Pensions tax relief
Room 2/E2
HM Treasury
1 Horse Guards Parade
London
SW1A 2HQ

23 August 2010

Dear sir / madam,

Restriction of pensions tax relief: a discussion document on the alternative approach

Local Government Employers, a body which represents local authority interests to central government and other bodies on local government pensions policy is pleased to respond to your discussion document dated July 2010.

Introduction

We note that the Government's overriding concern should the propositions in the discussion paper be taken forward is to ensure that tax revenues are generated equivalent to those that would have ensued from the current provisions in the Finance Act 2010 (c£3.5 billion in 2012/13).

However, we are concerned with the assertion in paragraph 3.1 of the discussion document that the proposed "approach of restricting tax relief through existing allowances would affect the highest pension savers. The group of individuals who can save more than an AA in the range of £30,000 to £45,000 in a year are concentrated among the higher earners." This statement is simply not true in relation to members of Defined Benefit schemes as a result of the method of valuing benefit accrual in such schemes.

Whilst we welcome any move to simplify the provisions that restrict pensions tax relief we are concerned that whereas the current Finance Act 2010 provisions target high earners, being those with income of £130,000 or more whose gross income, including the value of employer pension contributions, is £150,000 or more the proposals in the discussion document to significantly reduce the Annual Allowance will mean that many more people (not just high earners) will be brought within the scope of the tax charge. This is of concern as not only will the tax charge affect more pension scheme members but it will increase the administrative burden for pension scheme administrators.

We also note from the discussion document that fairness between defined benefit (DB) and defined contribution (DC) schemes is an important consideration. Seeking to devise a system that can adequately compare apples and pears is, inevitably, fraught with difficulties. We would point out, for example, that a member of a DC scheme whose combined employee and employer contributions during a tax year fall below the reduced Annual Allowance of £30,000 to £45,000 would suffer no tax charge even if the value of their DC 'pot' had increased during the year by, say, 25% due to a rise in the stock market, but a member of a DB scheme for whom the same level of employee and employer contributions were actually paid in that year would suffer a tax charge if the value of the benefits at the end of the tax year less the value of the benefits at the beginning of the tax year, multiplied by a factor of between 15 and 20, exceeded the reduced Annual Allowance. The DC member does not receive a tax bill but the DB member does. This is because the test for the DC member is applied against the contributions paid in a year (rather than the increase in the value of the benefits during the year) whereas the test for the DB member is applied against the increase in the value of the benefits during the year and assumes that the contributions to meet the cost of that increase in value would all have been paid in that tax year. In fact, the contributions to meet the increase in the cost of the DB benefit would have been spread over many years into the future. Using a system that assumes all the contributions to meet the cost are paid in one year means that many more DB members will receive a tax bill than would have been the case if the contributions were treated as being spread over a number of years (or, if only the current year's pension accrual was valued, as opposed to the proposed method which, for a final salary defined Benefit scheme member, values the increase in the value of all past service too).

We note that the timescale for the changes outlined in the discussion document are still planned for April 2011. As a decision on the way forward will not be made until after August 2010, the timescales for schemes to implement any outcomes from the consultation will be very short, if not impossible given the need to amend scheme rules, undertake employer and employee consultations, produce member communications and amend pensions administration software.

We will turn now to the specific questions raised in the discussion document.

1. There are currently exemptions from the AA test which would undermine the ability of a reduced AA to restrict pensions tax relief effectively. In implementing a reduced AA, the Government would remove the exemptions from the AA test in the year benefits come into payment, and the exemption for individuals claiming enhanced protection under the Finance Act 2004 tax regime. The Government welcomes views on any other changes that might be necessary to ensure the AA operates effectively and to address the risk of avoidance that could lead to further significant and potentially adverse changes to the regulatory regime (Paragraph 2.7).

Please see our comments under item 4 below on the removal of the exemption from the Annual Allowance test of increases in benefits in the year they come into payment.

We have no objections to the removal of the exemption from the Annual Allowance test for individuals claiming enhanced protection under the Finance Act 2004.

With regard to tax avoidance, the current Annual Allowance test includes an assessment of pension inputs for active and deferred members, but does not include pensioner members. Thus, granting an inflated annual increase to a pension in payment after retirement rather increasing benefits beyond the Annual Allowance during employment could potentially be used as a tax avoidance measure. Whilst the current Benefit Crystallisation Event 3 test under section 216 of the Finance Act 2004 would catch an increase in relation to the Lifetime Allowance (LTA), it would not catch increases that are potentially greater than the Annual Allowance.

It might, therefore, be appropriate to introduce a test similar to that already set out for the BCE 3 test as this would prevent tax abuse whilst following an already established procedure. Schemes (such as the public sector schemes) that can only increase pensions by RPI or CPI and have no discretion to award increases above such an index would, in effect, not have to be concerned with such a test.

2. By only taking the newly accrued amount of annual pension in a DB pension into account, the use of a flat factor potentially creates opportunities for DB pensions to be used to grant additional pension value without this counting towards the AA test. The Government therefore welcomes views on this issue and practical options for limiting it, including the option of requiring a CETV calculation, or the use of age-related factors, in specific circumstances to capture the value of certain pension enhancements (Paragraph 2.11).

AND

3. The Government would welcome views on the treatment of deferred members, revaluation and negative accruals, with a flat-factor approach to valuing DB accruals, and evidence on the administrative burdens of the different options (Paragraph 2.16).

Method of valuing Defined Benefit contributions

Use of flat factors

Flat factors have the disadvantage that they value benefit accrual at the same level for all schemes irrespective of the age at which a scheme provides unreduced benefits or the age of the member when the retirement benefit is drawn. For example, an unreduced pension coming into payment at age 55 is a lot more valuable than a pension that does not come into payment until age 65. However, whilst the use of a Cash Equivalent Transfer Value (CETV) calculation or the use of Age Related Factors (ARFs) in valuing benefit accrual would lead to a more precise valuation, it would also lead to extra administrative complexity and be more difficult for scheme members to understand.

For the sake of simplicity we would, on balance, support the use of flat factors, although one could develop a range of factors based on schemes' normal pension ages.

Are the proposals appropriate and proportionate?

Raising the Annual Allowance (AA) benefit accrual factor from the current factor of 10 to a factor of between 15 and 20, and reducing the Annual Allowance figure from £255,000 to a figure of between £30,000 and £45,000, will result in many more scheme members facing a tax charge than under the current arrangements which only impact on high earners. Quite how may would be drawn into the charging regime will depend on which factor and Annual Allowance figure is adopted.

Example 1 – assuming a 1/60th scheme, a flat factor of 15 and an AA of £30,000

Ben is currently aged 58 with 35 years membership and pensionable pay of £50,000 (increased from £46,020 the previous year as a result of, for example, an annual pay rise, or payment of a bonus, or a combination of these).

Value at end of current tax year
Pension: 35 x 1/60 x £50,000 x 15 = £437,500
Value at end of previous tax year
Pension: 34 x 1/60 x £46,020 x 15 = £391,170
Total deemed benefit growth = £ 46,330
Taxable benefit if AA set at £30,000 = £16,330

The discussion document suggests that the previous year's benefits could be revalued and we would support such revaluation. If this were to be the case and the revaluation allowed is, say, RPI or CPI (and assuming for this example, the revaluation rate is 2.5%), the figures would then be:

Value at end of current tax year	
Pension: 35 x 1/60 x £50,000 x 15	= £437,500
Value at end of previous tax year	
Pension: (34 x 1/60 x £46,020 x 15) + 2.5%	= £400,949
Total deemed benefit growth	= £ 36,551
Taxable benefit if AA set at £30,000	= £ 6,551

Under the current provisions in the Finance Act 2010, only those high earners with income of £130,000 or more and whose gross income, including the value of employer pension contributions, is £150,000 or more would be subject to a tax charge. We are concerned that the proposals in the discussion document will result in significantly more scheme members facing a tax charge, including those who would not be seen by many to be termed "high earners". Of course, if a factor of 20 were to be used in the above examples rather than a factor of 15, the numbers of scheme members becoming subject to a tax charge would be even greater and the taxable benefit would be even greater too.

If, instead of being on a salary £46,020 the previous year, Ben had a salary of £40,000 which had increased on promotion to £50,000, the following calculations would have applied:

Value at end of current tax year
Pension: 35 x 1/60 x £50,000 x 15 = £437,500
Value at end of previous tax year
Pension: 34 x 1/60 x £40,000 x 15 = £340,000
Total deemed benefit growth = £ 97,500
Taxable benefit if AA set at £30,000 = £67,500

or, if revaluation of the previous year's accrual is allowed:

Value at end of current tax year	
Pension: 35 x 1/60 x £50,000 x 15	= £437,500
Value at end of previous tax year	
Pension: (34 x 1/60 x £40,000 x 15) + 2.5%	= £348,500
Total deemed benefit growth	= £ 89,000
Taxable benefit if AA set at £30,000	= £ 59,000

Tax on the excess at 40% would generate a tax bill of £27,000 under the first calculation or £23,600 under the second calculation, far greater than the £10,000 pay increase.

Impacts

Levying a tax charge against scheme members such as the member in example 1 above does not seem reasonable. Ben is not a "high earner" and it could be argued that he has not received an undue amount of pensions tax relief during the year. He has simply received a reasonable increase in pay or an increase in pay upon being promoted to a job with greater responsibility.

Furthermore, a high earner would, perversely, always appear to be subject to a tax charge in the first year of joining the pension scheme because the value of the benefit at the beginning of the year is £nil. For example:

Value at end of current tax year
Pension: 1 x 1/60 x £150,000 x 15 = £ 37,500
Value at end of previous tax year = £ nil
Total deemed benefit growth = £ 37,500
Taxable benefit if AA set at £30,000 = £ 7,330

Another impact is that individuals receiving a pensionable bonus will be taxed on the bonus under PAYE and then be taxed again if that bonus takes the value of the defined benefit accrual in the year above the Annual Allowance. What is the incentive for the employee to work hard? Similarly, will employees be dissuaded from seeking a promotion or refuse to temporarily act up because of the tax charge that will be levied if the increase in their pay takes the value of the defined benefit accrual in the year above the Annual Allowance?

Unlike in the private sector, the public sector has little scope for changing the way that employees are remunerated.

Potential discrimination?

There are two areas of potential indirect discrimination that might need to be considered.

The first is potential age discrimination. Mark works alongside Ben performing the same duties for the same pay. However, Mark is much younger, only 38, and so has much less pensionable service. The calculations for Ben are shown in example 1 above and those for Mark are shown in example 2 below.

Example 2 – assuming a 1/60th scheme, a flat factor of 15 and an AA of £30,000

Mark is currently aged 38 with 15 years membership and pensionable pay of £50,000 (increased from £46,020 the previous year as a result of, for example, an annual pay rise, or payment of a bonus, or a promotion, or a combination of these).

Value at end of current tax year
Pension: 15 x 1/60 x £50,000 x 15 = £187,500
Value at end of previous tax year
Pension: 14 x 1/60 x £46,020 x 15 = £161,070
Total deemed benefit growth = £ 26,430
Taxable benefit if AA set at £30,000 = £ nil

If the provisions permit the previous year's benefits to be revalued by, say RPI or by CPI (and assuming for this example, the revaluation rate is 2.5%), the figures would then be:

Value at end of current tax year
Pension: 15 x 1/60 x £50,000 x 15 = £187,500
Value at end of previous tax year
Pension: (14 x 1/60 x £47,000 x 15) + 2.5% = £165,097
Total deemed benefit growth = £ 22,403
Taxable benefit if AA set at £30,000 = £ nil

So, because older employees are more likely to have longer lengths of pensionable service they are more likely to suffer a tax charge than younger employees. Could this be seen as indirect age discrimination? If so, the government might wish to demonstrate that the policy pursues a legitimate aim and that it is proportionate i.e. it is an appropriate and necessary means of achieving that aim and there is no reasonable alternative. If the legitimate aim can be achieved by less or non-discriminatory means then these ought to take precedence.

Secondly, more women than men work part-time. Therefore, proportionately more men than women are likely to become subject to the tax charge. Take, for example, a person (Mary) who has worked in exactly the same job and for the same length of time as Ben, but at half-time hours.

Example 3 – assuming a 1/60th scheme, a flat factor of 15 and an AA of £30,000

Mary is currently aged 58 with 35 years membership and pensionable pay of £50,000 (increased from £46,020 the previous year as a result of, for example, an annual pay rise, or payment of a bonus, or a promotion, or a combination of these). During the whole 35 years of membership she has worked half-time hours (0.5).

Value at end of current tax year
Pension: 35 x 0.5 x 1/60 x £50,000 x 15 = £218,750
Value at end of previous tax year
Pension: 34 x 0.5 x 1/60 x £46,020 x 15 = £195,585
Total deemed benefit growth = £ 23,165
Taxable benefit if AA set at £30,000 = £ nil

If the provisions put in place permit the previous year's benefits to be revalued by, say RPI or by CPI (and assuming for this example, the revaluation rate is 2.5%), the figures would then be:

Value at end of current tax year
Pension: 35 x 1/60 x £50,000 x 15 = £218,750
Value at end of previous tax year
Pension: (34 x 1/60 x £47,000 x 15) + 2.5% = £200,475
Total deemed benefit growth = £ 18,275
Taxable benefit if AA set at £30,000 = £ nil

So, despite the value of her benefits increasing proportionately at the same rate over the year as Ben's, Mary suffers no tax charge.

Revaluation of previous year's benefits for the purposes of determining new accrual

As we have mentioned earlier in this letter, investment returns would not be included when assessing the Annual Allowance for a member of a DC scheme. It would therefore be consistent to allow for the revaluation of the opening value of a DB pension in line with inflation when calculating the pension input for an active scheme member during a year. We would support such an approach. If the value of deferred members' benefits are permitted to be revalued for the purposes of the Annual Allowance regime it would be fair and consistent to also allow revaluation of the opening value of a DB pension for active members.

Negative Accruals

As discussed in the discussion document, by including revaluation in the test for active members there is the potential for negative accrual. Negative accrual in itself should not be an argument against including revaluation and we would agree that in the case of negative accrual the value should be set to zero in most cases.

However, we would propose that where an individual has benefits in other arrangements assessable under the Annual Allowance test, then this negative value should be taken into account as an offset against the test applied to those other arrangements as the individual should be able to protect their benefits from the effects of inflation.

If some form of carry forward provision (i.e. for a future tax year) was included, then the negative accrual value could be netted off against the future year's accrual. However, in keeping with the objective of simplicity it would be hard to justify going down this route.

Final pay figure to be used in final salary Defined Benefit schemes

Under many final salary DB schemes, the rules of the scheme may permit the final pay figure to be used when calculating a member's benefits to be a figure other than the final year's pay. For example, under the Local Government Pension Scheme, a member's benefits can be based on the final year's pay, one of the previous two years' pay if either is greater than the final year's pay or, in certain circumstances, the average of the best three consecutive years' pay in the last thirteen years ending on a 31 March. It will be necessary for the purposes of the Annual Allowance test, in years other than the year of leaving, for the benefits at the end of the tax year to be calculated on the pay for the tax year. Otherwise, there will be huge additional administrative costs if schemes have to request information from employers concerning the best one of the last three years' pay and the best average of three consecutive years' pay in the last thirteen years.

Exemption for deferred members

As there is no additional benefit accrual for a deferred member, other than the normal scheme revaluation, deferred members should generally be removed from the Annual Allowance test. This would provide symmetry with deferred members in DC schemes for whom increases in the value of the fund are not taken into account.

We recognise, however, that there is scope for abuse where the rate of revaluation is excessive. This could be overcome, however, by only exempting revaluation to the extent that it is equal to or below the indexation test set out in section 235 (3) of Finance Act 2004. That section does, however, need to be amended to also refer to CPI (in case CPI in any year exceeds 5% and exceeds RPI). This would, in effect, mean that the deferred benefits in most schemes would be outside the Annual Allowance tax regime. The public sector schemes would certainly be outside the test as they can only apply annual RPI or, from April 2011, annual CPI indexation.

4. With an AA operating at a significantly lower level it is important to consider whether exemptions from the limit should be granted in particular circumstances, while managing risks of avoidance, including the cases of death, serious ill health, redundancy, ill health, transfers and divorce. The Government would welcome views from interested parties on these issues and any other specific circumstances under which there may be an argument for applying the AA in a particular way (Paragraph 2.17);

AND

5. Individuals may receive from their employer a significant increase in the value of their pension in cases of ill-health early retirement or redundancy. It is not clear that it would be appropriate to apply an exemption from the AA in these cases. Given the risks of avoidance, the Government is minded not to provide exemptions from the AA in these cases, but is willing to consider proposals from interest groups that would provide protection for individuals in particularly hard cases without opening up unacceptable scope for abuse. (Paragraph 2.19).

Death and serious ill health benefits

We agree that death and serious ill health benefits (where the member draws a serious ill health lump sum) should remain outside of the Annual Allowance test.

Ill heath retirements

For an ill health retirement pension to be an authorised payment it must meet the conditions set out section 165 of, and paragraph 1 of Schedule 28 to, the Finance Act 2004[1]. As there are strict tests governing entitlement to an authorised ill health pension we believe that ill health retirees should either be outside the Annual Allowance test (and so covered by the lifetime allowance test only) or there should be some form of protection.

If these members were not excluded or protected in some way there would inevitably be cases that would produce unenviable outcomes. For example, take the case of a 45 year old scheme member with 10 years membership who is certified by an independent medical practitioner qualified in occupational health medicine as being permanently incapable of undertaking the duties of his job and as having no likelihood, because of his medical condition, of obtaining gainful employment before age 65. Under the Local Government Pension Scheme that member would receive benefits based on his potential service to age 65. His pensionable pay on leaving is £20,000 and his pay at the end of

[1] The Local Government Pension Scheme contains even stricter provisions regarding entitlement to an ill health pension.

the previous year was £19,000. Applying an Annual Allowance test using a factor of 15 and an Annual Allowance of £30,000 would produce the following result.

Value at end of current tax year
Pension: 30 x 1/60 x £20,000 x 15 = £150,000
Value at end of previous tax year
Pension: 9 x 1/60 x £19,000 x 15 = £ 42,750
Total deemed benefit growth = £107,250
Taxable benefit if AA set at £30,000 = £ 77,250

So, this member, who is a standard rate tax payer, and who has been told he will never work again, will be sent a tax bill on £77,250. Even if this is set at 20% it will still produce a tax bill of £15,450. If charged at 40% this would be double the rate at which both the member's pay during employment and pension during retirement would be taxed at.

Whilst hopefully not common, such a case would inevitably lead to adverse publicity which could impact on scheme take-up.

For high earners, the implications are also similarly disproportionate.

Take a member aged 60 earning £130,000 a year with 25 years membership (plus 5 years ill health enhancement to age 65). His pensionable pay at the end of the previous year was £128,000.

Applying an Annual Allowance test using a factor of 15 and an Annual Allowance of £30,000 would produce the following result.

Value at end of current tax year
Pension: 30 x 1/60 x £130,000 x 15 = £975,000
Value at end of previous tax year
Pension: 24 x 1/60 x £128,000 x 15 = £ 768,000
Total deemed benefit growth = £207,000
Taxable benefit if AA set at £30,000 = £177,000
[tax = £177,000 x 40% = £70,800]

In order to meet all or part of the tax bill, scheme members might choose to commute pension into lump sum leading to a reduction in future tax receipts from the remaining pension in payment.

If it is not felt appropriate to completely exclude ill health retirees from the Annual Allowance test one suggestion is to spread the ill health augmentation over a period between the individual's date of retirement and normal pension age. A basic example would be to calculate the percentage by which accrual exceeded the Annual Allowance for the tax year of ill-health retirement and divide this percentage by the number of years between retirement date and the scheme's normal pension age. For example, in 2010/11 an individual's pension input amounted to 110% of the Annual Allowance. The NPA was not for another 2 years and therefore the individual will have used up 5% of the Annual Allowance for both 2011/12 and 2012/13. Any additional pension input in these years will increase the percentage used. This method ensures that if an individual is able to find employment at a later date they are not treated on more favourable terms as far as the

Annual Allowance is concerned than anyone else. The significant downside to this is that it would be complex, and difficult to administer and police.

The suggestion in the discussion document that schemes could avoid the Annual Allowance issues associated with ill health retirements by replacing the ill health benefits with Permanent Health Insurance is simply not realistic, given the timescales. To suggest that schemes, and particularly the statutory public service pension schemes, can consult on and introduce such changes before April 2011 is simply not feasible. Furthermore, if the Annual Allowance proposals eventually led to the removal of ill health enhancements from pension schemes, this would result in lower pension benefits leading to lower tax receipts and a potential increase in the level of claims for means tested state benefits.

Redundancy

We would not object to any augmentation of membership awarded by an employer falling within the Annual Allowance test. Local Government employers have the facility to make lump sum payments to individuals outside the pension scheme instead. The first £30,000 of such a payment (including any statutory redundancy payment) would usually be tax free.

Pension debits and credits

We agree that for the Annual Allowance test, the opening value of the benefits for pension debit members and the closing value for pension credit members should be adjusted to disregard the effect of the pension debit or credit.

Transfer of pension rights between registered pension schemes

We agree that for the Annual Allowance test, the opening and closing value of pension benefits in the two pension schemes should, as now, be adjusted to eliminate the effect of the transfer in the input period in which the transfer is made.

However, where a member leaves the Local Government Pension Scheme (LGPS) with a deferred benefit, has a break in service for, say, a couple of years, then returns to local government employment, rejoins the LGPS and aggregates the two periods of LGPS membership, it will be necessary to specify how the increase in value is to be calculated. This is because the "transfer" occurs within a registered pension scheme, not between different registered pension schemes. One method might be to compare the closing value at the end of the tax year with the closing value of the revalued deferred benefits at the end of the previous tax year.

Purchase of added years and payment of additional regular contributions (ARCs)

Under the Local Government Pension Scheme members could, prior to 1 April 2008[2], elect to purchase extra years of scheme membership. A member might, for example, have taken out a contract to purchase 5 additional years of membership, for which he would pay additional contributions over a set period of years. Although he pays the contributions over a period of years the added years are, technically, not granted until the earlier of the date the member leaves or the date the contract was due to end. To prevent

[2] 1 April 2009 in Scotland

there being a spike in the year when the contract comes to an end, the member in the example should be deemed each tax year to have purchased that proportion of the 5 additional years he has paid for during the pension input period in question.

Members of many of the public sector pension schemes are able to pay additional regular contributions (ARCs) to purchase additional annual pension in multiples of £250, up to a maximum of £5,000 of additional annual pension. We assume that ARCs, which purchase a defined amount of pension (although the amount of pension is not linked to length of membership or final pay), would be treated as a Defined Benefit for the purposes of the Annual Allowance test and not as a Defined Contribution. It would be helpful if this could be confirmed.

6. The Government welcomes views on the appropriate level of the LTA, other issues associated with its operation in the context of a reduced AA, and on the trade-off between these and the level of the AA (Paragraph 2.25).

Change to the LTA

We agree that if the LTA is reduced, it would seem reasonable to protect individuals who are above the revised level of LTA. However, we are concerned that further transitional protection will simply add to the complexity involved in these cases.

LTA Valuation Factor

We would not welcome a change to the valuation factor for the LTA test if this meant that individuals would have different tranches of their benefits valued at different rates. Any such change would add to complexity.

What is needed is simplification. Adding to complexity creates additional administration, communication and system update costs.

7. The Government would welcome views on the merits of capping relief at 40 per cent as an additional means of restricting pensions tax relief and the trade-off between this and the level of the AA (Paragraph 2.27).

The numbers in local government affected by this proposal would be relatively small. Capping relief at 40% would introduce extra complexity but would mean that the amount of the Annual Allowance could be set slightly higher or the Annual Allowance factor set slightly lower than would otherwise be the case. This would benefit a wider group of people than those affected by a restriction of tax relief to 40%.

8. The Government is keen to support employers to make adjustments to help individuals who may face large, but one-off, increases to their DB pension. The Government welcomes views on legislative action that could facilitate appropriate scheme redesign without undermining other aspects of the regulatory regime (Paragraph 3.10).

As is recognised in the discussion document DC schemes might be able to target contributions to fall below the Annual Allowance. However, the suggestions put forward in paragraph 3.9 of the discussion document as to how DB schemes could potentially be amended to head off any breach of the Annual Allowance are simply not feasible in the timescale leading up to April 2011. For the public sector statutory schemes, amendments to the scheme rules require a period of consultation and approval of the relevant Minister. The public sector does not have the same degree of flexibility that the private sector has in terms of benefit structure and the remuneration package.

We have already provided our views on spikes due to ill health and redundancy.

Spikes can, however, occur for other reasons, such as a back-dated pay rise, a bonus payment or a payment for temporarily acting up in a higher post. The effect can be that a scheme member in a final salary DB scheme exceeds the Annual Allowance in one year, due to, for example, the bonus or acting up payment, and does not do so in any subsequent year. Is it reasonable or equitable that the member has to pay tax on the excess in the year the Annual Allowance is breached even though it was a one off and the value of the bonus or acting up payment is not taken into account in calculating the member's final pay upon which his actual retirement benefits are eventually calculated? In addition to the inequity of taxing in advance a benefit that is never realised, without refund, this may also result in employees deciding there is little point in working hard to receive a bonus and could cause difficulties for employers in finding employees to temporarily undertake additional duties or responsibilities. A solution might be to allow the amount by which the previous two year's accruals had fallen short of those years' Annual Allowances to be used to reduce the amount by which the current year's accrual has exceed the current year's Annual Allowance. Alternatively, a tax refund could be given if the accruals in the two years following the current year fell below the Annual Allowance for those two years. Either provision would, of course, simply add additional complexity. As a final fall-back position, depending on the level of the pay increase and when it occurred in the tax year, it might be possible for the member to keep his benefit accrual below the Annual Allowance by opting out of the scheme for some or all of the tax year. This would, of course, result in yet more work for the pension scheme administrator having to deal with the opt out and subsequent opt in forms, and answering the inevitable request from the scheme member to calculate the optimum time to opt out / opt back in. Such an approach is hardly a recipe for stable, long term, pensions planning.

9. The Government welcomes views and evidence on the benefits and burdens associated with aligning the pension input period to the tax year, for individuals, pension schemes and advisors (Paragraph 4.12).

At the present time the pension input period for the Local Government Pension Scheme is specified as ending on each 31 March, not each 5 April. This date was chosen for payroll and accounting reasons. As the pay period for the majority of the workforce is normally a calendar month, calculating pay for the year to 31 March was felt to be administratively simpler than calculating pay for the year to 5 April. Having a scheme year end of 31 March makes the production of annual benefit statements easier. It would be helpful if this administrative simplification could be retained for any scheme that has chosen to use 31 March.

10. Given the need to support individuals, the Government welcomes views on the appropriate reporting requirements on pension schemes to provide statements of the total pension input amount over the pension input period (Paragraph 4.20).

AND

11. The Government welcomes views and evidence on the benefits and burdens associated with introducing reporting requirements on schemes to provide this information (Paragraph 4.20).

AND

12. The Government welcomes views on how quickly schemes could provide this information before the Self Assessment tax return is due, and whether employers could help pension schemes provide this information in a timely way (Paragraph 4.20).

To leave individual scheme members to request the Annual Allowance information from the pension scheme administrator would, to put it bluntly, be a disaster. No matter how much publicity there may be, many scheme members will simply not understand what is required of them. Even where they do understand, they are likely to request information at the last possible moment before completing their self-assessment tax return, causing major difficulties for the scheme administrator.

Given the above it would seem sensible for Local Government Pension Scheme administrators to produce the Annual Allowance information on the member's annual benefit statement[3] (as the LGPS has a year end of 31 March). As the scheme administrator will not know what other pension arrangements the scheme member may be paying into concurrently it would seem sensible to produce the Annual Allowance information for all active scheme members. Where the scheme member is also paying AVCs, the member would need to aggregate the Additional Voluntary Contributions paid during the year with the information shown on the annual benefit statement for the main LGPS benefits when deciding whether, when completing their annual self assessment tax return, the Annual Allowance had been exceeded.

The difficulty with the above is that it creates additional administrative and cost burdens and requires amendments / reprogramming of the pensions administration software.

To meet the deadline for submission of self assessment tax returns (i.e. 31 October following the end of the tax year for paper tax returns and 31 January for electronic returns) it would be necessary for the annual benefit statements to be issued by mid October at the latest.

To comply with such a deadline the pensions administrator will require payroll information to be provided by the employer, which is then uploaded to the pensions administration system before the annual benefit statements are run. Legislation requiring employers to provide the pay information by a specified deadline would greatly help. At the present time employers are legally required to file their employer annual return (P14's and P35's) by 19 May, provide a P60 to employees by 31 May and file the expenses and benefits annual return (forms P11D, P9D and P11D(b)) by 6 July. The date for provision of pay information to the pension scheme administrator should be no later than 6 July.

[3] Our comment relates to the administration of the LGPS. We suspect other schemes will want the flexibility to decide whether to amend their current annual benefit statements or produce a mini-statement showing the annual allowance information to those members who make an individual request.

The discussion document also suggests that pension schemes might have to also report to HMRC where individuals have exceeded a set limit. As a scheme cannot know what other pension arrangements a scheme member may have it would seem that the only logical solution would be for schemes to provide information to HMRC on all scheme members. This would be a huge task for HMRC. Would the tax collected outweigh the huge extra administration costs?

13. The Government welcomes views on any practical or administrative issues that may arise from applying the reduced AA, and associated information and compliance requirements, to individuals who are members of overseas pension schemes and benefiting from UK tax relief (Paragraph 4.22).

We have no comments to make on this question.

General Comments

Triple taxation

The proposals in the discussion document leave open the possibility of triple taxation on the same benefit accrual, particularly if the lifetime allowance (LTA) is reduced. Tax would be levied on the same benefit accrual under the Annual Allowance regime (40%), under the lifetime allowance regime (25%) and on the benefit itself once in payment as a pension (40%) giving a potential total tax charge in excess of 100%. Consideration would need to be given to a method by which any pension accrual already taxed through the Annual Allowance does not again become taxed through the LTA.

Managing High Tax Charges

The document suggests that it may be possible to allow members to elect to have the scheme pay the tax charge in return for a reduction in benefits. If this approach is to be followed, detailed guidance will need to be given on how such foregone benefits are to be treated in subsequent years for comparison purposes when undertaking the Annual Allowance test. Presumably the comparison would have to be to the pre adjustment benefit in order to avoid the possibility of tax being effectively levied twice on the foregone benefit.

Additionally there may be scope for avoidance if the scheme determines the foregone benefit at too low a rate. This could effectively mean that the employer is simply paying some of the tax on the employee's behalf via the pension fund.

Given the potential level of tax liability, many members may find themselves unable to meet any demands, unless they are allowed to spread the payment of the tax charge over a number of years. We can see the attraction to HMRC of allowing members to elect to have the pension scheme pay the tax charge in return for a reduction in benefits as this would provide greater surety of the revenue stream being achieved. It also has the merit of ensuring that the financial impact on the tax payer is aligned in time with the receipt of the benefit giving rise to the taxation, rather than being levied many years in advance of receipt of the benefit being taxed.

However, if the reduction to benefits occurs at the point of crystallisation of benefits, there may be difficulties in applying this approach if the tax liability and reduction in benefits is not determined at the point of crystallisation. Amendment to existing tax legislation[4] may be necessary to allow the member to elect for the scheme to pay the tax charge, and to receive reduced benefits, after the crystallisation.

On the negative side, the facility to allow members to elect to have the scheme pay the tax charge in return for a reduction in benefits would again complicate administration and increase administration costs. This is not welcomed. Also, the reduction of a member's accrued pension benefits to pay tax charges runs counter to the governments' stated aims of encouraging the workforce to provide income for themselves in retirement. Leaving aside the complications of actually reducing the member's benefits to pay for tax charges, what would happen where a member exceeds the Annual Allowance year on year? Presumably a limit would have to be set beyond which a member could not reduce his benefits anymore.

Public sector pension schemes

Although probably not politically acceptable, there is a case to be made for members of public sector pension schemes to be exempt from the Annual Allowance on the grounds that the rules of the schemes are controlled by central government. If the government believes that the schemes generate excessive annual increases in value, it is open to the government to amend the legislation governing the schemes. For example, the government could move the schemes to career average or could cap pensionable pay. In view of the fact that the tax payer contributes to the funding of the administration of these schemes, it is vital that any arrangements introduced as a result of the discussion document are as simple and cost effective to administer as possible.

Effect on retirement behaviour

Those employees who are able to foresee the effect on them of the proposals are likely to be of an age and with sufficient service to be able to retire before April 2011 with immediate pension benefits in order to avoid the Annual Allowance tax charge. Affecting employee behaviours in this way will mean that employers will lose the experience and expertise of employees they might otherwise have wished to retain. Such adverse effects are not helpful, particularly at a time when cutbacks in public services mean that employers cannot afford to lose their most able and experienced staff, the very staff who are required to manage the changes to service delivery.

Other alternatives for consideration

Whilst responding to the proposals in the discussion document we thought it might be helpful if we put forward for consideration other suggestions raised by local authority pension mangers. These are set out below:

1. Instead of introducing yet more complexity, the government could revert back to having a mandatory pensionable earnings cap for future benefit accrual. Before 6 April 2006 the rules of pension schemes limited the amount of benefits that could be provided and / or contributions paid by reference to the permitted maximum

4 i.e. paragraph 2(4) of Schedule 28 to the Finance Act 2004, paragraphs 11(6) and (7) of the Finance Act 2005, and The Pension Schemes (Reduction in Pension Rates) Regulations 2006 - SI 2006/138 as amended by SI 2006/1311

under section 590C of the Income and Corporation Taxes Act 1988. Although section 590C of the ICTA 1988 was repealed on 6 April 2006, schemes could continue to use the permitted maximum for a period up to 5 April 2011 because of regulation 4 of The Registered Pension Schemes (Modification of the Rules of Existing Schemes) Regulations 2006 – SI 2006/364. A number of schemes continue to do so and apply the notional earnings cap for 2010/11 of £123,600. If necessary, the reintroduction of an earnings cap could be coupled with a maximum contribution limit (being a specified percentage of the earnings cap figure).

2. The problem with an earnings cap, however, is that it takes no account of a scheme's accrual rate or normal pension age. An alternative would be to ascribe a value to set levels of pensions accrual. This could be done by ascribing a value based on pensionable pay. For instance, a scheme with a $1/60^{th}$ accrual and a normal retirement age of 60 might have a factor of 30% of pensionable pay ascribed. So a scheme member earning £120,000 would have a notional benefit of £40,000 and if the AA was set at £30,000 would pay tax on £10,000. If that scheme wished to ensure its members avoided a tax charge, it would set its own individual earnings cap at £90,000. The Government Actuary could produce a standard set of factors for scheme with different accrual rates and normal pension ages, or could produced a standard factor for, say, a $1/60^{th}$ scheme with a normal pension age of 65, and provide a mechanism for adjusting the factor depending on schemes accrual rates and normal pension ages where these differ from a $1/60^{th}$ accrual and / or a normal pension age of 65. This would provide a fair way of valuing DB pensions, place them on the same footing as DC schemes and prevent the introduction of a tax rule that discourages hard work leading to bonuses or promotion.

3. Alternatively, would it be more equitable to limit tax relief on employee contributions to 20% for all, even those subject to 40% or 50% tax under PAYE? Those employees paying into a pension scheme who do not earn enough to pay tax would have a 20% credit paid to their scheme by HMRC. If the reaction to this was that an employer set the employee contribution rate at 0% and paid all the contributions necessary to fund the scheme benefits, the member would still be subject to the current Annual Allowance and to the LTA.

Yours faithfully

TBE Edwards

Terry Edwards
Head of Pensions