Why 3% of Lifetime Allowance is the correct contribution cap

Introduction

Previous work on a contribution cap as a method of limiting the tax relief given to high earners has concentrated on finding a solution which would be tax neutral for HMRC.

Last year TISA proposed a £50,000 annual contribution cap, and I produced some modelling that argued that this would save a similar amount of tax as the proposals contained in the 2009 Budget to limit tax relief to basic rate for all pension contributions from high earners, with a sliding scale up to incomes of £180,000.

Recently, NAPF have called for a cap of between £45,000 and £60,000 alongside research they have published showing that the Government's proposals may not generate anything like the tax savings claimed.

This paper takes a fresh perspective. From a consumer point of view, it asks what level of contribution cap will still enable savers to reach the Lifetime Allowance, the maximum level at which accumulated pension funds retain all their tax advantages, currently set at £1.75million.

I find that if the contribution cap is set at 3% of the lifetime allowance, then a high flyer who begins pension contributions modestly at age 25, and increases pension saving progressively until restricted by the contribution cap, will just be able to reach the full lifetime allowance at age 65.

The model

The key assumptions are as follows :

> Price inflation is 2%, in line with the Bank of England's target
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> Average wage inflation is 4%, so assuming around 2% economic growth over and above prices
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> Investment returns are 6% after charges, so assuming a predominantly equity based strategy able to produce gains in excess of economic growth on average over the full period to retirement. The long term nature of pensions investment makes the risk of equity investment acceptable, enabling the consumer to expect higher returns than those who restrict themselves to lower risk investments
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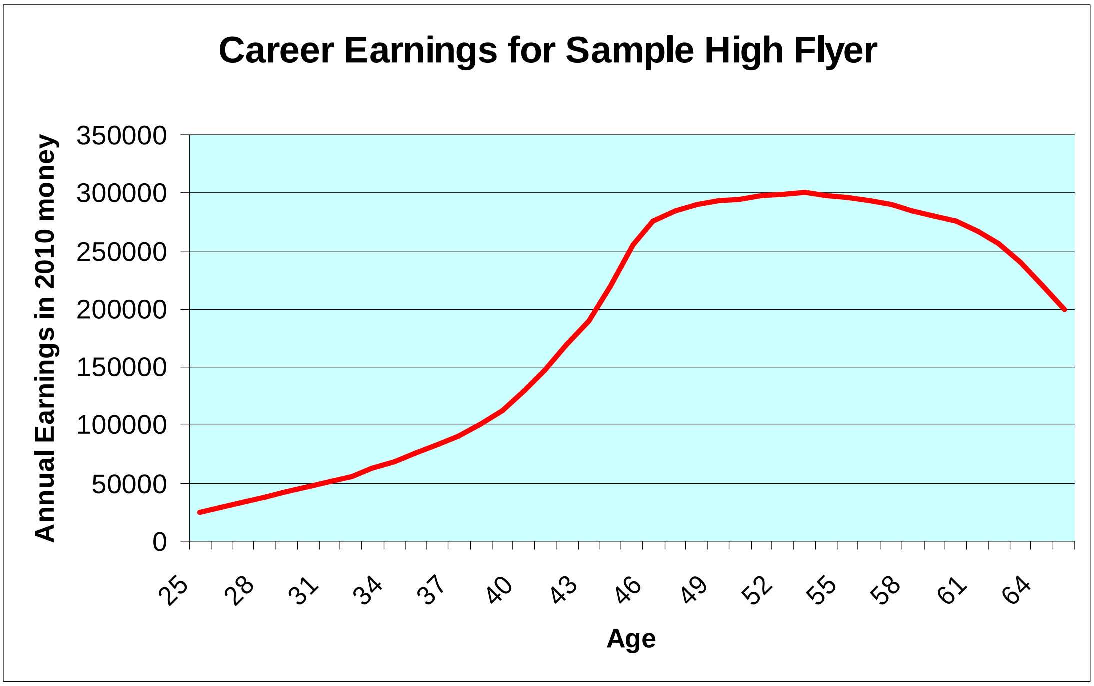
> Retirement age is 65. Although today's high flyers are more likely to retire at around age 60, the general drive for retirement age is upwards, with State Pension Age now legislated to reach 68 eventually.

The Lifetime Allowance is assumed to increase annually in line with average wage inflation, so preserving the lifestyle of future pensioners relative to future earnings.

The typical high flyer

Using earnings in 2010 terms, my high flyer is assumed to have earnings of £25,000 at age 25, commensurate with a first job for someone graduating from a university with a PhD. Rapid career progression then takes these earnings to a peak of £300,000 at age 53, as the high flyer reaches a career pinnacle. After this, earnings fall away, as the high flyer moves more into part time or non-executive director territory, with earnings assumed to have fallen to £200,000 by retirement at age 65.

The full earnings distribution is :



Source : Legal & General Internal Models

Pension Contributions are assumed to be made at the following rates, being the combined rate for employee and employer contributions added together :

Age	Contribution Rate
25 – 35	10%
35 – 40	15%
40 – 45	20%
45 – 50	25%
50 – 55	30%
55 – 60	35%
60 – 65	40%

Where this results in a contribution in excess of 3% of the lifetime allowance, the model assumes that contributions are limited to 3% of LTA.

Accumulated Fund at age 65

My model high flyer will achieve an accumulated pension fund at age 65 of fractionally under £1.75m. To all intents and purposes they will have maximised their pension entitlement as provided for under the A-Day pension reforms introduced in 2006. They will have achieved the coveted status of being "fully pensioned".

Hence I conclude that a cap of 3% of the lifetime allowance is the right answer from a consumer point of view.

But to achieve this, they will have had to have saved in a disciplined fashion over many years. The effect of an annual cap set at 3% of lifetime allowance is that in future high flyers will not be able to make up for early years of little or no pension contributions, and will not be able to retire in their 50's, if they are to achieve a full pension as measured by the annual allowance. Career breaks will also prevent achievement of a full pension :

Looking at these sensitivities :

> A high flyer who misses out the first ten years of pension saving, only starting at age 35, but who is otherwise identical to the model high flyer, would achieve a pension fund of only 94% of the lifetime allowance
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> A high flyer who starts saving at age 25 as my model high flyer, but who early retires at age 60, would achieve a pension fund of only 84% of the lifetime allowance
>
> A high flyer who takes a five year contribution holiday from ages 45 to 50, perhaps while buying his way into partnership status in a professional practice, but who is otherwise identical to the model high flyer, would achieve a pension fund of only 78% of the lifetime allowance
>
> A high flying mum, who takes a five year career break between ages 30 and 35, and whose husband is assumed to pay contributions of £3,600pa on her behalf, but who is otherwise identical to the model high flyer, would achieve a pension fund of 98% of the lifetime allowance. It is a strength of this model that the detrimental effect on career mothers is only slight.

How the cap limited the contributions :

My model assumes that where the standard contribution rate exceeds the cap of 3% of lifetime allowance, the high flyer chooses not to contribute over the cap, and to limit his contributions in that year.

This would be sensible financial advice, and is the way that most people will operate. In practice, I imagine that Government would operate the limits in the same way that the annual and lifetime allowances are operated at the moment. This post A-Day philosophy (in stark contrast to the strict pre A-Day rules) permits savers to make contributions in excess of the annual allowance, but just removes the tax benefits from them by way of special tax charges. It would be preferable to continue in this manner, as it would allow late starters and early finishers to build up their pension pots to their desired levels, albeit without tax benefits.

The way contributions are limited in the model are as follows :

Age	Un-capped contribution, in accordance with above table of contribution rates	Contribution capped at 3% of lifetime allowance
25	2,500	2,500
26	2,900	2,900
27	3,400	3,400
28	3,800	3,800
29	4,200	4,200
30	4,600	4,600
31	5,100	5,100
32	5,600	5,600
33	6,200	6,200
34	6,900	6,900
35	7,600	7,600
36	12,450	12,450
37	13,650	13,650
38	15,000	15,000
39	16,950	16,950
40	19,500	19,500
41	29,600	29,600
42	33,800	33,800
43	38,000	38,000
44	44,000	44,000
45	51,000	52,500
46	68,750	52,500
47	71,250	52,500
48	72,500	52,500
49	73,250	52,500
50	73,750	52,500
51	89,100	52,500
52	89,700	52,500
53	90,000	52,500
54	89,400	52,500
55	88,800	52,500
56	102,550	52,500
57	101,500	52,500
58	99,750	52,500
59	98,000	52,500
60	96,250	52,500
61	106,800	52,500
62	102,400	52,500
63	96,000	52,500
64	88,000	52,500

The effect of the cap is that contributions are going to be limited in the years when earnings are high, thus restricting the tax relief given at the 50% income tax rate payable by high earners. Contributions are unrestricted during the early career years when tax relief is available at only 20% and 40%.

Conclusion

An annual contribution cap set at 3% of the lifetime allowance would be fair from a consumer point of view. It will still allow consumers to achieve accumulated savings equal to the full pensions lifetime allowance.

But doing so will require a disciplined and lengthy approach to pension savings, both of which can actually be seen as desirable pension traits.

The limitations bear most strongly during the years of high earnings, thus restricting the share of tax relief that would be enjoyed by 50% taxpayers, which was one of the Government's aims for the package they introduced.

Finally, an annual cap set at 3% of the lifetime allowance has the advantage that it would automatically uprate as and when the lifetime allowance was reviewed.

The reader will note that 3% of the lifetime allowance is currently £52,500

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