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2 January 2013

To HM Revenue & Customs Pensions Policy

Dear Sir/Madam

Draft statutory instrument - The Annual Allowance Charge (Amendment) Order

I refer to the draft statutory instrument HM Revenue & Customs (HMRC) has published for external comment making a number of changes to the annual allowance (AA) legislation following the changes in Finance Act 2011.

As requested we are emailing our comments, albeit one working day after your deadline of 31 December 2012.

This is one of two letters. Our other letter of today's date relates to the closing adjustments made when a transfer is brought into a scheme for a credit in a DB or CB arrangement.

This letter deals with the balance of our comments on the draft instrument, set out in the Appendices to this letter. Appendix 1 deals with two headline issues, retrospection and GMPs. Appendix 2 deals with clauses in detail.

We have however one overall comment. The consultation period 16 November to 31 December is too short given the particular circumstances that have arisen, including:

- HMRC has not yet provided answers to ACA's technical questions, some posed as early as February 2012, which touch on exactly the issues aimed at being addressed. Without knowing whether HMRC agree our readings as set out in those letters we cannot be sure how the proposed changes would work. (The list of letters is set out at the end of the main section of this letter.)

- Finance Bill 2013 material was issued 11 December, with clauses covering similar issues (with an overlapping but different implications and applications for determining "accrual" for fixed protection) - but using different wording. Inevitably the different wording will mean slightly different things, and we suggest time is given to allow considered analysis of the differences and to work out which is

better. It would be unfortunate if different wording is used where the same wording could apply - unnecessarily increasing complexity in subtle ways, extra cost of advice and more HMRC guidance.
Time constraints mean our response has paid no regard to the Finance Bill material.

- The draft regulations include a new 236(5A) which casts very new light on HMRC's interpretation of 236(5) (transfer-in offsets to PIA) and then attempts to solve issues that arise (via a block transfer provision). A very helpful explanation was given orally at the PISF meeting of 18 December but we feel that beyond this there has been little explanation and potentially the provision will have either been misunderstood or had little time for full consideration by many. (5) and (5A) are important provisions that potentially have impact in a wide variety of circumstances.

In relation to these latter two points, the Christmas holiday period has further limited time for discussion and further consideration.

Several of the changes are being proposed so as to solve problems identified to HMRC; some important ones appear to address new concerns of HMRC. They aim to prevent AA being used up for an individual through no fault of their own with the potential for an AA charge arising, to help ensure that the annual allowance rules work as intended; and to reduce the burdens on scheme administrators. It is important they are appropriately written and do not either fail to solve the problem or unintentionally create new problems.

We think this would be a substantial advantage to Government, HMRC and to scheme members, trustees and scheme providers and employers, if further time could be allowed for HMRC to answer the questions we have already posed so we can better consider the draft legislation, and for development alongside the Bill measures. The gain in the long term outweighs the longer period of uncertainty involved.

We hope that you find our comments of assistance and would be happy to discuss them further if helpful. You can contact me on 020 7432 6622 (karen.goldschmidt@lcp.uk.com) or Mike Richardson on 0118 977 2277 (mike.richardson@puntersouthall.com).

Yours sincerely

Karen Goldschmidt
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The letters to HMRC setting out questions from ACA on the operation of this legislation and so far not fully answered include the following, all to be found on http://www.aca.org.uk/aca-briefing_papers.html:

- *15 June: the "relevant percentage" and in particular the operation of the "specified rate" when there is a change in scheme rules (after 14 October or 9 December 2010 as appropriate), in testing for benefit accrual under fixed protection (FP) and correspondingly for the "carve-out for deferred members" benefits for the AA test.*

- *15 June: the issue of how arrangements can be defined by the scheme administrator (typically the trustees) of a pension scheme, particularly in the context of "split NPAs" in defined benefits arrangements (a very common feature of UK schemes).*

- *24 July: effectively this was a reissue of our previous letter dated 5 February 2012 (no response yet from HMRC) on how to calculate PIA for AA (and carry out the accrual test for Fixed Protection) for deferred members.*

- *Scheme Pays letters (the last one being 15 March 2012) – some of this has been answered by RPSM changes since March, but not all.*

We have had some ad hoc discussions with your team about some issues for deferment revaluation and AA and FP, raised by the QinetiQ court ruling, which discussions have not yet come to conclusions as far as I am aware.

APPENDIX 1: DETAILED COMMENTS – headline points

Headline point 1: Retrospection

The legislation is drafted to come into force with effect from 6 April 2013 so the changes would impact calculation/provisions as they apply for tax years 2013/14 onward (except for provisions about nominating PIP end dates, which work in "real time" so impact immediately from 6 April 2013).

We have marked against each provision below whether we think "full retrospection" is essential. By this we mean that the provision should apply

- for calculations for PIPs ending in tax year 11/12 onward (ie years actually triggering AA charge under the new regime); and also
- for the notional calculations for tax years 2008/9 to 2010/11 for carry forward purposes.

If such retrospection is not granted, then the problems solved for the future will continue to emerge for those years: for example to the extent that "deferred member carve out" does not apply, trustees will have to calculate figures of potentially complex amount for individuals in unintuitive situations and communicate this appropriately when members need figures.

We understand that tax law usually allows retrospection only so long as no individual is worse off: so retrospection might have to be such that eg PIA outcome is whichever would be the lower of the new and old provisions. You might be concerned that this creates an extra burden on trustees either having to redo numbers already quoted or else carry out two sets of calculations. However the statutory timeline means that to a large extent trustees have not yet done the "old numbers", holding off because of uncertainty or in the hope of a change in the law; or have used the "new" proposed method already not realising their error. And the new method will often give the lower figure (and can be shown to do so without detailed number work) so that the old method can be ignored under such an approach.

Headline point 2: GMPs

We have set out how we think calculations of PIA "numerically" take into account the revaluation imposed by statute for non-GMP benefit and are awaiting HMRC confirmation on that. We have not yet explored how GMP revaluation is to be taken into account "numerically". (While these might be ignorable in some cases (where "carve outs" apply), we are finding plenty of circumstances where that is not the case.) We note a few points within this letter but feel that the matter merits more exploration with HMRC when your resource is available.

(The same issue arises for Fixed Protection and the assessment of benefit accrual.)

APPENDIX 2: DETAILED COMMENTS – comments by section

References below are to the resulting provision that would arise in Finance Act 2004 not to the provision in the regulation making the change

Changes to 230 to 232

Comments correspond to the comments below on 234-236, except for

- A missing change for 232(6) corresponding to the provisions eventually being made for 236 (5)/(5A) – see our separate letter.

- Changes to 232 (8B): this appears appropriate to us.

Changes to 233 (2) (2) No comment

234(5AA)

Changes to 234(5AB)

There are several points on this key provision that [for a deferred member] *"there is to be taken to have been no increase in the value of the relevant rights of the individual [in the arrangement] during the pension input period where the whole of what would otherwise be such an increase is the result of any provision contained in or made under an enactment".*

- It can be difficult to determine that a provision is wholly required by an enactment – for example the interaction of preservation and contracting out is complex and not absolutely determined; and we are not sure whether this covers unavoidable second order impacts. We would also hope that this easement could cover an approach which is deliberately overgenerous but set this way as to avoid disproportionate legal and admin costs to determine the absolute minimum solution.

  Would it therefore be possible to have something like "is, according to advice from the appointed legal adviser of the scheme administrator, reasonably attributable to a provision contained etc".

  (Without detailed analysis yet, we note that this is a particular area where the Finance Bill corresponding provisions are framed differently, and where one would hope for consistency between concepts.)

- How does this combine with other carve outs? Under contracting out legislation, a deferred pension with a Normal Retirement Age of 60 is not required to include any revaluation on the GMP until the member reaches their "GMP Age" (65 for men, 60 for women); but it is common for scheme rules to require a proportion of the revaluation to be added from age 60. So this could not be said to be required by law, but presumably would be a specified rate and thus – if the only thing applying - would fall within the existing “relevant percentage carve-out”? If the balance of the revaluation is solely as required by preservation on non GMP, would it qualify for this carve out? (We note that this may or may not qualify overall for a carve out on grounds of being a “specified rate” if written into the rules, but we are not sure it would if arising solely because of overriding law.)

Similarly it is not uncommon for schemes to operate an annual revaluation grant (which may or may not benefit from the deferred member carve out on the basis of being a “specified rate”; but have the (cumulative) statutory revaluation as an underpin when the individual eventually reaches retirement. How would the provision work for these?

- It has a cliff edge effect: a benefit of £1 more than what can be deemed as minimum means the whole carve out would be lost. So for example this would appear to happen in the PIP of retirement, if the pension put in place is the statutory minimum rounded up to the next £12 multiple (rounding not being uncommon given that pensions are paid monthly, or even weekly). See the changes put in place to BCE3 measures (the annual threshold) for how this issue was dealt with elsewhere.

- The Government is requiring benefits with GMPs to be “equalised”: we would hope that changes made to benefits so as to comply with this are covered in this carve out, but would need confirmation of this.

  (And this is particularly an area where practical overgenerous approaches will be devised: it may well be that an employer chooses a simplified approach (that is not the “minimum to achieve equalisation” and so can only err on the generous side so as to comply with the law) so as to hugely reduce the administration costs of benefit set-up and/or to ease data sourcing.)

  This provision applies solely for deferred members. GMPs accrued up to 1997 ie before the current AA regime, so it would be appropriate to put in place legislation now to avoid increasing PIA for active members (or would the equalised benefit be deemed to have been in place all along)? If the latter, it is even more vital to completely exclude GMPs for PIA calculations as otherwise a scheme implementing GMP equalisation may find it has restate all PIA calculations.

We note as an aside that there will need to be guidance on how to calculate the PIA related to certain statutory increases. For example it is not uncommon where employers are seeking to reduce DB accrual, for service accrual to stop at Date X but salary linking to continue while the individual is still with the employer; but (following legal advice) with the proviso that this is subject to not being less than had the member instead become a normal deferred member at Date X. So if the individual has a pay freeze, the individual’s accrued pension will grow in the PIP solely according to statute but s/he will not be a deferred member for tax purposes so no carve out. Hence our letter of http://www.aca.org.uk/files/D._ACA_letter_to_HMRC_dated_24_July_re_aluation_methodology_for_AA_and_FP_for_deferred_members-24_July_2012-20120724114453.pdf

In reading this law, we would appreciate HMRC's confirmation as to whether statutory minimum revaluation counts as a "specified rate" if referred to specifically in the scheme rules? Is the answer the same if the rate is not explicitly referred to but in practice is overriding?

234(5B) and 234(5BA) No comment

234(5BB)

This appears to apply only at the instant when the policy is put in the member's name.

We had hoped that this could apply in the wider circumstance of the earlier stage in the scheme's "flight path" to wind-up envisaged by the Regulator; that is, the trustees buying deferred annuities when the price is considered best and appropriate albeit as a scheme asset rather than in the name of the individual. If there is a mismatch between the benefit due and the asset purchased, it may be that the difference is crystallised when the individual comes to retirement and the asset rearranged; or in rarer cases it may be that the benefit is adjusted upfront (ie when the asset is purchased but before it is moved into the member's name), and this latter circumstance would not be encompassed in the draft legislation.

Even in a wind-up, there may be a time delay between the members' benefits being fixed at a particular level – potentially higher than under the scheme rules because of what could be secured – and the date that the policy is moved from being in the name of the trustees to that of the member (albeit that there may have been a commitment to do so at that fixing). Is this time delay encompassed here? Other than to note this point, we leave APL to consider this provision further, as it relates to a highly technical one needing understanding of the structure of benefits in wind ups in general law and tax law.

This clause needs a (iii) to encompass the possibility of the "specified rate" applying in the arrangement being maintained in the buyout.

234(5BC) No comment

Changes to 234(5C) definition of deferred member

The draft change highlights a previously unknown interpretation by HMRC that a deferred member bringing a transfer in to a scheme for a credit (even if a mirror image deferred pension) has “accrual”. We note that the new wording stops “accrual” causing the deferred member status being lost but does not eliminate the “accrual”. We are working on analysing what implications this could have (in the relatively limited circumstance of a deferred member transferring into a deferred member defined benefit arrangement) – for example we think that a pre 2006 leaver would lose the status of having no PIP (RPSM06107210 refers).

We would appreciate confirmation that the carve out applying because of a predecessor scheme “specified rate” would carry through including in the PIP of transfer in. We comment further in our comments in our separate letter about section 236(5) and (5A).

234(5C) definition of relevant percentage

We are worried at the word “solely” and not sure of its meaning.

- A key reason for requests for this law change was because schemes have put in place revaluation mimicking the statutory requirements but using RPI rather that CPI for future years: that is, [inflation] cumulatively over the period from leaving to retirement but with a cumulative cap of 2.5% pa or 5% pa and “collar” of 0%. The collar means that the rate could actually exceed inflation (if inflation is negative); and the cumulative nature of the increase combined with the cap means, we believe, that the Finance Act “valuation assumptions” cause an intermediate increase element over a particular PIP as being more than inflation. A full account of this, requesting confirmation that you read the legislation in the same way, is set out most recently in our letter to you of 24 July 2012:

http://www.aca.org.uk/files/D._ACA_letter_to_HMRC_dated_24_July_re_aluation_methodology_for_AA_and_FP_for_deferred_members-24_July_2012-20120724114453.pdf

If the current drafting encompasses this, please confirm; if not, then the drafting needs to be changed to solve the problem raised.

- Would this encompass the better of CPI and RPI? (A few schemes have found it necessary to adopt this.

We cannot be sure how this provision works without answer to our letter http://www.aca.org.uk/files/B._Letter_to_HMRC_dated_15_June_2012_re_relevant_percentage-24_July_2012-20120724114146.pdf

Re the date set of “6 April 2012” is there scope for this to be extended? While we appreciate that HMRC want to limit the window for such change, there may be a few schemes still trying to work out their legal obligations and hence whether they are outside the legal requirements/want to make a change outside the minimum legal requirements.

Changes to 236 (5A) and implications on the reading of (5)

This is a significant change as well as highlighting an unknown interpretation by HMRC of the current 236(5). We set out comments to this in our separate letter.

Changes to 236(8D)

We appreciate the aim of this paragraph and we think that perhaps it works, but it is difficult to read and it would be helpful if it could be rewritten.

The provision maintains the original scheme-based test rather than an arrangement-based test, presumably because a SP reduction can be made from any arrangement wherever the accrual causing the charge arose - but we are not sure that is appropriate. It also focusses solely on the position when all scheme benefits are drawn and again we are not sure this is appropriate. Would the following work?:

> *"(8D) But no amount is to be added under subsection (8C) by reason of an adjustment made during the pension input period in consequence of the scheme administrator satisfying a liability under section 237B in a case where the individual became entitled to any of their benefit under the arrangement to the extent that the adjustment was made to that benefit within the arrangement after the individual became so entitled."*
>
> So if at the start of the PIP the individual had accrued pension DB £100 pa, and during the PIP was granted a BCE2 of £100 pa that subsequently but within the PIP dropped to £80 pa following a scheme pays reduction of £20 pa, the PIA will properly reflect £100 pa end level because of 236(6) and needs no add-back; and the same is true whatever is going on to other arrangements within the scheme.

This provision would not be expected to be put through with retrospective effect. We have not worked through whether there might be any transitional anomalies.

There are various outstanding questions in our letter to HMRC of 7 March 2012 and in order to properly analyse the changes proposed further we would need answers to those (see http://www.aca.org.uk/files/AA_and_Scheme_Pays_-_letter_to_HMRC-15_March_2012-20120316150336.pdf).

Changes to 237B

We read this as intended (because it doesn't mention PIPs or tax years at all) to accelerate the deadline to opt for SP for all "open" tax years. We support the concept of aligning of the condition for deadlines (although our preference would have been that they were aligned such that the long "normal" deadline applied for all SP charges, to avoid the situations where individuals miss the election deadline by mistake).

This change should not be made retrospective, but the current transition does not work. Consider an individual with PIPs ending 7 April who retired June 2012 (ie in the 2012/13 tax year although in a PIP ending in the 2013/14 tax year). Such a member may have unsettled AA charge for the tax years 2011/12 (current deadline for SP 31.12.2013), 2012/13 (not a closed tax year at the date of retirement, but with accelerated deadline June 2012 under current law) and 2013/14 (not started at date of retirement or indeed yet). He cannot opt for SP for 2013/14 under current law until after 5 April 2014; but by then would be required to have opted before June 2012.

We note that the change means that there will be circumstances where there is no "reasonable estimate" that can be made by the member of their annual allowance charge, so that they may be forced to make a token estimate; and there will be a high likelihood of corrections.

Given the accelerated deadlines, we would also ask for SI 2011/1793 The Registered Pension Schemes (Notice of Joint Liability for the Annual Allowance Charge) Regulations 2011 to be changed: a scheme having to demand a declaration from a member confirming that *"the amount specified in the notice has been calculated at the correct relevant rate*" for a tax year that potentially has not even opened yet is unreasonable, even in the background of tax returns often requiring estimates. Alternatively there should be clear HMRC member-targeted guidance on this rather than schemes having to explain it.

Changes to 237B(9) No comment

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