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To: Neeta Ruperalia (cc Paul Cottis),
HMRC Pensions Policy Team/ Policy Adviser
Specialist PT Pensions
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Dear Neeta

Dependants' Pension Problems in Finance Act 2004

Thank you for the meeting on 8 August and for the very full discussion on the problems with the provisions of paragraph 16A-16C of Schedule 28 of the Finance Act 2004 (the "dependants' scheme pension test", or "DSP test") triggered when a member (who has begun to draw scheme pension from a registered pension scheme on or after 6 April 2006) dies after age 75, and intended by Government to be a measure to counteract certain actions to avoid LTA charge that might otherwise arise. The ACA's letter of 28 February 2007 and emails of 4 May 2012 and 9 April 2013 in particular are relevant

We had a good discussion at the meeting about the fact that the test is directed at far too wide a membership, and as a consequence involves risk for, and administration relating to, individuals for whom the test is, in principle, unintended. The administration for the scheme arises most obviously in setting up the right data at retirement and carrying out the test at death. Where the test is failed, further administration then arises in setting up the right processing of unauthorised payment charge on each subsequent instalment paid (or cutting back each instalment appropriately, if the rules of the particular scheme involved do not permit unauthorised payments). But the provision also impacts core communications to members – for example in connection, particularly (but not only) with any option they are offered that might worsen or lessen the risk of failing the DSP test – issues it would be very difficult for most members to understand or get appropriate advice about, even before they have to assess the impact of the risk on their own circumstances.

In your follow-up email of 9 August 2013 you asked for information about typical DSP levels with a view to possibly setting a carve-out from the DSP test, and we will be dealing with this in a separate communication.

However, you also noted that, if the government chose to retain 16A to 16C (albeit targeted with more focus on the high pensioned) the government would need to address existing technical issues in the drafting, and you asked for input on what those are. In the Appendix to this letter I attach our list of what we have identified so far. These focus on DB benefits, where the majority of Scheme Pension lies (we have not yet worked through the issues that might arise on DC Scheme Pension).

We do hope that a very wide carve-out can be put into the law, given that HMRC think that a tiny proportion of the populace will be impacted by the LTA – and of these few, fewer still will be deliberately seeking (or even able to seek) "abusive" levels of DSP to avoid LTA charge.

But a carve-out is likely still to mean testing applying for a significant number of cases, many "innocent" – and if the current approach is to continue for them, the Appendix shows how essential it is for corrections to the many flaws. (This is particularly demonstrated in the requirement for monitoring the dependant's pension year on year once in payment.) The administration burden being placed on schemes in relation to the many genuine situations of dependant pension structures (which are unlikely to lead to any tax charge) are totally disproportionate.

Yours sincerely,

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Appendix - Particular difficulties with the limit as drafted

In respect of the limit on the opening pension - the adjustment for tax free cash taken

- There is no indexation of the tax-free lump sum allowance (such that over time, the allowance progressively is less representative of the (real) member pension given up.

  As a suggestion to address this difficulty, we note the indexation permitted before a BCE3 is considered to have arisen. We suggest that the legislation there is looked to as an appropriate base for adjusting the allowance in the DSP test for retirement cash (or this could be simplified even more by considering the greater, each year, of 5% or the year's RPI, since retirement).

In respect of the limit on increases on the DSP

- This test will potentially need to be carried out each future year for all DSPs (if arising from death of a member who started to receive their scheme pension post-2006), except where the "excepted circumstances" apply. The "excepted circumstances" as drafted are inadequate and impractical:
  (a) there will be up to 366 "periods of 12 months in question" as for each dependant they are set based on the date of the member's death and it is implausible in the extreme that all dependants will have the same combination of a percentage increase and a lump sum increase from the previous 12 month period

  (b) as drafted, for the excepted circumstances to apply, once the scheme has passed the criterion that there are at least 50 pensioners, within that group, all the dependant pensioner members must be getting the same [combination] of increases. Just one variation in all the dependant pensioner membership (let alone the natural variations that will have emerged as benefit scales and laws have changed) would stop the excepted circumstance applying. A variation affecting one dependant (eg the most recent one to commence pension) would change the 'excepted circumstances status' of pensions to all the existing dependants.

  (c) the existence of different tranches of benefits (not least GMPs) give rises to different increases between dependants (either as amounts or percentages)

  An "excepted circumstance provision" applies under Schedule 32 para 10 in relation to member's pensions and BCE3s, with a similar purpose but expressed in a more practical manner:

  A pensioner's increase does not count as a BCE3 if that pensioner is within a group of 20 pensioners all having the same increase, a very different structure from the above – and one which could be used even more practically here if the group can include both pensioners and dependent pensions in payment (provided they all have the same increase structure).

In addition the BCE3 test uses the vaguer phrase "at the same rate" with RPSM clarifying this in certain circumstances. It would be helpful if a similar approach could be applied for the dependant pension test.

Overall a better outcome would thus be that the increases to a dependent scheme pension would be "safe" if s/he can be identified as within a sub-group (within however large a group of pensioner members overall, eg the 50 as currently set out in legislation) of say 20 dependent pensioners getting the same increase pattern. And ideally the total 50 would be reduced to 20 – because where the excepted circumstances do not apply for some DSPs, the consequential complexity is considerable.

- Lack of any indexation effectively for **three** years. As drafted the level of maximum dependant pension is determined by the level of member's pension over the year before death, with no indexation, and there is then a further restriction that the maximum level in year two is the same as in year one, with indexation (from year two) only kicking in for year three. Here is an example to show why:

  Data: Date of death 1 January 2021, Initial member pension limit IMPL =1000, RPI 5% each year constant

year	2020	2021 (post death year)	2022	2023
pension	1000 (paid to member) = IMPL	Max 1000 paid to dependant	Max 1000 paid to dependant. Revaluation starts to be measured from the opening month of Feb 2012, ie the first month beginning after the end of the post-death year	Max 1050 (ie IMPL increased by 5%) Actually slightly less during the calendar year because the January RPI increase isn't considered

- As drafted, the maximum level of pension can, in some circumstances, reduce from one year to the next (for example if the first year inflation is 12%, an initial pension limit of £1000 would rise to a current pension limit after year 1 of £1120, but if prices actually fall by 3% the following year the current pension limit for year 2 would be £1102.50 (using the 5%pa underpin). However scheme dependants' pensions in payment generally cannot reduce under typical scheme rules (in the same example, the dependant's pension might be increased in line with inflation or zero in years of deflation, so the first year's increase would be 12% and the second year's increase would be nil - not a decrease). This problem would be avoided if the test were done on a year by year basis, not on the whole period from commencement.

Continued/

FURTHER ADJUSTMENTS RELEVANT FOR THOSE WHO ARE HIGH PENSIONED

In respect of the limit on the opening pension - adjustment for taxed cash taken

- Under 16B(3c) the allowance applies only in respect of 'lump sums on which there is no liability to income tax to which the member has become entitled in connection with scheme pensions under the pension scheme before his death.' This definition does not include a lifetime allowance excess lump sum; but we can see no logic for excluding this lump sum from the adjustment; and this benefit element will be more material as the Lifetime Allowance reduces (in actual terms, and in real terms if it is frozen).

In respect of adjustments to the member pension for other taxes

- The member's pension in payment will reflect any reduction in benefit due to Lifetime Allowance charge. We noted in our 2007 letter that the structure of the law is such that it effectively forces trustees to recoup the value of LTA charge all from member pension with no impact on the spouse's pension. (Say Mr X has accrued £6,000 pension, with an attaching dependant's pension of £4,000 pa, but Mr X has already used up a lot of LTA by the time he draws this. The Trustees identify that he has LTA charge on £3,000 pa of this and so apply a reduction of say £750 pa to £5,250. This 15% reduction in his pension increases the probability (when added on to the other issues mentioned) that the dependants' pension will at some stage breach the limit. This seems inappropriate, so we believe that such reductions should be "unwound" in identifying the benchmark member pension at death – although we think this will make the test extremely complex to do.

- A similar point might arise if trustees choose an AA scheme pays policy of benefit reduction that is similarly focussed on member pension (as the initial HMRC guidance suggested HMRC preferred, although this has been deleted in the RPSM page version of the HMRC guidance).