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# AN ISA-CENTRIC SAVINGS WORLD

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## SUMMARY


- The current system of pension tax relief is incompatible with the abolition of the annuitisation requirement announced in the 2014 Budget.
- In addition, it is expensive, inequitable, illogical, incomprehensible and, crucially, an ineffective use of Treasury funds. The Chancellor's call for consultation on the future tax regime of pensions is therefore welcome.
- An ISA-centric savings world is proposed. Employer contributions, taxed as employee income but eligible for a Treasury incentive (such as 50p per post-tax £1 saved), would be paid into a Workplace ISA, operating within the auto-enrolment arena. Withdrawals would not be permitted until the age of 60, thereby trapping the Treasury incentive, along with income and net capital gains. Thereafter, they would, ideally, be tax-free.
- Auto-enrolled employee contributions (paid post-tax) would go into an employee's Lifetime ISA, and be subject to the same incentive, access and taxation rules as other Lifetime ISA contributions.
- The Workplace ISA and Lifetime ISA could reside within an ISA warehouse, alongside other segregated ISA cells dedicated to specific saving purposes (Help to Buy, long-term care, etc.). Each cell could have its own (tax-based) incentives and deterrents, to reflect prevailing policy objectives. The warehouse could become a universal, all-purpose savings vehicle to serve everyone from cradle to grave. Simplicity to the fore.
- This paper also introduces the idea of an ISA Pension, secured with Workplace ISA assets. Given the individual and societal benefits of annuitisation, a Treasury-funded inducement should be considered, such as a 25% income uplift. Participation would be optional, consistent with 2014's pensions' liberalisation.
- Individual, employee and employer contributions into different ISA cells would share the annual allowance. The originally proposed £8,000, alongside the 50p Treasury incentive is, of course, subject to Treasury modelling confirmation. A smaller incentive, for example, could accommodate a higher annual allowance. In addition, both could be watered down if an ISA Pension uplift were to be included, particularly if it were extended to include today's ISA suite.
- A 50p incentive would significantly help realise the Pension Commission's vision for median earners to have a two-thirds total combined earnings replacement rate.
- Drawing on international experience, a "Big Bang" approach is favoured in terms of the transition to a TEE world.

# PROPOSALS

**Proposal 1:** All tax relief on pensions contributions should be scrapped. A Lifetime ISA should be introduced, eligible for an upfront incentive paid irrespective of taxpaying status, up to a modest annual allowance (e.g. 50p per post-tax £1, and £8,000, respectively). Pre-60 withdrawals would require repayment of the incentive. Savings made after 50 must remain *in situ* for ten years. Post-60 withdrawals would be tax-free, or taxed at a sub-marginal rate, as determined by Treasury cost modelling.

**Proposal 2:** The Chancellor should revitalise the Pensions Commission's vision for median earners to have a two-thirds total combined earnings replacement rate. This would be a realistic target within an auto-enrolment contributions framework of 6% employee + 5% employer + 5.5% in Treasury 50p's (totalling 16.5% of band earnings).

**Proposal 3:** A Workplace ISA should be included in the auto-enrolment legislation. The same facility should be made available to those without an employer sponsor (perhaps within NEST).

**Proposal 4:** The Lifetime Allowance should be scrapped.

**Proposal 5:** Auto-enrolled, post-tax, employee contributions should be paid directly into a Lifetime ISA and be subject to the same incentive, access and taxation rules as other Lifetime ISA contributions.

**Proposal 6:** Auto-enrolment's Workplace ISA employer contributions, taxed at the recipient's marginal rate, should be eligible for the same upfront Treasury incentive as the Lifetime ISA, sharing the annual allowance.

**Proposal 7:** Employer contributions in the Workplace ISA cell, and allied accumulated income and capital growth, should be locked in until the age of 60. The tax treatment of subsequent withdrawals, taxed at a sub-marginal rate (and potentially tax-exempt), would depend upon Treasury cost modelling, key parameters being the annual allowance and the size of the upfront incentive.

**Proposal 8:** Consideration should be given to introducing an ISA Pension, secured with assets accumulated within the Workplace ISA cell, enhanced by a Treasury-funded 25% uplift on the underlying annuities. Income would be taxed at a sub-marginal rate (potentially tax-exempt), subject to modelling confirmation.

**Proposal 9:** The Lifetime and Workplace ISAs could reside inside an ISA warehouse, alongside a suite of other ISA cells, each dedicated to a specific saving purpose.

**Proposal 10:** The Treasury should adopt a "Big Bang" approach to radically simplify the savings arena. It should name a date when EET simply ceases in respect of all future contributions, leaving us with a TEE tax framework for all saving.

## BACKGROUND

In 2014 the Centre for Policy Studies published two sister papers that proposed:

(i) that all Income Tax and employer NICs reliefs on pension contributions should be replaced by a highly redistributive Treasury incentive of 50p per post-tax £1 saved, up to a modest annual allowance and paid irrespective of the saver's taxpaying status.[1] Thus, the incentive would not be a tax relief, thereby nailing the conundrum that because Income Tax is progressive, tax relief is inevitably regressive; and

(ii) the introduction of a Lifetime ISA, which would be eligible for the Treasury's 50p, repayable on pre-60 withdrawals.[2] This would replace private pension provision.

Appendices I and II contain the two papers' specific proposals. They were followed by a Briefing Note, published ahead of the July 2015 Budget, proposing the introduction of a Workplace ISA to replace occupational pension provision.[3]

Following the announcement by HM Treasury of a call for consultation on the future of pensions earlier this year,[4] this paper provides further detail of the original proposals.

### A note on tax treatment nomenclature

This paper has adopted the pension industry's form of product codification for tax purposes, namely Exempt or Taxed, shortened to "E" and "T". A product's tax status is described chronologically by three letters, either E or T, where the first letter refers to contributions (of capital), the second to investment income and capital gains and the last letter to capital withdrawals or pension income.

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[1] *Retirement saving incentives; the end of tax relief, and a new beginning ;* Michael Johnson, CPS, April 2014.

[2] *Introducing the Lifetime ISA*; Michael Johnson, CPS, August 2014.

[3] *The Workplace ISA and the ISA Pension*, Michael Johnson, CPS, 3 July 2015.

[4] HM Treasury; *Strengthening the incentive to save: a consultation on pensions tax relief,* July 2015.

## INTRODUCTION

The Oxford English Dictionary informs us that the word "pension" comes from late Middle English, meaning *payment, tax or regular sum paid to retain allegiance.* This implies certainty and, indeed*, annuity* appears as a synonym. In short, a pension *is* an annuity so, given last year's pensions-liberating Budget (ending the requirement to annuitise), one could conclude that the days of private and occupational pensions are numbered. Such a perception is reinforced by the 2015 Summer Budget, in which the Chancellor launched his pensions' tax regime consultation.

Meanwhile, we continue to refer to DC (defined contribution) pensions, which is a contradiction. DC are savings vehicles, nothing more: they provide no certainty in respect of retirement income. And, apart from the public sector, the next generation is now saving in a Defined Benefit (DB) desert. Personal and occupational pensions, *as originally defined*, should be consigned to history. The question is what should replace them.

## PART I: TAX RELIEF

## 1. TODAY, TWO DISPARATE WORLDS

### 1.1 Pensions vs. (New) ISAs

The savings landscape is characterised by a fundamental schism. Saving within a pensions framework provides tax relief on the way in ("EET"), whereas subscriptions to New ISAs ("ISAs") are made with post-tax income, but withdrawals are tax-free. Consequently, ISAs are "TEE".

Over the last six years, stocks and shares ISA subscriptions have increased by 85%, to £17.9 billion in 2014-15, taking the total market value to £245 billion.[5] In the same year, an additional £61 billion was subscribed to 10.3 million cash ISA accounts (averaging £5,924 per account), taking the ISA cash mountain to £237 billion. Clearly, engagement with ISAs is high, confirmed by industry surveys, and acknowledged by the Chancellor when he raised the annual subscription limit to £15,240 for 2015-16, up 32% over the last two years. In addition, and importantly, the brand is still reasonably trusted.

Conversely, the amount contributed by individuals to personal pensions has reduced by 24%, to £7.8 billion, averaging £940 per person, a figure which *includes* basic rate tax relief.[6]

### 1.2 ISAs to the fore

It is clear from the manner in which basic rate taxpayers are saving (i.e. 84% of all taxpayers) that the lure of 20% tax relief on pension contributions is insufficient to overcome pension products' complexity, cost and inflexibility (until the age of 55). In addition, the pensions industry is widely distrusted, so the decline in private pension saving is unsurprising.

## 2. PENSIONS' TAX RELIEF

### 2.1 Expensive, incompatible, inequitable, illogical, incomprehensible, ineffective

**(a) Expensive**

Today's tax-based incentives for pension saving are hugely expensive, totalling over £52 billion[7] in 2013-14, in the form of:

(i) upfront Income Tax relief on contributions (£27 billion);

[5] HMRC; *Individual savings accounts statistics, Tables 9.4 and 9.6,* August 2015. In 2014-15, 2.7 million people contributed an average of £6,593 to their stocks and shares ISA.

[6] Over six years to 2013-14 – HMRC; *Table PEN 2, Personal pensions,* February 2015. Official data exclude SIPPs and SSASs, which attracted perhaps another £6 billion.

[7] HMRC; *Cost of Registered Pension Scheme Tax Relief, Table PEN 6,* February 2015.

(ii) NICs relief related to employer contributions, costing some £14 billion (a figure that will rise with auto-enrolment)[8];

(iii) roughly £4 billion related to the 25% tax-free lump sum; and

(iv) some £7.3 billion in respect of the investment income of both occupational and personal pensions schemes, assuming relief at the basic rate of tax. HMRC does not make an estimate of the relief provided for capital gains realised by pension funds.

To put this into perspective, this is over 93% of 2013-14's Total Managed Expenditure on Education (£56 billion), substantially more than Defence (£43 billion), and about the same as the combined budgets for Business, Innovation and Skills (£33 billion), Transport (£14 billion) and Energy and Climate Change (£8 billion).[9]

**(b) Incompatible with 2014's liberalisation**

Following the 2014 Budget, from April 2015 there is no obligation to annuitise a pension pot. This shatters the historic unwritten contract between the Treasury and retirees that the latter, having received tax relief on their contributions, would subsequently secure a retirement income through annuitisation.

This expectation was made clear by Lord Turner's Pensions Commission, which explicitly linked the receipt of tax relief with annuitisation, thereby reducing the risk of becoming a burden on the state in later life:[10]

"*Since the whole objective of either compelling or encouraging people to save, and of providing tax relief as an incentive, is to ensure people make adequate provision, it is reasonable to require that pensions savings is turned into regular pension income at some time*."

In addition, a subsequent review of annuities by the Treasury stated that:[11]

*"The fundamental reason for giving tax relief is to provide a pension income. Therefore when an individual comes to take their pension benefits they can take up to 25% of the pension fund as a tax-free lump sum; the remainder must be converted into a pension – or in other words annuitized."*

As tax relief and the 2014 Budget's liberalisation are incompatible: the door is wide open for the wholesale reform of, not tinkering with, tax relief.

**(c) Inequitable**

**(i) *Not* Income Tax deferred**

Income Tax is progressive, so tax relief is inevitably regressive. Consequently, affluent baby boomers are able to minimise their Income Tax by harvesting tax relief on pensions contributions.[12] And for those who are within touching distance of the private pension age of 55, shortly thereafter they can access their pots to withdraw the 25% tax-free lump sum and, in most cases, drop down to a lower tax bracket before making further (taxable) drawings. Roughly, only one in seven of those who receive higher rate tax relief while working *ever* subsequently pay higher rate Income Tax in retirement. In this respect, tax relief is *not* Income

8 Note that NICs relief is a combination of NICs relief in respect of employers' contributions (cost c.£9.5 billion) and the saving for individuals from the employers contributions not being treated as part of their gross income, and thus not subject to employee NICs (cost c.£4.5 billion).

9 See www.gist.cabinetoffice.gov.uk/oscar/2013-14/

10 The Second Report of the Pensions Commission; *A New Pension Settlement for the 21st Century*, 2005.

11 HM Treasury; *The Annuities Market,* December 2006.

12 Baby boomers: people born between 1946 and 1964 (i.e. now aged between 51 and 69).

Tax deferred, as claimed by proponents of higher and additional rates of tax relief.

Consider the evidence.

- In 2012-13, 10.8 million workers received tax relief of £28 billion on their (and employer) contributions
- A similarly sized pensioner population of 11.4 million paid only £11.5 billion in Income Tax (and £13 billion in 2013-14).[13] This latter figure will rise as the population ages, but there is no prospect of the Treasury recouping its investment through Income Tax paid by pensioners.

Higher and additional rates of tax relief are therefore a huge net cost to the state and a bad use of taxpayer funds.

**(ii) An unfair subsidy for fund managers**

Treasury-funded tax relief boosts the volume of assets that fund managers have to manage, and therefore their income. Indeed, the Treasury is the fund management industry's largest client: since 2002, it has injected, through people's pension pots, over £325 billion of cash, on which charges and fees are then levied.[14] This is similar to a state subsidy of one of the highest paid industries in the world.

**(iii) Generation Y: missing out on tax relief[15]**

Private pension products are at odds with how younger age groups (Generation Y) are living their lives: the word "pension" does not resonate. Ready access to savings is the key requirement, valued above tax relief. Indeed, Generation Y is so disengaged from private pensions that the industry's next cohort of customers could be very thin. Consequently, Generation Y is missing out on upfront tax relief: an EET tax framework for retirement saving is failing the next generation, a major justification for making the move to TEE.

**(d) Illogical**

**(i) Means testing**

Assets held within an ISA count against income-related means-tested benefits (IRBs), whereas pension pot assets do not.[16] Such inconsistency is illogical because, in light of pension pot liberalisation, from the age of 55 pots are as accessible as ISA assets. In the meantime, there is an arbitrage to exploit. Just prior to reaching the age of 55, ISA assets could be moved into a pension pot, providing full access to IRBs *and* the pot assets upon reaching 55. This birthday present from the Chancellor would potentially be funded by *two* new bills for taxpayers: pensions tax relief and additional IRBs. Fiscally bonkers.

**(ii) Post-death**

Before the 2014 Budget, failure to use pension savings to buy an annuity before reaching the age of 75 was penalised by a 55% tax charge. This was viewed as reasonable given the prior receipt of tax relief on contributions, and tax-exempt income and capital accumulation. Post-Budget, any remaining pension assets in the estates of savers dying after reaching the age of 75 may be passed to beneficiaries for drawdown taxed at their marginal rate (similarly lump sums from 2016). Thus, for example, the grandchildren of a wealthy saver leaving a large pension pot could draw up to £10,600 a year tax-free, by using their personal allowances, perhaps in perpetuity: exempt, exempt, exempt, i.e. "EEE".[17]

13 HMRC; *Personal Pension Statistics;* September 2013.

14 HMRC; *Personal Pension Statistics, Table Pen 6*, February 2015.

15 Generation Y: broadly, people born between 1980 and 2000.

16 People with accessible savings over £16,000 are denied access to Housing Benefit or Council Tax Support, unless they qualify for Pension Credit Guarantee Credit (which disappears in 2016).

17 As pointed out be Pauline Armitage, FIA.

Such fiscal generosity is out of synch with contemporary times, and it represents a policy reversal that would appear to be illogical as well as without purpose, there being no evident *quid pro quo*. In addition, it stands in stark contrast with the inheritance tax treatment of other assets, including ISAs: pension pots are now likely to take a major role in estate planning.

**(e) Incomprehensible**

It is no secret that a significant proportion of the workforce does not understand, and therefore does not value, tax relief on pension pot contributions. Several recent research reports suggest that two thirds of workers do not understand the system:[18] this alone justifies the Summer Budget's consultation.

**(f) Ineffective**

The purpose of a tax relief is to influence behaviour. However, it is evident that for many of the wealthy, tax relief on contributions to pension pots is primarily a personal tax planning tool, rather than an incentive to save: they would save without it.

This conclusion is not new: it has been in seminal academic papers going back decades. A typical example:[19]

*"Evidence indicates that tax-favoured schemes tend to be used disproportionately by upper-income individuals. And, according to some empirical studies, the latter are more likely to finance the bulk of their contributions by diverting other sources of savings rather than by reducing consumption*."

It is extraordinary that we accept a framework which provides the top 1% of earners, who are in least need of financial incentives to save, with 30% of all tax relief, more than double the total paid to half of the working population. Roughly two thirds of tax relief goes to higher (40%) and additional (45%) rate taxpayers, who represent some 13% of the workforce.[20] Such inequitable distribution partly explains why the huge annual Treasury spend has failed to meet a key policy objective, to establish the *broad-based* retirement savings culture that Britain needs.

In addition, tax-based incentives to save have been found to be largely ineffective because most people (perhaps 85% of the population) are passive savers: they do not pro-actively pursue such incentives. Default ("nudging") policies are deemed to be far more effective for broadening retirement savings across those who are least prepared for retirement, i.e. lower-income workers, in particular.

The Danes, for example, concluded that tax relief is ineffective in catalysing *additional* savings creation, by the wealthy in particular, who save anyway. Their focus is primarily on tax planning, which encourages the reallocation of *existing* savings into tax-efficient vehicles. For each DKr1 of government expenditure spent on incentivising retirement saving, the Danes found that only one ore (DKr 0.01) of net new savings was generated across the nation.[21]

Given that Denmark is not wildly different to the UK (both culturally and economically), one could

18 Including reports from Hargreaves Lansdown and Aviva (August 2015).

19 *Long-Term Budgetary Implications of Tax-Favoured Retirement Plans*; OECD Economics Dept. Working Paper No. 393; Pablo Antolín, Alain de Serres, Christine de la Maisonneuve (2004).

20 *Tax relief for pension saving in the UK*, PPI, 2013. Chart 2 indicates that 75% of tax relief goes to higher and additional rate taxpayers: subsequent changes in allowances have reduced this figure.

21 *Active vs. passive decisions and crowd-out in retirement savings accounts: evidence from Denmark;* Chetty, Friedman, Harvard University, Leth-Petersen, Nielsen, University of Copenhagen, Tore Olsen, Centre for Applied Micro-econometrics, December 2013.

conclude that much of the UK Treasury's spend on upfront tax relief does little to head off future pensioner poverty: it is wasted.

### 2.2 The Conservative Party's 2015 manifesto

The Conservative Party's pre-election manifesto suggested small changes to tax relief, proposing to reduce it on pension contributions for those earning more than £150,000 a year ("high earners"). The July Budget confirmed that high earners' Annual Allowance will be reduced on a sliding scale, from £40,000 to £10,000 by the time income reaches £210,000: added complexity, and to what end? The envisaged saving is already ear-marked to fund inheritance tax reform, so it will do nothing to help the Chancellor meet his target of a balanced budget by 2019-20.

Fortunately, by announcing the consultation into the whole future of the pensions tax regime, the Chancellor has now opened the door to proposals for wholesale reform, not tinkering, of tax reliefs on pension contributions. So, what to do?

First, we must consider a fundamental question.

### 2.3 Do financial incentives encourage additional saving?

Some people believe that the answer to this question is "no", and others are unsure. An OECD report, for example, concludes that:[22]

*"The effectiveness of tax-favoured schemes in raising private and national savings is an issue that remains largely unresolved both theoretically and empirically. This underscores the importance of assessing how tax-favoured schemes can be best designed to stimulate personal savings."*

We are faced with the significant challenge of having to show how things *would have been* without tax incentives, i.e. the counter-factual. The Treasury has a similar difficulty, in respect of showing that tax relief provides value for money, and this also applies in respect of NICs relief on employer contributions.

If we were to conclude that the answer is indeed "no", then we should cease all tax relief and perhaps direct the saving into a sovereign infrastructure fund, say, thereby socialising the benefit across the nation.

A commonly held view is that, very broadly, 20% of adults will never save (many of them cannot afford to) and 20% will always save (generally, the wealthy), so incentives are irrelevant to them too. But the middle 60% can be persuaded to save more than they currently do, particularly if a significant up-front incentive were combined with much improved communication (avoid the words "tax relief", for example) and other barrier-reducing nudges. An advice-free sales model would help, not least to make the application process simpler and to help open up the industry to disrupters.[23] An FCA waiver on some of its rules would be required, to facilitate safe harbour status (but incorporating tough consumer protections). In any event, we should do away with the ridiculous advice versus guidance distinction, which is entirely lost on the consumer.

### 2.4 An upfront incentive

#### (a) 50p per post-tax £1

Last year the author proposed that today's tax relief on pensions contributions be replaced by 50p from the Treasury for each post-tax £1 saved,

[22] *Long-Term Budgetary Implications of Tax-Favoured Retirement Plans*, OECD Economics Department Working Paper No. 393; Antolín, P., A. de Serres and C. de la Maisonneuve (2004).

[23] See Trevor Llanwarne's *Greater savings for retirement*, ILC-UK, September 2015.

up to an £8,000 annual allowance (subject to modelling confirmation). This would be more than sufficient to accommodate the savings capacity of at least 90% of the population, i.e. up to £12,000 per year, including the Treasury's 50p. Appendix I contains the specific proposals.[24]

**(b) Justification: effectiveness and fairness**

Crucially, the 50p would be paid *irrespective* of the saver's taxpaying status: thus, it would *not* be a tax relief, thereby nailing the conundrum that because Income Tax is progressive, tax relief is inevitably regressive.[25]

In addition, 50p per £1 saved is highly redistributive, double the *rate* of incentive that basic rate taxpayers receive under the current tax relief system. This could only help to develop a more broad-based savings culture, targeted at low and medium earners. Higher rate taxpayers would see a 25% reduction in their incentive, from 66.7p per £1 saved from post-tax earnings.

Overall, this approach would substantially improve the effectiveness with which the Treasury disperses public money to encourage saving, "effectiveness" being measured by the increase in the nation's aggregate pool of savings per £1 of Treasury spend.

**(c) Communicating the 50p**

The 50p incentive per post-tax £1 could be marketed in a number of simple ways, including "save £2, get £1 free". Certainly, there should be no reference to tax relief, not least because it would not be a tax relief.

# PART II: AN ISA-CENTRIC WORLD

## 3. CHANGE: INEVITABLE

### 3.1 Stepping stones

In the Treasury Select Committee's response to the 2014 Budget, it commented that in light of pensions' improved flexibility, ISAs and pensions will become "*increasingly interchangeable in their effect*". It went on to suggest that the government should work towards a single tax regime to reflect this, and also examine the appropriateness of the present arrangements for the pension 25% tax free lump sum.[26]

The TSC chairman, Andrew Tyrie MP, was clear:

"I*n particular, there may be scope in the long term for bringing the tax treatment of savings and pensions together to create a "single savings" vehicle that can be used – with additions and withdrawals – throughout working life and retirement. This would be a great prize.*"

The unification of pension savings and ISAs would be consistent with several recent saving-related policy initiatives, which could be interpreted as stepping stones towards the ultimate merger of pensions and ISAs. These include:

(i) successive reductions in pensions' lifetime and annual allowances, from £1,800,000 and £255,000 respectively in 2010-11, to £1,250,000 and £40,000 today (with the lifetime allowance further reducing to £1 million in 2016);

(ii) significant increases in the ISAs' annual subscription limit;

(iii) the 2015 Budget's expansion of the ISA range, to include the Flexible ISA and the

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24 *Retirement saving incentives: the end of tax relief and a new beginning,* CPS, April 2014.

25 This proposal is now garnering substantial industry support, most recently from Aviva. http://www.aviva.co.uk/media-centre/story/17526/two-thirds-of-people-in-the-dark-over-pension-tax-/

26 *Treasury Committee Budget 2014 Report, paragraph 205,* May 2014.

Help to Buy ISA, and a broadening of the range of investments permitted within an ISA;

(iv) the end of pensions' so-called "death tax" (announced at the 2014 Conservative Party conference)[27], followed by its abolition for ISAs (2014 Autumn Statement); and, of course,

(v) the annuitisation liberalisation announced in the 2014 Budget, effective from April 2015.

### 3.2 The Treasury's perspective: TEE preferred

From a Treasury cashflow perspective, moving the whole savings arena onto a TEE basis would be hugely attractive. Tax receipts would be advanced by up to a generation, as upfront Income Tax and NI relief, paid out to today's workers and employers, respectively, would be replaced by Income Tax foregone from today's workers, once they had retired a generation later. This cashflow benefit would, however, be *partly* mitigated by any up-front incentive (such as 50p per post-tax £1 saved), but the Chancellor would still be left with a golden opportunity to make a (necessary) significant reduction in the budget deficit (£87.3 billion for 2014-15).

So, what savings vehicles should replace private and occupational pensions in an ISA-centric savings arena?

## 4. THE LIFETIME ISA, TO REPLACE PERSONAL PENSIONS

### 4.1 Background

Last year the author proposed the assimilation of today's two Junior ISAs with the two New ISAs (NISAs) into a single Lifetime ISA, able to hold cash and investments funded with post-tax savings.[28] Appendix II contains the original proposals, which includes a 50p incentive from the Treasury for each post-tax £1 saved, up to a modest annual allowance.

### 4.2 Design: overview

The Lifetime ISA is intended to address a fundamental conundrum: how could we combine an upfront incentive (50p, say) with ready access to contributions, thereby overcoming what is a major barrier to retirement saving: the lack of ready access, until retirement? The proposed solution is for Lifetime ISA providers to automatically return 50p to the Treasury for every £1 withdrawn before the age of 60 (today's private pension age of 55 is far too early).[29]

Income and net capital gains, however, would not be accessible until 60. We know that over a lifetime of saving, a significant portion of a pot is derived from investment return rather than capital contributions; between 50% and 75%, depending upon the rate of return.[30] Let us trap this component within the Lifetime ISA, to harness the positive power of compounding to the saver's

27 Death under the age of 75: no tax payable, even when a beneficiary withdraws income or takes the fund as a lump sum.

28 *Introducing the Lifetime ISA,* CPS, August 2014. Note that since publication of this paper, some simplifications have been made (herein).

29 The private pension age of 55 is set to rise to 57 in 2028, and then stay at ten years below State Pension age thereafter, as confirmed in HM Treasury's response to the consultation on *Freedom and choice in pensions,* July 2014. In practice it should be rapidly raised to 60 in 2020, commencing in 2016, i.e. by a year every year. In addition, politicians should prepare people for 65 by 2030.

30 Based upon saving a regular annual amount over 40 years. If the rate of return were 3%, then 47% of the pot at retirement would be due to investment returns rather than contributions. This rises to 74% if the rate of return were 6%. Considering the FTSE All Share return, since 1997 roughly 63% of it has come from income (dividends) and 37% from capital growth, with a similar split for real assets (66% from the income component (dividends, rental income) and 34% from capital growth.

benefit, while still providing ready access to capital sums saved into it. An example of a variation of this structure can be found in Turkey.[31]

Behind this approach is a behavioural arbitrage. Knowing that savings are readily accessible encourages people to save, but many then leave their savings intact and accumulating, confident that they could retrieve them at any time….but then many do not. Stocks and shares ISAs, for example, are "sticky", and people are increasingly viewing them as core retirement savings, notwithstanding their easy access (and lack of up-front tax relief).

The introduction of the Lifetime ISA would formally bring the ISA brand into the retirement savings arena. It would also signal the emergence of a clear lifetime savings agenda.

### 4.3 Taxation: a chameleon

The original paper envisaged the Lifetime ISA combining ISA-like and pension-like characteristics. Crucially, the saver would be in control, able to choose between the two different tax treatments, depending upon when withdrawals were made.

Pre-60 withdrawals, requiring the return of the 50p, would unwind the incentive that was initially added to the post-tax £1 being saved. The overall effect would then be TEE. Note that 50p per post-tax £1 withdrawn is akin to a 33.3% tax rate so that, for people who will be basic rate taxpayers in retirement (i.e. over 90% of retirees), there would be an in-built incentive to wait until 60 before making withdrawals.

Savers who did wait until 60 would retain the 50p, withdrawals then being taxed at their marginal rate. Taking the retained 50p into account, the net effect for basic rate taxpayers (i.e. most people), would then be a more pension-like EnET, "En" for Enhanced (because the 50p incentive is double tax relief at the basic rate).

One point to note: savings made after the saver's 50th birthday should be required to remain *in situ* for at least ten years (along with the Treasury's 50p), to eliminate the prospect of "round-tripping", i.e. harvesting the Treasury's 50p more than once with the same £1.

Lifetime ISA assets should be subject to the same rules as pension assets, in respect of both means testing (i.e. excluded) and Inheritance Tax.[32]

### 4.4 Clear communication: crucial

Convincing people of the Lifetime ISA's merits would require clear communication. The presence of an upfront incentive (albeit unrelated to tax-paying status) potentially leaves scope for some confusion. In addition, some people, forgetting about the 50p incentive (which would, for basic rate taxpayers, more than offset the initial Income Tax deduction) may be puzzled as to why post-60 withdrawals would be taxed, contributions having been made with post-tax income.

### 4.5 Or: tax-free withdrawals, post-60

A simplification to the proposed chameleon Lifetime ISA would be to retain ISAs' traditional TEE, post-60 withdrawals being tax-exempt. But this could appear to be too good to be true, given the upfront 50p incentive: more like EnEE.

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31 The Turkish Treasury matches 25% of an individual's contributions, up to TRY1,000 (£220) per month, and savers have access to it through a gradual vesting system: 15% after the first three years; 35% after six years; 60% after 10 years and 100% at retirement at the age of 56.

32 Today, ISA assets in excess of £16,000 are included in a means testing assessment, whereas pension assets are not, so anyone aged 54 should transfer ISA assets into a pension pot, receive tax relief, and then, at 55, they would be eligible for means tested benefits: daft.

Morgan Stanley has costed such a framework using a more modest £1 incentive per post-tax £5 saved, with tax-free withdrawals at any time, although they refer to a *likely need to be some penalty for early withdrawal* (unspecified).[33] Their estimate of the tax benefit to the Treasury is between £12 billion and £19 billion per year, but their model differs to the author's proposed Lifetime ISA is several key respects (in addition to the tax treatment of post-60 withdrawals):

(i) today's annual and lifetime allowances are retained (£40,000 and £1 million, respectively, from April 2016). This is in significant contrast to the author's £8,000 annual allowance, offset by a much more redistributive 50p per post-tax £1 incentive;

(ii) NICs relief on employer contributions is retained. The author proposes that this is scrapped (saving a further £14 billion annually); and

(iii) the loss of tax revenue from pensioners (£13 billion in 2013-14) is omitted because it is assumed that TEE would only apply to new contributions. Withdrawal of today's savings would be tax as normal.

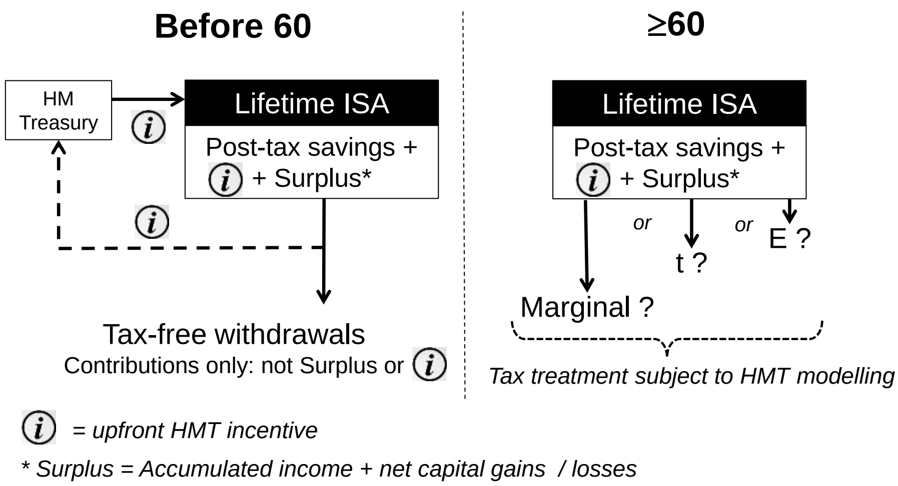
## 4.6 Modelling required

Tax-free post-60 withdrawals (combined with an upfront incentive) is more consistent with TEE, but it would have to satisfy Treasury affordability modelling, encapsulating a fiscal and behavioural ballet. Some tricky assumptions relating to behaviour would be required: for example, what volume of contributions could be expected over a range of different annual allowances and upfront incentives? What would be the implications for capital flows and investment, after taking into account different scenarios for withdrawals?

The challenge would be to find the optimal combination of incentive and annual allowance, i.e. that which maximised the effectiveness of the Treasury's upfront incentive. Today's £40,000 annual allowance combined with a 50p incentive clearly would not work, but with 20p it may, as might a lower allowance combined with a higher incentive (such as a far more redistributive £8,000 and 50p).

[33] *Diversified Financials, Insurance, Economics & Strategy, Insight: UK – Leaning towards a PISA;* Morgan Stanley Research, 10 September, 2015.

**Figure: 1 The Lifetime ISA: summary**



Some other tax frameworks are discussed in section 8, focused on the tax treatment of income and capital gains.

To be clear, before reaching the age of 60, savers would only have access to their Lifetime ISAs' capital contributions. The surplus and Treasury-funded 50p's would remain saved until the age of 60.

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| **Proposal 1 (reiterating a 2014 proposal):** All tax relief on pensions contributions should be scrapped. A Lifetime ISA should be introduced, eligible for an upfront incentive paid irrespective of taxpaying status, up to a modest annual allowance (e.g. 50p per post-tax £1, and £8,000, respectively). Pre-60 withdrawals would require repayment of the incentive. Savings made after 50 must remain *in situ* for ten years. Post-60 withdrawals would be tax-free, or taxed at a sub-marginal rate, as determined by Treasury cost modelling. |

## 4.7 Auto-enrolment: what target for contributions?

### (a) Background

The Pension Commission's seminal second report refers to *aiming for a "base load" of earnings replacement*.[34] Based upon an 8% model (as the 4% + 3% + 1% subsequently adopted for auto-enrolment), "*the median earner might secure a pension at the point of retirement of about 15% of median earnings*".[35] At the time (2005), the Commission envisaged this being added to a (full) State Pension of 30% of median earnings. This pretty much corresponds to what the single-tier State Pension is expected to be, roughly £155 per week from April 2016 (the actual amount will be set in autumn 2015).[36]

### (b) Recall the Commission's 2005 vision

The Commission also had an (aspirational) target for retirement income: that a median earner should reasonably expect to accumulate a pension pot which would take them close to the two-thirds total combined earnings replacement rate. Perhaps as a hint, it pointed out that this could be achieved if the 8% default minimum contribution amount were doubled to 16%.

### (c) Today's context

Today's auto-enrolment framework for occupational pensions is gently ramping up to a minimum total contribution of 8% of band earnings, as 4% from employee post-tax pay, 3% from the employer, and 1% tax relief.[37] Once ramp-up is complete, minimum employer contributions would range between £125 (for someone at the £10,000 earnings trigger) and £1,097 (at the top of the earnings band), with £641 for the median earner.[38] Consequently, the £8,000 annual allowance leaves substantial headroom for additional incentivised employer contributions; up to 33% of band earnings for a median earner (assuming the employee

[34] *A New Pension Settlement for the Twenty-First Century. The Second Report of the Pensions Commission,* 2005.

[35] For underlying assumptions, see Figure 6.34, page 285 of *The Second Report of the Pensions Commission,* 2005.

[36] £155 per week x 52 weeks = £8,060, divided by gross median earnings of £27,200 = 29.6%.

[37] For 2015-16, the lower and upper levels of qualifying earnings are £5,824 and £42,385, respectively (with an earnings trigger for automatic enrolment of £10,000).

[38] Gross median earnings of £27,200. Source: ONS; *Annual Survey of Hours and Earnings, 2014 Provisional Results*, November 2014. Figure for the year ending 5 April 2014, full-time employee who had been in the same job for at least 12 months.

contributes 4% and is not also saving elsewhere and receiving the 50p incentive).[39]

**(d) Impact of a 50p incentive**

If a 50p incentive were paid on both employee *and* employer contributions, auto-enrolment's 4% + 3% + 1% would become 4% + 3% + 3.5%.

Consequently, the Pensions Commission's hint of a total contribution of 16% of band earnings could be surpassed with an additional 2% from both employer and employee, i.e. as 6% + 5% + 5.5%, totalling 16.5%. For a median earner, this translates into contributions of £1,283 (employee) + £1,069 (employer) + £1,176 (the Treasury 50p), a total of £3,528, well inside the £8,000 allowance.

Note that someone earning at the top of the band (£42,385) and contributing 6% would hit the £8,000 allowance with an employer contribution of 15.9%.[40]

**Proposal 2:** The Chancellor should revitalise the Pensions Commission's vision for median earners to have a two-thirds total combined earnings replacement rate. This would be a realistic target within an auto-enrolment contributions framework of 6% employee + 5% employer + 5.5% in Treasury 50p's (totalling 16.5% of band earnings).

**(e) Impact of the 25% tax-free lump sum**

The Commission's modelling of earnings replacement rate assumes that the 25% tax-free lump sum is *not* taken (i.e. the whole pot is annuitised). Consequently, if its modelling results are to be used as a guide, scrapping the tax-free lump sum would be a pre-requisite. Fortunately, in a purely TEE world the lump sum would disappear automatically.

As an aside, the Commission reported that evidence on how much importance individuals attach to tax-free lump sums is unclear. Some 67% of those surveyed either said that they did not know of the feature (28%) or, if they did, that it had no impact on their decision to save in a pension (39%).[41] It is hard to believe that today it has any bearing on 30 year olds' propensity to save, given the immediate financial pressures that they face, and pension pot access being a quarter of a century distant.

**(f) Observation**

A high upfront incentive, such as 50p per post-tax £1 saved, has interesting implications for the extent to which contributions under auto-enrolment need be raised above today's 8% minimum. It potentially lessens the pressure on employers, which would assuage one unintended consequence experienced by the Australians. They have discovered that as (compulsory) employer contributions were pushed up, it becomes harder for employers to distinguish themselves relative to others, through high contributions. This has led to substantial employer disengagement with retirement saving.

## 5. THE WORKPLACE ISA, TO REPLACE OCCUPATIONAL PENSIONS

### 5.1 Auto-enrolment

Savings statistics and surveys suggest that, given the choice, most people would prefer to contribute to an ISA rather than a personal pension. For many, ready access to post-tax contributions is valued above tax relief. It is

39 (4% from the employee + 33.4% from the employer) x (£27,200 - £5,824 lower level of qualifying earnings) = £8,000 annual allowance.

40 (6% from the employee + 15.9% from the employer) x (£42,385 - £5,824 lower level of qualifying earnings) = £8,000 annual allowance.

41 Figure 7.12, page 317 of *The Second Report of the Pensions Commission,* 2005.

reasonable to conclude that similar sentiments are held in respect of occupational pension schemes. Given this, a Workplace ISA should be included in the auto-enrolment legislation, with employees making contributions with post-tax income.

Less than half of the working age population is eligible for auto-enrolment, including 23% of employees.[42] Consequently, the DWP should sponsor a Workplace ISA to cater to workers who are without an employer sponsor, perhaps operating within NEST. This should, of course, be exposed to private sector competition.

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| **Proposal 3:** A Workplace ISA should be included in the auto-enrolment legislation. The same facility should be made available to those without an employer sponsor (perhaps within NEST). |

Workplace ISA cell assets should be excluded for means testing purposes, as per today's pension assets, and their post-death Inheritance Tax treatment should also be the same as pension pots'.

## 5.2 Employers matter

Each year over £100 billion is contributed to occupational and personal pension pots, and roughly 70% of this comes from employers. DWP estimates that by 2019-20, auto-enrolment will lead to an extra c. £15 billion of saving per year, with nine million workers estimated to be newly saving or saving more as a result of auto-enrolment (by 2018).

Clearly, employers are integral to auto-enrolment's success. But they have long complained that their pension contributions are undervalued by employees, and therefore represent poor value for shareholders. Would it be better, for example, to simply increase pay, and let the individual decide what to do with their own money? This would certainly be consistent with the "freedom and choice" direction of travel that is behind the recent liberalisations concerning annuities.

## 5.3 Employer engagement

Engagement operates at two levels: corporate and personal.

### (a) Corporate paternalism

Just how real is employer paternalism today, in what is an increasingly competitive global market? In addition, is the current employer incentive, £14 billion in NICs relief on employer contributions, *really* required, given automatic enrolment? The answers to these questions is not clear, but the employers' perspective would be better understood if we were to replace NICs relief with a 50p incentive for each £1 employer contribution, the latter being taxed as part of employees' gross income. The 50p would be paid directly into a Workplace ISA, rather than to company shareholders, the annual allowance being shared with the Lifetime ISA's £8,000.

A by-product of scrapping NICs relief would be the end to salary sacrifice schemes which are, ultimately, a tax arbitrage at the Treasury's expense, costing it roughly £2 billion per year.[43] In addition, such schemes are iniquitous: they are only available to those with employer-sponsors and not, for example, the 4.5 million self-employed, the fastest growing employment sector.

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42 Briefing Note 75 - who is ineligible for automatic enrolment? Pensions Policy Institute, September 2015.

43 Cost estimate from the PPI analysis of Friends Life's proposals for a single rate of pensions tax relief, March 2015. This cost is included within the £14 billion annual cost of NICs relief.

In 2014 the author proposed merging Income Tax and National Insurance (NI) into a single Earnings Tax, which would facilitate the end of NICs relief (as well as improving transparency).[44] Consequently, the July 2015 announcement that the Chancellor had asked the Office of Tax Simplification (OTS) to undertake a study into the alignment of Income Tax and NI is welcomed (to report before the 2016 Budget).

**(b) Management's perspective**

Reducing the Lifetime Allowance (LTA) has become one of the Chancellor's cost cutting tools of choice.[45] Each time it is cut, it potentially exposes high earners, particularly members of final salary (i.e. DB) schemes, to adverse, and complex, tax implications, notably in respect of the value of accrued pensions relative to lifetime (and annual) allowances. This can only encourage employer disengagement from retirement saving, as well as spawning an array of economically unproductive consulting opportunities: the white collar equivalent of digging a hole and paying people to fill it in.

The LTA should simply be scrapped, not least as a simplification measure. There would be significant political value in so doing (in respect of higher earners), and its £ value to the Treasury is modest (less than £2 billion by 2019-20). In any event, it would become redundant over time, were a much more modest annual allowance introduced.

> **Proposal 4:** The Lifetime Allowance should be scrapped.

One side benefit of scrapping the LTA would be to put an end to the disparity between how DC and DB schemes are valued for LTA purposes.[46]

### 5.4 Contributions under auto-enrolment

**(a) Employee contributions**

Employee contributions under auto-enrolment, made from post-tax income, should be eligible for the 50p incentive, and should be subject to the same access and taxation rules as Lifetime ISA contributions. Given this, it would make sense for employee contributions to be made directly into Lifetime ISAs.

> **Proposal 5:** Auto-enrolled, post-tax, employee contributions should be paid directly into a Lifetime ISA and be subject to the same incentive, access and taxation rules as other Lifetime ISA contributions.

**(b) Employer contributions**

Employer contributions, taxed at the employee's marginal rate would be eligible for the same 50p incentive as Lifetime ISA contributions, sharing the annual allowance. Both would be paid into the employee's Workplace ISA. For simplicity, rather than being a separate savings vehicle, the Workplace ISA could be a segregated cell within the Lifetime ISA (further discussed in section 7).

This would leave savers with a dramatically simplified retirement savings product landscape: a single savings account to serve from cradle to grave.

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44 *NICs; the end should be nigh*, Michael Johnson, CPS, October 2014.

45 The Lifetime Allowance is the maximum amount of pension saving that can be built up over a lifetime that benefits from tax relief. It was reduced from £1.8 million to £1.5 million (2013-14), then £1.25 million from April 2014, and will be £1 million from April 2016.

46 DB schemes' valuation factor of 20 bears little resemblance to the market conditions (i.e. annuity rates) that DC schemes are now exposed to.

> **Proposal 6:** Auto-enrolment's Workplace ISA employer contributions, taxed at the recipient's marginal rate, should be eligible for the same upfront Treasury incentive as the Lifetime ISA, sharing the annual allowance.

Note that paying the Treasury incentive directly into a Workplace ISA would be far more visible to employees than today's arrangement whereby NICs relief goes to their employers' shareholders. Indeed, it could encourage employees to increase their own Lifetime ISA contributions.

### 5.5 Access to Workplace ISA savings

#### (a) No pre-60 access

The access rules for employer contributions should take into account employer objectives for contributing. As discussed, paternalism, for example, may, or may not, still be a consideration.

One approach would be to have a complete "lock-up" until the age of 60, including the Treasury's 50p; Figure 2.

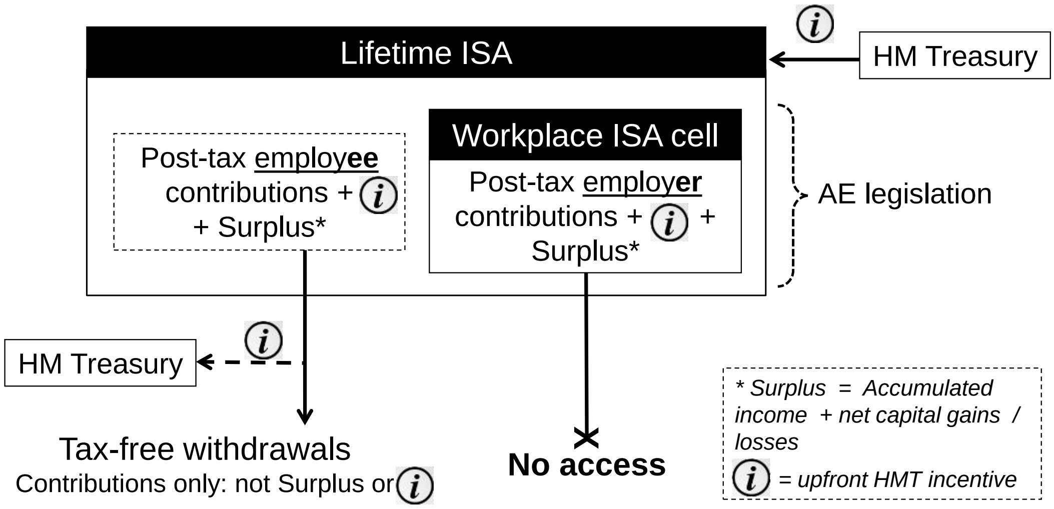
Thus, employer contributions in the Workplace ISA cell would be pension-like (i.e. locked up), but the employee's own contributions (made under the auto-enrolment legislation) would be readily accessible. Such flexibility within a single (integrated) Lifetime ISA would accommodate a wide range of employee savings objectives, influenced by age and socio-demographic profile. Practical considerations include payroll linkage, ongoing administration and employee communication (including guidance).

#### (b) Taxation of post-60 Workplace ISA cell withdrawals

Post-60 withdrawals of Workplace ISA cell assets funded by employer contributions (and the Treasury's 50p) should be taxed in the same manner as withdrawals from the Lifetime ISA. Ideally these would be tax-exempt but, as discussed in section 4.6, this may not satisfy the Treasury's budgeting requirements.

Alternatively, if post-60 withdrawals were taxed at the marginal rate, the net effect would be, for most people, a more pension-like EnET (enhanced, exempt, taxed), given the retained 50p accompanying the employer's contributions.

**Figure 2: Access before 60**



**Proposal 7:** Employer contributions in the Workplace ISA cell, and allied accumulated income and capital growth, should be locked in until the age of 60. The tax treatment of subsequent withdrawals, taxed at a sub-marginal rate (and potentially tax-exempt), would depend upon Treasury cost modelling, key parameters being the annual allowance and the size of the upfront incentive.

Note that, given the rapidly rising Personal Allowance and the growing gap between it and a full single-tier State Pension, TEE's Income Tax exemption in retirement could be viewed as regressive.[47] It would disproportionately benefit the retired wealthy, because low income retirees may not benefit from it. That said, many of them would have received the 50p incentive while working, double the rate of incentive that basic rate taxpayers receive today.

Finally, we should also consider another form of post-60 withdrawal from ISAs: an ISA Pension.

## 6. AN ISA PENSION

### 6.1 What is an ISA Pension?

The term "ISA Pension" has only recently appeared in the media (also referred to as "Pension ISA" or PISA) but a clear definition is lacking. The broad concept, however, has been in circulation for at least a decade.[48] The author uses "ISA Pension" to refer to a regular income stream derived from assets accumulated within an ISA: yes, an annuity.

ISA Pensions would facilitate risk pooling in decumulation, socialising the post-retirement inflation, investment and longevity risks that few of us are equipped to manage by ourselves.

### 6.2 People like annuities: they just do not know it

Several recent surveys have asked people about their intentions for their Defined Contribution (DC) retirement savings. One found that nearly 70% expressed a desire for a "steady, secure income" in retirement, without the risk of outliving their savings, i.e. a lifetime annuity, although few people describe it as such.[49] Another reported that the majority of DC pot holders aged over 55 want a guaranteed income for life, particularly an income protected against inflation.[50] It also found that only 50% of people understood how to obtain this from their pots: the word "annuity" does not resonate. It would appear that most people do not appreciate that an annuity *is* a pension.

### 6.3 Distinguish between noise and signals

Notwithstanding the prevailing anti-annuity mood, we should be careful to distinguish between background "noise", such as today's exceptionally low interest rate environment, and more permanent "signals". A recent paper from two eminent authors observes that:[51]

47 The Personal Allowance will be £10,600 for 2015-16, £10,800 for 2016-2017 and £11,000 for 2017-2018. It is targeted to reach £12,500 by 2020. It would then be some £5,000 higher than a full single-tier State Pension (arriving in April 2016).

48 The author has a copy of an industry presentation given to the DWP outlining a Pensions ISA, dated July 2005.

49 *In a brave new pensions world, what will DC members really want?* Aon DC Member Survey, Aon Hewitt and Cass Business School, December 2014.

50 *Making the system fit for purpose: How consumer appetite for secure retirement income could be supported by the pension reforms.* International Longevity Centre-UK, January 2015.

51 *New world faces challenges from an age-old problem;* Charles Goodhart, Emeritus Professor, London School of Economics and Philipp Erfurth, Financial World magazine, February 2015.

*"The current negative real rate of interest is not the new normal; it is an extreme artefact of a series of trends, several of which are coming to an end. Where might real interest rates reach? By 2025, they should have returned to the historical equilibrium value of around 2.5% to 3%, with nominal rates therefore at 4.5% to 5%."*

Higher real interest rates would feed through to better annuity pricing, and this could significantly change sentiment towards annuities.

## 6.4 International perspective

There is growing international evidence that more focus needs to be placed on decumulation. New Zealand, for example, has no annuitisation market, not least because of the lack of any state incentives to annuitise. Some are now suggesting that this should change, to facilitate the emergence of annuitisation's social gains (including fewer retirees falling back on the state, having exhausted their assets).[52]

Australia's "Murray Inquiry", charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support economic growth, was unequivocal.[53] It recommended a shift of focus away from tax-incentivised wealth accumulation (and estate planning) towards the provision of retirement income, including an increase in risk-pooling in decumulation, i.e. annuitisation. It also recommended placing an increased emphasis on setting clear retirement income objectives (such as an income replacement rate, as per the Pensions Commission; discussed in section 4.7).

## 6.5 ISA Pension

### (a) 25% uplift?

If we accept that annuitisation does offer some societal benefits (including protecting both the state and the individual), then perhaps we should incentivise it? This could take the form of a 25% uplift, say, on the annuity rates inherent in an ISA Pension. This could be particularly attractive given today's very low interest rate environment, and not without precedent. Swiss insurers, for example, are required to subsidise annuities, which perhaps explains why they have the highest level of voluntary annuitisation in the world (some 80% of pension pot assets).

Any uplift would have to be funded out of savings made from ending tax relief. If it were decided that an enhanced ISA Pension were a good idea, but financially problematic, then the Workplace ISA's upfront incentive could be reduced to help pay for the annuity uplift.

### (b) Eligibility

Securing an ISA Pension could be restricted to using assets within a Workplace ISA cell, in which case the cost to the Treasury, of the 25% uplift, would develop slowly over time.

Alternatively, we could include *today's* stock of ISA assets as eligible for a tax-exempt ISA Pension, at any time after the age of 60, say.[54] Part of the £41 billion annual saving made from scrapping all Income Tax and NICs relief could be redeployed to fund the 25% uplift. Once the initial swathe of annuitants had died off, the "steady state" annual cost would settle down at

52 Notably Prof. Susan St. John, Co-Director, Retirement Policy and Research Centre, University of Auckland. She has also suggested that cost-effective insurance for long-term care could be incorporated within annuities.

53 Financial System Inquiry, Final Report to the Treasurer, November 2014.

54 In April 2015, £483 billion was held in adult ISAs, with people aged at least 60 holding roughly £270 billion (56%), split roughly 50:50 between cash and stocks and shares ISAs. Distribution by age inferred from HMRC; *Individual savings accounts statistics, Table 9.11.*

a few £ billion per year, as successive cohorts of 60 year olds secured enhanced, ISA Pensions with their ISA capital.[55]

Some ISA Pension criteria would be required, such as a minimum term; ten years, say, or maybe even lifetime. If the latter, the term structure of annuity pricing would discourage people from annuitising early (perhaps not until they reached 70). In addition, we should at least debate whether the Treasury should support tail-end longevity risk (beyond 85, say) so that annuities could be written more efficiently (from a regulatory capital perspective). In any event, the state should also be free to offer ISA Pensions, perhaps via the Post Office and National Savings (acting as agents for the Treasury), not least to add some pricing tension.

It should be noted that annuities would be 33% larger following the end of the 25% tax-free lump sum. Indeed, the latter's availability today risks encouraging some people to take what is likely to be a short-sighted decision.

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| **Proposal 8:** Consideration should be given to introducing an ISA Pension, secured with assets accumulated within the Workplace ISA cell, enhanced by a Treasury-funded 25% uplift on the underlying annuities. Income would be taxed at a sub-marginal rate (potentially tax-exempt), subject to modelling confirmation. |

### 6.6 ISA Pension as a default at retirement?

To be clear, there is no desire to row back on "freedom and choice"; savers should be free to choose what they do with their savings in retirement. In time, however, demand for auto-protection at retirement could emerge (i.e. a default), which could take the form of an ISA Pension.[56]

## 7. AN ISA WAREHOUSE

The Workplace ISA has been described as a separate cell residing within the Lifetime ISA. But it could be a separate cell *alongside* the Lifetime ISA cell, as well as a suite of other ISA cells within an ISA warehouse, a universal, all-purpose savings vehicle. Each cell would be dedicated to a specific saving purpose, with its own input and output (tax-based) incentives and deterrents to reflect prevailing policy objectives. Thus, the ISA warehouse could include:

(i) a **Workplace ISA**, housing employer contributions, upfront Treasury incentives, and accumulated income and capital growth;

(ii) a **Lifetime ISA**, containing employee contributions under the auto-enrolment legislation, upfront Treasury incentives, and accumulated income and capital growth;

(iii) a flexible **Daily ISA**, for general saving in excess of the annual allowance (and therefore not receiving any Treasury incentive), assimilating today's two Junior and two New ISAs (cash, stocks and shares)[57];

(iv) the **Help to Buy ISA**, to assist in respect of housing; and

(v) a **long-term care ISA**.

[55] Today, annuities purchased with ISA assets are partially taxable at the beneficiary's marginal rate. Part of the income is treated as a return of capital, and is tax-free. The rest is paid with tax of 20% already deducted.

[56] *Auto-protection at 55,* Michael Johnson, CPS, February 2015.

[57] Note that the introduction of the Personal Savings Allowance (April 2016) on the first £1,000 of interest probably makes a cash ISA unnecessary for 95% of people.

**Proposal 9:** The Lifetime and Workplace ISAs could reside inside an ISA warehouse, alongside a suite of other ISA cells, each dedicated to a specific saving purpose.

All cash and investments would be pooled, income and capital growth would be tax-exempt ("middle E"), and total contributions would be capped at an annual £30,000, say, to limit the cost of "middle E". Indeed, "middle E" warrants further consideration.

## 8. THE GOLDEN NUGGET: "MIDDLE E"

### 8.1 Pre-2015

The value of "middle E" has not been lost on successive Chancellors, irrespective of political hue. In 1993 Norman Lamont first cut tax credits on share dividends paid into pension funds, a move completed by Gordon Brown in 1997, when he scrapped the remaining 10% dividend tax credit. Estimates vary as to how much the Treasury has subsequently benefited, with a corresponding reduction in the value of retirement funds; figures between £150 billion and £225 billion are quoted, to the detriment of millions of savers and pensioners.

### 8.2 The 2015 Summer Budget

In the recent Budget the Chancellor played a similar card as some of his predecessors, replacing the 10p tax credit with a £5,000 tax-free allowance (from April 2016) in respect of investment income received outside of ISAs and pensions (to be clear, ISAs and pension pots are *excluded* from this arrangement). Additional tax will apply on dividend income above the allowance.[58]

This prompts a question: has the unwritten rule that income should not be taxed twice been broken? Given that the government expects to raise an additional £2.5 billion in 2016, and £6.8 billion over the next five years……the answer is probably "yes" because the UK does not offer full dividend imputation.[59] So, a precedent has been set.

### 8.3 A flaw with TEE?

A TEE framework means that investment income and capital growth are never taxed. Conversely, with EET, retained income and capital growth may eventually get taxed as capital is withdrawn, depending upon the saver's total income and prevailing tax bands. Thus, one could conclude that, over time, ending EET and moving to a single TEE framework would disadvantage the Treasury. But we should not forget that with today's EET, Income Tax and NICs relief paid out by the Treasury (totalling £41 billion) exceeded Income Tax receipts from pensioners by nearly £30 billion, in spite of the recipient and payee populations being almost identical in size (around 11 million each). This huge imbalance, to the Treasury's disadvantage, is likely to remain for decades to come, despite our ageing population.

In the meantime, we should at least ponder the sanctity of "middle E" for ISAs and pension pots: even a "middle t" (i.e. a tax below the basic rate of Income Tax) could have a substantial impact on net fiscal revenues (and the time to make

58 As 7.5% (basic rate taxpayers), 32.5% (higher rate) and 38.1% (additional rate). The Chancellor is countering a tax arbitrage whereby the directors of owner-managed limited companies pay themselves via lower-taxed dividends, rather than salary.

59 Dividends are paid out of companies' post-tax income so, to avoid taxing the same income twice, some countries permit some, or all, company tax paid to be attributed, or imputed, to the recipient shareholders (via a tax credit). This reduces, or eliminates, the tax disadvantages of distributing dividends; shareholders then have to pay any difference between the corporate rate and their personal marginal rate.

such a change would be when interest rates are low). For now, the annual allowance remains the most effective way of controlling the cost of "middle E", but there are international precedents for taxing such income.

## 8.4 Antipodean precedents

### (a) Australia (ttE)

Australia has full dividend imputation, so shareholders are fully credited in respect of tax paid by a company. Their investment income is then, however, taxed at 15%, although in practice the rate is often much lower due to tax rebates and other credits, i.e. well below standard rates of income tax (hence the "middle t").[60]

In recent years Australia has considered whether to change from ttE to tEE, i.e. to remove *any* tax burden during accumulation. It decided not to, not least because with some A$2 trillion of assets sitting in the pension system, the government could not afford the loss in tax revenue that "middle E" (i.e. "gross roll-up") would entail. This is an indication of the size of "middle E's" contribution to savers' pots at retirement.

### (b) New Zealand (TTE)

New Zealand also has full dividend imputation, but it then taxes pension pots' investment income at 28% (corresponding to the rate of corporate taxation). In addition, income within KiwiSaver accounts is taxed at the saver's marginal rate of income tax. In general there is no capital gains tax (and inheritance tax was abolished in 1992).

## 8.5 The taxation Holy Grail?

Any discussion of "middle E" should take into account the bigger picture, because the rates of Corporation Tax and investment income tax, and the extent to which there is any dividend imputation, are inter-connected. The latter is irrelevant if, for example, there were no company taxation. Indeed, Gregory Mankiw has suggested that companies are more like tax collecting conduits than taxpayers.[61] Given that the burden of business taxes is ultimately borne by people, perhaps company taxation should be replaced with consumption taxes to reflect the extent to which people enjoy an economy's output of goods and services?

Since 2010, Corporation Tax has been gradually cut from 28% to 18% (for 2019). Perhaps the cleanest tax structure for retirement saving would be TTE with 0% Corporation Tax and higher taxes on pollution, TEE being an interim step towards that goal.

# 9. TRANSITION FROM EET

## 9.1 Gradual?

Transitioning to a single tax framework of TEE could be done gradually, by progressively chipping away at upfront tax relief, synchronised with gently reducing the Income Tax paid by pensioners. A potential first step would be to introduce a single (i.e. flat) rate of relief of 20%, say, with the same flat rate of pensioner Income Tax. Subsequently all upfront tax relief could be scrapped, along with any obligation by pensioners to pay Income Tax.

Invariably, all sorts of issues would bubble to the surface. How, for example, could we ensure that there were no "lucky generation" that received upfront tax relief and, subsequently, tax-free pensions without having to create two distinct

[60] Indeed, when the big change was made in 1988, from EET to ttt, those retirees who were invested in shares got a credit for company tax paid which was, at that time, at a rate of 36%: it was possible for wealthy retirees to structure their affairs to pay no tax at all.

[61] Mankiw was George W. Bush's former chairman of the Council of Economic Advisors and is currently an economics professor at Harvard.

pension product categories that would co-exist during transition? It is worth considering the transition experiences of the Antipodeans, so often in the vanguard of retirement saving reform.

## 9.2 Australia

### (a) Multiple steps to ttE

Until 1983, the tax treatment of Australian retirement savings was EET, i.e. as per the UK today, with lump sums taxed at 5%. The first transition step was to increase tax on lump sums to between 15% and 30%, depending upon the recipient's income. Then, five years later, in 1988, Australia made a major change by introducing a 15% tax on contributions and investment income, and a 15% tax rebate on retirement income: essentially a "ttt" arrangement, where the "t" denotes a tax rate lower than the standard rates of individuals' income tax.[62] Paul Keating, the Treasurer at the time, was unambiguous as to the rationale: to bring forward the receipt of tax revenue that would otherwise be received in the future, thereby improving today's budgetary position.

This framework endured for nearly 20 years until, in 2007, Australia removed any tax liability on the over 60s' retirement incomes, in respect of contributions that had already been taxed: "ttE"; see Table 1. This change was widely welcomed by everyone close to, or in, retirement…..and was introduced just before a federal election.

### (b) Outcome: tax complexity in retirement

Today, the tax treatment of Australians' retirement incomes is very complicated, a consequence of a protracted transition to ttE via different tax treatments of contributions, depending upon when they were made, and by whom. Many retirees have, within the same pot, tax-free and taxable components to their incomes, the latter being subject to two different tax rates, depending upon whether tax was, or was not, paid when the contributions were made.[63] This places a significant data tracking burden on providers.

## 9.3 New Zealand

### (a) An early adopter of TTE

In the 1980's, New Zealand set about *moving from a tax system of high taxes which the rich avoid,*

[62] See Institute for Fiscal Studies; *Some Implications of Changing the Tax Basis for Pension Funds*, (1999) vol. 20, no. 2, page 192, Margaret Atkinson, John Creedy and David Knox.

[63] Employer contributions are tax-deductible business expenses, as are some contributions from the self-employed, whereas employee contributions are not tax-deductible.

**Table 1: Australia's transition from EET to ttE**

| | Contributions | Fund income & capital gains | Income in retirement | Summary | Lump sum at retirement | |
|---|---|---|---|---|---|---|
| **Pre-1983** | E | E | Taxed at marginal rate | EET | Taxed at 5% | |
| **1983-88** | E | E | Taxed at marginal rate | EET | Taxed at 15%-30% | |
| **1988-2007** | Taxed at 15% | Taxed at 15% | Taxed at marginal rate with 15% rebate | ttt | Taxed at reduced rates | |
| **2007+** | Taxed at 15%, 30% on earnings > $300k | Taxed at 15% | E if from a taxed source, otherwise marginal rate less 10% | ttE | Lower of marginal rate and 16.5% to a cap, then top marginal rate | In respect of retirees aged ≥ 60 |

*Small "e" and "t" indicates partial treatment* *to one with lower taxes that everyone pays*.[64] Consequently, as part of the wider tax reforms, all tax privileges on private (personal and occupational) pension plans' contributions and accumulation were removed. This ended the distinction between pension savings and other forms of saving and investment.

A subsequent report reiterated the rationale, concluding that of three main public policy levers that a government might apply to retirement savings, tax incentives were the worst.[65] Compulsion was described as only slightly better, because it applied to *all* employees. Non-incentivised voluntary private provision was identified as *by far the best strategy because it allows savers to make the decisions that best suited their circumstances over time.*

**(b) Transition**

On 17 December 1987 the New Zealand government announced the withdrawal of all tax concessions for retirement saving, starting that day. No prior consultation.[66] Over the next 28 months New Zealand marched, in three steps, from EET (with a 25% tax-free lump sum, as per the UK today) to a TTE tax framework (Table 2).

Consequently, members of pension schemes in 1987 experienced an enormous wealth gain, made at the expense of future taxpayers. Having received incentives on past contributions, but then not having to pay tax on subsequent retirement incomes, they had their cake *and* eat it. This approach has the merit of simplicity, but came at the price of a huge inter-generational injustice: it is not recommended.

**(c) DB scheme accommodation**

The move from EET to TTE reduced scheme contributions and income, so DB schemes were permitted to reduce benefits to compensate. Adjustments to pensions have to be signed off by the Government Actuary as being (financially) equivalent to the net effect of the tax changes on investment income (in respect of past service) and on investment income and employer contributions (future service).

Since 1990, however, the government has collected nothing from DB schemes to recognise the value of tax forgone on future pensions, a component of the wealth transfer from future taxpayers to 1987's scheme membership.

With DC schemes, however, members bear the consequences of smaller employer contributions (being net of tax), and lower (post-tax) investment income, offset by (potentially) larger tax-free retirement incomes.

64 Hon. Roger Douglas, Minister of Finance, *Tax Treatment of Superannuation; report of the Consultative Committee*, July 1988.

65 Taskforce on Private Provision for Retirement; *The way forward*, 1992.

66 This was the final part of wide-ranging tax changes that included a new Goods and Services Tax (GST, i.e. VAT) and a lowering and flattening of all income tax rates.

**Table 2: New Zealand's transition to TTE**

| | |
|---|---|
| EET | Before 17 December 1987 for regular payment pension schemes (lump sum schemes were ETE) |
| TET | 18 December 1987 to 31 March 1988 |
| TTT | 1 April 1988 to 31 March 1990 |
| TTE | 1 April 1990 onwards, for all retirement schemes, both lump sum and pension |

**(d) KiwiSaver: lessons learnt?**

New Zealand's KiwiSaver savings account was introduced in 2007 with compulsory 3% employer contributions (taxed at the employee's marginal rate) and a one-off upfront NZ$1,000 "kick-start" from the government. The latter was removed in May 2015, following publication of an evaluation report which significantly doubted whether the kick-start provided value for money for taxpayers.[67] Cited concerns include KiwiSaver's:

- zero impact on asset accumulation. No evidence was found to indicate that people were accumulating more retirement savings than before the account was launched. This suggests that savers simply switched to the KiwiSaver account to capture the kick-start payment, a "savings efficiency" behaviour seen in other countries (usually related to chasing tax-related handouts);
- small benefit, at best, to local capital markets; and
- expense. Over the six years to 2013-14, the additional savings amongst the estimated (low income) target group for each NZ$1 of government expenditure ranged from 20 to 38 cents: a ridiculously low return on (taxpayer) investment.

After five years (i.e. in 2013), KiwiSaver schemes held NZ$16.6 billion, including NZ$5.3 billion in government payments via members and employers. Unsurprisingly, KiwiSaver proved popular with the fund management industry, not least because, as in the UK with tax relief, the government had (unwittingly?) become its largest client.

KiwiSaver continues to benefit from a very small Member Tax Credit on contributions, limited to NZ$521 (£240) per year[68] but otherwise all of New Zealand's retirement savings are essentially made on a TTE basis[69].

**(e) New Zealand's experience: a local perspective**

Professor Michael Littlewood of the University of Auckland Business School believes that governments cannot convince people to save more than they want to save, and should stop trying. He has concluded that *tax breaks for retirement saving are regressive, complex, distortionary, inequitable, inflexible, expensive to administer, and carry significant deadweight costs.*[70] Indeed, Professor Littlewood was clear about the ineffectiveness of tax incentives back in 1998; *but worst of all is that they seem not to work. "Bribing" people into saving for retirement emerges as a thoroughly bad idea*.[71]

Professor Littlewood has proposed that other countries should follow New Zealand's move from EET to TTE (rather than TEE). In so doing, he has suggested that pension schemes should be required to transfer 15% to 20% of assets (representing previously paid tax incentives) to the government, to compensate for the loss of future tax revenues when benefits became tax free under TTE. This would certainly help in

67 NZ Inland Revenue; *KiwiSaver evaluation final summary report,* February 2015.

68 The Government pays 50 cents for every dollar of member contribution, annually up to a maximum payment of $521.43 on a $1,042.86 contribution: quite generous for the low paid, given the 17.5% marginal tax rate to $48,000 a year.

69 There is a minor concession on the investment income of all "Portfolio Investment Entities" (PIEs) because income earned there is taxed on a different basis to income earned directly.

70 *Ageing populations, retirement incomes and public policy: what really matters;* Michael Littlewood, Co-director, Retirement Policy and Research Centre, University of Auckland, 2014.

71 *How to create a competitive market in pensions – the international lessons* (IEA, 1998).

deficit reduction, but could present a communications challenge.

**(f) New Zealand: summary**

New Zealand's TTE framework for pension savings has now been in place for over 30 years. It provides for a "neutral" income tax environment in that the tax treatment of bank accounts is the same as that for savings, for example.

In addition, there is a policy focus on retirement saving education, encouraged by the Commission for Financial Literacy and Retirement Income.[72] This resonates with an observation made by the Finance Minister back in 1988: *if the vast resources of the (financial services) industry are redirected from selling tax concessions to educating the public about the need to save for retirement, a more secure pool of savings for investment and growth will result*.[73]

## 9.4 The US experience of TEE: the Roth IRA and Roth 401(k)

Traditional Individual Retirement Accounts (IRAs) have been middle-America's staple EET-based retirement savings vehicle for over 40 years, owned by roughly 31 million households. Subsequently (1998), TEE-based Roth IRAs were introduced, contributions (with income-related limits[74]) being made with post-tax earnings, capital growth and drawdown being tax-free.[75]

The Roth IRA appeals, for different reasons, to two distinct audiences at the opposite ends of the income distribution: high earners who anticipate paying a high marginal tax rate in retirement, and low earners who have insufficient tax liabilities to really benefit from tax relief on contributions. From 2006, the Roth-style TEE tax-treatment has also been available within a 401(k) plan which, like Roth IRAs, are eligible for matching employer contributions (albeit on a post-tax basis). Take-up of TEE-based Roth accounts is now growing at such a rate (over 19 million households now have them) that their number could overtake the traditional EET accounts.

In additional, Roth accounts have attracted major support from younger savers because many of them expect marginal tax rates to increase over time. On this basis, it is better to have tax exemption well into the future (i.e. during drawdown), as per a TEE tax framework, rather than immediately (i.e. on EET-based contributions).

The US avoided any transitional issues between EET and TEE because the latter (Roth) accounts were introduced to co-exist with, rather than to replace, the traditional (i.e. EET) IRA and 401(k) accounts.

## 9.5 Early support for TEE in the UK

PwC recently asked 1,197 working adults to choose the most appealing tax scenario for their pension.[76] The key message to emerge is that people *want pensions to be taxed like ISAs,*

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72 See www.cflri.org.nz for details. It is headed up by an independent Retirement Commissioner, Diane Maxwell.

73 Hon. Roger Douglas, Minister of Finance, *Tax Treatment of Superannuation; report of the Consultative Committee*, July 1988.

74 There are income limits for contributions, commencing at $61,000 (single) and $98,000 (married, joint-filing). No Roth IRA contributions can be made with incomes above $71,000 and $118,000, respectively. In addition, workers cannot put more than $5,500 per year into their Roth and traditional IRAs combined ($6,500 if aged 50 or more. Limits reduce for high earners).

75 Provided contributions are invested for at least five years and the account owner has reached the age of 59½.

76 Press release, 8 August 2015: http://pwc.blogs.com/press_room/2015/08/people-want-pensions-to-be-taxed-like-isas-pwc-research.html

primarily because today's pensions framework is far too complicated (two-thirds of respondents said they do not understand it). In addition, it is clear that people want a once in a lifetime overhaul of how pensions are taxed to create a simple and stable system which they can understand and trust, preferable one that that is consistent across all savings pots. Moving towards an ISA-style tax system would create such consistency.

## 9.6 Big Bang preferred

In the interests of simplicity, the Treasury should grasp the nettle and adopt a "Big Bang" approach by naming a date when EET simply ceases in respect of all future contributions. The existing world of personal and occupational pensions would be left to wither naturally, there being no further tax relief on contributions. Retirees would continue to pay their marginal rate of Income Tax on withdrawals.

**Proposal 10:** The Treasury should adopt a "Big Bang" approach to radically simplifying the savings arena. It should name a date when EET simply ceases in respect of all future contributions, leaving us with a TEE tax framework for all saving.

## 9.7 Transition challenges

### (a) The change cycle

July's launch of the consultation to consider the future of the pensions' tax regime triggered a predictable Niagara of reasons why going to TEE could not be done. Some industry vested interests went into overdrive, reacting emotionally rather than thinking logically or reasonably. Subsequently refocusing, some are now directing their energies towards opposing change, but a rapidly growing contingent are starting to look forward, seeing possibilities as to how TEE could be made to work. And a few have already accepted that major change is probably inevitable, and they are now anticipating further changes. This is the change cycle made manifest: the recent behaviour exhibited by the industry is normal.

### (b) What of DB?

#### (i) TEE for future contributions only?

DB schemes are the most cited area of potential transition difficulty, compounded by sensitivities concerning public service pensions. They cannot be ignored, not least because DB schemes receive some 70% of tax relief (55% of which goes to public service schemes). The challenge would be diminished if a TEE framework were to apply only to future contributions, but we would still have to consider, for example, the tax treatment of employer contributions in respect of deficit repair (approaching £50 billion per year). And, unless some sort of accommodation were provided, employees would face substantial tax bills in respect of DB accruals relative to a much more modest annual allowance. Alternatively, this might just force the issue of whether the public sector should continue to accrue DB pensions rights, now that the private sector is almost a DB desert.

#### (ii) TEE to include today's pension assets?

Alternatively, the Chancellor could include today's pool of pension savings within a TEE framework. For a one-off tax payment to the Treasury, of 17.5%, say (i.e. at a discount below the basic rate of Income Tax), withdrawals would be tax free. This could trigger a huge one-off cash inflow, given the c.£2 trillion held in pension assets. Implementation should be effected over several years via asset assignment rather than market sales (to generate cash), thereby minimising market disruption. Unfunded public service schemes could not, of course, participate in such an arrangement.

The risk of a future government reintroducing tax on withdrawals is mitigated by the knowledge that to do so would severely diminish people's inclination to save (not to mention inviting a backlash at the polls).

**(c) Diminished take-home pay**

If TEE were to replace EET, take-home pay would be immediately reduced. Some workers may then reduce their contributions to maintain take-home pay, but the significant majority would be more than compensated by the upfront incentive. If 50p per post-tax £1 saved, it would be double the rate of tax relief that basic rate taxpayers receive today.

## 10. CONCLUSION

The primary driver for moving from pensions' EET framework to the TEE world of ISAs is the inflexibility of pension savings prior to 55. This is at odds with how those in Generation Y, in particular, are living their lives. Many eschew pension saving, thereby missing out on tax relief, but engagement with ISAs is high. Ready access and flexibility is valued above tax relief: EET is patently failing the next generation.

In addition, a single TEE tax framework for savings would represent a marked simplification of the savings arena. But, in progressing from EET to TEE, it would be naïve to assume that the Chancellor would pass up an opportunity to reduce the budget deficit by at least £10 billion per year.

Industry opposition to an ISA-centric savings arena is rife. One trade paper recently ran the heading *Concern ISA-pension merger would harm savings culture* to reflect the angst oozing out of industry CEOs. Sorry, what savings culture? The UK has one of the lowest household savings ratios in the OECD.[77] This, combined with our apparent addiction to expensive consumer credit, is a dangerous cocktail. We should remember that society is shaped by the significant majority, many of whom EET ignores. Hopefully the national interest will trump narrow vested interests.

77 https://data.oecd.org/hha/household-savings.htm

# APPENDIX I
# Retirement saving incentives:
# The end of tax relief, and a new beginning[78]

### The proposals

**Proposal 1**: Pension contributions from employers should be treated as part of employees' gross income, and taxed as such.

**Proposal 2**: Tax relief on pension contributions should be replaced by a Treasury contribution of 50p per £1 saved, up to an annual allowance, paid irrespective of the saver's taxpaying status.

**Proposal 3**: ISA and pension products should share an annual combined contribution limit of £30,000, available for saving within ISA or pension products (or any combination thereof). This would replace the current ISA and pensions tax-advantaged allowances.

**Proposal 4**: The 25% tax-free lump sum should be scrapped, with accrued rights to it protected.

**Proposal 5**: The Lifetime Allowance should be scrapped. It adds considerably complexity to the pensions landscape, and with a £30,000 combined contributions limit for pensions and ISAs, it would become less relevant over time.

**Proposal 6**: The 10p tax rebate on pension assets' dividend income should be reinstated.

**Proposal 7**: People should be able to bequeath unused pension pot assets to third parties free of Inheritance Tax (perhaps limited to £100,000), provided that the assets remained within a pensions framework.

**Proposal 8**: The annual allowance should be set at £8,000, with prior years' unutilised allowances being permitted to be rolled up, perhaps over as much as ten years, all subject to modelling confirmation.

[78] Published by the Centre for Policy Studies, Michael Johnson, April 2014.

## APPENDIX II

## The Lifetime ISA: the original proposals[79]

**Proposal 1**: The Chancellor should signal his intention to merge the cash New ISA and stocks and shares New ISA into a single Lifetime ISA, by 2017, say.

**Proposal 2**: Junior ISAs should, in due course, be folded into the Lifetime ISA. For the under-18s, the Lifetime ISA would behave like today's Junior cash and stocks and shares ISAs.

**Proposal 3**: A Lifetime ISA should be automatically established when a baby's name is registered, with a provider nominated by the parents. A lump sum kick-start (up to £500?) could be offered to low earning parents, resuscitating the Child Trust Fund concept, albeit within the Lifetime ISA. Existing CTFs could be assimilated into the Lifetime ISA.

**Proposal 4**: The Lifetime ISA should be eligible for the same Treasury incentive as proposed in the sister paper when saving within a pensions product: 50p per £1 saved, up to an annual allowance of £8,000. The Treasury incentive, capped at £4,000, would be paid irrespective of the saver's taxpaying status. Further savings, up to an annual limit of £30,000, would not receive any Treasury incentive. The proposed annual allowance and annual limit would be shared with pension products.

**Proposal 5**: The Lifetime ISA's withdrawal rules:

(i) Prior to the age of 60: ready access to incentivised contributions, provided 50p were repaid to Treasury for every £1 withdrawn. No deduction in respect of withdrawals of non-incentivised savings.

(ii) Incentivised savings made after the saver's 50th birthday must remain *in situ* for at least ten years (along with the Treasury's 50p).

(iii) At 60 and beyond, withdrawals up to the equivalent of the total non-incentivised amount saved (less any pre-60 withdrawals) would be tax-free. Any further withdrawals (representing incentivised savings and any accumulated income and capital growth) would be taxed at the saver's marginal rate of income tax.

**<u>Note</u>: the detail of (iii) has subsequently been modified, as discussed in section 4, herein.**

**Proposal 6**: All Lifetime ISA providers should be required to offer a default fund, which would have to meet a set of quality criteria. Dividends should be reinvested in the fund, rather than paid out as cash, there should be stringent disclosure requirements, and a cap on the underlying fund costs of 0.35% per annum.

**Proposal 7**: The Lifetime ISA should be included in the auto-enrolment legislation's definition of a "qualifying" scheme, and eligible to receive employer contributions, provided that they were taxed as part of employees' gross income.

**<u>Note</u>: Proposal 7 has now replaced by the Workplace ISA, as discussed in section 5, herein.**

**Proposal 8**: Savers should be permitted to bequeath unused Lifetime ISA assets to beneficiaries' Lifetime ISAs free of Inheritance Tax (perhaps limited to £100,000).

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[79] *Introducing the Lifetime ISA;* Michael Johnson, Centre for Policy Studies, August 2014.

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