HM TREASURY

Removing the requirement to annuitise by age 75

July 2010

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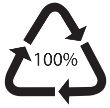

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Basic Information

Subject of this consultation:	The removal of the effective requirement to purchase an annuity by age 75 from April 2011, announced at the Emergency Budget in June 2010.
Scope of this consultation:	This consultation deals with the implementation of new tax rules to replace the existing requirement to secure an income from savings in a registered pension scheme by age 75.
Impact Assessment:	A consultation stage Impact Assessment is attached in Annex C.
Who should read this:	Annuity providers, personal pension providers, insurance industry representative bodies, consumer organisations, industry advisers, professional bodies and all other organisations and individuals who have an interest in annuities and pensions taxation.
Duration:	The consultation will run for 8 weeks from 15 July 2010. This will allow time to consult on draft legislation ahead of Budget 2011, having taken full account of the consultation responses. The closing date for responses is 10 September 2010.
Enquiries:	Enquiries should be directed by e-mail to age75@hmtreasury.gsi.gov.uk. For telephone enquiries please contact Jonathan Deakin at HM Treasury on 020 7270 5675.
How to respond:	Responses to the consultation should be sent by e-mail to age75@hmtreasury.gsi.gov.uk or by post to: Age 75 consultation Pensions and Pensioners Team Room 2/SE HM Treasury 1 Horse Guards Road London, SW1A 2HQ
Additional ways to become involved:	HM Treasury intends to hold a series of meetings with interested parties during the 8-week consultation process. Please e-mail age75@hmtreasury.gsi.gov.uk to register interest in attending.
After the consultation:	The Government will consider all responses to this consultation in drafting legislation to remove the effective requirement to purchase an annuity by age 75. Draft legislation will be published for consultation in advance of Budget 2011. It is intended that legislation will be in Finance Bill 2011.
Getting to this stage:	The Emergency Budget on 22 June 2010 announced that the effective requirement to purchase an annuity by age 75 will be removed from April 2011. Transitional measures for those yet to secure a retirement income who will reach 75 on or after 22 June 2010 but before new rules come into effect next year have also been introduced.

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Foreword

As the UK economy moves out of recession, it is important to ensure that future economic growth is driven by saving and investment, rather than unsustainable levels of debt.

The Government wants to foster a new culture of saving in the UK. This means that saving has to become more flexible and attractive in order to encourage people to take greater responsibility for their financial future. Nowhere is this more important than in planning for retirement.

Whilst other work we are doing, such as auto-enrolment and the consultation on the Default Retirement Age, increases flexibility as people build up their savings, we also recognise that increased flexibility over retirement age, and the increased range of assets held by the retired, means that some will want greater choice on the timing of the payment and amount of pension income.

However, the current inflexibility in the pensions tax rules acts as a barrier to saving for some because people have very little choice in securing a retirement income and finding a solution that is best for them. That is why the Government has committed to ending, from April 2011, the current rules that effectively require individuals to purchase an annuity by age 75.

This consultation document sets out the changes to the pensions tax rules that the Government believes are necessary to remove this requirement. It also invites views on the design of an appropriate safeguard to ensure that individuals do not exhaust their pension savings prematurely and fall back on the state.

The UK has a thriving annuities market – the largest and most diverse in the world – and, for many people, purchasing an annuity will remain the best way to secure a guaranteed income for life. As part of this consultation, the Government is keen to explore how the UK annuities market can benefit from greater flexibility.

I am keen to receive your views on the issues set out in this document and encourage you to take this opportunity to contribute to the consultation.

Mark Hoban MP
Financial Secretary to the Treasury

1 Introduction

1.1 Recent economic growth in the UK has been driven by unsustainable levels of debt, making the UK vulnerable to financial instability. Household saving was negative in 2008 for the first time since the 1950s. The Government is committed to encouraging higher saving and to fostering a culture of personal responsibility.

1.2 Pensions tax relief is available to encourage individuals to take responsibility for retirement planning.[1] The Government believes that reform of this tax relief is a necessary part of deficit reduction and is considering the use of a reduced annual allowance in place of the reforms legislated at Finance Act 2010. The Government is also committed to re-invigorating pension saving by giving people more flexibility to choose retirement options that are best for them.

1.3 7.8 million people currently save into Defined Contribution (DC) pensions.[2] This number is expected to increase, as more people move from Defined Benefit (DB) to DC provision and as a result of the Government's commitment to automatic enrolment.[3]

1.4 The nature of DC provision is that individuals can make active choices about their pension saving. The Government wants to ensure that individuals have access to advice about these choices and has asked the Consumer Financial Education Body to establish a national financial advice service, which will also offer individuals and families an annual financial healthcheck. This will help savers to understand the options open to them and to choose appropriate products.

1.5 The rules governing retirement income must be simple enough for people to make responsible choices while continuing to ensure that pension savings are used to provide a retirement income. The requirement to secure an income by age 75 has existed since 1976, when the average life expectancy of a healthy 65 year-old male was 13 years.[4] On average, a healthy 65 year-old male can now expect to live for 21 years, a 65 year-old female 24 years.[5]

1.6 As longevity increases and people work for longer, the existing rules will be restrictive for an increasing number of people. The Government believes that people should have more choice over the use of their pension savings and has therefore committed to ending the effective requirement to purchase an annuity by the age of 75 from April 2011.

1.7 Annuities remain an effective way of insuring against the risk of exhausting savings prematurely and are good value in comparison with other similar products. Research shows that individuals often underestimate their own longevity and the risk of individuals running out of retirement savings increases as longevity continues to increase. Individuals who wish to benefit from greater flexibility will therefore be able to do so provided they do not fall back on the state.

1.8 This consultation invites views on how this commitment can best be implemented. The Government will aim for a new system of rules that allows maximum flexibility without creating undue complexity or incurring a cost to the Exchequer.

[1] estimated to be worth £18.9 billion net of tax received on pensions in payment in 2008-09.

[2] *Pension Trends*, Office for National Statistics, 2009.

[3] the details of auto-enrolment and NEST are subject to a review by the DWP.

[4] *English Life Tables No. 16*, Office for National Statistics, 2002.

[5] *2008 based cohort life expectancy*, Office for National Statistics.

2 Developing a new tax framework for retirement

2.1 The Government is committed to ending the rules that create an effective obligation to purchase an annuity by age 75. As the previous chapter outlined, this will support the Government's objective to re-invigorate private pensions saving, by giving people greater flexibility to choose the retirement options that are best for them.

2.2 The requirement to secure an income by age 75 is a key feature of the existing pensions tax rules that apply during retirement. Removing this requirement therefore involves changes to the wider pensions tax framework.

The current tax framework

2.3 The tax treatment of pension savings follows an "exempt, exempt, taxed" (EET) model.

- (Exempt). Pension contributions by individuals and employers receive tax relief and employer contributions are exempt from national insurance contributions (NICs);
- (Exempt). No tax is charged on investment growth from pension contributions; and
- (Taxed). Pensions in payment are taxed as other income, but individuals are able to take up to 25% of their pension fund as a lump sum on retirement.

2.4 The current tax rules require that tax-relieved pension savings must be used to secure an income by age 75. This requirement is intended to ensure that pension savings accumulated with the help of tax relief are used to provide an income in retirement.

2.5 Most members of Defined Contribution (DC) schemes secure a retirement income by purchasing an annuity. The existing options for members of DC schemes who do not wish to purchase an annuity are limited:

- before age 75, individuals can enter an unsecured pension arrangement (USP), which enables them to leave their pension fund invested while drawing down an income. The maximum amount that can be drawn down each year is 120% of the amount of an equivalent annuity;[6] and
- after age 75, individuals can enter an alternatively secured pension (ASP) arrangement. ASP is similar to USP but has a lower maximum drawdown limit (90% of the amount of an equivalent annuity). There is also a minimum drawdown limit of 55%, to ensure that pension savings are used to secure a retirement income.

2.6 ASPs were introduced to provide an alternative to annuities for people who have principled objections to annuitisation, and were never intended to be widely used as an alternative to annuitisation. Consequently, the existing pensions tax rules effectively require most members of registered pension schemes to purchase an annuity by age 75.

2.7 Different tax charges currently apply before and after age 75 to different kinds of pension benefits, in particular death benefits:

[6] the precise amount is set by the pension scheme administrator using tables specifically compiled for this purpose by the Government Actuary's Department (GAD).

- **if an individual dies before age 75 and has not taken any income from their pension fund**, the entire fund can be paid out as a tax-free lump sum;
- **if an individual dies before age 75 under a USP arrangement**, any unused funds can be paid out as a lump sum, taxed at 35%. Ordinarily there is no inheritance tax (IHT) charge; and
- **if an individual dies after age 75 and is in an ASP arrangement**, any unused funds are subject to an unauthorised payment charge (up to 70%), unless they are used to provide a dependant's pension or donated to charity.[7] IHT may be chargeable on the remainder, resulting in a maximum total tax charge of 82%.

Principles for a new tax framework

2.8 Annuities provide a guaranteed income for life and are an effective way for individuals to insure themselves against longevity risk. However, some individuals will benefit from greater flexibility. For example, they may wish to annuitise only part of their savings in order to leave the remainder invested or they may wish to delay purchasing an annuity beyond age 75.

2.9 While promoting greater flexibility, the Government also wishes to ensure that people do not exhaust savings prematurely in retirement and fall back on the state, or use pension saving as a tax-privileged means for passing on wealth. There is a balance to be struck between greater flexibility, managing fiscal risks and ensuring that people have good retirement outcomes.

2.10 The Government intends to reform the tax rules for retirement and death benefits in line with the following principles (**Box 2.A**):

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

1. The purpose of tax-relieved pension saving is to provide an income in retirement.
2. Any changes to the pensions tax rules should not incur Exchequer cost and should not create any opportunities for tax avoidance.
3. Individuals should have the flexibility to decide when and how best to turn their pension savings into a retirement income, provided that they have sufficient income to avoid exhausting savings prematurely and fall back on the state.
4. In line with the EET model, pension benefits taken during an individual's lifetime should be taxed at income tax rates. The tax-free pension commencement lump sum will continue to be available.
5. On death, pension savings that have been accumulated with tax relief should be taxed at an appropriate rate to recover past relief given, unless they are used to provide a pension for a dependant.

2.11 The remainder of this chapter sets out the Government's proposals for translating these principles into a new tax framework for retirement.

Options for securing a retirement income

2.12 The Government's objective is to make private pension saving more attractive by giving individuals greater choice over how they can provide a retirement income for themselves.

[7] in this context, a "dependant" broadly is a spouse or civil partner, or a child under 23.

2.13 Many people will continue to choose an annuity as the best way of securing an income in retirement and insuring themselves against longevity risk. From April 2011, there will no longer be a specific age by which people effectively have to annuitise. This will give people who wish to buy an annuity greater flexibility in the timing of their annuity purchase.

2.14 The Government will also create more flexibility for people who do not wish to buy an annuity. USP currently allows individuals to take a tax-free lump sum at the beginning of their retirement if they wish, keeping funds invested in a tax-exempt environment while drawing down an income from their remaining pension pot in line with their needs, subject to a prudent drawdown limit. The Government will allow capped drawdown - equivalent to USP extended beyond age 75 - for the whole of an individual's retirement. This means that individuals will be able to choose how much to draw down annually from their pension pot throughout their retirement (subject to a capped limit), or whether to draw any income at all.

2.15 The Government will go further than capped drawdown by creating additional flexibility for individuals who wish to draw down more than the capped annual limit. Under this flexible drawdown model, individuals will be able to draw down unlimited amounts from their pension pot, provided that they can demonstrate that they have secured a sufficient minimum income to prevent them from exhausting their savings prematurely and falling back on the state. The requirement to demonstrate a minimum income will apply at the point at which an individual wants to exceed the annual capped drawdown limit. The Government wants to ensure that the requirement to secure a minimum income is transparent and fair and can be implemented without undue complexity or burdens on individuals or business. The design of this requirement is discussed in detail in Chapter 3.

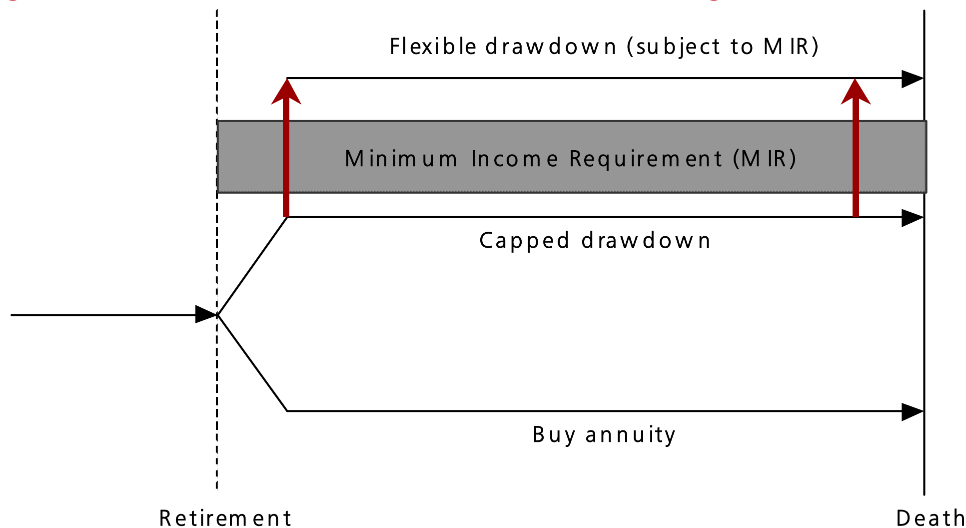
2.16 Both capped and flexible drawdown will increase flexibility for private pension savers before and after age 75. This will make it unnecessary to continue to offer ASP as an option after age 75. ASP will therefore cease to exist when new rules come into effect. The new capped and flexible drawdown limits and rules will apply to existing members of ASP from April 2011.

2.17 The annual USP limit (120% of the value of an equivalent annuity) was set in the context of the existing rules. The risk of running out of funds during drawdown increases with advancing age. The Government therefore intends to review whether the existing annual limit remains appropriate.

- The Government welcomes views on the level of an appropriate annual drawdown limit for capped drawdown

2.18 Figure 2.A illustrates the options that will be available following the proposed changes.

Figure 2.A: Choice model for retirement income following reform



Source: HM Treasury

2.19 The removal of the age 75 limit means that individuals will not be restricted to a single option and will be able to make different choices about their retirement income over time, while maintaining the principle that tax-relieved pension savings should be used to provide a retirement income. For example, an individual could choose to annuitise part of their pension pot and invest the remainder in a capped or flexible drawdown arrangement in order to benefit from more flexibility and investment growth. Conversely, an individual could enter a capped drawdown arrangement upon retirement and could decide to purchase an annuity at a later date in order to secure a guaranteed income for life.

2.20 Box 2.B sets out some sample case studies.

Box 2.B: Sample case studies

Case 1.

Mr A retires aged 65 with a DC pension. He decides to take 25% of his pot as a tax-free lump sum upon retirement and invests the remainder in a capped drawdown arrangement. At age 75, Mr A decides to draw down a lump sum in order to make urgent repairs to his house. This requires him to secure a minimum income. Mr A leaves the balance of his fund invested until his death at age 85. After deducting a tax relief recovery charge, the unused funds remaining in his capped drawdown arrangement are passed on as a lump sum to his dependants.

Case 2.

Mrs B decides to continue working until age 68, building up a DC pension fund. Upon retirement, she takes a 25% tax-free lump sum and invests the remainder of her fund in a capped drawdown arrangement, as she is able to meet her income needs from other sources. At age 77, she has exhausted her other assets and decides to convert the balance of her capped drawdown fund into an annuity, giving her a secure income for the rest of her life.

Case 3.

Mr C takes out a value-protected annuity at age 70. He dies at age 76, having received benefits worth less than the initial value of his fund. His wife receives a value protection lump sum equivalent to the difference, less deduction of a tax relief recovery charge.

Designing a new tax framework for retirement

2.21 Under the UK's EET system, tax relief is available on pension contributions and on investment growth, and pension income is taxed in retirement. This means that pension saving is mainly tax-deferred, rather than tax-free. Tax relief nevertheless acts as a significant incentive to save into a pension, since relief is granted immediately to an individual's pension scheme and accrues while the pension is building up. Individuals are also able to take up to 25% of their total pension pot as a tax-free lump sum. Many individuals also pay income tax at a lower marginal rate in retirement than they did during their working life and benefit from higher personal allowances.

2.22 Consistent with the mainly tax-deferred nature of pension saving, it is important that pension benefits continue to be taxed at a rate which reflects the value of relief given and which ensures that the cost of providing tax relief remains sustainable. The Government intends that:

- pension benefits drawn down under the new, more flexible arrangements will continue to be taxed at income tax rates. (The tax-free pension commencement lump sum will continue to be available);
- any unused funds remaining upon death will be taxed at a rate designed to recover past relief given unless they are used to provide a dependant's pension. (In this case, the pension will be taxed as income of the dependant in the normal way). The Government expects that an appropriate recovery charge will be around 55%;
- to make the new framework as simple as possible, the Government intends that the recovery charge should generally apply to all death benefits. However, death benefits for those who die before age 75 without having accessed their pension savings will remain tax-free; and

- inheritance tax will not ordinarily apply to unused pension funds remaining after death in addition to the recovery charge. However, the Government does not intend pensions to become a vehicle for the accumulation of capital sums for the purposes of inheritance. The Government will therefore ensure that the tax rate on unused funds remaining on death does not leave open incentives for pension saving to be used to reduce inheritance tax liabilities. The Government will monitor this closely and will take further action if there is evidence of such activity.

2.23 Further detail on proposed tax charges will be published in draft legislation later in the year.

2.24 There are a number of pensions tax rules which refer to age 75 but which are not directly linked to the requirement to purchase an annuity:

- 75 is the latest age at which tax relief is available on pension contributions;
- at 75, an individual's pension savings must be tested against the Lifetime Allowance (LTA); and
- pension commencement lump sums, trivial commutation lump sums and value protection lump sums are currently not available after age 75.

2.25 The Government does not propose to make any changes to the contribution limit, to the age at which the LTA test must be conducted or to the lump sums associated with these rules.[8] These rules use age 75 as a proxy for the end of an individual's working life and age 75 remains a reasonable proxy. However, the Government proposes to remove the age 75 limit on value protection lump sums,[9] pension commencement lump sums and trivial commutation lump sums.[10]

- The Government welcomes views on its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity by age 75

[8] i.e. the short service refund lump sum; refund of excess contributions lump sum; lifetime allowance excess lump sum.

[9] i.e. the pension protection lump sum death benefit and annuity protection lump sum death benefit.

[10] i.e. the trivial commutation lump sum; trivial commutation lump sum death benefit; winding up lump sum; and commutation payments prescribed in the Registered Pension Schemes (Authorised Payments) regulation) SI 2009/1171.

3 Minimum Income Requirement

3.1 The objective of the new tax framework set out in the previous chapter is to give individuals greater flexibility over the use of their pension savings. This will allow them to choose retirement options that are best for them.

3.2 An individual with a capped drawdown arrangement will be able to withdraw up to a maximum amount every year.[11] Under the new rules, an individual will also be able to access flexible drawdown – capped drawdown without the maximum annual withdrawal limit. This additional flexibility will be available to individuals who can demonstrate that they will not be able to exhaust their pension savings prematurely and subsequently fall back on the state.

3.3 The Government proposes that this should be achieved by satisfying a Minimum Income Requirement (MIR). An individual who can demonstrate a sufficient level of secure income will be able to access flexible drawdown.

3.4 There are a number of factors that need to be considered in designing the MIR:

- what constitutes 'secure income';
- at what age the MIR can be met;
- the level of the MIR; and
- how the MIR should be assessed.

3.5 The Government wants to ensure that any minimum income test is transparent, fair, and can be implemented without undue complexity or burdens on individuals or business.

What constitutes 'secure income'

3.6 The purpose of the MIR is to ensure that an individual with more flexible access to their pension saving does not fall back on the state after exhausting these savings prematurely. As this additional flexibility applies to pension savings only, only pension income will be considered for the purposes of the MIR.

3.7 To be 'secure', this pension income should:

- be currently in payment (i.e. not a deferred entitlement);
- be guaranteed for life; and
- take into account reasonable expectations of the future cost of living.

3.8 Both a basic State Pension and additional State Pension in payment will therefore be considered towards the MIR. Scheme pensions in payment from an occupational pension that are uprated annually by a minimum of Limited Price Indexation (LPI)[12] will also allow be considered for the purposes of the MIR.

[11] the annual drawdown limit is a matter for consultation – see paragraph 2.17 for more details.

[12] LPI is a method of providing capped annual increases to pension income. Since 6 April 2005, pensions in payment (relating to service after that date) have to be uprated annually by the lesser of the annual increase in prices and 2.5%. Between 6 April 1997 and 5 April 2005, this cap was 5%.

3.9 The Government proposes that life annuity income should be allowed for the purposes of the MIR providing it increases annually by at least LPI, defined as for scheme pensions to be the lesser of the annual increase in prices or 2.5%. Both an index-linked life annuity and an escalating life annuity (with an annual percentage increase of 2.5%) satisfy this criterion.[13]

- The Government welcomes views on what income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate

At what age the MIR can be met

3.10 An individual will be able to enter capped drawdown from the age of 55. Since the MIR must be met to enter flexible drawdown, the Government proposes that an individual should be able to satisfy the MIR at any age from 55 until death.

The level of the MIR

3.11 The appropriate level of the MIR should protect the Exchequer from the risk of an individual falling back on the state. One option would be to set the MIR at the level of income above which an individual cannot claim means-tested benefits. However, this would not be straightforward; means-tested benefit entitlements are not based on income alone, but take into consideration other factors such as long-term care, disability and housing circumstances.

3.12 The level of the MIR should therefore be a reasonable proxy for an income level above which the likelihood of an individual prematurely exhausting their pension savings and falling back on the state is minimal. Some examples of possible measures of minimum retirement income are outlined in Table 3.A below:

Table 3.A: Measures of retirement income

	Guarantee Credit	Expenditure Needs (ONS)	Minimum Income Standard (MIS)[14]
Single	£132.60	£151.30 - £185[15] (before housing costs)	£147.41 (before housing costs)
Couple	£202.40	£337.70[16] (after housing costs)	£222.22 (after housing costs)

3.13 The MIR also has to prevent an individual from falling back on the state in the future. It must therefore make some allowance for:

- likely variation in expenditure levels in retirement; and
- possible future changes in benefit policy (including uprating).

3.14 There is a clear pattern to retirement expenditure levels, with the highest levels typically immediately at retirement (to smooth income) and in the last years of life, as health and care costs rise. Analysis by the Pensions Policy Institute concluded that ill health and disability (which affect up to 80% of retirees) add between £50 and £250 per week to expenditure needs.[17]

[13] the case of an individual with income already secured with a flat-rate annuity or pension wishing to have more flexible access to other, unsecured income will be dealt with in technical provisions at a later date.

[14] Minimum Income Standard, Joseph Rowntree Foundation, 2010.

[15] *Family Spending: a report on the 2007 Expenditure and Food Survey (ONS),* Office for National Statistics, 2008.Only available before housing costs.

[16] Joseph Rowntree Foundation (2008) using data from 2008 Expenditure and Food Survey & Office for National Statistics. Only available after housing costs.

[17] *Retirement Income and Assets: do pensioners have sufficient income to meet their needs in retirement?*, PPI, June 2009.

Research by the Centre for Economics and Business Research concluded that average peak expenditure levels during retirement were around £423 per week for single pensioners, assuming inflation of 2.5%.[18]

3.15 Uncertainty about future expenditure requirements (as well as future pensioner inflation and future means-tested benefit provision) diminishes with increasing age, all other things being equal. To reflect this, it therefore seems reasonable that the MIR should be higher for an individual of, say, 59 years than for one of, say, 80 years. Longevity risk does not need to be factored in to the different levels of the MIR at different ages since this is dealt with at the source of income (i.e. the scheme pension or lifetime annuity takes on longevity risk at the point the income is secured).

- The Government welcomes views on what an appropriate level for the MIR should be and how the MIR should be adjusted for different ages

3.16 The state pension system differentiates between single pensioners and pensioner couples, in recognition of their different income requirements. Changes of marital or civil partnership status, such as death or marriage, are reflected in corresponding changes to state benefit entitlements.

3.17 Although this would introduce additional complexity, a different MIR could be set for couples and single pensioners, allowing their different income requirements to be reflected in the MIR at the time of assessment. However, subsequent changes to income requirements following an event such as death or marriage could not be reflected (as in the state pension system), since securing an income is a one-off event.

- The Government welcomes views on whether a different MIR should be set for individuals and couples

3.18 The Government will set the level of the MIR and will review this level periodically.

- The Government welcomes views on how often the MIR level should be reviewed

How the MIR should be assessed

3.19 The Government wants to ensure that any minimum income test can be implemented without undue complexity or burdens on individuals or business. The MIR assessment will only be possible within a capped drawdown arrangement. The Government therefore proposes that an individual should have to provide sufficient evidence of their secured income to satisfy their drawdown provider that the MIR is met before the provider is able to release the funds.

3.20 HMRC may need to produce regulations relating to the information that individuals have to provide to schemes and that scheme administrators have to report to HMRC. Detailed draft guidance on compliance with information requirements will be published in advance of the new reforms coming into effect.

- The Government welcomes views on how to minimise unnecessary burdens for individuals and industry in the assessment of the MIR

[18] *Life Trust Cost of Retirement report*, CEBR, 2008.

4 The UK annuity market

4.1 The UK annuity market is the largest in the world; in 2009, 450,000 annuities were purchased at a total value of nearly £11bn.[19] Annuity sales are expected to grow significantly in the coming years as an increasing number of individuals with DC pensions enters retirement.

4.2 A significant challenge for both industry and Government is the negative perception of annuities among consumers. Research conducted by ORC International on behalf of the Association of British Insurers has shown that consumer understanding of annuities is limited.[20] There is a widespread misconception that the balance of an individual's pension fund remaining on early death represents a profit on the part of the provider whereas, in fact, it is used to pay the annuity income of those who live longer than expected. This 'mortality cross subsidy' is one of the reasons why annuities can offer a guaranteed income for life.

4.3 The negative perceptions surrounding annuities have been exacerbated by the decline of annuity rates in recent years. The average annuity rate that a 65-year-old man could obtain fell from 11% to 7% between 1994 and 2007.[21]

4.4 The primary reasons for these falls are declining interest rates (which fell from 8% to 5% during the same period) and increasing longevity. A study by Cannon & Tonks concluded that the money's worth of annuities[22] between this period remained at around 90%. This represents good value in comparison with other insurance products.

4.5 The Government recognises this value and believes that annuities remain an effective form of insurance against the risk of outliving life expectancy. However, the Government also believes that a diversified and innovative market gives individuals the ability to make choices appropriate to their needs and that barriers to a more innovative and flexible market should be removed where possible.

4.6 The diversification that has taken place in the UK annuity market in recent years demonstrates the demand for a wider range of products and the ability of the market to supply them. Annuities exist in the UK that protect against inflation, provide payments to the surviving partner and where the annuity rate is linked to investment performance.

4.7 'Enhanced' annuities, introduced in 1995, pay a higher rate to people with health problems. The market for these products quadrupled in size in the decade to 2009, when sales reached £1.8 billion. As a percentage of total annuity sales, the market share of enhanced annuities more than doubled between 2001 and 2010, from 7.8% to 16.9%.[23]

4.8 The removal of the existing age 75 rules presents the Government with an opportunity to examine where other restrictions might be usefully removed. As individuals are able to work longer and more individuals save into DC pensions, existing restrictions will affect an increasing

[19] Association of British Insurers.

[20] *The Pension Annuity Market, Consumer Perceptions*, ORC International, 2005.

[21] *Money's Worth of Pension Annuities*, Cannon & Tonks, DWP, 2009.

[22] the 'money's worth' is the expected present value of the flow of payments made by the annuity divided by the actual price paid. This would be 100% if the annuity provider had no administrative costs and made no profit on the sale.

[23] Towers Watson, March 2010.

number of people. An example of such restrictions is the age 75 limit on the annuity protection lump sum death benefits, which the Government proposes to remove as part of these reforms.

- The Government welcomes views on whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks

4.9 Changes to the existing annuitisation rules provide an opportunity for greater innovation in the market. They also provide an opportunity to focus attention on the value of annuities and the importance of consumers making informed choices tailored to their needs.

4.10 It is Government policy that individuals can shop around for an annuity rather than remaining with the provider with whom they make their pension savings. Exercising the Open Market Option (OMO) enables an individual to find the best annuity for their personal circumstances, potentially resulting in a significantly improved annuity rate.

4.11 Despite this, ABI research in 2006 reported that almost two-thirds of annuitants arranged their annuity with their existing provider. Barriers to external purchase do exist for consumers with smaller pension funds but financial capability and awareness also play a significant role. The OMO review group was established in 2007 to help raise awareness of the OMO and to make recommendations on how to encourage and facilitate shopping around for the most appropriate product.

4.12 As more individuals save into DC pensions and more annuity products become available, it is important to ensure all individuals are able to make appropriate choices about their retirement income. The industry will have an important role to play in supporting savers to make sound and responsible decisions and ensuring they access suitable and competitive annuity products. The Government and the new Consumer Financial Education Body (CFEB) will also play a key part in this through the new national financial advice service and annual financial healthcheck, which will be available from next spring.

- The Government welcomes views on how the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75

4.13 In addition to the consumer issues discussed above, the Government continues to work with industry to ensure a suitable context in which the industry can thrive. The Government is therefore actively working with industry on the ongoing Solvency II negotiations to avoid the potentially harmful effect on the UK annuity markets of capital requirements that disregard the liquidity premium. In the light of the importance the Government attaches to the annuity market and its role in the UK economy, it is also important to understand the effects of the proposed reforms to existing annuitisation rules.

- The Government welcomes views on whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities

5 How to respond to the consultation

5.1 The Government welcomes responses to the questions raised in this consultation; these are summarised in Annex A. Respondents are encouraged to add any additional information they feel is relevant to the practicalities of implementing the removal of the effective requirement to purchase an annuity by age 75.

5.2 The Government also welcomes comments on the consultation stage Impact Assessment, attached in Annex C.

5.3 Responses to this consultation should be sent by 10 September 2010 to:

> Age 75 consultation
> Pensions and Pensioners Team
> Room 2/SE
> HM Treasury
> 1 Horse Guards Road
> London, SW1A 2HQ

Alternatively, please send responses by e-mail to age75@hmtreasury.gsi.gov.uk.

5.4 Queries or questions about the policy details in this consultation document should be directed to Jonathan Deakin at HM Treasury on 020 7270 5675.

Consultation process

5.5 This consultation is being run in accordance with the Code of Practice on Consultation, although it has been necessary for it to run for 8 weeks instead of the normal 12 weeks. The start date has been largely determined by the timing of the June Emergency Budget and the closing date has been set to allow time to take full account of the responses before publishing draft legislation in the autumn.

5.6 To ensure that people are able to contribute as fully as possible to this consultation HM Treasury will be holding a series of meetings with interested parties during the consultation period. To register interest in attending, please email age75@hmtreasury.gsi.gov.uk by 1 August 2010. Details will be e-mailed shortly afterwards.

5.7 A copy of the Code of Practice criteria and a contact for any comments on the consultation process can be found in Annex E.

5.8 The consultation is also being conducted in line with the principles outlined in the document *Tax policy making – a new approach* published by HM Treasury alongside the Emergency Budget.[24] The document sets out three stages for policy development:

[24] http://www.hm-treasury.gov.uk/d/junebudget_tax_policy_making.pdf

- stage 1 - set out objectives and identify options;
- stage 2 - determine the best option and develop a framework for implementation, including detailed policy design; and
- stage 3 - draft legislation to effect the proposed change.

5.9 This consultation is taking place during stage 2 of the process. The purpose of the consultation is to seek views on how best to implement the commitments made in the June Emergency Budget on removing the effective requirement to purchase an annuity by age 75.

Confidentiality

5.10 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

5.11 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, among other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury or HM Revenue and Customs (HMRC).

5.12 HM Treasury and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

A Summary of questions

The Government welcomes views on the following:

Developing a new tax framework for retirement (Chapter 2)

A.1 The level of an appropriate annual drawdown limit for capped drawdown.

A.2 Its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity at age 75.

Minimum Income Requirement (Chapter 3)

A.3 What income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate.

A.4 What an appropriate level for the MIR should be and how the MIR should be adjusted for different ages.

A.5 Whether a different MIR should be set for individuals and couples.

A.6 How often the MIR level should be reviewed.

A.7 How to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.

The UK annuity market (Chapter 4)

A.8 Whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks.

A.9 How the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75.

A.10 Whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.

B International comparisons

B.1 This annex provides details of the safeguards that exist in Canada and Ireland (both countries have an EET pensions tax model) that protect against exhausting pension savings prematurely and ensure pension savings are used to provide an income in retirement.

Canada

B.2 Individuals saving into a Registered Retirement Savings Product (RRSP) have to convert their RRSP into an annuity or a Registered Retirement Income Fund (RRIF) by 31 December of the year in which they turn 71.[25] Once an RRSP has been converted into an RRIF, further contributions cannot be made.

B.3 A pre-determined minimum amount must be withdrawn from the RRIF every year to ensure that pension savings are used to provide a retirement income. This minimum amount is calculated on January 1 of each year according to a formula provided in the Income Tax Act and unlimited withdrawals in excess of the minimum amount may be made at any time. All withdrawals are subject to income tax, with withdrawals in excess of the minimum amount subject to income tax withheld at source.

Ireland

B.4 Prior to 1999, pensioners were effectively forced to purchase an annuity at retirement. The Finance Act 1999 introduced Approved Retirement Funds (ARFs); these provide certain individuals with flexibility over the withdrawal of capital in retirement. An ARF is managed by a Qualifying Fund Manager (QFM[26]) and may invest in a wide range of assets, subject to certain restrictions introduced in the Finance Act 2003.

B.5 Eligibility for an ARF is dependent on either satisfying a minimum income requirement or on setting aside a fixed amount of money until a given age. If the retiree does not have a total guaranteed pension or income for life of at least €12,700 per annum (the minimum income requirement), then at least €63,500 must be placed in a Approved Minimum Retirement Fund (AMRF).[27] After investing in an AMRF (or satisfying the minimum income requirement), the individual can take the balance of the accumulated funds or invest in one or more ARF(s). However, an AMRF may not be drawn down to less than €63,500 until age 75.

B.6 Up to 25% of the accumulated fund may be taken as a tax-free lump sum at retirement and investment income and capital gains within ARFs and AMRFs are tax-free. An annual income tax charge applies on the values of the assets invested in an ARF (3% from 2010[28]). Any actual withdrawals from the ARF are offset against this charge and income tax is payable on withdrawals of capital and interest within the holder's lifetime.

B.7 On death, funds held in an ARF or AMRF form part of an individual's estate and are passed on to dependants.

[25] since 2007. Before 2007, an RRSP had to be converted into an RRIF by the age of 69.

[26] many institutions may act as a QFM, including banks, building societies, credit unions, investment managers and life assurance companies.

[27] the State Pension, an annuity or an occupational pension may be considered towards the minimum income requirement.

[28] for ARFs created on or after 6 April 2000. AMRFs are not affected by this tax charge.

Impact Assessment

Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury	Impact Assessment of removing the requirement to annuitise by age 75	
		Date: 15 July 2010

Related Publications: Removing the requirement to annuitise by age 75
Emergency Budget 2010

Available to view or download at:

http://www.hm-treasury.gov.uk/consult_liveindex.htm

Contact for enquiries: Adam Wreglesworth **Telephone:** 0207 270 5043

What is the problem under consideration? Why is government intervention necessary?

The current pensions tax rules require individuals to secure a retirement income by age 75, in most cases by purchasing an annuity. The Government has committed to ending these rules with effect from April 2011. These changes will support the Government's wider objective to reinvigorate private pension saving by allowing members of Defined Contribution pension schemes more flexibility and choice in deciding what to do with their pension savings.

What are the policy objectives and the intended effects?

The primary objective of the policy is to give individuals saving into Defined Contribution pension schemes greater flexibility over how they provide an income from their savings in retirement.

At the same time, the Government recognises that a safeguard is needed to ensure that individuals do not run out of savings prematurely in retirement and fall back on the state.

The Government also wants to ensure that changes do not incur Exchequer cost and do not create opportunities for tax avoidance, or cause excessive burdens for individuals or industry.

What policy options have been considered? Please justify any preferred option.

The consultation sets out changes to the pensions tax rules that are necessary in order to remove the effective requirement to purchase an annuity by age 75. The consultation invites views on:

- how an appropriate safeguard should be designed to ensure that individuals do not run out of pension savings prematurely and fall back on the state;
- how the UK annuities market could benefit from more flexibility, and whether there are any unintended consequences for the annuities market from the proposed changes.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

This impact assessment will be reviewed and updated in light of responses to the consultation.

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:

....Date: 15/07/2010

Summary: Analysis & Evidence

Description: Changing key tax charges and rules that create an effective requirement to annuitise pension savings at age 75

COSTS

ANNUAL COSTS	
One-off (Transition)	**Yrs**
£ 7m	-
Average Annual Cost (excluding one-off)	
£ 2m	**10**

Description and scale of **key monetised costs** by 'main affected groups'

One-off and annual costs to pension schemes assume a proportion of schemes will opt to revise their scheme rules and make minor but necessary changes to their systems to offer members greater flexibility beyond age 75.

Total Cost (PV) **£ 22m**

Other **key non-monetised costs** by 'main affected groups'

There may also be other currently unidentified compliance costs which have not been factored into the estimates above. The views of interested parties are sought.

BENEFITS

ANNUAL BENEFITS	
One-off	**Yrs**
£ -	-
Average Annual Benefit (excluding one-off)	
£ Small	

Description and scale of **key monetised benefits** by 'main affected groups'

The measure is broadly deregulatory and will increase flexibility for pension savers, although the benefits are difficult to quantify.
The Government expects small scale benefits for pension schemes as a result of not having to monitor the existing rules, which should offset and could exceed the quantified costs.

Total Benefit (PV) **£ Small**

Other **key non-monetised benefits** by 'main affected groups'

- Flexibility for DC scheme members, currently 7.8m and will rise with auto-enrolment;
- More innovation possible for annuity providers and consequently more consumer choice.

Key Assumptions/Sensitivities/Risks

Details of the quantified compliance costs are provided in the Evidence Section below.
Views from interested parties are welcome as part of the consultation process.

Price Base Year 2010	Time Period Years 10 yrs	**Net Benefit Range** (NPV) **£ Unquantified**	**NET BENEFIT** (NPV Best estimate) **£ Unquantified**

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			April 2011	
Which organisation(s) will enforce the policy?			Providers, HMRC	
What is the total annual cost of enforcement for these organisations?			£ n/a	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			N/A	
What is the value of the proposed offsetting measure per year?			£ n/a	
What is the value of changes in greenhouse gas emissions?			£ n/a	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £ Negligible | Decrease of £ | **Net Impact** £ Negligible

Key: Annual costs and benefits: Constant Prices | (Net) Present Value

Evidence Base (for summary sheets)

Introduction

1. This document should be read in conjunction with the consultation document *Removing the Requirement to Annuitise by Age 75*, which sets out the Government's proposed policy and consultation questions around removing the obligation to secure a retirement income by age 75. This announcement was made in the Emergency Budget 2010.

2. The consultation period begins on Thursday 15 July 2010 and remains open for 8 weeks. Following this period, draft legislation will be published in autumn 2010. Final legislation will apply from April 2011.

3. Responses to this impact assessment and the related consultation document can be directed to HM Treasury at: age75@hmtreasury.gsi.gov.uk.

Why has the Government decided to intervene in this policy area?

What is the existing policy?

4. Currently, pension saving is treated for tax purposes on an 'Exempt, Exempt, Taxed' basis (the EET model). This means that savings into registered pension schemes and any investment growth of funds within them are exempt from tax. On retirement, individuals are also able to take up to 25% of their pension fund as a tax-free lump sum (subject to scheme rules). Pension benefits drawn from the remaining fund are taxed as income.

5. Tax relief was worth £18.9bn (net) in 2008/09.[1] Current tax rules mean that an individual must secure an income from pension savings in a registered pension scheme by age 75.

6. For Defined Benefit (DB) scheme members, this will mean receiving an income from their pension scheme. For a Defined Contribution (DC) scheme member, the individual has a degree of choice. Before age 75, they can choose to purchase an annuity or enter an unsecured pension (USP) arrangement. At age 75, those individuals in a USP can then either opt to purchase an annuity, or enter into an alternatively secured pension (ASP) arrangement. Both USP and ASP place limits on the funds that can be drawn down annually, with narrower limits in the case of ASP.

7. The age 75 limit is also reflected in the varying tax charges that apply to death benefits, summarised as follows:

    - if an individual dies before age 75 and has not taken any income from their pension fund, the entire fund can be paid out as a tax-free lump sum;
    - if an individual dies before age 75 under a USP arrangement, any unused funds can be paid out as a lump sum, taxed at 35%. Ordinarily there is no inheritance tax (IHT) charge; and
    - if an individual dies after age 75, there are no authorised death benefit lump sums unless funds are used to provide a dependant's pension or donated to charity.[2] If an individual dies after age 75 and is in an ASP arrangement, any unused funds are subject to an unauthorised payment charge of 70%, and IHT may also be chargeable on the remainder to give a maximum potential tax charge of 82%.

What is the rationale for change?

8. While the Government believes tax-relieved savings should be used to provide an income in retirement, the current rules are unnecessarily restrictive.

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[1] HMRC, source: http://www.hmrc.gov.uk/stats/pensions/index.htm.
[2] In this context, a "dependant" broadly is a spouse or civil partner, or a child under 23.

9. The existing rules were set in 1976, when far fewer people were saving into a DC pension, and life expectancy was significantly lower. As people live longer and work longer, and more people save into DC pensions, the existing rules will become increasingly restrictive for an increasing number of people.

10. The Government has announced that it will end the effective requirement to purchase an annuity by age 75. The consultation invites views on how this commitment can best be implemented to provide greater flexibility beyond age 75, while still ensuring individuals have secured at least a minimum income from their savings.

What are the principles for designing a policy to achieve the above?

11. The Government intends to reform the pensions tax rules in line with the following principles:
    - the purpose of tax-relieved pension saving is to provide an income in retirement;
    - any changes to the pensions tax rules should not incur Exchequer cost and should not create any opportunities for tax avoidance;
    - individuals should have the flexibility to decide when and how best to turn their pension savings into a retirement income, provided that they have sufficient income to avoid exhausting savings prematurely and falling back on the state;
    - in line with the EET model, pension benefits taken during an individual's lifetime should be taxed at income tax rates. The tax-free pension commencement lump sum will continue to be available; and
    - on death, pension savings that have been accumulated with tax relief should be taxed at an appropriate rate to recover past relief given, unless they are used to provide a pension for a dependant.

12. The consultation document sets out the changes to the pension tax framework that the Government believes are necessary to implement its commitment in line with these principles.

Summary of the model and views sought from stakeholders

13. The Government's proposals are briefly summarised below, with more substantive detail set out in the main consultation document:

    i. Following reform, the main options for taking an income in retirement will be as follows:
       - purchasing an annuity; or
       - enter a "capped drawdown" arrangement, which is similar to the existing USP but available beyond age 75. The Government invites views on the appropriate level for the annual drawdown cap for this new arrangement, since the risk of running out of funds during drawdown increases with advancing age.

       In addition, individuals who are in a capped drawdown arrangement and want to take more income than the permitted maximum annual limit will be able to draw down unlimited lump sums, subject to their having secured a minimum income ("flexible drawdown"). The option of an ASP will cease to exist.

    ii. The Government is proposing that amounts received by individuals under any of the above arrangements will be taxed at income tax rates. A single flat-rate recovery charge of around 55% is proposed to apply to unused lump sums remaining on death, designed to recover past tax relief. However, death benefits for those who die before age 75 without having accessed their pension savings will remain tax-free. Inheritance tax will not ordinarily apply to unused pension funds remaining after death in addition to

the recovery charge. The Government invites views on its intended approach to reforming the pensions tax framework.

iii. These changes will also see the introduction of a Minimum Income Requirement (MIR), which will need to be satisfied by individuals who wish to access the flexible drawdown option. The Government welcomes views on:

  - what income should be considered 'secure' for the purposes of the MIR and whether proposals for the lifetime annuity income that can be considered for the MIR are practical and appropriate;
  - what an appropriate level for the MIR should be and how the MIR should be adjusted for different ages;
  - the Government welcomes views on whether a different MIR should be set for individuals and couples;
  - how often the MIR level should be reviewed; and
  - how to minimise unnecessary burdens for individuals and industry in the assessment of the MIR.

iv. Finally, the Government expects these changes to enable greater product innovation, and therefore consumer choice, in the annuities market. Input from industry and other interested parties would be welcome as to:

  - whether other legislative or regulatory barriers remain, the removal of which could enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks for the Government;
  - how the industry, Government and advice bodies such as the Consumer Financial Education Body (CFEB) can work together to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75; and
  - whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities.

Key costs / benefits / risks

14. Given these proposals still have key areas that need to be determined, it is difficult to quantify fully the potential costs, and some of the benefits are difficult to quantify by their nature. The Government's initial view of the key effects is detailed below. The Government welcomes views on the assumptions made in this section, and acknowledges that cost and benefit estimates may vary depending on the final policy design.

Pension fund administrators and annuity providers

Benefits:

15. The overall impact of changes will be broadly deregulatory, as ending the age 75 rules will mean there is no longer a need to monitor customers with retirement funds who are approaching this age without having yet secured an income.

16. Removing ASPs, and the accompanying different tax charges, will simplify retirement options and tax treatment.

17. There will be an opportunity for greater product innovation by removing constraints around age 75. Providers will have the option to provide more product choices to their customers.

Costs:

18. The Government expects that compliance costs will be relatively low for the final policy. Providers will need to decide whether they wish to offer greater flexibility to their members under the new capped and flexible drawdown system, and so any costs will be incurred on a voluntary basis. However, over time the expectation is that a significant number of providers could choose to take advantage of the new rules and offer their members greater flexibility beyond age 75. This is expected to generate some one-off and recurring costs, as outlined below.

One-off set up costs:

19. The main one-off cost for providers arises in cases where they voluntarily opt to revise their existing scheme rules and systems to accommodate greater flexibility for members. The Government presumes that the majority of personal pension and SIPP providers will choose to take advantage of the new rules for the benefit of their clients – an estimated 600 providers.

20. In the case of occupational scheme providers – of which there are around 39,000 DC and 9,000 DB providers with active members – the expectation is that relatively few will choose to make the required changes to their rules in the short term.

21. It is estimated that around 10% of occupational DC schemes will choose to make changes in the short term (split evenly between large and small/medium sized schemes), although this figure is provisional and pending further evidence and views from those affected by the policy change.

22. This assumption is based on the fact that many providers may either choose not to offer the new flexibility, for example if they expect few members will wish to access it, or else could offer the new flexibility on a case-by-case basis without needing to change their scheme rules. Occupational pension schemes may also prefer their members to access additional flexibility through specialist providers. Therefore, the Government's provisional estimate is that the one-off costs will affect a relatively small number of schemes. The Government welcomes views from the industry on this assessment.

23. On this basis, the Government assumes around 2,000 large and 2,000 small/medium sized private occupational DC scheme providers will incur compliance burdens in the short term and annual costs on an ongoing basis.

24. It is difficult to predict the precise range or scale of costs in respect of those schemes that choose to make changes as a result of the new policy. However, as a basis for further discussion with the affected parties, it is assumed that only minor system changes will be required and that changes to scheme rules will be relatively straightforward in most cases. On this basis, the average one-off cost per scheme is assumed to be in the region of £1,000 for small and medium sized providers and £2,000 for large sized providers.

Steady state costs:

25. There are also likely to be some annual recurring costs for scheme providers that choose to offer greater flexibility to their members. The main costs for scheme providers will relate to the MIR. The precise scale of any such costs will depend on the final policy, and Government invites views on the potential burdens on industry as part of the consultation.

26. However, at a minimum, it is assumed that providers will need to satisfy themselves that their members who opt for more flexible pension arrangements will meet the MIR conditions. Handling these requests will create administrative costs for providers.

27. The burden of providing the relevant evidence to providers will fall on the individuals who wish to access flexible drawdown. The Government estimates that providers will need to perform this function in respect of around 3,000 individuals approaching age 75 per annum and a further 5,000 between ages 55 and 75 – giving a total of approximately 8,000 individuals per annum. However these numbers could vary significantly depending on

what the final MIR level is set at. The average annual cost to schemes is assumed to be £500 per case.

28. On this basis, Table 1 below summarises the Government's initial view of compliance costs arising from the policy measure. Total one-off compliance costs are estimated at around £7m, while annual (recurring) costs are estimated at around £2m per annum. The views of interested parties are sought on the estimated scale and composition of compliance costs.

Table 1: Summary of Scheme Compliance Costs

	Number Affected	**Average Costs**		**Total Cost**	
		One-off	**Annual**	**One-off**	**Annual**
Personal Pension Providers*	250 (small/medium**)	£1,000	£1,000	£250,000	£250,000
	350 (large**)	£2,000	£1,000	£700,000	£350,000
Occupational Scheme Providers	2,000 (small/medium**)	£1,000	£500	£2m	£500,000
	2,000 (large**)	£2,000	£500	£4m	£1m
Total				**£6.95m**	**£2.10m**

Notes:

*HMRC data shows there are over 7 million individuals with personal and stakeholder pensions, of which a small minority will be impacted by the measure. These individuals are spread across an estimated 500 providers. There are also around 100 SIPP providers.

** Size distributions are based on ONS estimates of membership – small schemes are defined as having fewer than 12 members, medium between 12-999 members, and large over 999 members.

29. Although the lead-in time for proposed changes is relatively short, the changes give flexibility to scheme managers and trustees in applying the new rules. They can choose whether or not to change their overall scheme rules, and offering the new flexibility to scheme members remains a decision for individual providers. Over the longer-term, it is expected that increasing numbers of schemes could gradually implement rule changes.

Individuals

Benefits:

30. Individuals saving into a DC pension will benefit from additional flexibility in a number of respects:

- there will no longer be a specific age by which individuals need to secure a retirement income;
- the option of entering a capped drawdown arrangement will be available indefinitely for those who do not wish to purchase an annuity; and
- additional flexibility will be available for those who wish to draw down more funds than the capped drawdown limit allows, subject to meeting the MIR.

This additional flexibility gives rise to both short-term and long-term benefits.

31. *Short-term*: Estimates suggest that around 3,000 people immediately approaching retirement and a further 5,000 aged between 55 and 75 will benefit from the new flexibility

for pension savings.[3] However, these numbers will depend on the final level set for the MIR, since this will determine how many people will be able to access flexible drawdown if they wish to use it.

32. *Long-term:* over the longer-term, other savers in DC pension schemes could potentially benefit if they opt to take advantage of the new flexibility when they reach retirement age. 7.8 million people currently save into occupational or personal DC schemes.[4]

33. This number is likely to increase considerably as forthcoming private pensions reforms take effect. Auto-enrolment duties on employers, due to commence from 2012, could lead to 5-9 million people newly saving or saving more into a workplace pension scheme.[5]

34. The ability to remain in a capped drawdown policy beyond age 75 will mean fewer people are effectively forced to annuitise if they wish to continue in their existing arrangement.

35. Flexible drawdown will give much improved flexibility for those who can satisfy the MIR. In the longer-term, more flexibility may generally improve the perception of pension saving, as more options for use of retirement savings will exist than at present. Providers will be able to be more innovative in the products they offer, giving the consumer more choice and the ability to tailor investment products more closely to their retirement income needs or preferences.

Costs / risks:

36. Providers may charge consumers for the benefit of accessing the new flexibility with their savings.

37. It is possible that the rules and tax changes, combined with changes to products offered by providers, could increase costs more generally across pension and annuity providers, leading in turn to slightly higher charges for their customers.

38. By having more choice over the use of their retirement savings, individuals may be more open to investment risks, for example by staying in a drawdown product for longer when they may previously have bought an annuity, which is a guaranteed income for life.

The Exchequer

39. The Government intends that the measure should not incur Exchequer cost. In line with the EET model of pensions taxation, the Government intends that pension benefits taken will continue to be taxed at income tax rates, and that charges on death benefits will be set in order to recover the value of past relief.

40. The Government will monitor future developments and will take further action if there is evidence that pension saving is being used to reduce inheritance tax liabilities or if the reforms trigger any unforeseen avoidance activity.

HMRC

41. The Government does not expect the measure to have a significant ongoing operational impact and cost for HMRC.

42. It is anticipated that there will be some one-off costs for HMRC. HMRC will need to modify the Accounting for Tax system for online filing of income tax liabilities by registered pension schemes. Changes to the Self Assessment system may also be necessary, as will consequential changes to the online Event Report for pension schemes. Apart from IT costs, it is anticipated that there will be additional costs from communicating the reforms,

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[3] HMRC internal analysis.
[4] *Pension Trends*, Office of National Statistics, 2009.
[5] Department for Work and Pensions (DWP) – note that the private pension reforms are subject to an independent review commissioned by the Government, which is due to conclude in September 2010.

and handling extra queries from individuals, their advisers and from pension schemes. Current HMRC estimates are that these one-off changes will cost approximately £1m.

43. These cost estimates may vary depending on the final policy design that is implemented.

Summary of stakeholder views sought

44. The Government would welcome input and evidence as to the potential benefits, costs and burdens on individuals, government or industry in respect of any aspects of the policy design proposed. This is in addition to the specific policy questions set out in the consultation document.

The remainder of this section summarises any relevant details to the answers given in the checklist questions on page 2 (above).

Wider policy impact

Geographical impact

45. This measure applies for all of the UK.

Date policy will be implemented

46. Draft legislation for this measure will be published in the autumn, following the feedback from the consultation, and will be subject to further consultation.

47. Final legislation to remove the requirement to annuitise by age 75 will be legislated to apply from April 2011.

Which organisation(s) will enforce the policy and what are their costs?

48. Collecting tax and detection of tax avoidance is the responsibility of HMRC.

49. HMRC will continue to carry out risk-based compliance enquiries to check whether procedures are correctly carried out, which are standard under powers of collection and management of the tax system. It is not envisaged that HMRC would need any additional resources to monitor the new rules, once one-off guidance and systems changes are made.

50. It is intended that the MIR will be applied in such a way that it is the responsibility of individuals who wish to take advantage of additional flexibility to demonstrate that they can meet the requirement, with some burden on providers to administer this process.

51. The Government believes that it is reasonable to ask the individual who wants to use the new flexibility to provide the evidence that he or she is entitled to do so (i.e. that they meet the MIR). Providers can opt to charge customers that wish to access the additional flexibility.

52. Administrative burdens for the Government should therefore be low, since it will fall to schemes to satisfy themselves that the member has sufficient secured income - and to demonstrate they acted in good faith if it turns out the member did not have sufficient secured income.

53. However, the above will be subject to the final policy design being similar to that proposed.

Does enforcement comply with the Hampton principles?

54. The Hampton Review in 2005 set out principles for better regulation and enforcement by monitoring bodies.

55. It is not expected that this measure will create any increased regulatory burden on industry or individuals, and enforcement should not exceed that previously applied in taxing pension income.

56. The MIR will require an additional test. Individuals will need to provide evidence that they have sufficient qualifying income to meet the test, and providers offering flexible drawdown will need to satisfy themselves that the relevant test is met. HMRC may need to publish regulations relating to the information that individuals will have to provide to schemes and that scheme administrators have to report to HMRC, and will undertake relevant compliance activity. It is not expected that any other regulation will be required.

57. Overall, this measure will generally comply with the Hampton principles of reducing burdens of regulation, by reducing tax rules affecting pension schemes and individuals. New rules, such as the MIR, will not require significant new enforcement or regulatory processes.

Implementation and EU requirements

58. This measure is not in response to any EU Regulation, Directive or other instrument.

59. In designing the policy, consideration will be given to law concerning tax treatment of pension funds moved to other countries or territories and of individuals resident outside the UK. The Government will ensure taxes are consistent with any EU or international tax requirements as applicable to the final charge and taxation structure.

What is the value of the proposed offsetting measure per year?

60. As set out above, it is assumed that this measure will be broadly deregulatory since it removes the ASP arrangement and different tax charges, and removes restrictions around age 75. Although the MIR represents one new, additional rule, the emphasis will be on the individual to prove that they meet this requirement, minimising the burden on industry. Although a small administrative cost may arise for providers who decide to offer the new flexibility, this can be reflected in their charges to individuals.

Will the proposal have an impact on competition & the consumer?

61. Anecdotal evidence from the insurance and pensions industry suggests this measure will not have an adverse effect on competition.

62. The UK has the largest annuities market in the world. In 2009, 450,000 annuities were purchased at a total value of nearly £11bn.[6]

63. These measures may have some impact on overall levels of annuities purchased or the average value of annuities bought. This is because some people may choose to annuitise only up to the MIR level or stay in a capped drawdown arrangement beyond age 75, whereas previously they may have annuitised all of their retirement savings.

64. However, it is expected that the majority of pension savers will continue to buy an annuity at some stage in their retirement.

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[6] Association of British Insurers (ABI).

65. Early, anecdotal views from providers are that the age 75 measures will not negatively impact on product pricing to consumers, and may potentially improve annuity rates for many individuals. If the individuals who choose to make use of the new flexibility are also those who tend to live longer on average, this may improve annuity rates for the remaining market.

66. Improved flexibility means individuals can seek products most suitable for their lifestyles at different stages of their life, and according to their level of savings.

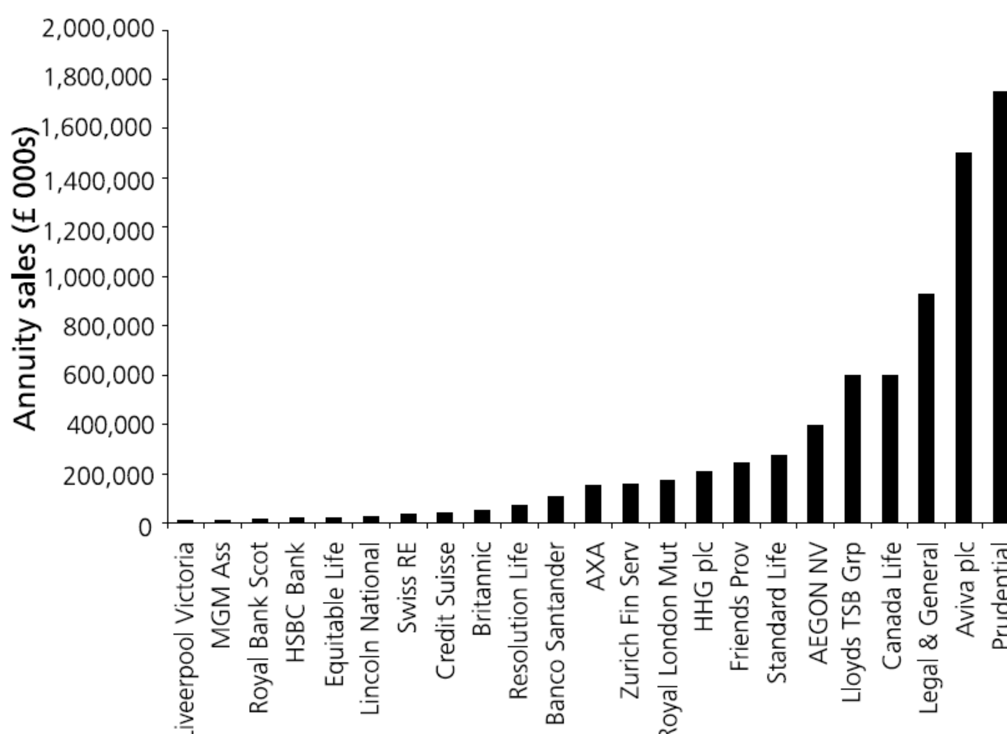
67. Removing the age 75 rules will create potential for more product innovation in the pensions industry. It is proposed that annuity guarantee products and value protection should be available beyond an individual's 75th birthday. Early discussions with providers suggest that these kinds of products could see a significant increase in take-up. This may help to address some of the negative perceptions that individuals may have in relation to annuities.

68. Overall, the competition effect is largely negligible, with small chance of a net positive effect if any. The Government would welcome views on this initial assessment.

Small and micro businesses

69. Small and micro businesses are unlikely to be affected by the changes. The annuities market is dominated by a number of large providers, as demonstrated by the chart below showing annuity sales by company. Between 2000 and 2006 the average combined market share for the largest 10 companies was 85%, with a high of 91% in 2004.[7]

Chart 1: Distribution of lifetime annuity sales across parent companies, 2005[8]



70. Smaller pension schemes should not be unduly burdened by the reforms – the single death benefit tax charge of around 55% (except for those who have not taken a pension before age 75) will simplify administration after a one-off change to systems. Small schemes do not have to provide flexible annuity products themselves, since members can transfer to other schemes to have access to such options if they wish.

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[7] ABI, *Pension Annuities*, Research Paper No. 8, 2008.
[8] Synthesis 2005, FSA Life Returns.

71. The Government welcomes views from smaller businesses in the pensions and annuities sector on the potential impact of the proposed reforms.

Annual costs for pension and annuity providers

72. Excluding one-off adjustments by organisations to the new measures, ongoing costs are estimated to be around £2m per annum across the industry – a relatively small cost.

73. Small or micro firms are not exempt from these changes, as it is not appropriate to do so. Smaller schemes and annuity firms will have the choice over whether they offer the new flexibility to their customers, and can choose whether or not they change their scheme rules. Where they do opt to make changes, ongoing costs are expected to be small and firms can always opt to charge customers for access to the additional flexibility option.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	No	Yes
Small Firms Impact Test	No	Yes
Legal Aid	No	Yes
Sustainable Development	No	Yes
Carbon Assessment	No	Yes
Other Environment	No	Yes
Health Impact Assessment	No	Yes
Race Equality	No	Yes
Disability Equality	No	Yes
Gender Equality	No	Yes
Human Rights	No	Yes
Rural Proofing	No	Yes

Annexes

A. Competition Impact Assessment

Will the proposal directly limit the number or range of suppliers?

A1. This measure has no direct bearing on the range of suppliers.

A2. Initial discussions with industry representatives have suggested there are no competition concerns among providers.

Could the measure indirectly limit the number or range of suppliers?

A3. As noted in the main impact assessment, costs to industry are estimated at around £7m in one-off costs, and just over £2m a year in recurring costs over the first 10 years of the new rules.

A4. Costs per scheme are estimated at between £1,000 and £2,000 in one-off costs, and £500 per annum thereafter. This is not considered likely to impact on competition or the ability of new businesses to enter the market.

A5. In addition, schemes can choose whether or not they allow their members additional flexibility, and so have choice in any costs they incur.

A6. The measures proposed are broadly deregulatory and should improve the potential for product innovation, and therefore more firms could provide a wider choice of financial retirement products.

Will the ability of suppliers to compete be limited?

A7. This measure broadens the scope to innovate with annuity and drawdown products without as many restrictions around age 75. In this respect, it may have a positive impact on competition in the annuity and income drawdown market.

A8. This should not prejudice any particular section of the market.

A9. Smaller investment and financial advice firms may benefit from more individuals being able to use their pensions savings flexibly, since this may increase the market for some specialist products and financial advice both before and after age 75.

Will reforms reduce suppliers' incentives to compete vigorously?

A10. There is no reason why this measure would reduce competition between providers.

Conclusion:

A11. This reform does not impact upon competition negatively. If anything the positive effect of greater innovation will offset small costs from the changes, which will be incurred equally across the industry. However, the Government welcomes views on this conclusion.

B. Small firms impact test (fewer than 20 employees)

Why are they included in the changes?

B1. These changes concern tax and pensions rules and the laws that apply to all individuals who have UK tax-relieved pension funds. Small firms cannot be exempt, but they will have the choice over whether to change their scheme rules. Firms do not have to offer the new flexibility to their customers.

Does the proposal affect small businesses, their customers or competitors?

B2. The Government does not foresee any specific effect on small businesses, their customers and competitors. There are small implementation costs caused by changes to tax laws, but these are not unduly burdensome on smaller schemes or providers compared with larger ones – as evidenced by an assumption of a £1,000 one-off cost to smaller schemes compared with a £2,000 one-off cost for larger pension providers.

What consultation has been carried out?

B3. The consultation document that this impact assessment accompanies provides the opportunity for all interested parties, including smaller firms, to respond to the proposals.

B4. The Government has not consulted specifically with small firms prior to this publication due to the negligible effects on small businesses that are anticipated.

Conclusion:

B5. This measure cannot exclude small businesses, but should have no detrimental impact on smaller firms compared with medium and larger businesses. The Government welcomes views from smaller businesses on this conclusion.

C. *Other impacts*

C1. In respect of the impact of these reforms on legal aid, sustainable development, health, rural areas, carbon levels, and the environment, the Government's assessment is that this measure will have no impact on these areas.

C2. In terms of potential effects on race, disability and gender equality it was concluded that proposed changes are not likely to have a significant impact. There is no reason to believe that this reform would affect people differently based on their equality group. There are also no human rights issues that these reforms would raise.

Conclusion:

C3. Given the above, the Government does not propose to undertake a full equality impact assessment. However, views are welcome on whether this measure could affect people differently because of their equality group.

D

Glossary

A-Day: 6 April 2006, when new pension legislation came into effect. As well as changing other aspects of the pension system, this legislation reduced numerous pensions tax regimes to one and introduced the *annual allowance* and *lifetime allowance.* See *Finance Act 2004.*

Alternatively Secured Pension (ASP): Enables the member or *dependant* to leave their pension fund invested while drawing down an income after reaching the age of 75. The maximum amount that can be drawn down each year is 90% of the amount of an equivalent *annuity*, the minimum drawdown limit is 55%.

Annuity: an insurance contract that guarantees to pay annual amounts for a fixed period. Pension annuities guarantee income for life.

Authorised lump sum death payment: These are the lump sum *death benefits* payable by registered pension schemes in respect of a member by reason of the member's death, which are listed in section 168 of *Finance Act 2004.*

Basic State Pension: a contributory benefit that can be received upon reaching *State Pension Age*, where the value of a person's entitlement is usually dependent on the number of qualifying national insurance contribution years accrued.[29]

Capped drawdown: a drawdown arrangement equivalent to a *USP*, but with the existing age 75 limit removed.

Death benefits: These are the pension death benefits, including lump sum death benefits, payable by a registered pension scheme under sections 167 and 168 of *Finance Act 2004*.

Defined Benefit (DB) scheme: a pension scheme where individuals accrue rights to a future pension. The benefit entitlement is determined typically by reference to a person's earnings and length of service within the pension scheme.

Defined Contribution (DC) scheme: a scheme where entitlement to benefits is wholly dependent on the contributions made to the scheme and investment return.

Dependant: The term "dependant" is defined in paragraph 15 of Schedule 28 of *Finance Act 2004.* It includes spouses and civil partners of the member, children of the member aged under 23 and other individuals who are financially or mutually dependent on the member.

EET model: Stands for "exempt, exempt, taxed". In this model for giving pensions tax relief, contributions are exempt from tax as are investment returns of the scheme. Retirement benefits paid by the scheme are, however, subject to income tax. (Individuals are, however, able to take up to 25% of their pension fund as a *tax-free lump sum* upon retirement, subject to scheme rules).

Enhanced annuity: An *annuity* that pays a higher rate because the annuitant has a shorter *life expectancy.*

Escalating annuity: an *annuity* whose payments rise over time by a fixed amount every year.

[29] the value of a full basic State Pension in 2010-11 is £97.65 a week

Finance Act 2004: an Act of the UK Parliament that introduced, among other things, the *alternatively secured pension* and the simplified pensions tax regime effective from *A-Day.*

Flexible drawdown: a drawdown arrangement equivalent to *capped drawdown*, but with no annual maximum withdrawal limit, accessible by satisfying the *Minimum Income Requirement*.

Guarantee Credit: a component of Pension Credit for households with someone aged over female *State Pension Age*. Guarantee Credit tops up income to the level of the standard minimum income guarantee.[30]

Index-linked annuity: an *annuity* whose payments rise over time in line with inflation or some other index.

Index-linked gilt: a security issued by the UK Government the yield from which rises over time in line with inflation.

Life expectancy: the length of time that an individual can expect to live.

Lifetime Allowance (LTA): the lifetime limit on the amount of tax-privileged pension saving to which an individual is entitled, including contributions made by employers or other third parties. The standard lifetime allowance is set at £1.8 million for 2010/11.

Limited Price Indexation (LPI): a method of providing capped annual increases to pension income. Since 6 April 2005, pensions in payment (relating to service after that date) have to be uprated annually by the lesser of the annual increase in prices and 2.5%.[31]

Liquidity Premium: the additional yield an investor may earn on an illiquid asset under stressed (and thus illiquid) conditions when there is little or no risk of the investor having to convert the investment into cash.

Longevity risk: the risk typically borne by annuity providers or pension funds of an unanticipated rise in longevity.

Marginal rate of relief: *tax relief* equivalent to the income tax rate the individual would have paid if the contribution were treated as their top slice of income.

Marginal rate of tax: an individual's highest rate of income tax in a tax year.

Minimum Income Requirement: the minimum level of income that will have to be demonstrated to access *flexible drawdown*.

Money purchase scheme: referred to as a *Defined Contribution scheme* in this document.

Money's worth: the expected present value of a product divided by the actual price paid.

Mortality: the probability of an individual dying over a given period of time.

Mortality cross-subsidy: the effect by which an annuitant who dies earlier than expected subsidises those who live longer than expected.

Occupational pension scheme: a trust-based scheme established by an employer to provide retirement benefits for employees.

Open Market Option (OMO): the option, open to any annuitant, to buy an *annuity* from any provider in the market.

Pension commencement lump sum: see *tax-free lump sum.*

[30] £132.60 a week for a single pensioner and £202.40 a week for pensioner couples (2010-11).

[31] between 6 April 1997 and 5 April 2005, this cap was 5%.

Pensions Commission: a commission set up in 2002 to review the UK private pension system and long-term savings, chaired by Adair Turner and reporting to the Secretary of State for Work and Pensions. The Pensions Commission published its final statement in 2006.

Personal pension scheme: any pension scheme that is not an *occupational pension scheme*. Unless otherwise specified, the term 'personal pensions' also refers to retirement annuity contracts and includes group personal pensions.

Scheme pension: a pension paid either by a *Defined Benefit* pension scheme or by an insurance company selected by the scheme administrator of a *money purchase pension scheme.*

Solvency II: EU Directive introducing modern and more risk-sensitive prudential regulation for insurers, scheduled to come into effect on 1 January 2013.

State Pension Age: the age at which an individual is able to claim their State Pension[32].

Tax-free lump sum: the benefits from a pension scheme that can be taken as a cash payment not subject to income tax. It must be paid in connection with an individual becoming entitled to draw an income from a pension scheme. Subject to scheme rules, this can normally be up to 25 per cent of the value of the pension fund. Also called the *pension commencement lump sum*.

Tax relief: A reduction in income tax liability resulting from incurring specified expenditure. For pensions, it means that tax can be reclaimed on pension contributions at the highest rate at which it is paid.

Trivial commutation lump sum: A lump sum benefit which can be paid to a member of a registered pension scheme (aged between 60 and 75) if all their pension entitlements are below 1% of the *lifetime allowance*. Members of *occupational pension schemes* can also be paid a trivial commutation lump sums if their total pension fund is worth less than £2000, regardless of other savings.

Unauthorised payment charge: a charge to income tax made on an unauthorised payment under the *Finance Act 2004*. The charge is made at a rate of 40% of the unauthorised payment.[33]

Unsecured Pension (USP): Enables the member or *dependant* to leave their pension fund invested while drawing down an income. The maximum amount that can be drawn down each year is 120% of the amount of an equivalent *annuity*. There is no minimum drawdown limit. A USP is currently only available until age 75, at which point remaining funds have to be used to purchase an *annuity* or enter an *ASP.*

Value protection annuity: an *annuity* that pays a lump sum on death (only before age 75 at present) equal to the original *annuity* purchase price less the gross payments to date. Subject to a tax of 35%.

Value protection lump sum: a lump sum *death benefit* paid following the death of a scheme member who died before age 75 and was in receipt of a *value protection annuity.*

[32] the State Pension Age is currently being equalised for men and women at 65 and the Government is currently reviewing when the State Pension Age will rise to 66.

[33] there is a further unauthorised payment surcharge at a rate of 15% on the member if the payment represents 25 per cent or more of the fund. An unauthorised payment is also subject to tax on the scheme administrator as a scheme chargeable payment. Such payments are generally liable to tax at a rate of 15%, unless the scheme administrator can demonstrate that it reasonably believed that the payment was not a scheme chargeable payment.

E The Code of Practice on Consultation

About the consultation process

This consultation is being run in accordance with the Code of Practice on Consultation, although it has been necessary for it to run for 8 weeks instead of the normal 12 weeks. The start date has been largely determined by the timing of the June Emergency Budget and the closing date has been set to allow time to take full account of the responses in drafting legislation. Draft legislation will be published ahead of Budget 2011.

The consultation criteria

1. When to consult - formal consultation should take place at a stage when there is scope to influence the policy outcome.
2. Duration of consultation exercises - consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
3. Clarity of scope and impact - consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
4. Accessibility of consultation exercise - consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
5. The burden of consultation - keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
6. Responsiveness of consultation exercises - consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
7. Capacity to consult - officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.
8. If you feel that this consultation does not satisfy these criteria, or if you have any complaints or comments about the process, please contact:

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