Request

Please provide the analysis behind the 55% figure as a reasonable estimate of the tax relief portion of a typical drawdown pension arrangement.

Response

The methodology used to calculate the portion of tax relief is a comparison between the final pension fund value of a typical defined contribution (DC) pension and the final value of an investment with the same assumptions and gross contributions but where no tax relief has been given (the counterfactual). The difference in final fund values as a proportion of the pension fund final value would be representative of the portion of the fund that can be accounted for through tax relief.

The calculations assume a percentage of gross salary that is contributed by both the employee and the employer (results are relatively insensitive to the exact percentages chosen). In the pension fund tax relief is given on the total contribution at the individual’s marginal income tax rate. In the counterfactual no tax relief is given and the level of contributions is decreased by the resulting tax.

Contributions are then accumulated tax-free in the DC example, while in the counterfactual returns are taxed according to the relevant dividend, capital gains or interest income tax rates (taking into account both the dividend tax credit and the annual exempt allowance). For the higher rate individual the income tax rate is 40%, the effective dividend tax rate is 25% and the capital gains tax rate is 28%.

The values for apportioning the returns to dividends, capital gains and interest are taken from the methodology used by the OECD (Taxation and Household Saving, 1994). Capital gains are expected to reflect 67% of the return to equities, with the remaining 33% of the return allocated to dividends. The pension fund is assumed to consist of 70% equities and 30% bonds, which broadly mirrors data on pensions fund assets from Towers Watson (Global Pension Asset Study, 2010). The nominal return to equities is assumed to be 7% and the nominal return to bonds is assumed to be 3.5%, providing the overall nominal return of 6%.

From this analysis the proportion of the fund that is made up of tax relief for an individual who is on the higher rate of income tax throughout their lifetime is around 55%. As per the consultation document, HMRC estimates that around 75% of individuals who are currently in drawdown will have received most of their relief at the higher rate. In addition the 55% rate is intended to eliminate any incentives for individuals to use a drawdown arrangement in order to avoid inheritance tax.