Financial Conduct Authority consultation CP16/32
Handbook changes to reflect the introduction of the Lifetime ISA
Response from the Low Incomes Tax Reform Group (LITRG)

1 We welcome the opportunity to respond to some of the questions asked in the consultation document on Handbook changes to reflect the introduction of a Lifetime ISA. We limit it to “some” because as a body whose professional remit is only concerned with tax and how tax relates to the welfare benefits system, especially affecting those on low incomes, we refrain from comment on the wider questions of the pros and cons of a savings vehicle with such a disparate duality of purpose. Nor are we concerned with the administrative practices and regulation of ISA providers.

2 About Us

2.1 The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.

2.2 LITRG works extensively with HM Revenue &Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.

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2.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3 General

3.1 Our main concerns centre around the tax differences between saving in ISAs and saving in pensions, presenting the average saver with an almost impossible decision. Complex calculations will be needed involving the relative advantages of the two routes as well as the inevitable uncertainty of an investment designed for both the long and the short term. The former tax-exempt input into pensions and taxed outcome has, since pensions freedom, become less clear-cut with the new possibilities of drawing serial tax-free lump sums or widely variable income drawdowns, giving the pensioner more control over their tax rates. It therefore becomes far from straightforward to compare the tax-free outcomes of an ISA plan with those of conventional pension schemes.

3.2 Furthermore, the taxed input into the proposed LISA can vary to the disadvantage of the saver whose salary increases so that he becomes a higher rate taxpayer. While for a basic rate taxpayer the tax relief on pension contributions was, at 20%, equal to the Government bonus of £1,000 for each year's £4,000 in a LISA, at 40% he is missing out on the extra 20% relief he would get on his pension contributions.

3.3 Not only should we note the taxation of the living but also take account of the taxation of the dead. ISAs will fall into the estate on the death of the saver and be subject to Inheritance Tax (IHT), either immediately or perhaps later, having passed intact to a surviving spouse or civil partner; pensions written in trust will fall outside IHT and can be passed on to nominated successors either tax-free before age 75 or at the legatee's marginal rate thereafter.

3.4 We could add to the difficulties of calculating the relative dis/advantages the point that between age 50 and 60 when no further contributions can be made to the LISA (and no penalty-free withdrawals apart from a very small handful of first-time buyers) and therefore no Government top-up, the tax relief continues with pension contributions and quite possibly at 40% when many savers are at peak earning power and empty-nesters.

4 Executive Summary

4.1 Tax relief on pension rather than LISA contributions adds considerable value both for higher rate taxpayers and those continuing to make contributions after age 50 when LISA contributions stop.

4.2 Pensions written in trust (which the majority are) do not fall into the estate on death unlike LISAs and therefore are not subject to IHT. Even LISAs passed intact to a surviving spouse or civil partner will ultimately become liable for IHT.

4.3 It will be difficult to calculate the advantages of tax-free withdrawals from LISAs over pensions since the reforms of pensions freedom have made it possible for pensioners to have more control over the tax due according to the various methods of crystallisation now open to them.

4.4 There is a major area of risk for the LISA saver if he finds himself having to claim benefits. Most benefits including universal credit (UC) are means-tested against income and/or savings. Uncrystallised pensions are usually ignored for such calculations, whereas the LISA saver may well find himself excluded from a claim by virtue of his LISA savings.

4.5 The value of employees' contributions + tax relief + employers' contributions into auto-enrolment will generally exceed the value of solely employees' contributions into a LISA. An exception to this would be if an employee is not earning enough to pay income tax, but can opt in to an employer's scheme with an employer contribution, and that scheme operates on a net pay arrangement – in which case, the employee will (quite unfairly, but that is another matter) miss out on tax relief.

4.6 Using part or all of a LISA for first-time house purchase means that the saver inevitably starts saving into a pure pension much later in life and therefore misses out on the enormous effect of compound interest and tax-free investment growth over a long period.

4.7 We now address in more detail the questions asked.

5 Q1: Do you have any comments about the impact of our proposals on equality and diversity?

5.1 No comment.

6 Q2: Do you agree that the risk categories we have identified capture all of the relevant risks the LISA poses to our objectives? If not, which categories or risks would you add to or remove from our list?

6.1 We agree that the list of risk categories captures most of the relevant risks (but note carefully the point we make at the end of this question). We would, however, amplify the section on tax to point out that not only is higher relief available for 40% taxpayers, twice the 20% equivalent in a LISA, but also that tax relief (and contributions) can continue until crystallisation of a pension, whereas contributions and government top-ups cease at age 50 for LISAs. The cumulative effect of continuing contributions, tax relief and the eighth wonder of the world, compound interest,[1] can only widen the gap of outcomes between the two savings routes.

6.2 Another important point is that 'tax relief' on pension contributions might be even higher than 40% if payment of a contribution via salary sacrifice in turn takes the individual out of the scope of the high income child benefit charge. Or if a personal contribution has the effect of extending their basic rate band such that they qualify for a £1,000 savings allowance instead of the £500 allotted to higher rate taxpayers. These intricacies of the tax system are difficult to explain, but attempts should be made to warn taxpayers of the potential significant differences in overall 'return' if looking at the big picture when comparing pension to LISA savings.

6.3 Furthermore, the statement "Investors may not understand the difference in how the proceeds of a LISA and a pension are taxed" understates the differences between the taxation of the living and the dead. While pension outcomes are taxable, there are big differences between 1) someone dying before age 75 when pension pots written in trust may transfer free of tax to nominated heirs and 2) LISAs passing into the estate and included for IHT purposes. It is, of course, true that a pension of someone who dies after age 75 becomes taxable but only at the beneficiaries' marginal rate of tax. Also, that LISAs can pass intact to a surviving spouse or civil partner, but this is merely deferring any potential IHT charge until second death.

6.4 In addition, the recent pension reforms of 2015 have now made the taxation of pensions more flexible depending on what routes of crystallisation are taken. It is now possible to draw serial untaxed lump sums or set up a drawdown scheme from which the pensioner can withdraw variable amounts of income as desired, thus giving him more control over the amount of tax he pays. Thus, comparisons of the taxation of the proceeds of pensions and LISAs are much more complicated and also difficult to predict over a longer term, with such imponderables as the pensioner's tax rates when he/she retires, health, marital status or country of residence.

6.5 There is an area not touched on in the consultation document but which can have a major impact on the saver. The interaction with the benefits system has to be taken into account in the event that the saver falls on hard times and needs to claim tax credits or benefits. We attach as an appendix a LITRG article published in '*Tax Adviser*' magazine in July 2016 on the conundrum raised by the different savings routes and in which we have marked in bold the particularly relevant paragraphs. Although the article principally compares pension savings with the proposed Help to Save scheme, many of the same principles apply in comparing pensions with the LISA. In addition, we highlight here two very important potential hazards for those pursuing the LISA route:

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[1] Albert Einstein

- First, for tax credit and UC purposes pension contributions are deducted before assessment of income to determine benefit. This is not the case with savings contributions, so the pension saver stands to receive a higher benefit award than the LISA saver on the same income.

- Secondly, untouched pensions savings are usually ignored for assessment of benefits whereas other savings will be included to determine eligibility for UC. Currently savings over £16,000 exclude the saver completely from UC and savings over £6,000 are deemed to yield a tariff income (at a highly improbable rate of return – at £4.35 a month for each £250 or part thereof over the threshold, the equivalent of 20.88%),[1] thus steadily reducing the benefit.

7 Q3: Do you agree with our proposal to add guidance on information about risks that should be included when communicating with retail clients in relation to a LISA?

7.1 We would hope that the FCA will emphasise strongly the need for very careful thought when considering using a LISA in preference to an employer's scheme or auto-enrolment (AE)(2.14). The value of employers' contributions to a pension pot plus the tax relief on the employees' must almost always exceed the benefits offered by a LISA, however large or small the contribution may be. That contribution, of course, may only be the legal minimum but is still open to increases by both employer and employee with a ceiling of relevance only to very high earners.

7.2 An exception to this would be if an employee is not earning enough to pay income tax, but can opt in to an employer's scheme with an employer contribution, and that scheme operates on a net pay arrangement – in which case, the employee will (quite unfairly, but that is another matter) miss out on tax relief. This would potentially make an alternative means of saving such as the LISA more attractive.

7.3 There should also be highlights of the risk incurred by the duality of purpose in LISAs where using up part or all of the savings for a first-time house purchase leaves the saver with much less time and money to establish an adequate pension plan for later life.

8 Q4: Do you agree with our proposals to require LISA-specific information disclosures? If not, please explain why.

8.1 Fullest information is crucial to such major financial decisions and we would like to see the point in 2.18 about employer contributions to auto-enrolment pensions highlighted. People

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[1] See our Revenuebenefits website for an overview of tariff income rules: http://revenuebenefits.org.uk/universal-credit/guidance/entitlement-to-uc/capital-rules/#Tariff income rules

cannot see these contributions as easily as ones they make themselves or see deducted from their payslips and therefore find it harder to understand their value.

8.2 There is no reason why the table in 2.21 should not be set alongside a comparable table showing the effects of identical pension contributions plus employer's contributions and extended to, say, age 60. Even though based on certain assumptions it would illustrate in cold figures the relative merits of the two routes.

9 Q5: Do you agree with our proposals on cancellation rights for LISAs?

9.1 No comment.

10 Q6: Do you agree with our proposal to require all money held within a LISA to be held as client money under the client money rules? If not, please explain why.

10.1 No comment.

11 Q7: Do you agree with the data and assumptions used in this CBA? If not, please explain why.

11.1 No comment.

12 Q8: Do you agree with the description of the costs and benefits in our CBA? If not, please explain why.

12.1 No comment.

LITRG
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Appendix A – Article published in Tax Adviser magazine, July 2016

The low-income savings conundrum

Kelly Sizer explores some of the difficult choices faced by low-income savers.

Two new Government-incentivised savings schemes were promised in the Budget – Lifetime Individual Savings Accounts (Lifetime ISAs) and Help to Save. Lifetime ISAs will be available from April 2017; Help to Save 'no later than April 2018'.

In a tax context, taking care not to stray into regulated advice, you might be asked about the pros and cons of pension savings as against Lifetime ISAs. Help to Save could also come into consideration for lower-income clients claiming either Universal Credit or Working Tax Credit.

But how will a saver of limited means, unable to afford professional fees, understand the tax and related benefits consequences of the various options? These are the kind of complex interactions that the Low Incomes Tax Reform Group wrestles with on a daily basis!

Incentivised savings options

Personal debt and lack of disposable income may prevent many low-income people from saving. But automatic enrolment into workplace pensions now means the issue is inescapable for many, as a savings plan is put in place for them unless they opt out.

Help to Save

Information on this future scheme is sketchy, pending detailed consultation. But the Government says that Help to Save will allow qualifying individuals to deposit up to £50 a month for two years, with an option to extend for another two years. The Government will add a 50% bonus to the amount saved at the end of each two year period, meaning maximum savings of £2,400 with a £1,200 bonus.

This article assumes that both the Government bonus and interest on the accounts will be exempted from income tax. If not, for this group of savers, a combination of the 0% starting rate band for savings and the Personal Savings Allowance would probably mean that both bonus and interest would be tax-free. But a specific exemption would be preferable, to save doing the sums!

Eligibility criteria apply, per Budget 2016 documents:

'The scheme will be open to… adults in receipt of Universal Credit with minimum weekly household earnings equivalent to 16 hours at the National Living Wage, or those in receipt of Working Tax Credit.'

It is not yet clear when the criteria will have to be met – whether only initially, or throughout the savings period. We are told that funds will be accessible by the saver 'to cover urgent costs and there will be no restrictions over how… funds are used'.

Lifetime ISA

The Lifetime ISA has completely different criteria to Help to Save. It is not linked to income; only those aged under 40 can open one; and the 'tax-relief' or 'bonus' of 25% will cease at age 50.

Accessibility and use of the funds will be restricted: they have to be put towards the purchase of a first house if withdrawn before age 60. Access can be had earlier, but with a clawback of tax relief and a 5% charge. Much more can be saved, however, than through Help to Save – up to £4,000 a year (plus £1,000 tax relief).

Pensions, and Automatic Enrolment

Most 'eligible jobholders' – generally those aged from 22 to state pension age, earning over £10,000 a year – will now be automatically enrolled into a workplace pension.

Such workers will benefit from a tax-free employer contribution. Their own contribution may be boosted by tax relief, but this depends on the level of their earnings and whether or not their employer is operating a net pay arrangement or relief at source. With a relief at source scheme, even if a worker is a non-taxpayer, tax relief of 20% is added to their pension fund. By contrast, a net pay arrangement means that a non-taxpayer will not benefit from tax relief as pension contributions are deducted from gross pay and paid to the scheme administrator.

A crucial factor in the 'better off calculation' when comparing savings options is that pension contributions are deductible from earnings when calculating income for Universal Credit (UC) (other types of saving are not so deductible). UC's 'taper rate' of 65 pence in the pound means that a £100 pension contribution could result in a £65 increase in the individual's UC award.[1]

Sifting through the options

So, where should the low-income worker start when choosing between Help to Save, the Lifetime ISA or pension contributions?

First, it would seem sensible to rule out a Lifetime ISA for someone eligible for Help to Save, unless they can afford more than the maximum £50 per month for Help to Save. The Lifetime ISA's lower rate of Government top-up plus its restrictions and potential charges on withdrawal render it an unlikely choice for those on the lowest incomes.

[1] NB – the taper rate is to reduce from 65p to 63p from April 2017, as announced in Autumn Statement 2016

This leaves us comparing Help to Save with pensions. A saver could put something into each but practicality probably dictates choosing one or the other when saving only a relatively small amount.

Let's look at an example. Given the time lag between announcement of the Help to Save scheme and its introduction, we will have to fast forward to April 2018!

Example

Julie, 26, is a low-income worker with one child. She is single and has no housing costs, as she lives with her mother. She has no childcare costs as her family look after her child while she is at work. She earns £1,000 a month before any deductions. For 2018/19, we might expect the personal allowance to be £12,000 (as it will be £11,500 in 2017/18 and the Government has committed to it being £12,500 by the end of this Parliament), meaning Julie will be a non-taxpayer.

Using current rules and rates, Julie will be eligible to claim some Universal Credit. Her maximum UC award will be tapered by 65p for every £1 that her income exceeds the Higher Work Allowance (for 2016/17, this is £397 a month for a single claimant with one child).

Julie wants to save £50 a month. Over four years in a Help to Save account, ignoring any investment growth, the total deposit of £2,400 would produce £3,600.

But Julie's employer automatically enrols her into their pension scheme. From April 2018, this would probably see her paying in 2.4% and her employer contributing 2% of her 'qualifying earnings' (between the Lower Earnings Limit and Upper Earnings Limit, as for Class 1 Primary NICs - £5,824 and £43,000 respectively for 2016/17). Contribution rates are planned to rise to 4% and 3% respectively from April 2019. The employer can choose to pay the entire minimum contribution, in which case no contribution is due by the worker (but they could make additional contributions).

So how does this compare to Help to Save? If, from April 2018, Julie puts £50 a month into the workplace pension, how much might she have after four years? For simplicity, the figures below assume that Julie's pay remains the same each year and that the qualifying earnings threshold remains at 2016/17 levels.

Julie's contribution – £50/m x 48 months	£2,400
Julie's employer's contribution	
– 2% of qualifying earnings for 2018/19 (£12,000 - £5,824 x 2%)	£124
– 3% of qualifying earnings for the three subsequent years (£12,000 - £5,824 x 3% x 3years)	£556
Tax relief, assuming a relief at source arrangement (Julie has opted to pay £50 a month out of her own pocket, so that is the net contribution) - £50 x 100/80 x 20% x 48 months	£600*

Total value of pensions savings, ignoring growth on the fund itself £3,680*

Prima facie,* the return appears better on pension savings than Help to Save.

We also need to consider the impact on Julie's UC award. Julie's £50 a month pension contribution should be deducted from her earnings for UC. This means she will receive 65p in the pound back in increased UC. Over four years, that is £1,560. Added to the £3,860 above, that would mean a total value of £5,240 for her £2,400 saved.

But the increased UC will be cash in hand; in effect it comes off the cost of saving (unless reinvested). So we could instead think about it in terms of Julie having saved only £840 (£2,400 less £1,560) from which she has produced a value of £3,680.

***Note that if a net pay arrangement is in place, Julie will have a fund of £3,080 which makes Help to Save look better value. But taken together with the UC boost, Julie's overall return under a net pay arrangement pension would be £4,640 – over £1,000 more than Help to Save.**

One might think that double benefit could be had by saving the maximum into the Help to Save scheme, then putting the funds into a pension. With the use of Help to Save funds being unrestricted, that would appear to be possible. But a one-off pension contribution (if moving Help to Save funds to a pension as a lump sum) might not be as beneficial for UC, given that UC is calculated monthly. If the pension contribution were to reduce that particular month's income below the standard allowance at which UC begins to be tapered away, there would be no positive impact on the UC award. This might therefore negate the £1,200 bonus achieved through Help to Save.

Multiple jobs

Low-income workers often have more than one job. Let's say Julie above earned £6,000 a year in each of two jobs, meaning she is a 'non-eligible jobholder'. She could opt in to her employers' pension schemes and get an employer contribution, but will not be *automatically* enrolled. This is because she is earning over the Lower Earnings Limit (£5,824 for 2016/17) but below the earnings trigger of £10,000 for automatic enrolment (gauged per job, assuming they are unconnected).

As employers are only obliged to make minimum contributions on qualifying earnings – above the LEL – this would wipe out most of the £680 employer contribution in the calculations for Julie above.

Moreover, if she were earning beneath the LEL, Julie would be an 'entitled worker' – that is, able to join employers' pension schemes, but not qualify for an employer contribution. (Detailed guidance on the categories of worker and automatic enrolment can be found on The Pensions Regulator website.)

The self-employed

The self-employed would also not benefit as much from pension savings for the obvious reason that there is no employer contribution (though automatic enrolment is based upon being a 'worker' which could include some who are self-employed for tax purposes). Not only that, but they would need to take extreme care in assessing the Universal Credit position when making pension contributions, due to the 'Minimum Income Floor' (MIF) for 'gainfully self-employed' claimants.

The MIF, if applied, means that if their actual income from self-employment falls below the set level (for most people, this is 35 hours x National Living Wage less notional tax and NICs), they are deemed to have earnings equal to the MIF in the UC calculation. Unlike tax and NICs, pension contributions are not deductible when calculating the MIF. So if a claimant's income is already near or below that minimum, the pension contribution may have little or no positive effect on their award.

A further Universal Credit consideration

Unlike tax credits, entitlement to which is assessed on income alone (ignoring capital), Universal Credit is based upon a much wider test of claimants' means. Claimants with over £16,000 in 'capital' (unless it is disregarded) will not qualify for UC. Claimants with 'capital' of £6,000 to £16,000 are deemed to receive a certain amount of income from it – known as 'tariff income' – and thus have their UC award reduced.

For claimants below state pension age, untouched pension savings are specifically disregarded in the capital assessment (Universal Credit Regulations 2013, Schedule 10, para 10). So, unless the UC Regulations are amended such that Help to Save funds are similarly disregarded, this is another point in favour of pension savings.

Are we any clearer?

Pension saving would appear to be the 'winner', especially if some of the amount saved is returned by way of increased Universal Credit. Another point in favour of automatic enrolment is the deduction of contributions direct from wages. It is psychologically much harder to save out of your net pay than to have never had the money! This could be one reason why pension savings rates are so poor amongst the self-employed and why there are calls to extend some form of automatic enrolment to them.

But it would be unwise to conclude generally that pensions are preferable to Help to Save. No doubt some may still prefer the more accessible Help to Save scheme (subject to seeing whether further strings are attached following consultation).

Take Julie in our example. Flexible access to savings might be crucial if her circumstances change – let's say her family is no longer able to take care of her child while she works. Whilst she might be able to claim extra Universal Credit to help with those costs, UC is paid monthly and there could be a delay between the claim and payment. She will also need to supplement the cost herself, as UC childcare payments cover only 85% of the cost and are subject to an overall cap.

Consider also the tax position on withdrawal – apparently Help to Save will be tax-free to access, as against potentially only 25% of a pension fund being tax-free.

There are many other factors to take into account such as age, access to the funds and the longer term prospects of financial security. With pensions flexibility, savers at least only have to consider the age restriction on accessing their savings, as the pot itself is now accessible in full (albeit with 75% of it potentially subject to tax).

But many might consider saving small amounts into a pension a rather fruitless exercise if they are unlikely to amass much of a retirement nest egg. Indeed, if savings were to exceed future capital or income limits for assessment of entitlement to state benefits, the up-front tax and UC advantages of their saving might quickly be eroded by restriction of future claims!

Unfortunately, it would take an extremely sophisticated calculator to help savers decide on the best route for them. It would have to take account of current and future tax position, likely benefits entitlement, personal circumstances, interest on current debts and many other factors. We could – and will! – call for better guidance to the public on how to make these decisions, but is that the answer?

One improvement might be to have a single form of tax-incentivised saving. There will always be personal factors and future unknowns which are impossible to quantify (without a crystal ball!). But at least simpler savings options would eliminate one unknown and mean that people have a better chance of making the best decisions for them.

Kelly Sizer CTA is a Senior Technical Manager for the LITRG. Members' thoughts on this topic are welcome – please email ksizer@litrg.org.uk

LITRG's guidance for advisers grappling with tax-related benefits issues, including tax credits and their transition to Universal Credit, can be found at www.revenuebenefits.org.uk