

HMT: Restriction of pensions tax relief: an alternative approach

27 August 2010

Summary

AEGON welcomes the government's decision to review the previous government's pension tax changes originally scheduled for April 2011. We recognise the need for the government to raise the same tax revenue as the previous government's pension tax policy from any future changes to pension tax rules.

We support the replacement of the previous government's tax rules with a simpler tax regime using a considerably reduced Annual Allowance (AA) of around £40,000, with full tax relief at individual's highest marginal rate. We see this as more transparent and easier to understand for the majority of our customers, who in the most part are defined contribution scheme members. Ideally, this should be indexed in line with earnings inflation to retain the concept of pensions as deferred pay. Without indexation, over time the AA will affect increasing numbers of pension savers, eroding the value of pensions. However, we recognize that in these difficult economic times, the government may be unable to promise this. At the very least it should commit to reintroducing AA indexation when finances permit, to preserve confidence in pensions. If indexation cannot be guaranteed now, we ask the government to commit to looking at this again in three years time as part of a wider review of pension and savings.

We are not in favour of a reduction in the Lifetime Allowance (LTA). Doing so undermines both the need for predictability and the value of pension saving for those people who have planned around the current LTA in good faith. A reduced LTA could represent a retrospective 'penalty' on those who have protection at present. Furthermore, adding a new layer of

protection simply increases complexity and compliance costs for individuals and providers.

We recognise the difficulties a reduced AA brings to members of defined benefit (DB) schemes and we encourage the government to work with the DB sector to find a workable solution. But in a pensions environment that is increasingly switching to defined contribution (DC), our overriding concern is to keep the new pension tax rules as simple as possible for DC members as these represent the future pensions market. It's important we preserve the integrity of the A-day changes and avoid complexities around DB concessions spilling over into what could be a simplified DC tax regime.

AEGON UK is part of the AEGON Group, one of the largest life insurance and pension companies in the world. In the UK we have pensions, life insurance, asset management and advice businesses. AEGON UK has assets under management of £55.7 billion, including revenue generating investments and employs around 4,000 staff. The AEGON Group has assets of around Euro 361bn (£320 billion).

Introduction

AEGON welcomes the government's decision to review the previous government's pension tax changes originally scheduled for April 2011. Given the current economic situation, we understand the need for the government to raise the same tax revenue as the previous government's pension tax policy from any changes to the pension tax rules. We see the consultation as an opportunity to retain the principles of pension tax simplification established in 2006.

We understand that a number of 'trade-offs' need to be made. Our view is that the Annual Allowance (AA) should be set as high as is feasible within the government's indicative band. We hope an allowance of around £40,000 can be made affordable, by limiting concessions. This would keep compliance simpler.

Policy Design

The annual allowance

We believe the level of the AA should be set as high as possible, and hopefully around £40,000. To achieve this level, the concessions proposed in the consultation should be kept to a minimum. A reduced AA is much more transparent, easier to communicate and to understand than the previous government's complex 2011 pension tax changes. It is also easier to regulate, simplifies compliance and preserves the simplicity of the A day changes.

Most of our customers are DC members, the majority of whom are unlikely to pay or benefit from contributions that exceed an AA of £40,000. However, we recognise that a reduced AA will affect a greater proportion of defined benefit (DB) scheme members. Nevertheless, any special provisions for DB members must not complicate the pension tax regime any further.

To protect the value of pension savings, particularly over the long term, the AA must be indexed against prices or preferably earnings. This also retains the concept of pensions as deferred pay. However, we recognise that given the state of public finances, the government may not be in a position to do this from April 2012, a year after the AA's introduction. We therefore call on the government to give a commitment to review the level of the AA, and introduce indexation when public finances have improved as part of a wider review of pensions and savings. We suggest this commitment is given for around three year's time.

The Lifetime Allowance

We are not in favour of reducing the Lifetime Allowance (LTA). Doing so undermines the value of pension saving for those people who have planned for benefits around the current LTA in good faith.

A reduced LTA adds another layer of complexity, bringing in a new type of protection for those people who have funds in excess of the new LTA, but below the current LTA of £1.8 million. This increases compliance, administrative and communication costs for the pension industry and HMRC. Reducing the LTA undermines the aim of restoring simplicity to tax relief on pensions.

Triviality levels are calculated as 1% of the LTA at date of crystallisation. Reducing the LTA reduces the amount people will be able to trivialise. This directly impacts other areas of government policy, such as Pensions Reform and the unavoidable increase in the number of small pots resulting from automatic enrolment from 2012.

In future, fewer people will accumulate pension pots that reach the LTA due to the considerably reduced AA. However, reducing the LTA now is not constructive to the pension savings message.

At this stage we strongly believe it's preferable to keep the LTA at its current level and maintain the status quo for protected benefits.

The rate of tax relief

From a customer, administrative and communication viewpoint it would be simpler for all pension contributions to receive tax relief at the individual's marginal rate of tax. Retaining full marginal rate of tax helps to keep key influencers engaged in workplace pensions.

Valuing defined benefit contributions

We accept that the government's approach to use a flat rate factor for valuing increases in value of defined benefit (DB) accrual is the simplest approach. There is sound logic to suggest that the increase should be any additional benefits over and above what the benefits secured one year before would have increased to under revaluation offered to preserved members. However, this adds a degree of complication.

We also agree that the current flat rate factor of 10 underestimates the real value of defined benefit accrual for some individuals, but the factor of 10 was always an average and there is a danger that too high a factor will penalise modest to middle earners who have long service or late promotion. However, any softening of the new higher flat rate factor must not come at the expense of reducing the AA to an amount lower than £40,000.

Deferred members

For purposes of simplification, we believe deferred benefits held in previous schemes should be excluded from testing under the AA. This would be consistent with excluding revaluation of previous benefits from the extra accrual calculation. It also removes practical issues for those with deferred pensions to work out their contribution or increase in the value of their defined benefit.

Applying the annual allowance in particular circumstances

Serious ill health and death

We agree that the AA shouldn't apply in the year of death or serious ill-health, thereby allowing employers to top-up their employees' pensions funds.

Applying the annual allowance in cases of ill-health early retirement or redundancy

We understand the government's concern about the possibility of anti-avoidance for those people retiring early on grounds of ill health. On balance, therefore we believe ill health early retirements shouldn't be exempt from the AA.

However, the nature of ill health early retirement varies widely. DB pension scheme rules set out the ability to retire early and the level of pension granted, which may be augmented by the employer. The risk is that scheme benefits are redesigned, removing beneficiaries' benefits and ill-health early retirement enhancements, to avoid breaching the AA in normal circumstances for the majority of members. If people fall ill and have to retire early, they risk falling back on the state as their income is insufficient.

The presumption should be that a tax charge applies, if the AA is exceeded. However, we believe people should have the right to appeal against the tax charge. We believe it's right the government should seek a natural justice solution showing compassion in what could prove to be very difficult circumstances for some people.

In the economic downturn many people are being made redundant. To soften the blow, some employers will top up their ex-employees' pensions as part of their redundancy package, while employees may choose to put some of their redundancy money into their pensions. If such redundancy payments exemptions are seen as a trade-off from setting the AA as high as possible, on balance we believe they should not be exempt as the overriding aim of simplicity and fairness (for the majority) should lean towards the highest AA possible.

Managing the impact on individuals

We expect DC customers will endeavour to avoid exceeding the AA and thereby avoid incurring tax charges. The simplest way of doing this is for them to keep track of the contributions paid into their pension plans. However, undoubtedly the AA may be exceeded unintentionally. In these cases, on provision of customer certification, customers should be given the option to receive a refund of the value of excess contributions, dependant on the provider's contract. However, we would want to avoid having to apply to the HMRC against sanction charges if the refunded amount proved to be unauthorised, when we had acted in good faith.

We do not support schemes paying the tax charge and reducing the individual's benefits due to the level of administrative complexity.

Delivery and compliance

Aligning the pension input period with the tax year

We agree it appears to be sensible to align the pension input period with the tax year. This will be simpler for customers completing their Self Assessment tax returns, although it will increase demand for information in the run up to the end of the tax year as people try to avoid exceeding the AA.

However it's not practical for annual benefit statements to be aligned with the tax year end. Currently the dates for producing annual benefit statement are spread throughout the year and resources are allocated accordingly. Having to produce and issue hundreds of thousands of benefit statements, all with an effective date of 6 April within a short period of time would significantly increase our costs as we would need to recruit a large number of temporary workers, even though most statements are system generated.

In addition the disclosure requirement would have to be changed for the interim period, as annual benefit statements must be issued every 12 months. Aligning the annual benefit statement date with the tax year would also have severe consequences for the postal service, as every pension scheme in the country would have to post annual benefit statements to customers at the same time.

Reporting requirements on pension schemes to provide statements of the total pension input amount in the pension input period

In reality, few DC members will receive contributions close to a revised AA of £40,000. Those that do are likely to be higher earners with financial advisers. We understand this is not necessarily the case for DB members.

Currently many DC customers are able to access details of their pension input amounts by using on-line tools. For the majority of our customers, most of the contributions are updated on the web within a month of the end of the tax year. The use of web-based tools will increase as the pension industry moves towards a more e-based model and

more people have access to computers. Although our customers are able to download a schedule of their and their employer's contributions, our web-based tools are not currently designed to produce on-line pension input statements.

For the reasons above, we believe there is no need for a blanket approach for pension schemes to provide statements of pension contributions, aligned to the pension input period. A better approach would be for administrators or providers to provide pension input statements on request two months in advance of the self-assessment deadlines or for customers to access web-based tools, as set out above.

Evidence of the benefits and burdens of proving statements associated with introducing reporting requirements on schemes to provide pension input information

The most efficient way to provide pension input certificates is to make these available on-line, but to issue paper copies on request. As we do not currently produce on-line pension input certificates, this will be a development issue, incurring additional costs.

Currently the pension industry has a number of very significant regulatory changes which must be implemented within the next two years, some of which are shown below:

- BAS and SMPI
- A move to asset specific projection rates
- Ending of contracting-out
- Pensions Reform
- New retirement options and ending of annuitisation at age 75
- Retail Distribution Review changes
- New pension tax rules

We therefore ask the government to consider carefully the impact of adding to this regulatory burden (and industry costs) at this time, bearing in mind that only a minority of our DC customers are expected to be affected by the new tax rules.

CONTACT

For further information, please contact Kate Smith, 0131 549 6445

e-mail: kate.smith@aegon.co.uk