IMPLEMENTING THE RESTRICTION OF PENSIONS TAX RELIEF: NAPF SUBMISSION TO THE HMT/HMRC CONSULTATION

Executive Summary

- The NAPF welcomes the Coalition Government's decision to adopt a tax regime based principally on a reduced Annual Allowance of c.£40,000 as a thoughtful new approach which we believe will continue to support good workplace pension provision in the UK.
- We are particularly supportive of an approach that, in principle, we believe will best meet the Government's financial objective of generating additional tax yield to help pay down the current deficit while also being fair to all types of UK pension savers.
- We do however have some concerns regarding the detailed implementation of the reduced AA approach particularly regarding the impact on DB schemes. Our specific concerns are:
    - The inclusion of past service (prior to 6 April 2011) will give rise to an inconsistency of the treatment of deemed contributions between DB and DC schemes and could result in DB members being unduly penalised and subject to a disproportionately higher tax charge;
    - The retention of the Lifetime Allowance (LTA) over the longer term is inconsistent with the reduced AA approach and could lead to some individuals incurring double (or even triple) taxation in respect of pension benefits;
    - A failure to exempt retirements on permanent incapacity from the reduced AA assessment could mean a significant tax charge being imposed on individuals who are not expected to work again during their lifetime;
    - Similarly those individuals being made redundant could suffer a tax charge because of a 'one off' earnings spike as a result of unreduced retirement benefits being paid early;
    - The inclusion of deferred member benefits within the new tax regime would be retrospectively unfair to individual deferred members and administratively burdensome for schemes to implement.
    - That the restriction of tax relief on employee pension contributions to a cap at 40% relief would remove the 'core' EET principle and introduce an unnecessarily complex two tier pensions tax system within the UK.

We are keen to work with HM Treasury to resolve these issues of detail and reiterate our support for the Government's proposals.

1. Introduction

1. In March 2010, in response to the previous Government's pensions tax consultation *Implementing the restriction of pensions tax relief,* the NAPF put forward alternative radical proposals for a significant reduction of the Annual Allowance (AA) from £255,000 down to £45,000. The NAPF has continued to argue the case for a regime which offers good practical incentives and protection for savers but which also allows employers respite from further unnecessary regulation. The NAPF's alternative proposal was grounded in familiarity and simplicity by the introduction of a lower AA of £45,000 which could potentially raise additional tax revenues from reduced pension tax relief being given but which still includes sufficient incentives for the vast majority of scheme members to continue pension saving through registered pension arrangements.

2. The NAPF therefore welcomes the Coalition Government's decision, announced in the Emergency Budget in June 2010, to adopt a tax regime based principally on a reduced Annual Allowance. This is an important change of approach, and one, we believe, is most likely to continue to support good workplace pension provision. However, the detailed implementation of this approach will be critical if it is to both meet the Government's financial objective of generating additional tax yield as a contribution to paying down the deficit whilst also meeting the industry's objectives of supporting good quality pensions in a way that is fair to all savers, whether in DB or DC schemes, and which is simple for schemes and individuals to administer. The NAPF is keen to work with HM Treasury on these issues of detail. In this regard, we would encourage HMT to be both open and transparent with stakeholders and to demonstrate the impact on yield of the individual proposals set out in the discussion document.

3. We are also pleased that the Government is building its proposals around an Annual Allowance of £40,000. By setting an Annual Allowance towards the higher end of the range announced in the Emergency Budget, the Government will help to ensure fairness between DB and DC schemes and support pension saving. These proposals rightly aim to set pensions tax policy over the long term. This means that Government must also consider the effects of limiting pensions tax relief through the Annual Allowance over the long term. In order that the impact of the current proposals remains focused on the higher paid, it will be important that the Annual Allowance is increased each year in line with inflation.

About The NAPF

4. The NAPF is the leading voice of workplace pension provision in the UK. We represent some 1,200 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. Ten million working

people currently belong to NAPF member schemes, while around 5 million pensioners are receiving valuable retirement income from those schemes. NAPF member schemes hold assets of some £800 billion, and account for over one sixth of investment in the UK stock market. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

2. Specific Issues of Concern

5. Whilst supporting the overall approach, the NAPF has a number of concerns regarding the fairness and possible additional administration burdens and reporting requirements resulting from the proposed approach to implantation which may impose further costs on pension schemes and employers. Our specific areas of concern are:

   - inclusion of past service in DB schemes in the pension input amount calculation;
   - LifeTime Allowance (LTA)
   - ill health Retirement;
   - DB enhancements on early retirement (e.g. redundancy);
   - deferred members; and
   - marginal rate of tax relief.

Inclusion of DB Past Service in the pension input amount calculation

6. The Government's proposals will calculate the pension input amount in DB schemes on the basis of total service and will therefore include pre 6 April 2011 service prior to the proposed introduction of the new tax regime.

   NAPF Concerns: *The inclusion of past service (pre-6 April 2011) service is a significant concern:*

   - *It gives rise to inconsistencies of treatment DB and DC arrangements. For DC schemes, deemed contributions will be the actual amounts paid by employers and employees after 5 April 2011. The impact of accrued contributions and investment returns received on those historical contributions is disregarded. We believe the same should be the case for DB schemes.*
   - *The inclusion of total accrued service is likely to result in DB members with significant pre-6 April 2011 service being unduly penalised and subject to a disproportionately high tax charge. We are particularly concerned that this could impact people on lower earnings, as we support the Government's objective that the Emergency Budget proposals should be*

focused on higher earners. Through its pension fund members, NAPF has undertaken some analysis of the likely impact on scheme members of including past service entitlements in the pension input amount. As can be seen for the examples in Annex A, the inclusion of past service could bring into the scope of the new regime basic rate tax payers on incomes as low as £26,000, ie basic rate tax payers. We believe a much fairer approach would be to treat DB in the same way as DC, ie to use the pension in the year of accrual and to disregard past service. We are mindful if the Government's desire to use the current tax proposals to general additional fiscal yield. We are therefore keen to work with Government to find an acceptable solution. To this end we urge the Government to set out in detail the expected tax yield split between DB and DC, and to specify the amount of yield generated by the inclusion of past service.

- *If the Government is minded to include all past service within the pension input amount calculation we believe that the Government should incorporate the revaluation of accrued service into the calculation process as this would help to neutralise the overall impact for DB scheme members.*

Lifetime Allowance (LTA)

7. Alongside the introduction of reduced AA the Government has proposed the retention of a reduced Lifetime Allowance (LTA) of £1.5m from 2011.

NAPF Concerns: *We recognise the Government's immediate need to use the current pensions tax proposals (including the reduction in the LTA from £1.8 to £1.5 million) to generate additional tax yield to address the country's current financial situation. And we accept that for the relatively few individuals whose retirement benefits already exceed £1.5 million in April 2011, some further restriction on benefits is logical. However, the emphasis on a significantly reduced Annual Allowance as the primary mechanism for preventing excessive tax-relieved saving in pensions means that the need for a Life Time Allowance falls away.*

Over the longer term the Government should remove the LTA which is no longer consistent with the reduced AA approach. This would bring much welcome simplicity to the pension landscape whilst not jeopardising concerns over excessive build up in pensions.

Failure to do so would mean some individuals paying tax on pension contributions, paying a LTA recovery charge and then paying tax on their pension once in payment, in effect triple taxation.

Ill health Retirement

8. We welcome the Government's decision to exempt from the reduced AA test cases of serious (terminal) ill heath retirement. However, we have significant concerns over the view proposals that all other retirees on medical grounds could be included for assessment under the new proposals.

   ***NAPF Concerns**: Ill health retirement on grounds of permanent incapacity is normally approved by scheme trustees, on the basis of expert medical advice, in accordance with a transparent retirement procedure. Permanent incapacity benefits are expensive for schemes to provide and should not be regarded as easy to manipulate and a mechanism for tax avoidance, The NAPF does not support HMT's suggestion that equivalent permanent incapacity benefits can be provided via PHI as this method will be less efficient and more expensive than being provided directly from the pension scheme.*

   We firmly believe that it would be unduly harsh to refuse an exemption for ill health retirement benefits paid on permanent incapacity as the tax charge at the time of retirement could be significant for individuals who are not expected to work again during their lifetime. We believe the nature of retirement on grounds of permanent incapacity with the restriction on future earnings capacity distinguishes this type of retirement from all other types of early retirement. Consequently, before deciding on which exemptions from the reduced AA test they will permit the Government must have a clear understanding of all relevant legislation and practice which underpins the ill health retirement process.

DB enhancements on early retirement

9. The Government has proposed that enhancements within DB schemes eg the removal of the actuarial reduction on early payment of pension will need to be subject to the reduced AA test as enhancements are usually funded through additional employer contributions.

   ***NAPF Concerns**: We believe that this approach is a particularly blunt 'correction' in the year of retirement as it could produce an excessive and disproportionate tax charge in respect of the unreduced early payment of benefits eg on redundancy. The Government should consider a limited system of carry forward (to a maximum of 5 years) of future unused amounts of the permitted reduced AA which would assist those individuals who exceed the reduced AA in a specific year because of a 'one off' spike when retirement benefits crystallise. This type of flexibility would demonstrate an innovative approach which could help alleviate a large tax charge for those individuals who in normal circumstances would not have been expecting to exceed the reduced AA.*

Deferred Members

10. The Government has invited views as to whether accrued benefits held by deferred members could be included for assessment against the reduced AA under the new proposals.

    NAPF Concerns: *In common with others, we believe that deferred members should not be brought into scope for the reduced AA test as benefits already calculated at date of leaving and subsequently revalued should be protected and not be subject retrospectively to a new tax regime. Furthermore the significant number of deferred members within UK pension schemes would create a major administration and communication exercise if schemes were required to provide further information to all deferred members.*

Marginal Rate of Tax Relief

11. The Government has invited views as to whether under the new regime tax relief on employee pension contributions should be capped at a maximum of 40% from 6 April 2011.

    NAPF Concerns: *As HM Treasury is aware, one of the NAPF's concerns with the previous Government's proposals was that, by restricting tax 'relief' on contributions, individuals could face double taxation. Restricting tax relief to 40%, as suggested in the consultation document risks repeating that mistake. Not only would it represent a departure from the 'core' EET principle that underpins the UK's approach to pensions taxation, it could also encourage high earners to seek more tax efficient saving solutions for earnings above £150,000 with the result that although less pensions tax relief will be granted, HMT's overall expected yield is unlikely to be achieved. This proposal would also create a 'two tier' tax system and introduce additional unwelcome complexity for both schemes and individuals, in contradiction to the statements set out in the Coalition agreement that future changes should not impose additional administrative or compliance burdens on employers or occupational pension schemes.*

3. Conclusion

12. The NAPF has been foremost in arguing the case for a pensions tax regime which offers good practical incentives and protection for savers but which allows employers respite from further unnecessary regulation and is operationally simple and easy to understand by all. While continuing to support the principle of a reduced AA as a sensible reform proposal we will continue to raise, for further discussion, all areas of valid concern as outlined in this response.

NAPF
August 2010

Consultation Questions

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.**

   The introduction of regulations which permit UK pension schemes the flexibility to unwind benefits (and refund contributions where appropriate) which unexpectedly exceed the reduced AA limit because of a 'one off' spike would demonstrate a pragmatic approach by Government. Moreover, given that the number of individuals who are in a position to 'manipulate' benefit accrual to reduce the impact of the reduced AA is minimal we believe that the issue of deliberate avoidance is unlikely to be material and should not be overplayed to justify further regulatory changes. Consequently we do not accept that any additional prescriptive changes to those set out in the discussion document are necessary.

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.**

   To counteract the possibility that potential past service enhancements may not be reflected in the design of the flat rate factor HMT could identify a range of benefits as base criteria (e.g. NRA to age 60, pension increases capped to RPI/CPI or specific set amount, 2/3rds maximum dependant's pension) and any scheme benefit changes which are more generous than these base criteria would need to be separately assessed against an additional enhancement factor to ensure that they are correctly valued. In reality the significant long term cost of granting enhanced pension benefits is likely to be a sufficient deterrent to such past service improvements being made by sponsors and trustees.

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.**

   The NAPF believes that deferred members should remain out of scope of these tax changes and not be subject to assessment against a reduced AA because:

   - Benefits already accrued and calculated at date of leaving should be protected from future retrospective changes to tax treatment. It would therefore be unfair to include deferred members within the reduced AA test; and

   - Given the significant number of deferred members within UK pension schemes their inclusion within the reduced AA assessment process would create a major administrative and communication burden, in terms of information delivery, for those schemes

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 the risks of avoidance, including 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.**

   The Government has proposed excluding death benefits and those benefits payable on grounds of serious ill health, where future life expectancy is seriously limited, from the test against the reduced AA and we endorse this proposal. However, we believe this exemption should be extended more widely to include ill health early retirement on grounds of permanent incapacity.

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.**

   We believe it is important to recognise that many early retirement benefits payable on redundancy are granted to individuals who are undergoing a major change to their circumstances ('life changing event') and it is therefore much too simplistic to see this event purely as an opportunity for tax avoidance. While an exemption for this type of early retirement benefits may not be appropriate the Government should work with the pensions industry to establish a suitably rigorous definition of redundancy which would eliminate the scope for manipulation of the early retirement process and possible tax avoidance. The introduction of a carry forward facility to use up future AA would be an innovative approach which could specifically help those individuals who face an unexpected tax charge as a consequence of a 'one off' spike produced by early payment of enhanced early retirement benefits.

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.**

   The introduction of a new test based on a reduced AA rather than against an overall LTA amount changes the basis of assessment for maximum pension entitlements and throws into question the need to maintain the LTA after 5 April 2011. If the Government wishes to maintain the LTA post 5 April 2011 (other than for those individuals who have already exceeded the LTA) to meet short term fiscal requirements we propose that once the reduced AA regime becomes established the Government should remove the LTA as being no longer consistent with the new regime and a welcome simplification to the UK pensions landscape.

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.**

   The restriction of tax relief to 40% would introduce further unnecessary complexity into the system as those individuals with income of £150,000 or more ('high earners') who pay income tax at 50% would now be treated differently from the rest of the UK population in terms of tax relief on employee pension contributions. Moreover those individuals who would be affected by this proposed change may defer pay increases or request that pensionable salary be capped at £149,999 to avoid any discrepancy regarding pensions tax relief. This proposal would seem to be in conflict with the notion of simplicity that underpins the Government's tax relief changes and the NAPF would support tax relief being retained at an individual's marginal rate.

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.

The NAPF is aware that UK employers have been reviewing their DB schemes as a result of funding issues, de-risking initiatives and increased pension cost for several years. General changes (including the possible introduction of a reduced AA from April 2011), specific scheme circumstances and market trends toward career average or defined contribution pension provision will continue to drive the future redesign of UK DB pension arrangements. We do not, therefore, see the need for further prescriptive Government regulation to assist the ongoing process of scheme redesign.

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.

We believe this to be a question of how easily schemes could amend existing processes to produce calculations to a new common date of 5 April. This may be a greater issue where available 'in house' system capability is limited or particularly for those pension schemes who outsource administration to third party providers who, given capacity issues due to multiple clients, may face more immediate problems in making the adjustment in 2011/12. A sensible compromise would be to allow any date in the period between 31 March (a common scheme year end date for UK pension schemes) and 5 April to serve as the pension input date.

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.

See response to Question 11 below

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

With regard to appropriate reporting requirements UK Schemes would certainly endorse the comments within paragraph 1.6 of the HMT discussion document " The system should be reasonably simple, both for individuals to understand and use, and for schemes and HMRC to administer, and minimise administration burdens while ensuring effective compliance" . In order to meet these objectives for a regime timetabled to begin in April 2011 the Government must place simplicity at the core of the final policy and we reiterate our view that the exclusion of deferred members will be an important contribution toward achieving this simplicity. Transitional arrangements in 2011/12 would need to recognise any delay in compliance issues while scheme processes are updated in year one of the new regime.

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.**

    As with question 9 above we regard this as primarily an issue of the adaptability of existing processes including those within employer payroll departments to be able to supply information to meet the timetable for submission of Self Assessment tax returns. The issue of available in house system capability in smaller schemes and possible third party delays where the work is outsourced, because of possible capacity issues, will be key to the timely provision of relevant information.

    Rather than regulate for UK pension schemes to have responsibility for information and reporting (as implied in questions 10 & 11 above) the Government may consider placing any legal obligation for compliance onto the employer to request the information. This approach would place the employer at the heart of the compliance process and should help improve information gathering and reporting for the pension input amount calculations.

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.**

    We believe it would be impractical to expect the administrators of an overseas pension scheme to have responsibility for UK tax compliance requirements. The provision of this information should become the responsibility of the principal employer in the UK.

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Annex A

Reduced AA : impact of past service accrual

Scheme A

Accrual Rate: 1/50ths

AA	Conversion factor 10		Conversion factor 14		Conversion factor 20	
	Inc past service	Excl past service	Inc past service	Excl past service	Inc past service	Excl past service
	Lowest salary	Lowest salary	Lowest salary	Lowest salary	Lowest salary	Lowest salary
£40,000	53,000	200,000	38,000	143,000	26,000	100,000

Scheme B

Accrual Rate : 1/54ths

AA	Conversion factor 10		Conversion factor 14		Conversion factor 20	
	Inc past service	Excl past service	Inc past service	Excl past service	Inc past service	Excl past service
	Lowest salary	Lowest salary	Lowest salary	Lowest salary	Lowest salary	Lowest salary
£40,000	50,000	240,000	46,000	163,000	36,500	111,000