

HM TREASURY & HMRC CONSULTATION ON RESTRICTION OF PENSIONS TAX RELIEF

RESPONSE OF BUCK CONSULTANTS LIMITED

INTRODUCTION

We are pleased to have this opportunity to contribute to the discussions on this important topic. Having watched with dismay the decline in non-state pensions provision in the UK over the past 15 years, we are keen to see the position turned around. We are therefore supportive of practices and government policies that encourage this. Unfortunately it will undoubtedly require changes in a number of areas and over a long period, to rebuild the confidence necessary to encourage both employers and employees back to voluntary provision.

It is difficult to predict which changes will have the strongest effect in this area; indeed, it is likely that different policies will have different effects upon different parties. Undoubtedly however, tax policies do exert an influence – particularly on employers, even though it is clear from many member surveys that the tax reliefs are not fully understood or appreciated by most members (or, if they are, they do not appear to outweigh the “pensions-negative” effects of other issues, because member engagement is at such a low level).

Whilst we understand the government’s need to raise tax receipts over the period of the next few years, and their desire to spread the tax burden as broadly and equitably as possible, this must be balanced against the longer-term need to reinvigorate funded pensions provision, principally through the workplace. We believe that it is also important to halt – and reverse – the decline in defined benefit provision. We are of the view that employers will want in time to run schemes that offer some degree of predictable outcome for their employees, if only to assist them in planning retirement at a time mutually agreed between the employee and their employer, following the implementation of another of the government’s proposed policies - the removal of the default retirement age.

We are as a matter of principle concerned that pensions are facing a further set of fundamental changes so soon after the new “simplified” tax regime was introduced under the Finance Act 2004. Whilst – as stated above – we understand the particular circumstances that have led to this situation, we are keen to ensure that this does not become the first of a series of further steps reducing state support for funded private pension provision. Indeed, if possible we would like to see these new restrictions be introduced subject to a “sunset clause” so that they can be reviewed at a time when the national deficit has been brought down to a more comfortable level, and the short-term imperative of additional tax revenue becomes of less importance to the nation than the need to encourage pension provision that will keep citizens away from overreliance on state benefits.

We do however agree with one of the fundamental starting points of this consultation – that the provisions of the Finance Act 2010 (April) introducing a complex and in some respects unworkable new tax regime targeting “higher paid” employees is not the appropriate solution. We note that the enabling legislation is still on the Statute Book and will come into effect if no alternative way forward emerges from this consultation exercise. We believe that in principle the correct approach is through further restrictions on the Annual Allowance and trust that the outcome of this consultation is a workable solution based upon this premise.

Our response to this consultation exercise reflects our view that the outcome must impose as little detriment as possible upon the cause of rebuilding confidence in pension provision, and it must not adversely affect one type of provision against any other (although given that its application to defined benefit arrangements will require some degree of complexity, there may be an opportunity here to craft a system that *improves* the cause of defined benefit provision in some areas).

RESPONSES TO SPECIFIC CONSULTATION POINTS

POLICY DESIGN

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

We understand the need to ensure from the government’s perspective that significant opportunities for avoidance under DB schemes should be closed from outset, and note that one of the resulting benefits for those involved in pension provision is the promised avoidance of the need to introduce further restrictions in the future, that might further disrupt provision and damage already fragile confidence in employer and employee engagement.

Consequently, we accept that it is appropriate to remove the exemptions from the AA test in the year benefits come into payment, and the exemption for individuals claiming enhanced protection under the FA2004 regime.

We also believe that there is further opportunity for manipulation of the system under a defined benefit scheme at any time that benefit is transferred from one scheme to another. This could arise if artificially generous actuarial factors were used to either value the transfer value out or to determine the benefit within the receiving scheme.

We are not sure that the guidance within RPSM relating to the adjustment of closing values following a transfer accurately reflects the wording of the legislation and in any event think that further thought needs to be given to avoid the risk of avoidance. We will be happy to discuss further.

By only taking the newly accrued amount of annual pension in a DB pension into account, the use of a flat factor potentially creates opportunities for DB pensions to be used to grant additional pension value without this counting towards the AA test. The government therefore welcomes views on this issue and practical options for limiting it, including the option of requiring a CETV calculation, or the use of age-related factors, in specific circumstances to capture the value of certain pension enhancements.

On balance and subject to caveats mentioned later, we can see a good argument that the simplicity offered by the flat-factor approach for valuing DB pension for normal accrual purposes outweighs the loss of precision in the valuation. This will be especially important for schemes, given that they will have to provide individual valuations for a larger number of members than now, because the lower AA will bring more members into the net.

Having accepted the inherent rough justice involved in using a flat factor, it is difficult to set out clear parameters for when an enhancement to the value of accrued pension should be caught within the AA test. We would accept, however, that there may be occasions when that could be justified and suggest that further consideration could be given to that by a joint working party, which should not impact the government's tight timetable for introducing the main provisions of the new policy.

The government would welcome views on the treatment of deferred members, revaluation and negative accruals, with a flat-factor approach to valuing DB accruals, and evidence on the administrative burdens of the different options.

From the perspective of reducing administrative burdens, it would certainly be preferable to exempt deferred DB pensions from testing under the AA. If testing were to be required, the combination of the large numbers of deferred members in schemes (apart from pensioners, the *only* members in many frozen DB schemes) and the significantly lower AA proposed would substantially increase the administration burden on DB schemes. Under normal circumstances, this would be unnecessary, since employers do not generally increase deferred benefits other than in accordance with LPI increases (or possibly, in line with RPI increases in respect of some old accrued pensions where the requirement is written into the rules or where such increases are discretionary and there is a practice of always having done so). It is unlikely therefore in the normal course of events that deferred members of DB schemes would receive any additions to their accrued benefits other than regular amounts designed to protect the benefit's purchasing power before it comes into payment.

However, if an employer wanted to give an additional benefit to either past (unlikely except perhaps by prior agreement reached with a former employee, as part of their leaving settlement,

and even then probably only in respect of senior ex-employees) or current employees who are deferred members for the purposes of a closed DB scheme (more likely), this could be done but subject to additional requirements. AA testing would not apply as long as the increase in any deferred pension did not exceed the allowable level of revaluation, and that any such increase was applied in the same way to all deferred members of the scheme. If any greater benefit were to be provided (which would in principle be allowable), the deferred benefit would be subject to the AA test. Benefits exempt from the AA test would also not be considered in the event of negative accruals.

A natural consequence of this would be to also allow for revaluation of the opening value when determining the pension input amount for a member with continuing accrual. We also think that such an approach is necessary to justify the use of a flat rate valuation factor. Without revaluation (in line with earnings) we think the disparity between DC and DB would be too great but allowing for a realistic revaluation would put DB and DC on to a reasonably comparable basis.

We would be happy for negative accruals to be simply treated as zero.

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

We agree that it is unlikely that any manipulation would be involved in the event of a member's death or diagnosis of serious (terminal) ill health.

We have commented upon transfers in response to an earlier question.

In cases of ill-health that satisfied the HMRC definition, we would suggest that payment of an unreduced accrued pension should be exempt but any enhancement over that level should be taken account of in the AA test.

Individuals may receive from their employer a significant increase in the value of their pension in cases of ill-health early retirement or redundancy. It is not clear that it would be appropriate to apply an exemption from the AA in these cases. Given the risks of avoidance, the government is minded not to provide exemptions from the AA in these cases, but is willing to consider proposals from interest groups that would provide protection for individuals in particularly hard cases without opening up unacceptable scope for abuse.

We have addressed the treatment of such cases in our previous answers above.

The government welcomes views on the appropriate level of the LTA, other issues associated with its operation in the context of a reduced AA, and on the trade-off between these and the level of the AA.

Although a reduction in the LTA to maintain the relationship with the new AA is superficially attractive, there is no need to do so. Simply freezing the LTA at the current rate will avoid the need to introduce any new complex transitional protections, since existing accrued benefits will by definition be protected if they are within the existing LTA. Future accrual will be controlled by the reduction in the AA, which will restrict the benefits that can be built up within the tax-favoured environment.

The government would welcome views on the merits of capping relief at 40 per cent as an additional means of restricting pensions tax relief and the trade-off between this and the level of the AA.

We believe that there are merits in the proposal of capping tax relief at 40%. This would allow for the flat factor for the AA to be slightly more generous than would be the case if relief were granted at the marginal rate, which would encourage more people below the “high earner” rate of income to engage with the pensions system. At the same time, even those designated as “high earners” would benefit from these improved AA rates on that part of their contributions/accrual. As a result, they would not lose out to such an extent that we believe they would be deterred from engaging with pension provision for themselves, and from that, lose interest in providing it for lower-paid employees in their organisations; this solution is therefore still an improvement over the Finance Act 2010 (April) basis.

The measure would also have the additional benefits identified in the consultation paper and in the document prepared by the Society of Pension Consultants, where this proposal was raised.

MANAGING IMPACTS ON INDIVIDUALS

The government is keen to support employers to make adjustments to help individuals who may face large, but one-off, increases to their DB pension. The government welcomes views on legislative action that could facilitate appropriate scheme redesign without undermining other aspects of the regulatory regime.

We wholeheartedly support the principle that the tax system should be kept as simple as possible, with reliance instead on employers to adjust the design of their schemes to help individual members who would encounter difficulties arising from the application of the new restrictions. It is true that in principle any of the actions identified in the consultation paper could be used in this regard; there may well be others that innovative employers may identify. Some of these solutions will involve more work, and therefore cost, than others, but the choice should in principle be open to schemes and employers to select.

We also welcome the consultation paper's apparent offer to adapt the taxation system to help in this regard. Rather than trying to anticipate problems and possible solutions and try to specifically assist those, the most helpful contribution would be to remove the threat of unsubstantiated financial penalties if the action taken is judged with hindsight by HMRC officials to have fallen within the category of "tax avoidance". The relevant legislation should be worded to make it clear that any action that is taken that is intended to, and does have, the effect of levelling-out an individual's income tax liability that arises in respect of contributions or accrual in any tax year to a registered pension arrangement will not be regarded as either tax evasion or avoidance.

DELIVERY AND COMPLIANCE

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

As the consultation document correctly states, the proposals will result in the assessment of the AA becoming a potential issue for a significantly larger number of individuals. Those individuals will have to manage and report their contributions/accrual on a tax year basis, and will therefore require information that they will be able to understand and use to take those decisions and to make the necessary disclosures on their self-assessment tax returns. There is likely to be a high incidence of errors in the completion of self-assessment tax forms unless the information provided to those individuals is on a tax-year basis. This would be compounded if our recommendations above that accruals in the value of deferred benefits should be ignored for the purposes of assessing the AA, are rejected.

However, even under the current rules, information from schemes can still clearly identify the relevant tax year to which the information relates and we see no value in a forced alignment of pension input periods, with the consequent additional workload that this would place upon schemes.

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

There will be an increase in the number of members requiring information from their schemes in connection with assessing their AA. Given that scheme administrators will not necessarily know what other pensions arrangements a member might have, they will not be in a position to anticipate which of their members will require information for their self-assessment tax forms; indeed, it is possible that individual members themselves may not appreciate that they may need the information from their scheme until they have to complete their tax return. Consequently, scheme administrators will be faced with additional work and uncertainty which they will find difficult to deal with; most are therefore likely to provide the required information on an annual basis for all members. It would seem sensible therefore to require all schemes to

provide information concerning pension input amounts to their schemes to each member annually on a tax year basis.

The information to be provided should be related solely to the particular scheme in question. It would create unduly onerous obligations on schemes and a significant increase in the complexity of the tax system if there were to be a system that required one scheme to become the “lead scheme”, responsible for collating all the pension input amounts for an individual from all their registered pension arrangements, and reporting an aggregated position to the member. It must therefore remain the responsibility of the member to collate the information from each of their schemes and to report the position to HMRC. It follows therefore that since the scheme should not be responsible for reporting the aggregate position across multiple schemes to a member, the cost to schemes of including a check of a member’s pension input amount for just one scheme against the AA will not generally be of assistance to members, and may mislead many of them. There would also be a cost to schemes to provide this; taking all these points into account, schemes should not be required to do so.

For all of the same reasons, there should not be a requirement for schemes to report such a situation to HMRC.

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

DC schemes must as a matter of course maintain records of each member’s contributions as and when they are made. As long as the information to be provided to each member is simply a record of those contributions during the relevant period, this should not in principle be an unduly onerous requirement.

DB schemes will have to perform a calculation on the increase in the value of the accrued benefit over the period; however, once again the trustees or managers should already have the information necessary to perform that calculation, which if it is done on the flat-rate factor basis proposed, should be straightforward. Again, if the information to be provided to the member is solely that figure, it should not necessarily impose unduly onerous additional obligations on the scheme.

However, although trustees or managers should have the information from employers to be able to calculate the increase in the value of each member’s DB benefit over the period, in some cases employers may drag their feet in providing it. There should therefore be an obligation on employers to provide the required information to the trustees or managers by a date sufficiently far in advance of the scheme’s deadline for reporting to members, to enable them to meet that deadline.

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

If the information to be reported is straightforward, and limited to factual information about the member's situation with that scheme alone, schemes should be able to establish a straightforward reporting routine to deliver the reports shortly after the end of the relevant tax year. Nevertheless, the earlier the end of the pension input period in respect of the tax year, the earlier schemes will be able to provide information and that is another reason why we do not think that there should be a forced alignment of pension input periods.

As mentioned above, there may need to be a requirement placed upon employers to ensure that they provide, in a timely fashion, the information that schemes will require. The requirement for reporting to members should remain with the scheme, since the employer may not always be in a position to know the full picture of the DC contributions made to a DC scheme, or to perform the calculation in respect of the value increase in a DB benefit.

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

By and large, benefits being provided for UK taxpayers by overseas schemes will be on a DC basis; furthermore, most members falling within this category will already have relatively complex tax reporting requirements, and will be capable, either themselves or by engaging professional help, of obtaining and presenting the information that HMRC will require.

Given the potential difficulties of enforcing reporting requirements upon overseas schemes, it would probably not be worthwhile trying to impose reporting requirements on them along the lines of those envisaged above for UK-based schemes.

Other comments

We would like to make two further recommendations which we would urge the government to adopt:

1. We would welcome a stated long-term aim of indexing the annual allowance and lifetime allowance in line with earnings, notwithstanding the need for a short term freezing of the limits. This would help maintain confidence in tax advantaged pension provision.
2. We would also like to see the ability to carry forward unused annual allowance over some reasonable period. Such a provision would help overcome the difficult 'spike in benefits' issue.

Buck Consultants Limited
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