Securing the future of pensions

HMT/HMRC discussion document options to meet high annual allowance charges from pension benefits: a response by the National Association of Pension Funds

January 2011

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Options to meet high annual allowance charges from pension benefits: 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 (AA) initially of £50,000 as an 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 generally being fair to all types of UK pension savers.

Concerns with the Government's proposals

- We do however have some concerns regarding the detailed implementation of the reduced AA approach, in particular regarding proposals to allow one off or periodic pensions tax charges to be mitigated by deduction from pension benefits. Our specific concerns are listed below:
    - The introduction of mitigation strategies which increase the complexity of scheme administration and will increase scheme costs. Some commentators have suggested that each individual case could cost c£2,500.
    - The additional complexity and cost associated with the mitigation proposals is at odds with the Coalition Government's aim to minimise the burden on business and help support and reinvigorate occupational pension schemes as outlined in the Coalition Agreement;
    - To ensure equal application of mitigation options across all pension schemes;
    - A lack of clarity on exemptions from mandatory requirements to allow payment from pension benefits for those schemes which demonstrate a commitment to modify their schemes' benefit accrual to fit within the revised AA limit;
    - Provision of a threshold at a level of c£2-6,000 which could introduce significant additional administrative burdens on pension schemes as more members exercise this option to meet tax charges.
    - That trustees are being mandated to undertake an additional duty to remit personal tax to HMRC which is not directly related to the pension scheme for which they have fiduciary responsibility.

Recommendations

- The Government needs to implement these proposals in such a way as to minimise burdens on pension schemes as per its commitment in the coalition agreement. To help alleviate the impact on schemes through the introduction of these proposals the NAPF recommends that:
    - The Government should set the threshold above which individuals can access their pension benefits to pay the tax charge at £10,000.
    - The Government should uprate any threshold by prices or the growth in national average earnings to ensure the threshold maintains its value in real terms.

- Scheme trustees and administrators should be able to pass any costs onto members who exercise the option of accessing pension benefits to pay the tax charge.
- The Government should update the AA either by earnings or prices to ensure the numbers of individuals likely to access the mitigation option is minimised.
- If the Government is going to introduce a requirement that schemes allow individuals to meet tax charges from pension benefits then this should apply to all types of scheme.
- The threshold above which individuals can pay the tax charge through pension benefits should be set at £10,000 (20% of the AA). This should reflect the key policy intent of restricting pensions tax relief to those on higher incomes and /or penalising excessive build up of benefits through tax charges on those better positioned to pay from personal income.
- An exemption from the requirement to allow the individual to opt to pay from the scheme should be provided as the primary incentive for all pension schemes to reassess their design to restrict annual pension accrual up to the limit of the Annual Allowance.
- An exemption from the mandatory requirements to provide a mitigation option should be granted to all DB schemes closed to future benefit accrual.

We remain committed to working with HM Treasury and HMRC to resolve these issues to find sensible and practical solutions to our concerns, and reiterate our general 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 to enable the Government to meet its fiscal objectives through a significant reduction of the Annual Allowance (AA). Throughout 2010 the NAPF continued to argue the case for a regime which offers good practical incentives and protection for savers, but which also allows employers and pension schemes respite from further unnecessary regulation. The NAPF's alternative proposal was grounded in familiarity and simplicity: the introduction of a lower AA could raise additional tax revenues from reduced pension tax relief, but still provided sufficient incentives for the vast majority of scheme members to continue pension saving through registered pension arrangements.

2. Following the change of Government in May 2010 the NAPF has welcomed the Coalition Government's decision, announced initially in the Emergency Budget in June 2010, to adopt a tax regime based principally on a reduced Annual Allowance. This important change of approach was set out in detail in *'restricting pensions tax relief through existing allowances: a summary of the discussion document responses'* issued on 14 October 2010 which confirmed the reduced AA at £50,000. It is a policy 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 meet both 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 remains keen to work with HM Treasury/HMRC on these key issues of detail.

About The NAPF

3. 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

4. The NAPF supports the overall approach adopted by the Coalition Government. However, we have a number of concerns regarding the fairness and additional administration burdens and reporting requirements resulting from the proposals for mitigation which would impose further costs on pension schemes and employers. Our specific areas of concern are:

- **Mitigation strategies for pensions tax charges** - The introduction of a mandatory provision from April 2011 to compel pension schemes to allow members faced with a tax charge under the post 2011 regime to meet this payment from pension benefits. We believe this approach to mitigation will introduce further complexity and increase administration burdens on UK pension schemes.
- **Additional administrative burdens on already overregulated schemes** - While the NAPF welcomes the new Government's proposals, the significant additional burdens potentially created by the mitigation options run contrary to the spirit of the Coalition Agreement commitment not to place any additional burdens on UK pension schemes but aspire to reinvigorate workplace pensions.
- **Equity of treatment – DB and DC schemes** - If declared mandatory, the option to meet tax charges from pension benefits should be extended from DB schemes only as is currently proposed to all types of DC schemes including Additional Voluntary Contribution (AVCs) plans.
- **Appropriate threshold for payment from pension benefits** - Within the Government's proposals the trigger point for payment of tax charges via the pension scheme has potentially been set too low, increasing the likelihood of members requesting the scheme to pay the tax charge.
- **Exemption from the mandatory requirements** - DB pension schemes that make the necessary adjustments to yearly benefit accrual to stay within the lower AA limit should be exempt from the requirements to allow members to pay the charge from the pension scheme. This should also be the case for those schemes closed to future benefit accrual.
- **Trustee responsibility to remit individual tax charges to HMRC -** The issue of whether (or not) trustees should have any involvement in the collection and remission of personal tax charges which are unrelated to the tax matters of the pension scheme for which they have fiduciary responsibility.

Each of these specific concerns and the NAPF's proposals to rectify or minimise those concerns are set out in more detail below.

Mitigation Strategies for pensions tax charges

5. The Government's proposals will introduce a mandatory requirement to allow individuals the option to meet tax charges - above a prescribed level - from their pension benefits.

NAPF Concerns*: We believe the mandatory requirement for pension schemes to offer a payment facility to meet tax charges under the post 5 April 2011 regime via the scheme will introduce even greater complexity and additional administration processes for UK schemes.*

The Government has indicated that tax charges must be 'manageable' - a term not defined - from personal income but has proposed a range of £2-6,000 as the legitimate starting point for payment via the pension scheme.The introduction of a potentially much lower threshold than *envisaged by the original policy proposals for 'scheme pays' (December 2009) reinforces the impact that the inclusion of legacy DB service has on the pension input amount calculation and highlights a remaining policy flaw regarding 'benefit spikes' (eg on promotion or enhanced early retirement) which could give rise to significant tax charges. These charges which will not all be negated by the three year carry forward easement although this facility should minimise the number affected on moderate earnings. If this mitigation proposal is introduced the Government should uprate the threshold by prices or the growth in national average earnings and should commit to a periodic review in the light of actual experience of the number of scheme members using this option to meet tax charges. The Government's policy intention was to restrict tax relief to those on higher incomes and penalise via tax charges excessive build up of pension benefits. We propose that the threshold should be set at £10,000 (20% of the AA) as the majority of individuals who use this mitigation option will be on high incomes and will be better positioned to meet the tax charges from personal income.*

Recommendation 1: The Government should set the threshold above which individuals can access their pension benefits to pay the tax charge at £10,000

Recommendation 2: The Government should uprate any threshold by prices or the growth in national average earnings to ensure the threshold maintains its value in real terms

The NAPF has expressed concerns in earlier consultation responses regarding the option to meet payments in real time (formerly scheme pays). However, having considered the two principal mitigation methods proposed in 'Options to meet high annual allowance charges from pension benefits' both of the options will bring additional administration challenges (burdens) for pension schemes. Given this, our main consideration is to ensure that whichever option to meet a tax charge from pension benefits is introduced the process that underpins it is as 'pension scheme friendly' as possible ie based on simplicity, easy to understand and deliver.

Additional administrative burdens on overregulated schemes

6. In its *Coalition Agreement (May 2010)*, the Government pledged to "simplify the rules and regulations relating to pensions to help reinvigorate occupational pensions, encouraging companies to offer high-quality pensions to all employees".

NAPF Concerns: *We recognise the Government's immediate need to use the pension tax proposals (including the reduction in the Life Time Allowance (LTA) from £1.8 to £1.5 million) to generate additional tax yield to address the country's current financial situation. However, by introducing the option to mitigate pensions tax charges through the pension scheme the new arrangements place further administrative requirements onto schemes which are at odds with an aspiration to minimise burdens on business, simplify administration and thereby help to reinvigorate workplace pensions. Although the estimated number of individuals likely to opt for mitigation through the pension scheme is expected to be small initially, given the likely complexity of this approach those affected will require bespoke communications and possibly even provision of independent financial advice regarding the impact on their pension scheme benefits. As schemes will be under* *a mandatory obligation to undertake extra calculations and provide additional information to affected members who request this option, trustees and administrators should have the option to charge members a fee for access to this mitigation option.*

Moreover, the fact that the draft regulations specify that the Annual Allowance will remain fixed at £50,000 until 2015/16 is likely to increase the number of individuals within scope for higher tax charges and as a consequence potentially increase the total number wishing to meet those charges via deduction from pension scheme benefits. The Government should therefore introduce an uplift either pegged to prices or the growth in national average earnings rather than keeping the AA fixed at a flat rate of £50,000 for several years.

Recommendation 3: Scheme trustees and administrators should be able to pass any costs onto members who exercise the option of accessing pension benefits to pay the tax charge.

Recommendation 4: The Government should update the Annual allowance either by earnings or prices to ensure the numbers of individuals likely to access the mitigation option is minimised.

Equity of treatment – DB and DC schemes

7. Although DB schemes will have a mandatory obligation to provide a mitigation option via the scheme if a contributing member requests that option, the Government has left open the question of whether members of other types of pension scheme (notably DC) should be permitted to use this option. This is principally because it should be relatively easy for members of such arrangements not to be in breach of the new AA of £50,000.

***NAPF Concerns**: Whilst it is true that members of 'pure' DC schemes should be able to 'aim off' (target) combined employee/employer pension contributions to ensure they stay within the new £50,000 AA limit, DC schemes are not always stand alone arrangements and can also be provided as a top up pension particularly as a vehicle to contribute toward money purchase Additional Voluntary Contributions (AVCs) alongside ongoing DB scheme accrual. Recent ONS data indicates that c.300,000 -330,000 individuals within DB schemes contribute towards money purchase AVCs. This figure indicates considerable scope for individuals affected to meet tax charges by disinvesting funds from their AVC 'pot' which would be a far simpler administrative process to implement and easier for individuals to understand the impact on their pension benefits.*

Consequently given the interaction between DB and DC benefits in UK pension provision we firmly believe that in order to ensure equitable treatment and a consistent approach that all types of pension scheme should be able to offer the opportunity to meet tax charges from pension scheme benefits.

Recommendation 5: If the Government is going to introduce a requirement that schemes allow individuals to meet tax charges from pension benefits then this should apply to all types of scheme.

Appropriate threshold for payment from pension benefits

8. The Government has proposed that individuals should be obliged to meet a de minimis tax charge of £2,000 from personal income and has suggested that the trigger point to allow payments to be met from a pension scheme should fall within the range of £2-6,000.

   ***NAPF Concerns**: We accept that the suitability of a particular threshold can always be viewed as arbitrary. However, a scale of £2,000 - £6,000 appears to be too low with the likely consequence that pension schemes will receive an increased number of requests from members to explore and implement this mechanism as a means of meeting the tax charge, particularly if no indexation is given on the AA before 2015/16 (see 6 above). Although the option to pay from the pension scheme is a member choice, the fact that the trigger point is set especially low implies that HMRC prefer to put the emphasis on pension schemes to collect this charge rather than through their own existing mechanisms for collecting additional tax due under the self assessment procedure.*

Exclusion from the mandatory requirements

9. The Government has suggested that some limited exclusions from the mandatory requirement to allow payment from scheme benefits will be permitted, but (excluding schemes already in the Pension Protection Fund) has provided no further detail or relevant criteria for exemption.

   ***NAPF Concerns**: We recommend that exemption from the mandatory requirements should be provided as the primary incentive for all pension schemes to reassess their design to restrict annual pension accrual up to the limit of the Annual Allowance. This approach to restrict annual accrual chimes with the Government's key policy aim within these tax changes which is to restrict the amount of relief being given to pension savings. However, the Government should recognise that scheme design changes of this magnitude cannot be introduced overnight as trustees and scheme managers will need to obtain relevant professional actuarial advice, consult with scheme members and communicate the proposed changes effectively. Moreover, those DB schemes closed to future accrual should also be exempt from any mandatory requirements as members will not be able to build up any future DB benefits to exceed the revised AA.*

Recommendation 6: An exemption from the mandatory requirements to provide a mitigation option should be provided as the primary incentive for all pension schemes to reassess their design to restrict annual pension accrual up to the limit of the Annual Allowance

Recommendation 7: All DB schemes closed to future accrual should be granted an exemption from mandatory requirements to provide a mitigation option

Trustee responsibility to remit individual tax charges to HMRC

10. The Government has indicated that where a scheme member elects to meet tax charges from pension benefits the trustees of DB pension schemes will have responsibility to remit the payment to HMRC in accordance with a draft timetable set out in the discussion document.

    ***NAPF Concerns**: We have particular reservations that under these proposals pension scheme trustees will be required to make payments to HMRC which are completely unrelated to the pension scheme itself. Consequently the trustees, via the Accounting for Tax process, will become the mechanism for the remittance of tax payments in respect of an individual which are not directly related to his/her membership of the pension scheme, but are a private matter between the individual and HMRC. This proposal would extend trustee responsibilities beyond normal fiduciary duties and the remission of tax deducted solely from pension scheme benefits (eg pensions in payment and refunds of employee contributions). We are aware that other industry stakeholders share our reservations about pension scheme trustees becoming 'agent's of HMRC with regard to individual tax collection.*

3. Conclusion

11. 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. The predictability of the tax regime for pensions is an important driver in the encouragement of future saving and a period of policy stability in this area would be particularly helpful to UK pension schemes.

12. While continuing to support the principle of a pensions tax regime predicated on a reduced AA as a sensible reform proposal we will continue to raise, for further discussion, all valid concerns regarding mitigation proposals and those issues listed below:

    - The potential for high tax charges on actuarially enhanced late retirement

      Late retirement benefits could be uplifted by c9% per annum to reflect deferred payment of benefits. As such enhancements could lead to higher or unexpected tax charges on eventual benefits paid we recommend that late retirement enhancement should be excluded from the reduced AA test.

    - Whether alignment of the pension input period with the tax year is permitted under current regulation

      We recommend a flexible approach on the alignment of the pension input period (PIP) to either the tax year or scheme year. HMRC has engaged with the pensions industry (including NAPF) through various stakeholder groups, but clarity of regulation regarding PIPs is now required urgently so schemes can take decisions and finalise their own PIP.

- The reduction of the LTA to £1.5m and the form of the new protection regime to ensure no retrospective taxation of individuals affected by the new limit

  We welcome the proposal to defer the reduction in the LTA to £1.5m until April 2012 as this will help with some retirement planning. We reiterate that the clauses in the Finance Bill must protect those savers, who had planned for retirement against a £1.8m ceiling, and are now above the reduced limit of £1.5m from retrospective taxation as this would be inequitable.

- The future indexation of the reduced AA and LTA and by what metric (eg National average earnings or prices.

  We recommend that the new AA and LTA amounts are uprated by either prices or the growth in NAE. This indexation should help to minimise the number of individuals brought into scope for tax charges going forward until 2015/16 (the date that the Coalition Government proposes to review the two limits).

- The future indexation of the trivial commutation limit (previously expressed as 1% of the LTA but now de-linked and fixed at £18,000)

  We also recommend that the trivial commutation limit is similarly uprated by either prices or the growth in NAE. This indexation would continue to allow many individuals to convert small pension amounts into cash and reduce the need for schemes to meet the administrative requirements to pay these trivial pensions either annually or quarterly.

- The future treatment of EFRBS

  EFRBS have been utilised since 2006 to facilitate more efficient retirement planning. We urge the Government to recognise this and (as per the reduced LTA issue) ensure that changes in the rules regarding EFRBS do not impose retrospective taxation on those individuals affected.

NAPF
January 2011

Consultation Questions

1. **The Government's current thinking is that it would be appropriate for individuals to pay the first £2,000 to £6,000 of any AA tax charge from their current income; and welcomes evidence to indicate an appropriate threshold figure**.

   Whilst we acknowledge that any threshold to permit excessive tax charges to be met from pension benefits can be regarded as arbitrary we propose an threshold of £10,000 (ie 20% of the reduced AA) before this option becomes available. Given the likelihood that it will be predominantly those individuals on higher incomes that will be affected, 20% of the reduced AA should be manageable for the majority of individuals who have to meet a tax charge from personal income.

2. **The Government welcomes views and evidence on whether individuals in DC schemes would have need of and / or would make use of a facility to meet AA charges from pension benefits. Views are also sought on whether restricting access to members of DB schemes only creates significant material administrative and communication issues for schemes**.

   As a general point of principle it seems fair and equitable to extend the option to DC schemes. In practice some DC members may only have DC provision above a certain level of pensionable salary (ie a notional salary cap) or may be utilising a money purchase AVC scheme as benefit 'top up' while still accruing benefits in an open DB scheme. Such individuals may choose to meet any tax charge from their DC 'pot'. This option will also be a simpler administrative process, less burdensome practically and should be much easier to communicate to the members involved.

3. **The Government welcomes views on whether there are other exceptional circumstances in which it is appropriate to exempt certain schemes from facilitating payment of AA tax charges, including whether this would differ under the broad options.**

   An exemption could be granted to those DB schemes which are closed to future accrual as the inability to accrue further scheme benefits will mean that members should not have the opportunity to exceed the reduced AA. Pension benefits in schemes closed to future benefit accrual should be regarded as deferred benefits with statutory revaluation being awarded. Those schemes should therefore be exempted from the mitigation proposals.

4. **The Government welcomes views on its proposed approach to multiple pension-holders. That is, that individuals are allowed to elect for a single scheme – in which they are an active member – to meet the AA charges each year; and that where the AA has been exceeded outright in a single scheme in a given year, that is the only scheme that can be elected to meet the liability from their pension benefits.**

We would be very supportive of any measure which can deliver greater simplicity of process and application, help to minimise complexity and reduce the potential for errors and misinterpretation.

5. **The Government welcomes views on whether it would adversely affect schemes, administratively or otherwise, to meet a charge that did not arise exclusively in that scheme.**

   Scheme administrators could have concerns regarding consistency of treatment of benefit adjustments across schemes, particularly given that each scheme could adjust benefits based on different methodology on the advice of their scheme actuary. This more flexible approach could also increase the need for more detailed record keeping – both electronically and in hard copy - to identify the full benefit trail for an individual across all schemes. Communication of revised benefit figures once finalised to all relevant parties will be particularly important under this dual or multi scheme approach.

6. **To inform the overall approach, the Government would be interested to see evidence on the numbers and characteristics of employees or scheme members respondents have identified as potentially eligible to meet AA liabilities from pension benefits.**

   Anecdotal evidence indicates that the number of potential candidates expected to meet AA liabilities from pension benefits could initially be quite low. However, individual personal circumstances and in particular availability of personal income will be a key factor in the decision by individuals to meet any liabilities from pension benefits. Moreover, the size of the charge(s) and the proximity to date of retirement could also be material in how charges are met by an individual.

7. **The Government welcomes views on whether respondents agree that it would be insufficient to report the value of the charge to be offset without explaining the corresponding effect on pension benefits to members; and whether the level of detail and precision required varies across the options.**

   Clarity and the impact on benefits – either immediately or on benefit crystalisation at retirement - will be very important for the particular members concerned. Putting any reduction into context of the expected benefit entitlement will be essential to reduce issues on entitlement at some future point and mitigate against future challenges to trustees and administrators through misinformation. Communication of revised benefit figures once calculated will be a major aspect of the additional administration required for this particular group of individuals.

8. **The Government welcomes views on whether it is necessary for individuals in the year of benefit crystalisation to have access to the option to meet their liability from the pension**

benefit, and if so how to ensure that this process works sensibly for both schemes and members.

On grounds of consistency and equal treatment it seems fair that members should be able to meet charges from scheme benefits in the year of benefit crystalisation. This may be particularly important for those retirees who are hit with either a higher or totally unexpected charge due to a significant benefit ‘spike’ which is not mitigated by the three year carry forward concession. The question of what time period individuals will be permitted in order to settle this charge and collection methodology will also be an important consideration here.

9. **The Government welcomes views on whether there are other circumstances in which the application of either option may need to be given specific consideration?**

   We have no comment to make.

10. **The Government welcomes information that explains how and why these might work differently in practice, and where that leads to different impacts for scheme members, or scheme administration.**

    Both methods of mitigation to meet tax charges from pension benefits as set out in the discussion document bring additional scheme requirements regarding administration, record keeping and in particular communications. The principal practical difference between the two mitigation proposals relates to the sequence in which this additional work has to be undertaken under each option. The communication of the process undertaken and the outcome for pension benefits, to the individuals concerned, will be particularly important under either option.

11. **The Government welcomes views and evidence to indicate where legislating for a standard approach would reduce burdens, or be necessary to ensure that the policy intent is delivered; and whether there are areas where the Government should be even less prescriptive.**

    With regard to less prescription the Government should address the question of an exemption – for trustees to exercise as appropriate - from mandatory requirements to provide a mitigation option from pension benefits for those UK schemes which redesign their DB arrangements in order to restrict annual pension accrual to within the limit of the revised AA. This should also be the case for those schemes closed to future benefit accrual.

12. **The Government welcomes views on any practical or administrative issues that may arise from implementing these options to meet charges from pension benefits, bearing in mind that the Government believes it is necessary to introduce a facility to meet high AA charges**

from pension benefits. In particular it is interested in the benefits and burdens associated with each of the options, and whether there are significant differences between the two.

The answer given to question 10 above reflects our views on this issue.

13. **The Government welcomes views on whether there are particular advantages to this approach of rolling – up AA excesses, rather than AA charges.**

It is likely that excesses over the AA may be more easily identifiable year on year as no calculation to identify the tax charge at an individual's marginal rate would be required. However, if an excess rolled up to reflect the change in the CPI until crystalisation is then treated – for tax purposes - in the same way as an unauthorised payment has been since the April 2006 changes, the tax due is likely to be higher than that levied on rolled up AA charges.

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