'Pen 6: Cost of Registered Pension Scheme Tax Relief' [www.hmrc.gov.uk/statistics/pension-stats/pen6.pdf](www.hmrc.gov.uk/statistics/pension-stats/pen6.pdf)
[4] Pensions Policy Institute (2013) *Tax Relief for Pension Saving in the UK* [www.pensionspolicyinstitute.org.uk](www.pensionspolicyinstitute.org.uk)

payment, the net deficit is £41.5 billion. In a climate of continuing austerity, the concessions have re-ignited political controversy about the affordability and fairness of tax relief on pension savings, with PCLS a particular bone of contention. In its case, affordability concerns disagreements about whether the 25%-rate is too generous and, from the consumer angle, the ramifications of allowing such large proportions of individual retirement pots to be withdrawn in one-off payments. Issues of fairness centre on the importance or otherwise of inequities in the distribution of lump-sum tax relief. At present, individuals with larger amounts of savings can take bigger PCLS' and thus shelter more retirement income from tax, but how significant is this in the face of its other benefits?

Those wishing to safeguard existing privileges argue that the inequities along with the £4 billion costs and the risks associated with reduced retirement income are relatively unimportant when compared with PCLS' role in securing the future of private pensions. Seen as a vital ingredient in the competition with other tax-free savings vehicles, it is both popular (most new retirees take it) and flexible (as there are no restrictions on how it is spent). Removing it or making yet further changes to its permissible size would, supporters maintain, be the 'final nail in the coffin' for these products with substantial repercussions for the pension industry's investments and, given their significance, UK financial markets.

Opponents of this viewpoint maintain that PCLS is an anomaly that should be abolished or reformed. Abolitionists speak of two options, removing the opportunity of taking lump-sums altogether or, alternatively, stopping their tax relief. Both options would produce additional state revenue through an increase in taxable retirement income which, dependent on political perspective, would either be retained by the Treasury or used to boost pensions through front-end payments (e.g. by matching proportions of individual contributions). Reformists provide a more cautious agenda that aims to amend rather than abolish tax relief. Those concerned with costs want further reductions to the Government's planned lowering of threshold allowances;[5] others, more focused on PCLS' unfair outcomes, seek to restrict the tax-free limit (e.g. at the trivial commutation level or the base-rate threshold) and tax the rest of the lump-sum progressively (e.g. 40% up to £150,000 and 45% above).

Whilst reformists and abolitionists contend that supporters of existing lump-sum arrangements both over-state the benefits of the status quo and the potential fall-out of revisions, they equally accept that the limitations of their own past proposals – in particular the complex transitional conditions and anticipated hike in administrative expenditure - have impeded change. Now, however, they see the ball firmly back in their court. With increasing cost pressures and concerns for greater fairness in stringent economic conditions, the government is clearly looking for ways forward. Although, it is more likely to favour reform over abolition, those seeking the elimination of the PCLS will simply see this as an interim step to its eventual demise.

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[5] Indeed, this is the line taken by the Liberal Democrats in proposals for their 2013 Party Conference.