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Dear Sir/Madam

Response to discussion document on restriction of pensions tax relief

The Association of Consulting Actuaries (ACA) welcomes the opportunity to comment on the Discussion Document *Restriction of pensions tax relief* published jointly by HM Treasury and HM Revenue & Customs on 27th July 2010, intended to facilitate discussion on the alternative approach to restricting tax relief on pension savings. This alternative approach is based around a significantly reduced Annual Allowance ("AA") rather than an income threshold test, the High Income Excess Relief Charge ("HIERC") approach.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members are all qualified actuaries and all actuarial advice given by our members is subject 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 defined benefit pension schemes. The ACA is the representative body for consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

We are pleased that the Government has listened to the concerns of employers and the pensions industry about the unfairness, complexity and unintended consequences that would be imposed by the HIERC approach. We believe that the alternative AA approach may, overall, be a fairer way than the HIERC approach, for collecting the Government's desired tax yield, with fewer anomalies and cliff edges. Nevertheless significant challenges remain, particularly when considering defined benefit accrual. In answering the questions asked in the Document we have, for some questions, set out alternative responses and explained the advantages and disadvantages of each.

We acknowledge the Government's aim to raise their target tax yield of £3.5bn - 4.5bn pa through changes to the pension taxation system but our overriding concerns are that:

- the changes do not impose disproportionate burden – particularly in relation to defined benefit schemes - on employers sponsoring schemes and on the pensions industry, both of which are already struggling under a burden of legislation from the last few years;

- the information exchange required to check whether pension accrual and contributions are within the new AA is not disproportionate when compared to the actual small amount of tax expected to be collected as a result of exceeding the AA (given our understanding is that the Government's intention is to incentivise individuals and companies to change their reward and savings arrangements to be within the new reduced AA);

- decisions are made for the long-term, not just to achieve the required tax yield in the next few years; and

- anti-avoidance provisions are not drafted so widely that they stifle reasonable actions to work within the AA tax limits without exceeding them.

This letter is structured as a main section directly addressing the Discussion Paper's specific questions (section 5.1) and then its open question (section 5.2); and Appendices specifically on treatment of early retirement benefits and carry forward/back.

Yours faithfully

Karen Goldschmidt

Chair, Pensions Taxation Committee, ACA

1. **There are currently exemptions from the AA test which would undermine the ability of a reduced AA to restrict pension 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 tax 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 (Paragraph 2.7)**

The existing AA legislation:

- is relatively untested (in particular against the wide variety of DB or hybrid benefit scales now in existence);
- has known flaws (the JWG correspondence with HMRC on Special Annual Allowance in August 2009 highlighted some items needing either legislative correction or very clear and full guidance in HMRC's Registered Pension Scheme Manual);
- has elements that are being changed that will also open up a range of issues to consider and test.

So it will be necessary for ongoing testing against real life situations once the initial legislation is framed and appropriate HMT/HMRC resources to make adjustments.

With regard to "avoidance", two areas currently relatively unconstrained in relation to how AA limits tax-relieved savings are as follows:

- Transfer value payments from DB to DC schemes: there needs to be a balance between preventing enhanced transfer values adding artificial value on transfer to a DC environment; but correspondingly allowing reasonable transfers which properly reflect the benefits forgone. For this purpose, it is not appropriate to set the benchmark for a transfer value at one based on the AA flat factor used to value accrual, because the minimum cash equivalent currently required by law could be higher.

- Additional or excess increases to pensions once in payment: we suggest that if an approach is taken to encompass AA testing on high levels of pension increases, it is limited to the occasions when an increase counts as a "BCE3" for Finance Act 2004 purposes; and should not encompass increases effectively required by law (eg for GMP anti-franking). This measure should not impact those who started drawing pension before 6 April 2011.

Conversely the aim for a relatively simply regime will be severely undermined if impractical anti-avoidance provisions are imposed.

The overly broad anti-avoidance provisions for the Special Annual Allowance in 2009/10 and 10/11 have caused much concern. The anti-avoidance legislation in Finance Act 2010 for the HIERC approach was of even more concern, in complexity of interpretation and potential breadth of application.

Too wide anti-avoidance legislation can have a significant drag on the cost and complexity for employers in designing pension arrangements best suited to their members. Schemes designs are already complex, reflecting past legislation and its lack of flexibility. Complexity also makes it difficult for members to make sensible decision. It increases the cost of legal advice and can also increase administration costs for schemes and for HMRC.

We would urge that any anti-avoidance legislation is kept to a minimum and is tightly focused on specific concerns, and has robust, consistent and fully broadcast guidance. The fact that Government wants employers to redesign schemes to "aim off" the AA tax means that this is particularly important for the new tax regime.

We assume HMT will permit designs that allow maximum accrual within the AA each year. There might be concerns about excesses being converted into quality improvements (e.g. pension increases where there would otherwise be none) but we would argue that this should be permitted if within the quality assumed in setting the AA factors. Most employers are trying to minimise the cost of their defined benefit arrangements and also to reduce risk by reducing the weighted term of their arrangements and so this is unlikely to be a significant issue.

Other examples of practices that may or may not be seen as avoidance are managing benefit-drawing around the end of the tax years/pension input periods (PIPs) and staggering drawing early retirement benefits over two PIPs.

As part of this need for employers to have clarity on what does **not** count as avoidance, there is a need for early clarification as to how employer-financed retirement benefit schemes (EFRBS) will be brought into the regime. We understand that Government's intention is that EFRBS (funded or unfunded) do not provide tax advantage compared to savings in registered pension schemes: the exact methodology will be very important for employer decision-making, including understanding the implications for arrangements already in place and appropriate ring-fencing of accrued past promises.

2. 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 (Paragraph 2.11)

If the key aim of the regime were to value the DB accrual "consistently" between DB and DC, between one form of DB and another, and to reduce intergenerational cross-subsidies, the natural way (as identified in the HIERC approach) would be factors reflecting age, due pension age, pension quality, scheme security etc. The Discussion Document indicates that the Government is minded, for various valid reasons, to adopt a simple flat factor approach instead. Once this sort of simplification is introduced, our view is that it is essential that the underlying simplifications are maintained consistently. Otherwise, complexity and inevitable inconsistencies are introduced.

Early payment

Our impression is that a key area of Government concern is "added value" by delivering benefits earlier than their due payment age (Normal Pension Age, NPA) – in particular below age 60; with a proposal that such retirements should be assessed separately using cash equivalent transfer value (CETV) factors (or factors that reflect age and scheme NPA).

In our view the use of scheme CETVs is inappropriate. As required by law, CETV bases are very scheme specific – two people retiring on the same date would receive a tax charge depending on the particular CETV assumptions used for the scheme on the particular date they retired. They are market related so their use would mean a member cannot plan ahead for his/her retirement, and this could lead to members asking for repeated quotes to assess the optimum time for retirement. CETVs reflect quality features which are otherwise ignored in the annual flat factor approach being adopted. We comment on this in full detail in Appendix 1 with a suggested approach (in summary, that NPA is ignored; that one flat factor is used for accrual and benefit drawing at all ages from 60 upwards; but higher age-related factors are used on actually drawing benefit below age 60).

Other quality aspects than payment age

Payment age is one feature of quality that is ignored in the current AA legislation.

Various other aspects are ignored in current AA legislation because accrual in the year of drawing benefit is ignored eg commutation for retirement lump sum, surrender of benefits for spouse pension. HMT will need to decide whether the benefit in the AA test is before exercise of such options (as was decided for HIERC) or the actual benefit delivered to the member (as applies for Lifetime Allowance testing). The latter introduces an extra element of complexity in a member's planning, but more fairly reflects the benefits paid.

Similarly qualities that represent value are whether there is a spouse pension attached and the level of pension increases. To bring some valuation of these when enhanced would be inconsistent with the simplified approach for accrual using flat factors that ignore the wide range these cover.

Setting the AA factors

In considering the new level of the AA, we suggest that this needs to be in conjunction with a flat DB valuation factor that is broadly realistic. To deliberately understate the factor (with a corresponding reduction in the level of the reduced AA) would be perceived as unfair to those who rely on DC provision; and vice versa.

3. 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 (Paragraph 2.16)

The question is asked in the context of current AA legislation that gives DB deferred pensioners an allowance for revaluation to offset each year before AA counts as used up, but according to specified formulae and in a regime that does not test in the year of retirement (and tests against a high AA so with large margins); and a regime that does not give active members any equivalent revaluation allowance offset.

The question of whether the DB valuation factors will allow for indexation on benefits for active members, and the wholesale carve out for deferred pensioners, are obviously interrelated. We have considered each in turn.

Revaluation offset for active members

Our view is that there should be an offset allowance for revaluation for active members' benefits:

- One of the key issues that will exercise employers and their advisers, once details of the new regime are fully known, is how best to design a pension scheme to ensure that accrual is kept within the AA, whilst still providing good quality benefits. Whilst the obvious answer would be to go down the defined contribution route, many employers would still like to be able to offer some sort of defined benefit style solution, including career average revalued-earning style schemes (CARE). In a CARE scheme, past benefits are revalued in line with an index. Provided the index was chosen so as to be less than or equal to the index incorporated into the Government's AA test, the employer would be confident that the past service element of an individual's benefits would never potentially trigger an AA charge. This would be a very simple scheme design that could operate in an efficient manner. If indexation were not allowed for, it would make it more difficult for employers to offer defined benefit style pensions in the future. (As the ACA has consistently argued, pure DC is often inappropriate for lower paid and less financially sophisticated employees and it is regrettable that accumulated legislation - of which this is another leg - has hastened the private sector abandonment of DB and, currently more difficult, risk-sharing models).

- An increasing number of employers have limited the open ended risks associated with DB accrual by placing an indexation limit on the benefits accrued in the past (often with such limit designed bearing in mind the statutory requirements for minimum revaluation for deferred pensioners); and on the salary increases counting as pensionable for future accrual. It would be appropriate that this closing off of risk is accompanied by a closing off of tax risks/checks too.

- If indexation is not allowed for active members, but deferred members' pension revaluation is ignored, as is currently the case under the AA, then there are likely to be avoidance opportunities (which could correspondingly be seen as a complex option decisions) involving members opting out of scheme accrual temporarily.

- If a benefit attracts revaluation, there is less difference in the present value of a given amount of DB benefit accrual, whether it is accrued by, say, a 55 year old or a 35 year old. The Government's being minded to use a flat factor for valuing DB benefit could therefore be said in some ways to be consistent with allowing revaluation offsets (and perhaps, if revaluation **were** to be assessed against the AA, employers' changes to mitigate the AA charge would have more potential to be in conflict with age discrimination legislation.)

There are some disadvantages to allowing a revaluation offset:

- Use of indexed factors increases the scope for negative accruals which, if not resolved, lead to inconsistent treatment (eg for individuals who receive no salary increase for a number of years followed by one large salary increase to bring them back to where they would be with inflationary increases). This issue could be mitigated if a limited carry-forward/back of accrual is permitted.

- Presumably granting the offset may mean that the flat DB valuation factor has to be set higher to achieve the same tax yield, all else being equal.

The current methodology used for the AA tests for deferred pensioners is a reasonable starting point for the "revaluation allowance" for actives. In effect, the starting accrued position each year is uplifted by the greater of 5%, RPI, and where appropriate, an allowance for GMP statutory revaluation, before being compared to the value of benefits at the year end, to determine the value of the AA used in the year.

Following the Treasury's recent announcement, CPI needs to be accommodated. Uncertainty remains as to how, if at all, the announcement will affect schemes which have RPI "hard coded" into their rules, both CPI and RPI should remain available as an option.

Ideally a scheme would have flexibility to choose the month on which annual RPI is assessed (as is the case for BCE3 testing) – to fit neatly with scheme design.

Carve out for deferred pensioners

Across DB schemes there are a huge number of deferred pensioners, substantially greater than the number of actives. Members, employers and scheme administrators would hope to incur minimal administration cost on these. They would certainly not expect a new tax charge on "future savings" to impact such accrued benefits – nor would they expect the existence of such accrued benefits in one scheme to impact on the scope within the AA for pension savings in the future in another scheme.

We consider firstly deferred pensioners leaving pensionable service after 22 June 2010 – when employers and individuals first knew of Government's possible intent to use a reduced AA. This highlights the potential burdens of testing deferred pensioners, so we then consider a desired easement for the very large number of individuals who became deferred pensioners before that date.

- Future leavers: should "normal" revaluation of deferred benefits before retirement be exempt?

  Reasonable deferment revaluations should clearly be exempt (ie not use up AA), as is indeed allowed for in the current AA legislation. The administrative implications of sending every deferred pensioner in the country a statement every year are unthinkable. Where deferment revaluation is in excess of normal levels (say as measured by the formula above for actives), as now, it might be appropriate that that excess uses up some AA. This would be onerous to manage but would be expected to affect a much smaller group of people, and this burden might be reduced or removed by careful benefit redesign (especially were this to be made easier under the legislation). Without such a provision for excess revaluation, there could be scope for tax avoidance eg by using a low accrual compensated for with a high revaluation rate.

- Future leavers: should benefits be tested at the point of retirement?

  For the reasons given above, ideally no deferred pensioner should face an AA test for "extra value" when they come to draw benefits.

  However, there may be a risk of avoidance for individuals who are employed or have been shortly before retirement: an active member could simply opt out, become a deferred pensioner for a brief period and then retire with enhanced terms. So there is an argument for treatment in line with actives. As for active members, this means that, if a scheme's early retirement factors are not broadly cost neutral when considered against the Government's DB valuation factors, AA could be used up and a charge arise (see Appendix 1).

  This burden could be limited by perhaps exempting scheme deferred benefits from this test, for an individual who has not been employed by the scheme's sponsoring employer for 2 full PIPs before drawing the benefit.

- Deferred pensioners who became deferred prior to 22 June 2010

  The above shows that to combat the risk of (rare) tax avoidance, some deferred pensions may need to be subject to some AA testing after the member has left pensionable service, despite the burden and complexity this causes.

  However, any of the many individuals who became deferred pensioners prior to the day of the emergency budget cannot possibly have been engaging in avoidance techniques aimed at the new AA legislation. Such an individual would assume that s/he had ceased accruing benefits in their pension scheme, so that (provided ultimate benefits were less than the Lifetime Allowance), there would be no further tax due apart from income tax when the benefit came into payment. As such, it seems appropriate that - whatever the revaluation or early retirement terms that had been put in place - these benefits should be completely ignored for AA testing. To do otherwise would seem tantamount to a retrospective tax.

The exemption might no longer apply if a change was subsequently made to the benefit - other than changes required by statute or certain categories of changes that affected all (or all of a category) of members in a scheme. We would be happy to discuss with HMT and HMRC ways in which the criteria for allowable changes could be defined so as to prevent avoidance opportunities.

Negative accruals

Whilst acknowledging that negative accruals are an issue and that, in an ideal world there would be some mechanism to recognise them, we cannot see a simple and efficient way to do so. As such, we agree with the Government's proposal that negative accruals should be counted as zero. This is subject to the carry-forward/back proposals noted in Appendix 2 being adopted, which should alleviate the majority of the problems associated with one-off atypical spikes eg promotional. If suitable carry-back/forward proposals are not adopted, then the issue of negative accruals would need to be looked at again.

4. 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 (Paragraph 2.17)

<u>together with</u>

5 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 (Paragraph 2.19)

Death/serious (terminal) ill health lump sum

We concur with the view in the discussion paper that *"The Government does not believe that it would be appropriate to apply the AA test in cases where individuals die or are diagnosed with serious (terminal) ill health. … therefore proposes that there would be exemptions for individuals who draw a serious ill-health lump sum, as defined by Schedule 29 of Finance Act 2004, and in the event of death"*

(Non –terminal) Ill health early retirement

It is not uncommon for DB or cash balance schemes to provide an immediate retirement package, more generous than the accrued leaving service benefit, if an individual leaves service satisfying an ill health criterion (for example for a member unable to continue with his/her current job and with no expectation of recovery). Such benefits may arise rarely but are of material value when they do, and are specifically encompassed as a tax relievable benefit within the past and present tax regime. (Effectively the benefit is designed to compensate for what the employee might otherwise have accrued over his/her future working lifetime on scales potentially never breaching the AA.)

The discussion document indicates concern on abuse. Ways to deal with this might be a combination of a higher AA to apply in the year of drawing pension on ill health grounds; a tighter definition of ill health to qualify for this; and specific reporting to aid audit by HMRC, as follows:

- Simply excluding ill health retirement benefit from the AA test could give means for very substantial benefits to be delivered to some individuals. Instead, a higher AA could be set to reflect what HMT consider a reasonable maximum value to be granted to an ill health retiree. Such a modified AA would need to be fairly high – £300,000 to £500,000 might be appropriate. (This would apply for both DB and DC schemes.).

  (An example to demonstrate this: take a 45 year old member with 20 years' past service in a 1/60th scheme on salary £30,000 pa. The ill health pension might be £20,000 pa (40/60 x £30,000 including credit for potential service to NPA). The accrued leaver pension would be only £10,000 pa. With no special provision, this might represent an uplift in value for AA purposes of the order of £150K - £250K or more.)

- The current ill health definition in Finance Act 2004 is very light touch. It might be appropriate to restrict easements such as the above to cases satisfying a tighter definition of more severe ill health.

- All ill health retirements benefiting from the easement could be reported to HMRC to allow monitoring/ad hoc investigation.

- HMT are concerned about abuse. It seems least likely for abuse to happen for younger individuals (less influential, potentially more costly) so one route would be to give allow the special AA only for those aged 50/55 or less.

DB schemes use a wide range of ill health criteria, sometimes with different benefit arising within the same scheme on different ill health measures. Schemes may wish to align their ill-health criteria with any new HMRC easement criteria so legislation will need to be sufficiently flexible to allow such changes to be made to rules without this being treated as a detrimental modification.

The Discussion Paper suggests that PHI may be a viable alternative for employers to provide a benefit on ill health. In order to assist employers to manage premium costs, legislation may be helpful to restrict the period of payment (now that setting an employment "retirement age" is no longer possible).

This is one of the more urgent areas needing resolving in the new legislation: if an individual is already becoming ill now (or by 6 April 2011), it will not be possible to buy them PHI cover.

Enhanced benefits on redundancy

We have no specific proposals in relation to enhancements that arise on redundancy/termination etc but comment on these indirectly in relation to early retirement (see Appendix 1). However, one could also argue that if the enhancement is designed as proxy compensation for not working for the next few years it is harsh to apply penalty tax to the enhancement in a single year.

A carry forward/carry back mechanism might help soften this issue – we comment on this in detail in Appendix 2.

6 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 (Paragraph 2.25)

In paragraphs 2.23-2.25 and 2.31, it is suggested that the level of the LTA might be reduced in the interest of "coherence" with the reduced AA and that a reduced LTA might help to facilitate a higher (reduced) AA and the possibility of indexing the latter over the longer term. It has also been suggested that the factor for valuing DB is changed.

- We regard this proposal with great concern. The LTA is fundamental to the Finance Act 2004 pensions tax regime, and has been central to pension planning for 'high earners' since its introduction. Changing any aspects of the LTA has wide implications for schemes, employers and individuals and can only further undermine confidence in the system. The bigger the change, the disproportionately wider the impact. Our view is that changes would only be worthwhile if the consequence was a very significant increase in the reduced AA. HMT's paper indicates that their modelling does not lead to this conclusion. On that basis we would argue strongly for maintaining the current LTA provisions unchanged - both its level and the standard DB valuation factor of 20.

- We do not see that there needs to be "coherence" between the LTA and the reduced AA – either in level or factor used. Under FA04, as originally contemplated, the main restriction on tax-privileged pension saving was via the LTA, with a relatively simple, albeit broadbrush, test being carried out on crystallising benefits. There were also very complicated transitional provisions to provide some protection for individuals whose accrued rights were already (or were expected to be) above the LTA. In general, the 'quid pro quo' for such protection was that there should be no further pension accrual from 6 April 2006. Under the latest proposals, it is clear that the main restriction will be via the reduced AA. The LTA will be at most a secondary concern for individuals who are still actively trying to build up their pension. It should be retained only as a separate backstop, if this is felt necessary, rather than compounding the already formidable difficulties of implementing the reduced AA – and a backstop does not need to be "coherent", just appropriately effective.

- A change in the LTA parameters would also create several second order consequences. Just two are that trivial commutation limits would reduce; and more lump sum death benefit would be LTA-taxed. If the DB valuation factor were to be increased from its current value of 20, PCLS limits in DB schemes would go up and all sorts of system changes would need to be made. The LTA factor is embedded into the structure of the tax regime, and we suggest that its level should be kept unchanged.

- Having a lower LTA would introduce extra complexity in other ways. Our experience from the 2006 changes showed how difficult it is for individuals to understand the LTA and how to operate within it. Employers will incur costs because of the need to communicate the issues to individuals in their pension schemes. Administrators will need to be involved in a much increased burden of LTA charge collection. Paragraph 2.25 acknowledges that reducing the LTA would necessitate the provision of new transitional protections for those with pension savings already above this level. Experience with the FA04 protections indicates that this is likely to add disproportionately to the complexity of the legislation and the need for individuals to obtain technically complex information and very sophisticated financial advice: if HMT chose to make a bigger reduction in LTA (so that the AA levels could be set more materially higher), this and an increased factor could mean someone on a salary of £60,000 but with long service being caught – not necessarily someone who can afford appropriate advice. Again there would be costs for administration and indeed for HMRC audit.

- There is a further suggestion that the FA04 protections should now be 'frozen' at their current levels. This implies a new tax on those who have made no extra savings since before 2006, which seems inappropriate. It would amount to retrospective taxation of savings that had previously been understood to be protected, and in relation to which, there might already have been considerable expenditure on advice and implementation.

- Paragraph 2.31 suggests that a reduction in the LTA might create "the possibility of indexing the reduced AA over the longer term". For the proposals to have any chance of leading to a pensions tax regime that is sustainable (paragraph 1.6), it is essential that there is a clear understanding that the AA will be indexed appropriately, even if it is not possible to make an immediate commitment to do so. This applies irrespective of whether there is any change in the LTA. Otherwise, it is hard to see how employers, schemes or individuals will be able to plan for the future with any confidence, leading to further erosion in pension savings.

7 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 (Paragraph 2.27);

This has been suggested as a potential trade-off to allow a higher AA or lower DB factors or more exemptions etc. It would attract additional tax revenue of up to 10% of the AA for each 50% tax rate payer (or indeed those with income above [£150,000 -AA]) – This has been assessed at £0.5bn pa. So it is material although no specific indication is given of the AA that would result.

However, we see that there would be considerable additional administrative complexity from this proposal:

The mechanics of such a tax would need to treat the deemed employer contribution as an additional benefit-in-kind to assess what counts as 50% relieved (all other approaches lead to cliff edges or create loopholes through salary sacrifice).

An example of how we see this might work is if an individual with income of £145,000 has employer deemed contributions of £10,000 towards benefit accrual in a DB arrangement, and no other pension saving. This is well within the AA so not triggering AA charge. But the suggested 40% relief restriction would mean an exact valuation is nevertheless needed, here to collect just £500 (= restriction of 10% x (£145,000+£10,000-£150,000).

8 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 (Paragraph 3.10)

Any change may - after the initial work of the employer investigating the issue and framing its policy - involve the employer in formal consultation with members which can involve at least 60 days. It may therefore be difficult for employers to understand the implications of the reduced AA, frame policy and seek to consult and agree changes with members in advance of the introduction of the new regime in April 2011.

Tax calculation allowing benefit surrender

In most schemes accrued benefits cannot be reduced even if the member agrees. We would hope that Government would introduce an opportunity for members to surrender benefits or have them restricted in such a way as to fall within the reduced AA.

Regulatory override akin to Finance Act 2004 Modification Regulations

It might be sensible to have override legislation capping all benefit accrual to such level as does not result in AA charge in 2011/12, except where the employee decides otherwise.

This would be akin to the "Modification of the Rules of Existing Schemes" Regulations in 2006. We do however acknowledge that it would be substantially much more complex to apply. By default, it would actively change accrual for some individuals, whereas the 2006 regulations by default maintained the status quo of how a scheme had operated before Finance Act 2004, for a transitional period.

The employee's decision whether to accept the cap would be a matter of his/her weighing the impact of the tax charge against alternative remuneration - if any - that might be made available.

Other transitional easements

See our comments elsewhere regarding early retirement transitional provisions; and the "real time" nature of ill health benefit transition considerations.

9 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 advisors (Paragraph 4.12

We leave this to scheme administrators to comment in principle.

We do note that having a tax year as the PIP lessens the risk of confusion and errors amongst pension savers, especially those in multiple arrangements including those changing jobs.

But moving to the tax year (so for some schemes away from their natural "scheme year" around which many calculations centre) may create a substantial additional burden for administrators. (This may be mitigated to some extent if the information exchange requirement is kept light touch). It would also result in a considerable timing concentration of work for third party administrators.

10 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 (Paragraph 4.20);

and

11 The Government welcomes views and evidence on the benefits and burdens associated with introducing reporting requirements on schemes to provide this information (Paragraph 4.20);

There is no current general disclosure requirement on DB schemes to provide accurate leaver benefit statements annually – and this position was maintained following a recent review of the regulatory requirements. Nevertheless many schemes voluntarily provide an annual illustrative statement possibly with some simplifications to ease the exercise (benefit statements might say be based on a basic salary rather than say a detailed averaging of bonuses, fluctuating emoluments etc).

If administrators have to do calculations to check whether the AA has been breached for even only 5% of the members both of the above could cause significant administrative burdens. It may be that Government wishes to move ultimately to exact statements for other reasons, but it should recognise that such a position would impose extra costs on some schemes - regular statements requiring accuracy to the level required for a leaver's statement potentially adds a lot of work - and would take some time to set up. It would also be helpful if such a regime gave some "materiality" leeway for approximations on elements that would be disproportionate to calculate compared to the amount involved.

As far as the tax regime itself is concerned, in principle the pension scheme will need to provide the member with sufficient information to be able to comply with their individual reporting requirements to HMRC. Although we understand the Government's belief that all pension savers should know the value of their pension in order to plan and understand their financial position, for the majority of members who will not be impacted by the current proposals for the restriction of tax relief, this information would be costly to produce for little direct benefit.

We therefore think that every effort should be made to avoid statements having to be provided by DB schemes for every member involving identifying a double figure (last year and this year at minimum). Two suggestions are:

- if schemes can confirm that the nature of benefit accrual is of a shape that is very likely to fall below AA it should have a "passport" such that so long as the individual can confirm that s/he has made no savings elsewhere in the PIP, no tax information need be exchanged.

- if HMT feel that it is essential that figures are provided by each DB arrangement we suggest schemes should be able to issue statements such as "*You have used up less than £10,000 of your annual allowance with benefits in this [arrangement]. If you need a more detailed figure (which should only be because you have accrued benefits in other arrangements too and the information you have is insufficient to confirm that you have not exceeded the AA) we can provide a more exact figure but will make a charge for doing so*".

Where schemes are required to provide accurate information, it would not be unreasonable to expect them to show the result of the pension input amount calculation ie including any inflation offsets for DB and multiplication by the relevant factor.

We would reaffirm that the lightest touch possible should be applied to deferred pensions (see question 3.) If the benefits of requiring schemes to provide accurate pension input amounts for all active members is disproportionate to the cost, the cost for deferred DB members would be extreme - schemes do not commonly provide annual statements for this group at all (there is no legislative requirement). In many schemes, the concept of "annual revaluation" does not exist as the revaluation works on a cumulatively capped basis: so annual statements would in fact be misleading.

12 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 (Paragraph 4.20)

This would appear to be an area for other groups to comment on in detail. However, clearly, the speed of response will depend on the extent of the legislative requirements requiring disclosure and the complexity of the schemes concerned. The employer's role in providing relevant data in a timely fashion may be crucial. Information provision may be particularly challenging in the first years especially if involving transition to a tax year PIP.

13 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 benefiting from UK tax relief (Paragraph 4.22).

The administrative requirements of the new regime will be harder for overseas pension schemes to meet; so it may be difficult for a member of such to comply with tax requirements.

Overseas scheme administrators may be reluctant to provide information to members in line with UK tax requirements, since their systems may not be set up to cope with such requests and the proportion of the membership affected may be small. Equally, overseas administrators may be reluctant to report information to HMRC as a foreign tax authority and local laws, eg data protection, may prohibit this.

Even if scheme administrators are willing to help with compliance, overseas schemes may be able to provide only limited data or data based on scheme years rather than (if relevant) tax years. The UK tax regime needs to be flexible enough to accept this without penalising the individual taxpayer for the inability of the overseas pension scheme to run its systems to conform to UK tax law.

If cash equivalent transfer values ("CETV") are used at all in the future UK tax rules then the approach to valuing benefits can vary around the world and in some countries the concept of an individual CETV may be alien.

There can be material foreign exchange issues in valuing overseas pension schemes' benefits for UK tax purposes and any regime needs to offer a choice of simple ways to value the benefits. Volatile foreign exchange movements can create swings of positive and negative values when measured in sterling that can be disproportionate to the actual underlying benefit and unfair when compared to an identical scheme operating in sterling.

Finally we note overseas schemes are unlikely to redesign to "aim off" the new UK tax.

5.2 In addition to addressing key questions, respondents are encouraged to add any additional information they feel is relevant to the practicalities of implementing the policy.

Meeting the charge

The Discussion Document implies that the mechanics for meeting the tax charge is going to be considered at a late stage. But employers need to know what to plan around; and employees need to know what they might face, so this cannot be deferred in terms of policy-setting in principle. This is particularly true where DB schemes are involved.

Where tax is likely to arise

The AA charge is designed to be "discouraging", but tax may nevertheless arise.

- Where an option is offered, the member may of course choose not to take it up. For example, it has been suggested that an individual with DB accrual that is twice the AA might take the view that an extra (average) 20% tax upfront is not enough to outweigh the benefit of significant DB. (This might be particularly true for an individual making DC savings to fund his pension commencement lump sum and avoid commuting DB scheme pension).

- Even where the employer has a robust policy that avoids AA excess, most routes cannot cope with the variety of new joiners or leavers part way through the year, or individuals who choose to pay additional contributions through their own personal pension savings, or who make AVCs.

- Some employers might not change their pensions offering, or offer no alternative; some employers may not have time to change their policy ahead April 2011.

Scheme pays

Trustees and scheme administrators are very concerned about Scheme Pays - see our consultation response letter on the HIERC regime proposals for reasons. With the AA charge being penal, and with the grossing-up that would be involved, if the scheme pays the charge and then recoups it by benefit reduction, this would wipe out most of the benefit accrual that gave rise to the charge.

One alternative to an entitlement to Scheme Pays, might be the right to have (all) accrual that gives rise to the charge unwound once that fact is identified (eg the next tax year). One precedent for this is the fact that trustees can choose not to pay out benefits due under scheme rules that are unauthorised for Finance Act 2004 purposes (always subject to their usual trustee duties in using such powers).

The advantage of this approach is that it does not involve knowing the individual's quantum of tax, just the excess pension value. It also by definition does not involve paying the charge. So the only parties involved are the member and scheme, and not HMRC. Appropriate overriding legislation would be needed.

However, this still involves the complexity of a divorce-type offset to administer – which should not be underestimated.

Design issues

Discussions we have attended have focussed on valuing "straightforward" DB and DC. It should be borne in mind that there are a range of scheme designs that do not fit neatly into these (hybrid and other) and suitable consideration needs to be given to creating a simple, fair and consistent treatment for these.

Special Exemptions

We would suggest that HMRC should have the power to exempt certain global exercises eg when a closure is discussed with trustees, it can be the case that the trustees will only accept closure where certain discretionary practices which are regarded as typical custom and practice are turned into rights. It would seem inappropriate if this were to result in additional tax consequences. Equally were a tax arises because of legislation imposed directly or indirectly such as "GMP equalisation" or CPI/RPI changes.

Basic rate tax payers (BRT)

The Discussion Document notes the Government's aim to avoid the AA charge arising for a basic rate tax payer.

We recommend avoiding any explicit income test to achieve this. The HIERC approach showed that this leads to cliff edges; inevitably has to involve unintuitive tests incorporating employer contribution; and to uncertainty ahead of accrual. It may also create loopholes.

A BRT is likely to hit AA charge only at "spike" events: promotional salary rises, or contingent events triggering augmented terms. If various mechanisms mentioned here are adopted (carry forward/back, re-spread, ignoring age of payment) this may result in no AA arising.

Appendix 1 - Enhanced value by way of drawing benefit before NPA without due reduction

Our impression from the paper is that a key area of concern of “added value” is the delivery of benefits earlier than the individual’s NPA while accruing benefit. The following demonstrates that identifying such an improvement in itself should not count as using up AA in the regime HMT have suggested.

> *Suppose member A accrues pension of £100 pa in a scheme with NPA 65 and member B £100 pa in a scheme with NPA 60. The core flat factor approach means that in the year of accrual, both would count as accruing the same value of benefit (say £1,500) to assess against AA; and no additional tax will arise if they simply draw the pension at their respective NPAs. If A’s scheme then allows him to draw his pension early, say at age 60 with no reduction, then A has certainly “gained” substantial value. But his benefit is now identical to B’s. It seems inappropriate - once the decision to use flat factors for accrual has been made - that A should attract more AA charge than B for this sort of extra value.*

We therefore suggest that increase in value arising from payment age is recognised in the AA test only in relation to retirements before age **60**. Age 60 is a reasonably common NPA; and some members may have a different NPA but a tranche of benefit with NPA of 60 because of past sex equality (“Barber”) exercises. When retirement actually occurs before age 60, then a higher factor specific to that age (but not reflecting other quality differences) would be used.

Suppose for example the following **illustrative** (not actuarially based) factors were used (the factors themselves can be considered separately, a key point being that there should not be a cliff edge between 59 and 60):

Retirement age	Factor
60	15
59	16
58	17
57	18
56	19
55	20

> *Take member C who reached age 58 at the start of the year having built up an accrued pension £20,000 pa due from an NPA of 60 or more. Each year the pension accrued in the year would have been valued using a flat factor of 15 and tested against the AA. Suppose C retires immediately at age 58 with an actual unreduced pension of £20,000 pa. In the year, the pension becomes payable from age 58 and so the value tested against the AA would be: £20,000 x 17 - £20,000 x 15 (so £40,000). If the scheme applies an actuarial reduction for early payment so that the actual pension paid is £18,000 pa, the value calculation would be £18,000 x 17 - £20,000 x 15 (so £6,000).*

In other words an individual’s NPA under the scheme would be irrelevant for testing against the AA (unless below age 60 – see below). It would be the age at which the pension was drawn that would determine the factor to be used in the year of drawing. This approach does hide some subtleties, but any other approach seems in conflict with the flat factor approach for accrual.

We note that there is potential for every early retirement to use some AA, for example solely because of the difference between the suggested HMRC factor table and the scheme actuary’s view on actuarially appropriate reduction for early payment (particularly if a scheme’s NPA is 60) – but this has seemed an inherent potential feature of all the regimes proposed, and the above seems the simplest approach.

Normal Pension Age already less than 60 prior to 2011

Some individuals have an NPA of less than 60 either because this is a general provision of their scheme, or a right they have been granted individually reflecting an unfettered promise in the scheme.

If the above proposal were used without refinement, the new tax would apply to benefits that are effectively fully accrued rights; and also a large charge for "added value" at retirement could be stored up inappropriately. So a modified approach should be adopted: where a scheme certifies to the member that such an NPA was enshrined in the scheme rules before April 2011, a higher DB flat factor should apply (corresponding to the table above) in valuing the annual accrual, reflecting the higher value of benefit being accrued.

Take a member with NPA 55 who had accrued £5,000 pa pension at 5 April 2011, and then accrues a pension of £2,000 pa in each of the next 10 years. Ignoring indexation for simplicity:

Unmodified approach: Lower NPA recognised only at retirement.
Value of annual accrual of benefit = 2,000 x 15 = 30,000 each year
Value of "enhancement" on retirement at NPA 55
= (5,000 + 10 x 2,000) x 20 – (5,000 + 10 x 2,000) x 15 = £125,000

Modified approach: Lower NPA recognised in each year
Value of annual accrual of benefit = 2,000 x 20 = 40,000
Value of "enhancement" on retirement at NPA = £nil

This approach protects unfettered rights to retire before age 60 **without** reduction; but there would be issues where the unfettered right was to a **subsidised** early retirement reduction.

Unfettered promises contingent on future events; and custom and practice
Transition into 2011/12 regime

Some members will have unfettered rights to certain early retirement provisions, but contingent on certain events arising. Typically this would be on redundancy or ill health and we address those through separate approaches in question 4.

Finally, there will be pension schemes that have a long-established practice of granting early retirement to all employees at an age before 60 - potentially pre-funded in the scheme. HMT maybe less sympathetic to these cases, as arguably the benefits are actually only enhanced on retirement. We do note that without some special provision, there will be a large discontinuity between someone who retires on 5 April 2011 and on 6 April 2011.

For example, a member has an accrued pension of £20,000 pa in a scheme with a NPA of 60 but the scheme has always allowed for members to retire early unreduced at age 55.

AA value of DB rights if retires at age 55 on 5 April 2011 *£Nil*

AA value of DB rights if retires at age 55 on 6 April 2011
20,000 x 20 – 20,000 x 15 *£100,000*
(using approach described above)

So, the AA charge if a 40% taxpayer (if the AA is £40,000) could be £24,000 to £40,000.

This pension of £20,000 pa could arise for a long serving member earning £40,000 - and lower salaries could be shown to trigger some AA charge in this scenario.

Members currently planning retirement will have no idea how they might be taxed – indeed may have no idea that there is a possibility they will be taxed. And the information they need will come through very late in the day. Typically individuals make retirement plans a good year in advance. In recognition of this very late roll out, we suggest that for retirements in 2011/12, added value from early retirement is ignored in such cases. This may help to prevent an unnecessary rush to retire before 5 April 2011 – when it may be found that the ultimate tax provisions do not actually affect a member disadvantageously. (We acknowledge that there may still be a rush before 6 April 2012 but at least this would be better informed.)

A further question would be whether HMT would permit an employer/scheme to make changes in 2010/11 that convert expectations into entitlements to lower NPAs (without triggering anti-forestalling under the Special Annual Allowance legislation) and so qualify for the exemption described above.

Appendix 2 – Carry-forward/carry-back

There are various reasons why individuals have atypical "spikes" in their DB accrual – examples being redundancy or salary increases on promotion. HMT have indicated a willingness for employers to rearrange benefits to smooth these spikes out (with the member still getting the full benefit involved). However not all schemes will be able to "aim off". There should be mechanisms to help the individual directly so that the policy intent does not rest solely with action by the employer.

- One approach might be to allow an individual to borrow from the next year's AA in the year of drawing [all] benefit from an arrangement (so potentially the next year s/he could make no tax relieved savings).

  This would be particularly helpful in the case of retirements. The fact that special detailed AA calculations will be needed could be planned for.

- Another approach could be allowing carry forward of unused AA headroom from say one or two years previous.

  A challenge would be the compliance management: there will be additional information requirements and therefore additional time will be required to collect the data and calculate the benefits. In particular there is the question of how this would fit in with the desired light touch on information about accrual of AA (we refer to our answer to question 11). If a member exceeds the AA in one year in a particular scheme, it might be reasonable that that scheme would need to provide exact scope figures for the relevant previous years (or sufficient calculation to prove that there was sufficient scope).

  The position would be more difficult if the member was not with the current scheme/employer throughout the previous period or where there has been a major reconstruction – the previous scheme may not have the relevant information and/or may not be willing to carry out the calculation.

  Another issue is the operation of this facility for any member who exceeds the AA in say 2011/12 or 2012/13 – would there need to be a notional look back calculation as if the regime had been in place in 2010/11 and 2009/10 (including a nominal AA for the purpose)?

  While the aim of the policy would be to assist "spikes" we do note that it would be difficult to limit this facility to "spike" events. If a member believes that there may be unused AA in a relevant year they may want to be able to request details from the relevant pension scheme for the years concerned (which may be in the past) in order to maximise their savings within the AA. This would therefore lead to an increased information requirement from schemes for most individuals where their pension input amount is likely to be in the region of the revised AA.

Overall we recognise that there is considerable challenge to a carry forward facility but feel that something of the sort (or "borrow future AA") is necessary to achieve the policy aim. If the Government agrees that a carry forward facility should be used, we would be willing to work with them to identify some acceptable solutions.

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