29 August 2014

By email to HM Revenue & Customs at Pensions Policy

Dear Sir or Madam,

Draft legislation - The Finance Act 2004 (Registered Pension Schemes and Annual Allowance Charge) (Amendment) Order 20XX

I am writing on behalf of the Association of Consulting Actuaries (ACA) in connection with the draft legislation, draft explanatory memorandum and draft guidance set out in https://www.gov.uk/government/publications/draft-legislation-the-finance-act-2004-registered-pension-schemes-and-annual-allowance-charge-amendment-order-20xx

We appreciate the opportunity to comment on this new draft (albeit that it has been a very limited window – but many thanks for slightly extending the deadline for our response).
This work follows on from and replaces the previous draft issued in 2012 on which we commented in letters dated 2 January 2013.

We have split our response into three:

- Appendix 1 relates to the adjustment to closing values on grant of a transfer in credit in a DB or CB arrangement;
- Appendix 2 relates correspondingly to the adjustment where there has been a transfer out from a DB arrangement;
- Appendix 3 relates to the balance of the proposals.

We consider both the legislation and the related guidance in each Appendix.

We hope that you find our comments of assistance and would be happy to discuss them further – including worked numerical examples - if that is helpful. You can contact me on 020 7432 6622 (karen.goldschmidt@lcp.uk.com) (or through David Robertson of the ACA secretariat on 020 3102 6761 (david.robertson@aca.org.uk).

Yours faithfully

Karen Goldschmidt
Chair, Pensions Taxation Committee
Association of Consulting Actuaries

Regis House, First Floor, 45 King William Street, London EC4R 9AN
Tel: +44 (0)20 3102 6761 Fax: +44 (0)20 3102 6766
Email: acahelp@aca.org.uk Web: www.aca.org.uk

APPENDIX 1 – Adjustment to closing values where there has been a transfer in credit

PLEASE NOTE In all the following we focus on the provision in the DB section of the legislation ie 236(5) and 5A to C. Our comments should be read to apply equally to the cash balance versions.

LEGISLATION

1. Appropriate pension reduction when Condition B applies (changes to create 236 (5A))

Issue: As already discussed, where there has been a transfer that satisfies Condition B, the legislation is currently missing a definition of the **pension/lump sum rate** to be deducted. This is because, having used an actuarial valuation of a package to determine whether Condition B is satisfied, the draft legislation then incorrectly currently deducts that actuarial **valuation** rather than a pension rate amount.

Solution: One possibility would be to move an element of para 5A(a) into condition B as follows:

- add in an extra condition (bb) for Condition B such that "Part or all of the reason that the value of the package has so increased is that there has been an increase in the annual rate of pension to which the individual would be entitled to under the arrangement [etc re LS]".
- Change 5A(a) to say "If condition B is met there is to be subtracted from PE or LSE the increase amount(s) mentioned in (bb)."

We do also recommend that para (c) of Condition B should read (just for clarity and not for meaning change): "(c)the amount of that increase **in value** is equal (or virtually equal) to the amount of that decrease **in value**".

2. Scheme wind ups – schemes that enter the PPF

Issue: Following an employer insolvency and a scheme entering PPF assessment and then being accepted to transfer into the PPF, the benefits granted to the member once in the PPF are typically different from those originally due in the scheme before transfer to PPF - typically the pension rate level is reduced, and potentially their original future-due deferment revaluations are changed to those under the PPF "benefit shape". Typically (and the reason why the scheme transfers to the PPF) the assets received will be less than the actuarial value of the benefits being granted in the PPF. So it is important that the transfer into the PPF does not fall to be treated as if it were a "non-Condition B" case (if that were what happens, because such a member may find some PIA arising as a result of the transfer, which is clearly totally inappropriate).
We think it is not clear that the proposed legislation at 236(5) et al achieves this.

Solution: the cleanest solution would be that SI 2006/575 is modified (perhaps a new clause inserted as 23B) to carve PPF benefits right out of the AA measures so that PIA is always nil for members of the PPF. This is because in all foreseeable events, the benefits from the PPF will be lower in actuarial value than the benefits due from the originating scheme just before wind up, sometimes considerably so – and generally lower in rate too.

Background workings: Reg 4 of SI 2006/575 confirms that tax acts apply as to the PPF as if it were a registered scheme, other than explicit differences. The AA clauses do not appear to be carved out at present.

Reg 31 of the same SI confirms that a transfer to a PPF is a block transfer for protected PCLS / pension age purposes. However, that is not relevant for the purposes of the **proposed** PIA calculation, which has its own specific definition of block transfer.

Condition B of 236 (5A)(b) requires:

1. A single transaction;
2. Of two or more individuals;
3. Transferring all their benefits;
4. With the reduction in the value of rights in the transferring scheme being equal or virtually equal to the increase in the value of rights in the receiving scheme;
5. Where the aim isn't tax avoidance.

1 and 5 are trivially satisfied in a PPF transfer.
2 is trivially satisfied for the vast majority of cases.
3. should usually be satisfied (although we note that the PPF does not accept DC benefits – so satisfying this condition does require that DC funds are secured before rather than after the PPF transfer – which we think is typically the case).
4. appears to be failed at the moment although we are not clear on some of the technicalities around timing and how and when benefits change in the wind up process. It is certainly the case that the benefits granted to the member once in the PPF are typically different from those originally due in the scheme due before wind up - typically the pension rate level is reduced, and potentially their original future-due deferment revaluations are changed to those under the PPF "benefit shape". If 4 is failed, this means condition B is failed.
If condition B is failed, then the individual will be charged PIA to the extent that the benefit granted to the individual exceeds the transfer received for that individual (as it usually will do by virtue of the scheme qualifying to go into the PPF, to the extent that the member's element of transfer is identifiable)

It would seem cleanest to have the PPF carved right out of the AA measures

We considered alternatives such as having regulation 31 changed such that a transfer to the PPF is always deemed to satisfy condition B of the new 236(5); or relying on a change to condition B such that element (c) (which we have described as 4 above) applies where the transfer credit is "**lower** than or virtually equal" (which we anyway request, see later).

3. Scheme wind ups – being arranged where there is not an insolvency event (ie with full funding)

As we noted in relation to the 2012 draft of the AA orders, the definition of "block transfer" here noticeably lacks an extension that appears for where "block transfer" is used for preserving certain 2006 rights, relating to where a deferred annuity is being bought for a member and the originating scheme is being wound up – see The Pension Schemes (Transfers, Reorganisations and Winding Up) (Transitional Provisions) Order 2006 (SI 2006/573). That extension was granted (recognising that the nature of such an exercise could well be out of a member's hands so deserved the easements) because a transfer to a deferred annuity cannot satisfy the core block transfer definition as it cannot relate to more than one member. We believe that the extension is needed here, so that Condition B can apply where all other relevant parts of the Condition do also apply.

One might argue that if Condition B is left to fail by not making this change, one still gets to the appropriate position (nil PIA arising solely because of transfer of mirror image benefits to the buy-out) because by definition a buy-out policy provides the benefits of exactly equal value to the transfer monies received. However, this does not allow for the situation (not unknown) where part of the mirror benefit is funded by a contribution direct to the buy-out policy by the employer. So our preference would be that such cases are brought into Condition B by extending the block transfer condition.

We also think there is a case for changing element (c) Condition B such that applies where the transfer credit is "**lower** than or virtually equal". It is difficult to pin down an example, but we think it would be unfortunate if a relevant transaction failed being treated under Condition B because benefits were granted at a lower rather than an equal level.

4. Scheme wind ups – schemes for which wind up is triggered, they enter PPF assessment but are assessed as better funded than PPF so go to (underfunded) buy out ("PPF plus schemes")

This is the more compex intermediate case where the scheme winds up because of an employer insolvency; the scheme enters the PPF assessment period; the assets are assessed to be sufficient to provide more than PPF (cutback) benefits, but are likely still to provide less than the benefits which would have been due had pensionable service ceased but the insolvency event not occurred.
As in the two cases above, the act of transferring to buy out should not lead to the member having any PIA in the buy-out policy.

5. Intra scheme transfers

In new subsection 5C, the definition of block transfer includes the term 'from the scheme'. Yet it seems from the guidance that the same principle would apply to block transfers within a scheme (ie between sections). So we suggest that 'the arrangements under the pension scheme from which the transfer is made' could be amended either to
'the arrangements from which the transfer is made' or
'the arrangements (under the pension scheme) from which the transfer is made'.

Alternatively the definition could be described separately for a transfer between arrangements of the same scheme. Internal bulk transfers could become more prevalent due to the need to rationalise, and if members want to use the new flexibility from 2015, transfers could be made from Defined Benefit to Cash Balance arrangements)

GUIDANCE

6. Guidance on the notional PIA calculations applied to 2008/9 to 2010/11 for carry forward

Issue: Several of the items in the AA order draft are said explicitly to be retrospective to the PIP that ends in 2011/12 onward – including in particular most aspects of the solution to 236(5).

We are concerned that any solution should ideally achieve the "natural/right" outcome not just the actual PIA calculations from 2011/12 onward, but also the calculations for the 2008/9- 2010/11 "notional PIAs" – and hope that you can easily give some reassurance.

We think that FA11 transition Schedule 17 Pt 2 does contain provisions that mean the proposed changes also apply to the calculation of the "notional PIAs". (We replicate relevant extractions below)

We also note that the released draft guidance continues to include a phrase that "the method of calculating how much of the deemed annual allowance of £50,000 has been used up for each of the tax years 2008-09, 2009-10 and 2010-11 by reference to the total pension input amounts for those tax years is based on the current methods of valuing pension input amounts generally, and .."

We hope that this phrase has been retained deliberately – ie it is confirmation that the current method as changed retrospectively by the proposed legislation does apply. For the avoidance of any doubt, it would be very helpful if you could confirm this.

(Of course, if the phrase has actually been left unedited in error, and it has not been possible to extend the solution to the notional PIAs, then, while we would be sad that this has not been achieved, we think it should be made explicitly clear.)

> Extract from FA11:
> "27 (2) Apart from the amendments made by paragraph 16(2) and (4), such of the amendments as apply in relation to pension input periods have effect in relation to pension input periods ending in the tax year 2011-12 but beginning earlier (as well as those beginning in that tax year). ...
>
> "30 (1) This paragraph has effect in relation to the application of section 228A of FA 2004 for the tax years 2011-12, 2012-13 and 2013-14.
>
> (2) The assumptions in sub-paragraph (3) are to be made in determining-
> (a) whether the amount of the annual allowance for the tax years 2008-09, 2009-10 and 2010-11 exceeded the total pension input amount in the case of the individual for the tax year, and
> (b) whether any excess of the annual allowance over the total pension input amount in the case of the individual for any of those tax years has been used up.
>
> (3) The assumptions are-
> (a)that the annual allowance for each of the tax years 2008-09, 2009-10 and 2010-11 was £50,000, and
> **(b)that the provisions of Part 4 of FA 2004 apply in relation to pension input periods in respect of arrangements relating to the individual that end in any of those tax years subject to the amendments made by this Schedule (including that inserting section 228A)."**

7. Guidance on where Condition B will not be met

We note some situations in which Condition B will not be met, where the nature of the scheme reconstruction involved might have made a provider think it should be. The result is that PIA may be used unexpectedly; and that detailed calculations may be needed, so it is important to understand this early on in planning.

We suggest that these are highlighted in the guidance; and possibly the guidance points out some mitigating factors/actions, as follows. If you disagree with our reading of the position on any of these cases, please let us know as this could be a material issue:

- Partial transfers: our reading is that Condition B is failed if not all the benefits for a member in the original scheme are transferred. So this could include situations where the receiving scheme takes on only the DB benefit for transferring members, but DC AVC funds are left in the original scheme; or because some of the DB benefit is left behind – perhaps pertaining to a different employer from the employer taking its employee liability out of a section or perhaps being deferred benefits from historic service.

HOWEVER: it might be possible to limit the problem, by defining the transferring group into two separate transfer groups, with one containing any member for whom all benefits will transfer – and to this group Condition B will apply. The problems arising from 236(5A) (b) then arise only for the other group.

- "Bulk individual transfers": where a bulk transaction is occurring potentially applying to a number of members, but it is a "with consent" transfer and only one member consents.

- "Transfer with augmentation" – ie where all the conditions are met, but some additional feature means that the actuarial value of the benefit granted in the receiving scheme, allowing for its quality, is higher than the benefit in the transferring scheme
  HOWEVER: it would be possible to frame this into two transactions – stage one being a grant that is the same in value so that Condition B is satisfied; and then a grant of augmentation in the receiving scheme as a separate transaction. So condition B is satisfied for the first, transfer, stage; and it is only the augmentation which will then be tested for PIA as for any other grant within a scheme – this not being a valid approach if it is solely as an annual allowance avoidance device.

8. Guidance on classifying past transactions

The matters described above may well not have been considered when transactions took place in the past. We would find it helpful if the guidance could confirm that, while the facts are as they are, where a particular position has not been considered, the Trustees may interpret it as they see fit (so for example in relation to the first bullet above, a transfer transaction may be considered to consist of one or two block transfers).

9. Guidance on approach where Condition B is not met

In relation to paragraph 236 (5A) (b) and (5D), where the transfer is underfunded but Condition B is not satisfied, what element of the increase in benefit is to count as solely attributable to the transfer value (which is the question that the HMRC interpretation of the original legislation raised).
It may be that HMRC are happy to leave this to the scheme trustees to determine.
If HMRC have strong views as to how this is to be approached, there needs to be guidance.
(We are aware of a case where HMRC was approached, and gave views on which part of the benefit "shape" should be counted as from the transfer value and which part had to be counted as from the excess.)

APPENDIX 2 Adjustment where there has been a transfer out

PLEASE NOTE In all the following we focus on the provision in the DB section of the legislation ie 236(4) and 4A to C.
Our comments should be read to apply equally to the cash balance parallel versions.

We do not support the changes made.
Our initial reading is that they will create considerable complexity, and indeed odd windfalls in certain types of cases inappropriately and potentially will create complex administration.

Our proposal would instead be a small change to the old version of the legislation as follows, which we think will in fact keep it in line with how it has been read by all parties to date:

> *(4) If, during the pension input period, the annual rate of the pension, or the amount of the lump sum, to which the individual would be entitled under the arrangement has been reduced* ~~***by reason of***~~ *in connection with a transfer relating to the individual of any sums or assets held for the purposes of, or representing accrued rights under, the arrangement so as to become held for the purposes of, or to represent rights under, any pension scheme that is-*
>
> *(a) a registered pension scheme, or*
>
> *(b) a qualifying recognised overseas pension scheme,*
>
> *the amount of the reduction is to be added to PE or LSE.*

The definition of "In connection with" would be as per the new definition in 5C.

This broader line should be taken for example because the underlying concept should be that members are "charged PIA" for accrual that happens. The fact of a transfer should not have any effect.

For example:

Member X accrues some benefit in a PIP but then becomes a deferred pensioner with entitlement D. The member is considering taking a cash equivalent out of the scheme - but the trustees are operating a cutback for underfunding – say to 80% of "full" cash equivalent. The proposed draft legislation would mean:

A if X does NOT transfer out in the same PIP as leaving, he is "charged" PIA based on a PE equal to D (his deferred pension at the end of the PIP) ***which includes the accrual in the scheme in the PIP****.*

B If X transfers out during the same PIP as leaving, his PIA would be calculated using an adjusted PE of nil plus 80% of D – ie he is not charged for some or all of the accrual.

C If X transfers out in any later PIP, his position is as in A for the PIP of leaving (ie he is charged for his last piece of accrual before leaving); and for the PIP of transfer, his PIA would be nil (ie 80%D – (1+CPI) x D, with a floor of zero.

This is not an appropriate variation in AA situation! And if the intention was to give some compensation for the member (here) losing 20% of the value of his benefits by transferring out you can see from the above example that the compensation is a random figure – for many individuals there would be no compensation, for the rest it is the broadly lower of 20% and (for scenario B applying) the PIA from accrual in the last PIP.

Furthermore, Member X might be able to control the situation so that he benefits from scenario B (if indeed that is what HMRC intends should be available). However, an individual who is already a deferred pensioner who has no accrual to play with would not have such an opportunity to get some “PIA compensation” for a cut back cash equivalent.

These issues would apply not just for “underfunded individual” transfers, but also for “bulk transactions” to the extent that they fail Condition A for the sort of reasons (eg partial transfer) discussed in Appendix 1.

We have also tried to think through how the current proposals would apply (or would need to be changed) to deal with transfers out to PPF or to buyouts and again our conclusion is that “in connection with” works best.

There are a whole range of transfer out levels that might apply in different circumstances. If HMRC have any concerns about the “looseness” of using “in connection with” here, we note, as we have before, that trustees of DB schemes have various duties and checks and balances, and we would expect these to prevent them paying transfer payments that are inappropriate for the scheme/member circumstances.

APPENDIX 3 Other

PLEASE NOTE In all the following we focus on the provision in the DB section of the legislation, but our comments should generally be read to apply equally to the cash balance parallel versions.

1. Deferred member carve out – statutory increases and "late retirement uplifts"

Issue: At the moment the definition of "statutory increases" includes a revaluation in accordance with Chapter 2 or Chapter 3 of Part 4 of the Pension Schemes Act 1993, but not late retirement uplifts under Chapter 1.

HMRC guidance at RPSM11101534 indicates this was deliberate when considering the terms for Fixed Protection *"Late retirement increases under Chapter 1 of Part 4 of the Pension Schemes Act 1993 or the Pension Schemes (Northern Ireland) Act 1993 are not relevant statutory increases. This is because schemes must first provide for late retirement uplifts before the legislation can apply, so the increases do not occur solely as a result of the statutory provisions."*

We take this to mean that HMRC notes that a scheme does not have to allow a member to draw long service benefits "late"; and it is only if it chooses to offer the option to draw late that the same policy has to apply to deferred members and the late retirement increase comes into play. We feel this is an unfortunate line to draw not least because this is not a matter of scope for abuse – the reference to the statutory requirement would only support increases that maintain actuarial value, not more.

However the application of late retirement factors is in practice not a matter of choice in an important majority of cases where LRFs apply – but is a legal requirement as a consequence of sex discrimination legislation following the Barber judgement. For example it may be that when a male scheme member draws his pension say at age 62, part is treated as having NPA 65 (so might indeed have an early retirement reduction) but part may be required to be treated as having NPA 60 and therefore MUST have a late retirement factor uplift applied, because of sex discrimination legislation and because of what was promised to female scheme members in the past.

Solution: The Barber situation is a common one but each scheme's situation may be slightly different and arise because of a different combination of rule wording, test case, legal interpretation, and history of treatment and reading. But fundamentally part of the obligation arises from a look through to "*Late retirement increases under Chapter 1 of Part 4 of the Pension Schemes Act 1993".* We therefore ask that you include increases required under Chapter 1 in the statutory increase requirements list.

This would of course also bring in cases that are not impacted by Barber, but also deferred pensioners in schemes which (since October 2010) have started to allow late retirement. We think HMRC should accept including these in the interest of keeping the legislation simple (bearing in mind the point we note above, that there is no scope for abuse: the statutory requirement would only support increases that maintain actuarial value, not more).

This is a technical complex area and we may have simplified the concepts a little - we suggest that you liaise with the Association of Pensions Lawyer if you want fuller details of the different ways schemes can be impacted, and the best way to widen the reference in the definition.

2. Deferred member carve out – statutory increases overall

Issue: The proposed provisions do closely mirror the provisions introduced for similar purposes into the legislation relating to Fixed Protection and Fixed Protection 2014 ("FP").
However, we would register that, unfortunately it is still very unclear to us how that legislation works for FP, particularly as to how so called "statutory increases" interact with CPI revaluation on the balance of the pension, to ascertain the relevant percentage.
Of course, compared to FP, for AA if the carve out does not work appropriately, probably the inappropriate extra tax amount is relatively small (if any), but potentially the number of cases affected and also the unnecessary administration work arising is much more significant.

Solution: More examples are needed to cover common cases in scheme design. We would be happy to work with HMRC on this.

If of course it emerges that the carve-out does not work appropriately this may mean a further change is needed to the law.

3. The change in deadlines for electing to use a right to use Scheme Pays (Changes to 237B (6))

Our comments are similar to those in our response to the 2012 draft:
This accelerates 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).

Issue 1: We agree that this change should not be made retrospective, but the current transition does not work. Some individuals will find that they lose the ability to elect for Scheme Pays for an AA charge transition tax year. We are sure this is not policy intent.
The following is an example provided by another party to you already and copied to us, with which we agree.

> Someone takes a PCLS and scheme pension in July 2014 (in 2014/15) in a PIP that ends on 6 April 2015 (in 2015/16). They have an uplift at retirement which means that the input will exceed their available AA for the 2015/16 tax year irrespective of any other contributions/accrual in other registered schemes. Although all of the scheme benefits are being crystallised the member cannot elect for scheme pays before crystallisation as currently s237B(6) FA2004 does not apply.
>
> Under the current legislation the member could elect for scheme pays after the end of the 2015/16 tax year and the scheme could reduce the pension in payment to reflect this. However, once article 8 of the Order comes into effect this will not be possible since it will be after the benefits have crystallised. This assumes that order will come into force at the end of 2014 and article 8 takes effect 6 months later.

Solution: it must be possible to insert a transitional provision to deal with this specific tax year issue!

Issue 2: 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 to scheme pays elections.

(Partial) solution: 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 issue rather than schemes having to explain it. (And perhaps to explain to members that they can correct their elected level of scheme pays upwards if their AA charge "changes", but must correct their election downwards if it turns out to be to have been overestimated; and that the correct figure should be reflected in their tax return when it comes (eventually) to be due.)

4. Edits to deal with individuals with accrued benefits at 5 April 2006 but whose first PIP starts on or after 6 April 2006 (changes to 228B and elsewhere)

Thank you for the changes made that substantially eliminate the anomalies that arise when a deferred member who left pensionable service in a scheme - and for similar but slightly different reasons applies when a member with Enhanced Protection - has accrual after 5 April 2011.

We do note that this means that for individuals with EP this means that in calculating the notional PIA for the tax years 2008/9 to 2010/11, these individuals have PIPs set to tax years whatever the schemes(s) involved may have thought applied – although thereafter the PIPS follow the standard rules.
Would it be possible to change the proposed draft legislation such that "where there is evidence that a PIP nomination was made by the scheme administrator - in ignorance of the anomaly for EP – that would have been valid had the member not had EP, that that PIP can be read as applying".

If you do not accept this proposal, some issued PIA number-work (to date and perhaps even in the future) will have to be revisited upward or downward, because we are sure that most scheme administrators would have treated an EP member as if he were not an EP member. And in any case a scheme administrator may not know that a member has EP until the member comes to crystallise benefits in the scheme which could be some time in the future.