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Pensions Consultation 2015
Pensions & Savings Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Dear Sir/Madam

"Strengthening the incentive to save: a consultation on pensions tax relief"

The Association of Consulting Actuaries is very pleased to have the opportunity to respond to the Consultation "Strengthening the Incentive to Save".

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes. Members also advise thousands of smaller pension arrangements and many life and general insurers.

The ACA is the representative body for UK consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

In March of this year, the Association published a Policy Paper entitled *"Creating a_sustainable_Pensions_Tax_Framework"*. Our paper set out many of the problems that exist in the current framework but in particular citing the complexity which even few pension professionals fully master. And if the detailed pension framework is opaque to pension professionals it must surely be beyond the average layman.

Whilst this complexity applied to relatively few individuals, it was possible for those impacted to both afford and be able to access professional advice. As the Lifetime and Annual Allowance reduce, the complexity begins to impact those individuals for whom professional advice is neither affordable nor economic. As a result, we suspect in a number of cases this leads to the wrong amount of tax being paid, or not paid.

Any further reduction in the Lifetime Allowance and, to a lesser degree, the Annual Allowance will further increase the numbers impacted by this complexity. And as well as complexity, the real anomalies in how the tax charges can operate will start to become significant. Both the reduced incentives and complexity will lead many employers and individuals to seriously consider whether it is appropriate to continue to support pension provision beyond the mandatory minimum. This would be particularly so for those employers who provide Defined Benefit pension arrangements where the complexity and anomalies are more acutely felt. Further reduction in the Annual and Lifetime Allowance will mean that both operate in a way that was never intended when they were first instigated.

With the new tapered Annual Allowance, the complexity is further increased and with the added difficulty that those impacted are unlikely to be able to determine their scope for pension saving until close to the end of the tax year in which they are accumulating benefits or paying contributions.

Our March paper called for a consultation and cross party consensus to examine whether an alternative arrangement would be preferable to the current system.

Our policy paper set out some characteristics that we believe would guide a solution to a better arrangement, these being:

- the new regime should continue to incentivise individuals explicitly to save for retirement while they are working and importantly – to encourage employers to make suitable arrangements for their employees;
- a new regime should replace the current regime - meaning for example that it should not require creation of two separate regimes to run in parallel dealing with past and future savings;
- the new regime should, ideally, be simpler to understand and operate than the existing regime; where it cannot be simpler it should at least be fairer and intuitive, with anomalies and perverse outcomes eliminated;
- the new regime should be capable of targeting tax relief in line with the Government's intentions and
- opportunities to manipulate the system should be minimised.

We acknowledge that these are not easy targets, particularly with the background of the multitude of different benefit scales and legal structures that constitute UK pension provision built up over many years. Rather than specifically answering the questions listed in the consultation, we have, with the above targets in mind, examined the relative merits of the following straw men put up by the paper and by HM Treasury in discussions:

- maintaining the existing structure (core feature being EET) but removing some of the existing anomalies and complexity;
- moving from an EET to a TEE model (so called "ISA plus incentive") and
- keeping the EET structure but moving to a "flat rate relief" model.

Examination of these options must be considered against the complexity of the existing tax regime which has

- tax rates which move from 0% to 20%, 40%, 60%, 40% and 45% as income rises, and National Insurance rates for the individual that move from 0% to 12% to 2% as income rises but at different thresholds;
- employee contributions paid to pension arrangements being subject to National Insurance whilst employer contributions are not; and
- more recently, the introduction of Freedom and Choice, which whilst providing greater options for members, means that consideration needs to be given to the relative merits of paying contributions into a pension arrangement or taking them as cash at 55 and beyond. A change from the existing pension structure also needs to consider the natural brake that existing tax structures (the final T in the EET) have on members taking all their benefits in one go – but also has to consider the ability of individuals aged 55 or more to pay into pension and withdraw the amount immediately.

It is also clear that the recent Chancellors have sought to modify the existing framework to limit the amount of relief for those on higher incomes, in part because the existing structure of marginal relief is inclined to provide greater incentives the higher the marginal rate of tax and by implication the higher the income.

Within the confines of the existing structures of Income tax and National Insurance it is clear to us that each option considered will solve some of the issues that exist with the present system but will create others.

A move to a TEE environment (and to some degree a move to a flat rate approach) with increased minimum contributions under auto-enrolment (beyond those currently in place) would have many attractions for the Government through:

- Bringing forward tax revenue through deferring tax relief,
- Removing the possibility for individuals to “band shift” - including having employees assessed for tax on employer contributions for accrual when their marginal rates are at their highest.
- Eliminating tax free cash,
- Minimising the impact of loss of tax relief through more employees being auto-enrolled and increases in auto-enrolment contributions required over the next few years and beyond,
- Potentially, providing a means for the Government to remove NIC relief on employer contributions.

However, such a change would bring a significant administrative burden and remove many of the reasons that employers cite for providing pension arrangements and their attractions for employees. The complexity would be felt particularly by Defined Benefit arrangements as they would need to objectively value each person's accrual under the arrangement and levy a tax on the individual for the same amount. It is likely that a specific and new methodology and assumptions would be needed for this purpose. The Government would need to provide a significant incentive to employers maintain generous pensions to overcome these additional burdens.

On the macro level, it would lead to a very substantial segment of the community (ie pensioners) being tax-exempt which may be divisive.

With the success of auto-enrolment, and the increased numbers now contributing towards retirement saving for the first time, it is critical that a new pension system does not dissuade those currently saving from doing so and ultimately will encourage those saving to save more.

But perhaps most importantly, if we are to have a credible long term incentive structure for retirement, whatever is put in place for the future will need to be stable. The constant changes to the current system have seriously undermined a savings structure established in 2006 which was largely welcomed by all.

The changes under consultation could represent a real "revolution" in pension provision, (following closely on from the Freedom and Choice changes announced in 2014 and in force from earlier this year). We welcome the review of the tax structure but any proposals should be subject to full consultation and with sufficient time to implement.

Further thoughts are set out in Appendices as follows:

- Appendix 1 – some key general points
- Appendix 2 - the current tax regime - but modified?
- Appendix 3 - the two proposed alternative approaches, as they would apply to Defined Contributions savings
- Appendix 4 - Defined Benefits under an alternative model – either "ISA plus incentive" or "flat rate relief"
- Appendix 5 - some numerical comparisons of the various proposals

Yours faithfully

David Fairs
Chairman
Association of Consulting Actuaries

APPENDIX 1 – some general key points

1. Costing the current system and changes

The consultation paper identifies that *"any proposal for reform should also be in line with the government's long-term fiscal strategy*" and notes the *"current pressure on public finances".* We therefore think it essential that any proposal be measured against a realistic measure of current tax incentives and how those incentives would change under different approaches.

The document states that *"including relief on both income tax and National Insurance contributions, the government forwent nearly £50 billion in 2013-14."* and then quantifies savings made by various measures.

As we noted in our March paper – and indeed acknowledged in the consultation document –this figure is clearly misleading if it is to judge the incentives being given by government or year-by-year pension savings. The figure inappropriately includes tax relief on "deficit contributions" now being paid by employers into Defined Benefit (DB) schemes. Furthermore the figure above does not include any offset for the tax collected on pensions once in payment. The consultation paper does later include an offset for tax collected in respect of current pensioners but it would be more appropriate to offset the predicted tax that will be collected from the current cohort of savers, because tax relief given and tax collected in any one year will vary according to the size of different cohorts of population, other things being equal. The consultation note also highlights the fact that the relief granted to Defined Contribution (DC) savers under the current system is expected to increase substantially in the future as auto-enrolment matures.

We would welcome the opportunity to discuss how more representative figures could be developed to properly compare the impact of the different options.

2. Employer engagement is key – redistribution/complexity

As noted in our introduction, many of the changes made to the 2004 pensions tax framework have been to limit the amount of relief for those on higher incomes. We make no comment on the appropriateness of those changes. However we do note that employers play a key role in the levels of savings being made. Many employers provide matching incentives to any additional pension savings the employee makes above a minimum; or automatically provide part of the remuneration package as pension, beyond the minimum levels required for auto-enrolment. Employers are incentivised to do this because of the efficient method of rewarding employees using pensions. Maintaining the incentive and willingness of employers to contribute to pensions is vital in any change from the existing arrangements.

Much of the focus of the consultation document is on individual responsibility and engagement – but we note that **employers** will be less inclined to support pension provision beyond the legal minimum if:

- the provision of pension savings involves huge complexity (and hence risk and cost);
- pension is potentially subject to double taxation and therefore an ineffective means of passing reward to employees; and
- senior decision makers are disenfranchised from the savings vehicle.

3. National Insurance on Employer contributions

Connected with the point above, we note that currently employer-sponsored pension (whether DB or DC) provision has favourable treatment for National Insurance (NI) purposes in accumulation and payment.

- This is a significant incentive for employers to include pension saving within remuneration packages rather than cash.
- The current consultation is on income tax. A separate OTS project is being carried out to consider closer alignment of income tax and national insurance, but it is not clear if its remit includes considering how NI might apply to employer pension contributions.
- Our comments in this paper assume that the current NI system persists. If changes are considered to this position, then we think it essential that the government maintains the same quantum of incentives to employers through other means to incentivise them to provide good pension provision.
- We note that the same issues in identifying the value of DB accrual for tax purposes under a TEE or flat rate system and meeting the charge (see Appendix 4) would exist if employer contributions become subject to NI.
- We note that the current structure lessens the impact of the regressive nature of employee NI charges.

4. Could a different approach be taken to DB and DC?

DB and DC accrual are very different in nature and it is difficult to frame one approach that works sensibly for both. However any approach that treats them differently has to accommodate the following:

- Individuals typically hold both so there has to be a clear rule for interaction,
- Some pension arrangements are hybrid, that is include elements of DB and DC,
- Pension schemes are seeing an increase in requests for transfer values from DB to DC arrangements as a result of Freedom and Choice.

- To counter the opportunities for arbitrage (dressing one form of benefit to look like the alternative when more favourable) one might need additional anti-avoidance legislation, tax applying on transfers from one to the other – etc.

- Although more than 1m individuals continue to accrue DB benefits in the private sector, the majority of members accruing DB benefit are now in the public sector. So public perceptions of “fairness” of tax on the two types of benefit will be coloured by this.

APPENDIX 2 - The current tax regime - but modified?

The current system encompasses an “EET” structure, with broadly 25% of funds available tax free at retirement (usually from age 55 onwards).

The EET system has been in place for many years. Its perceived advantages for encouraging retirement savings include the fundamental point that the incentive is given upfront to lock money away into pension savings for potentially many years. There is an even greater incentive for those who think they might “band shift” (e.g. enjoy tax relief while a higher rate payer but pay tax when they are a basic rate payer in retirement) although some may see this as an approach to smooth tax take over an individual’s lifetime; and the system has the advantage that there is no need for a complex mechanism to tax employer contributions as a benefit in kind (nor as part of this, to value DB accrual except of course the crude valuation for the Annual Allowance measure).

Benefit accrual and contributions are of course constrained by the Annual Allowance (in its several forms) and the Lifetime Allowance intended to restrict the relief for the wealthiest, both of which either act as a deterrent to savings beyond certain levels or else apply a form of double taxation, particularly in the case of the Annual Allowance. These Allowances (particularly the Annual Allowance) are becoming more complex and affecting more members (as well as administration systems) with each (multiple) change and reduction.

- Both Allowances originally applied to a few individuals and acted mostly as a deterrent so their exact operation did not matter in detail. As they have been lowered and variations added, the weaknesses in their design and operation have become significant. They are being used for purposes that they were never designed to do.
- We noted in our March paper that the current Annual Allowance system in particular suffers from a number of flaws, much centred around the nature of DB arrangements and the difficulty of expressing a year’s additional pension as a single monetary amount and concluded that its approach for DB is increasingly not fit for purpose – we refer you to our March paper for further details.
- We also noted an increasing anomaly in the way these measures impact DB versus DC, due to the use of fixed factors for DB.
- Our previous paper noted that the cost of monitoring and administering features of the current system are significant and growing, with much of the cost being borne by the employer. Money spent on compliance costs is money that is not invested for individuals’ retirement (or indeed for business growth). We also note that both measures rely substantially on the member providing information to schemes and to HMRC outside of any sort of regular systematic process, and (for Lifetime Allowance) require the member to understand any relevant protections sufficiently and (for Annual Allowance) to report and arrange payment of tax. This may arguably be appropriate when the individuals are high paid and used to consulting tax professionals to comply with their tax reporting obligations. It does not work with a wider and less well remunerated group. HMRC implicitly acknowledge this

by their rethink about how registration for 2016 LTA protections will work. We further doubt that HMRC have the means or resources to check that tax is being reported/paid correctly where due.

- It would be possible to create separate tax treatment of DC and DB arrangements. One could argue that using just the AA for DC and the LTA for DB, would better match the very different nature of the two benefits (DC being a clearly input-driven benefit, DB being a promised formula where actual output depends on all sorts of contingencies.) This has some attractions but we note the points raised in Appendix 1, particularly where many current individuals have a combination of the two.
- Whilst the Annual and Lifetime Allowance could be reduced further and applied to just each type of benefit, there would need to be yet a further Lifetime Allowance protection regime to add to the 7 that currently exist and there would be an even wider group impacted.
- We do believe that there are some changes that could be made to minimise the ways that the two Allowances are interfering with normal scheme activities. The Annual Allowance causes problems for DB schemes at surprisingly low pay levels when there is no real accrual happening. It would be of substantial help if the law could give HMRC an element of discretion to apply to say that no Annual Allowance is used up in certain exercises. Such occasions might be where it is very clear from the facts (and with supporting submissions from professionals such as actuaries and lawyers) that all that is happening is a cost neutral change in benefit shape. The current mechanistic Annual Allowance results in real blocks and operational costs to exercises such as pension increase exchanges and options to draw bridging pensions.
- At the moment there are anomalies in treatment between Net Pay arrangements and Relief at Source and it would seem appropriate for there to be just one mechanism for the granting of tax relief for DC savings. A move away from Net Pay may be made necessary even for DB under one of the new models of relief – see Appendix 4.

APPENDIX 3: The two proposed alternative approaches, as they would apply to Defined Contributions savings

1. Items in common to the two systems

We assume that, under either of the two alternative proposed systems.

- All DC schemes would need to be operated as "relief at source" schemes.
- Employer and employee contributions are to be treated similarly for income tax purposes. So an employer contribution of £100 for a basic rate tax payer would attract a tax charge of £20 (paid direct to HMRC before the contribution is made to the scheme – see below) so leaving a net contribution of £80 to be made to the scheme, and then attracting a top-up depending on the nature of the system used.

  The tax rate to apply to the employer contribution would need to be determined by payroll by adding the employer contributions on to other taxable remuneration – so it is possible that someone who is normally a basic rate payer might find that the employer contribution attracts some higher rate charge; and someone who is normally a non-tax payer might find that some employer contribution is taxable.
- Any tax on employer contributions would not be operated as a deduction from employee pay ie would not be operated as a reduction to take-home pay. Instead the employer's contribution would be reduced before payment into the scheme to pay the tax. Any tax top-up due under the two alternative methods would then be claimed from HMRC by the scheme.
- If NIC relief on employer contributions is removed then NIC would presumably be treated consistently with the above.

The following are further thoughts on each approach.

2. ISA-style retirement savings plus incentive

We assume under this model the following would apply:

- Contributions (employer or employee) would be made from net-of-income into the scheme, and would be matched immediately by a top-up by government – which might be flat rate or age-related or some other variation.
- There would be a cap on the total amount of allowed (or incentivised) contributions in a tax year (this would substitute for the Annual Allowance) but there would be no need for a Lifetime Allowance restriction.
- Contributions would be allowed across multiple schemes (e.g. to accommodate changes of job) but a mechanism would need to be in place in respect of the cap on total incentive given to any one person per tax year – a difference from the current "ISA" that would need to be managed.
- There would be no access to the funds before age 55 (or whatever minimum pension age is set) or if there is it would involve a tax penalty that wipes out the benefit of the top-up.

We have seen suggestion of a top up bonus granted if monies stay within the scheme until state pension age; but if this is expressed as a % of fund, this does create challenges on matching the investment performance in the meantime; and if a fixed amount again it would create reserving challenges as well as mitigating some of the attractions of Freedom and Choice.

So this system would be a substantial move away from current tax relief system.

- Among other things, even if the top-up were set so that the quantum of total tax relief being granted were the same, it would of course bring the Government's tax income forward by many years.

  Corresponding to this is the perceived risk that, compared to the "Bird in Hand" nature of incentives under an EET system, the fund under this system might be vulnerable to a future government suffering deficits deciding to tax distributions. An argument to perhaps mitigate this is that tax takes would be very obvious (more so than for example understanding the impact of a reduction in AA or LTA) so a risky political move. It is not clear to us how much this distrust might put savers off locking their money into pension despite the top-up incentive. The more pertinent question is whether it would put off employers including pension saving at more than minimal levels in a remuneration package.

- Arguably it is much easier to understand than the current (or fixed rate – see later) system – it is certainly an easy comparison with an ISA as an alternative savings vehicle.
- Highest rate tax payers would still have an interest in pension savings (up to the cap applied).
- The incentive to save into pension rather than spend immediately does not depend on the relativities of tax rate at saving and at withdrawal – perhaps simpler to understand but it loses the concept under EET of smoothing tax rates over an individual's lifetime.
- The lower paid (non tax payers, and those who expect to pay no tax in retirement) would get an advantage from saving into this system but probably much less than now.
- Unless extra measures apply (for example the bonus on monies being held in the fund until state pension age), those aged 55 or more would be able to wash contributions through a scheme to acquire the incentive with no real intention to save for the longer term.
- It may be more affordable for Government to increase auto-enrolment minimum contributions in the future.
- Benefits will have already built up on the basis of being taxed (bar 25%) when drawn. So;
  - Either, we will operate two separate systems (existing and new) for many years – continuing the current complexities, or

- there could be an option (or compulsion) to convert existing old funds to count as being after-tax ISAs, following imposition of a one-off tax charge, taken from the fund.

  Setting such a rate so that it fairly reflects the tax charge that might otherwise have been expected on the old funds would need, if anything, to err on the generous side to avoid accusations of retrospective tax.

  If a flat rate were used it would by definition be regressive ie generous to those who would have been higher rate tax payers as pensioners.
  A method that shows the complexity involved in trying to be "fairer" is as follows:

  - require the individual to obtain a valuation of all his accrued benefits (which may be multiple),
  - apply an age- related factor to the total representing expected growth and conversion so as to identify a notional income that might be drawn from them and hence (after allowing for the expected 25% tax free element) what tax bands might have applied all else being as now – and
  - convert that into an immediate tax rate.

  There could be a de minimis level of savings below which no charge would need to be considered (this might mean many of the smaller auto-enrolment pots avoid incurring a charge).

3. EET + flat rate relief system

- We would note a variety of assumptions as to how an "EET+ flat rate relief" regime would work – it would help the debate if there was a single benchmark on which to comment. We have here assumed that the design under consideration is one under which, as well as the points raised at the start of this section:

  - A flat rate relief expressed as say 25% would mean a top-up of "£1 from government for each £3 to the scheme" to be applied to the contribution paid to the scheme from post-tax income. So an employee contribution of £60 into the scheme whether from an individual subject to 20% or 40% tax would be topped up by £20.
  - Employer and employee contributions are to be treated similarly for income tax purposes. So an employer contribution of £100 for a higher rate payer would attract a tax charge of £40 (paid direct to HMRC before the contribution is made to the scheme – see below), or an employer contribution of £75 for a basic rate payer would attract a tax charge of £15 so in both cases leaving a net contribution to be made to the scheme of £60, again attracting a top-up into the scheme of £20.
    (We note that the employer contribution itself could put the member into a higher marginal tax banding.)

    - If NIC relief was removed from employer contributions we assume the NIC charge management would be consistent with the above.
    - Tax on drawings at the end of the day would follow the current tax process i.e. a tax free cash element would still be available as per the current regime and the balance would be taxed at the individual's marginal income rate in retirement.

- Whether a pension contribution with matching payment under flat rate relief is more tax efficient than cash depends on the rate of tax that will be paid at retirement. So (depending on what level the flat rate is set at) some higher rate individuals should choose not to save for pension.
- The flat rate would be set recognising that more tax will be paid from the fund at drawing, whereas an incentive attaching to an ISA would be set recognising that no more tax will be collected. This means the flat rate will look more attractive to savers – perhaps wrongly in some cases as noted above. The language surrounding the flat rate approach suits auto-enrolment messaging.
- Because the approach uses EET it may be the case that no special partitioning or transitioning is needed from past savings (i.e. all savings will be subject to the same treatment at retirement).
- A policy decision would be needed as to whether an individual needed taxable earnings to enjoy the top-up from HMRC. If not then this would leave an unlimited opportunity for individuals to move savings into pension to take advantage of the top-up.
- If all other elements of the current regime are maintained (Annual Allowance and Lifetime Allowance) there would be extra complication rather than simplification.
- We note that if the flat rate results in a negative cash-flow for HMRC on contributions from basic rate taxpayers
    - Auto-enrolment will bring in many lower paid workers into pensions. Tax steps to shift future pension contributions from the higher-paid to the lower paid would exacerbate this cash-flow issue:
        - If the relief is not larger than the tax bill then the incentive disappears.
        - If the relief is larger than the tax bill then this costs HMRC cash.
- Unless extra measures apply (adding complexity), those aged 55 or more would be able to wash contributions through a scheme to acquire the incentive with no real intention to save for the longer term.
- Consideration would need to be given as to whether the Scottish rate of income tax should affect the flat rate relief.

APPENDIX 4: Defined Benefits under an alternative model – either "ISA plus incentive" or "flat rate relief"

The following are thoughts on how a regime might need to work if DB accrual were to fall under one of the two alternative models, whatever the detailed parameters.

- The build-up of benefit represents an employer gross contribution that is not taxed through PAYE. So a tax adjustment would be needed for all in respect of this element:
  - the first part of the adjustment to be to create the normal tax charge due at the particular level of banding the member (consequently) falls into; and
  - the second being the tax credit for this being pension saving – either the incentive added to the ISA or the flat rate of relief being granted.

  It may be that these have to be two separate steps or can operate as a single net step: if a single step, then we note that the "ISA + incentive" is more likely to be a single net charge, whereas the Flat-rate relief approach could be a net credit OR net charge for each member. This could be particularly complex if someone's marginal tax rate changes mid-year.
  Under the ISA approach the tax adjustment would also have to accommodate any mechanism to cap incentivised contributions in, or across multiple, arrangements.

- If individuals' take home pay is not to be impacted, it would be necessary to introduce Scheme Pays (automatic or on request) in cases where the net position identified is a charge. Where the net position identified is a credit, perhaps a tax code adjustment could be made.
- All accrual would need to be valued, and valued **exactly** each year in accordance with whatever methodology is decided upon.
- Any anomaly in valuation would result in an anomalous charge, so the valuation method is important.
- The first step would be to identify the quantum of accrual each year. Methods considered for valuing this might include the following (we note some of the key features of each below):
  - The Annual Allowance – but this notional value (which has no other real use) uses flat rate factors so favours the older over the younger saver (ignoring the extra time value of money); favours high quality benefits (low retirement age, high increases once in payment, high attaching death pensions) versus low quality; and has some real anomalies (for example overvaluing bridging pensions and its approach to "targeted benefits").
  - Employer contribution rate (% of pay) that is the element agreed with the trustees at the latest valuation for funding "on-going accrual" - but this is an average % calculated taking into account the average age/benefit profile of the membership so has similar cross-subsidy issues to using the AA flat factor. It reflects many other factors such as the investment strategy of the scheme which would seem inappropriate to influence tax charge. There would be

opportunities for manipulation (the Trustees and employer could agree to a low on-going percentage combined with a large "deficit reduction percentage".

- The cash equivalent transfer value (CETV) that would be available from the scheme in lieu of the accrued benefit were the individual to leave service at the valuation date: This closely reflects the quality of the benefit - but the demographic and financial assumptions are set according to views of trustees in discussion with their Scheme Actuary (taking into account the nature of scheme and employment) so cover a wide range. Further, using this as a tax measure might put conflicts on the valuation process. It would be a number that has a real meaning in the scheme and for the member rather than just notional tax purpose (but would not usually be calculated annually).
- The CETV but using a demographic/financial basis set by the Government Actuary (GAD), reviewed and revised on perhaps a 5 yearly basis - or a set of factors reflecting age and crude benefit quality.
- It is difficult to envisage that any of the above methods would be appropriate and we are therefore lead to the belief that a special methodology and set of assumptions would be needed for this purpose.

  When benefits are drawn in the tax year, the value would reflect the actual benefits drawn which depend on the options taken (commutation for lump sum, early retirement with reduction for early payment) - this could create a positive or negative tax charge because of the difference between the specified basis and the way the Trustees set the option terms.
- Any of the above could be adjusted to make allowance for the strength of the employer and hence the likelihood of delivery of the benefit.

- Valuations of accrual for the tax year would only be possible in arrears. An on-account system could be used but would need truing up annually both for the exact value of the benefit and to tie in with the individual's ultimate correct tax banding (taking into account other income) to be applied to pension savings for the tax year.
- Depending on the method used, there will be some years of negative values – how would an appropriate credit be determined and then given?
- Additional aspects not covered above are how one would apply any cap on accrual under the ISA + incentive approach etc.
- If the "TEE ISA + incentive" structure is adopted for the future, the question would then be how the past is handled. There would need to be:
  - a decision (and laid down methodologies)) of how to identify (once-off) what counts as past and what as future accrual, and
  - either the past element (and any relevant growth on it) falls under a past regime or
  - there needs to be a transition to the new regime: if the transition adopts the sort of one-off tax levy approach speculated on in our DC section, then we assume the approach taken to collecting that tax would be that the scheme

values the past benefit, the member incorporates that into a process that identifies the tax due (allowing for all schemes in existence), the scheme pays the tax and reduces the accrued benefit to source that payment using a “Scheme Pays” type approach.

Overall these extra calculations might be practical these days for schemes that are substantially automated but even then there will inevitably be manual intervention needed in a material proportion of cases. So the extra cost of having to do this for all accruing members could be substantial.

We would regard it as essential that a substantial change in the tax treatment of DB arrangements would also require an overriding power such that employers could redefine the benefits to be provided so that they do not change the balance of cost falling on the employer.

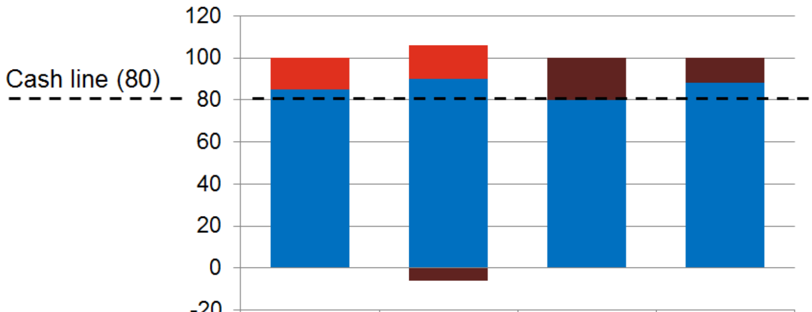
The scheme would also be taking on the risk in terms of liability for delays/corrections. Similarly if Scheme Pays is automatically used, that is another significant burden.

Inevitably this extra cost might be a factor in the choice of some of the sponsoring employers of the remaining private sector schemes with accruing members, to close to DB accrual.

APPENDIX 5 – Illustrations of the implications of the different systems

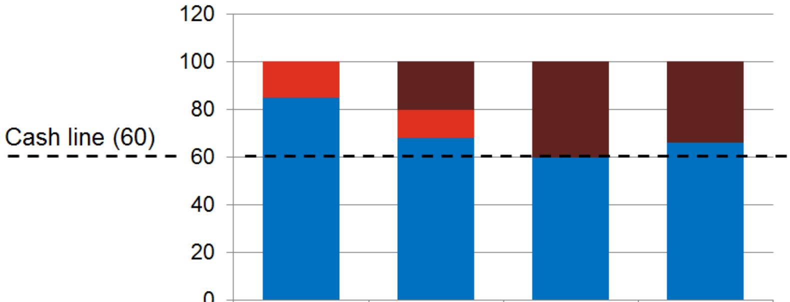
Tax paid under different options

Basic rate (20%) in work and in retirement



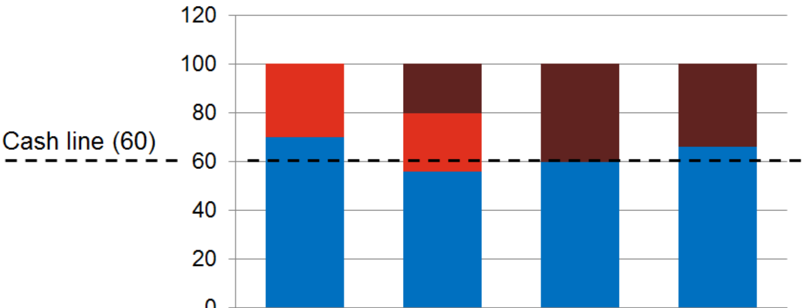
	Current	Flat Rate (25%)	ISA	ISA+10%
HMRC: Now	0	-6	20	12
HMRC: At Retirement	15	16	0	0
Member: At Retirement	85	90	80	88

Higher rate (40%) in work and Basic rate (20%) in retirement



	Current	Flat Rate (25%)	ISA	ISA+10%
HMRC: Now	0	20	40	34
HMRC: At Retirement	15	12	0	0
Member: At Retirement	85	68	60	66

Higher rate (40%) in work and in retirement



	Current	Flat Rate (25%)	ISA	ISA+10%
HMRC: Now	0	20	40	34
HMRC: At Retirement	30	24	0	0
Member: At Retirement	70	56	60	66

Assumptions: Many, including assuming no National Insurance
Note: Tax relief at 25% is equivalent to a Match of £1 for every £3 of (net)

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