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BRIEFING PAPER

Number SN-05091, 22 November 2016

Restricting pension tax relief

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Summary

The principle of the current system of tax relief is that contributions to pensions are exempt from tax when they are made, but taxed when they are paid out to the individual. Pension contributions made by individual employees are usually paid out of pre-salary, so tax relief is received at the individual's marginal tax rate. The main limits that apply are the lifetime allowance (LTA) and annual allowance (AA).[1] At introduction in 2006, the AA was set at £215,000 and the LTA at £1.5 million.[2] Both were set to increase in stages, with the LTA reaching £1.8m and the AA £255,000 by 2010.[3] Since 2010, both allowances have been reduced on a number of occasions.

- In October 2010, the Government announced that the AA would reduce from £255,000 to £50,000 from 2011 and the LTA from £1.8m to £1.5m from 2012.[4] This was legislated for in the *Finance Act 2011* (s66-7 and Sch 17 and 18).

- In the Autumn Statement 2012, the Government announced that from 2014-15, the LTA would reduce from £1.5 million to £1.25 million and further reduce the AA from £50,000 to £40,000.[5] This was legislated for in the *Finance Act 2013* (ch 4).

- In the March 2015 Budget, the Government announced a reduction in the LTA from £1.25 million to £1 million from April 2016 (para 1.232). Provision for this is in the *Finance Act 2016* (s19 and Sch 4).

- In the Summer 2015 Budget, the Government announced that it would introduce a taper to the Annual Allowance for those with adjusted incomes, including their own and employer's pension contributions, over £150,000 from April 2016 (para 1.223).[6] This was legislated for in the *Finance (No. 2) Act 2015* (s23 and Sch 4).

The table below shows changes in both allowances since introduction:[7]

	Lifetime allowance	Annual Allowance
2006/07	£1.5m	£215,000
2007/08	£1.6m	£225,000
2008/09	£1.65m	£235,000
2009/10	£1.75m	£245,000
2010/11	£1.8m	£255,000
2011/12	£1.8m	£50,000
2012/13	£1.5m	£50,000
2013/14	£1.5m	£50,000
2014/15	£1.25m	£40,000
2015/16	£1.25m	£40,000
2016/17	£1.0m	£40,000

[1] *Finance Act 2004*, Part 4
[2] *Finance Act 2004* s218, s218 and 228
[3] HM Treasury, Budget 2004, para 5.45
[4] HM Treasury, Restricting pensions tax relief through existing allowances: a summary of the discussion document responses, October 2010, para 2.6 to 2.7
[5] HM Treasury, Autumn Statement 2012, para 1.179
[6] HM Treasury, Sumer Budget 2015, July 2015, para 1.223
[7] National Statistics, Personal pension statistics, September 2015, p9

The Government estimates that reductions since 2010 have "significantly reduced the share of pensions tax relief that goes to additional rate taxpayers" and reduced costs to the Exchequer by over £6 billion a year. (HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July 2015, para 1.5 and 2.6.)

Calls for more fundamental reform continued, partly fuelled by concerns that the current system is not effective in encouraging saving particularly among those most at risk of not saving enough for their retirement.[8] The Government launched a consultation on reforming pension tax relief to strengthen the incentive to save in July 2015. However, in Budget 2016, the Chancellor did not announce any fundamental change to the tax treatment of pension on the grounds that there was 'no consensus' (HC Deb 16 March 2016 c966). However, he did announced the introduction of the Lifetime ISA from April 2017. For more detail, see Library Briefing Paper CBP-07724 Lifetime ISA and pensions (November 2016) and CBP-07505 *Reforming pension tax relief* (February 2016).

[8] See, for example, Michael Johnson, Retirement saving incentives, Centre for Policy Studies, April 2014

1. Introduction

The tax treatment of pensions follows an "exempt, exempt, taxed (EET) model":

- (Exempt). Pension contributions by individuals and employers receive tax relief and employer contributions are exempt from national insurance contributions. The main limits applying are the annual and lifetime allowances (see section 2 below).
- (Exempt). No tax is charged on investment growth from pension contributions; and
- (Taxed). Pensions in payment are taxed as other income, but individuals are able to take up to 25% of their pension fund as a lump sum on retirement.[9]

A general overview can be found on Gov.UK – Tax on your private pension contributions.[10]

The main pension tax legislation is set out in Part 4 of the *Finance Act 2004* (*FA 2004*). Legislation relating to the taxation of pension income is in the consolidated *Income Tax (Earnings and Pensions) Act 2003*.

Exchequer cost

In 2014/15, an estimated £34.2 billion in tax relief was provided on contributions to approved pension schemes. In the same year, £13.0 billion in tax was collected on private pensions in payment. National Insurance (NI) relief on employer contributions cost £13.8 billion.[11]

HMRC estimates of the cost of pensions tax relief, 2014-15

		£ billion
Income tax relief on:		
	Contributions from employees	6.6
	Contributions from employers	19.5
	Contributions from self-employed	0.5
	Investment income of pension funds	7.7
Total reliefs		**34.2**
	Income tax received on private pension income	13.0
	Total	21.2
	National Insurance relief on employer contributions	13.8

Source: ONS, PEN6 - Cost of registered pension scheme tax relief

While it could be argued that the net cost to the Exchequer was £21.2 billion (£34.2 billion minus £13.0 billion), HM Treasury explains that this could misrepresent the actual cost to the government each year:

[9] HM Treasury, Removing the requirement to annuitise by age 75, July 2010, para 2.3; Bill 97-EN, page 2

[10] More detailed information is on archived versions of the HMRC website – pension schemes and tax – the basics and tax relief on your private pension contributions.

[11] HMRC Cost of Registered Pension Schemes Tax Relief – PEN 6 (Updated February 2015)

> First, the income received by the government from pensions in payment will in all likelihood come from pensions which received tax relief many years ago. Therefore subtracting it from the gross costs of relief provided on pensions today may not provide an appropriate estimate of the next cost. Second, tax rates of individuals may change over their lifetime and therefore the rate of relief they may not correspond to the amount of tax they ultimately pay on their pension.[12]

HMRC and National Statistics Personal Pension Statistics (September 2016) includes charts showing:

- The **cost of tax relief between 2001-02 and 2014-15** (chart 8). It commented that gross tax relief was projected to be £34.2 billion, down from £34.3 billion in 2013-14. Recent reductions in the annual and lifetime allowances were expected to be "the main cause of flattening and now falling gross cost of pension tax relief since 2010-11."
- **Gross tax relief by source** (chart 9).

HMRC commented that:

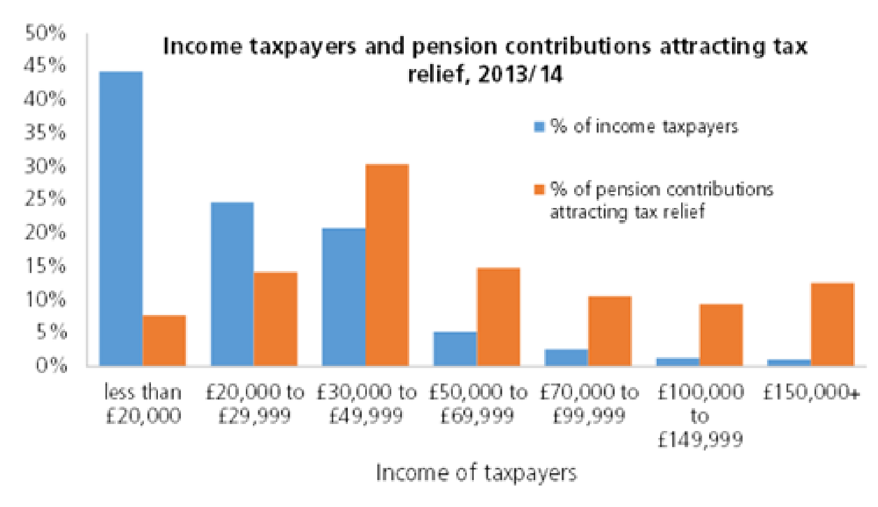
> While income tax relief in respect of employers contributions to occupational schemes fell in 2014-15, it remained the largest element. Contributions to occupational schemes (employee and employer) account for over 60% thirds of the total relief. Contributions to personal pensions account for about 15 per cent of the total relief and contributions by the self-employed a further 2 per cent. The remainder of the cost of relief is relief on investment income.[13]

[12] HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July 2015

[13] HMRC and National Statistics, Personal Pension Statistics, September 2016

Distribution

In 2013/14, people with incomes over £50,000 accounted for around 10 per cent of income tax payers, but nearly half (47%) of private pension contributions attracting tax relief. The 1 per cent of income tax payers within incomes of £150,000 and above accounted for 13 per cent of pension contributions attracting tax relief.



sources: HMRC Table 3.8 – Distributions and reliefs: 2013/14
HMRC Table 3.3 – Distribution of total income before and after tax by gender: 2013/14

The Government estimates that reductions in the AA and LTA since 2010 have:

> [….] significantly reduced the share of pensions tax relief that goes to additional rate taxpayers since 2009, a trend that is likely to continue when the tapered annual allowance is introduced in April 2016 for those with an income over £150,000. Increases in the Personal Allowance in recent years have also led to a decrease in the share of pensions tax relief which goes to those with an income below £19,999.[14]

The Institute for Fiscal Studies (IFS) comments that it is unsurprising that individuals with "a higher current income are, on average, estimated to receive more up-front relief than individuals who have a lower current income." Focusing only on the proportion of relief on contributions going to higher earners takes no account of the income tax that will eventually be paid on that income. Furthermore, some individuals may have high incomes temporarily and may be making greater pension contributions to benefit from tax-rate smoothing. It argues that the tax system should treat pension contributions and income in a symmetric way.[15]

[14] HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, Cm 9102, July 2015, para 2.6

[15] IFS Green Budget 2014, Chapter 10, p231; IFS, Green Budget 2015, p260

1.1 Principles

In 2007, the Labour Government said that "a principled and transparent tax regime was crucial to providing the right environment and incentives to encourage long-term saving." Its approach was underpinned by the following principles:

- generous tax relief is provided to support pension saving to produce an income in retirement. Pension saving is not, however, provided to support pre-retirement income, asset accumulation or inheritance;
- pensions are provided with more favourable tax treatment, compared to other forms of saving, in recognition that they are less flexible than other savings, and are locked away until retirement;
- incentives for employer contributions are provided as it is more efficient for pensions to be provided on a collective basis through the employer; and
- the cost of pensions tax incentives must be affordable and fall within current fiscal projections.[16]

In 2010, the Conservative-Liberal Democrat Coalition Government said the purpose of tax-relieve pension saving was to provide an income in retirement but that individuals should have the flexibility provided that they had sufficient income to avoid exhausting savings prematurely and falling back on the state:

Box 2.A: Principles for a new tax framework for retirement

1. The purpose of tax-relieved pension saving is to provide an income in retirement.

2. Any changes to the pensions tax rules should not incur Exchequer cost and should not create any opportunities for tax avoidance.

3 Individuals should have the flexibility to decide when and how best to turn their pension savings into a retirement income, provided that they have sufficient income to avoid exhausting savings prematurely and fall back on the state.

4. In line with the EET model, pension benefits taken during an individual's lifetime should be taxed at income tax rates. The tax-free pension commencement lump sum will continue to be available.

5 On death, pension savings that have been accumulated with tax relief should be taxed at an appropriate rate to recover past relief given, unless they are used to provide a pension for a dependant.[17]

In November 2014, it announced that it would introduce give people aged 55 and over greater choice about when and how to draw their defined contribution (DC) pension savings.[18] It said the introduction of the new single-tier State Pension from April 2016 meant the state

[16] HM Treasury, Budget 2007, HC 342; Chapter Five; See also, HM Treasury and HM Revenue and Customs, Implementing the restriction of pensions tax relief, December 2009, pages 6-9

[17] HM Treasury, Removing the effective requirement to annuitise by 75, July 2010

[18] HC Deb 19 March 2014 c793

needed to be "much less prescriptive about how people use their accumulated pension savings."[19] For more detail, see Library Note SN *6891* Pension flexibilities (July 2015).

1.2 Views of the different parties

The views of the main political parties as reflected in their manifestos for the 2015 general election were as follows:

> […] we will take the family home out of tax for all but the richest by increasing the effective Inheritance Tax threshold for married couples and civil partners to £1 million, with a new transferable main residence allowance of £175,000 per person. This will be paid for by reducing the tax relief on pension contributions for people earning more than £150,000.[20] *Conservatives*
>
> Labour will cut tuition fees from £9,000 to £6,000 a year, funded by restricting tax relief on pension contributions for the highest earners and clamping down on tax avoidance.[21] *Labour*
>
> Establish a review to consider the case for, and practical implications of, introducing a single rate of tax relief for pensions, which would be designed to be simpler and fairer and which would be set more generously than the current 20% basic rate relief.[22] *Liberal Democrats*
>
> We will end the unfair 40% plus pensions relief subsidy for higher rate tax payers.[23] *Plaid Cymru*
>
> We will also look to release additional resources by backing a series of revenue raising measures - the reintroduction of the 50p top tax rate, a tax on bankers' bonuses, a bank levy, a mansion tax, a crackdown on tax avoidance, the abolition of 'non dom' status, reversal of the married couples' tax allowance, and a review of the pension tax relief available to the wealthiest.[24] *SNP*

19 HC Deb 20 March 2014 c950-1
20 The Conservative Party Manifesto 2015
21 The Labour Party Manifesto 2015
22 Liberal Democrats Manifesto 2015
23 Plaid Cymru 2015 Westminster Election Manifesto
24 SNP Manifesto 2015

2. Pension tax simplification

A major reform of the system was the introduction of the 'pension tax simplification' regime from 6 April 2006 ('A day') under the *Finance Act 2004 (FA 2004).* This replaced eight different tax regimes governing pensions with a single set of rules applying to saving across pension schemes and rules as to how pension savings are turned into benefits.[25] The Labour Government said its aim was to simplify the system:

> 2.6 The complexity of the current system makes these generous tax incentives difficult to understand. The reforms outline in this document are intended to bring out the value of tax relief for pensions more strongly. Removing complexity will reduce costs and make advice on pensions more straightforward and comprehensible. So simplification will put people in a better position to make informed choice about what they are prepared to save and how.[26]

Previously, there had been a range of limits on annual contributions and final benefits in pension schemes. These would be replaced by annual and lifetime limits, applying across pension schemes, on the amount of savings eligible for tax relief:

> 4.2. Instead of the current plethora of limits, people will be able to get full tax relief on all contributions to pensions. The current limits on annual pension contributions and final benefits will be replaced by a single lifetime limit on the total amount of pension savings that can benefit from tax relief. This will be complemented by a light touch compliance regime with an annual limit on the value of the increase in each person's pension rights that qualify for tax relief.
>
> 4.3 These rules will only limit the amount of tax-privileged pension. Those who wish to save more will enjoy the flexibility to do so, but will not benefit from the additional tax reliefs in the longer-term. This removes the requirement on pension schemes to carry out regular checks against tax limits. Instead schemes will carry out one single test against the lifetime limit, levying a recovery charge on any pension savings that exceed this limit. Pension savers will be responsible for checking inflows into their pension funds against the annual limit and, in the few cases where these limits are exceeded, account for any tax due.[27]

The two limits set were the annual and lifetime allowances:

- The annual allowance (AA) limits the amount of annual pension savings that benefit from tax relief. There is a tax charge if contributions or the value of benefits accrued in a year, exceed the AA.[28]
- The lifetime allowance (LTA) limits the amount of pension saving over an individual's lifetime that can benefit from tax relief. Pension savings are tested against the LTA at 'benefit

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[25] HM Treasury, Simplifying the taxation of pensions: increasing choice and flexibility for all, December 2002
[26] Ibid
[27] Ibid, see also para 2.22-8
[28] *FA 2004*, s227; HMRC, Registered Pension Schemes Manual, RPSM06100000

crystallisation events', for example, when an individual becomes entitled to a lifetime annuity.[29]

The background to the reforms are discussed in more detail in Library Note SN 2984 Pension tax simplification (11 December 2008)

2.1 The lifetime allowance (LTA)

In December 2002, the Labour Government proposed to set the LTA at a level broadly equivalent to the maximum under existing occupational pension rules:

> 4.10 The Government intends to set the control level for the value of an individual's pension fund at retirement at £1.4 million. This amount is broadly equivalent to a maximum pension at the date of implementation under the current occupational pension rules for a man of 60 drawing an indexed pension and providing a surviving spouse's pension. It will be indexed to keep pace with inflation – as the earnings cap is now. For most people this limit will be well above the pension they expect to get at retirement.[30]

At that stage, it proposed that the capital value of DB pension rights would be determined according to actuarial tables published by HMRC.[31] However, in December 2003, it announced that it had decided to apply a single factor of 20:1 for valuing DB benefits against the lifetime allowance:

> 1.17 Using a factor 20:1 at all ages, the Government believes that £1.4 million is broadly equivalent to the maximum pension allowable under the 1989 regime for those earning at or above £99,000 per year, and represents a generous level of savings on which to provide tax relief. **This will be the level of the lifetime allowance from the introduction of the new regime in April 2005, if it is decided to proceed.**[32]

The allowance would be uprated annually in line with prices.[33] There would be transitional arrangements for those who had already accrued rights in excess of £1.4 million.[34]

In the Pre-Budget Report 2003 the Government announced that it had asked the National Audit Office (NAO) to look into concerns that more people would be effected than the Government had estimated.[35] In March 2004, the NAO confirmed that, using a 20:1 valuation factor, a lifetime allowance of £1.4 million was broadly equivalent to the maximum occupational pension allowable under the existing regime.[36] In its Budget on 17 March 2004, the Government announced that the

[29] *FA 2004*, s216; RPSM11200000
[30] HM Treasury, Simplifying the taxation of pensions: increasing choice and flexibility for all, December 2002
[31] Ibid para 4.11
[32] HM Treasury, Simplifying the taxation of pensions: the Government's proposals, December 2003
[33] Ibid, para 1.32
[34] Ibid, Annex C
[35] HM Treasury, Pre-Budget Report 2003, para 5.60
[36] NAO press release, The Government's estimates of the pensions lifetime allowance, 9 March 2004

LTA would be set at £1.5 million for the first year, rising to £1.8 million by 2010.[37] It would be reviewed quinquennially.[38]

2.2 Annual allowance (AA)

The AA limits the amount of annual pension savings that benefit from tax relief. Where an individual's 'total pension input amount' exceeds the AA, there is a charge on the excess. Before April 2011, the charge was 40%. From April 2011, it is the individual's marginal tax rate.[39]

The AA was initially set at £200,000 – a level that was not expected to affect most savers. The Labour Government said:

> 4.17 There will be a light touch compliance regime including an annual limit on value inflows into a person's pension savings. This annual limit will be designed not to constrain most pension savers. Its prime purpose will be to limit the leakage of tax relief which could occur if a determined opportunist tried to wash contributions through a pension fund quickly, planning to extract the proceeds improperly.
>
> 4.18 The Government is minded to set this annual limit at £200,000. Like the lifetime limit, this figure will be indexed.
>
> 4.19 Such a high annual limit will be quite academic for most people. No one can get tax relief on personal pension savings of more than about £40,000 a year now; and very few people in occupational schemes, probably fewer than 1,000 have their pension rights raised by £200,000 or more in a single year. So this will not affect the vast majority of people […] [40]

It proposed to measure DB pension rights against the AA, using a flat factor of 10:1:

> 1.31 Again there needs to be a simple means of valuing the annual increase in benefits in DB schemes. The actual cost of making annual provision for people at all different ages, where the funds have different periods over which to accumulate and grow, varies widely. A factor of value for every £1 of DB pension would reflect this.
>
> 1.32 The Government therefore proposes that, taking into account the range of factors that could be applied across a range of ages, a single factor of 10:1 will be used for this purpose.[41]

The legislation relating to the annual and lifetime allowances is in Chapter 5 of the *Finance Act 2004.* Detailed guidance is in the technical pages of HMRC's Registered Pension Schemes Manual – see RPSM06100000 - Technical Pages: Annual allowance and RPSM 111000000 – Technical pages: lifetime allowance.

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[37] HC Deb 17 March 2004, c 329; HM Treasury, Budget 2004, para 5.45
[38] Ibid
[39] *FA* 227 (as amended from April 2011 by *FA* 2011, Sch 17 (3)); Detailed information is in HMRC's Registered Pension Schemes Manual (RPSM) – Technical pages: annual allowance.
[40] HM Treasury, Simplifying the taxation of pensions: increasing choice and flexibility for all, December 2002, para 4.17
[41] HM Treasury, Simplifying the taxation of pensions: the Government's proposals, December 2003,

3. Budget 2009 – proposals to restrict relief to higher earners

In Budget 2009, the Government announced said that those on the highest incomes benefitted disproportionately from tax relief on pension contributions. This would be exacerbated by the introduction of an additional rate of income tax of 50% to income over £150,000:

> 5.91 Those on highest incomes benefit disproportionately from this relief, and the personal tax changes announced in this Budget would increase the value of the reliefs given to individuals with the highest incomes. This would exacerbate the current situation whereby in 2008-09 individuals with income over £150,000 represented 1.5 per cent of pension savers, yet received a quarter of all tax relief on contributions (£6.1 billion). This amounted to an average of £27,000 per person, an amount in excess of median earnings, and compares with £1,000 for people who pay income tax at the basic rate.[42]

To address this, from April 2011, higher rate pension tax relief would be restricted for those with incomes of £150,000 and over. Above that level of income, the value of pension tax relief would be tapered down until it was 20 per cent for those over £180,000:

> 5.92 The 2008 Pre-Budget announced that the Government would maintain the lifetime allowance at £1.8 million for five years up to and including 2015-16. To ensure fairness, affordability and sustainability of tax reliefs, **Budget 2009 announces that, in addition, from April 2011, tax relief on pension contributions will be restricted for those with incomes of £150,000 and over**. From that level of income, the value of pensions tax relief will be tapered down until it is 20 per cent for those over £180,000, making it worth the same for each pound of contribution to pension entitlement as for a basic rate income taxpayer. This restriction applies to all contributions, including employers', but employers will continue to receive full relief on their contributions into employees' pensions through corporation tax and NICs.

The Government would consult with stakeholders to "ensure that defined benefit pension schemes are treated fairly in relation to defined contribution and personal pensions." To prevent individuals taking advantage of pension tax relief at the higher rate by making substantial additional pension contributions prior to the restriction taking effect in 2011-12, the Government would introduce "anti-forestalling" provisions in the forthcoming *Finance Bill.*[43] It estimated that the change would yield £200 million to the Exchequer in 2011-12. However, the process of self-assessment meant there was a lagged effect. For 2012-13, the estimated yield was £3.1 billion.[44]

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[42] HM Treasury, Budget 2009, HC 407, 22 April 2009, para 5.88 and 5.91
[43] Ibid, p5.93-4
[44] Ibid, Table A1, page 153; See also HM Treasury and HM Revenue and Customs, Implementing the restriction of pensions tax relief, December 2009, Annex E

Comment

In advance of the Budget, calls had been made for higher rate tax relief to be scrapped. Pension Campaigner Ros Altmann described the system as "designed for a bygone age" and failing to address the needs of savers. She asked why "should the people who need the subsidy least get double the amount paid to people who need it most."[45] The Liberal Democrats said on 20 April 2009 that their proposals for changes for the tax system included "restricting tax relief on pension contributions to the basic rate."[46]

However, concerns were expressed from within the pensions industry and by employer representative groups. Following the Budget, the Association of British Insurers (ABI) questioned the message that would be sent to pension savers and was concerned at the likely expense and complexity of implementation.

> Tax relief is there for a reason – it compensates responsible people who agree to defer some income by locking pension savings away until they retire. That principle was enshrined by Lord Turner in his Government-backed report on pensions in 2006. To maintain consumer confidence in the pensions system, the Government must give a categorical assurance that the historic principle of pension savers receiving tax relief on their contributions will not be undermined any further. This move is likely to be expensive to implement and will reintroduce complexity and change to the pension system, just three years after the Government's 'A-Day' reforms. It is vital there is detailed and effective consultation on the implementation of these changes...[47]

Pension providers were concerned that there might be unintended consequences resulting from reduced incentives to save in a pension. Higher earners might look at other ways of saving, such as buy-to-let property, or moving money overseas.[48] There were also fears that the added complexity would lead to more DB schemes being closed.[49]

The IFS questioned the fairness of the proposed change (was higher rate relief only "unfair" and "an anomaly" above £150,000?) and commented on the difficulties of implementation. It It also argued the change could lead to undesirable distortions in behaviour. For example, a person could change work patterns, save less, save in other forms or at another time. If less money went into pensions, the Government might receive less tax on pension income in future years.[50]

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45 Phillip Inman, 'Campaigners call for end to high earners' pension advantage', *The Guardian,* 21 April 2009

46 Liberal Democrat Press Release, 20 April 2009, Liberal Democrats will cut people's income tax bill by £700

47 ABI Press Release, 'Pensions tax relief move 'disappointing day for pension saving', 22 April 2009; See also, 'Government to restrict pension tax relief – Update 5', *Professional Pensions,* 22 April 2009

48 Matthew Vincent, "Pension providers warn of unintended consequences'", *Financial Times,* 23 April 2009

49 'Budget small print could spell doom for final salary pensions', 24 April 2009, *The Guardian*

50 Institute for Fiscal Studies, Post Budget briefing, 23 April 2009. 'Direct taxes and benefits', Stuart Adam

An article in the *Financial Times* commented on the fact that tax would be levied on employer contributions, though this was not without precedent:

> With the introduction of a higher tax rate of 50 per cent on salaries higher than £150,000, and the limit on tax deductibility at only a 20 per cent rate for those earning more than £180,000, employers would have had an incentive to design remuneration packages to limit tax. So high-earning employees will also be taxed on their employer contribution as though it were a benefit in kind, akin to health insurance or gym membership. However, that contribution will also attract relief of at least 20 per cent, unlike other benefits. "Without attacking the employer contribution element, employers would have said to the employee: 'Don't contribute to your pension; we will contribute for you", Mr Mody said.[51]

Debate in Parliament

The House of Lords Select Committee on Economic Affairs was concerned about complexity and the potential impact on incentives to save in a pension:

> We fully accept that the Government has to be free to make the changes it sees fit. But on the taxation of pensions, we regret that significant changes were introduced so soon after the redesign of the whole system. There seems little official recognition that this precedent has undermined simplicity, consistency and certainty or that it risks a reduction in pensions savings. We accept the views of our private sector witnesses that the highly paid may look elsewhere to invest their savings. Whilst the numbers directly affected may be relatively small, among them will be individuals who are influential in many companies.
>
> We accept that the Government intends that there should be a level playing field between defined benefit (DB) and defined contribution (DC) schemes, but close attention needs to be paid to the practical difficulties; we recommend that the Government should complete the consultation well before implementation in 2011. Careful consideration is also needed to avoid exceptionally high marginal rates exceeding 100% from the combination of the marginal rate of income tax and the reduction in pension tax relief on significant increases in incomes which cross the £150,000 threshold. We do not recommend alternative approaches to restricting relief.
>
> We question whether the anti-forestalling provisions are necessary. Solutions will need to be found for all the individuals who have good reason for not making their pensions savings regularly or frequently: these include the self-employed and those retiring or made redundant. If answers cannot be found for all these groups, as a fall-back the special annual allowance should be increased significantly. Otherwise the introduction of these provisions will require the most careful consideration of all the concerns of legitimate expectation, complexity, even handedness and the practical and administrative issues raised by witnesses.[52]

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51 Norma Cohen, 'New tax rules threaten company pension plans', *Financial Times,* 25 April 2009

52 House of Lords, Select Committee on Economic Affairs, The Finance Bill 2009, 3rd Report 2008-09, Abstract

The House of Commons Treasury Select Committee recommended that the Treasury monitor the impact on pension saving and keep under review the option of reducing the annual allowance:

> 104. **We note that this budget marks a departure from the long-standing principle that tax relief for pension contributions should be given at an individual's highest marginal rate. We urge the Treasury to monitor the effect of this change on pension savings and to keep under review the possibility that a cap on annual contributions might be a more equitable way of reducing the percentage of tax relief that benefits the highest earners.**[53]

In debate on the *Finance Bill* on 6 May 2009, the then Shadow Chief Secretary to the Treasury Philip Hammond asked why the Government had not looked at changing the maximum contribution limits:

> The measure introduces more complexity and uncertainty; long-term commitments are being overturned for short-term gain. I have already acknowledged the Government's concern that the 50 per cent. rate of tax makes pension tax relief an obvious route for legal avoidance; that is why they have sought to limit the availability of tax relief to the highest earners. But why on earth did they not do that in the simple and obvious way—albeit one that would also have breached the A-day commitments—of changing the maximum contribution limits under the A-day regime?[54]

In Public Bill Committee, the then Shadow Treasury Minister Mark Hoban said the Bill added a layer of complexity.[55] He was also concerned about the possible impact on the "culture of saving" in the UK.[56]

However, in February 2010, the then Shadow Work and Pensions Secretary, Theresa May said the Conservative Party could not pledge to reverse the changes:

> It breaks the basic covenant that has long been accepted by all parties – that responsible saving will be rewarded and not punished; that savings will be protected not taxed several times over. This damaging decision will hurt pension funds and further weaken our culture of saving. As we have made clear, we do not support this change, but given the dreadful state of the public finances we cannot pledge to reverse it at this point.[57]

3.1 "Anti-forestalling" provisions – *Finance Act 2009*

The restriction of higher rate tax relief was not to take effect until April 2011. The Government therefore proposed to introduce "anti-forestalling provisions" to prevent people making large contributions in order to get the benefit of the higher tax relief that would not be available after that date.

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53 Treasury Select Committee, Budget 2009, Eighth Report of 2008-09, HC 438-I, 5 May 2009

54 HC Deb, 6 May 2009, c204

55 PBC Deb, 18 June 2009, c443

56 Ibid, c445

57 Theresa May, Providing for Pensions, Politeia, 2010

In broad terms, from 22 April 2009, individuals making regular patterns of contributions (at least quarterly) would continue to get tax relief at their marginal rate. However, where contributions were made or benefits accrued which were outside normal patterns of contributions, and above the level of a "special annual allowance" (£20,000), they would attract a tax charge so that relief was restricted to the basic rate. Details were provided in a Written Statement.[58] Further detail was provided for in Budget Note 47.

Comment in the press focused on the potential impact on the self-employed and others who make annual lump sum pension contributions.[59] In debate on the legislation, the then Financial Secretary to the Treasury, Stephen Timms, confirmed that the Government would be looking at the position of people who make regular contributions to a pension, but less frequently than quarterly.[60]

Debate in Parliament

The provisions were debated in Public Bill Committee on 18 June 2009. The then Shadow Minister for the Treasury Mark Hoban described the anti-forestalling provisions as crude, in that it did "not necessarily take account of how people run their lives and how their income flows from year to year."[61] He was concerned at the position of those making non-regular contributions:

> Someone who does not have a regular pattern of contributions will be disadvantaged, but someone earning £150,000 with regular contributions of £30,000 could enjoy the full relief. If they do not have a regular pattern of contributions, full tax relief will be limited to £20,000. A problem is emerging, partly as a consequence of the treatment of regular contributions.[62]

The then Financial Secretary to the Treasury, Stephen Timms, argued that provisions would achieve a balance:

> …one the one hand preventing people from making large increased contributions to pre-empt the reduced relief that is available from April 2011, and on the other ensuring that those who continue with their normal, regular pattern of pension saving will receive higher rate tax relief until the new legislation takes effect in April 2011.[63]

He said the Government might return to the issue of those making non-regular pension contributions at the Bill's Report Stage.[64] At the Bill's report stage the Government tabled an amendment which would increase the special annual allowance (or level of contributions that could be made on a non-regular basis) to £30,000.[65]

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[58] HC Deb, 22 April 2009, c15-17WS
[59] See, for example, 'Self-employed people claim discrimination over pensions savings', *Financial Times,* 28 April 2009
[60] HC Deb, 6 May 2009, c311
[61] PBC Deb, 18 June 2009, c443
[62] Ibid, c458
[63] Ibid, c472
[64] Ibid, c445 and 473
[65] Amendment 49

The Chartered Institute of Taxation (COIT) said the change answered some of its concerns regarding unfairness to those making non-regular contributions to their pension.[66]

Provision for the "special annual allowance charge" was made in section 72 and Schedule 35 of the Finance Act 2009. Detailed explanation is in the Explanatory Notes (page 258-67).

3.2 Consultation on implementation – Pre-Budget Report 2009

In Pre-Budget Report 2009, the Labour Government announced that the restriction of tax relief would apply to those with gross incomes of over £150,000, including the value of any pension benefit funded by (or eventually funded by) the employer. Those with pre-tax incomes (excluding employer contribution) of less than £130,000 would be unaffected:

> As announced in the 2009 Pre-Budget Report, it has therefore decided that the restriction will apply to individuals on gross incomes of £150,000 and over, where gross income includes the value of the pension benefit funded by (or eventually funded by) their employers. This reduces distortions and unfairness otherwise caused by excluding the value of pension benefits provided by employers.
>
> To provide certainty for individuals around whether they are affected, and to reduce administrative burdens for schemes, the Government is introducing a floor at £130,000 of pre-tax income (including an individual's own pension contributions, and charitable donations). Only individuals with pre-tax incomes at or above this level will need to establish the value of the pension benefit funded by (or eventually funded by) their employers. So individuals with incomes (including the pension contributions they make themselves) of less than £130,000 are unaffected by this change. And the restriction will apply to 300,000 individuals, about 2 per cent of pension savers, or around 1 per cent of working-age taxpayers, who will continue to receive tax relief of at least 20 per cent on all pension contributions, and tax relief on all investment growth.
>
> Around 98 per cent of pension savers will not see their tax relief restricted by this change. The Government wishes to ensure that pensions tax relief is well targeted, to ensure that it is fair, affordable and sustainable. That is the purpose of this change.[67]

The intention was to ensure the restriction applied fairly across individuals in different types of schemes and employment, and with different remuneration arrangements.[68] Amendments would be made to the anti-forestalling measures to reflect this.

[66] Chartered Institute of Taxation Press release, 6 July 2009 'CIOT acknowledges changes to pension contributions relief proposals

[67] HM Treasury and HMRC, Implementing the restriction of pensions tax relief, December 2009, page 5; See also, HM Treasury, Pre-Budget Report 2009, para 5.48-5.50

[68] HM Treasury and HMRC, Implementing the restriction of pensions tax relief, December 2009, page 16

A consultation document Implementing the restriction of pensions tax relief included proposals on how the change should be implemented for members of Defined Benefit schemes.[69] The argument that it would have been better to restrict the lifetime or annual allowance was rejected:

> 2.22 In the context of the Government's commitment to halve public sector net borrowing over the next four years, the Government has acted to rebalance the pensions tax system, so that those with the highest individual incomes contribute most to ensuring sound public finances. Alternative approaches, such as reducing the existing pensions tax relief limits, the annual or lifetime allowance, would constrain the amount of tax-privileged pension savings for everyone, but would still allow those on the highest incomes to receive more tax relief per pound saved than basic-rate taxpayers. This would not be a targeted or fair approach to rebalancing pensions tax relief, nor do as much to contribute to fiscal consolidation.

Another question raised was how any tax charge should be recovered. It was proposed that this should primarily be through Self Assessment, with special arrangements for those facing particularly large charges.[70] An HMRC Technical Note Pensions: High income excess relief charge contained draft legislation and explanatory notes on key elements of the policy.

Comment

The IFS said that implementing the reform would create "complexity, unfairness and inefficiencies."[71] A number of organizations continued to argue that a different approach should have been taken – for example, by reducing one of the existing allowances.[72] However, BBC Economics Editor, Stephanie Flanders, doubted that the Chancellor would rethink his approach:

> He knows it's going to be horrendously complicated to administer for companies with final salary pension schemes. He also knows there are other ways to prevent high earners from parking their income in pensions to avoid the new 50p rate - for example, by cutting the lifetime cap on the tax-free pensions pot, or the cap on the amount that can be contributed in a single year. The problem is the Treasury doesn't think these steps would be as effective. And crucially, they don't think it would raise nearly enough cash.[73]

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[69] Ibid Executive Summary and para 1.8-9
[70] Ibid, para 1.10-12
[71] IFS Press Release, 'A response to the Treasury consultation on restricting pensions tax relief', 1 March 2010
[72] See, for example, NAPF Submission to the HMT/HMRC joint consultation on implementing the restriction of pensions tax relief; Implementing the restriction of pension tax relief – response by the Chartered Institute of Taxation' March 2010; Chartered Institute for Personnel and Development, Implementing the restriction of pensions tax relief, March 2010; Institute for Chartered Accountants in England and Wales, TaxRep 13/10, Implementing the restriction of pension tax relief. The "annual allowance" is the cap on contributions to Defined Contributions (DC) schemes and increases in the capital value of benefits accrued in Defined Benefit schemes.
[73] BBC News website, Stephanomics, 22 March 2010

Government response to consultation

In its response, the Labour Government again rejected the argument that it should have adopted an alternative means of restricting pension tax relief:

> […] the Government believes that it is right for those on the highest incomes to contribute most to fiscal consolidation and is clear that the restriction of relief should be targeted towards this group. A reduction in the annual or lifetime allowance would potentially apply to pension savers with much lower incomes, particularly in DB schemes. Furthermore, it would allow high-income individuals to continue to benefit from a higher rate of tax relief than other pension savers.
>
> 2.18 In addition, alternative options could not be implemented fairly without making significant adjustments to the pensions tax system that would also add their own complexity. The Government does not propose any changes to the annual allowance or the lifetime allowance at this stage.[74]

It pointed out that the restriction would apply to only around 300,000 individuals, around two per cent of pension savers.[75]

In Budget 2010, the Government gave details on how the restriction of relief would be applied and delivered. A key issue for the consultation had been to identify the most appropriate method for valuing the pension benefits of those in defined benefit (DB) schemes and of valuing the related employer contributions.[76] In November 2009, the Government said it had identified three main valuation options – "flat factors, cash equivalent transfer value (CETV), and age-related factors (ARFs).[77] It now confirmed that it would adopt the ARFs approach.[78] Decisions on other issues were also announced. For example:

- The restriction of tax relief on pension contributions would be primarily delivered through Self-Assessment.[79]
- Individuals incurring charges of over £15,000 would be able to elect for their pension scheme to "pay the charge on their behalf."[80]
- To prevent a cliff-edge effect, the rate of relief would be tapered down from 50 to 20 per cent as gross income increases from £150,000 to £180,000.[81]

3.3 *Finance Act 2010*

In Budget 2010, the then Chancellor of the Exchequer, Alistair Darling, announced that the Government would indeed bring forward legislation on the core elements of the restriction in *Finance Bill 2010*:

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[74] HM Treasury and HMRC, Implementing the restriction of pensions tax relief: a summary of responses to consultation, March 2010
[75] Ibid, para 2.4
[76] HM Treasury, *Budget 2009,* para 5.93
[77] HM Treasury, Implementing the restriction of pensions tax relief, December 2009, para 1.9, para 4.21-2
[78] Ibid, para 4.4
[79] Ibid, para 2.11
[80] Ibid, para 2.14
[81] Ibid, para 2.5

> 5.41 At the 2009 Pre-Budget Report the Government announced that, from April 2011, tax relief on pension contributions will be restricted for individuals on gross incomes of £150,000 and over (where gross income incorporates all pension contributions, including benefits provided by an employer), subject to an income floor of £130,000 (excluding pension contributions)[…] The Government intends to bring forward legislation on the core elements of the restriction in Finance Bill 2010, including provisions for tackling avoidance. The Government will continue to monitor areas of abuse and will act to develop further, targeted anti-avoidance provisions as necessary.[82]

Budget Note 33 gave more detail.[83] The relevant provisions were included in the *Finance Act 2010* (section 23 and schedule 2).

> Section 24 and Schedule 2 introduce a restriction of pension tax relief to the basic rate for high income individuals, to be known as the "high income excess relief charge". The charge arises in respect of pension contributions and benefits for individuals whose income, including employer contributions, is £150,000 or more, subject to a floor so that only individuals whose income (excluding employer contributions) is £130,000 or more are affected.[84]

HMRC produced technical guidance on the "high income excess relief charge".[85]

Changes were also made to the anti-forestalling provisions to reflect the announcement in *Pre-Budget Report 2009* that the core restriction would apply to those with gross incomes of £150,000 plus (including the value of pension benefit funded by their employer) with those on pre-tax incomes of less than £130,000 unaffected.[86] This was provided for in section 48 of the *Finance Act 2010*:

> Section 48 amends Schedule 35 to the Finance Act (FA) 2009 to lower the income threshold at which an individual is a high income individual for the purposes of determining whether the special annual allowance charge is applicable. The income threshold is lowered from £150,000 to £130,000 on and after 9 December 2009.[87]

In advance of the Budget, the then Shadow Financial Secretary, Mark Hoban, expressed concern that, given the impending general election, there would be inadequate time for Parliamentary scrutiny.[88]

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[82] HM Treasury, Budget 2010, HC 451
[83] HM Treasury, Budget Note 33, March 2010
[84] *Finance Act 2010*: Explanatory Notes to section 23 and schedule 2
[85] HMRC, Finance Bill 2010: Pensions: High income excess relief charge, 1 April 2010
[86] HMRC, PBRN 18, Pensions: Restricting Tax Relief for High-Income Individuals (Anti-forestalling); See also, HMRC Technical Note Pensions: Special annual allowance charge provides guidance on how the provisions will apply
[87] Explanatory Notes to section 48
[88] Cuts to pension tax relief prompt concerns', *Financial Times,* 22 March 2010

4. Reductions in the AA and LTA

4.1 LTA reduced to £1.5m, AA to £50,000

In its first Budget after the 2010 election, the Coalition Government announced that it would investigate other ways of making the £3.5bn savings the Labour Government had expected to achieve through the restrictions it had introduced for higher earners.[89] Following consultation, it decided to reduce the AA from £255,000 to £50,000 from 2011 and the LTA from £1.8m to £1.5m from 2012.[90] This was legislated for in the *Finance Act 2011* s66-7 and Sch. 17-18.

The issues debated in the course of the consultation are discussed below.

June 2010 Budget

In his first Budget, in June 2010, the new Chancellor, George Osborne, said he was committed to achieving the same level of savings as would have been achieved through the measures introduced by the Labour Government in the *Finance Act 2010.* However, it would investigate an alternative approach, possibly by reducing the annual allowance (AA):

> Many businesses are alarmed at the complexity this will introduce. I have listened to those concerns. However, I must also protect the £3.5 billion of revenues this policy was set to raise from high income people. I will therefore work with industry on alternatives ways of raising the same revenue, potentially by reducing the Annual Allowance.[91]

Provisional analysis carried out for the Coalition Government had suggested that an AA in the range of £30,000 or £45,000 would raise the necessary yield.[92] The Government would consult on how a lower annual allowance might work:

> The Government recognises that various features of a much lower annual allowance would need to be revised to ensure it operated fairly and effectively. The Government wishes to engage employers, pension schemes, experts and other interested parties to determine the best design of a regime, looking at a wide range of issues that will need further consideration. Relevant issues for the Government to consider include:
>
> - How pension accrual in DB schemes would be valued;
> - Options to ensure basic-rate taxpayers are not subject to the restriction, and to support hard cases cause by one-off 'spikes' in pension accrual'
> - Whether and how there could be flexibility for individuals over paying any charges that arise;
> - How compliance and delivery will work in practice.

89 HC Deb 22 June 2010 c179
90 HM Treasury, Restricting pensions tax relief through existing allowances: a summary of the discussion document responses, October 2010, para 2.6 and 2.7
91 HC Deb 22 June 2010 c179; HM Treasury, Budget 2010, HC 61, June 2010, para 1.118
92 HM Treasury, Budget 2010, HC 2010, para 2.27

> These and other policy design issues will have a bearing on the revenue raised by the policy. In taking forward these discussions the Government's over-riding concern will be the delivery of the fiscal set out above. [93]

Legislation would be introduced before the summer recess to "repeal through regulations the legislation passed at the *Finance Act 2010."* This would be done once the Government had decided on the detail of its approach. There would be no changes to the anti-forestalling regime as this broadly protected against forestalling risk.[94]

The Budget resolutions included one on pensions. This had two parts, one of which was to enable the "high income excess relief charge" (introduced by *Finance Act 2010* to restrict pension tax relief for higher earners) to be repealed.[95] This resolution was voted on, with the Government winning by 366 votes to 247.[96]

The Chancellor's announcement was welcomed by industry representatives. John Whiting of the Chartered Institute of Taxation (COIT) said:

> We, the pensions industry and taxpayers generally understand that pensions tax relief is going to be curtailed. Our argument from the start is that there has to be a simpler way than the absurdly over-complex system pushed through by the previous government. The cost of implementing the changes in rules was estimated at some £900m. Our suggestion has always been that a simple and pragmatic deep cut in the annual contribution limit was the way to go and we are very pleased to see the Chancellor is going to look properly at this route.[97]

Joanne Segars of the National Association of Pension Funds (NAPF) said

> Reducing the amount that can be paid into a pension tax-free each year will protect the Treasury's tax take, but will be much more supportive to pensions saving and less costly to implement. However, there is a lot of detail to be ironed out, and the level of the allowance is critical. We look forward to working with the Treasury to get the policy ready for implementation in April 2011.[98]

The *Financial Times* reported some concerns about the level at which the cap would have to be set:

> Yesterday, several pension advisers warned that even setting the level indicated by the chancellor ran the risk of cutting tax relief not just earners but to those on ordinary incomes in some circumstances.[99]

The IFS said:

> Perhaps the most welcome change [announced in the June Budget] was the decision to rethink the last Government's

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[93] HM Treasury, Restricting Pensions Tax Relief, 22 June 2010
[94] Ibid
[95] HM Treasury, Notes on Budget Resolutions, 22 June 2010
[96] HC Deb, 28 June 2010, c682
[97] COIT Press Release, 22 June 2010, '*Budget response: pension tax relief review strongly endorsed by COIT'*
[98] NAPF Press Release, 22 June 2010, 'Rethink on pension tax relief welcome, says NAPF"
[99] Norma Cohen, 'Pension plan for rich put on hold', *Financial Times,* 23 June 2010

> complex, unfair and inefficient plans to limit pension contributions relief for high earners. The Coalition now has a better approach than was in any of the three main party manifestos.[100]

Consultation

In July 2010, the Government published Restriction of pensions tax relief: a discussion document on the alternative approach.[101] It said its overriding concern would be delivery of its "fiscal objective."[102] Within these constraints, it would balance other key objectives of fairness, simplicity and sustainability of the pension tax regime:

> Fairness between defined benefit (DB) and defined contribution (DC) schemes is an important consideration. This needs to be appropriately balanced against simplicity. The system should be reasonably simple, both for individuals to understand and use, and for schemes and HMRC to administer, and minimise administrative burdens while ensuring effective compliance. It is important to design a regime that can be introduced in April 2011.[103]

A reduction in the AA to around £30,000 to £45,000 was proposed:

> The Government is committed to raising at least the same revenue through restricting pensions tax relief as has already been accounted for in the public finances. In order to meet this fiscal objective, provisional analysis suggests an AA set in the region of £30,000 to £45,000 would deliver the necessary yield.[104]

In order for an AA of this level to work, a number of features would need to change. These included the charge on contributions above the AA. The Government also proposed removing the existing exemptions from the AA test. [105]

Establishing a mechanism for valuing contributions to Defined Benefit (DB) schemes would be important:

> 2.8 For individuals in DC schemes it is straightforward to determine the level of contributions put into a scheme over a given period and to assess that against the AA. For DB schemes, however, individuals accrue a right to an amount of annual pension from pension age and a method is needed for calculating the 'deemed' level of contributions associated with that right for the purposes of testing against the AA.[106]

The Government asked for views on the proposal to use a "flat factor", set at a higher level than at present:

> 2.11 By only taking the newly accrued amount of annual pension in a DB pension into account, the use of a flat factor does, however, potentially create opportunities for DB pensions to be used to grant additional pension value without this counting towards the AA test. **The Government therefore welcomes**

[100] IFS post-budget presentations, 23 June 2010
[101] Other documents issued to support the consultation can be found on the archived Restriction of pension tax relief section of the HM Treasury website
[102] HM Treasury, Restriction of pensions tax relief: a discussion document on the alternative approach, July 2010, para 1.2
[103] Ibid, para 1.6
[104] Ibid, para 2.3
[105] Ibid, para 2.5-7. For information on exemptions from the current annual allowance test, see HMRC's Registered Pension Schemes Manual, para 6200060
[106] Ibid, para 2.8

> **views on this issue and practical options for limiting it, including the option of requiring a CETV calculation, or the use of ARFs, in specific circumstances to capture the value of certain pension enhancements.** The Government would also look to monitor and review the flat-factor approach for a reduced AA to ensure it did not open up scope for abuse, and would consider the need for specific anti-avoidance rules in this regard.
>
> 2.12 If a flat-factor approach were to be continued, then the Government believes that the valuation factor to be used should be higher than the current level of 10. The Government will consider further what the appropriate factor would need to be, taking advice on the actuarial considerations from the Government Actuary's Department. Provisional analysis suggests that the appropriate factor may need to be within the range 15-20.[107]

It had been suggested that past service should be stripped out of the definition of new accrual for the purpose of assessing DB pensions against the reduced AA. The Government decided against this:

> This could simplify the DB valuation methodology and reduce the issue of spikes in DB pension accruals (i.e. large one-off accruals – this is discussed further in Chapter 3). However, it would also significantly reduce the amount of revenue the policy could raise, and would leave too much scope for manipulation of scheme design to avoid the AA restriction. It would also introduce a major disparity between DB and DC schemes. With all else being held constant, it would have no effect on the amount of annual pension that could be acquired by DC contributions made up to the level of the AA. But it could greatly increase the amount of annual pension individuals in DB schemes could accrue over the period before the AA was breached, particularly for those with significant past service.[108]

Other questions for consultation included the treatment of particular circumstances (for example, cases of death, serious ill health, redundancy, ill health, transfers and divorce)[109] and whether the rate of relief on contributions below the AA should be capped at 40 per cent.[110]

The consultation paper asked for views on managing the impact on individuals. The Government expected that members of DC schemes would be able to "aim off" the AA (by adapting savings behaviour and remuneration terms to keep their contributions below the level of the reduced AA). However, members of DB schemes would be less able to do so:

> 3.4 Members of DB schemes may have less ability to aim off the AA, given that:
>
> the value of accrual is less easily controlled by the individual, as it is a function of overall scheme design, accrual rate and other factors that are not simply discretionary saving decisions; and
>
> the value of new accruals can be uneven year on year, or exhibit spikes (atypically large accruals in single years).

[107] Ibid
[108] Ibid, para 2.13
[109] Ibid, para 2.14-8
[110] Ibid, para 2.23-7

> 3.5 It is such spikes in pension benefits that 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 benefiting from a substantial enhancement to their pension rights.[111]

It was possible that sponsoring employers of DB schemes might consider making changes to scheme design to help address this problem, for example, smoothing benefit accrual so that any large one-off increase would be delivered over a number of years. The Government asked for views on "legislative action that could facilitate appropriate scheme redesign (as noted in 3.9) without undermining other aspects of the regulatory regime."[112] Where high charges were incurred, there might be a scope for a support mechanism:

> For example, by allowing individuals to unwind pension saving in excess of the AA (so disapplying the charge), or by extending more flexibility to pay charges (such as by spreading the charge over multiple years, or enabling schemes to pay the change over multiple years, or enabling schemes to pay the charge and reduce the individual's pay benefits correspondingly).[113]

October 2010 – details announced

On 14 October, the Government published a summary of responses to the discussion document and announced some of the decisions that had been taken. With a view to protecting members of DB schemes, the AA would be reduced to £50,000 from April 2011 and the lifetime allowance (LTA) to £1.5 million from April 2012:

> 2.6 Many respondents emphasised the need for the AA to be as high as possible, citing concerns that the regime could otherwise impact on members of DB schemes on moderate incomes and individuals close to retirement. A £1.5m LTA enables the AA to be set at £50,000, generating around £4bn annual revenues in steady state, similar to the previous Government's plans, and thus protecting the public finances. The Government believes that this will create a fairer and more sustainable regime.
>
> 2.7 An AA of £50,000 is a level which far exceeds average annual contributions to pensions, with around 100,000 pension savers making annual pension savings in excess of this level. It will impact on fewer individuals on lower incomes, and provide individuals with greater flexibility to make their annual pension contributions than allowed by a lower AA. The Government has decided that the level of the AA will be set at £50,000 from April 2011, with a reduction in the LTA to £1.5m from April 2012. Beyond the forecast period to 2015-16 the Government will consider options for indexing the level of the AA.[114]

For the purpose of the annual allowance, deemed contributions to DB schemes would be valued using a "flat factor" of 16 (meaning that an

[111] Ibid
[112] Ibid, para 3.10
[113] Ibid, para 3.12
[114] HM Treasury, Restricting pensions tax relief through existing allowances: a summary of the discussion document responses, October 2010, para 2.6 to 2.7

increase in annual pension benefit of £1,000 would be deemed to be worth £16,000):

> 2.12 As set out in the discussion document, the Government's provisional view was that the "flat-factor" method should be used to calculate deemed contributions under a reduced AA. Nearly all respondents agreed with the Government that this simple method is preferable to other methods to calculate deemed contributions, and that it would further ease administrative burdens as it is already embedded in the pensions tax system. The vast majority of respondents also acknowledged that the factor should be higher than the current level of 10. The Government sought advice on the appropriate level of the factor from GAD and has published a technical report setting out its considerations and conclusions. Reflecting this advice, the Government has decided that the level of the factor will be set at 16 – meaning, broadly, that an increase in annual pension benefit of £1,000 would be deemed to be worth £16,000.[115]

It would be possible to carry forward up to three previous years' unused allowance to offset against any excess contribution:

> 3.5 The nature of DB schemes means that some individuals on moderate incomes could exceed the AA – particularly where they are in final salary DB schemes and see spikes in pension accrual. Some respondents raised concerns that the resulting impacts could lead to unfortunate consequences on retention and remuneration, for example where individuals exceed the AA as a result of being promoted, and face a tax charge as a consequence. The Government is committed to managing impacts on these individuals as far as possible.
>
> 3.6 To prevent individuals who would typically have pension contributions below the AA, but who exceed it in a single year, from facing a tax charge as a result, the Government has decided that individuals will be able to carry-forward unused annual allowance from up to three previous years, to offset against contributions in excess of the AA in a single year. This facility will be automatic, so individuals on incomes below £100,000 who are not already within Self Assessment will not have to complete a tax return to benefit from it. Carry-forward will be available against an assumed AA of £50,000 (with revaluation of DB accruals to reflect the new factor 16 and uplifts of opening value) for the tax years 2008-09, 2009-10 and 2010-11 to enable individuals affected in the first years of the regime to benefit from it. The three year carry forward will ensure that individuals on moderate incomes who may otherwise have been caught by a reduced AA should be able to smooth away any spikes in pension accrual. The Government has decided that where individuals exceed the AA in a given year, unused allowance from up to three previous years will be carried forward to offset against the excess contributions.[116]

The *Finance Bill 2011* would include transitional provisions, taking effect for pension savings on or after 14 October 2010, reflecting the announcement that an AA of £50,000 would apply in the tax year 2011-12.[117]

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[115] Ibid
[116] Ibid
[117] Ibid, p18-19

Decisions on other issues were announced:

-The Government had decided not to cap relief on contributions below the level of the AA because it was "unwilling to introduce unnecessary complexity and burdens into the pension tax relief system."[118]

- Deferred pensioner members would be excluded from the regime because to include them would increase administrative complexity and in any case there is no increase in the value of their pensions attributable to ongoing service and salary.[119]

- There would be exemptions from the AA test in a year of death or in which an individual was diagnosed with serious (terminal) ill health.[120] However, there would be no exemption in case of redundancy.[121]

The Government announced its intention to take action against certain intermediary vehicles used to disguise remuneration and void, reduce or defer payment of tax:

> 2.29 Under the current rules it is possible for individuals to "top up" their retirement provision through unregistered pension saving arrangements – including EFRBS. These vehicles are essentially a type of employee benefit trust (EBT), and alongside other intermediary vehicles can be used to disguise remuneration and avoid, reduce or defer payment of tax. The June Budget confirmed that the Government will take action against intermediary vehicles, including EFRBS, being used in this way. If EFRBS were not included, employers/individuals would simply switch to use them rather than other forms of trusts as the way to provide immediate cash and other benefits to employees.

Draft legislation would be brought forward for consultation, with the aim of ensuring that "funded EFRBS are less attractive than other forms of remuneration."[122]

Responses

The decision to reduce the AA by less than had originally been suggested, and to consult on the LTA changes, was welcomed by the CBI:

> "Today's announcement is not as bad as feared. The Government had considered making the annual allowance as low as £30,000. It rightly heeded warnings about the impact that restrictive regimes can have on pension saving, and these new proposals are a significant improvement on the approach proposed by the previous government, which was simply unworkable. We particularly welcome the Government's commitment to consult on how to proceed with changes to the lifetime allowance, and to consider delaying this change until 2012."[123]

Professional Pensions reported that the approach taken was "backed by industry". For example:

[118] Ibid para 2.8
[119] Ibid para 2.13-6
[120] Ibid para 2.18
[121] Ibid para 2.19
[122] Ibid para 2.29
[123] CBI Press release, 'Reaction to Government announcement on pension tax relief', 15 October 2010

> National Association of Pension Funds chief executive Joanne Segars welcomed the government's pragmatic approach. "We are particularly pleased that the government has listened to the NAPF and taken steps to protect moderate earners. The increased annual allowance, three-year carry forward, exclusion of ill-health retirement, and protection for deferred pensioners are sensible and helpful improvements to the earlier proposals. Increasing the annual allowance to £50,000 will help to ensure that modest earners with long periods of pensionable service are not caught with an unintended tax charge. It is important that these fundamental changes to the taxation of pensions remain focused on higher earners. Today's announcement will help meet that objective," she said.[124]

However, the then TUC General Secretary, Brendan Barber described the proposals as a "big missed opportunity" to improve incentives to save for basic rate taxpayers:

> What we need is a much more serious discussion of pensions and tax relief. At present it costs a higher rate taxpayer just 60p to put one pound into their pension because they get 40p tax relief. But a standard rate taxpayer - the real middle income Britain - gets only 20p relief, so it costs them 80p to save one pound. Reform of the tax treatment of pensions savings could unlock billions that could be used to improve pensions for ordinary people. Instead millions of pensioners are facing cuts in income because of the Government's switch to CPI indexing.[125]

Reduced LTA - protection regime

On 9 December 2010, the Government set out its proposals for a new protection regime for individuals who had already built up pension savings in the expectation that of a £1.8 million lifetime allowance:

> This new "fixed protection" will give anyone the opportunity to apply for a lifetime allowance of £1,800,000 instead of the reduced lifetime allowance of £1,500,000 on the condition that they no longer actively contribute to their pension or actively accrue pension benefits (that is, broadly excluding annual inflationary uprating). Individuals who are already entitled to primary protection and/or enhanced protection will also continue to receive their current levels of protection.
>
> Draft clauses and draft guidance are being published today on the reduced lifetime allowance, including the operation of "fixed protection". It is intended that from 6 April 2012 individuals will be considered "inactive" if they do not make or receive any further contributions to a registered defined contribution pension scheme, or build up additional annual pension over an allowable "relevant percentage" in a registered defined benefit or cash balance pension scheme. In order to prevent pension scheme rules being amended following this announcement so as to allow for artificially inflated annual increases to pensions rates the "relevant percentage" is defined as being the rate of increase specified in the scheme rules as at today's date, 9 December 2010. If no rate is specified in the scheme rules, the "relevant percentage" will be the annual percentage increase in the consumer prices index for September in the previous tax year.

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[124] Jenna Towler, 'Tax relief restrictions backed by industry – Updated', *Professional Pensions* 14 October 2010

[125] TUC Press Release, Pension tax relief measures a missed opportunity, 14 October 2010

> A revised set of draft clauses on the annual allowance, that were previously published on 14 October, have also been published today. This contains some additions and amendments, including details of the proposed exemption from the annual allowance in cases of severe ill health.[126]

Payment of charges

Over the course of the consultation, the Government announced a number of measures designed to mitigate the impact of its proposals on those who risked incurring charges under the new arrangements. For instance, the AA was to be reduced by less than originally intended and people would be able to carry forward unused allowances from up to three previous years. However, the Government recognised that in "exceptional cases" this mitigation would not be sufficient and consulted on options to give individuals and schemes more flexibility over payment of charges." [127] On 3 March 2011, the Government announced its conclusions on this issue:

> In line with the strong preference expressed by most respondents, the Government have decided that where AA charges are met from pension benefits, the tax should be paid at the point the charge arises. In effect, schemes will have a considerable amount of time to complete the payment process, with additional flexibility being granted in the first year. Individuals with AA charges above £2,000 will be able to elect for the full liability to be met from their pension benefit. Schemes will be required to operate this facility only where an individual has exceeded the AA outright within that scheme in the relevant year. The Government have given schemes flexibility in how they operate, but is clear that any adjustment to an individual's pension benefit should be fair to all scheme members. The detailed policy specification has been set out in a summary of responses document and draft clauses on which the Government welcome comment by 17 March.[128]

The NAPF was concerned that the threshold for paying charges from the pension scheme had been set at such a low level.[129]

Finance Act 2011

Draft legislation was published on the HM Treasury website for consultation. The Government estimated that its proposed changes will have the following impact:

> The overall number of pension savers who would potentially be affected by the reduced AA is estimated to be around 100,000, around 80 per cent of whom have incomes over £100,000. For the remaining 20 per cent with incomes below £100,000, carry forward of unused allowances will reduce or eliminate the charge for many of these individuals. [...]
>
> The individuals that will be affected to the largest degree from a decrease in the LTA are those that have accrued pension assets worth more than £1.5 million as they would need to stop contributing to their pension in order to avoid a tax charge.

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[126] HC Deb, 9 December 2010, c31WS
[127] HC Deb, 14 October 2010, c25-6WS
[128] HC Deb, 3 March 2011, c31-2WS
[129] NAPF Press Release,' NAPF response to the Government's details about changes to tax relief', 3 March 2011

> Estimates suggest that around 40,000 individuals have current pension assets that are worth more than £1.5 million and will be impacted in this manner (though some of these will already have protection they took out due to the changes to pension legislation in 2006).[130]

The relevant provisions were included in clauses 66 and 67 and Schedules 17 and 18 of the Finance (No 3) Bill 2011. The Bill was published on 31 March 2011. Explanatory Notes were placed on the HM Treasury website.

In debate, Treasury Minister, Mark Hoban, explained that the mechanism chosen by the Government would raise £16.6 billion over the period 2011-12 to 2015-16, compared to £15.6 billion under the Labour Government's plans.[131] It would also, he argued, be simpler and fairer:

> The previous Government's approach to achieving a reduction in pension relief introduced significant additional complexities to the tax system; it undermined pension saving ad damaged UK businesses and competitiveness. We believe that an approach which limits the amount of tax relief for those who make the highest contributions is better than restricting the rate of tax relief available to those on incomes above an arbitrary threshold. In our proposals, those whose pension contributions exceed £50,000 will not receive any tax relief. Under proposals put forward by the previous Government, even those earning the highest salaries and paying the highest rate of tax would have received tax relief at a rate of 20% per annum.[132]

The Government expected that less than 1% of pension savers would be affected.[133] As regards those at risk of exceeding the annual allowance, the then Financial Secretary to the Treasury, Mark Hoban explained:

> To reduce the likelihood of individuals exceeding the annual allowance, we first set a more generous annual allowance than originally proposed. Secondly, we ensured that individuals would be able to carry forward any unused allowances from the previous three years. Citing the right hon. Gentleman's example, someone who is out of the market for three years would effectively accumulate a £50,000 annual allowance in each of those three years, which they could use in a year in which they were in employment and pay higher pension tax contributions. Similarly, someone setting up a business could achieve exactly the same goal. They could choose not to make pension contributions for three years and use the accumulated unused annual allowance to make a larger contribution in one particular year.
>
> We recognise that there may be circumstances, despite the mitigation measures, in which people pay a higher charge. Individuals with an annual allowance charge exceeding £2,000 will be able to elect to meet their full charge from their pension benefits instead. That recognises that a substantial increase in pension wealth has led to the liability in the first place.[134]

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[130] HM Treasury, Restricting pensions tax relief – summary of impacts,
[131] Public Bill Committee, 7 June 2011, c478
[132] Ibid, c479
[133] Ibid, c480
[134] Public Bill Committee, 7 June 2011, c482

In steady state, the reductions in the annual allowance in 2011-12 and lifetime allowance from 2012-13 are "forecast to reduce the cost of relief by around £4 billion per annum in the steady state, most of which relates to individuals with incomes over £150,000."[135]

The *Finance Act 2011* received Royal Assent on 19 July 2011.

HMRC guidance explained how the rules would work:

- Annual allowance guidance
- Restriction of tax relief: PIPs and carry forward – further information (December 2010)
- Lifetime allowance guidance

More detail is in HMRC's Registered Pension Schemes Manual – technical pages: Annual allowance from 2011.

Debate on further reform

On 14 February 2012, the *Financial Times* reported that Ministers were considering a further reduction in the Annual Allowance.[136] In his Budget 2012 the Chancellor of the Exchequer, George Osborne, announced that from April 2013 the additional rate of income tax paid by individuals on income in excess of £150,000 would be cut from 50% to 45%.[137] No change to pension tax relief was announced.

Calls for reform continued in the run-up to the Autumn Statement, with the Institute for Fiscal Studies calling for a clear and robust long-term strategy:

> We need a rational debate about the appropriate tax treatment of pensions. A clear, robust, long-term strategy is vital for individuals, employers and pension providers alike. The government does a disservice to all by not setting out a clear sense of direction.[138]

However, the National Association of Pension Funds (NAPF) argued that there should be no further changes:

> There should be no further changes to the pension tax system. The relentless upheaval of recent years has imposed huge administrative costs and burdens on businesses and schemes, damaging confidence in pensions as a way to save. The Government should stop tinkering with the system and provide stability so that people can plan and save with confidence.[139]

4.2 LTA reduced to £1.25m, AA to £40,000

On 5 December 2012, the Chancellor announced further reductions in the lifetime and annual allowances from 2014-15, to protect the public finances:

> 1.179 In 2010-11, tax relief for pension savings cost the Government around £33 billion, with over half of this relief going to higher rate taxpayers. Even with changes made to reduce the

[135] HC Deb 18 July 2011 c541W
[136] Kiran Stacey, 'High earners' pension relief targeted', *Financial Times,* 14 February 2012
[137] HM Treasury, Budget 2012, para 1.184
[138] Paul Johnson, 'If you want to tax the rich, do it fairly', Financial Times, 22 November 2012
[139] NAPF, Autumn Statement 2012: Building better pensions, November 2012

> cost of pensions tax relief, the Government is still likely to forgo around £31 billion in tax revenues this year, rising to £35 billion in 2015-16. To protect the public finances from this growing cost, from 2014-15, the Government will further reduce the lifetime allowance for pension contributions from £1.5 million to £1.25 million and further reduce the annual allowance from £50,000 to £40,000.
>
> 1.180 These measure affect the wealthiest pension savers. 98 per cent of individuals currently approaching retirement have a pension pot worth less than £1.25 million – the level of lifetime allowance that will apply from 2014-15 – while the median pension pot for individuals approaching retirement is £55,000. 99 per cent of pension savers make annual contributions below £40,000 – the level of the annual allowance that will apply from 2014-15 – with the average person contributing around £6,000 a year.[140]

The Chancellor said these changes would "reduce the cost of tax relief to the public purse by an extra £1 billion a year by 2016-17."[141]

The Government said that a transitional "fixed protection" regime would be introduced for those who believed they might be affected by the reduction in the lifetime allowance. This would work in the same way as that introduced from April 2012, when the lifetime allowance was reduced to £1.5 million. In addition, the Government would discuss with interested parties whether to offer a "personalised protection regime" in addition to a fixed protection regime:

> It is anticipated that personalised protection will give individuals a lifetime allowance of the greater of the value of their pension rights on 5 April 2014 (up to an overall maximum of £1.5 million) and the standard lifetime allowance (£1.25 million from April 2014). However unlike with fixed protection 2014, individuals with personalised protection can carry on saving in their pension scheme without losing their protection. Any pension savings above the individual's lifetime allowance will be subject to a lifetime allowance charge when benefits are taken.
>
> Personalised protection will only be available to those with pension pots over £1.25 million on 5 April 2014.

Individuals would still be able to "carry forward" any unused annual allowance from the previous three years:

> **What are the carry forward rules?**
>
> If your total pension savings for the tax year are more than the annual allowance you can carry forward any unused allowance from the previous three years to the current tax year. You only have to pay tax on any amount of pension savings in excess of the total of the annual allowance for the tax year plus any unused annual allowance you carry forward from the previous three years.
>
> See www.hmrc.gov.uk/pensionschemes/calc-aa.htm#3 for further information
>
> **Are there any changes to the carry forward rules?**

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[140] HM Treasury, Annual Statement 2012, Cm 8480, December 2012

[141] Autumn Statement 2012 to the House of Commons by the Rt Hon George Osborne, MP, Chancellor of the Exchequer , 05 December 2012; Cm 8480,Table 2.1, line 33; For more detail, see HM Treasury, Autumn Statement 2012 – Policy Costings, p14-15; See also Budget 2013, Table 2.2 (p)

> No, there are no proposed changes to the carry forward rules.
>
> This means that the amount of any unused allowances arising from the tax years 2011-12 to 2013-14 and available for carry forward to 2014-15 and subsequent years will still be based on the £50,000 limit.[142]

This was legislated for in chapter 4 of the *Finance Act 2013*. The impact assessment said:

> Up to 140,000 individuals are expected to be affected by the reduction in the annual allowance. The reduction in the lifetime allowance could potentially affect around 360,000 individuals who could have pension wealth between the new and the old lifetime allowances in future years when they retire. Around 30,000 of these individuals are expected to have pension assets that are worth between £1.25 million and £1.5 million in 2014-15.[143]

Regarding the Exchequer impact of the reductions in the allowances announced in 2010 and 2012, the Government said:

> The lifetime allowance limits the total value of tax relieved savings that may be accrued by an individual throughout their life. This allowance affects only the wealthiest 2% of pension savers.
>
> *(a)* The reductions in the lifetime allowance and annual allowance for pensions tax relief announced in 2010 are expected to raise £4 billion per year in steady state. Disaggregated figures for the revenue from each of these measures are not available due to the level of interaction between them. Further information may be found in the accompanying Tax Impact and Information Note (TIIN):
>
> http://webarchive.nationalarchives.gov.uk/20130102171134/http://hmrc.gov.uk/budget-updates/pensions-tax-relief.pdf
>
> *(b)* The reductions in both allowances announced at autumn statement 2012 and effective from 2014-15 are expected to raise around £1 billion per annum in steady state. Further information may also be found in the TIIN:
>
> http://www.hmrc.gov.uk/budget2013/tiin-1046.pdf[144]

Responses

The NAPF argued that the further changes to the pension tax relief would "destabilise pensions and reach beyond top earners":

> People in a final salary pension who have worked loyally for the same employer for years and then get a pay rise, or a promotion, could end up with a tax bill of several thousand pounds. This is a charge just for saving into a pension. The self-employed and those nearing retirement desperately trying to 'catch up' by boosting their pension are also at risk. What we desperately need is stability, so that people can trust the pensions system and get on with saving for their old age, instead of being treated like a cashpoint when things go wrong. This raid also adds an extra

[142] Ibid
[143] HM Treasury, Reducing the pensions tax annual and lifetime allowances, December 2012; HC Deb 15 January 2014 c599W
[144] HC Deb 24 February 2014 c35W

> layer of admin and cost for the businesses trying to run final salary pensions.[145]

However, the PPI found that:

> After allowing for carry-forward, an individual who earns £40,000 with 20 years of service in a Defined Benefit pension scheme would need a 49% pay increase to breach the Annual Allowance. In contrast, without the carry-forward provision, the same individual would need just a 15% pay increase to breach the allowance. An individual in the same scheme who earns £120,000 with 20 years of service would need just a 3% pay increase to breach the allowance. This is not significantly changed by the carry-forward provisions, as the individual is likely to have little unused Annual Allowance to carry forward. In this way, the carry-forward provision significantly reduces the level of pay rise that would lead an individual to exceed the Annual Allowance. Overall the change to the Annual Allowance is most likely to affect high earners and may affect moderate earners with long service histories, with the carry forward provisions limiting the impact on lower earners.
>
> An individual who is a member of a Defined Contribution scheme may decide to cap their contributions in order to avoid paying a tax change. In turn this will limit the value of their pension fund and their income in retirement.
>
> While these changes will reduce the cost of tax relief and reduce the value of tax relief available, they will not improve the incentives for anyone to contribute to a pension.[146]

Nigel Stanley of the TUC argued for a redistribution of tax relief spending:

> With auto-enrolment starting, why not put more into the pensions pot of standard rate taxpayers with extra relief on contributions up to the maximum required on the full earnings band under minimum contributions? Or use some of it to help current pensioners who will not benefit from the flat-rate pension reforms due to be announced in the not too distant future. Or to think a bit laterally, use it to help fund social care.[147]

Some articles in the press suggested that, because of the way DB pensions are valued against the lifetime allowance, MPs were unlikely to be affected. [148] However, MPs are not exempt from the rules, which apply to the MPs' Pension Scheme in the same way as they apply to other pension schemes.[149]

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[145] NAPF press release, 'Tax relief meddling will destabilise pensions and reach beyond top earners', 5 December 2012; KPMG Press Release, Autumn Statement 2012: Pensions annual allowance cut – public sector employees to face unintended consequences, 5 December 2012; 'Pensions savings cap lands retired with £230m tax bill', *Financial Times,* 11 March 2014

[146] PPI, Tax relief for pension saving in the UK, July 2013, p4

[147] Nigel Stanley, Why the pensions industry gets tax relief wrong, Touchstone blog, 5 December 2012; The Touchstone blog is an informal blog my members of TUC staff.

[148] Leah Milner, ' MPs and public sector avoid pension hit', *The Times,*10 December 2012

[149] Explanatory Memorandum to the Parliamentary Pension (Amendment) Regulations 2006 (SI 2006 No. 920), para 7.1

4.3 LTA reduced to £1m

Budget 2015

In the Budget on 18 March 2015, the Chancellor announced a reduction in the lifetime allowance (LTA) from £1.25 million to £1 million from April 2016. He had decided not to further reduce the annual allowance:

> We have already taken steps to curb the size of the very largest pension pots. But the gross cost of tax relief has continued to rise through this Parliament, up almost £4 billion. That is not sustainable. So from next year, we will further reduce the Lifetime Allowance from £1.25 million to £1 million. This will save around £600 million a year. Fewer than 4% of pension savers currently approaching retirement will be affected. However, I want to ensure those still building up their pension pots are protected from inflation, so from 2018 we will index the Lifetime Allowance.
>
> We have had representations that we should also restrict the Annual Allowance for pensions and use the money to cut tuition fees. I have examined this proposal. It involves penalising moderately-paid, long-serving public servants, including police officers, teachers and nurses, and instead rewarding higher paid graduates.[150]

As on previous occasions, there would be transitional protection:

> **2.35. Pensions – lifetime allowance.** Legislation will be introduced in a future Finance Bill to reduce the pensions Lifetime Allowance to £1 million, with effect from 6 April 2016. Transitional protection will be introduced alongside the reduction in the Lifetime Allowance to ensure the change is not retrospective and protect savers who think they may be affected. These protections will have the same effect as those introduced for previous changes to the Lifetime Allowance. The Government will work with industry to ensure that these protections are implemented in the simplest way possible. The Government also announced that the Lifetime Allowance will be increased in line with Consumer Prices Index from 2018-19 onwards.[151]

Further detail was in the Budget 2015: policy costings document:

> This measure reduces the pensions tax relief lifetime allowance (LTA) from £1.25m to £1m from tax year 2016-17 onwards, with a protection regime. The allowance will be indexed by CPI from 2018-19.[152]

Regarding the Exchequer impact, the Government said:

> A behavioural adjustment is made to take into account changes in individuals' pension contributions to avoid lifetime allowance charges. The costing is also adjusted to account for some public sector workers near retirement choosing to opt out of their pensions to protect any current pension wealth above the new LTA, thereby reducing the value of pension contributions the government receives from public sector workers. Small adjustments have also been made to account for possible forestalling.

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[150] Chancellor George Osborne's Budget 2015 speech, 18 March 2015
[151] HMRC's 'Overview of tax legislation and rates', March 2015, para 2.35
[152] HM Treasury, Budget 2015, March 2015; HM Treasury, Budget policy costings, March 2015, p14

Exchequer impact (£m)

	2015-16	2016-17	2017-18	2018-19	2019-20
Exchequer impact	+60	+300	+420	+550	+590

Areas of uncertainty

The main uncertainty in this costing relates to the assumptions on the real rates of return on pension savings and the extent of the behavioural effect.[153]

The reduction in the LTA will be provided for in future legislation.[154]

The current Government confirmed its intention to proceed with this in the Finance Bill 2016:

2.82 Lifetime Allowance for pension contributions – The government will reduce the Lifetime Allowance for pension contributions from £1.25 million to £1 million from 6 April 2016. Transitional protection for pension rights already over £1 million will be introduced alongside this reduction to ensure the change is not retrospective. The Lifetime Allowance will be indexed annually in line with CPI from 6 April 2018. (Finance Bill 2016).[155]

In December 2015, it confirmed its estimate of the Exchequer impact.[156]

Comment

The NAPF welcomed the commitment to index-linking but was concerned about the future:

The Chancellor's commitment to index-link the Lifetime Allowance from 2018 is welcome. But the question remains, what will the LTA be in three years' time? Let's hope past performance is not an indication of future cuts. The LTA has been cut by £0.5m in the last three Budgets which if repeated would leave an LTA of £0.5m. This would buy an income of around £10,000 per year.[157]

The ABI called for a fundamental review of the system:

Pension providers support reform of pension tax relief but three piecemeal cuts to the current system in five years is the wrong way to go about it. We need a fundamental review of the whole system to make it fairer and to deliver long-term stability for people doing the right thing by saving for their retirement.[158]

Financial services provider Hargreaves Lansdown commented that:

Another cut to the Lifetime Allowance will bring increasing numbers of middle earners into paying tax charges and added complexity into the system. The fact that it will rise with inflation from 2018 is welcome, but arguably with the annual cap on contributions there is actually no need for a lifetime allowance at all.[159]

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153 Ibid; For OBR's comment on the uncertainty rating, see Table B.1
154 HMRC's 'Overview of tax legislation and rates', March 2015, para 2.35
155 HM Treasury, Summer 2015 Budget, HC 264, July 2015, para 2.82
156 HM Treasury, Reduction in the Lifetime Allowance, December 2015
157 NAPF comments on Budget 2015, 18 March 2015
158 Budget 2015: ABI comments on reduction of lifetime allowance, 18 March 2015
159 Hargreaves Lansdown, Budget 2015: Our view, 18 March 2015; See also, Budget 2015: Osborne confirms plans to slash lifetime allowance, *Professional Pensions,* 18 March 2015

The Labour Party had previously proposed reducing the LTA from £1.25 to £1m (as the current Government intends to do) and the AA from £40,000 to £30,000. To protect lower earners in DB schemes, it said it would continue the policy of allowing people to "carry forward" unused allowances from previous years. It would consult on whether this should apply to the previous three years or the previous five years.[160]

The IFS argues reducing the annual and/or lifetime allowance is a simple way of raising money from a well-off group. However, it thinks better options are available. It thinks that reducing the annual allowance makes less sense than reducing the lifetime allowance:

> Pension saving is tax-privileged, and a simple way to raise money from a well-off group would be to reduce the annual and/or lifetime limits on what can be contributed to a registered pension scheme. This would be very much in keeping with recent reforms, repeating what was done in the June 2010 Budget and the 2012 Autumn Statement. The Liberal Democrats propose a further reduction in the lifetime limit from £1.25 million to £1 million. We are not aware of any estimates of the yield from further reductions in the annual or lifetime limits from the current level; the government estimates that the reduction of the annual limit from £50,000 to £40,000 and the reduction of the lifetime limit from £1.5 million to £1.25 million will together raise £1.1 billion in 2017–1843 and increasing amounts thereafter, but further reductions of the same size would raise significantly more than that because far more people would be affected.
>
> Tightening limits on what can be saved in tax-privileged forms over a lifetime is not the worst way to reduce the generosity of the pension system; in Section 10.6, we discuss a distinctly inferior proposal. But there are better options available, which we discuss in Section 10.5. In particular, rather than preventing people with very large pension pots from saving any more in a registered pension scheme at all, it would be better to let them save in a pension but without the large subsidies they currently receive through the tax-free lump sum and the NICs exemption of employer contributions.
>
> The lifetime limit is currently more generous for those in defined benefit pension schemes than for those in defined contribution schemes. This differential is hard to justify. If the government was minded to reduce the lifetime allowance again, it should do so in a way that equalises it for members of defined benefit and defined contribution pension schemes.
>
> Reducing the annual allowance makes less sense than reducing the lifetime allowance. For a given level of desired lifetime contributions, it is not clear why we would want to penalise making occasional large contributions rather than frequent smaller contributions. In practical terms, too, reducing the annual allowance is more problematic, as valuing annual contributions to defined benefit pension schemes is difficult; the lower the annual limit, the more of these difficult valuations must be done.[161]

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[160] Labour Party Press Release, 27 February 2015; Ed Miliband, speech at Leeds College of Music, 27 February 2015; Blog post, Labour's plans to cut tuition fees – five things you need to know

[161] IFS Green Budget 2015, Chapter 10; IFS, Green Budget 2014, chapter 10

Finance Act 2016

In the March 2015 Budget, the Government announced a reduction in the LTA from £1.25 million to £1 million from April 2016. The Chancellor said:

> We have already taken steps to curb the size of the very largest pension pots. But the gross cost of tax relief has continued to rise through this Parliament, up almost £4 billion. That is not sustainable. So from next year, we will further reduce the Lifetime Allowance from £1.25 million to £1 million. This will save around £600 million a year. Fewer than 4% of pension savers currently approaching retirement will be affected. However, I want to ensure those still building up their pension pots are protected from inflation, so from 2018 we will index the Lifetime Allowance.[162]

Draft legislation published in December 2015 included provision to:

> […] reduce the standard lifetime allowance from £1.25 million to £1 million for the tax year 2016 to 2017 onwards and increase the standard lifetime allowance each year by the increase in the consumer prices index from tax year 2018 to 2019 onwards.[163]

A policy paper issued by HMRC explained that, as in 2014, there would be two types of protection arrangement – fixed protection and individual protection:

> Legislation will also introduce two further transitional protection regimes, 'fixed protection 2016 (FP16)' and 'individual protection 2016 (IP16)' for individuals with UK tax relieved pension rights of more than £1 million or who think they may have rights in excess of £1 million by the time they take their pension benefits.
>
> FP16 and IP16 will work in a similar way to the two previous transitional protection regimes, FP14 and IP14. Individuals have to obtain a reference number from HM Revenue and Customs (HMRC) if they want to rely on FP16 or IP16, before they take their benefits. Individuals with FP16 will have a personal lifetime allowance equal to the greater of £1.25 million and the standard lifetime allowance. Individuals with IP16 will have a protected LTA of the value of their pension savings on 5 April 2016 subject to an overall limit of £1.25 million.
>
> The conditions for maintaining FP16 include that:
>
> - individuals in defined contribution pension schemes must ensure that no further pension contributions are received by the scheme on or after 6 April 2016
> - individuals in a defined benefits scheme must not accrue further benefits above a 'relevant percentage' after 5 April 2016. The relevant percentage for defined benefit savings will normally be either the annual rate specified in scheme rules as of 9 December 2015 for the revaluation of accrued rights, or CPI (if no rate is specified), although certain statutory increases will be excluded from the test
> - Individuals with IP16 will be able to carry on actively saving in a registered pension scheme, should they so wish, but

162 HC Deb 18 March 2015 c721-2;

163 Gov.UK, Reduction of pensions lifetime allowance 9 December 2015; See also Explanatory Notes

> would be subject to the LTA charge on any excess savings over their personal LTA when they take their benefits.
>
> Relieved members of relieved non-UK pension schemes will also be able to apply for FP16 subject to their not having a pension input amount of greater than nil in the non-UK pension scheme in any tax year from 2016 to 2017.[164]

In the Bill's Second Reading debate on 11 April 2016, Financial Secretary, David Gauke, said:

> The pension lifetime allowance is currently set at £1.25 million, but 96% of individuals now approaching retirement have a pension pot worth less than £1 million. We want a system that is targeted and sustainable and supports the majority of those approaching retirement. That is why the Bill reduces the pension lifetime allowance to £1 million—a change that will affect only the wealthiest pension savers.[165]

The legislation to implement this is the *Finance Act 2016*. Section 19 and Sch 4 made provision to:

> […] reduce the standard lifetime allowance from £1.25 million to £1 million for the tax year 2016 to 2017 onwards and increase the standard lifetime allowance each year by the increase in the consumer prices index from tax year 2018 to 2019 onwards.[166]

An explanation is in the Explanatory Notes to the Bill.

Transitional protection arrangements were put in place, so it was possible for individuals to apply to protect their LTA when it was reduced in April 2014 and April 2016 – see HMRC Guidance, Pension schemes: protect your lifetime allowance (April 2016) and HMRC's Pension Tax Manual. Information about the process for applying for protection online is in its pension schemes newsletters.[167]

4.4 Restrictions for incomes over £150,000

Labour Party proposals

In the last Parliament, the Labour Party proposed reducing the relief going to higher earners in order to fund other policy priorities. In his speech to the Labour Party conference in September 2013, the then Shadow Chancellor Ed Balls has said that a future Labour Government would restrict pension tax relief "for the very highest earners to the same rate as the average taxpayer."[168] This would be done by "reversing the Government's decision to stop tax relief on pension contributions for people earning over £150,000 being limited to 20 per cent" see section 3 above. [169]

In its 2015 election manifesto, the Labour Party said it would:

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[164] HMRC, Reduction of pensions lifetime allowance, 9 December 2015

[165] HC Deb 11 April 2016 c101

[166] Gov.UK, Reduction of pensions lifetime allowance 9 December 2015

[167] HMRC, Pension schemes newsletter 80 – July 2016; and Pension schemes newsletter 81, September 2016

[168] Ed Balls, Speech to the Labour Party Conference in Brighton, 23 September 2013

[169] Labour's compulsory jobs guarantee for the long-term unemployed, Labour Party website, 4 January 2013; Labour Party Press Release, Next Labour government will guarantee starter jobs for all young people out of work for a year, 10 March 2014

> […] cut tuition fees from £9,000 to £6,000 a year, funded by restricting tax relief on pension contributions for the highest earners and clamping down on tax avoidance.[170]

The IFS commented that this would affect fewer people than a flat-rate but questioned the rationale:

> The Labour Party proposes to restrict relief to the basic rate only for people with incomes above £150,000. This has the merit of limiting a bad policy to a smaller group of people, and would raise correspondingly less revenue: roughly £1.5 billion, according to HMRC. But it has even less of a coherent rationale than a more general limit on tax relief: it is hard to see why it should be unfair for those above £150,000 to get tax relief at their marginal rate, but not for other higher-rate taxpayers to do so. Indeed, these very-highest-income individuals are less likely to be only basic-rate taxpayers in retirement, removing one of the principal arguments for restricting relief.[171]

Conservative Government's proposals

The Conservative Party manifesto for the 2015 general election, included a commitment to reduce tax relief on pension contributions for people earning more than £150,000:

> […] we will take the family home out of tax for all but the richest by increasing the effective Inheritance Tax threshold for married couples and civil partners to £1 million, with a new transferable main residence allowance of £175,000 per person. This will be paid for by reducing the tax relief on pension contributions for people earning more than £150,000.[172]

In its Summer 2015 Budget, the newly-elected Conservative Government explained how this would work. (Its approach was different to that proposed by the Labour Government in 2009):

> 1.222 To pay for the reforms to inheritance tax and to control the cost of pensions tax relief in the short term the government needs to make sure that the support provided to pension savers is affordable and targeted where it is needed most.
>
> **1.223 Therefore, from April 2016 the government will introduce a taper to the Annual Allowance for those with adjusted annual incomes, including their own and employer's pension contributions, over £150,000**. For every £2 of adjusted income over £150,000, an individual's Annual Allowance, the limit on the amount of tax relieved pension saving that can be made by an individual or their employer each year, will be reduced by £1, down to a minimum of £10,000.
>
> 1.224 To ensure this measure is focussed on the higher and additional rate tax payers who currently gain the most benefit from pensions tax relief, those with income, excluding pension contributions, below a £110,000 threshold will not be subject to a Tapered Annual Allowance. Only 1% of taxpayers exceed this threshold and save into pensions, and even fewer will actually be affected by this measure.[173]

A policy paper provided more detail:

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[170] The Labour Party Manifesto 2015
[171] IFS, Green Budget 2015, Chapter 10; IFS, Green Budget 2014, Chapter 10
[172] The Conservative Party Manifesto 2015
[173] HM Treasury, Summer 2015 Budget, HC 264, July 2015

Legislation in *Summer Finance Bill 2015* introduces a tapered reduction in the annual allowance from 6 April 2016, for those with an 'adjusted income' of over £150,000.

The 'adjusted income' definition adds-back any pension contributions, to prevent individuals from avoiding the restriction by exchanging salary for employer contributions. For those in defined benefit or cash balance arrangements, the value of the employer contribution will be calculated using the annual allowance methodology. That is the employer contribution will be the pension input amount for the arrangement, less the amount of any contributions made by or on behalf the individual during the tax year.

To provide certainty for individuals with lower salaries who may have one off spikes in their employer pension contributions, a net income threshold of £110,000 will apply. If the individual's net income is no more than £110,000 they will not normally be subject to the tapered annual allowance. However, anti-avoidance rules will apply so that any salary sacrifice set up on or after 9 July 2015 will be included in the threshold definition.

The rate of reduction in the annual allowance is by £1 for every £2 that the adjusted income exceeds £150,000, up to a maximum reduction of £30,000.

Where an individual is subject to the money purchase annual allowance, the alternative annual allowance will be reduced by £1 for every £2 by which their income exceeds £150,000, subject to a maximum reduction of £30,000.

The carry forward of unused annual allowance will continue to be available, but the amount available will be based on the unused tapered annual allowance.

All pension input periods open on 8 July 2015 are closed on that date, with the next pension input period running from 9 July 2015 to 5 April 2016. All subsequent pension input periods will be concurrent with the tax year from 2016-17 onwards.

To prevent retrospective taxation, individuals will have an £80,000 annual allowance for 2015-16, but subject to a £40,000 allowance for savings from 9 July 2015 to 5 April 2016. To achieve this, the 2015-16 tax year will be split into two notional periods, 6 April 2015 to 8 July 2015, the 'pre-alignment tax year' and 9 July 2015 to 5 April 2016, the 'post-alignment tax year'. All individuals will have an annual allowance of £80,000 for the 'pre-alignment tax year'. Where this amount has not been used in the 'pre-alignment tax year', it will be carried forward to the post-alignment tax year, subject to a maximum of £40,000. In addition, any unused annual allowance from the previous three years can be added to these amounts in the normal way.

The calculation of the pension input amount for the 2015-16 tax year will be modified for cash balance and defined benefits arrangements. Rather than having to calculate separately the pension input amount for pre-alignment and post-alignment tax years, the pension input amounts will be based on the total of the increase in the value of the individual's rights across the combined pension input periods for the arrangement ending in the period to 5 April 2016, but apportioned to the pre-alignment and post-alignment tax years.[174]

[174] HMRC, Pensions tapered annual allowance, July 2015

The Government estimated that savings from this measure would rise to £1.28 billion by 2020-21:[175]

Exchequer impact (£m)	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
	-70	+260	+425	+900	+1180	+1280

Comment

Paul Johnson of the IFS described the phasing down of the annual allowance as "complex, distortionary and difficult to justify":

> As for the rest there is a continuation of some earlier themes, not least of which is a further reduction in the value of pension tax relief for those on high incomes through a complex, distortionary and difficult to justify phasing down of the annual contribution limit to £10,000. This will bring to £6 billion a year the additional tax revenue raised from reducing pension tax relief.[176]

An IFS paper published in April 2015 explained that:

> While affecting a relatively small number of high-income individuals, this reform would further complicate the pension tax system. It would have the curious effect of allowing tax relief on up to £40,000 of pension contributions for those with an income of up to £150,000 but restrict that to £10,000 a year for those with an income of more than £210,000. As discussed in the February 2014 IFS Green Budget, a desirable benchmark for the taxation of pensions is a system where full tax relief is given up front, returns in a pension are left free of personal taxation and income is taxed in full on receipt. Given that there is a great deal to be said for this system of taxation, the added complexity that the Conservatives' measure would bring would not improve the efficiency of the system. It is really not clear why someone earning £150,000 should be able to receive income tax relief on £40,000 of pension saving while someone earning £250,000 should only be able to receive relief on £10,000 of pension saving. [177]

It said the estimated savings would depend in large part on how people responded:

> To the extent that those affected spend their income now rather than in the future, at least some of the apparent additional tax revenues will be brought forward rather than increased in total. Similarly, if people respond by putting more money into ISAs, the exchequer will get more revenue now and less later on.[178]

The National Association of Pension Funds was concerned about 'tinkering' with the tax treatment of pensions:

> It's deeply disappointing to see politicians once again syphoning cash from tomorrow's pensioners to pay the bill for today's political priorities. Ensuring a decent deal for today's savers and tomorrow's pensioners will only come from a stable pension system on which people can depend not to change overnight. Pension saving shouldn't be treated as a secret ATM for Government finances. Tinkering with the tax treatment of

[175] Ibid
[176] IFS, Summer post-Budget briefing 2015
[177] IFS, Taxes and Benefits: the Parties' Plans – IFS Briefing Note BN172, April 2015
[178] Ibid

> pensions from one Budget to the next does absolutely nothing to build confidence in them, and constant change may even discourage people from saving for retirement.[179]

Tom McPhail of Hargreaves Lansdown said that anyone affected by the change who hadn't already built up a decent-sized pension pot had been dealt a "big blow."[180] Changes to the 'pension input year' could provide an opportunity for some individuals to maximise contributions over the period to April 2016, when the new rules come into force.[181] In a speech on 30 June 2015, the then Pensions Minister, Steve Webb, suggested some individuals would not know they were affected until the following year:

> The idea is that if I earned between £150,000 and £210,000 then my annual allowance could fall from £40,000 to £10,000. […] Most people will only know this once they have filled out their tax return and so you could end up facing a tax charge in the tax year 2017/2018 based on your earnings in the previous year. You can't gauge how much you may have to pay the following year because you haven't done your return yet.[182]

Finance (No. 2) Act 2015

The *Finance (No. 2) Act 2015* (section 23 and Schedule 4) introduced the changes discussed in section 4.10 above, i.e:

- Restrict pensions tax relief for high-income individuals by introducing a tapered annual allowance with effect from 6 April 2015; and
- Amend the period over which pension savings are measured so that from this date pension savings will always be measured over a tax year. It also introduces transitional rules from 9 July 2015, intended to smooth the aligning of pension savings with the tax year.

Further detail is in the Explanatory Notes to the Bill.

At Committee Stage in the Commons, Financial Secretary to the Treasury David Gauke explained the intention behind the tapered annual as follows:

> Clause 23 and schedule 4 ensure that the cost of pensions tax relief is fair, manageable and affordable. These changes will restrict the benefits of pensions tax relief for the highest earners by tapering away the annual allowance for those with an income, including pension contributions, of more than £150,000[…]
>
> Pensions tax is one of the Government's most expensive reliefs. In 2013-14, the cost to the Exchequer of income tax relief for pensions was more than £34 billion. This has increased from £17.6 billion in 2001. About two-thirds of pensions tax relief currently goes to higher and additional rate taxpayers, and around 15% of the tax relief in 2013-14 went to those with an income of more than £100,000. In the last Parliament we took steps to control that cost and ensure that pensions tax relief is

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179 NAPF comments on 2015 Summer Budget, 8 July 2015
180 'Pension tax relief budget cut for earners of more than £150,000', *The Guardian*, 8 July 2015
181 Hargreaves Lansdown, Budget: our view, 8 July 2015
182 'PBUK 2015: Webb warns tax relief change could lead industry to 'a dark place', Professional Pensions, 30 June 2015

> appropriately targeted. These provisions take further steps to achieve that. They are focused on the wealthiest pension savers, to ensure that the benefit they receive is not disproportionate to that of other pension savers.[183]

For the Opposition, Rob Marris welcomed the changes:

> I have to say that I am delighted by the clause. Many years ago, I was a lone voice in Parliament calling for a restriction of tax relief on pension contributions. As the Minister quite rightly said, it cost almost £18 billion a year in 2001 and that figure has shot up.
>
> When I asked the Department for Work and Pensions—in 2003 or 2004—what evidence there was that tax relief on pension contributions encouraged people to save for a pension, the DWP had no such evidence. To me, that was shocking for a tax relief that then cost £18 billion a year. In a sense, the Government were spending, through forgone income, to encourage a pattern of behaviour when there was no evidence that they were encouraging such behaviour. I salute this Government for grasping that nettle.
>
> The other reason I oppose pension tax relief—the Minister generously adverted to this today and clarified for the Committee—is that it has hitherto been incredibly regressive. When I raised this matter 10 or 12 years ago, it was even more regressive. The proportion being claimed by higher and additional rate taxpayers is now down to two thirds; it used to be about 90%. It was astounding to me that a Labour Government—a socialist Government in name—would continue with a tax measure that did not do what it was designed to do and which favoured the very well-to-do. We then had my hon. Friend Ruth Kelly, then Member for Bolton and, I think, Financial Secretary to the Treasury, introducing the nonsense of the annual allowance. It was completely bodged, as the Finance Bill Committee at the time, on which I sat, pointed out to her.
>
> I still think there is a question mark over the whole concept of pension tax relief system for pension contributions, but this measure is progressive and, I have to say, it is somewhat to my surprise that the Government and their predecessor have now grasped the nettle twice.[184]

The Government made amendments to the Schedule 4 designed to ensure that the transitional easements for defined benefit schemes worked as intended.[185]

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[183] PBC Deb 13 October 2015 c83

[184] HM Treasury, Budget, March 2015, Cm 1093, para 1.232; Ibid c84-5

[185] PBC Deb 13 October 2015 c83; Explanatory Notes – Clause 23 and Schedule 4: Pensions: annual allowance

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BRIEFING PAPER
Number SN-05091, 22 November 2016