HM TREASURY

HM Revenue & Customs

Restricting pensions tax relief through existing allowances:

a summary of the discussion document responses

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1 Introduction

Summary of the new pensions tax regime

To ensure that the system of pensions tax relief remains fair and sustainable, and to protect the public finances:

- From April 2011 the annual allowance for tax-privileged saving will be reduced from its current level of £255,000 to £50,000. Tax relief will be available at an individual's marginal rate. Deemed contributions to defined benefit schemes will be valued using a "flat factor" of 16. Individuals will be allowed to offset contributions exceeding the annual allowance against unused allowance from the previous three years. For those individuals who see a very significant increase in their pension rights in a specific year, the Government will consult on options that enable them to pay the tax charge out of their pension rather than current income.
- The lifetime allowance will also be reduced, from its current level of £1.8m to £1.5m. The Government is minded that the reduced lifetime allowance will operate from April 2012. It is inviting views on the detail of its approach, as set out in this document, including on the relative burdens for schemes and employers of implementation in 2011 compared with 2012.

1.1 The Government provides generous tax relief to save for a pension, to encourage individuals to take responsibility for retirement planning and to recognise that pensions are less flexible than other forms of saving. The cost of tax relief net of income tax on pensions paid doubled under the previous Government to an annual cost of around £19bn by 2008-09.

1.2 The Government confirmed in the June Budget that it is committed to reform of pensions tax relief and would continue with plans that it inherited to raise revenues from restricting pensions tax relief from April 2011. However, the Government had reservations about the previous plans. It felt that this approach could have unwelcome consequences for pension saving, bring significant complexity to the tax system, and damage UK business and competitiveness. These concerns were shared by representatives of the pensions industry and employers.

1.3 The June Budget announced that the Government was considering an alternative approach to restricting pensions tax relief, involving reform of existing allowances. A discussion document on the subject "Restriction of pensions tax relief: a discussion document on the alternative approach" was published in July, inviting views on a range of issues around the precise design of any such regime.

1.4 Throughout the summer an informal consultation was held, with a wide range of pensions professionals, industry bodies, employers and individuals' representatives across the public and private sector engaging with HM Treasury and HM Revenue and Customs (HMRC). 238 written responses were received, 183 of which were from organisations. A full list of those respondents is in Annex D. The Government is grateful to all those who have provided views and participated in discussions, and will continue to work closely with interested parties to ensure that the reform is introduced as smoothly as possible.

1.5 Almost all of the responses to the discussion document welcomed the alternative approach of reforming existing allowances as a more workable way of restricting pensions tax relief, and one which would also preserve incentives to save.

1.6 The Government is clear that reform of existing allowances is preferable to the previous Government's approach. It believes that a regime limiting the amount of tax-privileged pension saving that all individuals are entitled to is fairer and more sustainable than restricting the rate of relief available to individuals above a certain income.

1.7 The Government has committed to making pensions tax relief affordable and to protect the public finances, and wants any reform to be fair and sustainable. The discussion document noted that reform using existing allowances could involve a reduction in the lifetime allowance (LTA) as well as a significant reduction in the AA. The Government has decided to set the AA at £50,000 and the LTA at £1.5m. Taken together, these measures should generate around £4bn annual revenue in steady state, similar to the previous Government's plans.

1.8 This creates a regime that is fair, with the reduced LTA allowing a higher AA to be set than otherwise, which will benefit members of both DB and defined contribution (DC) schemes. This creates a regime that is more sustainable in the longer term.

1.9 A number of features of the existing allowances will need to be revised to ensure that the regime operates fairly and effectively. Chapter 2 sets out the Government's response and further details around the design of the regime, including further issues around the valuation of DB pensions, applying the reduced LTA, avoidance, and exemptions in specific circumstances.

1.10 To assess accruals in DB schemes against the AA, a flat factor will continue to be used, although provision will be made to take some account of the increase in annual accrual attributable to inflation. Following advice from the Government Actuary, the Government has decided that the level of the factor used to value accrual will be 16. The Government intends to design a protection regime that supports those individuals who have already made pension saving decisions based on the current level of the LTA. In order to provide sufficient time to design the protection regime appropriately, the Government is minded to introduce the reduced LTA from April 2012, with the reduced AA coming into effect from April 2011. Annex B sets out further details on the possible design of the protection regime and other features of the reduced LTA.

1.11 Only around 100,000 individuals currently have annual pension savings above £50,000 – around 80 per cent of whom are on incomes above £100,000. The Government anticipates that most individuals and employers will look to adapt their pension saving behaviour and remuneration terms following introduction of the new rules. However, the Government recognises that the restriction of relief will create particular challenges for members of DB schemes. To protect individuals who exceed the AA due to one-off "spikes" in accrual, the Government will allow individuals to offset excess contributions against unused allowance from up to three previous years. Chapter 3 sets out elements of design to support individuals in managing any tax charges that may arise.

1.12 The reduced AA will be introduced from April 2011, with a reduction in the LTA from April 2012. The Government recognises that this is a stretching timetable. The Government's aim is to minimise the burdens on industry associated with the change where possible, provided that this is not compromised by avoidance risks, or unacceptable impacts on individuals. Chapter 4 summarises the Government's response to issues around delivering the restriction of pensions tax relief, and also sets out the rules designed to enable the transition to the new regime. These transitional rules will take immediate effect, and will apply to pension input periods ending in 2011-12.

1.13 Chapter 5 outlines the next steps for engaging with interested parties on the restriction of pensions tax relief ahead of implementation in April 2011. Accompanying this Summary of Responses is draft legislation on core aspects of the regime. Draft guidance has also been published on the HMRC website. The Government has decided to publish this in advance of the draft Finance Bill 2011 in order to enable pensions experts and interested parties as much time as possible to scrutinise the proposed legislation and to prepare for the new regime. The legislation will be included as part of the consolidated draft clauses planned for Finance Bill 2011, due to be published for consultation towards the end of 2010. At this time, the Government will lay the Treasury Order to repeal the measure legislated at Finance Act 2010 (April) that it inherited.

1.14 Answers to each question from the discussion document are given, though in some cases the ordering has changed slightly. These decisions are summarised in Annex A. This document also includes a technical annex (Annex C) which summarises the current assessment of the distributional impacts of the new regime. Full impact assessments will be published alongside the consolidated draft clauses planned for Finance Bill 2011, due to be published for consultation towards the end of 2010.

2 Policy design

2.1 The Government believes that reforming existing allowances is the right way to restrict pensions tax relief. It believes that the previous Government's approach was unworkably complex, and would have severely damaged incentives to save in pensions across organisations – to the detriment of UK business and competitiveness.

2.2 This chapter summarises the Government's decisions on the level of the reduced annual and lifetime allowances, the factor for valuing DB contributions against the AA, exemptions from the AA regime and features to ensure that it is robust against risks of avoidances, and the policy proposals around the LTA.

Setting the level of the allowances

2.3 The Government's overriding objective in restricting pensions tax relief is to protect the public finances. It is clear that a significant reduction in the AA is necessary to achieve this. The discussion document noted that there are a number of variables that could influence the level of the AA, including the rate of tax relief available for additional rate taxpayers, and the level of the LTA.

> The discussion document asked for 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.

2.4 The Government has considered the relationship between the AA and the LTA. Some respondents suggested removing the LTA altogether. However, the LTA remains an important feature of a sustainable and affordable tax regime. The LTA is currently set at £1.8m until 2015-16. This level of LTA is very generous, enabling individuals who reach it to buy an annual pension of around £74,000 a year, in addition to a £450,000 tax-free lump sum.

2.5 Therefore, the Government believes that it is appropriate to reduce the LTA, to the level that it was at A-Day in 2006, in order to deliver a durable system of pensions tax relief. Analysis suggests that a reduction of the LTA to £1.5m could generate around £0.5bn annual revenues, higher than initial estimates.

2.6 Many respondents emphasised the need for the AA to be as high as possible, citing concerns that the regime could otherwise impact on members of DB schemes on moderate ncomes and individuals close to retirement. A £1.5m LTA enables the AA to be set at £50,000, generating around £4bn annual revenues in steady state, similar to the previous Government's plans, and thus protecting the public finances. The Government believes that this will create a fairer and more sustainable regime.

2.7 An AA of £50,000 is a level which far exceeds average annual contributions to pensions, with around 100,000 pension savers making annual pension savings in excess of this level. It will impact on fewer individuals on lower incomes, and provide individuals with greater flexibility to make their annual pension contributions than allowed by a lower AA. **The Government has**

decided that the level of the AA will be set at £50,000 from April 2011, with a reduction in the LTA to £1.5m from April 2012. Beyond the forecast period to 2015-16 the Government will consider options for indexing the level of the AA.

> The discussion document asked for 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.

2.8 Although respondents welcomed the Government's willingness to consider how the level of the AA could be as high as possible, and a small minority were in favour of a cap at 40 per cent, the overwhelming majority of responses were opposed to a cap on the rate of relief. Representatives of pension schemes, employers and individuals all stated that a cap would re-introduce many of the complexities associated with the previous Government's approach to restricting pensions tax relief, and be administratively burdensome.

2.9 The Government is unwilling to introduce unnecessary complexity and burdens into the pensions tax relief system, and intends that the new regime will be as simple to operate and to understand as is possible. **The Government has decided not to cap pensions tax relief at 40 per cent.**

2.10 Contributions in excess of the AA will face a tailored tax charge, reflecting the marginal rate of relief that they have benefitted from.

Valuing DB contributions

2.11 For individuals in DC schemes it is relatively straightforward to determine the level of contributions to be assessed against the AA. However, in DB schemes, individuals accrue a right to an amount of annual pension from pension age. To treat the two in a comparable way, it is necessary to deem the value of notional contributions in a DB scheme. These notional contributions should reflect what would need to be invested in a DC scheme to deliver the extra annual pension accrued in a DB scheme.

2.12 As set out in the discussion document, the Government's provisional view was that the "flat-factor" method should be used to calculate deemed contributions under a reduced AA. Nearly all respondents agreed with the Government that this simple method is preferable to other methods to calculate deemed contributions, and that it would further ease administrative burdens as it is already embedded in the pensions tax system. The vast majority of respondents also acknowledged that the factor should be higher than the current level of 10. The Government sought advice on the appropriate level of the factor from GAD and has published a technical report setting out its considerations and conclusions. **Reflecting this advice, the Government has decided that the level of the factor will be set at 16** – meaning, broadly, that an increase in annual pension benefit of £1,000 would be deemed to be worth £16,000.

2.13 As set out in the discussion document, a number of other issues need to be considered alongside the method for valuing deemed contributions to DB schemes.

> The discussion document asked for 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 different options.

2.14 Respondents acknowledged that these issues are interrelated. All those who responded to the issue of the treatment of deferred members stated a strong preference for carving them out of the regime. Several responses noted that including deferred members would create administrative complexity and could put aspects of the delivery of the regime at risk. The Government believes that it is not appropriate to include deferred pension benefits in the regime i.e. where there is no increase in value attributable to ongoing service and salary, and revaluation of accrued rights is within reasonable limits.

2.15 Alongside this, the Government believes that it is fair to include an allowance for revaluation of accrued rights for active members. The vast majority of respondents were in favour of this. Including revaluation for active members in the DB calculation means that negative accruals may arise. Respondents agreed with the Government's view set out in the discussion document that negative accruals should be treated as zero.

2.16 **The Government has decided that deferred members will be excluded from the regime, that the previous year's benefits will be revalued for active members, and that any negative accruals will continue to be treated as zero.**

Applying the reduced AA in particular circumstances and ensuring that the regime is robust against avoidance risk

2.17 The Government believes that the restriction of pensions tax relief must apply fairly to individuals in different circumstances as far as possible, but that it must also be robust against risks of avoidance.

> The discussion document asked for views on whether exemptions from the AA should be granted in particular circumstances, while managing the risks of avoidance, including the cases of death, serious ill health, redundancy, ill health, transfers and divorce.

> Individuals may receive from their employer a significant increase in the value of their pension in cases of ill-health early retirement or redundancy. The discussion document asked for views on whether it would be appropriate to apply an exemption from the AA in these circumstances.

2.18 The Government is clear that it is not appropriate to apply the AA test in the year of death or the year in which lump sums are paid where individuals are diagnosed with serious (terminal) ill health. An overwhelming majority of responses supported the view that there should be exemptions from the AA test in these cases. It was also argued by respondents that there should be further exemptions for ill health, where the view was expressed that the risk of this being abused could be limited. The Government recognises that in some cases of major ill health, it would be inappropriate for the AA to apply. **The Government will therefore look to exempt ill health benefits from the AA regime. The Government intends to set out further details around how such an exemption will operate, managing the risks of avoidance that it could open up, in the draft clauses planned for Finance Bill 2011, due to be published for consultation in late 2010.**

2.19 However, the Government believes that there are unacceptable risks of avoidance associated with exempting individuals in other circumstances from the regime. Some respondents believed that individuals made redundant should be exempt from the regime, but others stated that there was scope for employers and employees to agree alternative remuneration arrangements in most cases, and that such an exemption could create undue complexity. On balance, the Government does not believe that exemptions should be made for individuals who have been made redundant. Most redundancy packages include an upfront payment, the first £30,000 of which is tax-free. In many cases, the entire redundancy package is less than £50,000. Even where it exceeds the AA limit, individuals generally have a choice over whether to pension all or part of their redundancy package. Where there is little choice the Government expects schemes to adapt to provide individuals with more flexibility in the future. And for the rare cases where large one-off spikes in pension accrual might still occur on account of redundancy, Chapter 3 sets out more detail on how individuals will be given flexibility through the system to manage this. **Therefore the Government has decided that there will be no exemption for individuals in the case of redundancy**.

> The discussion document asked for views on additional pension value being granted to members of DB pensions, and practical options for limiting it, including the option of requiring a CETV calculation or the use of age-related factors.

2.20 The Government has considered the options for taking additional pension value into account, for example in cases of early retirement in DB schemes. **In order to maintain the simplicity of the regime the Government intends to operate a simple flat factor that does not vary to reflect the value of pensions taken from an earlier age.** As discussed in Annex B a case could be made for making the LTA valuation factor age-related, so that the overall value of early retirements is picked up by the pensions tax regime. The Government is minded to make no change and for the LTA valuation factor to remain at 20, but it will continue to monitor this issue.

2.21 **The Government is clear that any exceptional increases in the value of a pension in payment designed to avoid the AA should be caught by the pensions tax regime, and will bring forward legislation setting out how it intends to close off this potential avenue of avoidance.**

2.22 The Government recognises that redundancy payments are often associated with early retirement.

> The discussion document asked for views on the removal of exemptions from the AA test, to ensure that the AA operates effectively and to address the risk of avoidance

2.23 There are currently exemptions from the AA test which would undermine the ability of a reduced AA to restrict pensions tax relief effectively. As set out in the discussion document, the Government is clear that no exemption from the AA test will apply to individuals claiming enhanced protection, and that no exemption will be granted in the year that benefits come into payment. Many respondents accepted the rationale for removing these exemptions.

Applying the reduced LTA

2.24 As explained above, the Government has decided to reduce the LTA to £1.5m. This is estimated to raise annual revenues of about £0.5bn, as individuals with pension pots already above or close to the new reduced level are expected to stop saving in a pension so as to avoid incurring an LTA charge. However, reducing the LTA creates a critical transitional issue for individuals who may have already built up pension pots on the expectation that the LTA would be around its current level of £1.8m.

2.25 The Government intends to design a protection regime that supports those individuals who have already made pension saving decisions based on the current level of the LTA. This protection regime should aim to be relatively straightforward, and to minimise administrative burdens for pension schemes, employers and HMRC. Annex B sets out further details on the possible design of the protection regime, and other features of the LTA regime.

2.26 In order to provide sufficient time to design the protection regime appropriately, the Government is minded to introduce the reduced LTA from April 2012. The Government wishes to discuss the issues set out in Annex B further with interested parties in the coming weeks. It will then look to bring forward draft legislation as part of the consolidated draft clauses planned for Finance Bill 2011, due to be published for consultation towards the end 2010. The Government welcomes views on this approach, and the relative burdens for schemes and employers of implementation in 2011 compared with 2012.

Employer-financed retirement benefit schemes (EFRBS)

2.27 From April 2011, the AA will be set at £50,000, with a reduction in the LTA to £1.5m from April 2012. The Government believes that these allowances represent an appropriate level of tax-privileged saving for retirement. These limits will apply to savings in registered pension schemes, where investment growth on pension savings remains untaxed, and individuals can also benefit from a tax-free lump sum of up to 25 per cent of the total pension right. This means that individuals can benefit from up to £25,000 tax relief a year, and can build up pension wealth sufficient to generate a tax-free lump sum of around £375,000 – with an annual pension of around £62,000.

2.28 These reforms are necessary to deliver a fair and sustainable system, and to protect the public finances. They are expected to deliver around £4bn per year in steady state, similar to the previous Government's plans.

2.29 Under the current rules it is possible for individuals to "top up" their retirement provision through unregistered pension saving arrangements – including EFRBS. These vehicles are essentially a type of employee benefit trust (EBT), and alongside other intermediary vehicles can be used to disguise remuneration and avoid, reduce or defer payment of tax. The June Budget confirmed that the Government will take action against intermediary vehicles, including EFRBS, being used in this way. If EFRBS were not included, employers/individuals would simply switch to use them rather than other forms of trusts as the way to provide immediate cash and other benefits to employees.

2.30 New and extensive use of EFRBS to provide retirement benefits would create significant risk around the yield projected from the restriction of pensions tax relief, and is not in keeping with the principle of creating a more affordable pensions tax regime. Without action, EFRBS would be more tax advantaged than registered pension schemes for pension savings above the AA.

2.31 **In keeping with the need to preserve coherence of the registered pensions tax regime, to protect revenues, and to stop people moving from other EBTs to EFRBS in order to disguise remuneration and avoid, reduce or defer income tax and NICs, the Government cannot support the use of EFRBS in these ways.** It will bring forward legislation as part of the consolidated draft clauses planned for Finance Bill 2011, due to be published for consultation towards the end 2010,that will ensure that funded EFRBS are less attractive than other forms of remuneration. It will also continue to monitor changes in patterns of pension saving behaviour for all other forms of EFRBS, on which it will be ready to act if necessary to prevent additional fiscal risk.

3 Providing flexibility for individuals

3.1 An AA of £50,000 will ensure that the overall pensions tax regime is affordable and sustainable. However, as set out in the discussion document, the Government is committed to supporting hard cases where individuals exceed the AA in one-off circumstances. An AA of £50,000, with a valuation factor of 16 applied to deemed contributions in DB schemes, will mean that fewer members of DB schemes will be affected than if the allowance was lower or the factor was higher. The majority (over 80 per cent) of individuals affected will have incomes above £100,000. The technical annex (Annex C) provides further details on the distributional impacts.

3.2 The Government anticipates that most individuals and employers will look to adapt their pension saving behaviour and remuneration terms following the introduction of the new regime so that annual pension savings are below the AA, meaning that very few people will actually face charges for exceeding the AA. It is relatively simple for individuals who are members of DC schemes to do this, as they have a readily identifiable pension "pot" into which contributions can be controlled.

3.3 However, it is more complex for individuals in DB schemes to keep pension saving under an AA of £50,000. This is because in DB schemes, members are promised a future pension. Individuals will usually see an increase in their future pension promise (their accrued rights) as they progress within the organisation. The size of this increase in pension will be determined by various factors including length of service, scheme accrual rate, level of salary and rate of salary increase. The combination of increases in these factors could create uneven, and potentially substantial, annual increases in pension in certain years. The Government is keen to apply the restriction of pensions tax relief in a way that is appropriate and manageable for members of DB schemes as well as DC schemes.

3.4 This chapter sets out the decisions that the Government has taken to smooth through the tax system the impact of "spikes" in pension savings, and also to allow employers and pension schemes to redesign their arrangements. It also explains that the Government is consulting further on options to provide individuals with flexibility over the payment of tax charges where these are unmanageable out of current income.

Managing spikes in pension accrual

3.5 The nature of DB schemes means that some individuals on moderate incomes could exceed the AA – particularly where they are in final salary DB schemes and see spikes in pension accrual. Some respondents raised concerns that the resulting impacts could lead to unfortunate consequences on retention and remuneration, for example where individuals exceed the AA as a result of being promoted, and face a tax charge as a consequence. The Government is committed to managing impacts on these individuals as far as possible.

3.6 To prevent individuals who would typically have pension contributions below the AA, but who exceed it in a single year, from facing a tax charge as a result, the Government has decided that individuals will be able to carry-forward unused annual allowance from up to three previous years, to offset against contributions in excess of the AA in a single year. This facility will be automatic, so individuals on incomes below £100,000 who are not already within Self Assessment will not have to complete a tax return to benefit from it. Carry-forward will be available against an assumed AA of £50,000 (with revaluation of DB accruals to reflect the new factor 16 and uplifts of opening value) for the tax years 2008-09, 2009-10 and 2010-11 to enable individuals affected in the first years of the regime to benefit from it. The three year carry-forward will ensure that individuals on moderate incomes who may otherwise have been caught by a reduced AA should be able to smooth away any spikes in pension accrual. **The Government has decided that where individuals exceed the AA in a given year, unused allowance from up to three previous years will be carried forward to offset against the excess contributions.**

3.7 Several respondents emphasised the role of the tax system in supporting impacts on individuals. They suggested the use of a mechanism such as carry-forward or carry-back of allowances, as was in place before A-Day, as the Government is proposing. These respondents recognised that there could be administrative challenges associated with these mechanisms, but felt that these would be far outweighed by the benefits of directly helping individuals and providing them with greater flexibility in managing their pension savings.

3.8 In addition to providing this facility through the tax system, the Government is keen to support employers and schemes to make adjustments to scheme design, particularly where these help minimise the risk of individuals facing large one-off increases in pension accrual.

The discussion document asked for views on legislative action that could facilitate appropriate scheme redesign without undermining other aspects of the regulatory regime.

3.9 The Government is content for schemes to smooth pensionable pay and accruals before benefits are put into payment, in order to manage away spikes. However, it will take appropriate action against manipulation in order to avoid payment of tax that is properly due, for example where the smoothing of accrual extends beyond the date at which employment ends.

3.10 **The Government understands that generally, schemes can be redesigned in a way that does not affect accrued rights and therefore that there should not be legislative barriers to doing so.** However, the Government recognises that in some cases scheme trustees may not have the power to amend their rules to smooth accruals in this way. It will therefore continue to engage with interested parties, together with the Department of Work and Pensions (DWP), and will take action if necessary, consistent with its overall principles of simplicity, fairness and protection of the public finances, to support employers and schemes in adapting to the new regime.

Helping individuals to meet tax liabilities that occur

3.11 It will still be possible for individuals to exceed the AA, especially those on high earnings, reflecting substantial annual increases in pension accrual or contributions. This is most likely for those who are long servers in final salary DB schemes with generous accrual rates. Individuals in these circumstances may not be able to benefit from carry-forward, as their typical annual pension contributions may already be close to or above the AA. The Government recognises that, as a result, individuals may face substantial tax charges reflecting contributions significantly in excess of the AA. This is particularly true of high regular contributors who experience a spike in accrual, for example due to promotion. These charges will reflect a significant boost to pension for these individuals. Although such individuals will typically be on high incomes, it is possible that charges will not be manageable out of current income.

3.12 While the Government believes that only a small number of individuals will be in this situation in any year, and it is right that all DB schemes are subject to the regime, as are DC **it**

will consider options for those individuals to pay the charge out of their pension entitlement, rather than current income. This reflects the point that it is a significant increase in that pension wealth that has resulted in the liability.

3.13 One option is for the scheme to pay the charge on behalf of an individual at the point at which the charge arises. However, the Government is aware that there may be administrative challenges associated with this. Another option is for excess contributions above the AA, or tax liabilities, to be "rolled up" until the point of benefit crystallisation. Adjustments could then be made to either pension benefits or lump sum to offset the tax liabilities. From an Exchequer perspective, this would lead to a loss of yield in the short term, to be recouped at a later date. The Government will assess options against their impact on the public finances, and administrative complexity and burdens for schemes and HMRC, while ensuring that the regime remains robust against risks of avoidance.

3.14 This issue relates to the payment of tax charges, the first of which will not be due until January 2013. The Government is keen to provide clarity to individuals, employers and pension schemes as soon as possible on options to offer more flexibility to individuals with charges – reflecting their annual pension savings – that are unmanageable out of current income. However, it recognises that many employers, pension administrators and affected individuals will have views on this issue and therefore will consult with interested parties before taking final decisions in advance of April 2011.

4 Delivery and transition

4.1 The Government recognises that any significant reform to pensions tax relief will inevitably come with some complexity, but it is keen to minimise any burdens associated with implementing the new regime. However, in doing so, the Government cannot compromise the ability of individuals, employers and pension schemes to comply with the new regime.

4.2 This chapter sets out the Government's decisions on necessary rules relating to pension input periods that are required to enable effective transition to the new regime, which will take immediate effect. It also sets out the Government's decisions on the role the pension schemes and employers will need to play in ensuring that individuals have necessary information about their annual pension savings, so that they can comply with the regime; and summarises the guidance that HMRC will be providing to support organisations and individuals.

Pension input periods

4.3 An individual's total annual pension savings within their pension arrangements will determine whether they exceed the AA. Under current rules an individual's pension savings (referred to as pension input amount in legislation) are measured by reference to their benefits accrued within a pension arrangement during an annual "pension input period" (PIP). The PIP is normally a 12 month period generally determined by the scheme, and it is not necessarily aligned to the tax year. As an individual may be a member of more than one pension arrangement, the aggregation of all of their pension input amounts for PIPs ending in the relevant tax year is taken for the purpose of assessment against the AA.

4.4 The Government noted in the discussion document that with a significantly reduced AA there may be a case for aligning the PIP to the tax year, to make it easier for individuals to identify the value of their pension savings. However, it recognised that aligning PIPs with the tax year could create administrative burdens for pension schemes.

> The discussion document asked for views and evidence on the benefits and burdens associated with aligning the PIP to the tax year, for individuals, pension schemes and advisor.

4.5 The majority of responses to the discussion document gave a view on this topic, and responses were mixed. Nearly all respondents acknowledged that aligning the PIP to the tax year would make things simpler for individuals (and to a lesser extent, for advisors). Responses also highlighted that the complexity that currently exists is as much due to a lack of awareness about the PIP as the fact that it may end at a date that is different from the end of the tax year. Several responses commented that for the majority of pension schemes it would not be a significant administrative burden to align PIPs to the tax year. However, there was agreement that for some pension scheme administrators – particularly third party administrators – the costs and resource implications associated with aligning the PIP to the tax year could be very substantial.

4.6 The Government has listened to these concerns and recognises that for a significant minority of pension scheme administrators, it would not be practical to align the PIP to the tax year.

Rather than impose disproportionate administrative burdens on these schemes, **the Government has decided not to change the existing rules around PIPs.** This means that pension schemes (and where relevant, individuals) will continue to be able to determine the PIP, and that schemes will be able to align the PIP to the tax year if they wish to do so.

Transitional rules for PIPs

4.7 The Government has been clear that the new pensions tax regime will apply in the tax year 2011-12. However, for some individuals, the relevant PIP for that tax year may already have begun. To protect the integrity of the new AA for the tax year 2011-12, without penalising those who have already made tax-privileged pension savings under the current AA of £255,000, transitional rules are necessary. **The Government will include legislation in the 2011 Finance Bill (operating with immediate effect) to apply transitional rules taking effect for pension savings on or after 14th October 2010, reflecting the announcement that an AA of £50,000 will apply in the tax year 2011-12.** Even if the Government had decided that PIPs should be aligned with the tax year, similar transitional rules would have been needed, with immediate effect.

4.8 These transitional rules will not affect anyone who has annual pension savings less than £50,000.

4.9 For individuals with PIPs ending in 2011-12 that begin on or after 14th October, pension savings in excess of £50,000 will be subject to the new AA rules. The majority of people have a pension input period starting on 1st January or 1st April (around 2/3rds pension schemes fall into this category), and so will still currently be in a PIP ending in 2010-11.

4.10 However, for those whose PIP ending in 2011-12 has already started, new rules will apply, affecting the pension savings that can be made between 14th October 2010 and the end of the PIP. For these individuals, the test of total pension input amount against the annual allowance will be in two parts.

- The first part of the test applies to pension savings in respect of all PIPs ending in 2011-12 that are made on or after 14th October 2010. Savings in excess of £50,000 will be subject to the AA charge. The factor applied to value contributions in DB schemes for the period on or after 14th October will be 16, with revaluation offset to account for inflation.
- The second part of the test applies to the total pension input amount across all PIPs that end in 2011-12, regardless of whether the savings accrued before or after 14th October 2010. Any savings in excess of £255,000 will be subject to the AA charge. For rights accruing in DB schemes, a factor of 10:1 will apply to accruals up to 13th October 2010, and there will be no revaluation for inflation for active members.

4.11 The box below illustrates how the transitional rules will apply. These rules will apply alongside the existing special annual allowance regime, and alongside the facility under the new regime for individuals to carry-forward unused allowance from up to three previous years. This carry-forward will reduce further the number of individuals subject to any charge as a result of the transitional rules.

Box 4.A: Illustrations of how the transitional rules apply

A is a member of a scheme with a PIP running from 1st January to 31st December 2011. Their 2011-12 PIP under the new rules will be from 1st January 2011 to 31st December 2012 and they are not affected by the transitional rules.

B, **C** and **D** are members of a scheme with a PIP running from 1st June to 31st May. Their first PIP under the new rules started on 1st June 2010 and ends on 31st May 2011. Because their 2011-12 PIP straddles the 14th October, they need to consider the transitional rules.

B works out his pension input amount for the whole of the PIP under the new rules. His pension input amount is £40,000 which is less than the AA of £50,000 so he does not have an AA charge.

C has a PIA of more than £50,000 so needs to apply the transitional rules to see whether she has an AA charge. Her pension input amount for the year ending 31st May 2011 is £70,000 up to 13th October, and £40,000 from 14th October. So C's total pension input amount for 2011-12 is £110,000. Although this is more than the new AA, D does not have an AA charge because her total pension input amount is less than £255,000 and her pension input amount from 14th October is less than £50,000.

D has a pension input amount for the year ending 31st May of more than £50,000 so needs to apply the transitional rules to see whether she has an AA charge. Her pension input amount up to 13th October is £40,000 and from 14th October is £60,000. So D's total PIA for 2011-12 is £100,000. Although D's total pension input amount is less than £255,000, her pension input amount from 14th October is more than £50,000.

However, D had a PIA of £30,000 in 2010-11 so has a deemed surplus AA from that year of £20,000 that is carried forward and set off against her excess AA for 2011-12. Therefore, D does not have an AA charge for 2011-12.

If D did not have any unused allowance from previous years to carry forward, she would face a tax charge on the £10,000 (£60,000 - £50,000) pension input amount saved after 14th October.

Information requirements

4.12 Individuals will require information from all their pension schemes on the level of their annual pension savings, in order to determine whether or not they have exceeded the AA. Currently, it is the responsibility of the individual to gather this information. As set out in the discussion document, there is a role for pension schemes and employers in ensuring that affected individuals have access to this information.

Given the need to support individuals, the discussion document asked for views and evidence on:

- the appropriate reporting requirements on pension schemes to provide statements of the total pension input amount over the PIP.
- the burdens and benefits associated with introducing reporting requirements on schemes to provide this information.
- how quickly schemes could provide this information before the SA tax return is due, and whether employers could help pension schemes provide this information in a timely way

4.13 Responses were mixed between those who felt that a fairly wide reporting requirement was necessary, and those who thought that could be problematic. DC scheme representatives and employers generally acknowledged that providing information about the value of pension contribution was relatively straightforward, and in many cases happened already. Respondents generally felt that if a simple approach was taken to value contributions in DB schemes, it would also be relatively straightforward to provide information on pension input amounts to individuals, although more complex pay and reward structures would create some difficulties. However, a number of respondents felt that it was difficult for schemes to provide information about annual pension savings amounts to individuals, and that the resource implications of doing so would be disproportionate. This would particularly be an issue for those pension schemes that are smaller, or not able to benefit from simple, automated, systems changes.

4.14 The Government believes that ultimately all individuals should have ready access to easily understandable information on the current value of their pension, alongside other information about their overall financial position. It is also keen to ensure that administrative burdens associated with providing this information are proportionate and are minimised where possible. The Government acknowledges that mandating pension schemes to provide information about pension input amount to all individuals, for the purposes of assessing their pension savings against the AA, is not strictly necessary for successful implementation of this policy. However, it is clear that individuals who exceed the AA in a particular arrangement should have this information, and that individuals must be able to access this information if they request it, reflecting the fact that individuals may have several different pension arrangements.

4.15 Therefore, **the Government has decided that where individuals have contributions above the AA in a pension arrangement, pension schemes must provide members with their pension input amount for the relevant year, within six months of the end of the tax year**. Where individuals have exceeded the AA, pension schemes must also provide this information for the previous three years, to allow individuals to take advantage of the carry-forward facility. Without this requirement the carry-forward facility could not be operated.

4.16 **The Government has also decided that where individuals request this information pension schemes must provide their members with their pension input amount by the later of three months from the request and six months from the end of the tax year.** Individuals must request information about unused allowance from previous years if they do not exceed the AA (in which case the scheme must provide it). This enables individuals who are members of multiple pension arrangements to comply with the regime, and also provides opportunity for individuals to plan their pension saving. In keeping with existing rules around the request for full, cash-equivalent transfer valuations, individuals will be entitled to make one such request in relation to each tax year free of charge.

4.17 The Government believes that an information requirement targeted in this way meets the objectives of ensuring that affected individuals can comply with the regime, while ensuring that administrative burdens are minimised on pension schemes as far as possible. The Government recognises that some pension schemes may choose to provide information about pension input amounts to all their members, and welcomes this.

4.18 As highlighted in the discussion document, the Government believes that there is a role for the employer in ensuring that individuals have access to information. Some workplace schemes rely on certain information from the employer in order to calculate the pension input amount. Employers provide this kind of information to DB schemes already, but there are generally no obligations or deadlines associated with it. **The Government has decided that employers must provide information about employees pensionable pay and benefits, and length of service to DB schemes by 6th July following the end of the tax year.** This is should not impose any substantial burdens on employers.

4.19 The Government will bring forward regulations on the information requirements, which will be published in draft in early 2011, and will engage with interested parties around the application of these requirements.

4.20 The Government does not currently believe that there is a need for pension schemes and employers to provide additional information to HMRC on individuals' pension input amounts. However, it will monitor the compliance with the regime closely and may choose to act in future if necessary.

Enabling flexibility in particular circumstances

4.21 A number of responses raised concerns about making the necessary systems changes in order to be able to provide information about pension input amounts. The Government believes that the targeted information requirement is deliverable for the majority of schemes. However it recognises that for some schemes and employers it may not be possible to change their systems and processes in time to provide the information to individuals in the first year. **Therefore, the Government has decided that for the first year only, employers and pension schemes will be given an additional 12 months, i.e. until 6th July 2013 or 6th October 2013 respectively, to provide this information.**

4.22 In these circumstances, if individuals do not have the required information from their pension scheme in time to file their 2011-12 tax return, they will be able to use the existing process within Self Assessment to use an estimated figure in their return. HMRC will provide guidance and support to individuals on how to go about making a reasonable estimate of the pension input amount, to work out if they have exceeded the AA charge. Individuals will then have up to 12 months from the filing date to amend their return to reflect the final figure and pay any additional tax and interest due, or have a refund of any overpaid tax.

The discussion document asked for 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.

4.23 The Government also recognises that there are practical difficulties in requiring overseas schemes to provide this kind of information. **The Government does not, therefore, propose to introduce new rules to require overseas schemes to provide information to members.**

4.24 Some respondents suggested that the AA tax charge should be creditable for double taxation relief purposes. Under current tax rules, the amount brought into to charge to compute the AA charge due does not count as income for any other tax purpose, which means that the charge itself is not creditable for double taxation relief purposes. Reducing the AA does not affect the principles underlying that policy and the tax charge will remain not creditable for double taxation relief purposes.

4.25 The Government recognises that it will be difficult for members of overseas schemes to obtain details of their pension input amount. As for registered pension schemes, HMRC will provide guidance and support to individuals contributing to overseas schemes, on how to go about making a reasonable estimate of the pension input amount, to work out if they have exceeded the AA. The Government will continue to monitor behaviour and keep tax relief for contributions to overseas schemes under review.

Publishing regulations

4.26 The information requirements for pension schemes and employers will be set out in regulations. HMRC will publish these in draft to allow pension scheme administrators and employers time to comment on the regulations before they are laid prior to April 2011. HMRC will also publish draft guidance before April 2011. This will raise awareness of the information requirements and help scheme administrators and employers understand their obligations and make any changes necessary to the systems in order to provide the required information within the prescribed timescales.

5 Next steps

5.1 The views expressed in response to the July discussion document have been fully considered in determining the key features of reform to the pensions tax regime from April 2011. A summary of decisions is included at Annex A. The reduced AA and LTA will be enacted through Finance Bill 2011.

5.2 Chapters 2 to 4 outline how the reduced AA will operate. The Government recognises the importance of detailing the legislative framework as early as possible, and as such, has published the draft clauses alongside this document. HMRC has published draft guidance alongside this, and is taking comments on this draft legislation, to ensure it delivers the Government's stated policy intent.

- While the core aspects of the AA regime are covered, the Government has committed to further consider a number of specific issues. These are highlighted in Chapters 2 to 4 and decisions will be reflected in the consolidated draft clauses planned for Finance Bill 2011, due to be published for consultation towards the end of 2010. The Government recognises that in some cases of major ill-health, it would be inappropriate for the AA to apply. The Government intends to set out further details around how such an exemption will operate, managing the risks of avoidance that it could open up, in the draft Finance Bill 2011, published in late 2010.
- As a result of measures taken the Government believes that unwelcome impacts will be mitigated for the vast majority of individuals. However, it recognises that there will be a few outstanding cases, typically of long-serving individuals in DB schemes, where it is possible that large charges could occur. The Government has decided to engage with interested parties on options to make the payment of significant tax charges, which reflect a significant uplift in pension value in a given year, more manageable for schemes and for individuals. The Government will bring forward proposals in November 2010 for consultation. The Government intends to publish draft clauses on the chosen approach will be published by February 2011.
- The Government intends to publish draft clauses on the reduced LTA as part of the full draft Finance Bill in late 2010. Ahead of this, the Government wishes to engage with interested parties on the policy issues associated with reducing the LTA, especially provisions around transitional protection. Further details of these provisions are set out in Annex B.

5.3 The full draft of Finance Bill 2011 will also include details of the action the Government will be taking against intermediary vehicles used to disguise remuneration to avoid, reduce or defer the payment of tax. This includes EFRBS.

5.4 The information requirements for pension schemes and employers will be set out in regulations, and these will be published in draft early in 2011. The Government will engage with interested parties around the application of these requirements.

5.5 The technical annex (Annex C) to this document sets out analysis on the distributional and yield impacts of the policy. The Government is committed to producing a full impact assessment, including the administrative implications for the pensions industry, employers, and HMRC for the new regime. This will be published alongside the consolidated draft clauses planned for Finance Bill 2011, due to be published for consultation towards the end of 2010.

5.6 The Government intends to repeal the measure legislated at Finance Act 2010 (April) to restrict the rate of pensions tax relief available to those with incomes of £130,000 and over. It will lay the Treasury Order which achieves this in parallel with the publication of the consolidated draft clauses planned for Finance Bill 2011, due to be published for consultation towards the end of 2010. This draft legislation will also include the regulations which will turn off the special annual allowance (the anti-forestalling regime) at 6 April 2011.

A Summary of decisions

The annual allowance (AA)

A.1 From April 2011, the AA for tax-privileged pension saving will be £50,000 (reduced from £255,000 in 2010-11);

A.2 There is no proposal to index the level of the AA during the forecast period. Beyond that, the Government will consider options for indexing the level of the AA;

A.3 Relief will be available at an individual's marginal tax rate;

A.4 The tax charge for exceeding the AA will be a tailored charge, to recoup the full marginal rate relief that an individual has benefited from;

A.5 Deemed contributions to DB schemes will be calculated via a flat factor. Reflecting the Government Actuary's advice, the level of the factor will be set at 16, meaning that an increase in annual pension benefit of £1,000 would be deemed to be worked £16,000;

A.6 Deferred members will be exempt from the AA regime;

A.7 The previous year's accrued pension benefits will be revalued for active members;

A.8 Any negative accruals will continue to be treated as zero;

A.9 No exemption from the AA test will apply to individuals claiming enhanced protection, and no exemption will be granted in the year that benefits come into payment;

A.10 The AA test will not be applied in the year of death, or in the case of lump sums paid where individuals are diagnosed with serious (terminal) ill-health. The Government also recognises that in some cases of major ill-health, it would be inappropriate for the AA to apply. The Government will therefore look to exempt ill health benefits from the AA regime. The Government intends to set out further details around how such an exemption will operate, managing the risks of avoidance that it could open up, in the draft Finance Bill 2011.

A.11 Exemptions will not be granted in cases of redundancy;

A.12 The Government intends to operate a simple flat factor that does not vary to reflect the value of pensions taken from an earlier age;

A.13 The Government will bring forward legislation to prevent avoidance that could otherwise occur through exceptional increases in the value of a pension in payment;

A.14 Where individuals exceed the AA in a given year, unused allowance from up to three previous years will be available to offset against the excess pensions savings. Carry-forward will be available against an assumed AA of £50,000 for the tax years 2008-09, 2009-10 and 2010-11;

A.15 The Government understands that, generally, schemes can be redesigned in a way that does not affect accrued rights and therefore that there should not be legislative barriers to doing so. However, it recognises that in some cases scheme trustees may not have the power to amend their rules in this way. It will therefore continue to engage with interested parties, together with DWP, and will take action if necessary, consistent with its overall principles of simplicity, fairness and protection of the public finances, to support employers and schemes in adapting to the new regime.

A.16 Some individuals will – due to a significant boost to their pension rights in a given year – incur charges for exceeding the AA that are unmanageable in-year, from current income. The Government is therefore considering options for those individuals to pay the charge out of their pension entitlement, rather than current income. This reflects the point that it is a significant increase in that pension wealth that has resulted in the liability. One option is for the scheme to pay the charge on behalf of an individual at the point at which the charge arises. Another option is for excess contributions above the AA, or tax liabilities, to be "rolled up" until the point of benefit crystallisation. The Government will assess options against their impact on the public finances, and administrative complexity and burdens for schemes and HMRC, while ensuring that the regime remains robust against risks of avoidance;

A.17 PIPs will not be compulsorily aligned with the tax year. Schemes wishing to align their PIPs with the tax year will, as now, be able to do so;

A.18 Transitional rules for PIPs will be introduced on 14th October (taking immediate effect). These will apply to those whose PIP for 2011-12 has already started;

A.19 Where individuals have (deemed) contributions over the AA in a pension arrangement, the scheme must provide the member with their pension input amount for the relevant year within six months of the end of the tax year. Where individuals request this information, pension schemes must provide details on the pension input amount by the later of 3 months from the request and 6 months from the end of the tax year;

A.20 Employers must provide information about employees' pensionable pay, benefits and service to pension schemes by 6th July following the end of the tax year;

A.21 For the first year only, employers and pension schemes will be given an additional 12 months, i.e. until 6th July 2013 or 6th October 2013 respectively, to provide the required information.

The lifetime allowance (LTA)

A.22 From April 2012, the LTA for tax-privileged pension saving will be £1.5m (reduced from £1.8m in 2010-11);

A.23 The Government is minded to maintain the LTA valuation factor at its current level of 20;

A.24 The LTA tax charges will remain unchanged (55 per cent if paid as a lump sum and 25 per cent if paid from annual pension income, on top of marginal rate tax on the pension income);

A.25 The maximum tax-free lump sum will remain at 25 per cent of the standard LTA;

A.26 From April 2012, the trivial commutation limit will be de-linked from the LTA (where it is currently set at 1 per cent LTA). It will remain at its current level of £18,000;

Legislation

A.27 HMRC is taking comments on the draft legislation for the AA regime, to ensure that it delivers the Governments stated policy intent. The Government will publish the consolidated draft clauses for the AA and LTA as part of the consolidated draft clauses planned for Finance Bill 2011, due to be published for consultation towards the end of 2010. The Government will publish a full initial impact assessment alongside this.

A.28 The Government intends to repeal the 'high income excess relief charge' measure, inherited from the previous Government and legislated at Finance Act 2010 (April). The Treasury Order which achieves this will be laid in parallel with the publication of the draft Finance Bill 2011 legislation. This draft legislation will also include the regulations which will turn off the special annual allowance (the anti-forestalling regime) at 6 April 2011.

A.29 The Government will bring forward legislation LTA as part of the consolidated draft clauses planned for Finance Bill 2011, that will ensure that intermediary vehicles, including employee benefit trusts (EBTs), and funded employer-financed retirement benefit schemes (EFRBS), are no more attractive that other forms of remuneration. This is to address the use of these intermediary vehicles to disguise remuneration and avoid, reduce or defer payment of tax; and to maintain the principle that there is a limit on the level of tax-advantaged retirement saving the Government is willing to support. The Government will continue to monitor the fiscal risk on all other forms of EBTs and EFRBS.

B Reducing the LTA

B.1 As explained in Chapter 2, the Government has decided to reduce the LTA to £1.5m. However, reducing the LTA creates a transitional challenge for individuals who may have already built up pension pots on the expectation that the LTA would be at its current level of £1.8m. A protection regime is therefore needed to accommodate such cases appropriately. The Government plans to introduce the reduced LTA from April 2012.

Designing a protection regime for the reduced LTA

B.2 The Government believes that a number of principles should guide the design of a new protection regime. The new regime should aim to:

- not be retrospective – tax charges should not newly arise as a consequence of activity in the past that individuals cannot now amend;
- respect the long-term nature of pension planning - the protection regime should provide appropriate support for individuals that have already made pension saving decisions based on the current level of the LTA;
- be easy for individuals to understand – the regime should be as straightforward as possible, so that individuals can easily understand the implications for themselves and make appropriate choices accordingly; and equally so that advisors can provide accurate and well-informed advice with minimal need for additional training;
- minimise administrative burdens for pension schemes, employers and HMRC – the regime should minimise administrative burdens, ideally be capable of operating in a light-touch manner, and reduce the potential for schemes to be over-burdened with requests for pension valuations;
- support the stability and predictability of the UK pensions tax system – any changes should be for good reason and the overall regime should instil confidence in peoples' expectations around the Government's commitment to tax stability.

B.3 In designing the protection regime around the reduced lifetime allowance, the Government will also want to ensure this is in keeping with the spirit of restricting pensions tax relief, and the priority of protecting the public finances, and does not provide opportunities for individuals to be better off than they would have been under the previous regime. It will be mindful of the revenue and behavioural implications of the proposed approach and will want to limit opportunities for individuals to excessively increase their pension savings in anticipation of the reduced limit being introduced. Such opportunities are currently limited in 2010-11 by the existing anti-forestalling provisions, including the general anti-avoidance rule within that, the earnings limit on individuals' contributions, and the AA.

B.4 The Government believes that in order to meet these principles it will be necessary to design a protection regime that ensures anyone with pension pots currently in excess of £1.5m has that excess protected from any tax charge (subject to a cap at the level of the existing LTA of £1.8m). This will ensure that the new regime is not retrospective.

B.5 The Government also believes that individuals who are currently protected by primary protection (PP) and/or enhanced protection (EP) should continue to receive these protections. Individuals were given the opportunity to apply for PP and and/or EP when the LTA was first introduced at its initial level of £1.5m in 2006. Preserving these protections is important to demonstrate the Government's commitment to the stability and predictability of the UK pensions tax regime.

B.6 The Government will also look to design the new protection regime to ensure that individuals currently in the existing forms of protection also do not face retrospective charges as a result of the LTA being reduced. For example, the Government will look to ensure that the current 'personalised LTAs' of those in PP are not reduced as a consequence of the standard LTA being reduced.

B.7 Besides the level of pension pots at the point at which the LTA is reduced, a crucial consideration for the protection regime is the expected growth in the value of a pension over time. If individuals have planned for their pension to grow to a level of £1.8m, but no more, between now and the point of retirement, it could be regarded as unfair for such growth to be caught by an LTA charge when the LTA is reduced to £1.5m. The Government recognises this issue of 'pension growth protection' and is minded to offer some protection in these cases, and welcomes views from the industry on the form this could take.

B.8 One option for providing 'pension growth protection' which the Government believes would meet its principles is to give anyone the opportunity to apply for a personalised LTA set at a fixed level of £1.8m, on condition that they must be neither making any further contributions to a DC scheme, or acquiring any further active benefits in any DB scheme (i.e. they must be a deferred member of any schemes in which they have entitlements). The standard LTA would apply to these individuals if they subsequently were to become an active pension member at any point in the future. The Government would welcome views on this proposal, and any other suggestions on the appropriate design of a protection regime for the LTA that would be in line with the principles set out above.

Other policy issues

B.9 Besides the protection regime, the Government has considered a number of other aspects of the policy issues around reducing the LTA.

B.10 At the moment, a factor of 20 is used to value DB pensions for the purposes of testing DB pension value against the LTA (i.e. the level of annual pension is multiplied by 20 to derive the deemed value of the pension pot). This is set at a higher level than the AA DB valuation factor, reflecting the fact that a given level of annual pension entitlement is more valuable to an individual at retirement than prior to that. Given changes to the DB valuation factor proposed for the purposes of assessing pension accrual against the AA a case could be made to review the LTA DB valuation factor. A case could also be made for making the LTA valuation factor age-related, so that the overall value of early retirements are picked up by the pensions tax regime.

B.11 The Government's provisional view is that changing the DB valuation factor used for assessing pension accrual against the LTA could complicate any potential protection regime, and have adverse knock-on impacts for the tax free lump sum. The Government is therefore minded to make no change and for the LTA valuation factor to remain at 20, but welcomes views.

B.12 Currently, funds in excess of the LTA are charged at 25 per cent of the excess amount if this is paid out in the form of a pension (and the pension is then taxed as income at marginal rates), and 55 per cent if paid out as a lump sum (on which no further tax is due). The Government does not see a pressing reason for amending these charges, and is therefore minded to keep the charge set at these levels, but welcomes views.

B.13 The pensions tax rules currently allow pension funds beneath a specified limit to be taken out as a lump sum ("trivial commutation"). The limit is currently set at 1 per cent of the LTA (£18,000). To prevent unintended consequences here for individuals on modest incomes with small pension pots, the Government intends on de-linking the basis on which the trivial commutation limit is set at the same time as reducing the LTA, and to set it at its current level of £18,000.

B.14 When a pension is drawn a tax-free lump sum of up to 25 per cent of the value of funds can be paid up to a maximum of 25 per cent of the standard LTA. Any reduction in the LTA would consequently reduce the maximum tax-free lump sum that could be paid. The Government's view is that the value of the tax-free lump sum should continue to be determined in this way.

Responding on the policy issues around reducing the LTA

B.15 We will work with interested parties on these issues over the coming weeks, and would welcome any representations on the issues by 29 October 2010. The Government will make a final decision on the nature of the protection regime for a reduced lifetime allowance later in the year. It plans to include draft clauses as part of the consolidated draft clauses planned for Finance Bill 2011, due to be published for consultation towards the end 2010.

C Technical annex

1. Distributional impacts

C.1 This annex sets out an analysis of the distributional impact of reducing the AA to £50,000 and reducing the LTA to £1.5m. Employer contributions in this model are imputed based on the relationship between employee and employer contributions taken from aggregate statistics. As a result the distributional analysis below is subject to a wide margin of error.

Numbers of individuals affected

C.2 The figures in this section are presented 1) before the application of any assumptions of behavioural change in response to a reduced AA, such as deliberately aiming off the AA to avoid exceeding it; and 2) before the use of unused allowances to smooth pension accruals.

C.3 The overall number of pension savers who would potentially be affected by the reduced AA is estimated to be around 100,000. Of these, around 70,000 (70 per cent) would be on incomes of £130,000 per year or more. This group accounts for 80 per cent of the reduction in tax relief targeted by the policy.

C.4 For comparison, under the measure to restrict pensions tax relief legislated for in Finance Act 2010 – the high-income excess relief charge – around 260,000 individuals would have been affected, all of whom would have had annual income of more than £130,000.

C.5 Under the reduced AA, fewer than 20,000 (20 per cent) of the individuals potentially affected would be on incomes of less than £100,000 per year, before any measures to mitigate impacts on these individuals have taken effect. However, in practice the introduction of carry-forward of unused allowances will reduce or eliminate the charge for many of these individuals. Furthermore, many pension savers, especially those in DC schemes and the more flexible DB schemes, are likely to make arrangements to reduce their contribution levels so that they fall below the AA in each year and thus avoid a charge.

Equality assessment

C.6 Around 15 per cent or 15,000 of individuals affected are expected to be female. This distribution is a result of the general bias towards a higher proportion of males in the higher income bands[1]. Also more than 90 per cent of those affected are expected to be aged 40 or over.

C.7 The model and availability of data have not allowed the 100,000 individuals affected to be further broken down by ethnicity, disability, caring responsibilities, religion or belief and sexual orientation. However, it is not expected that the policy would adversely or disproportionately impact on any of these groups.

[1] www.hmrc.gov.uk/stats/income_distribution/menu-by-year.htm#33

Other distributions

C.8 The majority (62 per cent) of the individuals affected by a reduced AA would be located in London, the South East and East of England Government Office regions (Table C.1).

Table C.1: Percentage of individuals potentially affected by a reduced AA by region.

Government Office region	% of individuals affected
North East	2%
North West and Mersyside	6%
Yorkshire and the Humber	4%
East Midlands	4%
West Midlands	4%
East of England	11%
London	29%
South East	22%
South West	6%
Wales	2%
Scotland	6%
Northern Ireland	1%

C.9 Based on standard industrial classification (SIC), around 52 per cent of those potentially affected work in financial intermediation (banking, finance and insurance), real estate and business activities (includes a ranges of business services) and pensions (Table C.2). Over 80 per cent are in industries that are predominately private sector.

Table C.2: Percentage of individuals potentially affected by a reduced AA by industry sector.

Industry	% of individuals affected
Manufacturing	6%
Construction	2%
Wholesale and retail trade	7%
Transport, storage and communication	2%
Real estate, renting and business activities	29%
Financial intermediation	23%
Public administration and defence	1%
Education	2%
Health and social work	10%
Other community services	3%
Others*	14%
All	100%

* includes agriculture, hunting & fishing, mining & quarrying, hotels, electricity and gas & water supply

2. Illustrations of contributions and charges

DB scheme contributions

C.10 The restriction of pensions tax relief applies to tax relievable pension contributions made during the tax year, but not to investment growth. In DC schemes (including personal pensions), individuals have their own pension pot, which is built up through contributions and investment growth. DC contributions made by both the individual and any other person on their behalf (most likely their employer) are generally easily identifiable, so the test to be made against the AA is straightforward to apply in this case.

C.11 In DB schemes, however, employers give individuals the promise of a future annual pension based on various factors. For a traditional final salary scheme, these factors are typically their salary, years of pensionable service and the scheme's accrual rate where, generally,

Annual pension = final salary * years of service / accrual rate.

Normally, an individual's final salary DB pension entitlement will increase each year, both as a result of working for the employer for an extra year and from any rise in earnings upon which the pension is based. Other types of DB scheme also exist, for example the pension might be determined by reference to average earnings over an entire career with an employer. Part of the accrued pension rights may be commuted for a lump sum on drawing benefits; in other cases, lump sum rights accrue separately each year alongside the pension. This section uses examples based on final salary DB schemes with a commutable lump sum.

C.12 Recognising that DB and DC schemes are not funded in the same way by employers, a notional DB equivalent of the DC scheme contribution – the 'deemed' contribution – is used to ensure fairness and consistency between DB and DC schemes.

C.13 The value of a DB pension can depend on many factors, including life expectancy, marital status, normal pension age (NPA) etc. On the basis of simplicity and to minimise administrative burdens, the Government has decided to use a variant of the current flat factor approach to value DB pension contributions. The valuation simply involves multiplying the increase in annual pension entitlement accrued over the current year by a flat factor, which has been set at 16 following advice from the Government Actuary.

C.14 The increase in annual pension entitlement is the difference between 1) the annual pension earned at the end of the year (the closing value of the entitlement) and 2) the annual pension earned at the beginning of the year (opening value), uprated or revalued to the amount it would assume if left to accrue till the end of the year.

C.15 To illustrate how DB contributions are deemed, we take an individual who has been a member of her employer's DB scheme with a 1/60th accrual rate for 34 years. In her 35th year, she receives a pay rise of 20 per cent from £60,000 to £72,000. The deemed contribution at the end of the 35th year is calculated as follows:

- Step 1 – calculate the opening annual pension entitlement. At the end of her 34th year, she was entitled to an annual pension of £34,000 (= 34/60 x £60,000) on retirement based on her salary, length of service and scheme accrual rate.
- Step 2 – revalue the opening annual pension entitlement. If the individual had stopped accruing pension after 34 years, then the pension would have been uprated by the CPI. If the CPI increase is assumed to be 2.5 per cent, then her pension earned after 34 years would have risen from £34,000 to £34,850.

- Step 3 – calculate the closing annual pension entitlement. If pension accrual instead continues, then her pension will rise to £42,000 (= 35/60 x £72,000) as a result of the extra year's service and the pay rise in the 35th year.

- Step 4 – the increase in annual pension entitlement is £7,150 (= £42,000 - £34,850).

- Step 5 – multiply by the flat factor to get the deemed contribution: £114,400 (= 16 x £7,150).

C.16 In schemes where the lump sum accrues separately to the annual pension, the increase in the value of the lump sum over the same period would be calculated and added to the annual pension contribution in step 5 to get the total deemed contribution.

C.17 The contribution is relatively large in this example due to the combination of long service and a large pay rise. Once deemed, the contribution can be tested against the individual's AA, taking account of unused allowance from the previous three years, and any charge due can be determined.

Carrying forward unused allowances

C.18 In the example discussed in the previous section, the deemed contribution was found to be £114,400, which is £64,400 in excess of the AA of £50,000. Before calculating the size of any charge, the individual would look to see how much unused allowance she had from the three previous years.

C.19 The individual had received increases in pay of 5 per cent per annum in her 32nd, 33rd and 34th years. Her allowance in each of these three earlier years was £50,000, but her contributions over those three years totalled only £80,600 (=£25,200 + £26,800 + £28,600). She therefore has unused allowance from these earlier years of around £69,400 (= 3 x £50,000 - £80,600) available to carry forward.

C.20 The individual thus has an effective annual allowance in her 35th year of £119,400 (= £50,000 + £69,400), which is sufficient to cover the deemed contribution in that year of £114,400 and still leave £5,000 to carry-forward to future years. **Carry-forward of unused allowance therefore allows the tax charge in this example to be reduced to zero.**

Calculating the tax charge due from excess allowance

C.21 If, after taking account of unused allowances, there had still remained some part of the pensions contribution in excess of the allowance, then a tax charge would have been due. Any charge would be calculated at the individual's marginal rate of income tax. The chargeable amount counts as if income for this purpose.

C.22 If the individual in the current example had had a pay rise of 22 per cent, rather than 20 per cent, then the deemed contribution would have been £125,600. The excess above the allowance, after carrying forward available unused allowance, would have been around £6,200 (= £125,600 - £119,400).

C.23 To determine the rate of charge, the excess would be added to her salary, taking her taxable income to £79,400 (= £73,200 + £6,200) which, in this case, remains in the higher-rate tax band of 40 per cent. The excess contribution would therefore be charged at 40 per cent, and the tax charge due to exceeding the AA would be around £2,500 (= 40% x £6,200).

D List of respondents

D.1 The following is a list of all the organisations that responded to the discussion document:

- 100 Group of Finance Directors
- Abell Morliss International
- Abingworth LLP
- A-Day Forum
- AEGON
- AISMA
- AJ Bell
- Allen & Overy LLP
- Anglian Water Group
- Aon Consulting
- Aquila Heywood
- Association of British Insurers
- Association of Chartered Certified Accountants
- Association of Colleges
- Association of Consulting Actuaries
- Association of Local Authority Chief Executives
- Association of Member-Director Pension Schemes
- Association of Principal Fire Officers
- Association of Taxation Technicians
- Aviva
- Baigrie Davies LifeSearch
- Baker Tilly
- Balfour Beatty plc
- BALPA
- Barnett Waddingham LLP
- Baylinks Ltd
- BDO Investment and Management Limited
- Bedfordshire Borough Council Pension Fund
- BG Group
- Bluefin Group
- BP
- BP Pension Trustees Ltd
- Britain's General Union
- British Dental Association
- British Medical Association
- British Steel Pension Scheme
- British Telecom

- Buck Consultants
- Cadbury plc
- Cambridge Colleges
- Cambridgeshire Fire and Rescue Services
- Cameron Mckenna LLP
- Canary Wharf Group plc
- Capita Hartshead
- Censeo Actuaries & Consultants Limited
- Chartered Institute of Personnel and Development
- Chief Police Officers Staff Association of England, Wales and Northern Ireland
- Church House Investments Limited
- Confederation of British Industry
- Crown Agents for Oversea Governments & Administrations Ltd
- Deliotte LLP
- Deutsche Post DHL
- Devon and Somerset Fire and Rescue Authority
- Devon County Council
- Diago plc
- Downing College Cambridge
- East Sussex Fire & Rescue Service
- EDF Energy
- Ernst & Young LLP
- Essex County Council
- Essex County Fire & Rescue Service
- Eversheds LLP
- Exxonmobil UK
- FDA
- Fidelity International
- Fire Brigades Union
- Fire Officers' Association
- Firefighter Pension Committee, Dept of Communities and Local Government
- Ford Motor Company Ltd
- Friends Provident
- FutureFocus Advisory Limited
- GlaksoSmithKline
- Goldsmiths, University of London
- Green Legal & Financial Consultancy Limited
- Grosvenor Britain & Ireland
- Group Risk Development
- Hargreaves Lansdown
- Henderson Global Investors
- Henderson Group Pension Scheme
- Hewitt Associates Ltd
- Higher Education Employers' Pensions Forum
- Hillierhopkins LLP
- Hornbuckle Mitchell Group Plc

- Hymans Robertson LLP
- ICI Pension Fund
- Institute for Chartered Accountants in England and Wales
- Institute of Directors
- InterContinental Hotels Group EMEA
- Investment & Life Assurance Group
- Jaguar Land Rover
- James Pay and IPS partnership
- JLT Benefit Solutions Ltd
- Johnson Matthey Plc
- Kent and Medway Fire and Rescue Authority
- Kent County Council
- Killik Chartered Financial Planners
- King's College London
- KPMG
- Lane Clark & Peacock LLP
- Legal & General Group Plc
- Leicestershire Fire & Rescue Service
- Liverpool Victoria
- Lloyds Banking Group.
- Local Government Employers
- London Borough of Hammersmith and Fulham
- London Borough of Merton
- London First
- London Pension Fund Authority
- Managers in Partnership Healthcare Union
- Manchester Metropolitan University
- Mars UK
- Mattioli Woods
- Mayer Brown International LLP
- Mercer
- Merseyside Pension Fund
- MM & K Limited
- MNPA Ltd
- National Association of Pension Funds
- National Association of Schoolmasters Union of Women Teachers
- National Grid plc
- Network Rail
- NHS Employers
- NHS Pensions and employment Service
- Nolan Baptist and Bond
- North Yorkshire Fire and Rescue Service.
- Nottinghamshire Fire and Rescue Service
- Osbourne Clarke
- Oxfordshire County Council
- Page Russell Ltd
- Pension Capital Strategies

- Pension Professionals
- Pensions Management Institute
- PFP Benefit Solutions
- Pilkington Group Limited
- Police Negotiating Board
- Pricewaterhouse Coopers
- Prospect
- Prudential UK & Europe
- Punter Southall Ltd
- Railways Pension Trustee Company Limited
- Reckitt Benckiser Group plc
- Rolls Royce
- Royal Bank of Scotland
- Royal London Group
- RPMI Ltd
- RWEnpower
- Sacker & Partners LLP
- Sainsbury's
- Sandisson Easson & Co
- SAUL Trustee Company.
- Scotia Gas Networks
- Scottish Water
- Scottish Widows
- SHIP Equity Release
- Siemens plc
- Skandia
- Slaughter & May
- SPC
- St James' Place Wealth Management
- Standard Life plc
- Strategic Remuneration
- Strathclyde Fire & Rescue
- Supertrust UK Pension Trustees Ltd
- Talbot and Muir SIPP LLP
- Tax Incentivised Savings Association
- The Chartered Institute of Taxation
- The Chief Fire Officers Association
- The Law Society of Scotland
- The Pensions Advisory Service
- Tower Watson
- Trade Union Congress
- Travers Smith LLP
- Tyne and Wear Fire and Rescue Authority
- Unison
- Universities Superannuation Scheme Limited
- Urenco Limited
- Waverley Borough Council

- West Midlands Fire Service
- Whitbread Group PLC
- Wragge & Co LLP
- Xafinity Paymaster
- Xerox Pension Ltd
- Yate Town Council
- Zurich

The Government also received a number of responses from individuals. Although names have not listed, all responses were welcomed and duly considered.

HM Treasury contacts

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

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