Pointmaker

THE LIFETIME ISA: POTENTIAL NEXT STEPS

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SUMMARY

- This paper provides an overview of the recently announced Lifetime ISA, and comments on its structure. Six specific proposals are made to broaden its appeal, perhaps to be introduced over time:
  1. double the contributions bonus rate from 25% to 50%;
  2. double the contributions cap (to £8,000);
  3. introduce a default fund;
  4. build a bridge with Cash ISAs, to encourage a culture of "investing" rather than cash "saving";
  5. assimilate today's Child Trust Funds and Junior ISAs into the Lifetime ISA, to simplify the savings landscape for children; and
  6. introduce stock dividends as the default (i.e. rather than cash, subject to availability), to help savers harness the positive power of compounding.
- Caution is recommended in respect of providing additional pre-60 access to Lifetime ISA funds. American 401(k) plans, for example, include such a loan facility, but many Americans are reaching retirement with a net liability (i.e. loans to be repaid), rather than finding themselves with 401(k) plan assets.
- The announcement of the Lifetime ISA was immediately condemned by some in the pensions industry, even though the population at large may like it. The cited concern is that the existence of the Lifetime ISA could undermine auto-enrolment, by encouraging savers to opt-out (thereby losing out on employer contributions).
- This paper's sister paper *The Workplace ISA* discusses the importance of both auto-enrolment and employer contributions. It proposes a Workplace ISA to specifically accommodate employer contributions (taxed as a benefit in kind), accompanied by the same 25% Treasury bonus as the Lifetime ISA. The Workplace ISA would complement the Lifetime ISA (recipient of post-tax employee contributions), and it would be included in the auto-enrolment legislation.
- A flexible, trusted vehicle is required to encourage the next generation to save, the subsequent investment being vital for their economic prosperity.

INTRODUCTION

The 2016 Budget introduced the Lifetime ISA (from April 2017), a triumph for common sense and welcomed by consumers, and Generation Y in particular.[1] Reform is particularly sensible due to the pensions industry becoming increasingly uncompetitive in recent decades. Indeed, the UK's financial services supremacy, a precious export industry, is now at risk.

When the author originally proposed the Lifetime ISA, the underlying objective was to combine an upfront incentive with a degree of ready access to savings.[2] It is described by Money Saving Expert's Martin Lewis as *the biggest change in personal savings this country has ever seen*.[3] That was indeed the intention.

The Lifetime ISA should provide some competition to the private pensions arena. But, hopefully, this is only the first step towards merging the disparate worlds of "pensions saving" and "saving" into a single, coherent framework. Ideally, a Workplace ISA, encompassed in the auto-enrolment legislation, will similarly provide competition to occupational pensions.[4]

1. THE LIFETIME ISA: KEY FEATURES, AND SOME OBSERVATIONS

1.1 For everyone aged between 18 and 40

The Lifetime ISA's specific age-range targeting is a rare initiative to help counter the looming intergenerational inequality. It will prove particularly effective if it encourages parental contributions (perhaps attracted by the bonus), i.e. an inter-generational trickle-down of wealth.

1.2 Government bonus of 25%

A bonus of £1 for every post-tax £4 saved will be added to any savings made, up to the age of 50. This 25% bonus is akin to basic rate Income Tax relief at 20%, but it is not a tax relief, i.e. eligibility is independent of tax-paying status. Given the regressive nature of tax relief, and that half of all adults do not understand it, the bonus concept is welcomed. One downside is the scope for confusion between a 25% bonus on Lifetime ISA savings and 20% tax relief on pension contributions. They are economically equivalent.[5]

Pensions savings products will retain their advantage of the 25% tax-free lump sum, but this is unlikely to be enough to overcome savers' behavioural bias for cash accessible today, over that in the distant future (even with the Lifetime ISA's 5% pre-60 withdrawal penalty).

1.3 Maximum contribution of £4,000 per year

Annual contributions to the Lifetime ISA are capped at £4,000, which places an annual £1,000 ceiling on the bonus. Contributions will sit within the overall ISA annual limit of £20,000 (from April 2017), up over 31% on 2016 (and a clear indication of the direction of travel for savings policy).

At first sight, £4,000 looks modest, but not once the combination of starting early and the positive power of compounding are taken into account. After 42 years of contributions (i.e. starting at 18 with 32 years of annual bonuses), a 60 year old would have a pot of £319,000 (assuming 2% real growth), or £532,000 with 4% growth.

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1 Generation Y (aka "millennials"): those born 1980 to 1999, i.e. aged 17 to 36 today.

2 See *An ISA-centric savings world* (October 2015), *The Workplace ISA and the ISA Pension* (July 2015); *Introducing the Lifetime ISA* (August 2014); and *Retirement saving incentives; the end of tax relief, and a new beginning* (April 2014); Michael Johnson, CPS.

3 Martin Lewis on LBC radio, 16 March 2016.

4 See *An ISA-centric savings world* (October 2015), and *The Workplace ISA* (April 2016); Michael Johnson, CPS.

5 £1 into a Lifetime ISA comes from *post-tax* income, whereas tax relief is 20% of a *pre-tax* (i.e. gross) amount.

Accepting that few 18 year olds will be saving £4,000 per year, Table 1 illustrates the pension that could be secured with a Lifetime ISA having received 32 years of contributions and bonuses.

Table 1: Lifetime ISA pot size after 32 years of contributions

Investment real annual growth	Pot size	Pensions from age 65
1%	£189,345	£6,046
2%	£225,558	£7,202
3%	£270,389	£8,634
4%	£326,048	£10,411

Assuming a modest 2% annual real growth rate for investment (net of costs), the Lifetime ISA would have assets of over £225,000.[6] This would be sufficient to generate a lifetime pension of over £7,200 from the age of 65.[7] Clearly, today's £40,000 annual allowance for pensions contributions look ridiculously excessive.

1.4 Withdrawal rules

Withdrawals made before the age of 60 may be used, without penalty, to buy the first home (costing no more than £450,000). Pre-60 withdrawals used for any other purpose would lose the bonus *plus* any allied investment income or capital growth, *and* incur a 5% penalty. Together, these would convert the Lifetime ISA's tax treatment from EEE to TTt, thereby acting as a significant deterrent to non-house-related pre-60 withdrawals.[8] But, crucially, the saver is in control. In addition, although the 5% charge may appear to be high, it will be far cheaper to access Lifetime ISA assets than many forms of consumer borrowing. Withdrawals from the age of 60 will be tax-free, i.e. conventionally ISA-like.

Note that the cut-off for contributions at the age of 50 eliminates the risk of people round-tripping the Treasury bonus over a very short timeframe. It effectively enforces a minimum ten year saving commitment, in return for keeping the bonus after reaching the age of 60 (and is therefore a good reason not to extend the age ceiling for contributions). Conversely, from April 2015, following the end of the annuitisation requirement ("freedom and choice"), the Treasury is exposed to a ridiculously costly tax arbitrage in respect of pension savings. As people approach the age of 55, they can flip existing savings into pension pots to collect tax relief, only to then take out the 25% tax-free lump sum a few days later, once they reach 55. This represents an utterly ineffective use of taxpayers' money, intended to encourage a term commitment to saving.

1.5 Other Lifetime ISA observations

- Assets may be held in the form of cash or securities, which is an improvement on today's requirement for *separate* Cash and Stocks and Shares ISAs. Any capital growth would be tax-free *except* on pre-60 withdrawals for non-house-related purposes.

[6] Why "only" 2%? We should be mindful of the risk of long-term flat or negative real returns from fixed income, sclerotic investment returns elsewhere, and a developed world potentially on the cusp of going ex-growth. Better to be cautious.

[7] An annuity of £3,193 per £100,000 purchase price, for a single life, RPI-linked annuity with a five year guarantee. Paid monthly in advance, based on an average postcode and basic personal details, as at 10 March 2016. *Source*: HL website.

[8] Retirement savings products are codified chronologically for tax purposes. Pensions are "EET", i.e. Exempt (contributions attract tax relief), Exempt (income and capital gains are untaxed, bar 10p on dividends), and Taxed (capital withdrawals are taxed at the saver's marginal rate). Conversely, ISAs are "TEE". The Lifetime ISA's incentive effectively converts the front "T" to an "E" for basic rate taxpayers. Little "t" indicates partial penalty (the 5% charge).

- The Lifetime ISA is especially well-suited to those with no access to an employer-sponsored scheme, including the self-employed.
- Post-death Lifetime ISA assets will form part of the estate of the deceased for IHT purposes. This is in stark contrast to the IHT treatment of pension pot assets.
- Savers diagnosed with a terminal illness can withdraw funds tax-free regardless of age.
- The (less flexible) Help to Buy ISA will be phased out.

1.6 Cost to the Treasury

The Treasury has costed the Lifetime ISA at £850 million in 2020-21 (rising steadily from £170 million in 2017-18).[9] This implies an expected maximum savings inflow of £3.4 billion that year (and a lower figure if the Treasury included an assumption for income from charges related to non-home-related withdrawals). Hopefully, if the Lifetime ISA's is popular, the actual cost will be higher.

1.7 Relative performance: Lifetime ISA vs. pension savings

Table 2 compares the Lifetime ISA with a pension pot under four different tax scenarios.

The Lifetime ISA is substantially more attractive to most people (i.e. those who pay Income Tax at 20% in work and in retirement), whereas the pension pot wins out for 40% taxpaying workers who then pay 20% in retirement: a small minority of the workforce.

1.8 Competition is vital for the industry

The announcement of the Lifetime ISA was immediately condemned by some in the pensions industry, even though consumers may like it. For many in the industry the Lifetime ISA will be a competitor product – an important detail as competition is widely recognised as healthy for a market economy such as the UK's.

(a) A threat to auto-enrolment?

Some in the pensions industry are claiming that the very existence of the Lifetime ISA could undermine auto-enrolment. Its early access feature, they say, could encourage savers to opt-out, thereby missing out on employer contributions, leaving the Lifetime ISA to become the default retirement pot. These critics are failing to recognise that some people may decide that the Lifetime ISA just happens to be a more attractive product than saving in a pension pot, better suited to their personal needs.

9 *Budget 2016; Table 2.1: Budget 2016 policy decisions;* HM Treasury, 16 March 2016. The £850 million figure includes raising the annual ISA limit to £20,000, but this cost component will be relatively small.

Table 2: Lifetime ISA compared to a pension pot

		Pension pot*			
	Lifetime ISA	**20%/ 20%**	**20%/ 40%**	**40%/ 20%**	**40%/ 40%**
Post-tax contribution	£800	£800	£800	£800	£800
25% bonus	£200	-		-	-
Tax relief	-	£200	£200	£533	£533
Sum at retirement	£1,000	£1,000	£1,000	£1,333	£1,333
25% tax-free lump sum	-	£250	£250	£333	£333
Income tax in retirement	£0	-£150	-£300	-£200	-£400
Post-tax outcome	£1,000	£850	£700	£1,133	£933
% uplift on initial contribution	25.0%	6.3%	-12.5%	41.6%	16.6%

** Income Tax when working/ Income Tax in retirement*

But, that notwithstanding, this paper's sister paper *The Workplace ISA*[10] discusses the importance of both auto-enrolment and employer contributions. It proposes a Workplace ISA to specifically accommodate employer contributions (taxed as a benefit in kind), accompanied by the same 25% Treasury bonus as the Lifetime ISA. The Workplace ISA would complement the Lifetime ISA (envisaged to be the recipient of employee contributions under auto-enrolment), and it would be included in the auto-enrolment legislation.

(b) Fear of future tax: unfounded, and irrational

Future governments could always introduce new taxes, for example on Lifetime ISA withdrawals. If this highly unlikely event were to materialise, the Lifetime ISA's tax treatment for basic rate taxpayers (84% of the workforce) would change from EEE (the first "E" being the net effect of post-tax contributions plus the bonus) to EET, i.e. as today's tax framework for pension savings. So, were this minimal risk ever to materialise, the downside for most people would be of no consequence relative to the position that they already find themselves in today, in respect of pensions savings products.

(c) An extra administrative burden

The Lifetime ISA will impose some data tracking requirements on providers, including each asset's purchase price and allied subsequent income. These would be required when repaying income and bonus on any non-home-related pre-60 withdrawals. The rules (to be set by government, ideally with industry input) should ensure that simplicity trumps intricacy.

(d) A potential tax loophole for high earners

Contributions to the Lifetime ISA will not be subject to the Lifetime Allowance (LTA), so it could prove attractive to high earners with pension pots in excess of the LTA. The population of under-40's in this (fortunate) position is tiny, so the cost to the Treasury would be small, but this concern could be overtaken by events. But, in any event, it is quite conceivable that a future wholesale restructuring of tax relief scraps the LTA as a *quid pro quo* for higher rate taxpayers.

(e) Industry behaviour: summary

Over the coming months we can expect to see examples of behaviour from different industry participants at all points of the change cycle (see the Appendix). Those who are first to accept the arrival of the Lifetime ISA will be in the strongest position to seize the commercial opportunities that it will offer.

2. POSSIBLE NEXT STEPS

2.1 Double the bonus rate to 50%

(a) The nation's savings pool would increase

The Lifetime ISA is an opportune vehicle with which to address looming intergenerational inequality. The bonus should be doubled to 50%, funded by terminating higher rate tax relief on pension contributions (a move which could also leave scope to reduce the deficit). Older, wealthier, workers may be placated by the thought that their loss could be their children's gain.

Notwithstanding the on-going debate about the effectiveness of upfront incentives, doubling the bonus would increase the amount in a Lifetime ISA, and therefore the total pool of the nation's savings.

(b) Politically attractive

Raising the bonus to 50% (i.e. 50p per post-tax £1 saved) would be a politically attractive message to disseminate. For basic rate taxpayers (i.e. most people, 84% of the workforce) it could be presented as "we are *doubling* your rate of incentive to save".[11]

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[10] Publication due April 2016.

[11] Today, basic rate taxpayers receive tax relief of 25p per post-tax £1 saved (which is £1.25 pre-tax, less 25p, being 20% Income Tax).

A bonus of 50% would be redistributive, thereby helping to catalyse the *broad-based* savings culture that Britain needs: a far more effective use of Treasury funds than today's tax relief. Paid irrespective of tax-paying status, it would nail the conundrum that because Income Tax is progressive, tax relief is inevitably regressive (thereby primarily benefiting the wealthy, who save anyway). In addition, the widely misunderstood concept (and language) of tax relief would simply not apply.

2.2 Increase the contributions cap

In time, the £4,000 cap on contributions should be raised to perhaps £8,000. This, combined with the Treasury bonus, would provide more than adequate savings capacity for over 90% of the population. The Treasury cost of the bonus could be controlled, if necessary (i.e. depending upon take-up), by offering 50% on the first £4,000, and 25% on the next £4,000. And for individuals with sporadic savings ability (for example, people investing in their own business), there could be a five or ten year roll-up of any unused allowance, so that they would not miss out on past bonuses.

2.3 Introduce a default fund

Most people are uncomfortable with making investment decisions, so Lifetime ISA providers should consider offering a low-cost default fund, with an opt-out to allow savers to embrace "freedom and choice". Given the range of timeframes over which people may be saving (five years, say, for a first home deposit, 35 years for retirement) the investment strategy would require careful consideration.

2.4 Build a bridge with Cash ISAs

Adults' Cash ISAs held £237 billion in April 2015, with Stocks and Shares ISAs holding a similar amount (£245 billion).[12] But the *number* of individuals under the age of 35 subscribing to the two different ISAs is 15 to one in favour of cash.[13] Perhaps an incentivised bridge between the Cash ISA and the Lifetime ISA's default fund is needed, to encourage a culture of "investing" rather than cash "saving"? This would increase the Lifetime ISA's proximity to the cash mountain residing within the nation's Cash ISAs.

2.5 A stock dividends default

Bizarrely, today's suite of ISAs cannot accommodate stock dividends. Taking dividends in the form of additional stock rather than cash (subject to availability) should be the default as it would help savers harness the positive power of compounding (assuming share prices rise over the long term). This feature could be incorporated in the Lifetime ISA before its 2017 arrival.

2.6 A loan facility?

The Government is considering whether to permit funds to be borrowed from the Lifetime ISA without the 5% charge, conditional upon the money being repaid in full. This would introduce additional complexity (i.e. a gamut of rules) but there is plenty of international evidence for the Government to consider prior, to making a final decision.[14]

American 401(k) retirement saving plans, for example, include a loan facility, but opinion is divided as to whether this is sensible. Some Americans reach retirement with a net liability to their 401(k) plan (i.e. loans to be repaid), rather than finding themselves with an asset.

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12 *Individual Savings Account (ISA) Statistics, August 2015, Table 9.6*; HMRC.

13 *ibid, Table 9.8.*

14 401(k) plan holders can borrow up to 50% of their fund, up to a maximum of $50,000, before they reach retirement age. Non-property loans must be repaid with interest over a maximum of five years. (The most popular use of loans are to pay college costs and medical bills not covered by insurance.)

Consequently, caution is recommended in respect of introducing a loan facility, although perhaps pre-60 access to funds for medical expenses and college fees could be permitted.

2.7 Extend the age range for contributions: a savings push at birth

When a baby's name is registered, a Lifetime ISA could be automatically established for the child, with a provider nominated by the parents from an approved list. For cost control purposes, the contributions bonus should commence at 18 (i.e. as planned), but a £500 starter bonus (locked in until 60) could be included, reminiscent of the now defunct Child Trust Funds (CTF).[15] There would be no access to funds until age 18.

Extending the age range of eligibility for a Lifetime ISA could serve as an early nudge towards establishing a savings culture regardless of family circumstance. Furthermore, existing CTFs and Junior ISAs could be assimilated into the Lifetime ISA, to simplify the savings landscape for children.

3. CONCLUSION

With its upfront incentive *and* ready access to funds, the Lifetime ISA combines within a single savings vehicle some of the attributes of today's ISAs with those of pensions savings: a savings chameleon. Crucially, the saver, not the industry, will be in control. The tax treatment of pre-60 withdrawals will be ISA-like (bar the 5% penalty), whereas post-60 withdrawals will be tax-free *and* permit the saver to retain the upfront incentive.

Meanwhile, all the forces that originally prompted the Government to consult on tax relief on pension contributions are still operating: nothing has changed.[16] Indeed, the postponement of fundamental reform provides the Government with an opportunity to flush out some of the technical details, including the question of *"what of DB in a TEE world?".* The author's next paper will consider this, alongside proposals for a Workplace ISA, to complement the Lifetime ISA.

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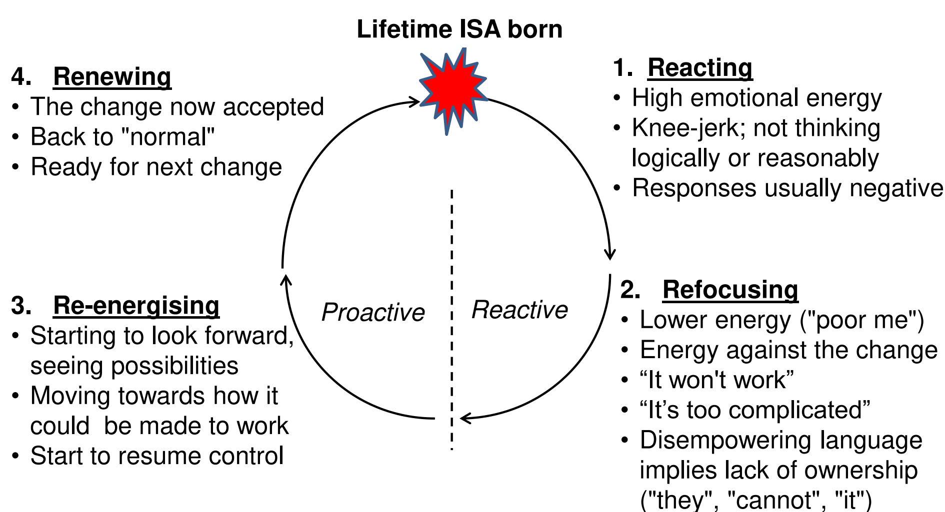
[15] All babies born between September 2002 and January 2011 got between £50 and £500 from the government to save in a Child Trust Fund (CTF). For children older or younger, Junior ISAs replaced CTFs, but over six million children are still locked into CTFs, and up to £3,840 a tax year can still be added, tax free.

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

APPENDIX: The change cycle



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