Pension tax simplification

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In his Budget on 17 March 2004, Gordon Brown announced that the Government would be going ahead with a radical simplification of the pension tax regime from April 2006:

> At a cost of £165 million by 2008, I will replace the eight existing tax schemes for pensions with a single lifetime allowance. I will set the allowance at £1.5 million for the first year of the scheme, from April 2006, and will set the allowance now for the years until 2010 when the figure will be £1.8 million.[1]

The necessary legislation is contained in the Part 4 of the *Finance Act 2004*. The new rules came into effect on "A-day"- 6 April 2006. The rules apply across all registered pension schemes, regardless of the time the individual joined.

The amount a person can contribute is limited by two allowances: an annual allowance (£1.65 million in 2008/09) and a lifetime allowance (£235,000 in 2008/09). Individuals may also now be able to carry on working while taking some, or all, of their pension. The earliest age at which a pension can generally be drawn (other than on ill-health grounds) is 50, rising to 55 by 2010. When an individual opts to withdraw some of their pension saving, they have a number of options:

- Up to 25% of a pension fund can be taken as a tax-free lump sum (where scheme rules allow). If their entire pension fund is less than 1% of the lifetime allowance, it is possible to take the whole fund as a lump sum, with 25% being tax-free.
- Income withdrawal or 'drawdown' (an "unsecured pension").
- They must use their pension fund to buy an annuity at some time between the ages of 50 (rising to 55 by 2010) and 75 (although at 75, there is the option of an Alternatively Secured Pension.)

This note outlines the development of the reforms. A more general explanation of the tax treatment of private pensions can be found in Library Standard Note SN/BT 625, *Tax and private pensions.* SN/BT 2181, *Pensions and lump sums* outlines the circumstances in which lump sum payments can now be made from pension schemes. SN/BT 712, *Requirement to*

[1] HC Deb 17 March 2004, c 329

annuitise covers the debate around whether individuals should be required to use their pension fund to buy an annuity by the age of 75. Some changes since 2006 are covered in more detail in SN/BT/4318, *Pensions term assurance;* SNBT/4189, *Alternatively secured pensions.*

Contents

1 Background

In March 2001, the Government announced an Inland Revenue review of the tax rules applying to defined benefit pension schemes:

> An Inland Revenue sponsored team will be reviewing the tax approval arrangements applying to defined benefit pension schemes with the aim of developing a package of practical options for administrative simplification. The team will not be considering options for changing the underlying tax or benefit structures. The team will consist of Inland Revenue officials and secondees from the pensions industry. The review is due to be completed by February 2003.[2]

In July 2002, the Sandler report on "Medium and Long-Term Retail Savings in the UK" made the case for a more radical simplification of the rules:

> 10.167 Pensions taxation is extremely complex and this has a number of effects. For instance, the fact that there are eight tax regimes for pensions, each of which is complicated, leads to confusion both for the public and professionals; this is a disincentive for saving, especially amongst the more modest income groups. Simplification of the pensions taxation regime is therefore a high priority.
>
> 10.168 The number of pensions tax regimes could be reduced. There would be benefit even if the simplification were limited to ensuring there was just one regime for occupational pensions. However, a more radical simplification, whereby there was a single regime for all pensions, both occupational and personal, would be desirable.
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> 10.169 Such radical simplification, requiring as it would the merger of existing rules, would also provide the opportunity to ensure that the rules associated with pensions are in themselves simple. Current limits on contributions and (especially) benefits are complicated functions of salaries. Of course, limits of some kind are essential. But there is no need for them to be complicated.
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> 10.170 It was announced last year that the Inland Revenue was initiating an examination of aspects of pensions taxation, which the Review welcomes. The Review has not carried out detailed work in this area. **However, the Review recommends that the Government should seek to take a radical approach to this work. It would be desirable to:**
>
> - **reduce the number of different regimes for pensions tax to the fewest possible; and**
> - **minimise the number of different variables that the tax system sought to control. In particular, it should seek to limit either contributions to pensions or the benefits paid out, but not both.**[3]

1.1 Consultation Document, December 2002

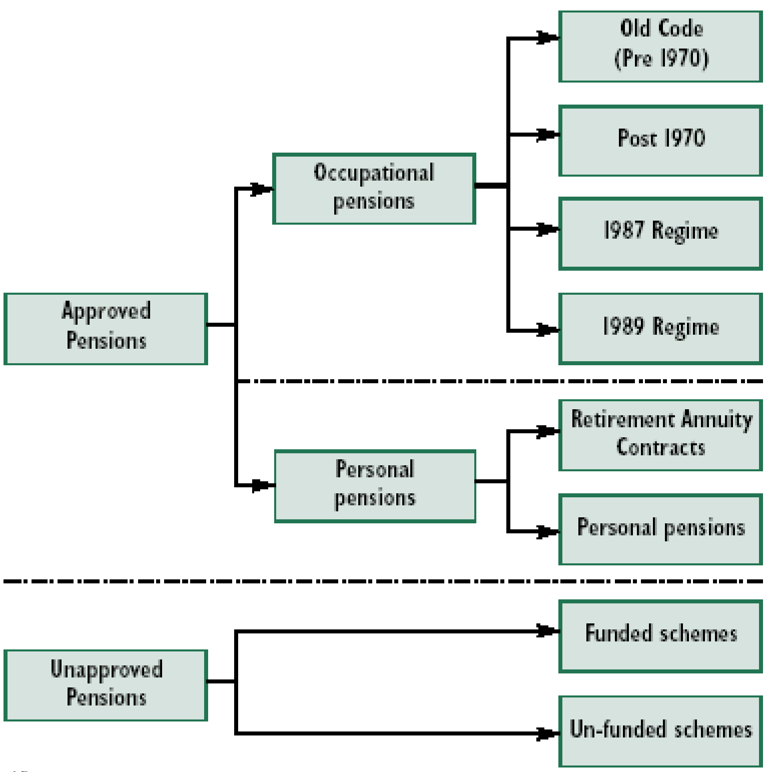
HM Treasury/Inland Revenue issued a consultation paper in December 2002, "Simplifying the taxation of pensions: increasing choice and flexibility for all". This summarised the existing tax regime for pensions as follows:[4]

[2] HC Deb 15 March 2001, c 690W

[3] Sandler Review:Medium and Long-Term Retail Savings in the UK, 9 July 2002

2.8 The complexity in the pension tax rules has arisen as the tax system has developed to reflect changing and increasingly more diverse demands for different kinds of pension provision. Most such developments have been incremental – that is, allowing people to continue to save using the previous rules until retirement, rather than using the new rules introduced by any change. As a result there are now no fewer than eight different ways of saving for a pension, summarised in Chart 2.1.

Chart 2.1: Current pension tax regimes



Source: *Inland Revenue.*

Occupational schemes

2.9 For people in occupational schemes, the main set of tax rules is the 1989 regime. Its main features are:

- employees may contribute, with tax relief, up to 15 per cent of remuneration up to the earnings cap (£97,200 in 2002-03);
- no specific limits on employer contributions with tax relief, but restrictions on overfunding;
- total benefits, including any lump sum, limited to two-thirds of final remuneration up to the earnings cap after 20 years' service;
- the tax free lump sum at retirement is limited to 2.25 times initial pension or 3/80ths of capped final remuneration for each year of service up to 40 years;
- retirement at any age from 50 to 75; and

[4] HM Treasury/ Inland Revenue, *Simplifying the taxation of pensions: increasing choice and flexibility for all*, December 2002

- scheme members must either be active (working) or retired from work with the sponsoring employer; it is not possible to contribute and draw benefits simultaneously.

2.10 There are three other sets of tax rules which may apply to people, who joined an occupational scheme before 1989. People in this position were allowed in each case to continue to contribute and get benefits under the superseded tax rules so long as they remained in that scheme. The main features of these older rules are outlined below:

2.11 Old code rules may still apply to people who joined a scheme before 1970. There are different rules for trust funds and pension schemes. The rules include:

- no limit on tax exempt employer contributions;

- employee contributions get tax relief up to 15 per cent of remuneration;

- in trust funds, pension benefits up to two-thirds of final remuneration after 20 or more years of service, with no right to commute any of this to a tax free lump sum; and

- in pension funds, benefits the same as trust funds, with some rights to commute.

2.12 Post 1970 rules, sometimes called new code, have similar restrictions on contributions but different rules for benefits:

- pension up to two-thirds of uncapped final remuneration after 10 years of service;

- tax free lump sums limited to 1.5 times uncapped final remuneration for 20 years of service;

- specific rules for early leavers, and early and late retirement; and

- certain retained benefit rules, namely restrictions depending on the benefits available from pension rights from previous employments.

2.13 The short lived 1987 regime had much in common with the new code rules but different benefit rules, including:

- pension up to two thirds of uncapped final remuneration after 20 or more years of service; and

- tax free lump sums limited by a formula with an upper limit of £150,000.

Personal pensions

2.14 For people in personal pensions, the tax rules date from 1988, with some updating in 2001 when stakeholder pensions were introduced, allowing non-earners to participate. The main features are:

- relief on contributions up to the higher of £3,600 a year or a percentage of capped earnings, irrespective of who makes the contributions. The percentage depends on age – 17.5 per cent for people under 36, rising to 40 per cent for people over 60;

- no limits on the size of pension benefits; and

- tax free lump sums of up to 25 per cent of matured pension savings.

Retirement Annuity Contracts

2.15 Before personal pensions there were retirement annuity contracts, to which some people who were using them in 1988 can still contribute. Their rules are similar to those for personal pensions, with some differences. The main rules are:

- relief on contributions up to a percentage of uncapped earnings. The percentage depends on age – 17.5 per cent for people under 50, rising to 27.5 per cent for people over 60;

- matured pension savings must be used to buy an annuity; and

- tax free lump sums allowed according to the size of the annuity.

Unapproved pension schemes

2.16 When the earnings cap was introduced in 1989, employers sought ways to continue to offer generous pension benefits to highly paid employees whose pensions would otherwise have been restricted. Hence two types of unapproved retirement benefit schemes are used, with less generous tax treatment. The main features of these schemes are:

- employer contributions count towards the employee's taxable income, with no limit, and they also count as a business expense against the employer's tax liability;

- employee contributions are unlimited, but do not attract tax relief;

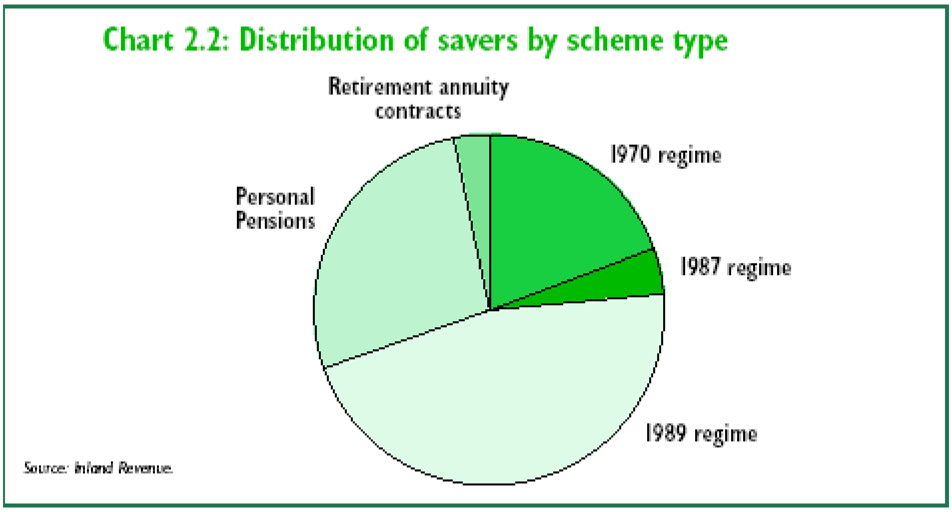
- no limits on benefits, which may be paid as

- tax free lump sums and/or

- taxable income.

2.17 Unapproved retirement benefit schemes may be funded (FURBS) or unfunded (UURBS). In FURBS, there are contributions during the member's working life, but not in UURBS. So UURBS work because the employer meets the cost of benefits to the employee, when they are payable, out of current income (pay as you go).

2.18 Pension provision is now scattered among these various different kinds of scheme. Chart 2.2 summarises the distribution of members between the different tax regimes. The sheer proliferation of different kinds of pension shows starkly how fragmented pensions in the UK now are:



The consultation document proposed a radical simplification, applying to all types of pension:

Principles of reform

1.5 In reshaping the tax rules for pensions, the Government seeks to achieve a transparent, consistent and flexible system which can be readily understood. Simplicity should hold compliance costs down, deliver clearer incentives to save and so encourage real competition among suppliers of pensions in the retail savings market.

The main proposals

1.6 Unlike previous changes to the taxation of pensions, this reform proposes a clean break. Pension rights built up before the reform is implemented will be respected. All pension saving after implementation will follow a single set of rules which will apply to saving in all kinds of pension schemes. And there will be a single set of simple rules about how pension savings are turned into benefits.

1.7 In the new system the current limits on annual pension contributions and benefits will be replaced by a single lifetime limit on the amount of pension saving that can attract favourable tax treatment. So people will be able to choose when and how much to save in order to achieve the retirement income they want. The Government intends to set this limit at £1.4 million per person for introduction in 2004 and indexed thereafter. Tax relief at the contributor's marginal rate will continue to be available.

1.8 This lifetime limit will be complemented by a light touch compliance regime with an annual limit on inflows of value to an individual's pension fund – both contributions and growth in pension rights in occupational schemes. The proposed level for introduction in 2004 is £200,000, which will also be indexed thereafter.

Pensions in payment

1.9 There will also be a single, consistent set of rules about delivery of pension benefits, whether they come from a scheme sponsored by an employer or a private scheme. The maximum tax free lump sum will be set at 25 per cent of the value of matured pension savings – appreciably more generous than now for many.

Flexible retirement

1.10 The proposals also drop the outmoded rule preventing people in occupational schemes from mixing work and retirement. Where scheme rules allow it, people will be

> able to begin to draw benefits from their pension while continuing to work, perhaps with reduced hours or responsibilities. Flexible retirement in this sense is intended to encourage those who can to work longer – allowing the economy to benefit from the skills and experience of older workers and encouraging them to save more to boost their retirement income.
>
> 1.11 As part of the introduction of flexible retirement, the Government intends to raise the minimum benefit age from 50 to 55 years of age by 2010. This change recognises the considerable improvements in life expectancy which have taken place over the last century. The concept of normal retirement age will vanish from tax legislation.
>
> 1.12 Greater flexibility about taking benefits from pension savings built up with the advantages of tax relief will also foster further development in the annuities market. The new rules will permit and indeed encourage innovation. Among the new kinds of annuity which will be possible are limited period and value protected annuities.
>
> **Advantages of simplification**
>
> 1.13 The proposed new tax rules for pensions will impose little real constraint on pension savers and pension schemes. For the vast majority of people, the tax system will simply cease to be a consideration when planning for retirement. Instead they will be free to concentrate on the real issues – deciding when and how much to save. This approach will afford scope for substantial innovation in design of pension schemes. Radical simplification should also generate significant savings in administration costs, feeding through to better value for pension savers with real opportunities for financial services firms to streamline their operations.
>
> 1.14 These proposals for radical simplification will transform the tax rules for pensions. By cutting administration costs and stripping out unnecessary controls, they will give everyone using pensions choice and flexibility.

These proposals were widely welcomed – particularly the abolition of the eight different regimes and their replacement with a single lifetime allowance on the total amount of pension saving that can benefit from tax relief. The Inland Revenue produced a "Summary of responses" which found that "two thirds of the responses from pensions industry and employers groups were extremely positive".[5]

However, some elements of the proposals attracted criticism, including:

- The **lifetime limit** of £1.4 million was considered too low. The Government picked this figure because it was

> 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. [6]

[5] Inland Revenue, Summary of Responses to; Simplifying the taxation of pensions: increasing choice and flexibility for all, published 17 December 2002

[6] HM Treasury/ Inland Revenue, *Simplifying the taxation of pensions: increasing choice and flexibility for all,* December 2002, para 4.10

The Government estimated that the limit would only affect about 5,000 people.[7] But the pensions industry was almost unanimous in proposing a higher limit, indexed to earnings, rather than prices, and arguing that far more than 5,000 people would be affected by a £1.4 million limit. The Association of British Insurers, for example, thought that "setting the limit at £1.8 million would be a more accurate cash equivalent of a pension equal to two-thirds of the pensionable earnings cap"; and Mercer thought the correct figure for the number affected was "closer to 300,000 – that's the 170,000 people potentially affected by the current earnings cap (£99,000 for 2003/04) plus another 120,000 if the limit is kept to £1.4 million indexed to no more than retail prices".[8]

- The start date – **"A-Day"** - for the new regime was considered too soon. The Inland Revenue Summary of Responses reported that:

> Two-thirds of respondents felt that 6 April 2004 was unrealistic and argued for 2005 or 2006 as being a more realistic time frame in which to plan for and implement the new regime.[9]

On 11 June 2003, the Government announced that A-Day had been postponed to 6 April 2005 "to allow time for people to familiarise themselves with the new rules, and for providers to make the necessary changes to their systems, in advance of the changes coming into effect".[10] (In March 2004, it was announced that A-Day was to be postponed further to April 2006.[11])

- The **recovery charge** of 33⅓% on pension saving above the lifetime limit was considered excessive.[12] The consultation document had argued that this charge

> together with income tax on any amounts withdrawn from the part of the fund above the limit, will roughly neutralise the tax relief given initially on contributions and then on the growth of funds during investment. In the interest of simplicity, the recovery charge will not be personalised to make exact recovery of the tax relief obtained by each person's pension savings built up above the lifetime limit.[13]

However, commentators argued that the charge and tax on amounts drawn amounted to a penal levy of 60%.[14]

- Raising the **age** at which pensions could be drawn from 50 to 55 was considered unfair, particularly on people with accrued rights who already expected to retire between 50 and 55, and on professions (such as sport) with permitted pension ages below 50.

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7 Ibid, para 4.31

8 "Tax simplification", *Pensions Today*, May 2003

9 http://www.hmrc.gov.uk/consult_new/summary_responses.pdf (retrieved 11 December 2008)

10 Inland Revenue press release, 11 June 2003, *Simplifying the taxation of pensions: implementation date*

11 HC Deb, 17 March 2004, c329

12 paragraph 4.12 of the consultation document proposed that benefits above the limit should "face a recovery charge of one third of he excess before they can be drawn as income"

13 para 4.13

14 See, eg, "Tax simplification", *Pensions Today*, May 2003

1.2 The Government's Proposals, December 2003

Modifications and clarifications

The Government responded to many of the criticisms of the original proposals in its document published with the pre-Budget Report on 10 December 2003 - Simplifying the taxation of pensions: the Government's proposals.[15] Important modifications and clarifications of the December 2002 proposals included:

- The **recovery charge** on pension saving above the lifetime limit (rechristened the lifetime allowance - LTA) was reduced from 33⅓% to 25%. Combined with higher rate tax at 40% on the remaining 75%, this is equivalent to a levy of 55%.[16]

- **Defined benefits** would be valued against the LTA by using a single factor of 20:1. In other words, someone with a DB pension worth £20,000 a year would be treated as having a "pot" of £400,000. With a lifetime allowance of £1.4 million this would allow someone to have a pension of £70,000 before becoming subject to the recovery charge.[17] The annual allowance would be calculated using a single factor of 10:1.[18]

- It would be possible to take benefits above the LTA as a **taxed lump sum**.[19]

- More generous **transitional arrangements** were introduced for people who had already built up large pension pots by A-day. As well as the original proposal that it should be possible for people who already had pension rights in excess of the LTA to register them and protect that percentage of the LTA (e.g. 150%) against the recovery charge, a second option was introduced. Anyone – whether already above the LTA or not – would be able to register their pre-A day fund and stop contributing to any tax-relieved pension scheme. All post A-day increases in the value of their funds would be protected from the recovery charge.[20]

- The **annual allowance** of £200,000 would not apply in the year in which benefits are taken in full. This would help some people whose pension rights were enhanced in the case of redundancy or ill health retirement.[21]

- Both the lifetime and annual allowances would be **uprated** annually in line with the RPI.[22]

- **Unapproved schemes** – FURBS (funded unapproved retirement benefit schemes) and UURBS (unfunded unapproved retirement benefit schemes) - would no longer be necessary as separate top-up vehicles for high earning employees as the new regime would be sufficiently flexible to allow unlimited pensions within registered schemes. Registration would replace approval. However, transitional protection would be put in

15 HM Treasury and Inland Revenue, Simplifying the taxation of pensions: the Government's proposals, December 2003
16 Ibid, paras 1.18-1.24
17 Ibid, paras 1.14-1.17
18 Ibid, paras 1.31-1.32
19 Ibid, paras 1.23-1.24
20 Ibid, paras 1.35-1.37, Chapter 5
21 Ibid, paras 1.25-1.30
22 Ibid, paras 1.33-1.34

place for amounts in FURBS at A-day and the value of the UURBS promise would not be tested against the lifetime and annual allowances.[23]

- Pensions subject to a **sharing order** on divorce would count against the LTA of the spouse to whom they were credited, rather than the spouse from whom they were debited. (This was a U-turn from the December 2002 proposal).[24]

- Schemes would be free to decide how and when to move the **minimum pension age** to 55 by 2010. Any member of a scheme who already had a contractual right to draw a pension from age 50 would have that right honoured. There would also be transitional protection for professional sportsmen and others with retirement ages below 50.[25]

- Schemes would be able to invest all types of investment including **residential property**.[26]

However, the controversial lifetime limit remained at £1.4 million.

Registration instead of approval

Under the new arrangements the current system of "approving" pension schemes for tax relief purposes would end. Instead, pension schemes will have to be registered if they want to benefit from tax relief.

The December 2002 consultation document had made the case for registration to replace approval:

> 6.4 The current system of tax approval for occupational pension schemes operates in a very different fashion to how it works for other savings vehicles. Taxation of pensions relies primarily on prior approval of occupational schemes' rules, with the threat of withdrawal of tax relief if schemes do not keep to their rules.
>
> 6.5 By contrast, providers of ISAs are simply required to register as managers and respect the rules about what investments qualify for tax relief. Auditing then picks up and corrects any errors. The great advantage of this approach is that providers of ISAs can readily establish for themselves what kind of scheme qualifies for tax relief and what does not.
>
> 6.6 Simplification affords an opportunity to apply the same basic approach to pension schemes.[27]

Annex B of the December 2003 document gave further details of how the registration process would work and how compliance with the new regime will be secured. Existing approved schemes would automatically be registered under the new regime, unless they choose to opt out.

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23 Ibid, paras 1.38-1.44
24 Ibid, paras 3.18-3.22
25 Ibid, chapter 2
26 Ibid, chapter 4
27 HM Treasury, Inland Revenue, *Simplifying the taxation of pensions: increasing choice and flexibility for all*, December 2002, paras 6.4-6.6, http://www.hmrc.gov.uk/consult_new/pensions_consult.pdf (retrieved 11 December 2008)

Scheme benefits

Schemes would need to meet certain conditions to register, and comply with general benefit rules, which would be the same for all types of pension:

> 3.2 The new rules would allow up to 25 per cent of the capital value of the pension, below the lifetime allowance, to be paid as a tax free lump sum. In addition pension benefits must:
>
> - start before age 75;
> - not start before age 55 (age 50 until 2010), with an exception for ill-health retirement;
> - last for the remainder of the person's life;
> - be paid in instalments at least annually;
> - not be assignable to anyone, other than where permitted by Inland Revenue requirements;
> - not be guaranteed for a minimum period greater than 10 years;
> - up to age 75, not offer a capital guarantee of more than value protection;
> - lie between certain minimum and maximum income limits; and
> - be taxed as income, generally under PAYE. (…)
>
> 3.3 The Government confirms that the new regime will contain this set of general benefit rules. The rules outline the characteristics of pension benefits but, unlike the existing rules, the means of delivery of the income is no longer specified.[28]

1.3 Pre- Budget Report, December 2003: the lifetime limit

The Chancellor made his Pre-Budget statement to the House on 10 December 2003. In it he announced that he was asking the National Audit Office to provide an independent evaluation of the numbers affected by the proposed £1.4 million lifetime limit. He hinted that the whole simplification plan could be dropped if consensus could not be achieved:

> Our pension proposals, published also in detail today, include a single set of rules that set the tax-free lump sum at 25 per cent. of the value of an individual's pension fund; more flexible annuity rules; and provision for older workers to draw occupational pensions earlier. Because consultation on the proposed single lifetime tax allowance for pension savings has revealed contrasting interpretations of its impact, I am asking the National Audit Office to provide, by Budget time, an independent evaluation of the numbers affected. Our aim is to secure a broad-based national consensus on the way forward. If a decision is made to proceed, the measures will be introduced in April 2005; otherwise, the current regime will remain in place.[29]

The December 2003 document, Simplifying the taxation of pensions: the Government's proposals, published in conjunction with the Chancellor's statement (see above), set out more fully the Government's case for sticking with the £1.4 million lifetime limit:

> The Government believes, as set out in the first consultation document last December, that around 5,000 people – either currently in, or previously in, a pre-1989 uncapped pension scheme – will have aggregated pension funds worth £1.4 million or more when these proposals come into force – for these people the Government has ensured that all of their accrued rights are fully protected; and that there may be a

[28] HM Treasury, Inland Revenue, *Simplifying the taxation of pensions: the Government's proposals*, December 2003, paras 3.2-3.3, http://www.hmrc.gov.uk/pbr2003/simplifying-pensions.pdf (retrieved 11 December 2008)

[29] HC Deb 10 December 2003, c 1066

further 1,000 people a year, with pension funds currently worth below £1.4 million, who over the next ten years will retire and be affected by the lifetime allowance on account of membership of a pre-1989 regime – for these people the Government has ensured that they can opt out of the simplified regime and protect their accrued rights.

For all other pension savers currently subject to the post-1989 regimes, the Government believes that £1.4 million is the lifetime equivalent of the existing annualised earnings cap, equivalent to the maximum pension available under the post-1989 occupational regime, and is therefore – balancing the need to incentivise saving, to ensure fairness, and of public expenditure priorities – the right level for converting the annual limit to a lifetime allowance.

In response to concerns expressed during the consultation so far, the Government will ask the National Audit Office to consider, in the light of the proposals set out in this document:

- whether it is factually accurate that the £1.4 million lifetime allowance is, using a factor of 20:1 to calculate the capital value of a defined benefit pension, equivalent to the maximum pension available under the current occupational pensions regime which includes the earnings cap;
- whether it is reasonable for the Government to estimate that around 5,000 people will have pension funds in excess of £1.4 million at 5 April 2005; and
- whether it is reasonable for the Government to estimate that around 1,000 people a year may be affected by the lifetime allowance who would not have been affected by the earnings cap.

The National Audit Office will report in advance of Budget 2004, in order to allow an announcement to be made in the Budget on whether or not the Government will introduce the simplified regime. If it is decided to proceed, the measures will be in the 2004 *Finance Bill* and will be introduced in April 2005. Otherwise the current eight different regimes will remain in place.[30]

Many commentators argued that, by introducing a 20:1 valuation factor for DB schemes, the Chancellor was making it more likely that the numbers affected would be lower. It was argued that a pension of £70,000 a year would, in reality, require a fund of much more than £1.4 million. For example, Scottish Life's Steve Bee has said that a man aged 60 would need a fund of £2.6 million to give a pension of £66,000, with a widow's pension of two-thirds, if his wife was three years younger than him and assuming 5% escalation.[31]

1.4 National Audit Office Report, March 2004

The National Audit Office reported back to the Treasury on 9 March 2004. The NAO's main conclusions were:

Question 1: Relation between the earnings cap and the lifetime allowance

It is factually accurate, assuming the 20:1 valuation factor suggested by the Government in the 2003 consultation document, that £1.4 million is broadly equivalent to the maximum pension allowable under the earnings cap. This means that those

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[30] HM Treasury and Inland Revenue, Simplifying the taxation of pensions: the Government's proposals, December 2003, p 3-4

[31] "Valuation method favours DB over DC", *Pensions Week*, 15 December 2003

affected most by the proposed lifetime allowance are likely to be high earners who have not changed their jobs since 1989.

Question 2: A-day estimate

Using the 20:1 factor proposed by the Inland Revenue for valuing benefits against the lifetime allowance, the estimate of 5,000 people is at the lower end of a range of reasonable estimates.

Using assumptions more likely to be tailored to the attributes of high earners, and other evidence we examined, gave figures consistent with an estimate around 10,000.

Evidence from a survey of more than 60 FTSE 100 companies is consistent with this estimate.

Other different though reasonable ways of estimating the numbers, including the much higher estimates quoted by some commentators, are not directly comparable to either the 5,000 or the 1,000 estimate figures produced by the Government. They use different definitions of those affected and include large numbers of people already subject to the earnings cap (who are not included in the Government's estimates), and they project up to 40 years into the future.

Great uncertainty attaches to any estimates since there is no single source of data.

Question 3: Estimate of those affected in the future

Even greater uncertainty attaches to projections into the future, which makes it even harder to provide a reliable estimate of the number likely to be affected.

The estimate of 1,000 additional people a year with funds exceeding £1.4 million had a thin evidential base.

However, other evidence, for example, from the survey of FTSE 100 companies, from pensions currently in payment, does not discredit the Inland Revenue's estimate. [32]

Although the Government welcomed the NAO's report as vindicating their own earlier calculations that just 5,000 people would be hit by the £1.4 million limit, the NAO's preferred figure of 10,000 was twice the Government's estimate. Further, Watson Wyatt estimates that a 1% increase in annual real salary could double the 10,000 figure. KPMG called for the Chancellor to "avoid disenfranchising executives from corporate sponsored pension provision" by allowing individuals to build up some future provision regardless of the amount accumulated to date. [33] A Datamonitor report suggested that wealthy people would put their money into other savings vehicles such as offshore investments, hedge funds and property. [34]

[32] NAO press notice, "The government's estimates of the impact of the pensions lifetime allowance," March 2004: http://www.nao.org.uk/pn/03-04/0304pensions_estimates.htm (retrieved 11 December 2008). To view the full report see: http://www.nao.org.uk/publications/pensions_estimates_march_04.pdf (retrieved 11 December)

[33] "Govt understated reach of lifetime limit," *Pensions Week*, 15 March 2004, p14

[34] "Lifetime limit likely to dissuade wealthy investors," *The Guardian*, 12 March 2004

The then Shadow Secretary of State for Work and Pensions David Willetts stated that the challenge was “not to limit the amount going into pension funds, but to encourage more to go in.”[35]

2 The New Regime

2.1 Budget , 17 March 2004

The Chancellor announced in his 2004 Budget that, in the wake of the NAO report that substantially backed up the Treasury's initial calculations, he would be going ahead with the tax simplification plans.[36] Two important changes were announced in the brief reference in the actual Budget statement: A-day would be postponed to April 2006 and the lifetime limit would then be increased to £1.5 million, rising to £1.8 million in 2010:

> At a cost of £165 million by 2008, I will replace the eight existing tax schemes for pensions with a single lifetime allowance. I will set the allowance at £1.5 million for the first year of the scheme, from April 2006, and will set the allowance now for the years until 2010 when the figure will be £1.8 million.[37]

An Inland Revenue Budget Note describes the “key elements” of the new regime:

- A single lifetime allowance on the amount of pension savings that can benefit from tax relief. The value of the lifetime allowance will be set at £1.5m on introduction rising as follows:

2007 - £1.6m
2008 - £1.65m
2009 - £1.75m
2010 - £ 1.8m

- The lifetime allowance will be reviewed quinquennially.
- An annual allowance initially set at £215,000. It will increase steadily each year such that in 2010 it will be at £255,000 for contributions to DC schemes or increases in accrued benefits in DB schemes. The level of the annual allowance will be reviewed quinquennially.
- Contributions will no longer be limited to a fraction of capped earnings. Individuals will be able to make unlimited contributions and tax relief will be given on the higher of 100% of relevant earnings or, where the individual contributes to a scheme that operates relief at source, £3,600.
- All Schemes will be able to pay tax-free lump sums of up to 25% of the value of the pension rights. The maximum permissible tax-free lump sum rises, under simplification, to 25% of lifetime allowance.
- A lifetime allowance charge of 25% on funds in excess of the lifetime allowance. Funds in excess of the lifetime allowance may be taken as a lump sum, in which case the lifetime allowance charge will be at a rate of 55%.
- An annual allowance charge of 40% on contributions or increases in excess of the annual allowance.

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[35] *Op cit,* “Govt understated reach of lifetime limit.”
[36] HM Treasury, *Budget 2004*, HC 301, 2003/04, 17 March 2004, paras 5.42-5.47

- In order to value the capital worth of defined benefits for the purpose of the lifetime allowance, there will be a single valuation factor of 20:1. Individuals who receive payment of a pension at 5 April 2006 will be treated as having used up part of their lifetime allowance if, after 5 April 2006, they receive payment of a new benefit. The factor for valuing such pensions will be 25:1, which reflects the fact that people will generally have taken tax-free lump sums.

- A valuation factor of 10:1 will be used to measure the annual increase for the purpose of the annual allowance.

- Transitional arrangements will protect pension rights built up before 6 April 2006. There will also be protection for rights to lump sum payments that exist at 6 April 2006. There will be two options for transitional protection from the lifetime allowance charge:

- **Primary Protection** which will be given to the value of the pre-April 2006 pension rights and benefits in excess of £1.5 million; or

- **Enhanced Protection** which will be available to individuals who cease active membership of approved pension schemes by 6 April 2006. Provided that they do not resume active membership in any registered scheme, all benefits coming into payment after 5 April 2006 normally will be exempt from the lifetime allowance charge.

- The minimum pension age will rise from 50 to 55 by 2010. Those with certain existing contractual rights to draw a pension earlier may have that right protected. There will be special protection for members of those approved schemes in existence before April 2006 with low normal retirement ages, such as those for sports people.

- It will no longer be necessary for a member to leave employment in order to access an employer's occupational pension. Members of occupational pension schemes may, where the scheme rules allow it, continue working for the same employer whilst drawing retirement benefits.

- Employers will continue to be able claim a deduction in computing profits chargeable to UK tax for employer contributions paid to a registered pension scheme. The Government intends to continue the current practice of spreading large contributions over 2 to 4 years.

- It will continue to be a requirement that pensions are secured by age 75. However, pension income may be delivered after age 75 through Alternatively Secured Income, an alternative method to provide benefits via an income for life which may be used by those with principled objections to the pooling of mortality risk.

- Death benefits from a scheme can be in the form of either a lump sum, a pension to one or more dependants or a combination of lump sum and pension. This will depend on whether the benefit is in payment at the time of the member's death and the age of the member at death.

- There will be new, simpler processes for scheme registration and reporting. The current limits on what a scheme may invest in will be lifted and replaced by a single set of investment rules for all pension schemes.

[37] HC Deb 17 March 2004, c 329

- Non-registered pension schemes may continue in the new regime, but without any tax advantages. They will be treated like any other arrangement to provide benefits for employees. Amounts in non-registered pension schemes will not be tested against the lifetime allowance and the lifetime allowance charge will not apply to them. Transitional protection will be available for pension rights accrued at 6 April 2006 within non registered schemes.[38]

Budget 2004 added the following on death within five years of retirement:

> Under the current system, lump sum payments are currently made by many occupational pension schemes to the spouses of pension scheme members who die within five years of retirement. Under the simplified pensions regime, subject to the lifetime allowance, these lump sum payments will continue to be able to be made tax free, with the potential for many scheme providers to offer larger tax-free lump sum payments. Under the simplified regime, where a member dies before age 75, it will be possible for the scheme provider to arrange for a capital sum equal to any unused lifetime allowance to be paid taxfree along with unlimited dependants' pensions, instead of the current specific provision to allow schemes to pay a tax-free lump sum equal to the balance of five years' payments undrawn at the time of the member's death.[39]

2.2 Immediate reaction

The changes to the initial proposals have been broadly welcomed, though with some words of caution from experts. On the increase in the lifetime allowance from £1.4 million to £1.5 million rising to £1.8 million, Andy Cox, pension consultant at Hewitt, Bacon & Woodrow said: "We…welcome the increase in the Lifetime Allowance…we are also impressed with the built-in facility to review tax limits under the new regime every five years. We hope this signals the Government's intention to be flexible and timely in reacting to changes such as future improvements to life expectancy." Similarly, Mary Francis, director general of the Association of British Insurers, said: "The new system will be better for savers and for the pensions industry. The new regime will boost 'flexible retirement,' by allowing people to draw a company pension while working for the same employer, though the minimum pension age will go up from 50 to 55."[40]

Sue Bartlett, a partner at Watson Wyatt, stated: "…about 20 per cent of those who would have been affected by the £1.4m lifetime allowance at the changeover date will now not be. However, many of these individuals will be quickly caught up by the new maximum allowance and they will not be able to claim protection for their current pension savings." Francis Fernandes, a partner at Lane Clark & Peacock, concurred. He stated that those coming close to the cap now needed to decide how to protect the savings that they have already accumulated.[41]

Others were more critical of the proposals. Rowena Marsh, a partner at accountants Grant Thornton, said: "The limit might be all right for the average earner but it is extremely low for a lot of midrange executives." A major concern is that the limit applies to the value of pension investments rather than the amount contributed. Somebody who invested £500,000 in

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38 Inland Revenue, "Simplification of the taxation of pensions", Budget Note 39, 17 March 2004, http://www.inlandrevenue.gov.uk/budget2004/revbn39.htm (retrieved 11 December 2008)

39 HM Treasury, Budget 2004, Chapter 5, para 5.47

40 "Fat cats hurt by pensions squeeze," *Daily Mail*, 18 March 2004

41 "Reprieve for high earners as pensions cap is relaxed," *The Times*, 18 March 2004

shares which rose rapidly could face a punitive tax bill. If a pension fund is over the allowed amount when the saver retires the excess can be taken as a lump sum, but 55% of it will go in tax. Savers who choose to leave the extra untouched lose 25% in tax but will then be taxed a further 40% on the income.[42]

The relatively favourable valuation of DB benefits has led advisers to predict that some people in money purchase schemes might withdraw their funds when approaching retirement and transfer them into final salary schemes. Billy Burrows of William Burrows Annuities has said: "People will end up setting up one-man final salary schemes for the extra tax breaks. This will involve additional cost and complexity for the individual when the Government is supposed to be simplifying the system".[43]

2.3 Finance Bill 2004

Part 4 of the *Finance Bill 2003/04*, published on 8 April 2004, contained the legislation needed to implement these changes.[44] The relevant clauses were clauses 139-270. The Regulatory Impact Assessment quantified the reduction in the size of the legislation applying to pension tax:

> The draft primary legislation to enact the changes has today been published in the Finance Bill. These 151 pages of primary legislation, together with an expected 100 pages of secondary legislation and estimated 350 pages of guidance, will be replacing over 350 pages of primary and secondary legislation and nearly 1000 pages of guidance. It is proposed to publish draft Regulations for comment during the remainder of 2004, and to have the guidance ready for publication early in 2005.[45]

It set out the benefits of the reform for different groups:

- the pensions industry (sponsoring employers, scheme administrators, providers and advisers): a 2001 Inland Revenue sample survey[46] suggested new steady state administrative cost savings to the pensions industry of at least 5 per cent, about £80 million a year. Responses to the December 2002 consultation, in the main, said it was difficult or impossible to estimate realistic figures in the absence of detail. Following the publication of the detailed proposals in December 2003, and consideration of the responses, this still remains the Government's best estimate (see paragraph 46).

- employers: the new rules will permit flexible retirement, helping employers retain experienced staff and allowing staff to stay on longer in work. (Current rules prevent occupational scheme members from drawing a pension without leaving that employer's service, whereas individuals with personal pensions may, if they wish, commence drawing their pension as soon as they reach minimum pension age);

- those employers that have previously been deterred from setting-up schemes, because of the overall cost and complexity, may now decide to do so;

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42 "Retirement savings cap will rise to £1.8m after pension climbdown," *Daily Mail*, 18 March 2004
43 "The £1m pension gap", *Sunday Telegraph*, 21 March 2004
44 Bill 89 – I, 2003/04
45 HMRC, Simplifying the taxation of pensions: Regulatory Impact Assessment, 8 April 2004,para 2 http://www.hmrc.gov.uk/ria/simplifying-pensions.pdf
46 Survey of pensions industry by Inland Revenue, in conjunction with the Association of British Insurers and the National Association of Pension Funds, November 2001.

- members of occupational pension schemes: should, like members of personal pensions currently, have more opportunities to use their pension rights flexibly, to mix work and retirement toward the close of their careers;

- pension scheme savers: will nearly all be able to save more with tax relief if they wish. They will have increased flexibility in the amount they can save and when they can save, and the potential of a more generous tax-free lump sum. The exception to this will be a small number of high earners not subject to the 1989 earnings cap, whose future tax privileged pension saving will be capped by the lifetime allowance;

- people not yet saving for a pension: will find it easier to get started as they will need less advice and face lower costs. In turn this should mean that they are unencumbered in achieving an appropriate level of pension saving for retirement.

- Independent financial advisers: will need less detailed knowledge of different tax regimes, reducing their training costs. In response to the December 2002 consultation one industry representative suggested savings in training costs for this group alone could amount to £10 million per year.[47]

The pension industry would have one-off transitional costs for systems changes, documentation and training, and for individual advice about transitional protection, but these are very hard to quantify. The Association of Consulting Actuaries (ACA) estimated the total industry transitional costs at £150-£250 million (£15 - £25 per member).[48] Within this figure, the per capita costs for Small Self-Administered Schemes (SSAS) and Self Invested Personal Pensions (SIPPs) were likely to be considerably higher.[49] Once the transition had been accomplished, it was considered that schemes were likely to see ongoing savings rather than costs. The Government estimated that administrative costs would be reduced by about 5%.[50]

The cost to the Exchequer was likely to be considerable: £25 million in 2006/07, £70 million in 2007/08, and £165 million in 2008/09:

> 47 In 2002-03 the net tax relief for tax-approved private pension schemes was around £13 billion. This represents the up-front relief on contributions, plus the relief on schemes' investment income, net of tax on current pensions in payment. This is in addition to around £5 billion relief given in exempting employer contributions from National Insurance.
>
> 48 The proposals will ensure these tax advantages will not only continue – but will grow. Current estimates of the Exchequer cost of the simplified pension regime are: 2006-07: £25 million, 2007-08: £70 million and 2008-09: £165 million. These costs include the likely impact of increased pension savings from those who are constrained by the current rules. They also take account of the increased flexibility offered by the new regime, such as the ability for some to take a higher tax-free lump sum than under the current regime or, for people in occupational schemes, to draw benefit from

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[47] HMRC, Simplifying the taxation of pensions: Regulatory Impact Assessment, 8 April 2004, http://www.hmrc.gov.uk/ria/simplifying-pensions.pdf; Para 26

[48] Ibid, para 40

[49] Ibid, paras 41-42

[50] Ibid, para 46

their pension scheme while continuing to work (if their scheme allows it). However, the costs will depend to a large extent on behavioural changes and these figures are therefore best estimates. The range of uncertainty of the direct revenue effect of the measure increases the further into the future we look.[51]

2.4 Finance Bill debates

The pension tax simplification clauses of the *Finance Bill* were debated in Standing Committee A between 8 and 22 June 2004 and on Report on 7 July 2004. Although the Government made a large number of amendments to these clauses they did not alter the broad structure of the reforms as outlined above. The debates did offer an opportunity for Ruth Kelly, the Minister responsible, to explain the Government's thinking on a number of contentious issues and a few of these explanations are reproduced below. A fuller (though by no means complete) index to these debates follows to guide Members to where they might find a discussion of specific issues.

Lifetime allowance

Press reports during the passage of the *Finance Bill* implied that that the lifetime allowance had been raised to £2.3 million or £2.5 million.[52] In fact, the cap for defined contribution schemes remained at £1.5 million (rising to £1.8 million in 2010), although Ruth Kelly, the then Financial Secretary to the Treasury, made it clear that people with DC pensions would be able to convert them into DB pensions and benefit from what is seen as the more generous conversion factor of 20:1. People with DB pensions would not be subject to the lifetime allowance charge on pensions below £75,000 a year (20 x 75,000 = 1,500,000). However, it was estimated that, at current annuity rates, a 55 year-old would need a fund of £2.3-£2.5 million to buy an index-linked joint life annuity. On 15 June 2004, Ruth Kelly said:

> Practically all Opposition comments have been directed towards the general debate on the valuation factor, 20 to 1, and how it affects DB and DC schemes. (…)
>
> The second point is that we consulted widely on the regime. In the first round of consultation on pension simplification, the UK actuarial representative bodies supported the use of a single valuation factor for DB pensions. The Association of Consulting Actuaries firmly recommended a single factor and, after considerable research, proposed 20 to 1 as the most appropriate if there was an appreciable margin in the level of the lifetime allowance. In setting the lifetime allowance at £1.5 million, we have given that margin.
>
> As the National Audit Office agreed, the new regime mirrors the maximum pension under the 1989 regime. The Faculty of Actuaries and the Institute of Actuaries said at the time that
>
> "the factor should not attempt to accurately reflect market conditions at the time of calculation, as that would unnecessarily complicate retirement planning."
>
> The most accurate result for those taking pensions around the age of 60 was 20 to 1. That is the age at which the majority of people take their pension.

[51] Ibid

[52] See, e g, "Government raises cap on retirement funds to £2.3m", *Sunday Times*, 20 June 2004 and ""Pension cap to rise to £2.5m"", *Times*, 17 June 2004

> The hon. Member for Arundel and South Downs tried to persuade the Committee that we are giving much more support to DB schemes than to DC schemes. There are some in the House who may think that that would be a good idea, but I am sorry to disappoint them. It is perfectly clear to me that, if there is an incentive to take a DB scheme rather than a DC scheme in one year, that may well change in future years as annuity rates change, and the relative attractiveness of each option may change over time.
>
> If someone feels that they are disadvantaged in a money purchase scheme, they can always transfer to a scheme pension run by an insurance company and use the 20 to 1 valuation factor, if insurance companies decide to offer that vehicle for the non-corporate market. Under our plans, there is no reason that they could not offer such a vehicle. If the reverse were true, and someone felt disadvantaged by being in a DB scheme rather than a DC scheme, as could happen, of course they could switch to take advantage of annuity rates.
>
> I do not think that the measure is unfair. I think that it is by far the easiest, most transparent and simplest way of approaching the problem. It is the way that has been suggested to us by the actuarial profession as striking a fair balance and giving a reasonable level of pension for those in DB schemes. That presents the case for the valuation factor of 20 to 1.[53]

Residential property

The proposed removal of the ban on investment in residential property by self-invested personal pension schemes (SIPPs) and small, self-administered schemes (SSAS) encouraged a great deal of speculation that this would lead to significant distortions in the housing market and to people using their pension funds to buy their own homes.[54] However, Ruth Kelly argued that the controls in place (notably the fact that any personal gain would be taxed as a benefit in kind) would prevent this:

> The new regime will provide tax-favoured pension schemes with a much freer choice over what investments they make. I hope not to anticipate a debate, which I believe we will have later, about whether there should be greater restriction on the use of pension fund assets. We believe that schemes should, as far as possible, be left to decide in the light of market developments their own investment strategy and choice of investment assets. The new, simplified regime significantly reduces the current number of restrictions on the investments that can be held by pension schemes.
>
> In the new, simplified regime, a registered pension scheme may invest in an asset that may be used to provide a benefit to a member, their family or household. However, if a benefit is provided in that way, clause 162 deems an unauthorised payment from the scheme to have arisen, and that will attract an income tax charge. The clause provides for the amount of an unauthorised payment of this type to be valued for tax purposes in the same way as amounts under the existing benefits-in-kind tax legislation, which applies where an employee obtains a non-monetary benefit from their employer. It is an integral part of the more flexible approach to investments in the new, simplified regime.

[53] Ruth Kelly, SC Deb (A) 15 June 2004, cc 550-551

[54] See, eg, "Get ready to run your own pension", *Sunday Times*, 28 March 2004; ""Housing pension 'ill-conceived'", *Times*, 5 April 2004

(…)

In the current regime, only certain types of scheme have restrictions placed on the type of asset in which they can invest. A small scheme is not allowed to purchase a work of art, whereas larger schemes are. In the new regime, we want to reduce complexity by applying the same criteria to all registered schemes. That will give schemes the same opportunity to take advantage of potential growth in a wider range of assets.

I do not accept that suddenly to start investing in the housing market will prove a particularly attractive option for people who are in small, self-administered schemes. The motivation is not to increase incentives for people to invest in particular forms of equity investment, as the hon. Gentleman said. There are buy-to-let investments and others have mentioned holiday homes in hot spots and different parts of the country.

Most pension funds, covering 14 million active members, are free to invest in residential property, and many of them do. The relaxation of the rules covers only those who have self-invested personal pensions and those with small, self-administered schemes. They are specialised products typically taken out only by very wealthy individuals and held by about 200,000 people, compared with the 15 million people who contribute to pensions overall.

There are already certain restrictions that make it much less attractive than one might initially think for people holding small self-administered pensions and self-invested personal pensions to invest in property. First, a tax charge will be levied on personal or non-commercial use of the property. For example, if it is a holiday home in Wales or Cornwall, a person using it for their personal use will have to pay a tax charge. Secondly, if they rent out the house on a buy-to-let basis they will be required to put all the rental income secured from the property into the pension fund, which may be unsuitable for people who need the money to fund repaying a mortgage on the property. Thirdly, pension schemes will be allowed to borrow only up to 50 per cent. of the scheme's assets to finance the purchase of a property, so anyone who wants to take advantage of this would have to have 50 per cent. of the assets in cash to put into that property, which would rule out a lot of people in the categories to which the hon. Gentleman referred. Lastly - and this is a huge disincentive - the property will be owned by the pension fund rather than the individual, and in most cases it will need to be sold for income in retirement, and it will definitely need to be sold at the age of 75 in order to buy an annuity.

Therefore, the case that has been raised is not likely to be attractive to many people, although there may be some individuals for whom it is an attractive investment to secure income in retirement - which is, of course, the intended purpose of our giving tax relief in the first place.

Mr. Osborne: I mentioned the Picasso and the house in Cornwall -or wherever- but my alarm bells started ringing when I heard that a company in Glasgow was using this to allow people to exercise the right to buy council properties. All the disadvantages that the Financial Secretary has set out merely reinforce my concern that people may be led down this route. The flexibility of the pensions regime allows people to transfer out of pensions such as company pensions into specially designed self-invested pension schemes. If it is the case that the market is already coming up with such schemes, I suggest that she at least investigates that and takes a view on what is actually happening, because whatever we debate in this Committee it seems that out in the real world other things are afoot.

> **Ruth Kelly**: When our initial proposals were announced, there was a little flurry of press interest about the possible consequences - and opportunities, for some people - with regard to people buying their own home under the right to buy or buying a second home or holiday home. I think that almost all of that has now evaporated as people have come to realise the disincentives that are built into the system.
>
> Tax relief is provided for a purpose: to allow people to secure their income in retirement. I do not think that huge numbers of people will suddenly want to exercise the right to buy in this way when they are allowed to borrow only up to 50 per cent. of the value of the property, when they will be taxed if they make personal use of the property, and when they will have to sell the property by the age of 75 at least, if not before then, to secure an income in retirement.
>
> I do not know of the particular scheme that the hon. Gentleman mentioned and whether it is still expecting to continue to promote that offer. I would be very surprised if that were possible. Indeed, I would ask whether the company would be mis-selling to that particular category of people. It is not for me to stand here and make judgment. It is more for me to say that the principle behind our tax regime is not to use the tax system to distort investment decisions that are rightly made by the members or trustees of a scheme, and that tax relief should be used to secure an income in retirement. [55]

The Government subsequently announced, in the Pre-Budget Report 2005, that to prevent potential abuse, SIPPS would not after all be able to invest in residential property and certain other assets, such as fine wines:

> 5.63 A small part of the proposed simplification would allow all registered pension schemes to invest directly in residential property. To prevent the potential abuse of the simplification rules, where people could claim tax relief in relation to pension contributions into Self Invested Personal Pensions (SIPPs) for the purpose of funding purchases of holiday and second homes for their or their family's personal use, from 6 April 2006 SIPPs and all other forms of self-directed pensions will be prohibited from obtaining tax advantages when investing in residential property, and certain other assets such as fine wines. This action will ensure that tax relief is only given to those whose purpose in making the contribution is to provide themselves with a secure retirement income. However, the Government remains committed to encouraging investment in a range of assets as part of pensions saving and is therefore minded to allow SIPPs to invest in genuinely diverse commercial vehicles that hold residential property, such as the proposed Real Estate Investment Trust model (detailed further in Chapter 3). The Government will not hesitate to take action if it becomes clear that people are trying to use collective vehicles to get around the rules for prohibited assets.[56]

Compulsory annuitisation

The Opposition pursued their campaign to remove the rule, retained in the new scheme, that people who save for pensions through a defined contribution scheme must use their pension funds to buy an annuity before the age of 75. This issue is covered in more detail in Library separate standard note, SN/BT/712, *Pensions: requirement to annuitise.*

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[55] SC Deb (A) 15 June 2004, cc 532-534

[56] HM Treasury, Pre-Budget Report 2005;

Index to Standing Committee debates

The pension tax simplification clauses of the *Finance Bill 2003/04* were debated in Standing Committee A between 8 and 22 June 2004. The table below provides a guide.

Sitting	*Subject*
Thirteenth sitting, 8 June 2004 (Morning)	**Overview** of the reforms (cc 427-435). **Definitions –** including inconsistencies with *Pensions Bill,* group personal pensions, "member", four types of "arrangement" (defined benefit, money purchase, hybrid and cash balance) (cc 436-447) **Registration** – reasons for refusal will be given (c 452); turnaround will be one day (c 450); transitional arrangements; e-filing will not be mandatory (c 454) (cc 447-455) **Policing of Investments** – more properly discussed later (cc 455-457) **Deregistration** – start (cc 457-8)
Fourteenth sitting, 8 June 2004 (Afternoon)	**Deregistration** (cont) (cc 459-461) **Unauthorised payments** – including Government amendments; tax charged as benefit in kind where registered pension scheme invests in assets providing a benefit to a member or his family; treatment of loans (cc 461-466) **Authorised member payments** – lump sums, pensions, survivor benefits; treatment of payments to settle disputes (cc 466-469) **Compulsory annuitisation** – attempt to increase age at which this applies from 75 to 80 (defeated on a division) (cc 469-478) **Alternatively secured income** – why set at 70% of comparable annuity not 100%; whether it would become a popular vehicle for avoiding inheritance tax (cc 478-486) **Compulsory annuitisation** – attempt to remove requirement to annuities altogether (cc 486-491) **Reduction or stopping of pensions** – Government amendments to allow this (eg for bridging pensions or ill health pensions where recipient recovers) (cc 491-494) **Small schemes** – requirement that schemes with fewer than 50 members must purchase annuities to secure pensions (divisions) (cc 494-499) **With profits annuities** – confirmation that Government is not withdrawing them (cc 499-502) **Full time education** – withdrawal of current rule that people over 23 in full time education can count as dependants (cc 502-503) **Limited period annuities** (cc 504-505) **Tax free lump sums** – reasons for increase (cc 505-507) **Trivial commutation** – start (cc 508-510)
Fifteenth sitting, 15 June 2004 (Morning)	**Trivial commutation** (cont) – under new system this will be allowed in one 12 month period between ages of 60 and 75 if total fund value is less than 1% of lifetime allowance. Fears that lots of little pensions will remain with adverse impact on PPF levy (cc 511-517) **Compulsory annuitisation** – attempt to remove 75 age limit on passing on whole range of lump sums to next generation (division). Gibraltar open annuity will not be allowed under new scheme (Ruth Kelly, c 523) (cc 518-523)

	Benefits in kind – payment to scheme members who are alos scheme administrators (cc 525-527) **Assignment** – generally any pension assignment (eg selling your right to a pension to someone else) will be prohibited except for pension sharing orders (cc 527-530) **Residential property** – possibility that people will invest pension funds in residential property (cc 530-534) **Authorised surplus payments** – there will be regulations but Pensions Bill is place to discuss changes to rules on surpluses (cc 535-536) **Loans to sponsoring employer** – facility is to be retained for small schemes and extended to all schemes subject to safeguards to ensure it is done on commercial terms. DWP rules will deal with member protection aspects (cc 536-544)
Sixteenth sitting, 15 June 2004 (Afternoon)	**Valuation of rights** – is 20:1 valuation factor for defined benefit schemes more generous than £1.5 million allowance for defined contribution schemes? (cc 545-551) **Investment** – will removal of controls on investments lead to future scandal because of high risk investments? Confirmation that current distinctions between rules for SIPPs and Group Personal Pensions will be abolished. (cc 551-558) **Lower income savers** – tax relief is generous for high earners at 405 but less so for lower earners. Proposal that system should be restructured (match relief?) to encourage pension saving by low earners (cc 559-562) **Employers' contributions** – spreading of tax relief where employer makes exceptionally large contribution – current Inland Revenue discretionary approach will continue (cc 563-568) **Lump sums** – lump sums paid to charities are not taxable; treatment of short service refund lump sums; tax on special lump sum death benefits and authorised surplus payments (cc 570-575) **Lifetime allowance** – benefit crystallisation events; opposition attempt to have defined contribution lifetime allowance calculated in same way as defined benefit allowance (i.e.20:1) (division, c 582) (cc 576-588)
Seventeenth sitting, 17 June 2004 (Morning)	**Lifetime Allowance** – wide-ranging general debate on principle; history of; level of; sense of having it at all; whether future levels to 2010/11 should be in Bill rather than Explanatory Notes; whether index-linking should be in Bill; whether contracted-out people are disadvantaged; whether it will discourage risk-taking investment by wealthy individuals approaching the limit; whether Government Actuary was consulted; what National Audit Office said etc (division at end) (cc 589-616)
Eighteenth sitting, 17 June 2004 (Afternoon)	**Lifetime and annual allowances** – mechanism for uprating them; status of quinquennial review (cc 617-628) **Non-residents** – adjustment to lifetime allowance for those who contributed to UK scheme from abroad and did not therefore benefit from UK tax relief (cc 622-628) **Annual allowance** – level and purpose of (cc 628-631) **Annual allowance** in defined benefit schemes – special rules for deferred members (statutory 5% revaluation is ignored) (cc 632-634)

	Lifetime allowance charge – who is liable if scheme member exceeds allowance? Scheme administrator pays charge but is likely to pass it on to member. Undertaking that public sector schemes definitely will pass it on (cc 635-639) **Valuation factor (20:1)** – why is it not higher for younger people and lower for older people? (cc 639-644) **Minimum pension age** – increase from 50 to 55 by April 2010; "cliff edge" approach; why no phasing; will public and private sectors be treated the same?
Nineteenth sitting, 22 June 2004 (Morning)	**Transitional protections** – (i) are rules on pre-1989 schemes retrospective? (They will only be "grandfathered" if no further contributions are paid after A day); (ii) valuation method for defined benefit schemes registering for primary protection is more restrictive than expected – i.e. values it on early retirement at A day not full accrued pension; (iii) increase in minimum age – protection for those who already have right but lifetime allowance reduced by 2.5% for each year before 55; (iv) protection of right to pay balance of five years' pension on death even if over 75 (cc 653-657) **Scheme rules** – schemes will have three year window in which to amend rules which depend on current wording of the legislation (eg a rule allowing payments "up to Inland Revenue maximum") (cc 657-659) **Valuation of rights for primary protection** – including 25:1 factor for pensions already in payment; drawdown; pensions on death of spouse (cc 660-663) **Enhanced protection** for defined benefit and cash balance arrangements - government amendment to change approach as recommended by Association of Consulting Actuaries (cc 664-669) **Minimum pension age** – protection for those with an existing scheme right to pension before 55; Opposition attempt to extend this to people with employment contract right to pension on redundancy before 55 (division c 677); Government amendment to protect new joiners between December 2003 and A day (cc 669-672) **Pre-1989 schemes** – opposition attempt to permit continued grandfathering for all those in pre-1989schemes (division c 677) (cc 672-677) **Large lump sums** – Government amendments improving way in which large lump sums (over £375,000) can be protected by primary protection (c 679) **Five-year guaranteed pensions** – Government amendments to allow these to be paid out on death, even if over 75, for those already receiving the pension in April 2006 (cc 684-685) **Unfunded retirement benefit schemes** – consolidation of pre-2006 promises into registered pension scheme (cc 686-689)
Twentieth sitting, 22 June 2004 (Afternoon)	**Commencement date** – this will be 6 April 2006 for the whole simplification (cc 691-692)

3 The rules as they affect individuals

The HMRC's Registered Pension Schemes Manual explains that pension tax law now divides payments into "authorised and unauthorised benefits", with the latter attracting extra tax charges. Beyond this, the "amount and type of benefit that you can actually receive will depend on what the rules of the pension scheme you belong to say":

> **What benefits can I have from a pension scheme?**
> The tax rules do not set any limits on the amount or type of benefits you can take from a pension scheme. But when you take benefits, how much and how they are given to you will affect how the benefits are taxed.
>
> **Authorised and unauthorised benefits**
> The tax legislation splits benefits into authorised and unauthorised benefits.
>
> Unauthorised benefits will have an extra tax charge on them and so we do not expect many to be paid. For more details on unauthorised benefits please see RPSM09208000.
>
> The tax legislation sets out if a payment is an authorised or unauthorised payment.
>
> Normally you benefits will be authorised benefits. These include the main benefit types of
>
> - a pension paid for life,
> - a lump sum benefit paid when the pension starts,
> - a lump sum benefit if you die before you start a pension, and
> - a pension paid to one or more of your dependants following your death.
>
> Benefits paid to you are described in more detail in the rest of this section. Benefits paid following your death are described in Chapter 10 – RPSM10200000.
>
> **What do the rules of your pension scheme say?**
> The amount and type of benefit that you can actually receive will depend on what the rules of the pension scheme you belong to say. When you join your pension scheme you should be given information about what benefits you will get, and when benefits can be paid you. You should also be told about any changes to your benefits.
>
> You should speak to the administrator of your pension scheme if you have a question on what benefits you are entitled to from your scheme. See RPSM09200060 for information on how to find out who the administrator of your scheme is.[57]

An overview of the rules as they affect individuals is provided in an HMRC leaflet, Pension tax simplification and you, copied in the Annex to this note.

4 Developments since the *Finance Act 2004*

The Government has made various changes to the rules since the *Finance Act 2004* received Royal Assent. For example, in Pre-Budget Report 2004, it announced a package of changes it intended to make in response to representations made on the legislation.[58] In Budget 2007, it said:

[57] http://www.hmrc.gov.uk/manuals/rpsmmanual/RPSM09200030.htm (retrieved 11 December 2008)
[58] HM Treasury, Pre-Budget Report 2004, Para 5.67

> The Government recognises the importance of a stable environment that allows the pensions industry to plan ahead and minimise disruption to the regimes already in place that are working well. At the same time, the Government will need to respond to circumstances that move away from the above principles, or where the market seeks to identify loopholes in legislation that permit behaviours clearly outside the original intention of the legislation. In making these principles transparent, Government is seeking to provide greater clarity for the industry.[59]

Changes made so far include those relating to:

- Alternatively secured pensions;
- Pensions Term Assurance;
- Lump sum payments; and
- The level of the lifetime allowance for 2008 onwards.

4.1 Alternatively secured pensions

It is Government policy that the purpose of tax relief is to "provide a pension income." Therefore, when an individual comes to take their pension benefits they can take 25% as a tax free lump sum; "the remainder must be converted into a pension – or in other words annuitised – between the aged of 50 (rising to 55 from 2010) and 75."[60] Alternatively Secured Pensions (ASPs) were introduced on "A day", as an alternative to buying an annuity at 75.

The Financial Services Authority (FSA) explains unsecured pensions (for people under 75) and alternatively secured pensions (for people aged 75 and over) as follows:

> **What are unsecured pensions?**
>
> They are an alternative to buying an annuity. They allow customers to draw an income from their pension fund while leaving their fund invested.
>
> A customer under 75 can take out an unsecured pension and either draw an income by using income withdrawal (also known as pension fund withdrawal or pension drawdown), or by using a 'short-term annuity'.
>
> An unsecured pension will stop at age 75. By that time, customers must secure an income from their pension funds, which generally means buying a lifetime annuity, or an alternatively secured pension (see below).
>
> **What are alternatively secured pensions?**
>
> Alternatively secured pensions (ASPs) work in a similar way to unsecured pensions, but have different rules. They are available to people reaching age 75 who do not want to buy an annuity with their pension fund.
>
> When first introduced, ASPs had no minimum income withdrawal requirement. And it was possible to pass any remaining funds on the member's death to the pension funds of other members of the same scheme if the member had no dependants.

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[59] HM Treasury, Budget 2007, para 5.67
[60] HM Treasury, *The Annuities Market,* December 2006; http://www.hm-treasury.gov.uk/d/pbr06_annuities_293.pdf (retrieved 11 December 2008)

> However, the Government has indicated ASPs are intended to provide an income in retirement for scheme members and their dependants, rather than be used as a device to pass on tax-privileged pension funds. Therefore a minimum income level has been introduced. Also, any lump sum death benefits passed to other scheme members will be taxed at up to 70% and could also be subject to inheritance tax.. [61]

ASPs were introduced in response to some religious groups who had "principled objections to the pooling of mortality risk."[62] However, there is nothing in the legislation to restrict them to those with religious objections.

In Budget 2006, the Government said it had become clear that some advisors were intending to use the provisions "for a much wider purpose to enable individuals to pass on tax-privileged retirement savings to their dependants rather than to provide a pension in retirement." It therefore intended to examine how best "to restrict ASPs to their original limited purpose."[63] Changes were introduced in the *Finance Act 2007* and applied from 6 April 2007. The FSA explains this as follows:

> When first introduced, ASPs had no minimum income withdrawal requirement. And it was possible to pass any remaining funds on the member's death to the pension funds of other members of the same scheme if the member had no dependants.
>
> However, the Government has indicated that ASPs are intended to provide an income in retirement for scheme members and their dependants, rather than be used as a device to pass on tax-privileged pension funds. Therefore a minimum income level has been introduced. Also, any lump sum death benefits passed to other scheme members will be taxed at up to 70% and could also be subject to inheritance tax.[64]

This is covered in more detail in Library Standard Note, SN/BT 4189, *Alternatively secured pensions.*

4.2 Pension Term Assurance

Term assurance policies are life assurance policies that only pay out on the death or mortal illness of the insured person. They may last for a specified term, for example the term of a mortgage or may be for life.[65]

In the Pre-Budget Report 2006, the Government said it had become aware that:

> as a result of the flexibilities that the new pensions tax regime has brought in, life insurance policies that provide lump sum death benefits alone are being offered as personal pension arrangements eligible for tax relief. This undermines the principles set out above. The Government will therefore work with the pensions industry to explore in time for the Budget, how the principles can be applied to pensions term assurance contracts.[66]

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[61] http://www.fsa.gov.uk/smallfirms/your_firm_type/financial/practice/unsecured.shtml (retrieved 11 December 2008).

[62] HM Treasury/Inland Revenue, *Simplifying the taxation of pension: the Government's proposals,* para 3.4, December 2003, http://www.hmrc.gov.uk/pbr2003/simplifying-pensions.pdf (retrieved 11 December 2008)

[63] Para 5.61-2

[64] HM Treasury,Budget 2006

[65] Finance Bill 2007. Explanatory Notes, Volume 2 of 2. Clause 67 and Schedule 18, para 3

[66] HM Treasury, Pre-Budget Report 2006, para 5.77

In Budget 2007, the Government said it had become "clear that providing a meaningful link between term assurance contracts and pension saving is not practical or commercially viable" due to the additional administrative burdens this would impose. It therefore confirmed that it would "no longer provide tax relief on individuals' contributions that are used to fund personal assurance policies."[67] This was legislated for in the *Finance Act 2007,* with some transitional protection, for example, for cases in the pipeline.[68]

4.3 Lump sums

The Government announced in Pre-Budget Report 2005 that the Government would:

> take action to prevent abuse of the rules for tax-free lump sums from 6 April 2006, by removing tax advantages when lump sums are recycled back into funds in order to generate artificial levels of tax relief.[69]

Budget 2008 announced some changes to the rules for trivial commutation. Before 6 April 2006, a pension could be commuted it if was less than £260 per annum and no account had to be taken of any other pensions in payment.[70] The effect of the rules introduced in April 2006 was that it was no longer possible to commute some sums that could previously have been commuted. Chris Lewin and Ed Sweeney, who produced an independent report on the Deregulatory Review of Private Pensions for DWP, said

> One problem brought to our attention has been the expected build up over time of large numbers of small benefits that can no longer be commuted (or can only be commuted after considerable administrative effort) due to changes in the tax laws.[71]

At the time of Budget 2008, it was announced that:

> 8. Additionally, some easements will be made to the rules for 'trivial commutation' – the circumstances in which pension rights giving rise to very small pension entitlements can be commuted into a lump sum up to 25 per cent of which would be tax free. Regulations under the widened power set out above will provide that it will be possible to commute some small 'stranded pots' as well as pension savings below £2,000 in occupational pension schemes. These will have effect in addition to the current rule that restricts the aggregate of an individual's pension savings to £16,000 for trivial commutation.[72]

The *Finance Act 2008* (section 92 and schedule 29) made provison for "stranded pots to be commuted as lump sums and to allow a *de minimis* limit for commutation payments by occupational schemes."[73]

HMRC issued the draft *Registered Pension Schemes (Authorised Payments) Regulations 2008* for consultation in March 2008. On 9 November, *Professional Pensions* reported an

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67 HM Treasury, Budget 2007, Para 5.74
68 Section 68 and Schedule 18
69 HM Treasury, Pre-Budget Report 2005, para 5.64
70 DWP, Deregulatory review – Government response, October 2007, para 2.10.2; http://www.dwp.gov.uk/pensionsreform/how_review.asp (retrieved 11 December 2008)
71 Chris Lewin and Ed Sweeney, 'Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions', July 2007, para 82, http://www.dwp.gov.uk/pensionsreform/pdfs/ReviewPaperJuly2007.pdf (retrieved 11 December 2008)
72 HMRC, Budget 2008 Notes, BN 42, Pensions: Regulation making powers
73 Finance Bill 2008; Explanatory Notes, para 76; Clause 89 and Schedule 29

HMRC spokesperson as saying that the regulations had been "put on hold until the middle of 2009."[74]

4.4 The lifetime and annual allowance from 2010/11

In the Pre-Budget Report in November 2008, the Government announced that it would freeze the level of the lifetime and annual allowances from 2010-11 to 2015-16:

> 5.89 On the introduction of the simplified pension rules in April 2006, the Government set a lifetime allowance (LTA) to provide an overall cap on tax-relieved pension savings, set at an initial £1.5 million in 2006-07, rising to £1.8 million by 2010-11. In line with its core principles and to ensure fairness, affordability and sustainability of tax reliefs, the Government will maintain the LTA at £1.8 million for a further five years, up to and including 2015-16. This only affects the largest pension pots, those above £1.8 million over this period. The annual allowance will also be held constant at £255,000.[75]

HM Treasury estimated savings of £400 million in 2011-12 as a result.[76]

The Association of Consulting Actuaries described the freeze as a "huge surprise for the pension savings industry" and "an immediate disincentive to making pension savings." Those likely to be effected were advised to reconsider their plans:

> Senior executives drawing their benefits before April 2011 can leave their plans unchanged. But all others will need to reconsider their pension savings plans immediately – particularly urgently for those who had built up savings before 2006 and have been having to make decisions about "protections" that have to be registered by April 2009. We can see executives retiring early on account of the freeze. The very complex "Enhanced Protection" may be attractive to a much wider group than before. Countless others will need to reassess their long-term plans.[77]

The *Financial Times* reported that for some the impact might be offset by other changes:

> Although it has not been confirmed that income tax at the 45 per cent rate will be available on pension contributions, experts said this type of saving would be an obvious way to mitigate the tax rise…
>
> Standard Life said pension saving would remain worthwhile for top earners. "Longer-term investors may want to deliberately exceed the lifetime allowance and pay a 55 per cent tax charge as this may produce a better return than investing in an equivalent mutual fund", said John Lawson, head of pensions policy.
>
> Killick & Co, the financial adviser, said the 0.5 percentage point rise in National Insurance rates would help to boost the attractiveness of "salary sacrifice" and "bonus waiver" arrangements for pension contributions. With these, individuals benefit from NI savings, as well as upfront income tax relief.[78]

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74 Steven Dignall, 'Trivial commutation rules delayed', 9 November 2008; http://www.professionalpensions.com/ (retrieved 11 December 2008)

75 HM Treasury, Pre-Budget Report 2008, Cm 7484

76 Ibid, Table B5

77 ACA Press Release, "ACA slams freeze on life-time allowance', 26 November 2008; http://www.aca.org.uk/files/ACA_slams_freeze_on_Lifetime_Allowance-26_November_2008-20081125184936.pdf (retrieved 12 December 2008)

78 Steve Lodge, 'Freeze on savings ceiling limits scope for tax breaks', *Financial Times,* 25 November 208

The *Times* drew attention to the implications for lower income savers because of the knock-on effect on the trivial commutation limit, which is set at 1% of the lifetime allowance:

> The move could also hurt thousands of low-income earners who have the right to take any pension pot that is worth less than 1 per cent of the lifetime allowance - at present £16,500 - as a lump sum rather than being forced to buy an annuity. However, with the lifetime limit being frozen at £1.8 million, it means that many more savers could breach the 1 per cent limit - forcing them to buy an annuity for a sum as trivial as £40 per month.[79]

Trivial commutation is discussed in more detail in SN/BT/2181, “Pension Lump Sums”.

5 Some reactions to the new regime post-implementation

A number of articles have appeared in the pensions press commenting on the changes and assessing whether they actually amount to “simplification.” Pensions Management Institute news argued that “simplification became lost along the way.” For example:

> We should have seen that it would be impossible to completely remove the old regime limits and its devilish details. The moment this became clearer was on the realisation that schemes would not have to change their deeds to remove the old rules and accept the new. This means that any scheme that maintained explicit reference to the old regime immediately created a further level of complication. Not only were administrators confronted with complexities of the post A-Day regime, they still had the old regimes to contend with.[80]

Professional Pensions asked a panel of pension scheme administrators whether the pension tax simplification regime had in fact “reduce[d] administration and compliance costs for the pensions industry and pension scheme sponsors.” One for example, commented that:

> The main impacts have been around the new (often higher) amount of tax-free lump sum available at retirement, additional complications in dealing with low levels of benefits, and the increased level of explanatory documentation provided to members at the time of a claim. We are also starting to see some members taking flexible retirement and a few increasing their additional retirement savings.
>
> Simplification has been a catalyst for change (in amending scheme design and often helping to ease the funding burden).”

Another said:

> Over the longer-term simplification may indeed end up reducing compliance costs. However, from what we have seen in the market, the transition has been painful and has actually added to the burden and underlying costs of administration.
>
> Legal fees and consulting fees have risen due to the need to review benefits structures and ensure provisions of simplification are properly implemented. One thing that’s for certain is that those schemes that have made the bare minimum of changes are less likely to benefit from potential cost savings.

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79 Ian King, ‘Freeze on pensions lifetime limit to hit savers’, 26 November 2008; http://business.timesonline.co.uk/tol/business/economics/pbr/article5233873.ece (retrieved 11 December 2008)

80 David Brooks, ‘Simplification, the Holy Grail!” PMI News – January 2007

> The processes for policing benefit restrictions are fundamentally different, leading to a major review of many basic administration processes. This has driven up underlying costs in the short term but should really be viewed as an investment for the future.

Another said:

> I think HMRC genuinely believed that simplification would reduce costs, but this remains no more than an aspiration. Overall costs may have increased, especially with the level of legal and specialist technical advice still being sought by trustees and the growing volume of HMRC "guidance". Ask me again in a few years' time."[81]

6 Further information

The pension tax simplification consultation documents can be found on HMRC's website.

Detailed guidance on the rules can be found in HMRC's Registered Pension Schemes Manual

HMRC has also produced a series of Pension Tax Simplification Newsletters

[81] Professional Pensions, *Admin panel,* 8 February 2007

7 Annex: An overview of the rules

HMRC factsheet, Pension Tax Simplification and You, provides an overview of the rules affecting individuals:

Pension Tax Simplification and You

Saving for your pension - tax rules

There are rules around how much you can save in a pension scheme and how much tax relief you can get on your contributions. There are a set of rules that apply to everyone, no matter what type of scheme you are in or when you joined the scheme.

There is choice and flexibility in when and how you can save for your pension. You can pay more towards your retirement while still gaining the tax advantages. The rules allow you to pay what you want when you want to pay it. This is easier for you to plan with confidence for a comfortable retirement.

Does this mean I can pay more into my pension?

Yes

- Providing your pension scheme agrees, there is no limit on the amount you can put into your pension.

- But there are limits on the tax relief you can get.

Should you wish, you can save in more than one pension scheme at the same time, for example in both a personal pension and an occupational pension.

So what are the tax limits?

You can get tax relief on contributions of up to 100% of your UK earnings if you are a UK taxpayer.

If you are a non-taxpayer, every £100 of contributions will receive a contribution of £25 from HMRC up to a total maximum of £3600 per tax year. You can contribute more than this, but your fund will not receive any further contributions from HMRC.

Any contributions from your employer will not count against the tax relief you could receive.

There is an annual allowance, set at £235,000 for the year 2008/09. If the increase in the value of your pension rights or your contributions, (plus any contributions from your employer) exceeds the annual allowance, you will be taxed at 40% on the excess.

There is also a lifetime allowance (LTA), which is set at £1.65 million for the year 2008/09. When you take your benefits, if your total pension savings exceed this, you will be taxed on any amount over £1.65 million. This ‘Lifetime Allowance charge’ is set at 25% if your additional savings are taken as a pension, and 55% if taken as a lump sum.

So most people can save as much as they can afford without worrying about the limits.

So how does tax relief work?

For most people, tax relief is given automatically either through their pay packet or by their pension scheme. In which case all you need to do to get tax relief is pay your pension contributions.

This means that for every £100 you want to put into your pension you only need to find £80 out of your income after tax – as the Government contributes the remaining £20.

You pay	Government pays	Your pension contribution is worth
£80	£20	£100

When can I take my pension?

The Government is changing the rules on the earliest age at which you can take your pension. This is currently 50, although many pension schemes may have a higher limit. By 6 April 2010 every pension scheme must have an age limit of at least 55.

Different rules apply if you retire due to serious ill health or if you already have the right to retire before age 55 at 6 April 2006.

The rules mean that if you want, you may be able to carry on working and take some or all of your pension, which will allow you more flexibility in planning and managing your move to 'full' retirement.

You must start taking your pension by age 75, although there are a number of options on how you can do this.

If you are unsure about any of this contact your pension scheme for advice.

Will I be taxed on my pension?

Any pension that you receive is subject to income tax. However most schemes in addition to a pension, offer a tax-free lump sum.

So what lump sum can I have?

This will depend on the rules of your particular scheme, but the rules mean that all schemes can, if they choose, offer a tax-free lump sum of up to 25% to members when they first take their pension.

If I only have a small pension fund, what are my options?

If the total value of all your pension savings (in all schemes if you are a member of more than one scheme) is £16,500 or less in 2008/09, and your scheme rules permit, you may be able to take your entire fund as a lump sum. This is known as 'trivial commutation'. 25% of the lump sum will be tax-free and the rest will be taxed as part of your income. Trivial commutation of pensions already in payment is fully taxable as income.

Who administers a pension scheme?

The only person who can register a scheme for tax purposes is the Scheme Administrator. The tax rules require that a registered pension scheme must have at least one Scheme Administrator. That is to say a person or persons legally responsible for fulfilling certain functions on behalf of the pension scheme. Often the employer or an individual director will be the Scheme Administrator for their scheme.

Reporting obligations also rest with the Scheme Administrator. The online filing system is Pension Schemes Online through which Scheme Administrators make returns of information and submit reports. It is mandatory for many of the new reports and returns to be filed online. Scheme Administrators need to pre-register with our new Pension Schemes Online service to be able to use it.

For more information about the Scheme Administrator, please see our factsheet on our website at www.hmrc.gov.uk/pensionschemes/scheme-administrator-facts.pdf

For information on using the HMRC Pension Scheme Online service, there is a guide at http://www.hmrc.gov.uk/pensionschemes/online-user-guide.pdf

What do I need to do now?

Only those few individuals with pension savings (or potential pension savings) of over the lifetime allowance, or promises of a lump sum of greater than a quarter of this, will have to apply to HMRC to ensure they are exempt from the lifetime allowance charge. Those with promises of lump sums greater than 25% but that are worth less than a quarter of the lifetime allowance automatically receive protection so long as they stay in their pension scheme.

You are able to claim protection of pre-A-Day rights from the lifetime allowance charge by registering a claim with HMRC. You can also protect existing lump sum rights where these would be greater than is permissible under the tax rules after A-Day. Claims must be registered by 5 April 2009 on the Protection of Existing Rights form (APSS 200). If you think you may be affected by this, you should seek financial advice.

If you don't know who the Scheme Administrator is for your scheme you may wish to check with your pension provider. And if you are the Scheme Administrator, you should make yourself fully aware of your responsibilities. Remember, it is mandatory for Scheme Administrators to file information returns to HMRC online!

Where can I find out more?

Visit our website at www.hmrc.gov.uk/pensionschemes

to get the most up to date information on pensions tax simplification including all the required forms and completion notes.

Look for guidance specifically written for individuals, including explanations of the terms used in this handout. This can be found at www.hmrc.gov.uk/manuals/rpsmmanual/index.htm

Phone our Helpline on 0845 600 2622

(Monday to Friday 09.00 to 17.00)