

ITEM NO: 14

Report To:	Pension Fund Management Panel and Advisory Panel
Date:	10 September 2010
Reporting Officer:	Peter Morris, Executive Director of Pensions
Subject :	RESTRICTIONS OF PENSIONS TAX RELIEF
Report Summary:	HM Treasury has published a consultation document – Restriction of Pensions Tax Relief – a discussion document on the alternative approach. This report summarises the key points of that document and provides a copy of the Chair's response to the Treasury.
Recommendation:	To note the report.
Financial Implications: (Authorised by the Borough Treasurer)	No direct costs from the Fund's point of view but potentially significant for a substantial minority of the Fund's employee members. The proposals if approved would add to the administrative workload.
Legal Implications: (Authorised by the Solicitor to the Fund)	There are no direct legal implications arising from this report. Any changes regarding pensions taxation will be applied.
Risk Management:	The type of changes proposed in the consultation will have an adverse impact on the perceived value of the scheme by those members that may be affected. From the administering authority perspective the supply of information on a timely basis will be challenging because of the Pension Office's reliance on data supplied by the Fund's employers.
ACCESS TO INFORMATION:	NON-CONFIDENTIAL This report does not contain information which warrants its consideration in the absence of the Press or members of the public.
Background Papers:	Restriction of pensions tax relief – a discussion document on the alternative approach can be found at: http://www.hm-treasury.gov.uk/d/consult_pensionsrelief_discussion.pdf

1. INTRODUCTION

- 1.1 The Government announced in its budget that it had reservations about the previous government's approach to restricting pension tax relief for high earners. The Treasury has recently published a discussion document setting out alternative proposals that are designed to raise the same amount of revenue. The closing date for responses was 27 August 2010. The Government hopes to announce changes in Sept 2010 with new rules coming into force from 6 April 2011. The purpose of this report is to outline the proposed changes, comment thereon, and advise the Panel of the Chair's response.
- 1.2 In the main pensions are taxed via the exempt, exempt taxable rule. This means pension contributions are exempt from tax, the investment returns these provide are exempt from tax but the resulting pensions are taxable. This is referred to as an EET regime and has generally applied since the creation of tax relief for pensions by the Finance Act 1921.
- 1.3 Within the EET regime limits have always been imposed by the HMRC. These have changed over the decades with the current rules comprising an annual allowance (AA) and the lifetime allowance (LTA). The Annual Allowance is the amount by which a pension pot can increase in a year without penalties applying, the lifetime allowance is similar but provides an absolute maximum regarding tax relief.
- 1.4 This year the AA is £255,000 and the LTA is £1,800,000. Consequently, very few Fund members exceed these limits.
- 1.5 This report focuses on the implications for members of defined benefit pension schemes.

2. BUDGET 2009 AND BUDGET 2010

- 2.1 Arising from last year's Budget (2009) the taxation of high earners' pensions is to be changed from April 2011, with tax relief reducing for those earning more than £150,000 p.a. including the value of employer and employee pension contributions. However in this year's Budget the Government announced (to quote from the Treasury paper) "... It is considering the reform of pensions tax relief. Having listened to the concerns of the pensions industry and employers, the Government has reservations about the approach adopted by the previous administration in Finance Act 2010 (April). It believes this approach could have unwelcome consequences for pension saving, bring significant complexity to the tax system, and damage UK businesses and competitiveness.

The Government nevertheless believes that reform in this area is a necessary part of its commitment to tackling the fiscal deficit. It considers that an alternative approach involving reform of existing allowances, principally of a significantly reduced annual allowance (AA), might better meet its objectives. The Government will seek to ensure that it raises at least the same amount of revenue through restricting pensions tax relief as has already been accounted for in the public finances from the Finance Act 2010 (April)..."

- 2.2 The amount of tax the Government wishes to raise by these measures is substantial - £3.5bn in 2012/13.
- 2.3 The change the Government is proposing is to replace the restriction on high earners that will otherwise apply next April, with a reduction in the AA from £255,000 p.a. to £30,000 - £45,000 p.a. By doing so it calculates that it will raise the same amount of tax, but from a greater number of people.
- 2.4 The Treasury propose an increase in the valuation factor for valuing defined benefits from 10 to a factor of 15-20. Assuming a factor of 18, an illustration of the impact is shown

below. For the sake of simplicity a rate of accrual of $1/60^{\text{th}}$ has been applied for all membership.

In March 2012 Mr. Smith has 29 years membership. His pay is £40,000 p.a. His benefits are therefore valued at:

$$29 \times 40,000 \div 60 \times 18 = \text{£}348,000.$$

In April 2012 Mr. Smith is promoted and his pay increases to £45,000 p.a. In March 2013 his benefits are therefore valued at:

$$30 \times 45,000 \div 60 \times 18 = \text{£}405,000.$$

Increase in value of benefits = £57,000.

If Mr. Smith made contributions to other pension savings such as AVCs this would also count against his annual allowance.

2.5 The Treasury also proposes that people who exceed the AA should be taxed at their marginal rate. If the AA is set at £45,000 Mr. Smith could have a tax bill of £4,800 (£57,000 - £45,000 x 40%). If it is set at £30,000 he could have a tax bill of £10,800 (£57,000 - £30,000 x 40%).

2.6 The Treasury recognise that "... Spikes in pension benefits might tip individuals on low and moderate incomes, whose annual accruals are typically well below the AA, over it in a single year. For example, where they are a long-serving member of a DB scheme experiencing a promotion, or other significant boost to their pensionable salary, or for those benefitting from a substantial enhancement to their pension rights.

The statement published alongside the June budget set out the Government's intention to engage with employers, pension schemes, experts and other interested parties to determine the best design of a regime, to ensure it works fairly and effectively. This includes considering options to protect basic-rate taxpayers, and to support hard cases caused by one-off spikes in pension accrual"

In contrast to the existing rules, there are no exemptions proposed in the year in which a person becomes entitled to all their benefits. There would be no AA test on death or payment of a serious ill-health lump sum. However, significant increases arising from ill-health retirements or redundancies are not expected to be exempt.

2.7 The Treasury suggest that pension schemes consider the following four methods of avoiding spikes:

- 1) cap accrual – redesign benefit basis to minimise the risks of breaching the AA in any one year, for example by capping pensionable pay increases;
- 2) smooth accrual – smooth benefit accrual so that any large one-off increase is delivered over a number of years, to avoid breaching the AA in that scheme in any one year. For example, increase pensionable pay slowly over a number of years, or introduce an overriding rule to limit accrual such that the AA is not likely to be exceeded and any excess is carried over;
- 3) offer members an alternative to future DB accrual – offer the option of opting-out of employer's DB scheme altogether and taking an alternative in its place, for example a cash allowance (some of which could be put into a DC plan); and

- 4) remove spiky benefits – redesign or withdraw benefits elements that cause spikes in accrual, for example, enhanced early retirement terms, ill-health service top-ups, top-ups at retirement based on a service qualifier or in the event of redundancy. For example, incentives to retire early could be paid in cash rather than through the pension scheme. Permanent Health Insurance could replace ill-health benefits.

These options are not currently available in the LGPS.

- 2.8 Where the AA is exceeded however, the Treasury will consider phased payments of the tax due. Funds may also be allowed to pay the tax on behalf of the individual and reduce pension benefits correspondingly.
- 2.9 The full list of items raised by the Treasury is attached at **Appendix A**.

3. COMMENTS ON PROPOSALS

- 3.1 For the Treasury to raise £3.5bn in tax, they will have to be stringent regarding the flexibilities that are allowed.
- 3.2 The intention is that the tax charge would continue to be collected through the self-assessment system. This is clearly a significant administration challenge for the Pension Office if there is a requirement on funds to advise members where they have exceeded the Annual Allowance and/or advise HMRC of such cases.
- 3.3 The Finance Act 2010 changes will only be repealed if the Government finds a suitable alternative. Over the last 12 months, high earners have been informed of the potential impact of tax changes on them. If a new regime is introduced, there will be limited time to communicate the new process to employees.
- 3.4 The Government's proposals are less complicated than those proposed by the previous regime. They will however affect employees on much lower incomes than the original £130,000. Members with long service are more likely to be affected than those members with short service. The key factors that will determine the scale of any charge are the amount of increase and the duration of service for defined benefit schemes. This is likely to be more onerous than for defined contribution schemes where the value of employee and employer contributions made in the year is used to determine the increase in value of benefits (i.e. excludes investment gains).
- 3.5 The new proposals offer schemes the opportunity to limit benefit accrued up to the new annual allowance, this is not currently available in the LGPS.
- 3.6 The Government is currently making a number of decisions that will have an impact on pension provision. It is vital that these decisions are considered in the round.

4. CONSULTATION RESPONSE

- 4.1 The Chair of the Panel has submitted a response to the consultation and a copy is attached at **Appendix B**.
- 4.2 Further comments on the consultation will be given at the meeting.

APPENDIX A

RESTRICTION OF PENSION TAX RELIEF SUMMARY OF VIEWS REQUESTED

1. There are currently exemptions from the AA test which would undermine the ability of a reduced AA to restrict pensions 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).
2. By only taking the newly accrued amount of annual pension in DB pension into account, the use of a flat factor potentially increases 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).
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).
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 case 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).
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).
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).
7. The Government would welcome views on the merits of capping relief of 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).
8. The Government is keen to support employers to make adjustments to help individuals who may face large, but one-off, increases to the DB pension. The Government welcomes views on the legislative action that could facilitate appropriate scheme redesign without undermining other aspects of the regulatory regime (Paragraph 3.10).
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).

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).
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).
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).
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 benefitting from UK tax relief (Paragraph 4.22).