



HM TREASURY



HM Revenue
& Customs

Restriction of pensions tax relief:

a discussion document on the alternative approach

July 2010



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1

Introduction

1.1 The Government announced in the June Budget that it is considering the reform of pensions tax relief. Having listened to the concerns of the pensions industry and employers, the Government has reservations about the approach adopted by the previous administration in Finance Act 2010 (April). It believes this approach could have unwelcome consequences for pension saving, bring significant complexity to the tax system, and damage UK business and competitiveness.

1.2 The Government nevertheless believes that reform in this area is a necessary part of its commitment to tackling the fiscal deficit. It considers that an alternative approach involving reform of existing allowances, principally of a significantly reduced annual allowance (AA), might better meet its objectives. The Government will seek to ensure that it raises at least the same amount of revenue through restricting pensions tax relief as has already been accounted for in the public finances from the Finance Act 2010 (April) measure over the forecast period, and beyond that in steady state.

1.3 Provisional analysis suggests an AA in the region of £30,000 to £45,000 might deliver the necessary yield. The level required would, however, be influenced by a number of policy design features, including the appropriate level of the lifetime allowance (LTA). The Government also recognises that various features of a reduced AA would need to be revised to ensure it operated fairly and effectively.

Key driving principles

1.4 Generous tax relief is available to encourage individuals to take responsibility for retirement planning and in recognition that pensions have been traditionally less flexible than other forms of saving. An incentive to save in a pension is also provided by the ability to take a tax-free lump sum worth 25 per cent of the fund and the possibility that individuals may be taxed on their pension in payment at a lower marginal rate than the rate at which relief was received when contributions were made.

1.5 Reform of tax relief on pensions contributions is, however, an integral part of the Government's deficit reduction programme set out in the June Budget. In taking forward the development of the new pensions tax regime, the Government's overriding concern will be the delivery of the fiscal objective. The Office for Budget Responsibility will consider the final design of the pensions tax regime in producing its future forecasts.

1.6 Within the constraints of its fiscal objective the Government will also balance its other key objectives of fairness, simplicity and long-term sustainability of the pensions tax regime. Fairness between defined benefit (DB) and defined contribution (DC) schemes is an important consideration. This needs to be appropriately balanced against simplicity. The system should be reasonably simple, both for individuals to understand and use, and for schemes and HMRC to administer, and minimise administrative burdens while ensuring effective compliance. It is important to design a regime that can be introduced in April 2011.

Discussion document

1.7 This document sets out the range of issues on which the Government will make decisions in designing a new regime. It provides further detail on the technical questions, including delivery, that the Government wishes to engage on with interest groups and experts. Those fall into the following categories:

- Policy design (Chapter 2) – discusses the level of the AA and how pension accrual in DB schemes would be valued, among other issues;
- Managing Impacts (Chapter 3) – includes options to protect basic-rate taxpayers; support for hard cases caused by one-off ‘spikes’ in pension accrual; and
- Design and Delivery (Chapter 4) – considers how compliance and delivery would operate in practice.

1.8 Annex A sets out the methodology and assumptions underpinning the Government’s modelling of fiscal yield from reform of pensions tax. It also sets out some of the trade-offs between variables to achieve that yield, for example the level of the AA and how DB scheme accruals would be valued.

1.9 The Government is grateful for the engagement it has had from employers, pension schemes, experts and other interested parties to date. It encourages further contributions on the issues covered in this discussion document ahead of decisions later in the year. In particular, **the Government would welcome written submissions on the specific issues discussed in this document by 27 August 2010.** Chapter 5 summarises the issues that the Government would like specific views on and where further information is requested.

Next steps

1.10 Over the summer, there will be a period of informal consultation of which this discussion document forms a part. During July 2010, the Government met with scheme administrators, experts and industry representatives to take views on key aspects of policy design. In August, there will be continuing discussions on policy and delivery questions.

1.11 The Government recognises that schemes, employers and individuals would like clarity on the nature of the pensions tax system to facilitate planning and systems changes. It will therefore look to confirm its intended approach by the end of September 2010. If the Government decides that the alternative approach of reforming the AA will meet its objectives, then it will repeal the legislation passed in Finance Act 2010 (April).

1.12 The Government intends to publish draft legislation in the autumn in order to give certainty over the approach and to allow time for scrutiny of and consultation on the legislation.

1.13 If the alternative approach is adopted, then the restriction of pensions tax relief would take effect from 6 April 2011 and be legislated for in the Finance Bill 2011.

2

Policy design

2.1 Since 2006, there have been restrictions on the amounts that an individual can save via registered pension schemes each year and over a lifetime. The annual limit on tax-privileged pension saving set by the AA is currently £255,000. The tax-privileged limit set by the LTA is currently £1.8 million and has been frozen until 2015-16. Under the 2006 'A-Day' reforms, the LTA was designed to be the primary mechanism for limiting excessive tax relief.

2.2 This chapter outlines how a reduced AA would need to be redesigned in order for it to operate effectively as the primary means of restricting pensions tax relief. It also discusses how pension accrual in DB schemes could be valued; how the allowance might apply in specific circumstances; and considers some of the wider choices around the system of pensions tax relief. It does this in the context of ensuring that the restriction of relief meets the Government's fiscal objective.

Redesigning the annual allowance

2.3 The Government is committed to raising at least the same revenue through restricting pensions tax relief as has already been accounted for in the public finances. In order to meet this fiscal objective, provisional analysis suggests an AA set in the region of £30,000 to £45,000 would deliver the necessary yield. The Government envisages the allowance would be set at a flat rate, i.e. that it would not vary by age or scheme type.

2.4 In order for this reduced AA to operate effectively as the primary mechanism for limiting pensions tax relief, a number of features of the existing AA would need to change. This section considers some of those features.

2.5 One of the key AA design features is the rate of recovery of tax relief (the AA charge) that individuals face on any pension contributions that exceed the AA. The AA charge is currently set at a flat rate of 40 per cent. However, with a reduced AA, the Government believes that it would be more appropriate to apply a tailored charge on contributions above the AA. A tailored charge would ensure that any tax relief on those contributions is recouped in such a way that they would effectively receive no tax relief, regardless of an individual's income tax band. The charge would therefore operate in a similar way to the current special annual allowance charge, where contributions in excess of the AA are treated as the top slice of an individual's income.

2.6 This charge would aim to discourage pension saving in tax-registered pensions beyond the AA. It is expected that most individuals, employers and pension providers would actively seek to reduce pension saving to below the AA, rather than fall within the charging regime. This might be easier for individuals in DC schemes than for those in DB schemes – this is discussed further in Chapter 3.

2.7 There are currently exemptions from the AA test which would undermine the ability of a reduced AA to restrict pensions tax relief effectively. In implementing a reduced AA, the Government would remove the exemptions from the AA test in the year benefits come into payment, and the exemption for individuals claiming enhanced protection under the Finance Act 2004 tax regime. **The Government welcomes views on any other changes that might be necessary to ensure the AA operates effectively and to address the risk of avoidance that could lead to further significant and potentially adverse changes to the regulatory regime.** The

Government is also clear that a reduced AA must be robust against risks of avoidance and will consider the need for specific anti-avoidance rules under any alternative approach.

Valuing defined benefit contributions

2.8 For individuals in DC schemes it is straightforward to determine the level of contributions put into a scheme over a given period and to assess that against the AA. For DB schemes, however, individuals accrue a right to an amount of annual pension from pension age and a method is needed for calculating the 'deemed' level of contributions associated with that right for the purposes of testing against the AA. This section considers what method would be appropriate with a reduced AA.

Method for valuing defined benefit contributions

2.9 Under the existing AA regime, the newly accrued annual pension in a DB arrangement is valued using a flat factor of 10. That is, for each £1 a year of new pension payable from pension age, the present value of the contribution is taken to be £10. This approach ignores various ways in which the value of a DB pension depends on other factors such as an individual's age, the age at which they become entitled to benefits, and the generosity of ancillary benefits (e.g. increases in service, deferment and payment; dependants' benefits). Alternative valuation options, which take more factors into account, such as the use of tables of age-related factors (ARFs), or cash equivalent transfer values (CETVs) might be fairer between members of DB and DC pension schemes. However, they would also be more complex and time consuming to administer.

2.10 Under any implementation of a reduced AA, the weight of arguments in favour of simplicity arguably outweigh the need for a precise valuation methodology. This is partly because more individuals will need to acquire and understand pension input statements (see Chapter 4) in order to assess their pension savings against the AA. A relatively simple methodology, and one already embedded in the pensions tax system, seems preferable to ease implementation and administrative burdens, and to improve understanding and communications. The Government's provisional view is therefore that the flat-factor method should continue to be the method used to calculate deemed DB contributions under a reduced AA.

2.11 By only taking the newly accrued amount of annual pension in a DB pension into account, the use of a flat factor does, however, potentially create opportunities for DB pensions to be used to grant additional pension value without this counting towards the AA test. **The Government therefore welcomes views on this issue and practical options for limiting it, including the option of requiring a CETV calculation, or the use of ARFs, in specific circumstances to capture the value of certain pension enhancements.** The Government would also look to monitor and review the flat-factor approach for a reduced AA to ensure it did not open up scope for abuse, and would consider the need for specific anti-avoidance rules in this regard.

2.12 If a flat-factor approach were to be continued, then the Government believes that the valuation factor to be used should be higher than the current level of 10. The Government will consider further what the appropriate factor would need to be, taking advice on the actuarial considerations from the Government Actuary's Department. Provisional analysis suggests that the appropriate factor may need to be within the range 15-20.

Past service

2.13 One suggestion that has been made is that past service should be stripped out of the definition of new accrual for the purposes of assessing DB pensions against a reduced AA. This

could simplify the DB valuation methodology and reduce the issue of spikes in DB pension accruals (i.e. large one-off accruals - this is discussed further in Chapter 3). However, it would also significantly reduce the amount of revenue the policy could raise, and would leave too much scope for manipulation of scheme design to avoid the AA restriction. It would also introduce a major disparity between DB and DC schemes. With all else being held constant, it would have no effect on the amount of annual pension that could be acquired by DC contributions made up to the level of the AA. But it could greatly increase the amount of annual pension individuals in DB schemes could accrue over the period before the AA was breached, particularly for those with significant past service. Thus, the Government does not believe past service should be excluded from the calculation of pension accrual used to value DB pension rights.

Other issues around the valuation of defined benefit contributions

2.14 In finalising any method for valuing contributions to DB schemes, consideration will also need to be given to a number of other issues such as: (i) whether deferred members should be exempt from testing under the AA; (ii) whether the previous year's benefits should be revalued for the purposes of determining new accrual; and (iii) the appropriate treatment of any negative accruals that could arise. These issues are inter-related. If deferred members were exempt from the regime, it would be fairer for consistency to include revaluation for active members. However, if revaluation for active members were included in the DB calculation, then negative accruals would be more likely to arise.

2.15 In considering the options around deferred members, it is important to consider the administrative burdens associated with including them against the scope any carve-out might create for manipulation or avoidance. Excluding deferred members would be preferable for easing administrative burdens, however, careful consideration needs to be given to how this would be done.

2.16 The appropriate policy on revaluation needs to have regard to fairness between members of DB and DC pensions, as well as between the valuation of active and deferred pension rights. These considerations would suggest that amending the existing flat-factor methodology to include revaluation of the previous year's benefits would be preferable if deferred members were carved out of the regime. Whilst this might make negative accruals more likely to arise, the issue of negatives is less significant than it was in the context of the Finance Act 2010 (April) proposals and the Government's provisional view is that any negative accruals would be treated as zero under the AA approach. **The Government would welcome views on these issues, and evidence on the administrative burdens of the different options.**

Applying the annual allowance in particular circumstances

2.17 With an AA operating at a significantly lower level it is important to consider whether exemptions from the limit should be granted in particular circumstances, while managing risks of avoidance. This section considers the cases of death, serious ill health, redundancy, ill health, transfers and divorce. **The Government would welcome views from interested parties on these issues and any other specific circumstances under which there may be an argument for applying the AA in a particular way.**

2.18 The Government does not believe that it would be appropriate to apply the AA test in cases where individuals die or are diagnosed with serious (terminal) ill health, and does not believe exempting people in these circumstances would introduce any material avoidance risk. The Government therefore proposes that there would be exemptions for individuals who draw a serious ill-health lump sum, as defined by Schedule 29 of Finance Act 2004, and in the event of death.

2.19 Individuals may receive from their employer a significant increase in the value of their pension in cases of ill-health early retirement or redundancy. It is not clear that it would be appropriate to apply an exemption from the AA in these cases. There is scope for employers to redesign benefit packages in these circumstances such that most individuals (and certainly those with no other pension arrangements) would not be caught by the AA. Clearly defining eligible ill-health early retirement cases would also not be straightforward. **Given the risks of avoidance, the Government is minded not to provide exemptions from the AA in these cases, but is willing to consider proposals from interest groups that would provide protection for individuals in particularly hard cases without opening up unacceptable scope for abuse.**

2.20 Under a pension sharing order, pension debits and credits are used to divide up any accrued pension benefits between the divorcing parties. The value of the pension benefits of the person receiving the credit increases, and the value of the other's pension benefits reduces by the same amount. The annual allowance rules effectively disregard these changes in value for the input period in which the order takes effect. They do this by adjusting the opening value of the benefits for debits and the closing value for credits.

2.21 Where an individual transfers pension benefits between registered pension schemes, there is an increase in the value of the benefits in one scheme and a corresponding decrease in the value in the other. The AA rules adjust the opening or closing value of pension benefits in the two schemes to eliminate the effect of the transfer in the input period in which the transfer is made. The Government does not see any need to change the AA rules that cover pension debits and credits and transfers with a reduced AA.

Redesigning the system of pensions tax relief

2.22 This section considers two of the wider questions that need to be addressed around the overall system of pensions tax relief in any redesign of the AA.

The lifetime allowance

2.23 The most significant of these is the implication of the regime for the LTA. This is the primary mechanism for controlling the overall amount of tax-favoured pension savings an individual could amass in their working life. With a reduced AA, there are arguments for simultaneously reducing the level of the LTA so that there is more coherence between the two.

2.24 A key aspect of redesigning the AA is the valuation factor used for DB accruals. A likely range for a flat factor for the AA is between 15 and 20. As part of the work to establish the precise level for the AA, the Government will also look at what would be an appropriate level for the LTA valuation factor and other aspects of the regime.

2.25 When the LTA was first introduced, transitional rules were introduced to protect individuals whose pension savings exceeded the LTA, and if any changes to the level or factor are made as part of redesigning the AA rules, the Government would provide protection to those with pension savings above a reduced LTA. At the same time, the Government would also consider the merits of freezing the value of rights covered by primary and enhanced protection. This could mean that any increase in value after that date would be subject to the LTA charge when benefits are crystallised. This would remove much of the complications associated with the existing enhanced and primary protection rules and fit better with current policy. **The Government welcomes views on the appropriate level of the LTA, other issues associated with its operation in the context of a reduced AA, and on the trade-off between these and the level of the AA.**

Rate of relief for additional rate taxpayers

2.26 Another issue to consider is the rate of tax relief on pension contributions under the AA. It has been suggested that pensions tax relief, rather than being granted at an individual's marginal rate of tax, could be capped at 40 per cent. This would further reduce the amount of tax relief available to additional-rate (50 per cent) taxpayers and therefore raise more revenue, which could be traded against other design features such as the level of the AA.

2.27 Capping relief at 40 per cent would arguably give the right level of relief to any additional-rate taxpayers who became higher-rate (40 per cent) taxpayers in retirement. The approach would, however, also complicate the system of pensions tax relief and require the re-introduction of many of the delivery and tax collection features of the high-income excess relief charge (HIERC). **The Government would welcome views on the merits of this option as an additional means of restricting pensions tax relief and the trade-off between this and the level of the AA.**

Meeting the fiscal objective

2.28 As mentioned in Chapter 1, in line with the commitment to tackle the fiscal deficit the Government will seek to ensure that it raises at least the same amount of revenue through restricting pensions tax relief as has already been accounted for in the public finances over the forecast period, and beyond that in steady state. While provisional analysis suggests an AA in the region of £30,000 to £45,000 might deliver the necessary yield, the precise revenue raised by any given policy is influenced by the overall design of both the AA policy, and the wider system of pensions tax relief.

2.29 Annex A sets out the estimated Exchequer effect of options to reduce the AA and compares these against the yield from the Finance Act 2010 (April) policy to restrict pensions tax relief (Table A.1), which is reflected in the public finances. It illustrates that the level of the AA, and the approach to DB valuation both have a significant impact on the yield. The Government believes that the existing approach with a valuation factor of 10 values DB contributions at less than full actuarial value. The Government has asked the Government Actuary's Department to advise on the nature of a regime that would be more actuarially appropriate. Provisional analysis suggests that a full actuarial valuation, perhaps using a factor between 15 and 20, would imply that an AA of around £40,000 might be sufficient to deliver the yield.

2.30 These provisional, indicative figures in Annex A are all dependent on decisions to be made on a range of other policy design factors, which are set out in this document. The numbers in Annex A assume policy decisions in line with the Government's current preferences, as indicated in this document (e.g. charging at marginal rate, no exemptions for redundancy or ill health). If a different approach were pursued on any of those options then the figures in these tables would change.

2.31 These estimates of yield do not assume any reform of the LTA. Provisional analysis suggests that moving to an LTA of £1.5m would raise between £100m and £200m by 2014-15, although these estimates are sensitive to any protection arrangements that might be required. Yield in years after the forecast period would increase, creating the possibility of indexing the AA over the longer term.

2.32 In Paragraph 2.27, the Government said it welcomed views on whether relief should be capped at 40 per cent on savings below the AA, even for additional rate taxpayers. Capping relief in this way would increase yield, holding everything else equal, by around £500m a year.

3

Managing impacts on individuals

3.1 The approach of restricting relief through existing allowances would affect the highest pension savers. The group of individuals who can save more than an AA in the range of £30,000 to £45,000 in a year are concentrated among the highest earners. Few individuals on moderate incomes can save at this level, certainly not consistently, year on year.

3.2 The Government would expect members of DC schemes and employers sponsoring DC schemes to look to adapt their pension saving behaviour and remuneration terms from April 2011, effectively 'aiming off' the AA (so that their contributions remain below that level).

3.3 However, it is possible that some members might decide to save more than the AA. As in the existing system, where this occurs individuals would be required to pay a charge to recover the relief received in excess of the AA.

3.4 Members of DB schemes may have less ability to aim off the AA, given that:

- the value of accrual is less easily controlled by the individual, as it is a function of overall scheme design, accrual rate and other factors that are not simply discretionary saving decisions; and
- the value of new accruals can be uneven year on year, or exhibit spikes (atypically large accruals in single years).

3.5 It is such spikes in pension benefits that might tip individuals on low and moderate incomes, whose annual accruals are typically well below the AA, over it in a single year. For example, where they are a long-serving member of a DB scheme experiencing a promotion, or other significant boost to their pensionable salary, or for those benefiting from a substantial enhancement to their pension rights.

3.6 The statement published alongside the June Budget set out the Government's intention to engage with employers, pension schemes, experts and other interested parties to determine the best design of a regime, to ensure it works fairly and effectively. This includes considering options to protect basic-rate taxpayers, and to support hard cases caused by one-off spikes in pension accrual. This chapter discusses these options further.

Options for managing impacts

3.7 The Government has been discussing with relevant parties how employers might adjust reward arrangements and scheme design to support individuals wishing to aim off the AA, and to prevent or limit spikes in pension accrual or contribution.

3.8 In those discussions it has been suggested that employers sponsoring DC schemes might restrict contributions to employees' pensions (automatically or by negotiation), so that they fall below the level of the AA. Similarly, in relation to (group) personal-pension type arrangements, it has been suggested that some providers might impose a cap on aggregate contributions.

3.9 It has also been suggested that the sponsoring employers of DB schemes might consider making changes to scheme design, including the following:

- 1 cap accrual – redesign benefit basis to minimise the risk of breaching the AA in any one year, for example by capping pensionable pay increases;
- 2 smooth accrual – smooth benefit accrual so that any large one-off increase is delivered over a number of years, to avoid breaching the AA in that scheme in any one year. For example, increase pensionable pay slowly over a number of years, or introduce an overriding rule to limit accrual such that the AA is not likely to be exceeded and any excess is carried over;
- 3 offer members an alternative to future DB accrual – offer the option of opting-out of employer’s DB scheme altogether and taking an alternative in its place, for example, a cash allowance (some of which could be put into a DC plan); and
- 4 remove spiky benefits – redesign or withdraw benefit elements that cause spikes in accrual, for example, enhanced early retirement terms, ill health service top-ups, top-ups at retirement based on a service qualifier or in the event of redundancy. For example, incentives to retire early could be paid in cash rather than through the pension scheme. Ill health benefits could be replaced by Permanent Health Insurance.

3.10 The objective of the alternative approach would be to remove the tax incentive for those who consistently save large amounts in excess of any new AA. The Government is keen to support employers to make adjustments that help minimise the risk of individuals facing large one-off increases to the value of their DB pension. As such, the Government would consider that capping or smoothing of accrual with the purpose of keeping DB benefits within the AA would not generally be considered to fall foul of any anti-avoidance regime. An exception might be where DB scheme design is amended with the intention of taking advantage of the limitations of a flat factor valuation approach (as discussed in Chapter 2). For example, careful consideration would need to be given where normal pension age is brought forward or where the rate of indexation of pensions in payment is increased. **The Government welcomes views on legislative action that could facilitate appropriate scheme redesign (as noted in 3.9) without undermining other aspects of the regulatory regime.**

3.11 In the interests of simplicity for the tax regime, the Government’s preference is for employers to respond innovatively, as above, to help manage impacts on individuals. However, where schemes and employers are not able to effectively smooth away spikes in pension contribution or accrual, there may be a role for the tax system to help achieve this.

Managing high charges

3.12 While many individuals will aim off the AA, and the Government expects that it is likely that employers will look to facilitate this, some may exceed the AA and face charges year on year. These charges should be paid out of current income where they are manageable. However, for charges over a certain level, there may be a role for a support mechanism. For example, by allowing individuals to unwind pension saving in excess of the AA (so disapplying the charge), or by extending more flexibility to pay charges (such as by spreading the charge over multiple years, or enabling schemes to pay the charge and reduce the individual’s pension benefits correspondingly).

3.13 The Government will keep the question of how best to treat high charges under review, and will discuss potential mitigation options with interested parties beyond September. Any support options would be legislated in Finance Bill 2012.

4

Delivery and compliance

4.1 This chapter sets out the overall delivery mechanisms and the necessary features of a reduced AA regime to ensure that there is effective compliance. The Government is minded to limit changes to the existing AA rules in order to reduce complexity and the burdens associated with transitioning to a new regime. However, there may be a need to amend existing rules where they:

- leave open compliance risks, in turn creating a fiscal risk; or
- could improve workability of the regime and make it easier for individuals to understand their financial position.

4.2 In particular, the Government is keen to look carefully at how best to ensure individuals have the correct information to allow them to comply with a reduced AA regime, and the most sensible period to reference this information to.

Current rules and delivery mechanism

4.3 Under the current rules, an individual is eligible for full tax relief on their pension contribution where:

- their individual pension contribution does not exceed the higher of £3,600 or 100 per cent of UK relevant earnings over the tax year; and
- their total pension input amount (all contributions made to, or accruals in, registered pension schemes) assessed over pension input period(s) ending in the tax year does not exceed the AA.

4.4 Where the AA is exceeded, the individual is required to report this on their Self Assessment tax return. The individual is liable to a tax charge to recover any tax relief given on the excess, payable through Self Assessment (by the following 31 January).

4.5 The Government believes that the Self Assessment system still offers the best route for reporting, paying and collecting any AA charges that arise. Depending on the final design of a reduced AA, some additional information may be required on the Self Assessment tax return.

4.6 The Government recognises that it is possible that some individuals who are not already within Self Assessment may exceed a reduced AA. They would need to be brought into the Self Assessment regime for this purpose.

Pension input period

4.7 The 'pension input period' is the period over which the pension input amount for a pension arrangement is measured. Under the current rules, the pension input period is specific to the arrangement and an individual may have a different input period for each of their pension arrangements. It need not match the tax year. Instead, an individual's pension input that is tested against the AA is the aggregation of all of their pension input amounts for pension input periods ending in the relevant tax year.

4.8 The Government is considering whether, with a reduced AA, it is appropriate to align the pension input period to the tax year. It will consider the compliance and fiscal implications of doing this. It will also consider administrative burdens, and the simplicity of the system.

4.9 Under the current rules, an individual can potentially make three pension input amounts of up to the AA level within two tax years. However, the existing rules prevent them from making a further tax-relieved contribution in the next tax year, ensuring that there is no fiscal risk over the three year period as a whole. The Government believes that the position of the pension input period does not have an impact on the yield accounted for over the forecast period, or beyond that in steady state.

4.10 The existing rules mean that there may be several reference points for individuals to consider when assessing whether they have exceeded the AA – the tax year (for the relevant earnings limit) and for the AA, the end dates of any pension input periods in that tax year. However, currently very few individuals need to interpret multiple reference points, due to the present high level of the AA (£255,000 for 2010-11).

4.11 Because a reduced AA will mean that more individuals will need to assess whether they have exceeded the AA, there is a case for aligning the pension input period to the tax year so that individuals have only one reference point to consider. This could make it easier for individuals to identify the value of their pensions, simplifying the process that they need to go through in order to complete their Self Assessment tax return accurately.

4.12 However, alignment may create administrative burdens for pension schemes due to necessary changes to systems and processes associated with the pension input period. This may also lead to costs or efficiencies (depending on the size and structure of the pension scheme) on a recurring basis as it would require more activity towards the end of the tax year.

The Government welcomes views and evidence on the benefits and burdens associated with aligning the pension input period to the tax year, for individuals, pension schemes and advisors.

4.13 The Government is aware of the complexities associated with transitioning to a reduced AA, regardless of whether or not pension input periods are aligned to the tax year. For example, there may be cases where individuals have already saved more before April 2011 than the reduced AA in a pension, but where the input period does not come to an end until 2011-12. Where necessary, specific rules will be designed to apply at transition.

Information requirements

4.14 The Government believes that all pension savers should know the value of their pension, alongside other information about their savings and assets, to enable them to plan and to understand their financial position. This is in line with wider aims that the Government is progressing around empowering consumers and ensuring transparency of information, working with the Consumer Financial Education Body and establishing the Consumer Protection and Markets Authority.

4.15 It is already a legislative requirement that members of DC pension schemes receive an annual statement of contributions made to their pension arrangement(s). This must show the value of the contributions over a year, tied to the anniversary of the member joining or the scheme renewal date. Members of DB pension schemes are entitled to request a pension benefit statement once a year, which takes the form of a leaving certificate or accurate valuation statement.

4.16 Under the current AA regime it is the responsibility of the individual taxpayer to gather all the information that they need about their pension input amount(s), to determine whether they

have exceeded the AA. With a reduced AA, many more pension savers could be potentially affected than now.

4.17 There is therefore a strong case for pension schemes providing this information to all individuals. It is clear that any reporting requirements placed on schemes would need to link to the pension input period, rather than the scheme year. However the Government recognises that there are burdens associated with this and that, for example, necessary systems changes could take some time.

4.18 The Government is considering the implications of requiring pension schemes to provide or make available details of the pension input amount(s) to members who request it. This information would need to be provided within a reasonable timeframe, to enable individuals to complete the Self Assessment tax return accurately and on time.

4.19 To manage volumes of requests from scheme members (some of which may be unnecessary), it may be appropriate for schemes to provide details of pension input amounts to members in any case. For example, pre-empting that certain groups of individuals will be likely to be at or above the AA, or that certain groups e.g. those with very low pensionable pay and/or years of service, will not exceed the AA unless they have significant pension inputs in other schemes. In addition, the Government believes that pension schemes should inform members where their input amount for that scheme exceeds the AA.

4.20 The Government is keen to understand the benefits to schemes and members of reporting requirements on pension schemes to provide statements of the total pension input amount over the relevant period. It is also keen to understand the impacts associated with this, recognising that other aspects of policy design may affect how burdensome it would be, and how quickly schemes could calculate members' pension input amounts. The Government will work with interested parties through August and beyond, in order to design appropriate reporting requirements.

Given the need to support individuals, the Government welcomes views on the appropriate reporting requirements on pension schemes to provide statements of the total pension input amount over the pension input period.

The Government welcomes views and evidence on the burdens and benefits associated with introducing reporting requirements on schemes to provide this information.

The Government welcomes views on how quickly schemes could provide this information before the Self Assessment tax return is due, and whether employers could help pension schemes provide this information in a timely way.

4.21 To ensure effective compliance with the regime, the Government is considering whether it is necessary for pension schemes also to report to HM Revenue and Customs where individuals have exceeded a set limit. It will continue to engage with interested parties on all aspects of the reporting requirements on schemes over the summer on the broad approach.

How to treat overseas schemes and difficult cases for compliance

4.22 The Government is clear that a reduced AA would apply to all those receiving UK tax relief, with the exception of the cases set out in Chapter 2. However, in some cases, it will be more difficult for pension schemes to meet the types of reporting requirements set out above - for example in overseas schemes. Overseas schemes may also have specific issues around the positioning of the pension input period.

The Government welcomes views on any practical or administrative issues that may arise from applying the reduced AA, and associated information and compliance requirements, to individuals who are members of overseas pension schemes and benefiting from UK tax relief.

5

Views requested and how to respond

Summary of views requested

5.1 The Government would welcome written submissions on this discussion document in general and on the following requests for views and information.

- 1 There are currently exemptions from the AA test which would undermine the ability of a reduced AA to restrict pensions tax relief effectively. In implementing a reduced AA, the Government would remove the exemptions from the AA test in the year benefits come into payment, and the exemption for individuals claiming enhanced protection under the Finance Act 2004 tax regime. **The Government welcomes views on any other changes that might be necessary to ensure the AA operates effectively and to address the risk of avoidance that could lead to further significant and potentially adverse changes to the regulatory regime** (Paragraph 2.7);
- 2 By only taking the newly accrued amount of annual pension in a DB pension into account, the use of a flat factor potentially creates opportunities for DB pensions to be used to grant additional pension value without this counting towards the AA test. **The Government therefore welcomes views on this issue and practical options for limiting it, including the option of requiring a CETV calculation, or the use of age-related factors, in specific circumstances to capture the value of certain pension enhancements** (Paragraph 2.11);
- 3 **The Government would welcome views on the treatment of deferred members, revaluation and negative accruals, with a flat-factor approach to valuing DB accruals, and evidence on the administrative burdens of the different options** (Paragraph 2.16);
- 4 With an AA operating at a significantly lower level it is important to consider whether exemptions from the limit should be granted in particular circumstances, while managing risks of avoidance, including the cases of death, serious ill health, redundancy, ill health, transfers and divorce. **The Government would welcome views from interested parties on these issues and any other specific circumstances under which there may be an argument for applying the AA in a particular way** (Paragraph 2.17);
- 5 Individuals may receive from their employer a significant increase in the value of their pension in cases of ill-health early retirement or redundancy. It is not clear that it would be appropriate to apply an exemption from the AA in these cases. **Given the risks of avoidance, the Government is minded not to provide exemptions from the AA in these cases, but is willing to consider proposals from interest groups that would provide protection for individuals in particularly hard cases without opening up unacceptable scope for abuse** (Paragraph 2.19);
- 6 **The Government welcomes views on the appropriate level of the LTA, other issues associated with its operation in the context of a reduced AA, and on the trade-off between these and the level of the AA** (Paragraph 2.25);

- 7 **The Government would welcome views on the merits of capping relief at 40 per cent as an additional means of restricting pensions tax relief and the trade-off between this and the level of the AA** (Paragraph 2.27);
- 8 The Government is keen to support employers to make adjustments to help individuals who may face large, but one-off, increases to their DB pension. **The Government welcomes views on legislative action that could facilitate appropriate scheme redesign without undermining other aspects of the regulatory regime** (Paragraph 3.10);
- 9 **The Government welcomes views and evidence on the benefits and burdens associated with aligning the pension input period to the tax year, for individuals, pension schemes and advisors** (Paragraph 4.12);
- 10 **Given the need to support individuals, the Government welcomes views on the appropriate reporting requirements on pension schemes to provide statements of the total pension input amount over the pension input period** (Paragraph 4.20);
- 11 **The Government welcomes views and evidence on the benefits and burdens associated with introducing reporting requirements on schemes to provide this information** (Paragraph 4.20);
- 12 **The Government welcomes views on how quickly schemes could provide this information before the Self Assessment tax return is due, and whether employers could help pension schemes provide this information in a timely way** (Paragraph 4.20); and
- 13 **The Government welcomes views on any practical or administrative issues that may arise from applying the reduced AA, and associated information and compliance requirements, to individuals who are members of overseas pension schemes and benefiting from UK tax relief** (Paragraph 4.22).

How to respond

5.2 In addition to addressing key questions, respondents are encouraged to add any additional information they feel is relevant to the practicalities of implementing the policy.

5.3 To help the Government evaluate responses, it would be helpful if respondents could explain their interest in the discussion and also make clear if their response is being made on behalf of a group or representative body. In the case of representative bodies, please provide information on the number and nature of the people you represent.

5.4 Responses to this discussion document should be sent to HM Treasury by 27 August 2010. Please address to: Pensions tax relief, Room 2/E2, HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ. Alternatively, you can e-mail responses (and any queries) to: pensionstax@hmtreasury.gsi.gov.uk.

5.5 All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations. If you are willing and able to provide data on the impact of the reduced AA on pensions contributions on your business, pension scheme or scheme members then please do so. Responses will be shared between HM Treasury and HM Revenue and Customs.

Confidentiality

5.6 Information provided in response to this discussion document, including personal information, may be published or disclosed in accordance with the access to information

regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

5.7 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, among other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury or HM Revenue and Customs.

5.8 HM Treasury and HM Revenue and Customs will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

A

Note on estimate of Exchequer effect

Yield from previously announced policy

A.1 At the June Budget, the interim Office for Budget Responsibility (OBR) produced a forecast incorporating the impact of policy measures announced at or before the Budget. This included the measure to restrict pensions tax relief in Finance Act 2010. The yield from this measure was included in Table 2.4 of the June Budget. The figures for this measure are reproduced in Table 1 below. It is these numbers that set the fiscal objective for the alternative policy: raising the same yield over the forecast period (2010-11 to 2014-15) and beyond that in the steady state. The OBR has said that it will consider any revised approach in producing its future forecasts.

Table A.1: Exchequer impact of the high-income excess relief charge (HIERC) (£m)

| | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 |
|-------|---------|---------|---------|---------|---------|
| Yield | 0 | 200 | 3,500 | 3,600 | 4,600 |

Illustrations of Exchequer effects of a reduced annual allowance

A.2 The measure imposes a reduced AA for pension contributions which restricts income tax relief for pension contributions so that in future relief will only be available on contributions up to the new allowance. It is assumed for the purposes of these costing illustrations that:

- a tax charge will be imposed on the excess of pension contributions above the AA at the taxpayer's marginal income tax rate;
- the charge applies to the combined individual and employer contributions made by or on behalf of the individual in the tax year, including all contributions in the year of retirement; and
- the charge will generally be payable through Self Assessment, but that 'payments on account' will not operate in respect of these charges.

A.3 Four examples of possible levels of AA and valuation of DB contributions were considered:

- (i) AA of £30,000 with full actuarial valuation of DB contributions;
- (ii) AA of £45,000 with full actuarial valuation of DB contributions;
- (iii) AA of £30,000 with DB contributions valued at 60 per cent of full actuarial value; and
- (iv) AA of £45,000 with DB contributions valued at 60 per cent of full actuarial value.

The measure is assumed to come into effect from 2011-12.

Tax base

A.4 There are two primary data sources for estimating the size of the tax base for the measure:

- data on individuals' contributions and incomes is taken from the HMRC Survey of Personal Incomes (SPI), which covers around 600,000 individuals, weighted to be representative of all taxpayers. The SPI is based on individuals' tax records supplemented with data from pension providers and imputations using ASHE (Annual Survey of Hours and Earnings). The latest available SPI data is for the tax year 2007-08; and
- employer contributions are imputed to each individual in an occupational pension scheme using a distribution which results in aggregate pension contributions being consistent with total tax relief on contributions reported in National Statistics.

A.5 To estimate the size of the tax base over the forecast period, income components for all individuals in the sample are grown in line with relevant economic determinants included in the June Budget's economic forecasts. A further adjustment is made to allow for an increase in pension contributions expected as a behavioural effect of the 50 per cent additional income tax rate introduced in 2010-11, this effect not being reflected in the 2007-08 SPI base data.

Behavioural effects

A.6 The costings allow for the following behavioural effects:

- reduced contributions by those directly affected. This is generally neutral on income tax liabilities, but it brings forward some yield as in some cases there will be increased tax receipts through PAYE in-year on higher cash earnings. It also increases National Insurance Contributions;
- increased contributions by those with contributions below the AA who expect to exceed this level in the future;
- rebalancing of contributions between years by those with contributions that currently fluctuate either side of the AA; and
- an allowance for labour supply effects and tax avoidance, using a Taxable Income Elasticity methodology.

In total these behavioural effects are estimated to result in a loss of yield of £500m-600m annually, depending on precise policy specification.

Costings for a reduced annual allowance

A.7 Using the methodology described, the yields from a reduced AA under the assumptions of the four illustrative examples are as follows:

Table A.2: Exchequer impact (£m)

| | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 |
|---------------|---------|---------|---------|---------|---------|
| Example (i) | 0 | 1,200 | 4,800 | 5,000 | 5,300 |
| Example (ii) | 0 | 900 | 3,600 | 3,700 | 3,900 |
| Example (iii) | 0 | 900 | 3,900 | 4,100 | 4,300 |
| Example (iv) | 0 | 600 | 2,900 | 3,000 | 3,100 |

A.8 All these costings are provisional and specific assumptions may change, for example as a result of improved understanding of behavioural responses through our discussions with experts.

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

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