HM TREASURY

Restricting pensions tax relief through existing allowances:

response to the consultation on draft legislation

March 2011

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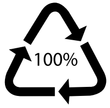

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1 Introduction

1.1 Following an informal consultation on the approach to restricting pensions tax relief, the Government announced on 14 October 2010 that, for the 2011-12 tax year onwards, the annual allowance (AA) for tax-privileged pension saving will be £50,000 and that from April 2012 the lifetime allowance will be £1.5m. Draft clauses and guidance were initially published on 14 October 2010. On 9 December 2010 the Government published updated draft clauses and further draft guidance on the main regime for the restriction of pensions tax relief.

1.2 A further discussion document about managing high AA charges was published on 30 November 2010, and on 3 March 2011 the Government set out the design of the regime for individuals to meet high AA charges from pension benefits. Draft clauses relating to this aspect of the regime were made available from 3 March 2011.

1.3 The Government is grateful to all who commented on the draft legislation, provided views and participated in discussions. HM Revenue & Customs (HMRC) has received over 45 responses to the consultations on the draft legislation, and has actively engaged with interested parties throughout the consultation period.

1.4 As a result of the consultation process, a number of areas have been identified where the Government has recognised the need to refine the legislation to deliver its policy objectives. Representations have also been received from individuals, organisations and pension schemes on the application of the policy in specific circumstances. This document therefore seeks to:

- explain what amendments have been made to the legislation and associated HMRC guidance as a consequence of the consultation on the draft clauses;
- articulate the Government's position on the application of the policy in a number of particular circumstances.

1.5 This document does not provide definitive guidance on the pensions tax legislation in Finance Bill 2011, which is subject to approval by Parliament.

2 Amendments to legislation and HMRC guidance

2.1 This chapter summarises some of the main technical representations that have been made on the draft legislation to restrict pensions tax relief. In some areas respondents expressed concerns or queried whether the legislation delivered what they understood to be the desired outcome. The Government has looked at these issues and considered whether and how to amend the legislation and/or update associated guidance. Some of the main changes to legislation and/or guidance that have been made as a consequence of this are set out in turn below.

Pension input periods (PIPs)

2.2 Following representations from the pensions industry, the legislation has been amended to give pension arrangements more flexibility to align their PIP with the tax year or scheme end date if they so choose to, regardless of whether they have chosen a different PIP previously. The legislation will:

- allow schemes to change their PIP end date to align with the tax year going forward, with schemes given flexibility to extend the length of their PIP from 2011-12; and
- change the default rules so that, for new schemes and members, the default PIP is the tax year when a scheme is first set up or a new member joins.

2.3 To allow for members who might have carefully planned and timed their pension savings and who do not want their PIP to change, in certain circumstances scheme members can choose to keep their existing PIP where schemes realign. This is in line with existing provisions.

2.4 Some responses to the draft legislation suggested that a one-off adjustment allowing schemes to retrospectively change their PIPs, would be appropriate. However, this would create fiscal and avoidance risks, enabling schemes to manipulate PIPs retrospectively to maximise annual allowances during the transition period. This could also adversely affect some people if it retrospectively treated their pension savings as relating to a different tax year.

2.5 The changes made to the legislation mean that pension schemes (and, where relevant, individuals) can continue to determine their PIP if they wish to, but that it is easier for schemes to change their PIPs to align with the tax year otherwise. This will make it easier for scheme members to work out their pension savings against the AA.

Severe ill health

2.6 The Government received representations on various aspects of the exemption from the AA charge in cases of severe ill health. Some respondents argued that the exemption did not go far enough as it is only available to those who are unable to undertake any gainful work (otherwise than to an insignificant extent). Others pointed out that many scheme rules on ill-health incapacity are based on the judgement as to whether the incapacity will extend to normal retirement age rather than to any time in the future.

2.7 In drafting the exemption, the Government has sought for this to apply to the hardest cases while minimising the potential for abuse. Due to the great range of scheme rules that exist on

ill-health retirement, it is inevitable that there will in some cases be a mismatch between a scheme's definition of severe ill health and the definition that qualifies individuals for an exemption from the AA charge. However, on consideration, the Government has decided to amend the duration of the qualifying incapacity (to last until state pension age) to bring that criterion closer to many scheme rules without introducing significant further risk of abuse. The Government believes that the final draft strikes a balance between exempting the hardest cases while minimising the scope for avoidance.

Deferred members

2.8 Individuals are exluded from any potential AA charge if they are deferred members throughout the PIP and simply receive inflation-based revaluation of their accrued pension until retirement. Respondents commented that, as drafted, this exclusion would not apply in the year of retirement, as individuals will be deferred members for only part of that PIP – they will be pensioner members for the remainder. The finance bill legislation has been amended to ensure that drawing benefits under an arrangement will not prevent someone from being treated as a deferred member.

In-year 'aiming off'

2.9 The legislation includes some amendments to the existing AA legislation. One such amendment is to the adjustment required to the closing value of pension rights in defined benefit and cash balance arrangements where an individual exercises an option to exchange part of their pension rights for other benefits. This may happen where, for example, an individual exchanges part of their annual pension for additional dependants' rights. The aim of the amendment is to ensure that the benefits valued are those that apply before the exercise of any option.

2.10 Representations received, however, have suggested that as well as achieving its aim, the draft amendment would prevent individuals from adapting and adjusting their pension savings 'in year' in order to keep their pension contributions below the level of the AA. The finance bill legislation has been amended to ensure that it does not prevent an individual 'aiming off' the AA in this way.

Refunded contributions

2.11 Under the anti-forestalling rules, which apply for the years 2009-10 and 2010-11, individuals are able to request a refund from their pension scheme of certain contributions. This is so that these are not taken into account when determining whether or not a special annual allowance charge arises. Comments received on the draft legislation have suggested that the amount of such refunded contributions should be ignored when calculating the amount of any unused AA available for carry forward from these years. This is to reflect the fact that once the contributions are refunded they no longer create pension savings for the year. Recognising this issue, finance bill legislation has been amended so that the relevant refunded amount attributable to that year is not tested against the AA.

Lifetime allowance transitional protection

2.12 'Fixed protection' allows an individual to retain a lifetime allowance of £1.8m if they make no further tax-relieved pension savings after 5 April 2012 i.e. if they accrue no further pension benefits. Although there was draft guidance on how to undertake the benefit accrual test for cash balance and defined benefit arrangements, some respondents noted that the legislation did not make clear how the benefit accrual should be valued. The legislation has been amended to clarify this.

2.13 The consultation on the draft legislation also raised a number of frequently asked questions on the operation of lifetime allowance transitional protection that HMRC has sought to clarify. For people who elect for fixed protection, some respondents were not sure whether the general 25 per cent of lifetime allowance upper limit on tax-free lump sums that can be paid out by a tax-relieved pension scheme is 25 per cent of the new reduced lifetime allowance of £1.5m or 25 per cent of an individual's protected lifetime allowance of £1.8m. HMRC has confirmed it is the latter (25 per cent of £1.8m).

2.14 HMRC has also clarified how the new lifetime allowance affects protected lump sums for people who opted for enhanced protection under the A-Day transitional rules. Structurally, lifetime allowance rules are generally framed in terms of the percentage of the lifetime allowance and not in absolute amounts. Respondents were concerned that a reduced lifetime allowance would operate for those with enhanced protection so as to reduce the value of their protected lump sum. HMRC has confirmed that the value of protected lump sums is not linked to the reduced lifetime allowance for individuals with enhanced protection. However, as was already clear in the draft legislation, for those who opted for primary protection the amount of their lump sum protection is linked to the level of the lifetime allowance. For individuals with either or both of enhanced protection and primary protection, but no lump sum protection, the maximum lump sum will be 25 per cent of the reduced lifetime allowance.

Meeting annual allowance charges from pension benefits

2.15 The summary of responses document published on 3 March 2011 explained that individuals with AA charges of more than £2,000 will be entitled to meet these from their pension benefits. Schemes will only be required to offer this facility and pay any AA liabilities arising as a result of a member's pension savings in that scheme in the year where they have exceeded the AA within that scheme. In the event that a scheme is obliged to meet the AA charge and make a corresponding deduction to pension benefits, they must do so free of charge. A scheme may provide the facility voluntarily, or settle any AA liability attributable to savings outside that scheme if it wishes to do so.

2.16 The Government believes that legislation as drafted delivers what is required on these points. However, in response to the comments on the draft clauses that have been received, the legislation has been amended as follows:

- Some respondents expressed concern that, under the draft clauses, schemes would be liable to pay an amount up to the amount of the excess over the AA within their scheme, rather than the amount of the AA charge relating to that excess. The finance bill legislation has been amended to link the amount of the charge payable by the scheme to the amount of the excess chargeable at the individual's appropriate rate.
- The legislation has been amended to provide the Treasury with regulatory powers to increase the level of the £2,000 eligibility threshold in future years. This is in line with the regulatory powers held for other special rates set in the pension tax rules, and provides flexibility to respond to changes elsewhere in the tax system.

2.17 To ensure that schemes are able to meet the member's AA charge where they receive a mandatory election, the legislation is also being amended to provide a power to make regulations to override scheme rules to facilitate this. It is intended that this power will be exercised to introduce such regulations.

The legislation is being amended to limit the amount of the charge paid by a scheme so that this does not reduce the member's benefits below their statutory Guaranteed Minimum Pension.

3 Application of the policy in specific circumstances

3.1 This chapter summarises the Government's position on a number of representations that have been received on the policy to restrict pensions tax relief – particularly regarding its application for defined benefit pensions in certain circumstances. This chapter brings out some general propositions guiding the Government's position on the restriction of pensions tax relief which are summarised below.

Discretionary / contingent pension accrual

3.2 The Government is clear that the level of annual pension that is used to determine an individual's pension input amount is the amount to which that individual has an unequivocal entitlement without the need for consent from a third party. In other words, where an individual receives an uplift to their pension to which they were not previously unambiguously entitled, the value of that uplift should be assessed against the AA at the time that the member becomes entitled to it.

3.3 The Government recognises that there may be instances where individuals have built up contingent or discretionary benefits, some of which may be explicitly in respect of service accrued in the past, and which individuals may have a strong expectation that they will receive. However, as long as there is a possibility that these benefits will not materialise – because, for example, it is possible for an employer to refuse to give their consent to the realisation of such benefits – such contingent or discretionary benefits cannot be brought within the calculation of the pension input amount until the point at which the individual becomes entitled to them.

3.4 The Government recognises that it is possible that the AA may be exceeded when discretionary or contingent benefits are suddenly granted, creating a large one-off spike in pension accrual in a single year. However, in order to help individuals manage one-off pension uplifts, the Government has already introduced the ability for individuals to carry forward unused allowances from up to three previous years to offset against any pension savings. This will help many individuals in such circumstances, especially those on lower incomes who are more likely to have unused allowances to carry forward. For individuals who do not have unused allowances to carry forward or who receive a pension uplift that is so large that an AA charge is still triggered, it is right to collect such a charge – this reflects the very valuable benefit they are receiving.

3.5 The Government believes that it is for individuals to manage their own tax affairs. However, the Government also believes that, where individuals do face high AA charges, it is necessary to provide additional support, and has committed to introduce a facility to enable them to meet high AA charges from their pension benefits. This reflects the point that it is the significant increase in pension wealth that has led to the tax liability. Overall, the experience for individuals who meet their AA liability in this way would be of a lower, but still substantial, uplift to their pension benefits.

Annual pension accrual

3.6 A fundamental feature of the operation of the AA in the pensions tax regime is that the value of a pension increase is taken into account and assessed against the AA in the PIP in which that increase arises. In other words, what matters in calculating whether an AA charge is triggered is the annual pension built up over the relevant period for a given tax year based on an

individual's entitlement and the facts of the matter, as things stand at that point, not on what the final position or pension is at retirement. This is an important aspect of any tax policy which needs to be capable of being effectively applied in discrete tax years.

3.7 The Government accepts that one consequence of this is that, in certain circumstances, individuals could incur a tax charge on the increase in their pension even if the value of that pension declines in the future, or if that value is never fully realised. This could occur, for example, in cases where a temporary promotion ends, or where a pension scheme winds up underfunded, or where an individual leaves their scheme and is entitled to a less generous pension as a deferred member than they would have been if they had stayed in service through to their scheme's pension age.

3.8 The most straightforward solution to this issue is for individuals to avoid incurring an AA charge on their pension in the first place. The Government anticipates that most individuals and employers will look to adapt their pension saving behaviour and remuneration terms to ensure that their pension contributions remain below the AA, thus preventing such issues from arising.

3.9 The Government is also clear that it is appropriate for the AA to operate on a tax-year basis. The purpose of the AA is to limit the amount of additional tax-privileged pension saving that individuals can benefit from in a single year. This is independent of any consideration of the final value of an individual's pension which may be affected by a number of factors, including investment risk (for defined contribution schemes) or solvency risk (for defined benefit schemes). The Government's view is that individuals should make their annual pension saving decisions with full knowledge of the tax implications and risks involved.

3.10 In cases where promotion is temporary and pensionable pay subsequently falls, the Government also encourages individuals, employers and pension schemes to consider the appropriate redesign of their remuneration and pension arrangements. This could prevent the situation arising whereby an individual may have paid an AA charge on a benefit that they later lose entitlement to. For example, pensionable pay could be increased more gradually, or not at all, until promotion becomes permanent. Alternatively, arrangements could be made such that pensionable pay will not decline even if an individual's actual pay were to do so subsequently. In many cases, there will be provisions in scheme rules that are designed to achieve these sorts of effects already.

Bridging pensions

3.11 One issue that was raised by respondents during the consultation on the draft legislation was the treatment of bridging pensions. A bridging pension is a temporary increase in a private pension that is often provided in cases where individuals retire before reaching state pension age. The pension is increased by the amount of the state pension, and reduced again when the individual reaches state pension age, so smoothing an individual's annual income in retirement. When the expected pension at the end of a pension input period is calculated, the value of this temporary increase in private pension will be multiplied by the usual flat factor of 16. The temporary nature of this pension uplift is therefore not recognised in the pension input amount that is assessed against the AA.

3.12 The Government has considered whether special provisions should apply when assessing bridging pensions against the AA. However, it has concluded that it would not be desirable to complicate the pensions tax regime in this way. If individuals have a concrete entitlement to a bridging pension that accrues year-on-year then the value of the bridging pension should be factored into both the opening and closing value of individuals' pension input rights – it is therefore unlikely to trigger a significant AA charge. It is when a bridging pension is offered as a discretionary award, or as a contingent benefit that arises when an individual opts for early retirement, that it may generate a large, one-off pension input amount when it is awarded,

which could exceed the AA. As discussed above, in order to help individuals manage one-off pension uplifts, the Government has already introduced the ability for individuals to carry forward unused allowances from up to three previous years. This will help many individuals affected by a discretionary, bridging pension award, especially those on lower incomes who are more likely to have unused allowances to carry forward.

3.13 Bridging pensions will usually be offered to individuals as a way of facilitating early retirement. However, the use of a flat factor in valuing defined benefit 'contributions' already provides for a generous treatment of early retirements. The Government does not think it would be appropriate to exacerbate this by making special provisions for the treatment of bridging pensions.

3.14 Given that it is discretionary or contingent bridging pensions that are most likely to lead to breaches of the AA, the Government also takes the view that individuals and employers will generally have some control over whether AA charges arise as a consequence of a bridging pension being offered or received. Employers and pension schemes may also wish to consider whether offering a bridging pension as an entitlement that accrues gradually, rather than as a discretionary award, would be desirable.

Late retirement

3.15 When an individual reaches their scheme's pension age, they may have the option to choose to defer drawing their pension (for example because they are continuing to work) such that they start receiving it any number of years later. In such cases, the level of the annual pension may be given an actuarial uplift when it is eventually drawn, to reflect the fact that it is being received later and will be paid over fewer years. In some cases, the preservation of the overall value of the pension benefits in this way is required by law.

3.16 One consequence of operating a simple 'flat factor' approach to the valuation of defined benefit contributions – that has no regard to pension age – is that the value of late retirement uplifts may be held to account against the AA in certain circumstances if the uplift in annual pension is large enough. In general, late retirement uplifts, where the uplift is expressed as a percentage determined in accordance with a provision in scheme rules as of 14 October 2010 will not be held to account against the AA. However, where the late retirement increase is determined by reference to continued accrual of pensionable pay or years of service, the value of the increase may give rise to a relevant pension input amount. In such cases, the pension input amount that arises will not be adjusted to reflect any loss of value due to the later payment of the pension.

3.17 The Government has always been clear that, in designing a methodology for valuing defined benefit pensions there is a trade-off to be struck between fairness and simplicity. Keeping the valuation methodology simple is beneficial to anyone who needs to assess the value of their pension accrual against the AA, or who is striving to ensure that their pension input amount over a year does not exceed the AA. In response to the original consultation on this issue, the majority of respondents agreed with the Government that a simple 'flat factor' method would be preferable to other methods of calculating deemed contributions, and that it would further ease administrative burdens as it is already embedded in the pensions tax system. This is why the Government has chosen to implement a simple method for valuing defined benefit pensions against the AA.

3.18 In order to take the actuarial value of late retirement into account in cases where late retirement uplifts are held to account against the AA it would effectively be necessary to introduce a scale of age-related factors of some kind, thereby complicating the valuation approach more widely. On balance, the Government does not think it is desirable to make the pensions tax system more burdensome by introducing complex rules for cases of late retirement. The possibility to take late retirement is typically an option that individuals can choose whether

or not to exercise and individuals therefore need to take the tax consequences of this into account as part of any decision to defer their pension.

Non-uniform accrual

3.19 In some cases, defined benefit pension schemes may be designed with non-uniform accrual rates. For example, rather than each additional year of service providing entitlement to an extra 1/60th of final salary at retirement, individuals may accrue 1/60th for the first 20 years of their service, and 2/60ths for subsequent years. The Government recognises that non-uniform or accelerated accrual could generate higher pension input amounts when high accrual rates apply. However, as previously discussed, it is a fundamental feature of the pensions tax regime that the pension input amount is calculated on the basis of discrete periods relating to tax years. The pension uplift is valued by reference to the accrual rate that applies over the period in question, in accordance with the valuation assumptions. Those assumptions consider the pension to which the member would be entitled, if they retired at the start or end (as appropriate) of the input period, having reached the age at which no actuarial reduction applies. The Government recognises that this might differ from the leaving service benefits, but does not consider it appropriate to make assumptions or considerations about how accrual rates might vary over a longer period of time, or whether an individual might leave pensionable service before normal pension age.

Summary of common themes

3.20 A number of the issues above bring out some general propositions that will guide the Government's view on any further representations of a similar nature. In particular, the Government is clear that:

- The valuation of an individual's pension should be based on the amount of pension that an individual has an unequivocal entitlement to without the need for consent from a third party. Where an individual receives an uplift to their pension that they were not previously unambiguously entitled to, the value of that uplift should be assessed against the AA at the time they become entitled to the uplift.
- It is appropriate to apply an AA charge for annual pension accrual that is in excess of the AA, irrespective of future changes in the overall value of that pension.
- In line with the majority of representations received in response to its consultation on the restriction of pensions tax relief, the Government has chosen to implement a simple method for valuing defined benefit pensions. The Government believes the value of this simplicity for the majority of pension savers is preferable to the establishment of complex rules that seek to address cases that may arise for a minority.
- The Government expects individuals, employers and pension schemes to adapt to the revised pensions tax regime. Employers and pension schemes should consider the implications of the new regime for their scheme rules and remuneration arrangements. Individuals should consider the tax consequences of pension accrual and draw-down options available to them. It would not be desirable to complicate the pensions tax regime by designing it to accommodate a plethora of different scheme designs and circumstances.
- The Government acknowledges that there can be a trade-off between administrative simplicity, that has been widely supported by respondents, and a level of complexity on scheme rules needed to take into account every conceivable variable. By allowing the carry forward of unused allowances from previous years the Government is clear that it has already acted to help alleviate these situations,

particularly for individuals on lower incomes who are most likely to have significant unused allowances to carry over.

3.21 The Government will continue to engage with external stakeholders on the detailed implementation and delivery of the policy. The Government will also continue to monitor the impact of the policy over time in order that it is delivering on its stated aims. As part of this the Government is fully committed to tackling tax avoidance and will take steps to protect the Exchequer where necessary.

HM Treasury contacts

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

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