



Pension Tax Reform Proposed in the UK

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The UK is reviewing a comprehensive overhaul on its taxation on private pensions including retirement plans. So far, the UK has adopted the system in which contributions, investment income and capital gains are tax exempt while pension benefits are taxed. The so-called EET system has been widely adopted by many countries including Korea. But after the Conservatives won the general election in May 2015, they announced a proposal for a shift towards a new system in which pension contributions are taxed upfront.

Such a policy shift in the UK purports to address the large shortfall in tax revenues accumulated due to the country's long-standing tax relief and annuitization policy. But Korea's pension taxation should prioritize increasing retirement assets and stabilizing post-retirement income.

1. Introduction

The Summer Budget 2015 released by UK Chancellor George Osborne in July 2015 included a consultation on pensions tax relief, which was designed to change the current system of tax-exempt contributions to a new one where pension contributions are taxed upfront. This means making the current tax regime for pensions more akin to the Individual Savings Account (ISA). The UK government is being consulted on this issue, and the consultation closes at 30 September 2015. However, if realized, this would make grave impacts on the existing pension system and industry.¹⁾ This is because the government currently uses tax relief on pension

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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1) Responses to the consultation are being received from July 8 to September 30, 2015. HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, July 2015. (<https://www.gov.uk/government/consultations/strengthening-the-incentive-to-save-a-consultation-on-pensions-tax-relief>)



contributions to force pension members to think twice before taking early withdrawals and annuitize retirement savings.

This article explores the pension tax reform proposed in the UK, its background, and the implications for Korea.

2. Pension tax reform proposed in the UK

Currently, the UK tax system for pensions is based on the principle where pension tax is deferred until withdrawal. This is referred to as “Exempt-Exempt-Taxed” (EET), in which pension contributions and investment growth are tax-exempt, but pension payments are taxed.²⁾ With regard to this, several reforms are being proposed. Among others, the UK government proposes to review a shift towards a TEE (“Taxed-Exempt-Exempt”) system with government top-ups to contributions.

Under the current system, pension contributions by individuals and employers are exempt from income tax and corporate tax. Furthermore, employer contributions are exempt from National Insurance contributions. Of course, the allowance is set for total contributions. Investment growth from pension contributions is exempt from tax during the accumulation phase, and is subject to the lifetime allowance. Pension payments up to 25% of the pension fund are tax-free, but the rest of the fund is taxed as income when it is taken. This means that pension payments are subject to the income tax rate of each individual.

The lifetime and annual allowances were first introduced in April 2006. Initially, the annual allowance was set at £215,000 and the lifetime allowance at £1.5 million, which in 2010 went up to £255,000 and £1.8 million, respectively. However, the allowances were reduced to the current level (the annual allowance at £40,000 and the lifetime allowance at £1.25 million) as Parliament tried to rein in the growing relief on pension tax during the last session. According to the 2015 budget, the annual allowance would be cut to £1 million in April 2016, and adjusted upward according to the Consumer Price Index from April 2018.

The biggest reason behind the UK government’s plan to overhaul its pension taxation is the sheer size of tax relief on pensions. In fiscal year 2013, total tax reliefs on pensions (including income tax relief and National Insurance relief) reached nearly £50 billion. Among them, relief

2) Not only the UK, but also many countries including the US, Canada, and Korea currently adopt the EET system for pension tax.



on income tax amounted to £34.3 billion, but the actual cost could be £21.2 billion because the government received £13.1 billion in tax on pension payments. Furthermore, income tax relief included National Insurance relief (£14 billion), relief on tax-free lump sum pension payments up to 25% of the fund (£4 billion), investment income relief (£7.3 billion), etc.

Going forward, the amount of pension tax relief is expected to rise dramatically due to wage growth and rising pension membership by automatic enrolment.³⁾ Hence, the government plans to reduce the relief to spare £6 billion per year on one hand while on the other hand receiving opinions on an ISA-like tax system that taxes pension contributions upfront and grants tax relief later.

Two weeks prior to the general election in May, the Conservatives announced as part of their campaign strategy that Ros Altmann would be appointed as the pensions minister if they were elected.⁴⁾ However, some of the remarks Ros Altmann made after being appointed as the new pensions minister seemed out of sync with the chancellor's policy direction, provoking the controversy around the tax reform. She said, "I do fear that making pension withdrawals tax free at a relatively young age offers dangerous incentives to stop locking the money in for later life."⁵⁾ Her concern was that taxing contributions upfront and not taxing them thereafter would increase the likelihood of pre-retirement withdrawals, which might raise the risk of funds being exhausted before retirement. Regarding tax relief on pensions, the Financial Times proposed a 33% flat-rate tax relief instead of tax deferrals via income tax deductions.⁶⁾ It was argued that such flat-rate tax relief would not only prevent tax benefits from going to the wealthy, but also encourage savings.

For the new policy to take hold successfully, current employees should be able to believe that their pension payments are tax-free when they retire in the future. Otherwise, they are likely to save less amid distrust of future chancellors.⁷⁾ Also notable is the criticism that constant changes in pension policy would make workers delay their saving for retirement.⁸⁾

3) Since October 2012, the UK government has tried to increase workplace pension membership by implementing automatic enrolment in which employees are automatically enrolled in workplace pensions, instead of voluntarily deciding their enrolment.

4) Ros Altmann had worked for ordinary workers on pension issues. She won the trust of the blue-collar workers the Conservatives needed to win the election.

5) Josephine Cumbo & George Parker, Pensions minister and chancellor divided, Financial Times, July 28, 2015.

6) Fix UK pensions, then no longer fiddle with them, Financial Times, July 29, 2015.

7) Madison Marriage and Claer Barrett, Osborne's Isa pension plan attacked by Royal London's Phil Loney, Financial Times, August 18, 2015.

8) Alistair Gray, Naomi Rovnick and Judith Evans, Stop constant changes to pensions, urges new Standard Life chief, Financial Times,



Whether the proposed reform progresses or not is uncertain for now. However, the Conservatives are highly likely to push forward with it considering their strong drive based on the general election victory. According to a new poll after the election, the most appealing pension tax system chosen by 41% of respondents was “for pensions to be distributed tax-free upon retirement”, which means an ISA-like system.⁹⁾ The proposed shift in pension tax policy has something in common with free pension withdrawals¹⁰⁾ that came in force in April 2015. Both of them have the effect of increasing tax revenues for the incumbent government. Although it leaves the current tax on pension assets accumulated by tax concessions of past governments intact, it enables the incumbent government to take away two tax revenues from future governments; one is tax on lump-sum payments that are expected to rise under free pension withdrawals; and the other is tax on pension contributions which should be passed on to future governments. If any tax reform to increase tax revenues weakens the existing pension system, such a policy failure would be hard to reverse.

3. Implications for Korea’s pension taxation

Korea’s tax reform plan announced in August 2015 contained no significant changes on pensions. Two reforms in 2013 and 2014 have helped build a basis for Korea’s reform on pension taxation.

Of course, UK policy may not be the one-size-fits-all solution. But based on the assumption that the UK government came up with the best available solution, Korea’s taxation on private pensions including retirement plans and personal pensions ostensibly seems to be heading in the right direction.

Among others, Korea’s taxation on lump-sum pension payments is too generous to create incentives for annuitization. In addition, Korea provides employees full access to their retirement assets. In this regard, Korea’s system has already reached the policy objective the UK government pursues.

In terms of taxation on contributions, Korea’s retirement plans are same to the current UK

August 4, 2015.

9) Judith Evans, Savers favour new ‘pensions Isa’ in poll, Financial Times, August 10, 2015.

10) For nearly 60 years since 1956, the UK had maintained its policy for pensioners to purchase annuities with DC plan assets by age 75. But the UK government announced a shift from the policy in March 2014. From April 2015, UK pensioners can withdraw their pension freely in any amount and at any time after age 55 as long as the withdrawals are taxed at marginal rates.



system. But as a result of the 2013 tax reform, tax deductions (tax deferrals) on personal pension contributions and voluntary contributions to employer-provided retirement plans were replaced by tax credits from 2014.¹¹⁾ Furthermore, the 2014 tax reform raised the amount of contributions to individual retirement pensions (IRP) that are eligible for tax benefits from KRW4 million to KRW7 million. It bolstered income tax progressivity by differentiating tax credit rates across income levels.¹²⁾ Overall, such policy moves of Korea are consistent with those of the UK government. Rather, Korea's system is ahead at least in terms of the timing and tax progressivity.

However, Korea and the UK face different policy challenges. While the UK has long maintained tax relief and forced annuitization which inevitably increased the cost of tax relief, Korea has a short history of retirement plans. Because Korea's retirement assets are far smaller than those of the UK, it would be inappropriate to apply the UK policy shift to Korea. Korea needs continuous support including tax benefits to curb pre-retirement withdrawals, encourage capped drawdown, increase pension membership, and attract more contributions. Still, Korea's pension taxation should prioritize increasing retirement assets as well as stabilizing post-retirement income.

11) For the author's opinion on the shift from tax deductions, refer to the previous Capital Market Opinion article (Wonku Hong, 2014, New pension tax policy for 2014 and its implications, Capital Market Opinion 2014-02, Korea Capital Market Institute).

12) The rate stands at 16.5% (local tax included) for those whose total income is less than KRW40 million or wage income less than KRW 50 million, and 13.2% (local tax included) for those whose total income is over KRW40 million or wage income over KRW50 million.