HM TREASURY

HM Revenue & Customs

Implementing the restriction of pensions tax relief

December 2009

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ISBN 978-1-84532-637-1
PU874

Basic Information

Subject of this consultation:	**The restriction of pensions tax relief for individuals on incomes of £150,000 and over, announced at Budget 2009.**
Scope of this consultation:	The implementation of the restriction of tax relief on pension contributions for individuals on incomes of £150,000 and over.
Impact Assessment:	A consultation stage Impact Assessment is attached as Annex E.
Draft Clauses:	A set of draft clauses on core aspects of this measure is available online at http://www.hmrc.gov.uk/pbr2009/index.htm
Who should read this:	Individuals with incomes of £150,000 and over, employers of these individuals, pension schemes and providers, tax and financial advisers, and all other stakeholders and individuals who have an interest in pensions taxation.
Duration:	The consultation will run for 12 weeks. The closing date for responses is 3 March 2010.
Enquiries:	Enquiries should be directed by e-mail to pensionstaxconsultation@hmtreasury.gsi.gov.uk. Additionally, for general enquiries regarding this consultation please contact Sarah Miller at HM Treasury, on 020 7270 5496; and for enquiries relating to the draft clauses please contact Paul Cottis at HM Revenue and Customs, on 0115 9742420.
How to respond:	Responses to the consultation should be sent either by e-mail to: pensionstaxconsultation@hmtreasury.gsi.gov.uk or by post to: Pensions tax consultation, Room 2/E2, HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ.
Additional ways to become involved:	HM Treasury and HM Revenue and Customs will be holding a series of stakeholder workshops during the consultation period. Please contact the pensions tax consultation team using the above e-mail address if you would like to attend one of these workshops or to discuss your response.
After the consultation:	The Government will consider responses to this consultation in determining the shape of legislation to restrict tax relief on pension contributions for individuals with incomes of £150,000 and over.
Getting to this stage:	Since the announcement of the restriction of pensions tax relief made at Budget 2009, HM Treasury and HM Revenue and Customs have worked in conjunction with the Government Actuary's Department (GAD), which has been advising on designing the methods for valuing deemed contributions. The Government has listened to the views of stakeholders through informal consultation with a number of representative bodies. The aim of these discussions has been to identify key issues in relation to the implementation of the restriction of pensions tax relief.

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1 Executive summary

1.1 Tax relief on pensions, estimated to be worth around £28.4 billion (2 per cent of GDP) in 2008-09, is provided to support pension saving and to help provide individuals with an income in retirement. Generous tax relief is provided to promote greater independence and wellbeing in later life, in recognition that pensions are less flexible than other forms of saving, and to encourage support from employers. The system of pensions tax relief is explained in more detail in Chapter 2.

1.2 The Government's aim is to deliver a system of pensions tax relief that is fair, affordable and sustainable. Countries do not generally offer limitless tax relief on pension savings, and few permit the same level as offered to individuals on high incomes in the UK. The cost of pensions tax relief in the UK has doubled over the last decade and the proportion of tax relief going to those on the highest incomes has risen markedly. The introduction of the additional rate of income tax of 50 per cent applying to individuals on incomes of £150,000 and over would have exacerbated this.

1.3 In the context of its commitment to halve public sector net borrowing over the next four years, the Government has therefore acted to ensure that pensions tax relief remains affordable. It has done so by addressing the disproportionate levels of relief going to individuals on incomes of £150,000 and over, so that individuals on the highest incomes will receive tax relief on pension contributions at the same rate as a basic-rate taxpayer.

1.4 To this end, the Government announced at Budget 2009 that, from April 2011, tax relief on pension contributions would be restricted for those with incomes of £150,000 and over. This restriction applies to all contributions, including employers' (which already count towards the annual and lifetime allowances).

1.5 The Government is clear that the restriction of pensions tax relief should apply as fairly as possible to individuals in different types of pension scheme and employment, and with different remuneration arrangements. As announced in the 2009 Pre-Budget Report, it has therefore decided that the restriction will apply to individuals on gross incomes of £150,000 and over, where gross income includes the value of any pension benefit funded by (or eventually funded by) their employers. This reduces distortions and unfairness otherwise caused by excluding the value of pension benefits provided by employers.

1.6 To provide certainty for individuals around whether they are affected, and to reduce administrative burdens for schemes, the Government is introducing a floor at £130,000 of pre-tax income (including an individual's own pension contributions, and charitable donations). Only individuals with incomes at or above this level will need to establish the value of the pension benefit funded by (or eventually funded by) their employers. So individuals with incomes (including the pension contributions they make themselves) of less than £130,000 are unaffected by this change. And the restriction will apply to 300,000 individuals, about 2 per cent of pension savers, or around 1 per cent of working-age taxpayers. These individuals currently receive around a quarter of tax relief on pension contributions.

1.7 A taper will apply for those on gross incomes between £150,000 and £180,000, gradually reducing tax relief on pension contributions until it is restricted to the basic rate (20 per cent). This restriction will apply to individuals' contributions and to any pension benefit (eventually) funded by their employer. The restriction of relief on pension contributions will be set at a rate determined by where individuals lie on the taper. Further details of how the restriction will apply are set out in Chapter 3. The restriction of relief will include anti-avoidance provisions.

1.8 As set out at Budget 2009, the Government is clear that all types of pension scheme should be treated fairly in comparison with one another. It is generally easy to identify the value of employee and employer contributions to a defined contribution (DC) scheme, whether occupational or personal. Within defined benefit (DB) schemes, employers commit to provide members with future pension rights, the level of which will typically be determined by their salary and length of service. To ensure consistent treatment across DB and DC schemes, a method is needed to value a deemed contribution on which to restrict relief for individuals in DB schemes.

1.9 The Government has identified three main valuation options – flat factors, cash equivalent transfer value (CETV), and age-related factors (ARFs) – and has assessed them against the two key principles of fairness and simplicity, as described in more detail in Chapter 4. The Government's view is that ARFs offer an appropriate balance between the objectives of fairness and simplicity, and a two-way ARFs scale varying with age and normal pension age (NPA) is the Government's preferred way of valuing the deemed contribution for individuals in DB schemes. Chapter 4 also considers other issues specific to DB schemes.

1.10 For most of the affected individuals on gross incomes of £150,000 and over, HM Revenue and Customs (HMRC) will collect a recovery charge reflecting the restriction of relief, using the Self Assessment process. Chapter 5 explains the existing ways that individuals receive tax relief on pension contributions and how the restriction of relief will be delivered.

1.11 The recovery charge that individuals affected by the restriction of relief will face is directly linked to the level of their contributions or deemed contributions in a given year. Where individuals build up particularly large pension entitlements in a year, the current levels of tax relief will be particularly high, so the charges from restricting pensions tax relief will be correspondingly large. Recognising this, the Government believes that it is appropriate to give individuals more flexibility over how they pay the charge. The Government proposes that individuals with the highest charges should have the option to elect for their pension scheme to pay the charge on their behalf, with schemes reducing their pension pot or accrued pension entitlement for that year by an equivalent amount.

1.12 Recognising that some individuals may not be able to take up the option for the scheme to pay, such as where they are in some overseas schemes or very under-funded DB schemes, the Government will also consider whether it may be appropriate to allow spreading of payments across three years in such circumstances.

1.13 The Government welcomes views on the questions raised in this consultation. Details of how to respond are set out in Chapter 6. A full list of questions being consulted on can be found in Annex A. A consultation stage Impact Assessment is attached as Annex E.

2 The taxation of pensions: current and future system

Chapter summary

The Government provides pensions tax relief to encourage and support pension saving to help individuals produce an income in retirement. Pensions have a more favourable tax treatment in order to encourage people to save, and to promote greater independence and wellbeing in later life. Pensions tax relief is also provided to recognise that pensions are less flexible than other forms of saving, requiring individuals to lock away their savings to produce a retirement income. Pensions tax relief is generous, estimated to be worth around £28.4 billion gross in 2008-09. The cost to the Exchequer net of income tax collected on pensions in payment has doubled since 1998-99. It also disproportionately benefits those on the highest incomes, with around a quarter of tax relief on pension contributions going to individuals with incomes of £150,000 and over in 2008-09.

The Government announced at Budget 2009 that, from April 2011, tax relief on pension contributions would be restricted for those with incomes of £150,000 and over, gradually tapered down until it is 20 per cent for individuals with incomes of over £180,000. This restriction applies to all contributions, including employers' (which already count towards the annual and lifetime allowances).

The Government is clear that the restriction of pensions tax relief should apply as fairly as possible to individuals in different types of pension scheme and employment, and with different remuneration arrangements. As announced in the 2009 Pre-Budget Report, it has therefore decided that the restriction will apply to individuals on gross incomes of £150,000 and over, where gross income includes the value of the pension benefit funded by (or eventually funded by) their employers. This reduces distortions and unfairness otherwise caused by excluding the value of pension benefits provided by employers.

To provide certainty for individuals around whether they are affected, and to reduce administrative burdens for schemes, the Government is introducing a floor at £130,000 of pre-tax income (including an individual's own pension contributions, and charitable donations). Only individuals with pre-tax incomes at or above this level will need to establish the value of the pension benefit funded by (or eventually funded by) their employers. So individuals with incomes (including the pension contributions they make themselves) of less than £130,000 are unaffected by this change. And the restriction will apply to 300,000 individuals, about 2 per cent of pension savers, or around 1 per cent of working-age taxpayers, who will continue to receive tax relief of at least 20 per cent on all pension contributions, and tax relief on all investment growth.[1]

Around 98 per cent of pension savers will not see their tax relief restricted by this change. The Government wishes to ensure that pensions tax relief is well targeted, to ensure that it is fair, affordable and sustainable. That is the purpose of this change.

[1] Provided that they do not exceed the existing annual allowance and lifetime allowance limits.

The purpose of pensions tax relief

2.1 The Government is committed to tackling pensioner poverty and promoting greater independence and wellbeing in later life. As a result of changes implemented by the Government, many of today's pensioners benefit from much improved standards of living. The Government spent over £13 billion more in 2008-09 on pensioners than it would have if the policies in place in 1997 had continued, with around half of this expenditure going to the poorest third of pensioners. Measures such as the Pension Credit have contributed to lifting 900,000 pensioners out of relative poverty since 1998. As a result of the Government's actions, pensioners are now no more likely to be in poverty than the population as a whole.

2.2 The Government has also legislated a package of reforms to both State and private pensions to meet the longer-term challenges facing the pensions system and an ageing population. The reforms include a simpler, more generous and widely available State Pension, which will provide a firm foundation on which individuals can save for their retirement. This, coupled with increases in the State Pension Age, will ensure that the system is sustainable in the face of demographic change.

2.3 While the State Pension system provides a firm foundation for saving for an income in retirement, many individuals have expectations for their lifestyle in retirement that exceed the level of provision the state can or should offer. However, evidence suggests that many individuals find it difficult to plan for and put money aside to meet future income requirements in the face of current financial demands. To help individuals in managing and meeting their aspirations for their retirement, and to reduce reliance on the state in later life, the Government encourages and rewards long-term saving through providing pensions tax relief. Building on this, and the recommendations of the Turner Pensions Commission, the Government is committed to encouraging more low- and middle-income individuals to build up a private pension income.

The nature and principles of pensions tax relief

2.4 The Government provides tax relief on individual and employer contributions to registered pension schemes. Tax relief is available on contributions to, and investment growth in, occupational defined benefit (DB) and defined contribution (DC) schemes and personal pensions. Employers also do not pay national insurance contributions (NICs) on contributions they make to schemes for their employees. In many cases, employers use pension provision as an important part of remuneration, effectively providing a pension benefit to their employees alongside their salaries, just as some also provide employees with the benefit of a company car.

2.5 Box 2.A sets out the more common types of pension provision.

Box 2.A: Different types of registered pension provision

Registered pension savings can take the form of occupational or personal pension provision (including group personal pensions). Occupational pension provision can be 'defined benefit' (DB) or 'defined contribution' (DC) in nature:

- DB pensions: individuals accrue rights to a future pension (and often a tax-free lump sum payment of up to 25 per cent of the value of the aggregate benefits, either as a separate right or by exchanging part of the pension for a lump sum). The benefit entitlement is determined typically by reference to a person's earnings and length of service within the pension scheme. Employers who sponsor these schemes will fund the liabilities in aggregate or, in the case of some public sector schemes, meet their liabilities on a pay-as-you-go basis, rather than making contributions on an individual basis;
- Occupational DC pensions: employers and employees contribute an amount, typically a percentage of the employee's salary, into the individual pension pot, which then grows with investment and later years' contributions. When benefits are drawn, individuals are usually able to take a tax-free lump sum of up to 25 per cent of the value of their pension pot, the remainder being used to provide an income, most commonly through the purchase of an annuity;
- Personal pensions: individuals can make regular or irregular contributions to personal pensions. Personal pensions work in the same way as DC schemes, but often without an employer contribution; and
- Retirement annuity contracts (RACs): before personal pensions were introduced in 1988, individuals who had no access to an occupational pension scheme could make contributions to a RAC. RACs have similar features to personal pensions, and while there have been no new RACs since 1988, existing policy-holders can continue to contribute to them.

2.6 On 6 April 2006 (A-Day), the Government introduced a new regime that radically simplified the rules regarding the taxation of pensions, replacing what were eight existing regimes, each with their own rules, with a single regime with two generous limits:

- a single lifetime allowance on the amount of tax-privileged pension saving to which an individual is entitled. This is set at £1.75 million for 2009-10, which is sufficient for an individual to obtain an annuity income of around £70,000,[2] after taking a tax-free lump sum of £437,500; supported by
- an annual allowance for tax-privileged inflows of value to an individual's pension fund, via contributions made by an individual or an employer on their behalf, or an increase in pension entitlement. This is set at £245,000 for 2009-10.

Employer contributions count towards both the annual and lifetime allowances.

2.7 The principles underlying the reforms and which continue to guide the Government's decision-making in pensions tax are outlined in Box 2.B below.

[2] Non-index-linked, based on an annuity rate of 5 per cent.

Box 2.B: The design and principles of pensions tax relief

The Government's framework for decision-making in pensions tax has been, and continues to be, guided by four key principles, to deliver a system that is stable, fair and enables individuals to make informed choices about pension saving:

- generous tax relief is provided to support pension saving to produce an income in retirement, and to allow a tax-free lump sum on retirement. Pensions tax relief is not, however, provided to support pre-retirement income, asset accumulation or inheritance;
- pensions are provided with more favourable tax treatment compared to other forms of saving, in recognition that they are less flexible than other savings and are locked away until retirement;
- incentives for employer contributions are provided as it is more efficient for pensions to be provided on a collective basis through the employer and it encourages employer support and engagement; and
- the cost of pensions tax incentives must be affordable and sustainable.

2.8 The UK's existing system of pensions tax relief is typically described as "exempt, exempt, taxed" (E,E,T), where each of the three letters corresponds to a phase in the lifecycle of pension savings. The first relates to the contributions, the second to the investment return and the third to the benefit payout, as follows:

- (E): tax relief is available on individual and employer contributions to a pension scheme. The employer contribution is not treated as a taxable benefit-in-kind for the employee. This means that contributions made to a pension are not subject to income tax or to corporation tax. Furthermore, employer contributions are not subject to a NICs charge. Tax relief is available on individual contributions at the individual's marginal rate. Relief is available on individual contributions worth up to 100 per cent of individuals' earned income, constrained only by the annual and lifetime allowances;
- (E): investment growth within pension schemes is not subject to income or capital gains tax; and
- (T): when benefits are drawn, individuals are able to take a tax-free lump sum of up to 25 per cent of the value of their benefits. The remaining pension rights are used to deliver an income for life, which is taxed like any other income, and the majority of pensioners over the age of 65 also receive higher personal allowances. Pensions from tax-registered pension schemes are not subject to national insurance.

2.9 While individuals do not normally begin to draw their pensions until they retire,[3] the benefit of tax relief is granted immediately to their pension scheme and accrues while the pension is building up. By giving tax relief on pension contributions, and exempting investment growth from income tax and capital gains tax, and by offering a tax-free lump sum on retirement, the Government provides generous incentives to support pension saving.

2.10 These strong incentives exist because the Government recognises that for many people it is necessary to encourage what is in effect the deferral of current income, usually from earnings, in return for security in retirement; and that pensions are less flexible than other savings. The long-

[3] The minimum pension age, the earliest that individuals can normally take benefits from a registered pension scheme, is currently 50 and is increasing to 55 in 2010.

term commitment to save in a pension would otherwise be less preferable for many than spending money today. However, marginal rate relief means that the incentive for basic-rate taxpayers to save in a pension is lower than for higher-rate taxpayers, even though they need that incentive more. Box 2.C illustrates the effect of marginal rate tax relief. Chapter 3 describes how marginal rate relief is given on pension contributions in more detail.

Box 2.C: Marginal rate relief

To achieve a total contribution into a pension of £100:

- a higher-rate taxpayer would need to pay £60 into a pension, on which they would receive £40 in tax relief; and
- a basic-rate taxpayer would need to pay £80 into a pension, on which they would receive £20 in tax relief.

Therefore, basic-rate taxpayers get less support for pension saving than higher-rate taxpayers.

2.11 Higher-rate taxpayers benefit further because they typically make larger contributions and are able to accumulate more in their pension over time. In addition, as well as benefiting from the 25 per cent tax-free lump sum, many higher rate taxpayers pay basic rate income tax in retirement. Even those on the highest incomes in retirement will pay basic rate tax on a substantial amount of their pension income.[4] The UK is the only major industrialised country that currently provides the combination of high limits on tax-deductible contributions to private pensions as well as partial taxation of pension payouts. Annex B describes the tax treatment of private pensions in other countries.

The scale and distribution of pensions tax relief

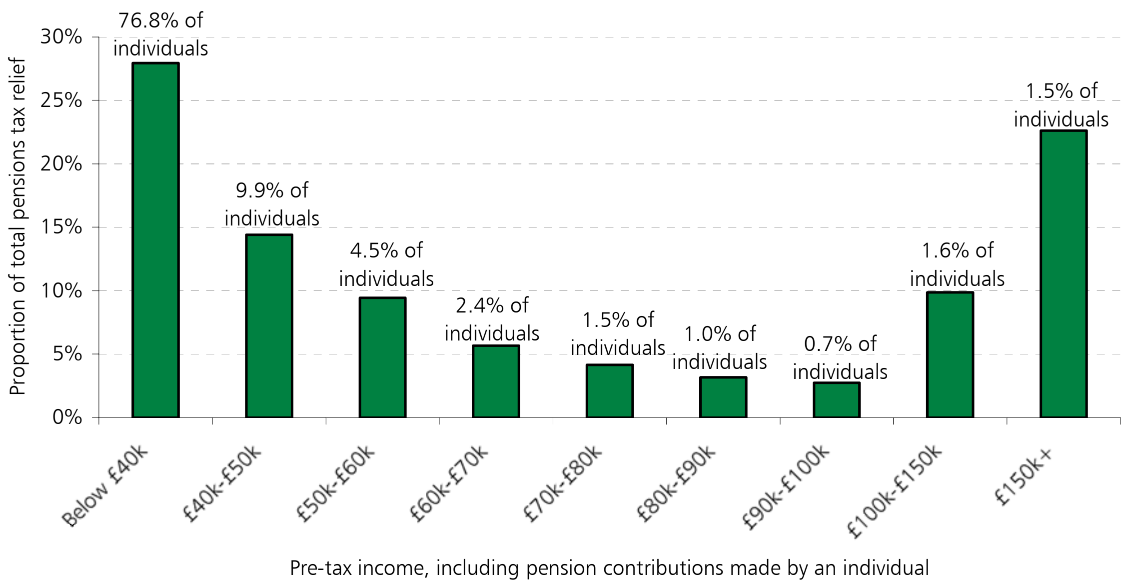
2.12 Pensions tax relief is estimated to be worth around £28.4 billion gross in 2008-09, roughly 2 per cent of GDP – compared to the 17 per cent of GDP that income tax and NICs receipts represent.[5] The cost to the Exchequer net of income tax collected on pensions in payment has doubled since 1998-99: from £9.3 billion in 1998-99 to £18.9 billion in 2008-09. In addition, NICs are not charged on employers' pension contributions, relief estimated to be worth £8.2 billion in 2008-09.

2.13 The benefit of this relief is not spread evenly, as illustrated in Chart 2.A. In 2008-09 higher-rate taxpayers received 65 per cent of tax relief on pension contributions, although they constituted only 19 per cent of pension savers. As Box 2.C showed, marginal rate relief means that tax relief is worth more to higher-rate taxpayers per pound saved, so it is unsurprising that higher-rate taxpayers receive a higher degree of relief per person. However, it has become clear that those with the highest incomes are benefiting disproportionately from the tax regime, at the expense of taxpayers generally.

[4] Aggregate data shows that the proportion of individuals paying higher rate tax is substantially lower among those of retirement age than non-retirement age.

[5] HM Revenue and Customs annual receipts: http://www.hmrc.gov.uk/stats/tax_receipts/table1-2.pdf.

Chart 2.A: Estimated distribution of pensions tax relief by income band, 2008-09



Source: HMRC projections based on Survey of Personal Incomes 2006-07

2.14 Ahead of the A-Day reforms the proportion of tax relief on pension contributions going to those on incomes of £150,000 and over was relatively stable, between 8 per cent and 12 per cent (from 1988-89 to 2005-06). This proportion grew to 21 per cent in 2006-07. It has since risen even further, so the around 2 per cent of pension savers affected by the restriction of tax relief now receive around a quarter of all pensions tax relief on contributions. This amounts to an average of around £20,000 per person, which is in stark contrast to the average of £1,000 of tax relief for basic-rate pension savers.

2.15 The introduction of an additional rate of income tax of 50 per cent applying to incomes over £150,000 from April 2010 would exacerbate this. Without the restriction of tax relief on pension contributions individuals would be able to benefit from tax relief of 50 per cent on pension contributions. That tax relief could be as much as £127,500 a year for those on the highest incomes (50 per cent of the annual allowance in 2011-12).

2.16 Pensions tax relief needs to be targeted appropriately. It is neither fair nor affordable to grant the biggest incentive to save for a pension to those who need it least. The financial crisis precipitated the most severe and synchronised global recession since the Great Depression, with profound implications for the public finances. As a result it is necessary for the Government to consolidate the public finances over the medium term. The extent of the advantage available to individuals on the highest incomes is not sustainable in the current fiscal context. While the Government remains committed to the provision of generous tax relief to support pension saving, there is a point beyond which it is no longer fair for taxpayers to provide disproportionately large support for pension saving for individuals on the highest incomes.

Rebalancing pensions tax relief

2.17 Against this backdrop, at Pre-Budget Report 2008 the Government took steps to limit pensions tax relief for those building up the largest pensions by announcing that the level of the lifetime allowance will be maintained at £1.8 million for five years from 2010-11. Budget 2009 announced that, from April 2011, tax relief on pension contributions would be restricted for individuals with incomes of £150,000 and over (1.5 per cent of pension savers). The value of tax relief will be tapered down until it is 20 per cent for those on incomes over £180,000, making it worth the same for each pound of contribution to pension entitlement as for a basic-rate taxpayer.

2.18 The restriction applies to all contributions, including employers', although employers will continue to receive relief from tax and NICs on their contributions into employees' pensions. Currently, individuals receive tax relief irrespective of the source of the contributions: their pension entitlement increases by the same value, with tax-free investment growth on the whole amount; and the value of the contributions, which can form a substantial element of an individual's remuneration package, are exempt from tax.[6] If the restriction on tax relief was limited to individual contributions, this would disadvantage those who fund all their pension contributions themselves, such as the self-employed. It would also disadvantage those employees in pension schemes with a relatively small employer contribution.

2.19 Budget 2009 set out that the level of the restriction of tax relief would be determined by an income measure that took account of an individual's own pension contributions, but not any pension benefit derived from any employer. However, the Government is clear that the restriction of tax relief on pension contributions must apply as fairly as possible to individuals in different types of pension schemes and employment, and with differing remuneration arrangements, while remaining targeted on those on the highest incomes. So, as announced in the 2009 Pre-Budget Report, the Government has decided that the fairest approach is to adopt a measure of gross income that includes all pension contributions (that is, the individual's own pension contributions together with the value of any pension benefit funded by (or eventually funded by) their employer.[7] This avoids favouring individuals who receive significant pension benefits from their employer in their remuneration packages, and those with most flexibility to rearrange their remuneration packages. As before, the restriction of the value of tax relief will apply to all contributions, including employers'.

2.20 Including the pension benefit an individual receives from their employer in gross income means that more individuals will have to determine the value of this benefit. To provide more certainty for individuals around whether they are affected, and to reduce administrative burdens for employers and for pension schemes, the Government is introducing a floor at £130,000 of pre-tax income (including an individual's own pension contributions, and charitable donations). Only individuals with pre-tax incomes at or above this level will need to establish the value of any pension benefit funded by (or eventually funded by) their employer. This also keeps the measure well targeted on those with the highest incomes. The restriction will therefore now apply to about 300,000 individuals (rather than the around 230,000 individuals originally envisaged). These individuals constitute about 2 per cent of pension savers or around 1 per cent of working-age taxpayers, yet they currently receive around a quarter of tax relief on pension contributions. Chapter 3 describes the restriction of relief in more detail, with a specific focus on how it will apply to those in DB schemes in Chapter 4.

2.21 Around 98 per cent of pension savers will not see their tax relief restricted by this change, including those who are most at risk of under-saving for retirement. Even for those affected by the restriction of tax relief on pension contributions, pensions will continue to represent a tax-privileged means of saving, and the Government believes there are still good incentives for individuals to save in pensions. Individuals who are affected by the restriction will still be entitled to receive a maximum of £51,000[8] in tax relief on pension contributions each year (nearly twice

[6] A report by Lane, Clark & Peacock in 2009 stated that pension benefit can be as much as 74 per cent of top executives' packages: http://www.lcp.uk.com/information/press_release.asp?ID=279.

[7] For high-income individuals in DC schemes, this benefit is funded directly by employer contributions into their pension pot over the tax year. For high-income individuals in DB schemes, a method is needed to value a deemed contribution over the year so that they continue to benefit from tax-free investment growth just as members of DC schemes do. This is discussed further in Chapter 4. Gross income therefore includes all pension contributions made over the tax year, whether by the individual, the employer (deemed or otherwise), or any other third party for the individual's benefit.

[8] This is because an individual can receive tax relief on their pension contributions up to 100 per cent of their earnings subject to the overall limit of the annual allowance, which will be £255,000 in 2011-12. The lifetime allowance will be £1.8 million in 2011-12.

the male median earnings in the UK) if they make contributions up to the annual allowance limit. They will also receive full tax relief on any investment growth on their pension fund and be able to take 25 per cent of their pension as a tax-free lump sum.

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

Implementation in 2011

2.23 The restriction of tax relief on pension contributions for those on gross incomes of £150,000 and over will come into effect from April 2011 and is an important part of the Government's fiscal consolidation. Chapter 5 discusses the delivery implications of the restriction.

2.24 The interim period between the announcement at Budget 2009 and implementation is necessary to give individuals on gross incomes of £150,000 and over, industry and HM Revenue and Customs time to prepare for the new arrangements, and to allow the Government to consult individuals, business, pension fund trustees, the pensions and insurance industries, and other stakeholders on the implementation of the new system.

2.25 The Government welcomes views on implementing the restriction of pensions tax relief for individuals on gross incomes of £150,000 and over, in particular to ensure that the treatment of DB schemes is fair in relation to DC and personal pension schemes; and so that these changes can be delivered in a way that is fair, robust and minimises administrative burdens for business and industry. Details of how to respond to the consultation are set out in Chapter 6. A summary of questions on which the Government would value input from stakeholders over the coming months is attached as Annex A.

Tackling the risk of forestalling

2.26 The gap between the announcement and implementation of the restriction of pensions tax relief for those on incomes of £150,000 and over posed a real risk that some individuals on the highest incomes would seek to increase substantially their pension contributions in the interim, to take advantage of higher rate tax relief while it is still available to them. Without action to curb this behavioural response, at least £2 billion of tax revenue would have been at risk over the two years before implementation of the change, driving up the cost of pensions tax relief for those on the highest incomes in the short run. This would have undermined the intention of the restriction of pensions tax relief.

2.27 To prevent this, at Budget 2009 the Government introduced an anti-forestalling regime, taking immediate effect. It was necessary that the anti-forestalling provisions were brought in without any delay, as otherwise people would have had an opportunity to markedly increase their pension contributions without constraint. For this reason, the Government was not able to consult on the anti-forestalling changes before the Budget. However, it received and acted upon representations made as part of the Finance Bill process to ease restrictions where this did not upset the careful balance between fairness for individuals, protecting the Exchequer and minimising administrative burdens.

2.28 As also announced in the 2009 Pre-Budget Report, the restriction of relief from April 2011 will apply to individuals whose income including the value of any pension benefit funded by (or eventually funded by) an individual's employer is over £150,000, subject to an income floor (excluding that benefit) of £130,000. To prevent tax revenues being put at risk by additional forestalling, in the 2009 Pre-Budget Report the Government therefore extended the anti-forestalling regime to apply to individuals on incomes of £130,000 and over. Box 2.D sets out the main features of the anti-forestalling regime.

Box 2.D: How the anti-forestalling regime works from 9 December 2009

The Government has sought to enable individuals to continue to receive higher rate relief on pension contributions that they would have made in the absence of the announcement of the 2011 reform. As it would be impossible to predict what they would have saved into their pension, the regime takes individuals' existing pension contributions as the best proxy for this.

To deliver this, the regime includes a special annual allowance protecting the level of pension contributions attracting higher rate relief for individuals on incomes of £130,000 and over. The effect of the anti-forestalling regime is that pension contributions will retain full tax relief up to the level of:

- normal, ongoing pension contributions (defined as quarterly or more regularly); or
- the lower of £30,000 and average contributions over the past three years if contributions are less regular than quarterly; or
- £20,000; whichever is highest.

Around 98 per cent of pension savers will not see their tax relief restricted by these provisions.

3 Applying the restriction of relief

Chapter summary

This chapter gives more detail about the restriction of tax relief on pensions contributions for high-income individuals from April 2011. There are three main steps in the process for applying the restriction of tax relief:

- step one looks at the individual's income to determine whether they are affected by the restriction:
  - an individual is not affected unless their pre-tax income, including their own pension contributions and charitable donations, is £130,000 or over;
  - if that is the case, they are only affected by the restriction if their gross income (the sum of their pre-tax income and the value of any pension benefit funded by (or eventually funded by) their employer) is £150,000 or over.
- step two is to determine the appropriate rate of tax relief on pension contributions to which an individual is entitled if they are affected by the restriction. A taper will apply for an individual with gross income from £150,000 up to £180,000, gradually reducing tax relief on pension contributions until it is restricted to the basic rate (20 per cent); and
- step three is to apply the appropriate restriction of tax relief to pension contributions made by or for the benefit of the individual, including the value of any pension benefit funded by (or eventually funded by) their employer. Just as income is assessed over the tax year, so the pension contributions or pension benefit on which tax relief is restricted will be those made over or accruing in a tax year.

This chapter covers the three steps above in more detail, and also describes how some particular circumstances will be treated.

Step one: the income test

3.1 The Government wants to restrict tax relief on pension contributions only for those on the highest incomes. To do this, it is necessary to specify the measure of income that will be used to determine whether the restriction applies.

3.2 Budget 2009 set out that the level of the restriction of tax relief would be determined by an income measure that took account of an individual's own pension contributions, but not any pension benefit derived from any employer. However, the Government is clear that the restriction of tax relief on pension contributions must apply as fairly as possible to individuals in different types of pension schemes and employment, and with differing remuneration arrangements. So, as announced in the 2009 Pre-Budget Report, the Government has decided that the fairest approach is to adopt a measure of gross income that includes all pension contributions (that is, the individual's own pension contributions together with the value of any pension benefit funded by (or eventually funded by) their employer).

3.3 This approach is in keeping with the assessment of an individual's income for income tax purposes, which includes the value of any benefits-in-kind provided for them. It also ensures that any pension benefit, which is as much a part of an individual's overall remuneration as their salary, is included in the definition of income. If any pension benefit were not included in gross income, the pensions tax regime would tend to favour individuals whose remuneration packages included large employer pension contributions; and those with the most flexibility to rearrange their remuneration package (see Box 3.A).

Box 3.A: Why employer pension contributions are included in the definition of gross income

Individual A has a salary of £140,000 and, on top of this, receives an employer pension contribution of £20,000. Individual B has a salary of £160,000 out of which he makes a £20,000 contribution into a personal pension, receiving no employer pension contributions. In both cases the full value of the individual's remuneration package is £160,000, out of which a pension contribution of £20,000 is made. However, if the definition of gross income did not include employer pension contributions, then the restriction would apply to B but not to A, even though their overall remuneration and pension contribution is identical.

3.4 Incorporating all pension contributions in the measure of income, including those (eventually) funded by employers, increases the number of individuals potentially affected and means more individuals will need to establish the value of the employer contributions they have received, in turn placing additional burdens on employers and scheme administrators. Including employer contributions would also make it possible, where the value of those contributions are particularly large, for individuals other than those on the highest incomes to be affected by the restriction. Therefore, to provide more certainty for individuals around whether they are affected, to reduce administrative burdens, and to keep the measure well targeted, only those whose incomes, without taking into account the employer pension benefit, are £130,000 or over will be affected. The measure of income to be used here will be pre-tax income including pension contributions (and charitable donations) made by an individual.

3.5 A summary of the income test and further explanation of the relevant definitions of income that will apply is provided in Box 3.B.

Box 3.B: Applying the income test

Individuals will be affected by the restriction of tax relief on pension contributions if their:

- pre-tax income, including pension contributions and charitable donations made by the individual, is £130,000 or over; and
- gross income is £150,000 or over, where gross income is their income as above, but including the value of any pension benefit the individual receives from others, typically their employer.

The definition of pre-tax income currently used in the tax system to determine when age-related and other personal allowances are withdrawn (adjusted net income)[1] is net of various adjustments, including deductions for pension contributions and charitable donations. It is not appropriate to use this definition for determining whether individuals have an income of £130,000 or over since individuals could manipulate their income by making additional pension contributions or charitable donations with the aim of circumventing the restriction of relief. Therefore the income used to assess individuals against the £130,000 threshold will be a modified version of adjusted net income, which includes such contributions made by an individual. For charitable donations, this will apply regardless of whether the contributions are made using gift aid, payroll giving, or are a gift of shares or property. Individuals will, however, still be able to receive full tax relief on such donations.

3.6 Individuals will only be affected by the restriction if their income including the value of any pension benefit (eventually) funded by employers (their gross income) is £150,000 or over, subject to an income floor of £130,000. The restriction will apply to about 300,000 individuals. These individuals constitute about 2 per cent of pension savers or around 1 per cent of working age taxpayers, yet they currently receive around a quarter of tax relief on pension contributions. Box 3.C provides some examples of how the income test will be applied.

[1] The definition of adjusted net income is in section 58 Income Tax Act 2007.

Box 3.C: Examples of applying the income test

The following examples illustrate how the income test will apply:

- Individual C has a salary of £140,000 and no other sources of income. He is a member of a non-contributory defined benefit pension scheme, where the deemed contribution from his employer is worth £40,000. His income is £140,000 and therefore above the income floor and his gross income for the restriction of tax relief on pension contributions is £180,000. He is therefore fully affected by the restriction of pensions tax relief on his £40,000 deemed contribution.

- Individual D has a salary of £180,000 and £20,000 of income from a rental property, makes £5,000 charitable contributions and a personal pension contribution of £10,000. She receives no pension benefit from her employer or any other source and her income for assessment against the income floor is therefore the same as her gross income at £200,000. She is therefore fully affected by the restriction of tax relief on her £10,000 personal pension contribution.

- Individual E has a salary of £160,000 and is a member of a defined contribution occupational pension scheme with 5 per cent (£8,000) employee and 10 per cent (£16,000) employer contributions – his income is above the floor at £160,000 and his gross income is £176,000. He is therefore affected by the restriction of tax relief on the £24,000 of pension contributions made.

- Individual F has a salary of £115,000, no other sources of income, and receives a pension benefit from her employer of £40,000. As her income is below the floor she is not affected by the restriction of tax relief on pension contributions, even though her gross income is over £150,000.

3.7 Only individuals whose pre-tax income, including their own pension contributions and charitable donations, is £130,000 or over will need to establish the value of any pension benefit funded by, or eventually funded by, their employer. They will then need to add that value to their income to determine whether their gross income is £150,000 or over. Obtaining the value of the employer pension benefit will be generally easy for those in defined contribution (DC) schemes, but individuals in defined benefit (DB) schemes will need to establish the value of their deemed contribution. The ways in which this could be calculated are discussed in more detail in Chapter 4.

3.8 In the absence of any restriction of tax relief on pension contributions, the introduction of the additional rate of income tax of 50 per cent in April 2010 would have meant that high-income individuals would have received more tax relief on their pension contributions. And the existing exemption from tax of the benefit from employer pension contributions would also have become more valuable to them. By restricting tax relief on pension contributions the Government is acting to limit the extent to which individuals on the highest incomes can benefit from tax relief at a rate of 50 per cent.

3.9 As in the anti-forestalling regime, there will be rules to address the rearrangement of remuneration packages away from salary to pension benefits, to limit manipulation around the £130,000 floor. These rules will operate by adding back onto income any salary sacrificed in return for greater pension benefits. The legislation applying from April 2011 will also include other necessary anti-avoidance provisions. And the Government will of course subsequently monitor operation of the restriction to detect and counter abuse.

Step two: determining the appropriate rate of relief

3.10 To restrict tax relief on pension contributions to the appropriate rate, it will be necessary to reflect that different tranches of an individual's pension contribution may effectively have received relief at different marginal rates before application of the restriction. The rate of the restriction will also depend on the taper that will operate so as to gradually reduce the level of relief available as gross income increases from £150,000 to £180,000.

Restricting marginal rate relief appropriately

3.11 As described in Chapter 2, individuals currently receive tax relief at their marginal rate of tax on contributions to, and investment growth within, registered pension schemes, subject to the limits of the annual and lifetime allowances. The level of relief an individual receives on the pension contributions they make is given by the income tax that they would have paid if they had not made those contributions. Similarly, individuals effectively receive tax relief on the value of the pension benefit funded (or eventually funded) by their employer equal to the income tax they would have paid if that value was instead treated as their top slice of income. In the current system, this generally means that a basic-rate taxpayer receives tax relief of 20 pence for every pound contributed to their pension, while a higher-rate taxpayer receives 40 pence. However, for some individuals, it will not be that straightforward. For example, if a higher-rate taxpayer makes sufficient pension contributions to take their taxable income below the higher rate limit, then in this case some of their pension contributions would have received tax relief at 20 per cent and some at 40 per cent. Similarly, a basic-rate taxpayer benefiting from an employer pension contribution (deemed or otherwise) could effectively receive relief at two rates if the value of that benefit is treated as the individual's top slice of income and takes their income above the higher rate limit.

3.12 This shows that it is possible for tax relief to be received at different rates on different tranches of pension contributions, and with the introduction of the 50 per cent additional rate of income tax it could often be the case that those on gross incomes above £150,000 would be receiving pensions tax relief at more than one rate. In order to ensure that an individual's relief is reduced to the right amount, it is important that the restriction is calculated in a tailored way on those different tranches of pension contribution. For example, for those who see relief limited to the basic rate of 20 per cent:

- relief will be restricted by 30 per cent on contributions which would have received marginal rate relief of 50 per cent; and
- the restriction will be 20 per cent on contributions which would have received marginal rate relief of 40 per cent.

Without applying a tailored calculation in circumstances like this, it would be possible for the restriction for some individuals to result in a tax relief entitlement of less than the basic rate. An example of how relief is restricted to the basic rate is given in Box 3.D.

Box 3.D: Restricting relief to the basic rate

Individual G has gross income of £180,000, and makes a £40,000 contribution into a personal pension:

- if G had not made that pension contribution, £10,000 of G's additional income would have been taxed at 40 per cent, and the remaining £30,000 of it at 50 per cent;
- therefore, G receives 40 per cent tax relief on the first £10,000 of contribution, and 50 per cent on the remaining £30,000;
- in order to restrict relief accurately to the basic rate of 20 per cent, a restriction of 20 per cent is applied to the £10,000 receiving 40 per cent marginal rate relief, and a restriction of 30 per cent is applied to the remaining £30,000 of the contribution receiving 50 per cent marginal rate relief; and
- this equates to a restriction of £11,000, with G still receiving basic rate relief of £8,000 (that is, 20 per cent).

Similarly, if G instead has income of £140,000 and is a member of an occupational defined contribution pension scheme into which his employer makes a £40,000 contribution, his gross income remains at £180,000 and he sees the same restriction of relief as that outlined above.

The taper

3.13 The restriction will affect only those with gross incomes of £150,000 and over, subject to the income floor of £130,000. Other higher-rate taxpayers will still benefit from marginal rate relief on their pension contributions. So reducing tax relief to 20 per cent as soon as an individual's gross income exceeded the £150,000 threshold would create a cliff-edge effect, with large differences in treatment for individuals either side of the threshold, and associated very high marginal tax rates. To prevent this effect, on the taper, the rate of tax relief from which individuals can benefit is gradually reduced from 50 per cent to 20 per cent as gross income rises from £150,000 to £180,000.

3.14 In order to implement the taper, the Government proposes to reduce the taper rate of relief through a series of steps. There is a choice around the size and number of those steps. Tapering relief through a small number of large steps (e.g. a reduction of 1 per cent for every £1,000 of gross income) would make it relatively easy for individuals to determine precisely what their level of relief should be. However, it could create significant differences in treatment where gross income crosses each £1,000 threshold. In contrast, tapering relief through a large number of small steps (e.g. a reduction of 0.01 per cent for an additional £10 of gross income) would smooth introduction of the restriction and reduce differences in treatment for a small increase in gross income, but it could make it less straightforward for individuals to determine precisely what their level of relief should be.

- The Government welcomes views on the best balance to strike between the smoothness of the taper and simplicity for individuals.

Ensuring the restriction on the taper appropriately reflects marginal rate relief

3.15 The taper described above will operate straightforwardly where all contributions would otherwise have received relief at 50 per cent. However, as described above, there are cases where, in the absence of any restriction, some contributions would have received relief at 40 per cent. In order to make sure that individuals do not receive more tax relief than they would have done in the absence of this measure, and that they are not restricted to less than the basic rate, the taper will apply in these circumstances as follows:

- where the taper indicates that the rate of relief on pension contributions should be between 40 per cent and 50 per cent, this rate will apply only to contributions that would otherwise have received marginal rate relief of 50 per cent, with contributions otherwise receiving 40 per cent marginal rate relief unaffected; and
- where the taper indicates that the rate of relief on pension contributions should be between 20 and 40 per cent, this rate will apply to all contributions.

3.16 Examples of how the taper will operate and how the rate of restriction will be set are given in Box 3.E and illustrated in Chart 3.A.

3.17 Individuals will be guided through the process of determining the restriction of relief on their pension contributions by the Self Assessment tax return. Additional information about their own pension contributions and the value of any employer contributions will have to be reported on the tax return. The Self Assessment calculation will work out the individual's gross income, position on the taper, and the restriction of their relief. For paper filers who want to self-calculate, the accompanying help sheets will guide them through the steps necessary to complete the return. Chapter 5 explains how the measure will be delivered in more detail.

Box 3.E: Examples of how the taper will operate

Example 1: taper rate of relief greater than 40 per cent

Individual H has income of £135,000 and his employer makes a contribution to his pension of £20,000:

- marginal rate relief received on that contribution in the absence of this measure would be 40 per cent on the first £15,000 and 50 per cent on the remaining £5,000;
- H's gross income is £155,000 (that is, his income including the pension benefit) so his maximum rate of relief as determined by the taper is 45 per cent;
- since the taper rate of relief is greater than 40 per cent, it is only applied to contributions that would have received marginal rate relief of 50 per cent, and contributions benefiting from 40 per cent marginal rate relief are unaffected;
- therefore, the first £15,000 of the contribution is unaffected, and a restriction of 5 per cent is applied to the remaining £5,000 of the contribution; and
- this is a restriction of £250, and H still benefits from tax relief of £8,250 on the £20,000 contribution.

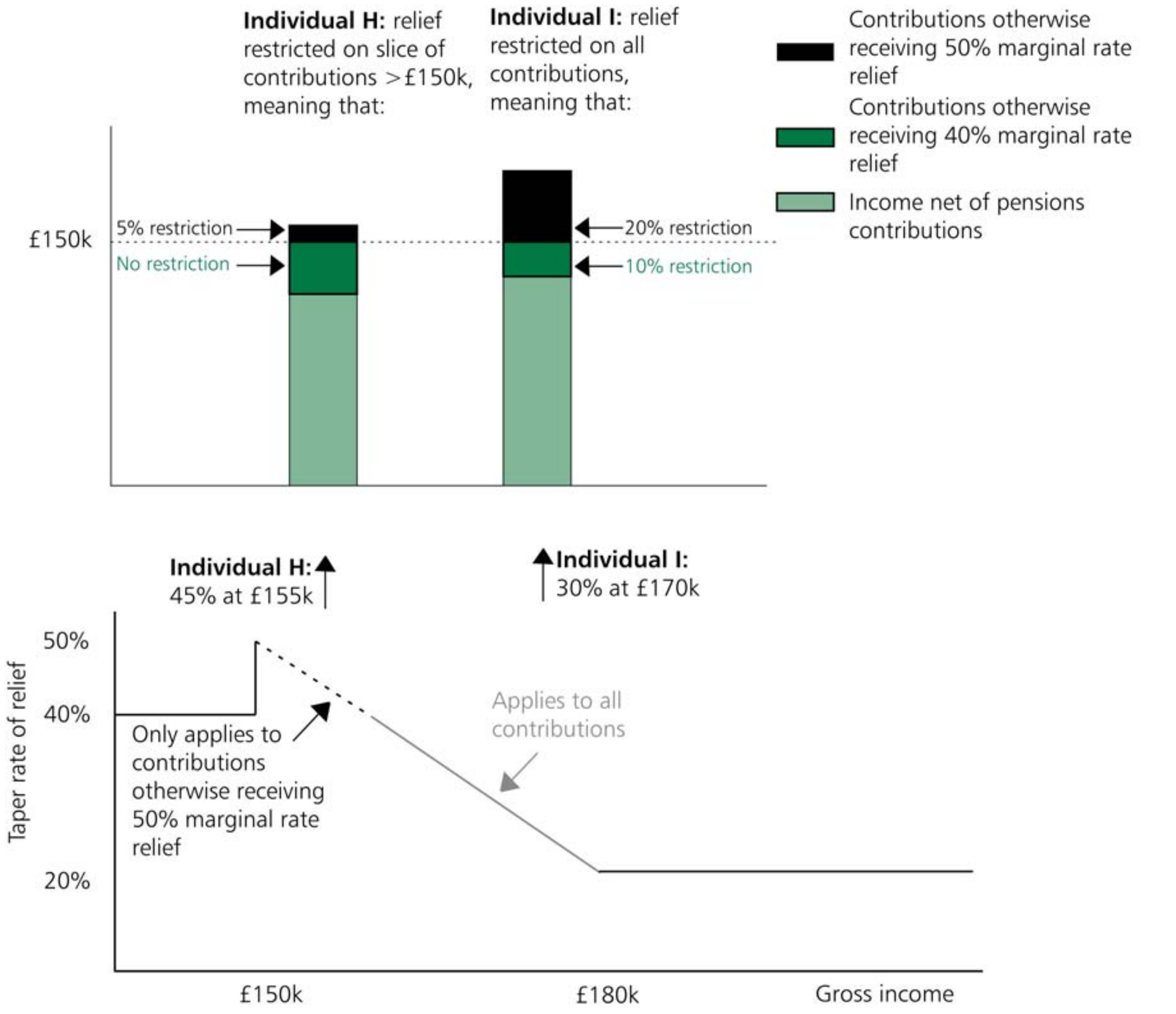
Example 2: taper rate of relief less than 40 per cent

Individual I has income of £170,000, and receives no employer pension contributions. She makes a personal pension contribution of £30,000:

- marginal rate relief received on that contribution in the absence of this measure would be 40 per cent on the first £10,000 and 50 per cent on the remaining £20,000;
- I's gross income is £170,000;
- her maximum rate of relief as determined by the taper is 30 per cent, and this is applied to the entire contribution;
- in order to give 30 per cent relief on the entire contribution, restrictions of 10 per cent and 20 per cent are applied on the first £10,000 and the remaining £20,000, respectively; and
- this corresponds to a restriction of £5,000, while I still benefits from tax relief of £9,000.

These examples are illustrated in Chart 3.A.

Chart 3.A: Illustration of how the taper will operate



Step three: applying the restriction of relief on pension contributions

3.18 Step two determines the rate at which tax relief on pension contributions is to be restricted, and this rate is then applied to pension contributions in step three. As explained in Chapter 2, the Government is clear that this restriction will apply to the contributions made by an individual into a personal or occupational pension scheme as well as to any other contributions made to that individual's pension by a third party, usually their employer. This is to ensure that the tax treatment of contributions from different sources is broadly the same. Identifying pension contributions to a DC scheme is generally easy, but there is a need to identify the equivalent (deemed contributions) where DB rights are accruing. This is discussed in more detail in Chapter 4.

3.19 The accrual of pension benefits for assessment against the annual allowance is currently determined over what is called the 'pension input period'. This need not align with the tax year – there is some flexibility for schemes and individuals to choose their own input period. However, whether high-income individuals are affected by the restriction of tax relief from April 2011 will be determined by their income arising in a tax year. It is therefore appropriate that the pension contributions, or deemed contributions, on which tax relief is restricted are also those made over the period of a full tax year. This raises the question of whether pension input periods for the annual allowance should also be aligned with the tax year.

- Given that the restriction of pensions tax relief for high-income individuals will apply over the tax year, the Government welcomes views on whether the pension input period for the purposes of assessment against the annual allowance should be brought in line with the tax year.

Applying the restriction of relief in particular circumstances

(i) Applying the restrictions to overseas schemes

3.20 Migrant workers coming to the UK from other countries, and their employers in the UK, can receive tax relief on contributions made to pension schemes based outside the UK. This is conditional on the non-UK scheme meeting certain conditions, but it ensures that these workers can continue to receive tax relief for contributions made to schemes they joined before coming to the UK, supporting the presence of an internationally mobile workforce in the UK.

3.21 For reasons of fairness in such circumstances, individuals who are members of non-UK pension schemes receive the same levels of tax relief as members of UK tax-registered pension schemes. Consequently, the relief they receive is subject to the same annual and lifetime allowances as apply to members of UK pension schemes.

3.22 The Government's intention is to apply the restriction of tax relief for those on high incomes to individuals in overseas schemes that are benefiting from UK tax relief. Otherwise UK-based pension schemes would be treated less favourably than these non-UK schemes.

- The Government welcomes views on any practical or administrative issues that may arise from applying the restriction of pensions tax relief to individuals on gross incomes of £150,000 and over who are members of overseas pension schemes and benefiting from UK tax relief.

(ii) Applying the restriction in the year benefits are drawn

3.23 It will be necessary for the restriction of pensions tax relief to apply to individuals in the year in which they start to draw benefits (commonly this will coincide with retirement). Otherwise, high-income individuals could benefit from marginal rate relief on contributions made in that year. This is particularly important in the case of DB schemes, where high-income individuals might negotiate, or be entitled to, significant pension enhancements as part of their retirement package (such as early retirement with an unreduced pension). Chapter 4 discusses in more detail how the deemed contribution associated with these enhancements would be calculated.

3.24 In the year in which an individual starts to draw benefits, the individual's income will often be significantly lower than in previous years, particularly where this coincides with retirement, if only because it reflects employment income for part of the year and a pension for the remainder. The Government therefore proposes that in the year that benefits are drawn the measure of income will be the higher of the gross income in the previous tax year or that in the year in which benefits are taken (subject to the £130,000 floor). This will ensure that a suitable income test is used in determining whether individuals are affected by the income threshold and taper.

- The Government welcomes views on the proposal to use the higher of gross income in the current or previous tax year for the purposes of assessing whether individuals are affected by the restriction of tax relief in the year that benefits are drawn.

(iii) Treatment of redundancy and other termination payments

3.25 The Government recognises that redundancy payments could in some cases mean that an individual is unexpectedly brought within the scope of the restriction of tax relief on pension contributions. Individuals who had made their pension choices with the expectation of one tax treatment would in these cases suddenly be faced with different tax consequences. In line with the wider tax treatment of termination payments, the Government is minded to exempt the first £30,000 of a redundancy payment (and other termination payments) from income for the purposes of restricting tax relief on pension contributions. The Government is willing to consider further, targeted, options for mitigating the impact of the restriction on those affected by redundancy that do not open up opportunities for abuse.

- The Government welcomes views on ways in which the impact on individuals affected by the restriction due to a redundancy payment of over £30,000 could be further mitigated without opening up scope for abuse.

3.26 Chapter 5 considers how some individuals will be able to mitigate the tax consequences of the pensions tax restriction in certain circumstances.

Questions for consultation

- The Government welcomes views on the best balance to strike between the smoothness of the taper and simplicity for individuals.
- Given that the restriction of pensions tax relief for high-income individuals will apply over the tax year, the Government welcomes views on whether the pension input period for the purposes of assessment against the annual allowance should be brought in line with the tax year.
- The Government welcomes views on any practical or administrative issues that may arise from applying the restriction of pensions tax relief to individuals on gross incomes of £150,000 and over who are members of overseas pension schemes and benefiting from UK tax relief.
- The Government welcomes views on the proposal to use the higher of gross income in the current or previous tax year for the purposes of assessing whether individuals are affected by the restriction of tax relief in the year that benefits are drawn.
- The Government welcomes views on ways in which the impact on individuals affected by the restriction due to a redundancy payment of over £30,000 could be further mitigated without opening up scope for abuse.

4 Valuing the defined benefit contribution

Chapter summary

Chapter 3 set out details of the restriction of pensions tax relief for those with gross incomes of £150,000 and over on all contributions, including employers'. Identifying individual and employer contributions to a defined contribution (DC) scheme is generally easy. In defined benefit (DB) schemes, employers promise their employees a future pension determined by certain factors, typically salary and length of service. Employers then fund their schemes in aggregate or, in the case of some public sector schemes, operate on a pay-as-you-go basis.

To ensure consistent treatment across DB and DC schemes, a method is needed to value a deemed contribution – the equivalent of the contributions to a DC scheme – in order to determine gross income and to restrict relief for individuals in DB schemes. The valuation method should take due account of investment growth, which remains exempt from tax. Since DB and DC schemes are not funded in the same way, there is no single valuation method, so the Government is committed to two key principles:

- Fairness: the valuation method should deliver fairness between DB and DC schemes; and
- Simplicity: the valuation method should be reasonably simple, both for individuals to understand and use, and for schemes to administer.

Several valuation options have been identified, and the Government has assessed them against these principles, recognising that any method will involve a trade-off between them:

- Flat factors: currently used for the annual and lifetime allowances, these are simple to understand and administer but will generally deliver less fair outcomes than more tailored methods;
- Cash equivalent transfer value (CETV): this actuarial calculation is also currently used within the pensions industry, including for valuing pension transfers. While it takes account of a large number of individual and scheme characteristics, it is a complex calculation that would hinder individuals from pre-planning their tax affairs and lead to variability across schemes; and
- Age-related factors (ARFs): this extends the flat factors approach by creating a fairer scale of factors that vary with age and possibly other variables such as normal pension age (NPA). This would take fewer individual and scheme characteristics into account than the CETV approach, but would reduce variability of outcomes between schemes, and be easier for individuals to understand and calculate.

A two-way ARFs scale varying with age and NPA is the Government's preferred way of valuing the deemed contribution for individuals in DB schemes, as it would give the appropriate balance between fairness and simplicity.

4.1 Chapter 3 presented more details of the restriction of pensions tax relief for high-income individuals, including how relief will be tapered to the basic rate for those with gross incomes of £150,000 and over, subject to a pre-tax income (including an individual's own pension contributions, and charitable donations) floor of £130,000, and how gross income will be used to determine the rate of relief that affected individuals will receive. The restriction will apply to all contributions made during the year, including employers'. However, employers will continue to receive relief from tax and national insurance contributions (NICs) on their contributions to employees' pensions.

4.2 For defined contribution (DC) schemes, whether occupational or personal, it is generally easy to identify contributions made to an individual's pension in a given year. Individuals and, where appropriate, their employer will contribute an amount – typically a percentage of the employee's salary – into their pension pot, which then grows with investment and later years' contributions. The situation for defined benefit (DB) schemes is more complex: individuals accrue rights to a future pension based on various factors, typically their salary and length of service. Employers fund their schemes in aggregate rather than making contributions on an individual basis, and funding patterns vary by employer. Some schemes may be fully funded, and others may be in deficit, targeting full funding only over an extended period (subject to the Pensions Regulator's approval). Some public sector schemes operate on a pay-as-you-go basis. Recognising that DB and DC schemes are not funded in the same way by employers, a method is needed to value the notional DB equivalent of the contribution to a DC scheme to ensure fairness and consistency between DB and DC schemes – this document refers to this as the deemed contribution.

4.3 This chapter:

- describes how the restriction works for DC schemes, and discusses the issue for DB schemes in more detail;
- presents the Government's principles for valuing the deemed contribution to a DB scheme;
- discusses the options the Government has identified; and
- explains why a two-way scale of age-related factors (ARFs) varying with age and normal pension age (NPA)[1] is the Government's preferred approach.

Applying the restriction for DB members

4.4 The restriction of pensions tax relief for high-income individuals will apply to contributions made during the tax year, but not to investment growth. In DC schemes (including personal pensions), individuals have their own pension pot, which is built up via contributions and investment growth. DC contributions made by both the individual and their employer are generally easily identifiable, so the restriction is straightforward to apply to DC scheme members (see Box 4.A for an example of this).

[1] NPA as referred to in this document is defined in the Glossary.

Box 4.A: Example of applying the restriction within defined contribution (DC) schemes

Individual J has a salary of £200,000 and a defined contribution pension pot of £500,000. His scheme has a contribution rate of 8 per cent of salary for the employee and 12 per cent for the employer. Ignoring investment growth on the current year's contributions for simplicity, during the year:

- the employee and employer make pension contributions of £16,000 and £24,000 respectively;
- J's gross income is £224,000 (his salary including the employer pension contribution), so his rate of relief will be restricted to 20 per cent;
- the £500,000 pension pot benefits from investment growth of £25,000 (5 per cent);
- relief is restricted to the basic rate on the £40,000 total contribution, but the £25,000 of investment growth remains untaxed; and so
- J sees a restriction of 30 per cent of the total contribution, that is £12,000. This leaves him with tax relief of £8,000 (20 per cent of £40,000).

4.5 In DB schemes, however, employers give individuals the promise of a future annual pension based on various factors. For a traditional final salary scheme, these factors are typically their salary, years of service and the scheme's accrual rate where, generally:

$$\text{Annual pension} = \text{final salary} * \text{years of service} / \text{accrual rate.}$$

Normally, an individual's final salary DB pension entitlement will increase each year, both as a result of working for the employer for an extra year and from any rise in earnings upon which the pension is based.

4.6 Other types of DB scheme also exist, for example, the DB pension might be determined by reference to average earnings over an entire career with the employer. This chapter focuses on final salary DB schemes with a commutable lump sum[2] – Annex D considers how the methodologies for valuing a deemed contribution presented in this chapter can be extended to other arrangements as classified in Finance Act 2004, including other DB schemes, and cash balance and hybrid schemes.

4.7 The value of an individual's increased annual pension entitlement is equivalent to the additional pension pot that would be needed to fund that extra portion of annual pension payment for life throughout retirement, as well as any additional benefits for survivors. The value of a DB pension can depend on many factors:

- Individual factors: for example, life expectancy and marital status (if provision is made for a spouse's[3] pension on death); and
- Factors set by the scheme: for example, NPA, rate of pension increase in retirement, death benefits, survivors' benefits (e.g. spouse benefits), and provisions for early or late payment of benefits relative to NPA.

Box 4.B gives an example of how an individual's DB pension increases over a year, and how different individual and scheme factors can influence the increase in pension value.

[2] I.e. part of the accrued pension rights is commuted for a lump sum on drawing benefits. In some cases, lump sum rights accrue separately each year alongside the pension.

[3] References to spouses should also be taken to include civil partners and any other partners entitled to benefits upon a member's death.

4.8 Having made DB pension promises to their employees, employers normally fund their schemes on an aggregate basis to meet their future liabilities. The funding methodology can vary significantly across different employers: at any point they could be significantly in deficit, while those running unfunded schemes meet liabilities on a pay-as-you-go basis. Individuals may also be required to make a pension contribution from their salary as part of the scheme membership rules.

4.9 The chosen valuation method for restricting tax relief on pension contributions will not reflect the actual funding position of DB schemes. It will translate the promise the individual receives of extra annual pension every year in retirement into a deemed pension contribution at the time the promise is made, in effect ascertaining the benefit-in-kind (which is the deemed contribution minus any actual employee contribution). In doing so, it will take into account a number of the individual and scheme factors described above.

Box 4.B: Deeming the defined benefit (DB) contribution

Increase in annual pension entitlement

Individual K has been a member of his employer's DB scheme with a 1/60ths accrual rate for eight years. In his ninth year, he receives a pay rise from £180,000 to £200,000. This means that:

- at the end of the eighth year, he was entitled to an annual pension of £24,000 (=8/60 * £180,000) on retirement based on his salary, years of service and the scheme accrual rate;
- at the end of the ninth year, this has increased to £30,000 (=9/60 * £200,000), both as a result of his extra year of service and his £20,000 salary increase; and
- he is therefore entitled to £6,000 extra pension every year in retirement.

If K had instead stopped accruing extra pension after eight years, his pension would have been uprated by RPI. If this is assumed to be 2.5 per cent, his annual pension earned up to the start of the year would notionally have increased from £24,000 to £24,600 at the end of the ninth year.

Increase in value of pension entitlement

Translating the increase in annual pension entitlement into an increase in the value of that pension entitlement involves a number of individual and scheme factors. This increase in pension value may differ depending on:

- the normal pension age (NPA) – the lower the NPA, the greater the value of the increase in annual pension entitlement;
- the level of pension increases in retirement offered by the scheme;
- whether the individual has a spouse or is single – within a scheme that provides a spouse's pension following the member's death, the pension is of greater value to the individual if they have a spouse who outlives them, as that spouse will receive some level of provision on the individual's death, whereas there is no extra provision when a single person dies; and
- how long the individual lives, and hence receives the increase in annual pension.

Deemed contribution

Based on the increase in value of an individual's pension entitlement, there is a need to deem a contribution for the purpose of restricting pensions tax relief, taking due account of investment growth (which remains exempt from tax).

4.10 DB scheme members can receive enhancements to their pension in the year of drawing benefits. These enhancements can also be awarded to the individual at any other time, including during active scheme membership, in deferment or after retirement. For example, an individual's annual pension may be increased, or they may take early retirement with no corresponding actuarial reduction in annual pension. In both cases, the overall pension value will rise.

4.11 The Government is committed to ensuring that enhancements are subject to the tax relief restriction where appropriate, which will involve deeming a contribution associated with the enhancement. This is necessary to maintain the fairness of the system since, otherwise, individuals would continue to benefit from marginal rate relief on such enhancements, which can be substantial.

4.12 However, there may be cases where it is inappropriate for pension enhancements to be subject to the restriction, such as when an individual retires early on ill-health grounds. The Government welcomes views on:

- whether there are any instances in which contributions or enhancements made to an individual's pension should not be subject to the restriction of pensions tax relief and why these exemptions are justified in the light of the Government's stated objective of fairness; and
- how these exemptions might best be crafted to avoid opening up scope for avoidance.

Principles for valuation

4.13 For DC schemes, this measure will restrict tax relief on the full amount of an individual's contributions as well as on any employer (or other third party) contribution from which they benefit. On the same basis, it will restrict relief on the equivalent deemed contribution based on the extra value an individual has accrued in a DB scheme. There is no single way of putting a value on this deemed contribution – as a result, the Government is committed to two key principles that the chosen valuation method should achieve as far as possible:

- Fairness: it should deliver fairness between DB and DC schemes; and
- Simplicity: it should be reasonably simple, both for individuals to understand and use, and for schemes to administer, to minimise their administrative burdens as far as possible.

4.14 An appropriate valuation method should use the increase in the value of an individual's pension entitlement during the year to calculate the deemed contribution, which is the equivalent of the contribution(s) to a DC scheme. This will be smaller than the overall value of the increase in pension entitlement at the time when it comes into payment since, in line with DC pension pots, it must be assumed that this value is partially met by investment growth[4] on the deemed contribution. In this way, the benefit from investment growth will continue to be exempt from tax for DB scheme members, just as for members of DC schemes.

4.15 This approach achieves parity between the two types of scheme regardless of how a DB scheme is actually funded. In both cases, the key metric is the value of an actual, or deemed, contribution into a pension pot before investment growth has any effect. To achieve fairness between DB and DC schemes, it is critical that the deemed contribution reflects the overall value

[4] The term "investment growth" is used here for comparability with DC schemes. Strictly speaking, for DB schemes it is the assumed "discount rate" which is relevant. The discount rate is derived from the expected return on assets, either assets that are assumed to be a match to the liabilities or the actual assets held by a scheme. Where the term "investment growth" is used in relation to DB schemes in later paragraphs, it should be understood to refer to the discount rate.

to an individual of their increased DB pension rights. Therefore, the actual funding of a DB scheme is not relevant, whether it is in practice unfunded, under-funded or in surplus.

4.16 Simplicity, the other objective, applies in two ways:

- the chosen method should be sufficiently simple to understand and apply, so that individuals are able to work out tax impacts in advance. This will help them to make informed decisions about their pension schemes and salary package, to the extent that they have flexibility around them; and
- it is also important that the chosen method is simple for schemes to understand and minimises any extra administrative burdens on them and on individuals.

4.17 The Government recognises that any valuation method involves a trade-off between the principles of fairness and simplicity since, generally, the simpler the method, the less fair it is to individual circumstances.

Employer insolvency

4.18 The restriction of tax relief on pension contributions will be based on the increase in pension entitlement accrued by an individual over a year. Where the sponsoring employer of an under-funded DB scheme becomes insolvent, it is possible that an individual will not actually receive some of that pension entitlement in the future. This is not an issue for members of DC schemes who have a definable pension pot, or for public sector DB schemes, which do not face the risk of employer insolvency. For those in private sector DB schemes who do face this risk, in 2004 the Government set up the Pension Protection Fund to provide compensation and the Pensions Regulator to regulate occupational pension schemes, with objectives to protect members' benefits and reduce the risk of them requiring compensation from the Pension Protection Fund.

4.19 The Government does not believe it would be appropriate to make any adjustments to an individual's tax position in those exceptional cases where benefits are not ultimately received, since the individual's outcome will reflect their decision to accrue pension at that point in time with full knowledge of the tax implications and risks being undertaken. In addition to this, refunding restrictions of relief on deemed contributions would not be administratively feasible given the potentially very long timescales involved.

Valuation options

4.20 The Government has identified three approaches for valuing the deemed contribution to a DB scheme:

- Flat factors;
- Cash equivalent transfer value; and
- Age-related factors.

The following section describes these methods in more detail and discusses some of their relative advantages and disadvantages (summarised in Table 4.A), with reference to the Government's principles of fairness and simplicity outlined above. Further technical details are available in Annex C. Each of these methods calculates the overall deemed contribution, which would include any actual employee contributions paid to the DB scheme, to avoid double-counting.

Flat factors

4.21 Flat factors are currently used in the context of limiting relief elsewhere in the pensions tax regime:

- for the purposes of the annual allowance, the increase in annual pension is multiplied by a flat factor of 10 to calculate the deemed contribution to a DB scheme; and
- for the purposes of the lifetime allowance, the value of an individual's DB pension rights is the amount of their DB pension entitlement multiplied by a flat factor of 20.

4.22 The flat factor approach to valuing a deemed pension contribution to a DB scheme simply involves multiplying the increase in annual pension accrued over the current year by the chosen factor. Applying this calculation to the restriction of pensions tax relief would be simple to carry out, and would also be easy for individuals to understand and apply themselves. However, a calculation of this simplicity does not enable investment growth to be taken into account properly (as it overstates investment growth for older people and understates it for younger ones) and is therefore less fair between individuals of different ages, as illustrated in Box 4.C. This shows that use of a flat factor would generally deliver less fair outcomes between DB and DC schemes. It would also be unsuitable for capturing the value of certain pension enhancements, notably in cases of early retirement.

4.23 One advantage of flat factors, besides their simplicity, is that pension schemes are familiar with how they operate and the administrative costs of operating a method involving flat factors may therefore be lower. Since the annual and lifetime allowance charges apply to very few individuals each year, it was not felt appropriate to develop a complex methodology for these purposes. The 10:1 factor was chosen for the annual allowance test on the basis that it operates over a wide age range, while 20:1 was considered a good approximation for the lifetime allowance given the ages to which it applies (generally over 50). However, since the introduction of the restriction of pensions tax relief will affect a larger number of people (around 300,000 pension savers), the need to ensure fairness is much stronger, so the Government does not consider that a flat factor is appropriate in this context.

Box 4.C: Stylised example of flat factors and age

For simplicity, the following example assumes no pension indexation before or after retirement, and no investment growth after retirement.

Two individuals both accrue an increase in annual pension of £1,000, L is aged 30 and M is aged 60. Both have a normal pension age of 65 and neither has to make an employee contribution. Assuming that both individuals are expected to live for 20 years in retirement, they require a total pension pot of £20,000 to fund this increase in pension at retirement. However, assuming a 5 per cent year-on-year rate of investment growth:

- L has 35 years until retirement, so a deemed contribution of £3,600 will grow to the requisite amount of £20,000;
- M will benefit from only five years of investment growth, so a much larger deemed contribution of £15,700 is needed to fund the same increase in pension; and
- the 10:1 flat factor approach currently used for the purposes of the annual allowance would assume that both individuals had received a deemed contribution of £10,000, which is an underestimate for the older individual and an overestimate for the younger one.

This illustrates the importance of age in determining the size of the deemed contribution, since a younger individual has more time to benefit from investment growth before retirement than an older person.

Cash equivalent transfer value (CETV)

4.24 The cash equivalent transfer value (CETV) is an actuarial calculation currently used by pension schemes to determine the lump sum value, in today's terms, of the pension rights accrued by an individual. It is mainly used to calculate the transfer sum representing an individual's pension rights should they leave the DB scheme, and for valuing pension rights on divorce. In those contexts it is familiar to both individuals and schemes. It is also the basis underlying the disclosure of the pension value for certain executives as required in a company's annual report and accounts. It provides an (arguably) fair comparison with DC schemes, since it uses an accepted mechanism to identify the cash amount that the individual would actually be able to withdraw from the DB pension scheme and invest in a different pension scheme.

4.25 The CETV calculation takes many of the individual and scheme characteristics which influence the value of a pension to an individual into account. It calculates the present-day "cash equivalent" of a pension promise to a member of a given age, discounting by expected future investment growth. It also recognises that the cost of providing a particular amount of pension payable from a future date depends on how that pension will increase in line with changes in the cost of living between now and when it comes into payment, generally referred to as revaluation. The CETV could be used to value the deemed contribution in various ways, for example, where:

- A = actual CETV at the end of the year;
- B = annual pension entitlement at the beginning of the year increased by the standard revaluation rate up to the end of the year;
- C = CETV at the end of the year based on B; then
- the deemed contribution = A - C.

This method is illustrated in Box 4.D, which describes how the different valuation methods presented in this chapter can be applied to a particular example.

4.26 Since CETV amounts will vary depending on the current value of investments, adjusting for market movements could be considered, so as to remove the volatility that these would otherwise create within the CETV framework. To achieve this the trustees could take a view on the market neutral conditions underlying the scheme's CETV calculation, or the Government could stipulate the market conditions to be used, based on a single historical date or an average over time. Neither option would be straightforward.

4.27 The CETV method could also be used to calculate the deemed contribution associated with pension enhancements – the methodology presented above would need to be adapted to achieve this, with the scheme required to carry out individual tailored calculations.

4.28 As a highly individual and scheme-specific calculation that takes many characteristics into consideration, the CETV approach may be viewed as fairer than methods that do not take some of these factors into account. However, trustees have a certain level of discretion over the assumptions underlying the CETV calculation, including the investment strategy over which they have control. If a CETV approach was used for the valuation of deemed contributions, this could result in individuals in different schemes, but otherwise identical circumstances, receiving different tax outcomes depending on the precise assumptions used by their respective schemes. Variations resulting from differing trustee approaches to essentially the same circumstances arguably undermine the fairness advantage of using a CETV-based methodology.

4.29 Schemes already use the CETV approach, and are also currently required by law to provide a CETV calculation at a member's request once a year. However, many members do not exercise this right at the moment, so using this method could increase schemes' administrative burdens. The method is complex for individuals to understand, and they would not be able to calculate the restriction of tax relief themselves since they would not have access to the specific CETV factors used by the scheme. This would hinder them from making informed decisions about their pension provision. Also, any market adjustment mechanism would be likely to require input from a scheme administrator, meaning that an individual would be unlikely to be in a position to understand the tax implications of a change in circumstances until the end of the relevant tax year.

4.30 Due to the potential for variations in charges across schemes and individuals' inability to work out the tax consequences of their DB pension decisions, the Government does not believe that the CETV methodology is suitable to value the deemed contribution for the purposes of restricting tax relief. If respondents believe otherwise, the Government welcomes views on:

- why the CETV methodology is appropriate given the Government's principles of fairness and simplicity;
- the best way to apply the CETV methodology to value the deemed contribution for the purposes of restricting tax relief; and
- whether market movements should be stripped out and, if so, how that should be done.

Age-related factors (ARFs)

4.31 As Box 4.C illustrates, age is a crucial factor in determining the level of deemed contribution needed now to notionally fund a given increase in pension throughout retirement. Age is reflected in the CETV approach, but is not taken into account by the use of flat factors. Another option is to extend the flat factors method by developing a scale of age-related factors (ARFs) that increase with age. Relative to a flat factor, the use of a scale of ARFs improves fairness between DB and DC schemes as it can capture the effect of investment growth, reflecting the fact that for a given annual pension increase, the deemed contribution must be higher for someone closer to retirement. The Government believes that this is an important aspect of the valuation method.

4.32 While flat factors are overly simplistic, and the CETV is a complex calculation that takes many individual and scheme characteristics into account, ARFs can incorporate the effects of various characteristics, while retaining the advantage of simplicity. The ARFs method is therefore the Government's preferred option.

4.33 The effect of revaluation would be incorporated into an ARFs approach, as it is in the CETV calculation. At a minimum, this should be consistent with the statutory revaluation rate[5] to which the individual has a legal right upon leaving a scheme. Since the restriction of tax relief on pension contributions will not apply to deferred members who are simply receiving statutory revaluation of their pension each year, this approach would ensure fairness between deferred and active members of DB schemes. It would also be possible for revaluation to be set at a higher rate within the ARFs to reflect expected future salary growth in DB schemes.

4.34 The ARFs method would operate by:

- adjusting the previous year's annual pension entitlement by a revaluation rate;
- subtracting this from the current year's annual pension entitlement; and
- multiplying by the appropriate ARF.

The ARFs approach could also be used to calculate deemed contributions related to pension enhancements, for example via a separate set of factors that would take any change in the individual's NPA into account.

4.35 Given the inclusion of revaluation, it is possible for the deemed contribution as defined above (and under CETV) to become negative under certain circumstances. Since an active DB member benefits from an added year of service each year, this situation would only occur for certain individuals with low salary growth and longer years of service at a time of higher inflation. The Government proposes to treat the deemed contribution as being zero in these cases.

- The Government welcomes views on the most appropriate treatment for DB employee contributions in a year when the deemed contribution is less than the value of the employee contribution.

4.36 The ARFs approach allows other influencing variables to be captured as well as age, such as NPA, pension increases in retirement and dependants' benefits. Technically, these could all be incorporated into the ARFs scale, but the more influencing variables that are included, the more complex the method would become. Therefore, the Government proposes that the ARFs scale could either take the form of a one-way scale that varies only with age, or a two-way scale that also varies with NPA. The Government does not envisage that ARFs would differentiate on the basis of other individual characteristics such as gender or marital status. Other scheme characteristics could be included in a more average sense, where the published ARFs would be applicable to a defined broad range of values for each scheme characteristic. Where, exceptionally, an individual's scheme fell outside that range (including through avoidance by restructuring of scheme benefits), an adjusted ARF would need to be used.

4.37 The Government's current preference is to use a two-way ARFs scale. While one-way and two-way scales should, overall, restrict relief by the same amount over time, a two-way scale

[5] Broadly, for newly accruing rights, inflation capped at 2.5 per cent over the whole period until benefits come into payment.

achieves this in a more timely manner, more accurately identifying an increase in pension value in the year in which it is accrued. By contrast, a one-way scale would effectively create artificial enhancements in the year an individual leaves a scheme, to correct any underpayment in previous years where the individual's NPA does not match the NPA assumed in the ARFs – adding complexity to the calculation of the deemed contribution in that year.[6]

4.38 Use of a CETV-based methodology would require the scheme to calculate the deemed contribution. Under an ARFs approach, schemes would hold the relevant information to complete the calculation, but it would also be feasible for the individual to calculate their own deemed contribution. To make this possible, they would need their scheme to provide them with figures for their previous and current years' annual pension entitlements, as well as their NPA and information on any scheme characteristic that may influence the choice of ARF. The individual would then be in a position to complete the calculation, as described above in paragraph 4.34, by picking out the correct ARF from a published table and using the specified revaluation rate.

4.39 Setting the ARFs scale would involve:

- fixing the ARF at a specified retirement age, based on various factors to ensure fairness between DB and DC schemes; and
- making an assumption about investment return in excess of the revaluation rate to derive the rest of the scale for different ages.

4.40 The investment return assumptions could be chosen by reference to different actuarial approaches, including the CETV described above, technical provisions and the discount rate used for valuing liabilities under the FRS17 accounting standard. This consultation is not intended to discuss the underlying assumptions which should be used when setting an ARFs scale, but rather the principle of using the ARFs methodology. Further consultation regarding these assumptions would occur as part of the process of setting the scale. The DB valuation methods presented in this chapter have been developed in conjunction with the Government Actuary's Department (GAD), and the Government envisages that GAD would have a role in advising HM Treasury on setting an ARFs scale.

4.41 Once a scale had been set, there would be a need for periodic reviews to ensure ongoing fairness between DB and DC schemes, as investment and annuity market conditions vary over time. The desirable length of time between reviews is a balance between this fairness and stability for individuals affected by the measure. One option would be for the Government to commit to a review every set number of years; another would be to use a market-based trigger to instigate a review, for example if yields on long-dated gilts moved by more than a specified amount. The latter approach would highlight a link between DB pensions and the cost of DC pension provision, but would be unpredictable for individuals. The Government's preferred approach is a fixed period of review which would retain ongoing fairness between DB and DC schemes, and would be easier for individuals to understand. It is envisaged that, whichever option is chosen, any changes made to an ARFs scale would be published several months before the start of the tax year to which they would apply, to give individuals an opportunity to plan their pension provision.

4.42 ARFs are simpler to understand than the CETV approach and individuals would be able to work out the level of restriction in advance, which would enable them to plan their pension saving with a fuller knowledge of the tax consequences. Since the factors would not be set by

[6] The Government is aware that it is possible for some individuals to accrue DB pension rights with respect to more than one NPA, for example, as a result of equalisation following the Barber judgement. It believes that these situations can be incorporated into a two-way scale, for example by deeming the contribution separately for each tranche of annual pension entitlement.

each scheme's trustees or managers, there would be less variability between schemes. However, some scheme characteristics may be lost, depending on how many factors are taken into account in the ARFs scale. It could also introduce some confusion, as schemes are obliged to use a CETV approach in other circumstances, such as transfers out of DB schemes. This means that the valuation approach for the purpose of pensions tax relief could differ from the approach to valuing the pension in different circumstances.

4.43 However, overall, the Government considers that ARFs offer an appropriate balance between the objectives of fairness and simplicity, with a two-way scale varying with age and NPA capturing accrual in a more timely manner than a solely age-related scale.

4.44 The Government welcomes views on:

- whether a two-way ARFs scale is preferable to a one-way scale;
- which other influencing variables an ARFs scale should include in an average sense, bearing in mind the objectives of fairness and simplicity;
- whether there is any reason why cases where individuals have more than one NPA could not be treated using a two-way ARFs scale;
- whether the individual or the scheme should carry out the ARFs calculation to compute the deemed contribution;
- whether GAD should have a role in advising HM Treasury on setting and reviewing the scale; and
- how the scale should be reviewed, taking into account predictability and fairness.

Summary of methods

4.45 This work has been carried out in conjunction with GAD, which has been advising on designing valuation methods that meet the Government's fairness and simplicity objectives discussed above. The Government's view is that there are significant issues with achieving fairness through the use of flat factors, and that using the CETV approach raises major challenges due to the level of discretion involved and the impact on an individual's ability to pre-plan their tax affairs. Therefore, the Government's lead option for valuing the deemed contribution is a two-way scale of ARFs. Table 4.A summarises some of the advantages and disadvantages of the three approaches outlined above, and Box 4.D gives an illustrative example of how these methods would work in practice.

4.46 As discussed in paragraph 4.21, flat factors of 10 and 20 are used for DB scheme members to assess them against the annual and lifetime allowances. Once a valuation method has been chosen for the purposes of restricting tax relief on pension contributions, the Government will consider the most appropriate approach for the annual and lifetime allowances for future years.

4.47 The Government welcomes views on how well the valuation methods meet the objectives of fairness and simplicity and whether any other factors should be taken into consideration.

- Do stakeholders agree that (a two-way scale of) ARFs is the best approach for valuing the deemed contribution? If not, the Government welcomes views on what alternative method is preferable.

4.48 Further technical details on the methods discussed in this chapter are available in Annex C. Annex D considers how the methodologies for valuing a deemed contribution presented in this chapter can be extended to other arrangements as classified in Finance Act 2004, including other DB schemes, and cash balance and hybrid schemes.

- The Government welcomes views on any of the issues raised in Annexes C and D.

Table 4.A: Advantages and disadvantages of methods

Method	Advantages	Disadvantages
Flat factor	Familiar. Simple to understand and administer. Tax impact can be calculated in advance. Less variability between schemes than with CETV.	Less fair, since does not include important characteristics such as age. Is not able to address some increases in value in the year of drawing benefits.
CETV	Familiar. Arguably fair, since it reflects many individual and scheme characteristics.	Complex calculation makes planning for charges difficult. Potentially high administrative costs. Significant variability between DB schemes – arguably less fair.
ARFs	Relatively simple to understand. Tax impact can be calculated in advance. Arguably fair, since it reflects some individual characteristics, including age. Less variability between schemes than with CETV.	Some scheme characteristics may be lost (depending on how scale is constructed). Possible confusion as value of the same benefit entitlement is determined differently for different purposes.

Box 4.D: Example of how the different methods work

Individual N has a pensionable salary of £190,000 and 16 years of service in a defined benefit (DB) scheme with a 1/60ths accrual rate. Her pension entitlement is 16/60 * £190,000, that is £50,700 per annum. She does not contribute to her pension.

She then receives a 5.3 per cent pay rise, all of which is pensionable, to £200,000 in her seventeenth year of service. This boosts her annual pension to 17/60 * £200,000, that is £56,700 per annum.

Note, the following examples are intended solely as illustrations, so the results are not a definitive guide to the relative restrictions that the methods would produce.

Flat factor of 10:1

- taking the increase in annual pension (£6,000) and multiplying by 10 gives a deemed contribution of £60,000.

CETV

- assume that the CETV factor at the end of the year is 13.4, with a revaluation rate of 3 per cent; and
- this gives a deemed contribution of

  (£56,700 * 13.4) - (£50,700 * 1.03 * 13.4) = £60,000.

ARFs

- assume that the individual's ARF is 13.4, and that the revaluation rate is 3 per cent; and
- this gives a deemed contribution of

  13.4 * (£56,700 - £50,700 * 1.03) = £60,000.

In each case, N's gross income is £260,000 (her pay of £200,000 plus the £60,000 deemed contribution), so her relief is restricted to the basic rate on the deemed contribution. This gives a restriction of 30 per cent of £60,000, that is £18,000. N still receives relief of £12,000.

Questions for consultation

- The Government welcomes views on how well the valuation methods meet the objectives of fairness and simplicity, and whether any other factors should be taken into consideration.
- Do stakeholders agree that (a two-way scale of) ARFs is the best approach for valuing the deemed contribution? If not, the Government welcomes views on what alternative method is preferable.
- The Government welcomes views on whether a two-way ARFs scale is preferable to a one-way scale; which other influencing variables an ARFs scale should include in an average sense, bearing in mind the objectives of fairness and simplicity; whether there is any reason why cases where individuals have more than one NPA could not be treated using a two-way ARFs scale; whether the individual or the scheme should carry out the ARFs calculation to compute the deemed contribution; whether GAD should have a role in advising HM Treasury on setting and reviewing the scale; and how the scale should be reviewed, taking into account predictability and fairness.
- If respondents favour the CETV approach, the Government welcomes their views on why the CETV methodology is appropriate given the Government's principles of fairness and simplicity; the best way to apply the CETV methodology to value the deemed contribution for the purposes of restricting tax relief; and whether market movements should be stripped out and, if so, how that should be done.
- The Government welcomes views on whether there are any instances in which contributions or enhancements made to an individual's pension should not be subject to the restriction of pensions tax relief and why these exemptions are justified in the light of the Government's stated objective of fairness; and how these exemptions might best be crafted to avoid opening up scope for avoidance.
- The Government welcomes views on the most appropriate treatment for DB employee contributions in a year when the deemed contribution is less than the value of the employee contribution.
- The Government welcomes views on any of the issues raised in Annexes C and D.

5 Delivering the restriction of relief

Chapter summary

The restriction of tax relief on pension contributions for individuals with gross incomes of £150,000 and over will primarily be delivered through Self Assessment. This:

- avoids fundamentally disturbing the net pay arrangements within Pay As You Earn (PAYE), which operate to give most employees tax relief for their pension contributions at their marginal rate of tax; and
- enables employer contributions to be brought into tax, as for other benefits-in-kind received by employees.

The restriction of tax relief on pension contributions builds on and adapts existing processes, to facilitate the change and minimise the need for additional administration.

All of the individuals affected by the restriction of relief will already be in Self Assessment. The Self Assessment tax return will be modified to allow these individuals to report additional information (as necessary) to HM Revenue and Customs and to calculate the restriction of pensions tax relief.

Where individuals build up particularly large pension entitlements in a year, the current levels of tax relief will be particularly high, so the recovery charges from restricting pensions tax relief will be correspondingly large. In recognition of this, where the restriction leads to a charge exceeding £15,000 the individuals affected will have the option of electing that the pension scheme pays the recovery charge on their behalf, with the pension scheme in return reducing their pension pot or their accrued pension benefit for the year by an actuarially appropriate amount. Allowing the scheme to pay a recovery charge on an individual’s behalf is already permitted where an individual’s pension pot exceeds the lifetime allowance.

There will be circumstances where the scheme will not be able to pay the restriction of pensions tax relief on behalf of individuals. This could occur:

- where the pension scheme is an overseas one and the foreign law governing it would not permit such a payment; or
- in a heavily under-funded defined benefit pension scheme, where payment might favour the individual incurring the charge over the membership of the scheme as a whole.

In these situations it may be appropriate to allow individuals to spread the payment of charges exceeding £15,000 over 3 years.

Current methods for delivering tax relief on pension contributions

5.1 Chapter 2 explained that the restriction of pensions tax relief for individuals with gross incomes of £150,000 and over will apply to all contributions, including employers', but not to investment growth. Individuals are not currently taxed on the value of employer contributions made for their benefit,[1] meaning that these contributions effectively receive tax relief at the individual's marginal rate. And individuals receive tax relief on the contributions they make themselves, also at their marginal rate. To ensure consistency across individual and employer pension contributions, it is necessary to restrict tax relief on both, as discussed in Chapter 2.

5.2 Tax relief on individual pension contributions is delivered in one of three ways:

- relief through net pay arrangements;
- relief at source; and
- relief on making a claim.

Box 5.A describes these methods in more detail.

Box 5.A: Methods of providing tax relief on individual pension contributions

Method 1: relief through net pay arrangements

Employee contributions to occupational pension schemes are normally given tax relief via net pay arrangements, with around 60 per cent of individuals affected by the restriction of relief receiving tax relief in this way. The employer deducts an employee's pension contributions from their income before operating Pay As You Earn (PAYE) to collect income tax. This means that PAYE is operated on their net pay. This automatically delivers tax relief at an individual's marginal rate of tax.

Method 2: relief at source

Relief at source typically applies to contributions made to personal pensions. Where an individual is in a personal pension, it operates by allowing an individual to make a pension contribution of the full value they wish to make, less an amount equal to the basic rate of income tax. Where an individual is in a group personal pension, their pension contribution can be deducted from their salary by their employer after operating PAYE, who then pays it to the pension scheme. The pension scheme then claims an amount representing the basic rate tax from HM Revenue and Customs (HMRC), which it credits to the scheme member's pension account. So, for a contribution of £100, the individual (or employer on their behalf) would actually pay £80 to the pension scheme, and the pension scheme would claim £20 from HMRC.

This means that higher-rate taxpayers will have received only basic rate tax relief at source. To receive the full higher rate relief, they claim the difference through their Self Assessment tax return (or through a PAYE coding adjustment). In this way, HMRC effectively returns £20 of the £80 paid to the pension scheme to the higher-rate taxpayer.

[1] Providing that they do not exceed the existing annual and lifetime allowance limits.

Method 3: relief on making a claim

Exceptionally, some pension contributions are not tax-relieved at all on payment. This usually relates to pension contributions made to retirement annuity contracts and some pension schemes established outside the UK. In these cases, individuals pay the full amount of the pension contribution that they wish to make from their taxed income, and claim back the tax relief to which they are entitled from HMRC. For example, if an individual makes a £100 contribution directly into their pension scheme, they can subsequently claim back £20 from HMRC if they are a basic-rate taxpayer (meaning an overall cost to the individual of £80), or £40 if they are a higher-rate taxpayer (with an overall cost of £60 for £100 of contributions).

5.3 The method of providing tax relief applicable to an individual's contributions is dictated by the type of scheme that they belong to (see Box 2.A in Chapter 2, which explains the main types of registered pension schemes). These methods need to be adapted to apply the restriction on pensions tax relief received by individuals with gross incomes of £150,000 and over:

- for those in net pay arrangements who will automatically be given pensions tax relief at the marginal rate on their employee contributions, HM Revenue and Customs (HMRC) will collect an amount equal to the appropriate restriction of relief. This will ensure that individuals do not obtain too much tax relief;
- for those in relief at source arrangements, individuals fully affected by the restriction will not receive any further tax relief (since they will already have received the basic rate relief to which they are entitled). Individuals whose income falls on the taper will have the amount of relief above basic rate relief that they can claim determined by where they fall on the taper; and
- for those making a claim for relief, individuals fully affected by the restriction will be given tax relief at the basic rate and individuals whose income falls on the taper will be given relief at a rate determined by where they fall on the taper.

5.4 The restriction of tax relief on pension contributions builds on and adapts existing processes, to facilitate the change and minimise the need for additional administration.

Calculating and collecting the restriction of relief

5.5 All individuals with incomes of £100,000 and over are required to complete a Self Assessment tax return, which means that all those affected by the restriction of pensions tax relief will already be in Self Assessment. The Self Assessment tax return will be the mechanism used to collect the tax from that restriction and will be extended to allow individuals within Self Assessment to report additional information to HMRC (as necessary) and to calculate the restriction of pensions tax relief.

5.6 Individuals with incomes of less than £130,000 will continue to receive tax relief on pension contributions at their marginal rate, and so are unaffected by this change. Some individuals with incomes of £130,000 and over will need to provide additional information to HMRC to calculate and report their gross income and any recovery charges arising from the restriction of tax relief on pension contributions. This will typically apply to individuals in net pay arrangements and where the employer makes a contribution to an individual's pension. In these cases it will be necessary for the individual to find out:

- the amount of the individual's pension contribution (which will often just be the difference between gross and net pay); and

- the value of the pension benefit provided by the employer. In a defined contribution (DC) scheme this is simply the employer contribution. In a defined benefit (DB) scheme it is equivalent to the deemed contribution, less the employee's contribution, as explained in Chapter 4.

5.7 Taken together with information on income already provided elsewhere on the Self Assessment tax return, this will enable individuals with incomes of £130,000 and over to determine whether their gross income is less than £150,000, in which case they will be unaffected by the restriction; or £150,000 and over, meaning they will be subject to the restriction. This information is also needed to enable the individual to work out the recovery charge arising from the restriction of tax relief on pension contributions (or allow the Self Assessment computer to do so).

5.8 The Self Assessment tax return will be amended to include boxes to record the amount of individual contributions (A) and employer contributions (B). Generally, it will work as follows:

- for individuals in DC schemes, it is generally easy for the individual to obtain both the value of the individual (A) and employer (B) contribution and work out their total contribution (A+B). This information will be readily available from the employer or pension scheme; and

- individuals in DB schemes will need a valuation of the deemed contribution (Chapter 4 has detail of this calculation). This will give the total deemed contribution made to their DB pension in the year (A+B). The individual will need to supplement this information with their employee contributions (A). This will be subtracted from the total deemed contribution (A+B) to derive the deemed employer contribution (B).

5.9 This process is outlined in Chart 5.A below. The recovery charge will be added to the Self Assessment tax bill at the final stage of the calculation of tax due and payable for the year by the following 31 January, and will be separately identifiable.

5.10 There will be an obligation on employers to identify any employee to whom they provide gross pay and taxable benefits[2] of £130,000 or over and whose pension they contribute to, and to request a benefit statement from the pension scheme on the employee's behalf. This statement will provide the employee with information regarding actual or deemed employer contributions and the employee's own contributions made to that scheme over the previous year. These benefit statements will need to be available by 6 July, in common with other benefits-in-kind notified to employees on form P11D. The pension scheme would have three months to provide these statements. This is an appropriate timeframe for pension schemes to provide this information, since they are currently permitted three months to calculate comparable information upon request where there is a pension sharing order. Individuals not in automatic receipt of this benefit statement will be able to request this information from the employer or pension scheme, which the pension scheme would again have to provide within three months. HMRC guidance will alert individuals to the need to do this.

5.11 It may be appropriate to extend the requirement so that an employer must automatically request that pension schemes provide statements of pension benefits accrued over the tax year to any employee for whom they had previously provided one. For example, this could be of benefit where someone's salary is less than £130,000 but they have significant additional sources of income unknown to the employer.

[2] Pay and benefits (not including employer pension benefits) before any income tax, national insurance contributions or other deductions.

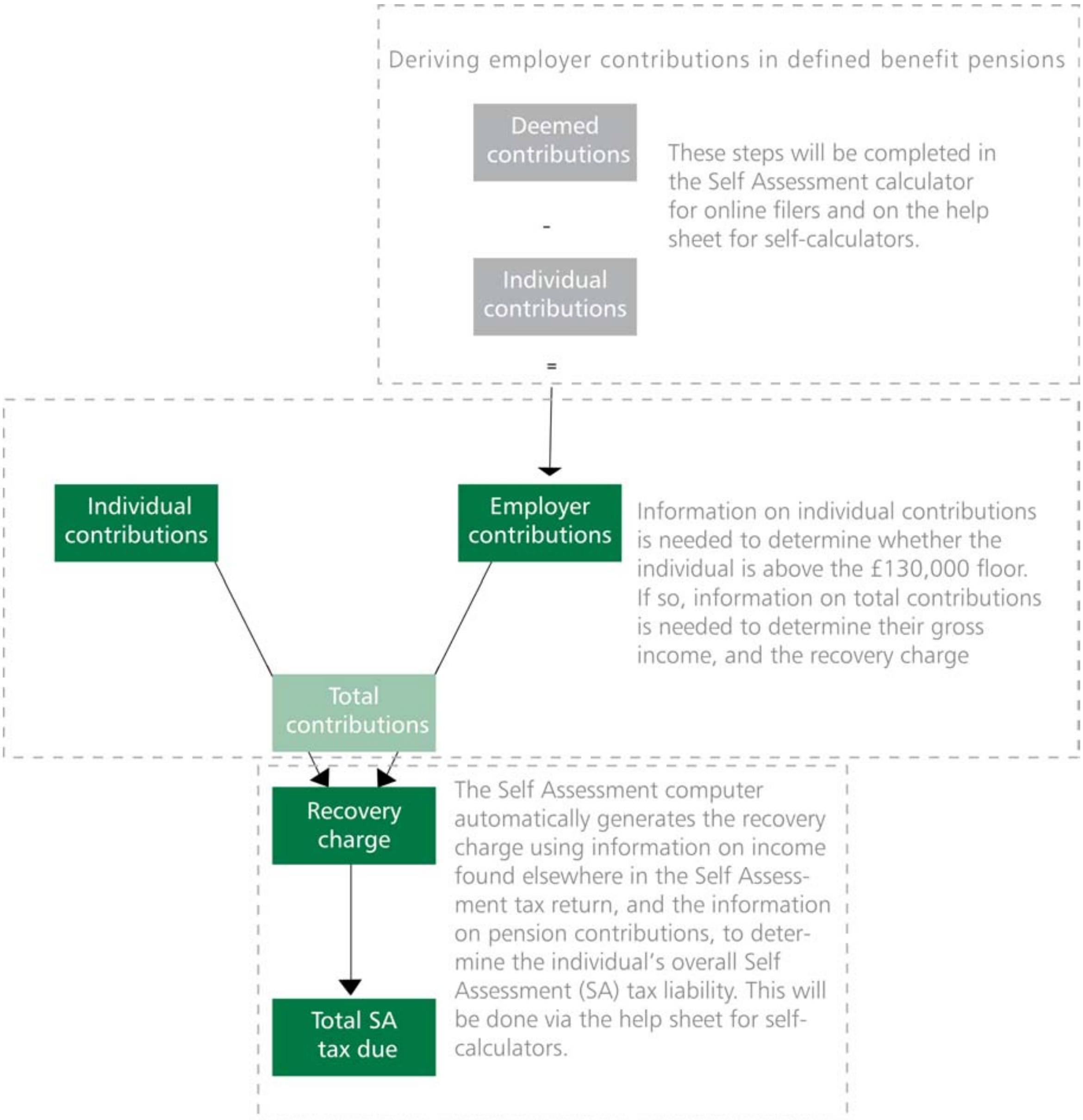
- The Government welcomes views on whether employers should automatically request that pension schemes provide pension benefit statements to any employee for whom they have previously asked for one.

5.12 Individuals who do not want to make a direct payment to HMRC already have flexibility to pay the charge in-year through HMRC's National Direct Debit Service Budget Payment Plan, which allows individuals to set up payments to be made in advance towards a Self Assessment tax liability. The individual can choose how much and how often (weekly or monthly) these payments are made.

- Do stakeholders agree that the Budget Payment Plan offers sufficient flexibility for those affected by the restriction of relief who wish to smooth payment of the tax liability across the year, paying a portion earlier than is legally required, if they wish to do so?

Chart 5.A: Diagram illustrating how the tax due will be determined through Self Assessment

This diagram illustrates that individuals with incomes of £130,000 and over will need to report on their Self Assessment tax return any pension contributions that they have made, and any actual or deemed contributions made by their employer (or a third party) for their benefit. Combined with information on income already reported on the Self Assessment tax return, this will determine the rate of relief to which they are entitled, and the recovery rate which is applied to total pension contributions to calculate the recovery charge.



Managing particularly large charges

5.13 The recovery charge that individuals affected by the restriction of relief will face is directly linked to the level of their contributions or deemed contributions in a given year. Where individuals build up particularly large pension entitlements in a year, the current levels of tax relief will be particularly high, so the charges from restricting pensions tax relief will be correspondingly large.

5.14 It follows that restricting pensions tax relief will mean recouping equivalently large charges from affected individuals, especially for those in final salary DB schemes who are promoted or have been accruing rights for a long period of time.[3] This is unlikely to occur year-on-year, but such spikes in deemed contributions and the resultant recovery charges could represent a sizeable proportion of an individual's net income for the year in which they get a large increase in pensionable pay. High-income individuals in DC schemes may also need to make a sizeable payment where a very large employer contribution has been made.

More flexibility over payment of large recovery charges

5.15 Pension schemes can already pay recovery charges on an individual's behalf, adjusting pension benefits accordingly to offset this. For example, individuals whose pension entitlement exceeds the lifetime allowance may be subject to a lifetime allowance charge. This recovery charge can be met by the scheme and deducted from the individual's pension benefits before they are paid.

[3] Around 110,000 individuals affected are estimated to be in DB schemes.

5.16 This approach will be extended to cover charges from the restriction of pensions tax relief. Where the restriction leads to a recovery charge exceeding £15,000, individuals affected will have the option of electing that the pension scheme pays the recovery charge on their behalf, with the pension scheme in return reducing their pension pot or their accrued pension benefit for the year by an actuarially appropriate amount. The election will be made and the charge will be reported by the individual through Self Assessment, but accounted for by schemes. The key steps for the 'scheme pays' process are set out in Box 5.B and illustrated in Chart 5.B.

Box 5.B: The 'scheme pays' process

The key steps of the 'scheme pays' process are:

- the individual calculates the recovery charge as part of the Self Assessment process;
- if the recovery charge is greater than £15,000 the individual can elect to use the scheme pays option. The individual informs the scheme and records this and the amount on the Self Assessment return;
- to ensure consistency of treatment between the scheme pays option and paying out of the individual's after-tax income, the scheme pays charge will be grossed up to reflect that the individual will have benefited from at least basic rate relief on their pension contributions or deemed contributions;[4]
- for a defined contribution scheme the individual's fund will be reduced by the amount of the scheme pays charge. For defined benefit schemes, the scheme will communicate the actuarially fair reduction to future pension benefits to the individual. Schemes currently undertake such valuations to pensions in a similar way when couples share pension rights on divorce. The scheme will have three months to provide this information in line with the requirements for pension sharing on divorce; and
- the individual confirms the scheme should proceed with the payment, and the scheme then reports and pays the recovery charge on the individual's behalf.

The individual will be able to elect for the scheme to pay up to the 31 January payment date for Self Assessment. In order to receive the necessary information from the scheme in time to make a decision as to whether to meet the recovery charge personally or to instruct the scheme to pay, individuals will have to initiate the scheme pays process three months before (by the end of October). If the individual initiates this process after the end of October, they will be liable for interest on any late paid tax if the scheme has not received confirmation to proceed with the payment by 31 January.

This process will have a facility to cater for individuals' circumstances changing, for example, where the recovery charge levied is adjusted downwards. It will also include a provision to allow HM Revenue and Customs the option of pursuing the individual for the tax, if, exceptionally, an elected scheme did not pay when instructed to proceed by the member.

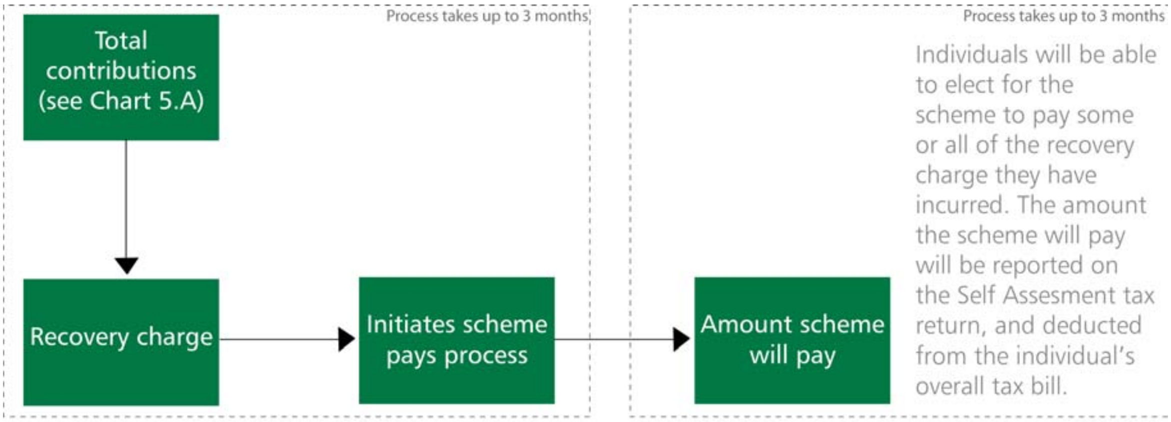
5.17 Administering the process described in Box 5.B will place some additional administrative burdens on pension schemes. The Government welcomes views on its proposed approach to scheme pays and, in particular, whether the approach could be modified to minimise burdens,

[4] Although the recovery charge paid by the scheme would be higher, the individual will be no better or worse off than if they had paid the recovery charge direct.

while delivering the same flexibility for individuals. In addition the Government welcomes views on:

- whether stakeholders consider it appropriate to make scheme pays available only to those in defined benefit pension schemes, recognising that individuals in defined contribution schemes, whether occupational or personal, have more scope to reduce contributions if they do not wish to incur the associated recovery charges;
- whether it is reasonable to allow individuals to only elect for a single scheme to pay in any given year, and for that scheme to pay only the portion of the charge relating to contributions or deemed contributions made to that scheme; and
- whether, for defined benefit schemes, given that the method and assumptions used to actuarially reduce the value of a pension could vary across schemes and could allow schemes to disadvantage members electing for the scheme to pay, it is appropriate to set parameters for calculating the actuarially fair offsetting reduction to a member's pension across all defined benefit schemes when implementing scheme pays, or to leave it to individual schemes' discretion.

Chart 5.B: Diagram illustrating the total tax due after the scheme pays the charge



To ensure that they meet the Self Assessment payment deadline of 31 January, individuals will need to initiate the scheme pays process by the end of October.

If individuals initiate the scheme pays process after the end of October but on or before 31 January, late payments of the recovery charge will be subject to interest (but no penalty).

5.18 To ensure that individuals wishing to take up the scheme pays option have access to it, and to give pension scheme trustees certainty over the response to member requests for the scheme to pay, the Government proposes that it would be mandatory for schemes to pay if elected by the member to do so. This would apply equally to the majority of EEA schemes.[5]

[5] The vast majority of EEA pension schemes with members in the UK are subject either to the Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision 2003/41/EC or, for personal pensions, Financial Services directives, such as Directive 2002/83/EC of 5 November 2002 concerning life assurance. These mean that where scheme pays is mandatory for UK-based schemes, it will be mandatory for EEA schemes too (overriding national legislation where necessary).

5.19 However, there will be circumstances where the scheme will not be able to pay the restriction of pensions tax relief. This could occur:

- where the pension scheme is an overseas one and the foreign law governing it would not permit such a payment; or
- in a heavily under-funded DB pension scheme, where payment might favour the individual paying the charge over the membership of the scheme as a whole. In the vast majority of cases, the impact on the funding position can be expected to be small.

5.20 Do stakeholders agree that it would be necessary to include an opt-out for the small minority of schemes that would be disproportionately affected, for example, by reference to a minimum level of funding?

5.21 In these circumstances it may be appropriate to allow individuals to spread the payment of charges exceeding £15,000 over three years. To ensure that the real value of the charge is maintained, interest would need to be charged on the deferred element.

- Do stakeholders consider that those with recovery charges exceeding £15,000 whose scheme is not able to pay the recovery charge should be allowed to spread payments over three years, with interest charged on the deferred element?

5.22 The Government does not intend to give everyone the option of spreading the charge over a number of years. This is because it does not believe that individuals with higher incomes should generally have greater flexibility over when they pay their tax than those on lower incomes.

Consultation Impact Assessment

5.23 An initial appraisal of the additional administrative implications for the affected individuals, their employers, and their pension schemes, as well as HMRC of implementing this reform is included as Annex E. It is the Government's intention to limit these burdens as far as possible, while maintaining flexibility for individuals, and this consultation invites views on how best to achieve this.

- The Government welcomes views on the consultation Impact Assessment, attached as Annex E.

Questions for consultation

- The Government welcomes views on whether employers should automatically request that pension schemes provide pension benefit statements to any employee for whom they have previously asked for one.
- Do stakeholders agree that the Budget Payment Plan offers sufficient flexibility for those affected by the restriction of relief who wish to smooth payment of the tax liability across the year, paying a portion earlier than is legally required, if they wish to do so?
- The Government welcomes views on its proposed approach to scheme pays and, in particular, whether the approach could be modified to minimise burdens, while delivering the same flexibility for individuals.
- Is it appropriate to make scheme pays available only to those in defined benefit pension schemes, recognising that individuals in defined contribution schemes, whether occupational or personal, have more scope to reduce contributions if they do not wish to incur the associated recovery charges?
- Is it reasonable to allow individuals to only elect for a single scheme to pay in any given year, and for that scheme to pay only the portion of the charge relating to contributions or deemed contributions made to that scheme?
- For defined benefit schemes, given that the method and assumptions used to actuarially reduce the value of a pension could vary across schemes and could allow schemes to disadvantage members electing for the scheme to pay, is it appropriate to set parameters for calculating the actuarially fair offsetting reduction to a member's pension across all defined benefit schemes when implementing scheme pays, or to leave it to individual schemes' discretion?
- Do stakeholders agree that it would be necessary to include an opt-out for the small minority of schemes that would be disproportionately affected, for example, by reference to a minimum level of funding?
- Do stakeholders consider that those with recovery charges exceeding £15,000 whose scheme is not able to pay the recovery charge should be allowed to spread payments over three years, with interest charged on the deferred element?
- The Government welcomes views on the consultation Impact Assessment, attached as Annex E.

6 How to respond to the consultation

6.1 Key questions aimed at guiding respondents to the central issues are set out in Annex A. Respondents are also encouraged to add any additional information they feel is relevant to the practicalities of implementing the restriction of pensions tax relief for individuals on incomes of £150,000 and over.

6.2 To help the Government evaluate responses, it would be helpful if respondents could explain their interest in the consultation and also make clear if their response is being made on behalf of a group or representative body. In the case of representative bodies, please provide information on the number and nature of the people you represent.

6.3 Responses to this consultation should be sent to HM Treasury by 3 March 2010 when the consultation closes. These responses should be clearly marked and addressed to:

Pensions tax consultation

Room 2/E2

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Alternatively you can e-mail your responses to pensionstaxconsultation@hmtreasury.gsi.gov.uk.

6.4 Any queries or questions surrounding the consultation should be directed to Sarah Miller at HM Treasury on 020 7270 5496, or for questions relating to the draft clauses published online at http://www.hmrc.gov.uk/pbr2009/index.htm, Paul Cottis at HM Revenue and Customs (HMRC) on 0115 9742420.

6.5 All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations. If you are willing and able to provide data on the impact of the restriction of tax relief on pensions contributions on your business or pension scheme then please do so. Responses will be shared between HM Treasury and HMRC.

6.6 A summary of responses will be published after the consultation has closed.

Confidentiality

6.7 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.

6.8 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 HMRC.

6.9 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.

The Government's consultation code of practice

6.10 This consultation is being conducted in accordance with Government's Code of Practice on Consultation. A copy of the Code of Practice criteria and a contact for any comments on the consultation process can be found in Annex H.

6.11 To ensure that people are able to contribute as fully as possible to this consultation, HM Treasury and HMRC will be running a series of workshops and other meetings throughout the consultation period. Please contact the pensions tax consultation team using the above e-mail address if you would like to attend one of these workshops or to discuss your response.

Additional information

6.12 We welcome comments from stakeholders on the consultation stage Impact Assessment, attached as Annex E.

A Summary of questions

The Government welcomes comments from stakeholders on the following questions:

Applying the restriction of relief (Chapter 3)

A.1 The Government welcomes views on the best balance to strike between the smoothness of the taper and simplicity for individuals.

A.2 Given that the restriction of pensions tax relief for high-income individuals will apply over the tax year, the Government welcomes views on whether the pension input period for the purposes of assessment against the annual allowance should be brought in line with the tax year.

A.3 The Government welcomes views on any practical or administrative issues that may arise from applying the restriction of pensions tax relief to individuals on gross incomes of £150,000 and over who are members of overseas pension schemes and benefiting from UK tax relief.

A.4 The Government welcomes views on the proposal to use the higher of gross income in the current or previous tax year for the purposes of assessing whether individuals are affected by the restriction of tax relief in the year that benefits are drawn.

A.5 The Government welcomes views on ways in which the impact on individuals affected by the restriction due to a redundancy payment of over £30,000 could be further mitigated without opening up scope for abuse.

Valuing the defined benefit contribution (Chapter 4)

A.6 The Government welcomes views on how well the valuation methods meet the objectives of fairness and simplicity, and whether any other factors should be taken into consideration.

A.7 Do stakeholders agree that (a two-way scale of) ARFs is the best approach for valuing the deemed contribution? If not, the Government welcomes views on what alternative method is preferable.

A.8 The Government welcomes views on whether a two-way ARFs scale is preferable to a one-way scale; which other influencing variables an ARFs scale should include in an average sense, bearing in mind the objectives of fairness and simplicity; whether there is any reason why cases where individuals have more than one NPA could not be treated using a two-way ARFs scale; whether the individual or the scheme should carry out the ARFs calculation to compute the deemed contribution; whether GAD should have a role in advising HM Treasury on setting and reviewing the scale; and how the scale should be reviewed, taking into account predictability and fairness.

A.9 If respondents favour the CETV approach, the Government welcomes their views on why the CETV methodology is appropriate given the Government's principles of fairness and simplicity; the best way to apply the CETV methodology to value the deemed contribution for the purposes of restricting tax relief; and whether market movements should be stripped out and, if so, how that should be done.

A.10 The Government welcomes views on whether there are any instances in which contributions or enhancements made to an individual's pension should not be subject to the restriction of pensions tax relief and why these exemptions are justified in the light of the Government's stated objective of fairness; and how these exemptions might best be crafted to avoid opening up scope for avoidance.

A.11 The Government welcomes views on the most appropriate treatment for DB employee contributions in a year when the deemed contribution is less than the value of the employee contribution.

A.12 The Government welcomes views on any of the issues raised in Annexes C and D.

Delivering the restriction of relief (Chapter 5)

A.13 The Government welcomes views on whether employers should automatically request that pension schemes provide pension benefit statements to any employee for whom they have previously asked for one.

A.14 Do stakeholders agree that the Budget Payment Plan offers sufficient flexibility for those affected by the restriction of relief who wish to smooth payment of the tax liability across the year, paying a portion earlier than is legally required, if they wish to do so?

A.15 The Government welcomes views on its proposed approach to scheme pays and, in particular, whether the approach could be modified to minimise burdens, while delivering the same flexibility for individuals.

A.16 Is it appropriate to make scheme pays available only to those in defined benefit pension schemes, recognising that individuals in defined contribution schemes, whether occupational or personal, have more scope to reduce contributions if they do not wish to incur the associated recovery charges?

A.17 Is it reasonable to allow individuals to only elect for a single scheme to pay in any given year, and for that scheme to pay only the portion of the charge relating to contributions or deemed contributions made to that scheme?

A.18 For defined benefit schemes, given that the method and assumptions used to actuarially reduce the value of a pension could vary across schemes and could allow schemes to disadvantage members electing for the scheme to pay, is it appropriate to set parameters for calculating the actuarially fair offsetting reduction to a member's pension across all defined benefit schemes when implementing scheme pays, or to leave it to individual schemes' discretion?

A.19 Do stakeholders agree that it would be necessary to include an opt-out for the small minority of schemes that would be disproportionately affected, for example, by reference to a minimum level of funding?

A.20 Do stakeholders consider that those with recovery charges exceeding £15,000 whose scheme is not able to pay the recovery charge should be allowed to spread payments over three years, with interest charged on the deferred element?

A.21 The Government welcomes views on the consultation Impact Assessment, attached as Annex E.

B International comparisons

B.1 This annex provides details of the tax treatment of private pensions in a selection of countries with mature pension systems, through a series of individual country studies. The countries presented are the G7, excluding the UK, and four other OECD countries, included to capture diverse pensions tax regimes and 'good practice' occupational pension models.[1]

B.2 Subject to the availability and comparability of information, the country studies cover the structure of the pension system; the pensions tax regimes, and the extent of and limits on the use of tax relief. The systems are described using the OECD framework, which separates the provision of pensions into three 'tiers': minimum guarantee (first tier), mandatory savings (second tier) and private savings (third tier).[2]

B.3 The structure of pension provision impacts the coverage of private pensions and, therefore, government expenditure on private pension saving. For example, Sweden and Italy both operate similar pensions tax models, but a greater proportion of pension savers are members of private pensions in Sweden (around 90 per cent) than in Italy (around 20 per cent). Correspondingly, Sweden provides tax relief for private pension saving worth roughly 1.5 per cent of GDP, while expenditure on private complementary pensions in Italy represents approximately 0.1 per cent of GDP. In recognition of the fiscal pressure associated with strong state provision in the context of increased longevity, the trend among OECD nations has been to shift towards a multi-pillar approach with a growing role for private pensions.

B.4 Pensions tax regimes are commonly categorised according to the tax treatment of three stages of the saving process where tax can be levied: (1) contributions by individuals and employers; (2) investment growth of the pension pot; and (3) withdrawal of the pension benefit. The UK's existing pensions tax regime is typically categorised as EET: contributions are exempt from tax (E), as is investment growth (E), while benefits – less an optional tax-free lump sum of up to 25 per cent– are taxed (T). Timing can also be an important factor: if an individual's marginal rate of tax is lower in retirement than during their working years, they can pay less on their pension savings in an EET regime than a TEE regime. A short income tax profile is presented in each country study to provide context. Where tax relief on pension contributions is given at the marginal rate, higher income tax rates imply more generous pensions tax relief; and as the difference between the top-rate and bottom-rate income tax increases, the more pensions tax relief benefits individuals on high incomes.

B.5 All countries surveyed have restrictions on pensions relief, the most common in the G7 being annual or lifetime allowances (usually including employer contributions). Limits on employer contributions are included because they often represent a significant proportion of an individual's total pension saving and play an important role in the incentives to save in a pension.

[1] G7: Canada, France, Germany, Italy, Japan, United Kingdom, and the United States of America. OECD 4: (1) Australia – one of the first countries to reduce the role of the state by encouraging saving through the private sector; (2) the Netherlands – which has a well-developed pension market; (3) New Zealand – which successfully introduced the KiwiSaver, a mandatory private pension, in 2007; and (4) Sweden – which conducted a comprehensive reform of its pension system, starting in 1998. Countries are presented in alphabetical order.

[2] 'First tier' provision exists to guarantee an absolute minimum standard of living for pensioners. The 'second tier' captures mandatory savings (public or private) and is designed to achieve a comparable standard of living in retirement as when working. The 'third tier' refers to voluntary savings where individuals or their employers are responsible for providing adequate retirement savings, without being mandated by the state.

Australia

B.6 The Australian pension system is two-tiered, comprising a means-tested state pension and a compulsory occupational private pension known as the Superannuation Guarantee (or Super). Employers are mandated to contribute a minimum of 9 per cent of an employee's salary into a superannuation fund. This amount can be increased by the employee, either through a process of pre-tax salary sacrifice or additional contributions from taxed income. Upon reaching the minimum state retirement age (currently 55 but rising to 60 by 2025), an individual is able to withdraw funds from the superannuation fund as a lump sum or a pension income.

Table B.1: Australia's income tax profile

0% up to AU$6,000 (£3,190)	40% up to AU$180,000 (£95,745)
15% up to AU$34,000 (£18,085)	45% top rate tax
30% up to AU$80,000 (£42,553)	Average earnings: AU$55,200[3] (£29,362) Exchange rate used[4]: £1 = AU$1.88

B.7 The Australian Treasury estimates the cost of superannuation tax concessions at AU$24.6 billion (2.3 per cent of GDP) for 2008-09.[5] Earlier analysis shows that in 2005-06 the top 5 per cent of earners received 37 per cent of all tax relief on pension contributions.[6]

B.8 The Australian pensions tax regime operates a TTE model.[7] Contributions to a superannuation fund are generally taxed like a taxable benefit at 15 per cent, as are investment returns within the pension fund. The taxation of withdrawals from the pension fund is guided by three factors: (1) age of retirement, (2) whether contributions were taxed and (3) how the pension is paid. For example, pension benefits derived from previously taxed contributions and accumulations are tax-exempt, while income from funds that pay benefits from untaxed contributions and earnings (such as public sector superannuation schemes) is taxed as income if taken as an annuity and at a concessional rate if taken as a lump sum.[8]

B.9 The maximum permitted cumulative contribution to a superannuation fund in any given year is AU$150,000, and employees may sacrifice up to 100 per cent of their salary as pension contributions. However, tax-deductible contributions are currently limited to AU$50,000 per year (equivalent to £26,596 and 91 per cent of average earnings), but this limit will be changed to AU$25,000 from 2010. Contributions beyond the ceiling are taxed at 46.5 per cent.[9] Tax relief is also restricted on any fund exceeding AU$1.045 million. However, this applies only to the fund and not the individual, who may pay into several funds, each with a restriction on pensions tax relief above AU$1.045 million. A high-earning individual could retire with AU$5 million, allowing them to withdraw AU$500,000 (£265,957 and 9 times average earnings) a year in retirement, tax-free.[10]

[3] All average earnings figures sourced from OECD.
[4] All exchange rates are based on a 6 month average, 01/07/2009.
[5] For full details see *Tax expenditures statement 2008*, Australian Treasury, 2009.
[6] Widely reported, but detailed in Ingles, D., *The great superannuation tax concession rort,* The Australia Institute, 2009.
[7] The system is also sometimes categorised as TTT.
[8] If income comes from untaxed funds, concessional rates of 15 per cent and 30 per cent apply up to specified limits if benefits are paid as a lump sum, 10 per cent of which is tax-deductible.
[9] If contributions are made from pre-tax income (such as through salary sacrifice), a 31.5 per cent tax is payable by the employee and a 15 per cent tax is payable by the fund. If contributions are made from post-tax income (personal contributions) then the employee bears the full tax.
[10] Ingles, D.,*The great superannuation tax concession rort*.

Canada

B.10 Canada's pension system is multi-tiered, with a state-administered first (Old Age Security) and second tier (Canada Pension Plan) complemented by a substantial private third tier (Registered Pension Plans). Around 50 per cent of all Canadians rely entirely on the state provided pensions for their retirement, while 40 per cent of all employees are covered by private occupational pensions, mostly in the public sector.[11] Roughly 80 per cent of all private occupational pensions are defined benefit plans. Though not strictly a pensions vehicle, Canada has recently introduced a new personal private defined contribution Tax-Free Savings Account (TFSA), from which funds may be withdrawn at any time and topped up again in later years.[12]

Table B.2: Canada's income tax profile

15% up to C$40,726 (£21,434)	Provincial income tax is levied at progressive rates in all provinces. Top combined marginal tax rates range from 39 per cent to 48.3 per cent.
22% up to C$81,452 (£42,937)	
26% up to C$126,264 (£66,560)	Average earnings: C$40,600 (£21,368)
29% top-rate tax	Exchange rate used: £1 = C$1.90

B.11 Canada operates an EET tax regime. Contributions to occupational pensions, within individual limits, and investment returns are tax-exempt, while income withdrawn from a pension is taxed at an individual's marginal rate. The new TFSA introduced a pre-paid expenditure tax (TEE) where contributions are taxed up to an individual's marginal rate.

B.12 Canada limits tax relief to Registered Pension Plans through a final benefit allowance. This determines the corresponding annual allowance, which permits combined, tax-assisted employee and employer contributions to pension plans, in any given year, up to the lower of 18 per cent of salary or C$22,000 (equivalent to £11,579 and 54 per cent of average earnings).[13] This effectively restricts tax relief for individuals whose incomes exceed C$122,222 (£64,327), the salary required to achieve the maximum tax-assisted pension income in retirement. There is a 1 per cent monthly charge on contributions beyond this level until the excess is removed from the fund.[14] However, if an individual fails to contribute their full tax-assisted allowance, the remainder is carried forward indefinitely, allowing the individual to make larger contributions in the future. In contrast, contributions to TFSAs are limited to a maximum yearly contribution of C$5,000, with similar 'carry-forward' provisions as Registered Pension Plans.

[11] For further information see: *International Pension Studies: Americas, Canada,* Allianz Global Investors, 2008.

[12] For a full explanation of the Tax-Free Savings Account, see: http://www.tfsa.gc.ca/.

[13] For defined benefit schemes, this is equated to 2 per cent per year of an individual's average best three years of remuneration times the number of years of pensionable service. For a fuller explanation of the tax treatment of contributions see: Beam, E. R., Laiken, S. L. & Barnett, J. J, *Introduction to Federal Income Taxation in Canada - 28th Edition*, 2007, CHH Ltd.

[14] The first C$2,000 excess contribution receives no tax relief, but is not liable for the penalty charge, nor is it tax-deductible. Employers do not face a penalty charge, but are required to submit a formal application to claim back the excess payment.

France

B.13 Two mandatory occupational pension schemes, which together cover over 30 million individuals, are the central features of the multi-tiered pension landscape in France, although the role of voluntary private pensions is growing. The *Association des Régimes de Retraites Complémentaires* (ARRCO) and *Association Générale des Institutions de Retraites des Cadres* (AGIRC) cater for blue- and white-collar workers respectively, and calculate pension benefits through a 'points' system.[15] Aside from the mandatory state-administered occupational pensions, numerous voluntary occupational plans exist. Of these, the *plan d'épargne enterprise* (PEE) and the *plan d'épargne retraite collectif* (PERCO) are the most popular. PEE plans are not specifically designed for pension saving, as funds may be withdrawn after five years. Voluntary personal pensions occupy a relatively small proportion of the market; however, pension reforms in 2003 introduced the third tier personal *plan d'épargne retraite populaire* (PERP) that attracted over 2 million members by 2008. Insured pension schemes, known as Article 83 and Article 39 schemes, offer plans providing defined contribution and defined benefit pension rights.

Table B.3: France's income tax profile

0% up to EUR 5,852 (£5,010)	30% up to EUR 69,505 (£59,508)
5.5% up to EUR 11,673 (£9,994)	40% top-rate tax
14% up to EUR 25,926 (£22,197)	Average earnings: EUR 31,000 (£26,495) Exchange rate used: £1 = EUR 1.17

B.14 France's pensions tax system follows an EET model. Contributions are exempt from tax, subject to limits that vary between scheme types, and investment returns are tax-exempt for all scheme types. Benefits received from life insurance plans are taxable as income, while income from pension funds is taxed at a lower rate, depending on the scheme.[16] Income from PERCO, for example, is tax-free if taken as a lump sum; however, the pension benefits gained from accumulated investment returns are taxed at 12.1 per cent when withdrawn. If taken as an annuity, benefits are taxed as regular pension income but are tax-deductible up to 60 per cent if the first annuity is paid before the age of 70 or deductible up to 70 per cent if the first annuity is paid after the age of 70.[17]

B.15 Employees can contribute up to 25 per cent of gross income to PERCO plans, though only the first 8 per cent is tax-deductible, capped at 8 per cent of eight times the social security ceiling.[18] The corresponding limit for PERP plans is 10 per cent of income or 8 times the social security ceiling. Further voluntary contributions do not attract tax relief.

B.16 Employer contributions can match employee contributions to PERCO plans up to 16 per cent of the social security limit. However, within this limit, only contributions up to EUR 4,600 (£3,923) are tax-deductible from employee income, after which the individual is taxed at their marginal income tax rate.

B.17 Employers are also able to deduct contributions as a business expense, depending on scheme type. Contributions to PERCO plans are deductible up to EUR 2,300 (£1,966). Further contributions are taxed at 8.2 per cent, up to EUR 4,600 (£3,932), after which contributions are fully taxed. When contributing to defined benefit Article 39 plans, employers can opt for one of two "social contribution" charges: either of (1) 8 per cent on annuities paid in excess of a third of annual social security ceiling; or (2) 6 per cent on contributions (12 per cent on allocations to book reserves). These social contributions will double from 2010.

[15] Details of the ARRCO and AGIRC are not discussed here, for more information about these plans see: http://www.arrco.fr/ and www.agirc.fr/ or, *International Pension Studies: Western Europe, France*, Allianz Global Investors, 2009.

[16] Employee contributions to personal defined benefit life insurance plans are not permitted.

[17] Source: Watson Wyatt and OECD.

[18] The social security ceiling is EUR 34,308 for the year 2009. The tax-deductible ceiling for contributions is, therefore, EUR 21,957 (£18,767).

Germany

B.18 The predominant facet of the German pension system is the state-administered second tier. The earnings-related system is based on accruing 'pension points'.[19] Demographic pressures have encouraged the development of voluntary occupational and personal pensions. In 2006, coverage of occupational pensions reached 65 per cent of employees. The most popular private occupational pension vehicle is *Direktzusage*, accounting for around 60 per cent of pension assets. There are four other options for employer-provided occupational pensions: *Direktversicherung*, *Unterstützungskasse*, *Pensionskasse* and *Pensionsfonds*. Two personal pension schemes are also available, the *Riester* and *Rürup* pensions, which cater for anyone covered by social insurance and the self-employed, respectively. All pension funds are legally required to provide a guarantee on benefits. This means that the value of the pension benefits cannot drop below the value of the contributions. The result is that all pension schemes are either defined benefit or hybrid defined contribution plans.[20] Most German pension plans are non-contributory and benefits can usually be paid as an annuity or lump sum.

Table B.4: Germany's income tax profile

0% up to EUR 7,834 (£6,707) 14% entry-rate tax 45% top-rate tax after EUR 250,400 (£214,384)	Germany applies a formula rather than a tax schedule to taxable income above the tax-free threshold. An additional solidarity surcharge of 5.5 per cent is also levied on income.
	Average earnings: EUR 42,400 (£36,239) Exchange rate used: £1 = EUR 1.17

B.19 The German pensions tax regime is in a state of transformation that began in 2002, moving from a TEE system to an EET regime. In all pension schemes investment returns will remain untaxed. By 2025 contributions to most schemes will be tax-free within set limits.[21] Additional contributions above the tax-deductible threshold will be taxed at an individual's marginal rate. From 2005, the proportion of pension income taxed at an individual's marginal rate was raised to 50 per cent, and will continue to be increased each year by the Government by either 1 or 2 per cent until all pension income is taxed in 2040.[22] However, full tax relief is given on a portion of pension income drawn from some schemes, currently up to EUR 9,643 for single pensioners.[23]

B.20 Limits to tax relief on pensions plans financed through direct *Direktversicherung*, *Pensionskasse* and *Pensionsfonds* are being synchronised. Cumulative employer and employee contributions to these plans are tax deductible up to a moving limit, currently the lower of EUR 4,392 (£3,754) or 4 per cent of the social security ceiling.[24] For contracts signed after 1 January 2005, an additional EUR 1,800 (£1,538) is exempt from income tax, though this amount is subject to social insurance tax. Within these limits, employee contributions through salary sacrifice are tax-deductible up to EUR 2,544. This threshold is reduced to EUR 2,100 for contributions to personal pensions. Employers are able to deduct contributions as a business expense, provided they are below the EUR 4,392 threshold.

B.21 Contributions to *Direktzusage* and *Unterstützungskasse* are not defined as wage components by the employer and so are fully tax-deductible and not subject to the limits on tax-assisted contributions applying to *Direktversicherung*, *Pensionskasse* and *Pensionsfonds*.

[19] For more details see: *International Pension Studies: Western Europe, Germany*, Allianz Global Investors, 2009.

[20] The *Pensionsfonds* is the only savings plan to allow this kind of hybrid defined contribution plan.

[21] Contributions to life insurance contracts will only be exempt if payable as an annuity, while contributions to life insurance contracts that pay benefits as a lump sum will be fully taxed.

[22] In 2009, 58 per cent of benefits drawn from a pension are liable to be taxed.

[23] This includes the tax-exempt income threshold, tax-allowable and special tax-allowable expenses and tax-deductible social insurance contributions.

[24] The social security ceiling in 2009 is EUR 64,800 per year, or EUR 5,400 per month.

Italy

B.22 A large state-run first tier targeting a high replacement rate has, historically, dominated the pension system in Italy. Successive reforms have steadily encouraged a greater role for private occupational pensions and, today, the private pension landscape is diverse, covering 20.7 per cent of employees in 2008.[25] The *Trattamento di fine Rapporto* (TFR), a mandatory severance pay scheme, is a popular private savings vehicle which attracts an annual contribution of 6.9 per cent of an individual's salary. The TFR is not necessarily a pensions product as contributions are paid during a person's working life at the end of each work contract irrespective of age, and may be withdrawn whenever employment is terminated. However, the TFR plays an important role in private pension schemes – particularly since 2004, when the Italian government took strides to encourage the growth of private pension funds by stipulating that TFR contributions be redirected into pension funds. Open and closed pensions and tax-favoured private life insurance (PIPs) offer further alternatives for pension savers and receive similar tax treatment as regular pension schemes.[26]

Table B.5: Italy's income tax profile

23% up to EUR 15,000 (£12,842)	Tax deductions are applied as tax credits.
27% up to EUR 28,000 (£23,973)	There is also a regional surcharge of between 0.9 per cent and 1.4 per cent and a local surcharge of up to 0.8 per cent, depending on the municipality.
38% up to EUR 55,000 (£47,089)	
41% up to EUR 75,000 (£64,212)	
43% top rate tax	Average earnings: EUR 24,600 (£21,026) Exchange rate used: £1 = EUR 1.17

B.23 The Italian pensions tax regime follows an ETT model. Contributions are fully tax-deductible for employers and deductible up to set limits for individuals, after which they are taxed at an individual's marginal rate. Since 2007, investment returns in a pension have been taxed at 11 per cent.[27] When drawn, income from a pension fund is taxed at between 9 per cent and 15 per cent, depending on the length of membership.[28] Up to 33 per cent of the investment returns from a pension pot may be withdrawn as a lump sum, tax free, though larger proportions are taxed.

B.24 Tax-assisted contributions, including employer contributions, are subject to an annual allowance, capped at the lower of 12 per cent of an individual's gross salary and EUR 5,164.57 (£4,414). For the first five years of an individual's first job they may contribute an additional EUR 2,582.29 tax free. Employer contributions are subject to the same tax relief as employee contributions. Employers making contributions to private pensions are required to pay a further 10 per cent solidarity contribution to the National Social Security Board (INPS).

[25] Source: Vigilance Committee on Pension Funds.

[26] For more details see: *International Pension Studies: Western Europe, Italy*, Allianz Global Investors, 2009.

[27] For more details see: *The pension system in Italy*, World Pensions, 2002.

[28] As a result, top-rate taxpayers implicitly gain most from the concessional tax rates – with tax relief of at least 30.5 per cent and 28 per cent on investment returns and pension income respectively, for high earners compared to 10.5 per cent and 8 per cent for base-rate taxpayers.

Japan

B.25 The Japanese pension system is diverse and in a state of reform. It combines a large state-run element (first and second tier), with a growing third tier. The public pension system has two pillars: a basic, flat-rate pension (National Pension System) and an earnings-related occupational pension (Employee Pension Insurance). Government support for private occupational pensions led to the introduction of new defined contribution and defined benefit corporate schemes in 2001 and 2002 respectively, which will replace the old Tax Qualified Pension Plan within five years. Overall, 44 per cent of workers are covered by voluntary occupational pensions.[29] Generally, the employer is responsible for making the full contribution to defined contribution schemes. The accumulated capital may be drawn as a lump sum payment or as an annuity.

Table B.6: Japan's income tax profile

5% up to JPY 1,950,000 (£12,415)	23% up to JPY 9,000,000 (£57,300)
10% up to JPY 3,300,000 (£21,010)	33% up to JPY 18,000,000 (£114,600)
20% up to JPY 6,950,000 (£44,248)	40% top rate tax

An inhabitant tax is imposed by prefectures and municipalities, and includes an income-based element.

Average earnings: JPY 4,990,000 (£31,769)
Exchange rate used: £1 = JPY 157.07

B.26 Japan's pension tax system can be described as ETT. In the new corporate pension schemes, employee contributions to defined benefit schemes are tax-deductible up to certain limits. Investment return is taxed at 1.173 per cent.[30] Benefits drawn from defined benefit schemes are taxed, though the extent of taxation depends on total pension income. The level of tax relief on benefits drawn from corporate defined contribution schemes is decreased if a company also offers a defined benefit plan.[31] Provided a resident taxpayer pays insurance premiums on a personal pension plan contract, and that the recipient of the pension payment is the same taxpayer or a spouse, a proportion of the contribution can be deducted from income and so is not liable for tax. This proportion is dependent on the size of the contribution – annual contributions above JPY 100,000 (£637) represent the highest contribution band and are deductible up to JPY 50,000.[32] However, contributions are largely the responsibility of the employer, and employees do not pay tax on employer contributions.

B.27 Some tax relief is given when the pension is withdrawn from corporate defined benefit schemes. For individuals on "miscellaneous incomes"[33] of JPY 7,700,000 or more, annuity benefits may be deducted up to the combined value of 5 per cent of miscellaneous income plus JPY 1,555,000 (£9,900).

[29] Source: *Pensions at a glance*, OECD, 2009.

[30] Composed of a 1 per cent national tax and a 0.173 per cent local tax.

[31] If an employer operates only a defined contribution scheme, tax relief is given on contributions up to JPY 552,000 (£3,514) per year; if the employer also runs a defined benefit scheme, this tax-free allowance is halved.

[32] Source: Watson Wyatt.

[33] For how to calculate relevant miscellaneous income, see National Tax Agency, *Income tax guide for foreigners, 2008.*

The Netherlands

B.28 The Netherlands' pension system is multi-tiered, with a flat-rate first tier pension provided by the state combined with a large occupational pension system (second tier) and insurance for additional personal retirement savings (third tier).[34] The occupational pension system has no statutory requirement for retirement savings, but industry-wide pension plans often require compulsory membership that can be approved by the Government on request.[35] As a result, occupational pensions cover over 90 per cent of employees, of which 80 per cent are members of industry-wide pension funds. These occupational pensions are overwhelmingly defined benefit plans (over 90 per cent of all schemes), with a growing trend towards average salary benefits rather than final salary. In the third tier, personal pensions are available, though coverage is low, while life insurance schemes cater for around one million individuals. Most private and occupational schemes target a replacement rate of 70 per cent of final salary.

Table B.7: The Netherlands' income tax profile

0% up to EUR 2,074 (£1,776) 33.5% (2.35%) up to EUR 17,878 (£15,306) 42% (10.85%) up to EUR 32,127 (£27,506) 42% up to EUR 54,776 (£46,897) 52% top-rate tax	The 33.5 per cent and 42 per cent (second bracket) rates include 2.35 per cent and 10.85 per cent income tax rates, respectively, the remaining 31.15 per cent in both cases is social security contributions. The 42 per cent (third bracket) and 52 per cent rates do not include any national social security contributions.
	Average earnings: EUR 39,700 (£33,932) Exchange rate used: £1 = EUR 1.17

B.29 The Netherlands does not provide a tax expenditure report; however, spending on tax relief on contributions in 2003 to private occupational pensions has been estimated at around EUR 9.6 billion, equivalent to 2.1 per cent of GDP.[36]

B.30 The Netherlands' pensions tax regime is an EET model. Contributions are tax-deductible; investment returns within pension funds are tax-free; and benefits drawn from a pension in retirement are taxed at an individual's marginal income tax rate.

B.31 Tax relief on employer and employee contributions to occupational pensions in the Netherlands is limited to a replacement rate of 70 per cent of final salary, after which surplus income faces an additional tax when drawn. The corresponding annual allowance for defined benefit schemes is a maximum 2 per cent accrual for final salary schemes or 2.25 per cent for average salary schemes. Individuals are permitted to accrue further pension benefits, of up to 100 per cent of final salary, by working beyond the retirement age.[37] Contributions to personal private pensions are included in the above limit, and may attract tax relief depending on the individual's future pension income and membership in other pension schemes.

[34] For a country profile of the Netherlands pension system see: *International Pension Studies: Western Europe, The Netherlands*, Allianz Global Investors, 2009; *Pensions at a Glance,* OECD, 2009.

[35] For this reason, the Dutch occupational pension system is often categorised as 'quasi-mandatory'.

[36] Source: Caminda, K. and Goudswaard, K. P., *The fiscal subsidy on pensions savings in the Netherlands,* Tax Notes International, 2004.

[37] For more information see: http://www.belastingdienst.nl/zakelijk/loonheffingen/lb22_vormen_van_loon/lb22_vormen_van_loon-43.html.

New Zealand

B.32 The pension system in New Zealand is predominantly two-tiered, with a first tier, flat-rate public pension supplemented by a quasi-mandatory private pension scheme, known as KiwiSaver. Occupational and private pensions are also available, but coverage has slipped significantly in the past decade to 13 per cent and 5 per cent respectively, in 2006.[38] By contrast KiwiSaver coverage has reached 29 per cent of eligible members since its introduction in 2007.[39] KiwiSaver is designed as a supplement to existing superannuation funds and requires a minimum contribution of 2 per cent of gross salary by both participating employees and their employers.[40] The state offers an additional NZ$1,000 (£435) start-up fund and weekly co-contributions up to a limit of approximately NZ$20 per week. Under special circumstances KiwiSaver funds can be used to purchase a first house.

Table B.8: New Zealand's income tax profile

12.5% up to NZ$14,000 (£6,087)	33% up to NZ$70,000 (£30,435)
21% up to NZ$48,000 (£20,870)	38% top rate tax
	Average earnings: NZ$43,000 (£18,696) Exchange rate used: £1 = NZ$2.30

B.33 In the first two years of KiwiSaver, the New Zealand Government spent approximately NZ$1.64 million on KiwiSaver, less than 0.1 per cent of GDP.[41]

B.34 In New Zealand, savings are generally taxed like any other income and the pensions tax regime is classified as TTE. Individual contributions are calculated from gross pay, but paid from taxed income, usually directly through the employer. Contributions to KiwiSaver schemes are also matched by the state up to NZ$1,042.86 per year.[42] Investment earnings of the fund, excluding capital gains, are taxed at 19.5 per cent or 30 per cent, dependent on income and the type of fund.[43] In retirement, withdrawals are tax-exempt.

B.35 Employer contributions up to the 2 per cent compulsory contribution are exempt from tax. Further employer contributions to KiwiSaver schemes and superannuation funds are subject to a withholding tax that is generally capped at 33 per cent. The employer is liable for the tax on behalf of the employee, usually reflecting this cost in the overall remuneration package.

[38] Source: *Pensions at a glance*, OECD, 2009.

[39] See details of eligible members at: http://www.ird.govt.nz/kiwisaver.

[40] This can be voluntarily increased by raising employee contributions to 4 per cent or 8 per cent. Employer contributions of 1 per cent became mandatory in April 2008 (increasing to 2 per cent in April 2009), while members are still able to opt out. The compulsory contributions are also required.

[41] See http://ird.govt.nz/aboutir/reports/research/report-ks/research-ks-annual-report-2009.html.

[42] Government contributions perform a similar function to tax relief by building incentives to save, and are specifically targeted at low earners for whom the NZ$1,042.86 annual limit represents a greater proportion of overall income.

[43] Those on incomes greater than NZ$60,000 (£26,087), or whose income exceeded NZ$38,000, for the previous two years pay the higher tax rate.

Sweden

B.36 Sweden implemented extensive reforms of the pension system in 1998. The pension system is now three-tiered. The first tier consists of a minimum guarantee pension and an earnings-related additional pension provided through state-run defined contribution accounts. The earnings-related pension requires an annual contribution equivalent to 18.5 per cent of employee income, mostly paid for by the employer. The second tier is large: around 90 per cent of employees in Sweden are members of voluntary occupational schemes. Because schemes are established through collective agreement, the majority of pension schemes are quasi-mandatory.[44] SAF-LO[45] and *Industrins och handelns tilläggspension* (ITP) are the two principal schemes, covering blue- and white-collar workers, respectively. The SAF-LO plan is a defined contribution plan, while the ITP plan includes both defined contribution and defined benefit elements. Forty per cent of employees are members of third tier personal savings schemes. These include insurance and personal pension accounts.

Table B.9: Sweden's income tax profile

Level 1 – Municipal Tax	Level 2 – National Tax
Progressive tax-free thresholds based on level of earnings.	0% up to SEK 380,200 (£29,944)
Flat rate tax ranging between 28.89%-34.09% dependent on municipality.	20% up to SEK 538,800 (£42,372)
Average rate: 31.60%	25% top-rate tax

The statutory top rate of combined municipal and national tax is 60 per cent.

Average earnings: SEK 324,600 (£25,559)
Exchange rate used: £1 = SEK 12.70

B.37 The tax treatment of occupational pensions in Sweden follows an ETT regime. Contributions are tax-exempt, subject to certain limits; investment returns are taxed at a flat rate of 15 per cent; and benefits drawn from a pension are taxed as income at the individual's marginal rate.

B.38 Contributions to occupational schemes are tax-deductible for employers up to 35 per cent of the employees' earnings. Employees' private pension savings are also deductible. Those who earn up to SEK 403,000 per year can receive relief on yearly savings of up to SEK 20,150, while individuals who earn up to SEK 800,000 can deduct up to SEK 40,300 per year from income tax. However, if employees are also covered by an occupational scheme the maximum deduction per year is SEK 12,000.[46]

B.39 In Sweden, the tax on employers who make contributions to occupational pensions is lower than on wages. When employers set aside occupational pension contributions they pay a special wage tax equal to 24.26 per cent instead of employers' fees equivalent to 31.42 per cent.

[44] For more information, see http://www.isa-northamerica.org/literature/Occupational_pension_and_insurance.pdf or www.isa.se.
[45] Named after the Svenskt Näringsliv (the Confederation of Swedish Enterprise) and LO (the Swedish Trade Union Confederation).
[46] Around 80 per cent of private pension savers save less than SEK 12,000 per year and so do not pay tax on their pension savings.

United States of America

B.40 The pension system in the United States is multi-tiered. The state pension provides earnings-linked benefits to ensure a basic standard of living. The large voluntary savings tier includes both occupational and personal pension schemes.[47] The state pension, referred to as Social Security, makes up around 18.5 per cent of retirement income for the highest 20 per cent of earners. Fifty-one per cent of employees are covered by voluntary occupational pensions.[48] Forty-three per cent of employees are covered by defined contribution plans, more than twice as many people as are covered by defined benefit schemes.[49] The 401(k) is the most popular defined contribution plan. The SIMPLE Individual Retirement Accounts (SIMPLE IRAs) are similar and offer an alternative for employers with fewer than 100 workers, though only around 5 million people are covered by these plans, significantly fewer than the 401(k). Standard Individual Retirement Accounts (IRAs) offer personal pensions to individuals without access to workplace schemes, while Roth accounts provide further options for pension savers.

Table B.10: The United States of America's income tax profile

0% up to US$3,650 (£2,230)	28% up to US$171,550 (£104,795)
10% up to US$8,350 (£5,101)	33% up to US$372,950 (£227,825)
15% up to US$33,950 (£20,739)	35% top-rate tax
25% up to US$82,250 (£50,244)	

Individual states and some larger cities may charge a separate income tax, averaging around 6 per cent.

Average earnings: US$39,400 (£24,024)
Exchange rate used: £1 = US$ 1.64

B.41 The United States' pensions tax system follows an EET model. Contributions are deducted from pre-tax income while investment return is untaxed. When drawn, pension benefits are taxed as income at an individual's marginal rate. An exception to the pensions tax system is the Roth account, which follows a TEE model with contributions made from taxed income.

B.42 Contributions to private occupational defined contribution plans are limited in a number of ways. Combined employer and employee contributions to 401(k) plans attract full tax relief up to 100 per cent of total salary, capped at US$49,000 (£29,878 or just under average income) in 2008. Within this threshold, tax relief is given on employee contributions up to US$16,500, although an additional US$5,500 per year is permitted for individuals aged 50 and over. Employer contributions are tax-deductible up to the limits described above, beyond which they are taxed at an individual's marginal rate.

B.43 Contributions[50] to IRAs receive tax relief up to 100 per cent of salary, capped at US$5,000 (£3,049).[51] An additional US$1,000 in untaxed contributions is permitted for individuals aged 50 and over. Tax relief on contributions to IRAs is restricted further if the individual is also a member of an occupational scheme.

[47] Information sourced from Allianz Global Investors, OECD and Watson Wyatt.

[48] A further 10 per cent of employees have access to occupational pensions but are not covered.

[49] For further details of coverage see: *International Pension Studies: Americas, United States of America*, Allianz Global Investors, 2008.

[50] With the exception of SIMPLE IRAs, employer contributions to IRAs are not permitted.

[51] If an individual contributes too much to an IRA, they have until 15 April to submit a formal claim to withdraw the excess. Any excess contribution left in the IRA after 15 October is subject to an annual penalty equal to 6 per cent of the excess amount until it is withdrawn.

C Defined benefit valuation methods

Introduction

C.1 Chapter 4 discussed the necessity of placing a value on the deemed contribution made to a defined benefit (DB) scheme for an individual, since both individual and employer pension contributions are included within an individual's gross income and the restriction of pensions tax relief. There is no single way of doing this, but the Government is committed to two key principles that the chosen valuation method should achieve as far as possible: it should be fair between DB and defined contribution (DC) schemes, and should be reasonably simple for individuals to understand and for schemes to administer.

C.2 Chapter 4 presented three possible valuation methods: flat factors, cash equivalent transfer value (CETV), and age-related factors (ARFs). Flat factors are currently used for the annual allowance (AA) and lifetime allowance (LTA) and are simple to understand and administer but will generally deliver less fair outcomes than more tailored methods. The actuarial CETV calculation is also currently used within the pensions industry, including for valuing pension transfers. While it takes account of a large number of individual and scheme characteristics, it is a complex calculation that would hinder individuals from pre-planning their tax affairs and lead to variability across schemes. The ARFs method extends the flat factors approach by creating a fairer scale of factors that vary with age and possibly other variables such as normal pension age (NPA). This would take fewer individual and scheme characteristics into account than the CETV approach, but would reduce variability of outcomes between schemes, and be easier for individuals to understand and calculate. The Government favours a two-way scale of ARFs varying with age and NPA, as it believes that this approach strikes an appropriate balance between the objectives of fairness and simplicity.

C.3 This annex gives further details on how these three methods would operate for final salary DB schemes with a commutable lump sum option, including how they would value the deemed contribution associated with pension enhancements, for example on drawing benefits or leaving a pension scheme. The proposed approach for other types of DB scheme, lump sum accruals, and other scheme types is discussed in Annex D.

Valuation options

Flat factors

C.4 Flat factors of 10 and 20 are currently used for valuing pension rights for the purposes of testing against the AA and LTA respectively, in accordance with Finance Act 2004.[1]

C.5 For the purposes of valuing pension rights for the AA test, an 'opening value of rights' and a 'closing value of rights' are separately determined at the start and end of the pension input

[1] Finance Act 2004 introduced a restriction on the amount of pension (and other) rights which might be provided tax-free within a registered pension scheme. Where the increase in pension rights in any input period exceeds the AA, tax is payable on the excess at an individual's marginal income tax rate. If, at retirement, an individual's total pension rights exceed the LTA, tax is charged on any excess value, effectively at the rate of 55 per cent.

period.[2] The 'pension input amount' (equivalent to the deemed contribution) is then calculated as follows:

Opening value of pension rights = 10 * annual pension entitlement at start of pension input period.[3]

Closing value of pension rights = 10 * annual pension entitlement at end of pension input period.[4]

Pension input amount = closing value - opening value.

C.6 Where an individual is no longer accruing pension rights, the opening value of rights is increased for the purposes of the valuation, broadly by the greater of 5 per cent or the increase in the RPI over the pension input period.[5] Where this increase equals or exceeds the rate at which rights actually revalue in the scheme, the opening value will at least keep pace with the closing one. This effectively means that no increase in value arises for most individuals under the AA after leaving active membership of a pension scheme.

C.7 No AA test applies in the year of drawing benefits because the LTA test does. Becoming entitled to a scheme pension is an example of a benefit crystallisation event,[6] where the value of the benefit which has crystallised after any options are exercised (e.g. a commutable lump sum) is compared with the available LTA. At retirement, the value of benefits coming into payment is determined, in most cases, as follows:

Value of pension = 20 * pension expected to be payable over the coming 12 months + any lump sum paid on commencement

C.8 If applied to calculate the deemed contribution for the purposes of restricting tax relief on pension contributions, flat factors would operate in the same way as this AA methodology. As discussed in Chapter 3, unlike the AA, the restriction of pensions tax relief will apply in the year of drawing benefits for reasons of fairness, whichever valuation option is chosen.

[2] Normally a tax year, or another period over which pension rights are earned. For the purposes of restricting tax relief on pension contributions, this will be aligned with the tax year.

[3] Assuming the individual had become entitled to payment at the beginning of the pension input period and assuming no reduction for early payment, and that ill health is not a factor.

[4] Assuming the individual had become entitled to payment at the end of the pension input period and assuming no reduction for early payment, and that ill health is not a factor.

[5] The Registered Pension Scheme (Uprating Percentages for Defined Benefit Arrangements and Enhanced Protection Limits) Regulations SI2006/130 provide for the situation where statutory revaluations of deferred benefit rights are higher than the usual uprating of 5 per cent per year or by the RPI.

[6] A defined event or occurrence where a benefit crystallises and a test against available LTA is triggered, including receipt of retirement pensions and lump sums, certain death benefits, overseas transfers, excessive pension increases and failing to annuitise by age 75.

Cash equivalent transfer value (CETV)

C.9 A CETV is an actuarial calculation currently used by pension schemes to give the lump sum value, in today's terms, of the pension rights accrued by an individual. Its main function is to calculate the amount available in relation to an individual's rights when they transfer their pension into another scheme. CETVs are also used in other circumstances, for example to value pension rights for divorce purposes and when disclosing directors' remuneration in company accounts.

C.10 The Pension Schemes Act 1993 gives individuals the right to request a CETV quotation from their scheme once a year free of charge. The legislation provides that a scheme's trustees or managers are responsible for setting the terms on which CETVs are calculated. In doing so, they must comply with the detailed provisions concerning the method of calculation which are set out in the Occupational Pension Schemes (Transfer Value) Regulations 1996 (as amended). These provisions stipulate the method for calculating the minimum amount of any CETV,[7] including the following:

- the CETV should be the trustees' (or, where applicable, the managers') best estimate of the amount required to make provision within the scheme for the member's accrued benefits, options and discretionary benefits. In doing so, the trustees must decide:
  - how much to take account of any options which, if exercised, increase the value of a member's benefits (for example, inverse commutation); and
  - if any potential future discretionary benefits should be taken into account, having regard to any established custom within the scheme and any requirement for consent (from the sponsoring employer, for example).
- the trustees must take actuarial advice in determining appropriate economic, financial and demographic assumptions to be used, including discount rate, rate of future RPI increases, and mortality assumptions:
  - when setting demographic assumptions, trustees have to have regard to the characteristics of the scheme's membership, or of the general population if the scheme is too small to derive scheme-specific assumptions; and
  - when setting the discount rate to be used for CETVs, the trustees must have regard to the scheme's investment strategy. Unfunded public service schemes are subject to Treasury guidance in this area.[8]
- CETVs may be reduced if payment of an unreduced CETV would be to the disadvantage of remaining members. This could be the case if the scheme is under-funded, that is, has insufficient assets to meet its existing liabilities for all members.

Due to all the scheme-specific assumptions described above, there is significant potential for variation in CETVs between members of different schemes even where the underlying member characteristics and scheme benefit structures are very similar.

C.11 To discharge their obligations under the legislation, trustees must also periodically review the assumptions used for CETVs and make any revisions necessary to ensure continued compliance. Such reviews typically follow the triennial actuarial valuation cycle, whereby a scheme and its sponsor seek to ensure that sufficient funds are available to meet benefit

[7] Some schemes may choose to offer higher transfer values.

[8] Current guidance *Basis for setting the discount rate for calculating cash equivalent transfer values payable by public service pension schemes* was published by HM Treasury on 11 September 2008. This is available at www.hm-treasury.gov.uk/d/publicservice_pensions110908.pdf.

payments as they fall due. The scheme's financial position is reviewed and its funding pattern adjusted accordingly. CETV reviews may be more frequent if, for example, there is a significant change in investment strategy between valuations.

Method of calculation

C.12 CETVs are typically calculated by applying one or more factors to individual elements of a member's benefit entitlement. For example:

CETV = Pension * factor 1

+ dependant's pension * factor 2

+ lump sum payable on death before retirement * factor 3.

C.13 A market adjustment factor may be separately applied to the result of the above calculation, or may be built into the factors in some way. This adjustment, either explicit or implicit, is intended to allow for market fluctuations in the investments pension schemes hold. In other words, the CETV is intended to reflect the amount the scheme needs at the time of calculation to provide accrued benefits in the future, based on the scheme's expectations of future investment yields.

Member specifics

C.14 CETV factors are normally gender-specific, and so otherwise identical male and female members of the same scheme would receive different CETV valuations, resulting in differing restrictions of pensions tax relief if a CETV-based methodology were used. The vast majority of schemes make assumptions about certain other member characteristics when determining CETVs. For example, neither an individual's marital status nor the age of their spouse is normally taken into account when calculating a CETV – rather, assumptions based on scheme or population averages are used. It is envisaged that the normal scheme practice would be adhered to if a CETV-based methodology were used.

Application of CETVs for calculating deemed contribution

C.15 The CETV methodology could be applied to value the deemed contribution in a number of ways. For example, as outlined in Chapter 4, the process could work as follows:

- calculate the actual CETV at the end of the pension input period;
- 'standardise' the actual CETV at the end of the pension input period (see below) (A);
- calculate the value of the annual pension entitlement at the beginning of the pension input period, revalued by the standard revaluation rate up to the end of the period (P);[9]
- calculate the CETV at the end of the pension input period based on P;
- 'standardise' the CETV at the end of the pension input period based on P (B); and
- subtract B from A.

[9] Revalued at the rate at which a scheme must increase the member's benefits on leaving service with a deferred pension entitlement.

C.16 Standardising the CETV would involve at least the first and possibly also the second of the following steps:

- remove any reduction being applied for scheme under-funding, since the restriction is based on the expectation that such under-funding will be addressed and individuals will receive their full accrued benefit entitlement on drawing benefits; and
- remove any adjustment made for day-to-day market movements.

C.17 This second step could potentially be included since, otherwise, the restriction of relief could vary significantly from year to year on similar increases in pension value – this could be particularly unfavourable for an individual accruing a large pension increase in a year where market conditions generate a larger charge. There are several options which could be used to achieve market neutrality:

- require the scheme to take a view on market neutral conditions in the context of the basis underlying its CETV factors. This task would most naturally lie with the trustees or managers given their responsibilities in setting the factors, but guidelines would be needed so as to achieve some level of consistency between schemes. This might not be straightforward; and
- the market conditions to be used could be specified. This could be achieved, for example, by requiring the use of market conditions prevailing at a specified, perhaps historical, date or by using historical averages of market measures. It is not clear whether using market averages would be practical in view of the diversity of approaches used to calculate CETVs in practice. For example, some schemes take account of an individual's age when determining the influence of market conditions, and so the effect of ageing could complicate the averaging process.

C.18 Other detailed applications of the CETV methodology may also be possible to deem a contribution for the purposes of restricting tax relief. Due to the potential for variations in charges across schemes and individuals' inability to work out the tax consequences of their DB pension decisions, the Government does not believe that the CETV methodology is suitable to value the deemed contribution for the purposes of restricting tax relief. However if respondents believe otherwise, as explained in Chapter 4, the Government would welcome views, including on the most suitable application of the CETV methodology.

Age-related factors (ARFs)

C.19 As explained in Chapter 4, age is a crucial factor in determining the level of deemed contribution needed now to notionally fund a given pension in retirement. Age is reflected in the CETV approach, but is not taken into account by the use of flat factors. Another option is to extend the flat factors method by developing a scale of age-related factors (ARFs). The ARFs method would differ from the application of flat factors for Finance Act 2004 purposes as the factor applied would increase with age, and the method would also take account of some level of revaluation of a pension up to retirement. The factors themselves would be set with regard to assumptions about investment growth and future pension revaluation.

C.20 The deemed contribution would be determined in the following way:

- calculate the annual pension entitlement at the beginning of the pension input period;
- increase this by the appropriate revaluation rate (see below) (A);
- calculate the annual pension entitlement at the end of pension input period (B);

- calculate the 'adjusted earned pension' (C) by subtracting A from B; and
- multiply C by the relevant ARF.[10]

Revaluation

C.21 There are two levels of revaluation which might be considered for use in the method described above:

- Revaluation consistent with statutory minimum provisions: as explained in Chapter 4, this is the minimum allowance that should be considered, since it is not intended that the restriction of tax relief should apply to deferred members of DB schemes (whose pensions will be uprated annually at least in accordance with the statutory revaluation rules). This revaluation approach therefore ensures fairness between active and deferred DB scheme members. A further advantage of using this approach is that it accommodates differing types of DB provision, including final salary and almost all career average schemes, since they are both subject to the same statutory revaluation legislation; and
- Expected salary growth: a case could be made for incorporating a revaluation rate in line with expected future salary growth. Technical provisions[11] and company accounting procedures (e.g. accounting standard FRS17) commonly allow for future salary inflation, which is generally referred to as a past service reserve approach. Taking account of some, or all, future salary revaluation in assessing the value of accrued pension rights generally means assigning a higher current value of pension rights than if only statutory revaluation were taken into account.[12] Allowing in advance for future salary revaluation will, on average, result in a more stable pattern of tax relief over the working lifetime.

  However, this method makes assumptions about the future which may not be borne out in practice. For example, it is possible that an individual who leaves before their NPA may have lower pension rights than the value assumed at the end of their final pension input period as an active member. This is because their pension will subsequently only be uprated in line with statutory revaluation, whereas restrictions of relief before they left the DB scheme would have been based on higher revaluation assumptions.

Member and scheme specifics

C.22 As discussed earlier, CETV factors are normally gender-specific, but most schemes make average assumptions regarding other member characteristics such as marital status. It is envisaged that, under the ARFs methodology, a single set of factors would apply for both men and women and an average approach would be taken for these other aspects. Chapter 4 welcomes comments on which factors should be taken into account when constructing an ARFs scale.

C.23 A considerable amount of detail relevant to the value of the pension rights would be captured by a solely age-related ARFs approach. However, other variables can influence the level of pension rights, including NPA, dependant provision, and pension increases in retirement. These could all be reflected within the ARFs methodology, but this would increase the

[10] As appropriate for age at end of the pension input period.

[11] Technical provisions are an estimate for regulatory purposes of the assets needed to make provision for benefits already accrued under the scheme.

[12] If only statutory revaluation is allowed for within the mechanism, the value of any higher salary revaluation will emerge over time within the accrued pension calculation and, for individuals who remain in pensionable service until retirement, the aggregate value recognised over the period of accrual will be the same under either method.

complexity of the method. As discussed in Chapter 4, the Government proposes that the ARFs scale could either take the form of a one-way scale that varies only with age, or a two-way scale that also varies with NPA. Other scheme characteristics could be incorporated into the ARFs in a more average sense, where the published ARFs would be applicable to a defined broad range of values for each scheme characteristic. Where, exceptionally, an individual's scheme fell outside that range (including through avoidance by restructuring of scheme benefits), an adjusted ARF would need to be used.

One-way scale

C.24 A one-way scale would be based around a single NPA assumption. This could sensibly be either 60 or 65, given that the vast majority of affected individuals are likely to be entitled to benefits payable from one of these ages. While a one-way scale ostensibly seems simpler than a two-way scale, it has significant drawbacks:

- it would create artificial pension enhancements. In the pension input period in which an individual retired, or otherwise left pensionable service, any increase in benefit value resulting from the actual payment age being lower than the NPA assumption within the ARFs would be captured (discussed further below); and
- it would potentially overcharge individuals with NPA greater than the assumed NPA. However, this is only generally the case for those who leave early with a basic deferred pension, or with a fully reduced early retirement pension.[13] Those who continue in service to their NPA and have high incomes throughout the period could generally expect roughly to recoup the overpayment in the period between the deemed NPA and their actual pension age. Similarly, those retiring early on beneficial terms are able to effectively offset the overpayment already made against the deemed contribution associated with this enhancement.

Two-way scale

C.25 A two-way scale would provide ARFs varying with age and NPA. In the pension input period in which an individual drew benefits, or otherwise left pensionable service, there would be no need for an adjustment unless the actual payment age were lower than the individual's NPA as at the start of the pension input period. This is simpler than the approach needed with a one-way scale, as discussed above. If a two-way scale were to be used, there may be scope to reduce the number of factors by grouping them by age and NPA. For each tabulated NPA, factors would increase steadily with age to that NPA. The tabulated rates would include factors for ages beyond the NPA to take account of any continuing accrual, and these factors would reduce to reflect the shorter expected period over which pension payments will be payable.

Assumptions underlying the factors

C.26 Setting the ARFs involves two distinct elements:

- An immediate pension factor: this is the assessed value of future pension payments when the pension first comes into payment. This would be fixed for a specified NPA, which in the case of a one-way scale would be the assumed NPA underlying that scale. It would take account of longevity expectations and make some

[13] That is, with a reduction which reflects the full period between actual retirement date and expected NPA.

allowance (perhaps on the basis of the average for the affected population of high earners) for dependant provision[14] and pension increases in retirement;[15] and

- A combined allowance for investment return and pre-retirement revaluation: an annual net discount adjustment is proposed between the end of the relevant pension input period and the NPA. The rate of revaluation assumed within the factors will tie in with the rate used in the application method, as described above.

This procedure would be carried out once for a one-way scale, with a deemed NPA assumption. To produce a two-way scale, this procedure would be repeated for each possible NPA.

C.27 The Government is not consulting on the underlying assumptions which should be used when setting an ARFs scale, but rather the principle of using the ARFs methodology. Further consultation regarding these assumptions would occur as part of the process of setting the scale.

Valuing pension enhancements

C.28 As discussed in Chapter 4, pension enhancements will be fully subject to the restriction of tax relief where appropriate, for reasons of fairness. Such enhancements would most typically arise on leaving a pension scheme, but could also be made at other times. This section explains how deemed contributions associated with these enhancements may be calculated for DB scheme members under the CETV and ARFs valuation methods.

C.29 When an individual leaves active membership of a pension scheme, there is potential for additional benefit value relative to the deemed value recognised for tax purposes arising in many circumstances, including:

- retirement at NPA (if a one-way ARFs table is used);
- early retirement (including on redundancy);
- ill-health retirement (including, in cases of terminal illness, total commutation of pension to a lump sum);
- other augmented leaving service rights; and
- augmentation of contingent death benefits (with dependant pension and/or lump sum).

Chapter 4 welcomes views on whether there should be any exemptions to capturing enhancements made in these or other situations.

How to assess value in the year of leaving

C.30 There are two main ways in which pension value can be enhanced:

- an award of additional annual pension; and
- a change to the expected commencement date of pension payments. The expected commencement date will often coincide with the scheme's NPA, and may change

[14] There is no requirement for schemes to provide pensions to dependants on death after retirement (except as required for schemes which contract out of the Second State Pension). The majority of schemes do provide some pension for dependants (the definition of which varies), the level typically varying between 38 per cent and 67 per cent of the member's pension.

[15] There is some variety in the level of pension increase awarded by pension schemes. Public service schemes typically increase pensions in line with the increase in the RPI. Since April 1997, private sector schemes have been required to increase pensions in line with the RPI, subject to a cap. The cap is 5 per cent per annum for pension earned between April 1997 and March 2005 and 2.5 per cent per annum for pension earned since April 2005. There was greater flexibility for pension earned before April 1997 with (generally) no minimum level of increase required.

following an alteration to the scheme's NPA or, more commonly, as a result of an agreement that an individual may draw unreduced benefits earlier than this.

Both the ARFs and CETV methods described above could be used unmodified in the first of these cases, but would require adaptation to value the deemed contribution associated with the second type of enhancement. Under a CETV-based methodology, schemes would be required to carry out individual calculations. Under ARFs, the exact approach would depend on whether a one-way or two-way scale of factors was adopted.

C.31 Under a two-way scale, enhancements caused by a change to the expected commencement date would be valued in the year the change was agreed, in common with the approach taken for the restriction as a whole. The deemed contribution associated with the increase in pension value would be captured by applying differing factors to the end of year entitlement and the revalued start of year entitlement:

- the factor F_1 applied to the revalued start of year entitlement, A, would be the normal ARF applicable before the enhancement was made;
- the factor F_2 applied to the end of year entitlement, B, would also be drawn from the two-way table of ARFs, reflecting the member's age and based on the NPA equal to the individual's age at the expected commencement date; and
- the deemed contribution would be given by F_2*B - F_1*A.

C.32 Under a one-way scale, the timing of the valuation of enhancements caused by a change to the expected commencement date would depend on when the enhancement was agreed. When the enhancement was agreed after leaving active service, it would be valued in that year. If the enhancement was agreed during a period of active service, it would be valued upon leaving service, as the tax relief restriction during active service would always be based on the single NPA implicit in the one-way scale.

C.33 The deemed contribution in these cases would again be calculated by applying two factors:

- the factor F_3 applied to the revalued start of year entitlement, A, would be the normal applicable ARF taken from the one-way scale;
- the factor F_4 applied to the end of year entitlement, B, would be drawn from a supplementary table of ARFs, according to the member's age at the time and assuming an NPA equal to the age when the pension was due to commence;[16] and
- the deemed contribution would be given by F_4*B - F_3*A.

This methodology would encompass genuine enhancements where individuals were entitled to draw benefits earlier than otherwise, but also artificial enhancements, as discussed above, where the individual's NPA was simply lower than that assumed in the one-way ARFs scale.

C.34 It is recognised that, using a one-way ARFs scale, any future increase in the value of existing pension rights as at 5 April 2011 would need to be assessed relative to the individual's actual NPA rather than the deemed NPA implicit in the ARFs. This would require a calculation method which identified pre- and post- April 2011 accruals and applied appropriate factors to each element.

C.35 The examples in Box C.A illustrate how the deemed contribution would be calculated under the different approaches outlined above. As discussed above, they demonstrate how a one-way

[16] This supplementary table of ARFs would be provided for use alongside the main one-way scale but would need to be used only in the year of leaving active service (or for enhancements awarded after leaving active service). The supplementary ARFs would be in the form of a two-way table according to the member's age and the age of pension commencement and would therefore be constructed in a similar way to the full two-way scale of ARFs.

scale would add complexity to the year of leaving calculation. It would also distort the timing of tax relief by creating artificial enhancements in the year of leaving, due to the embedded NPA assumption. The Government's lead option for valuing the deemed contribution is therefore a two-way ARFs scale.

Box C.A: Examples of year of leaving calculations under CETV and ARFs

The following examples illustrate the nature of pension enhancement calculations in the year of leaving a scheme under the CETV and ARFs approaches, comparing the use of one-way and two-way ARFs scales.

Individual P takes early retirement with unreduced benefits. P is aged 59. He leaves a pension scheme with NPA 60 after 10.5 years of service and receives an immediate unreduced pension, not on the grounds of ill health. His final pensionable salary is £200,000, rising from £193,500 the previous year. This gives him:

- pension accrued at the end of the last tax year = £32,250 (=10/60 * £193,500); and
- pension payable at the date of retirement = £35,000 (=10.5/60 * £200,000).

N.B. All factors are for illustration only, and revaluation has been ignored for simplicity.

Example 1 – Two-way ARFs scale for period of accrual

- ARF factor for age 59 (based on NPA of 60) = 22
- ARF factor for age 59 (for NPA of 59) = 23
- deemed contribution = (£35,000 * 23) - (£32,250 * 22) = £95,500

Using a two-way ARFs scale is analogous to the CETV method, which inherently uses the NPA applicable to the member in the accrual period, but with the factors set by the trustees or managers of each pension scheme.

Example 2 – One-way ARFs scale for period of accrual (based on NPA of 60)

- ARF factor for age 59 (based on NPA of 60) = 22
- supplementary factor for age 59 and immediate pension payment = 23
- deemed contribution = (£35,000 * 23) - (£32,250 * 22) = £95,500

This is the same as under Example 1 because in this case the actual NPA is the same as the NPA assumed for the one-way ARFs scale. This methodology would require a supplementary set of factors to be used for the year of leaving calculation.

In each case the deemed contribution is high because P has received a high increase in pension entitlement, which the employer will have to pay for.

Example 3 – One-way ARFs scale for period of accrual (based on NPA of 65)

- ARF factor for age 59 (based on NPA of 65) = 19
- supplementary factor for age 59 and immediate pension payment = 23
- deemed contribution = (£35,000 * 23) - (£32,250 * 19) = £192,250

This is higher than the amount determined under Examples 1 and 2 because the calculation is recognising an increase in value arising from payment six years early (i.e. six years before the NPA of 65 assumed in the ARFs scale) rather than one year early.

Example 3 extended

As the restriction on tax relief comes into effect from 6 April 2011 it is appropriate to adjust this calculation to 'strip out' the value increase which relates only to the difference in the individual's actual NPA attributable to rights already existing when the measure is introduced (age 60) and that assumed in the one-way ARFs scale (age 65).

This adjustment requires further factors and information as shown below.

- year of leaving factor for age 59 (based on NPA of 60, from supplementary table) = 22
- service to 5 April 2011 = 6.5 years and service after 5 April 2011 = 4 years
- adjusted deemed contribution, which can be calculated in two ways:

  (a) = £192,250 - (6.5/10.5) * £35,000 * (22 - 19) = £127,250

  (b) = (£35,000 - £32,250) * 19 + (6.5/10.5) * £35,000 * (23 - 22) + (4/10.5) * £35,000 * (23 - 19) = £127,250

This is still higher than the amount determined under Examples 1 and 2 reflecting lower deemed contributions (measured using the NPA of 65 anticipated in the ARFs scale, rather than an NPA of 60) since the introduction of the measure. This approach therefore implicitly assumes that P was a high earner subject to the measure in the earlier years and ensures that any under-restriction of relief applied in those years is appropriately adjusted for.

Even if P had retired at his expected NPA of 60, there would be a significant deemed contribution in the year of exit to reflect the earlier payment date than anticipated in the ARFs scale.

Again, the deemed contribution is high because P has received a high increase in pension entitlement from his employer.

C.36 The Government would welcome views on any of the issues raised in this annex relating to different types of DB valuation methods.

D Scheme types

Introduction

D.1 Finance Act 2004 defines three types of benefit and four types of pension arrangement, as described in Box D.1. It is envisaged that arrangements within schemes will be categorised in the same way for the purposes of this regime, with the tax relief restriction being applied accordingly. The following summarises how the proposals may be adapted to encompass all types of pension arrangement.

Cash balance arrangements

D.2 In a cash balance arrangement, the benefits are expressed in terms of a fund value. The difference between this and a standard money purchase arrangement is that the level of the fund does not depend directly on the value of any invested contributions. Instead, the fund is fixed formulaically, for example the fund value at the start of the year is revalued in a defined way, and 10 per cent of the member's salary earned over the year is added. On drawing benefits, the fund value is used to provide a pension (either by conversion within the scheme, through annuity purchase, or provision of an unsecured or alternatively secured pension) and, optionally, to provide a lump sum.

Box D.1: Finance Act 2004 definitions of pension benefit and arrangement

There are three types of pension benefit:

- Cash balance benefit: the rate or amount of benefit is based on the fund available, which itself is defined in some way and is not wholly dependent on contributions paid, and the form of benefit might not be set in advance. An example of a cash balance benefit is where the fund available to provide benefits is determined in some fixed way, such as a percentage of final salary or a fixed sum assured on maturity. That fund may then be applied in proportions chosen by the individual to provide benefits such as a lifetime annuity and a lump sum;
- Other money purchase benefit: the rate or amount of benefit is determined based on the fund available, which is dependent on the contributions paid and subsequent investment growth. Often, the form of benefit is not precisely defined, so the individual may choose whether to use all the proceeds for pension or whether to use some for a lump sum. For example, proceeds of the invested employer and individual contributions into an individual's pension pot amount to £50,000. The individual chooses to buy a pension with 75 per cent of this amount, obtaining a lifetime annuity of £1,180,[1] taking the remaining 25 per cent as a lump sum of £12,500; and
- Defined benefit: these benefits are not money purchase, but are defined in some way, being calculated by reference to factors other than the amount of the fund, such as earnings and length of service. The choices in the form of benefit to be provided are defined in advance as well, for example, optional commutation into a lump sum. These options do not lose the defined nature of provision, they merely provide flexibility in the delivery of the defined benefit. This differs from cash balance provision, where the actual benefit provision is not expressed in a specific way. Defined benefits can take several forms, including those found in final salary and career average schemes.

There are four types of arrangement through which these benefits can be delivered:

- Cash balance arrangement: all benefits provided are cash balance benefits;
- Other money purchase arrangement: all benefits provided are other money purchase benefits;
- Defined benefit arrangement: all benefits provided are defined benefits; and
- Hybrid arrangement: a 'wait and see' or 'better of' arrangement that may provide benefits which end up being either cash balance, other money purchase or defined benefit, depending on the circumstances. For example, an arrangement may offer the individual an other money purchase benefit with a defined benefit underpin to guarantee a minimum level of benefits. During the accrual phase the arrangement is hybrid, but it becomes a defined benefit or other money purchase arrangement at the start of the payment phase, according to how benefits crystallise.

Note, a scheme that provides members with a mixture of benefits is treated as a number of separate arrangements, according to the definitions set out above. For example, a defined benefit pension with additional money purchase benefits is treated as two arrangements.

[1] Non-index-linked, based on an annuity rate of 5 per cent.

D.3 For the purposes of the annual allowance, the value of any cash balance benefit accrued over a pension input period is based on the entitlement at the end, minus the entitlement at the start uprated by the higher of 5 per cent or the increase in the RPI over the period. The value of the deemed contribution for tax relief restriction purposes would mirror the approach adopted for restricting relief within defined benefit (DB) schemes. Using ARFs, the deemed contribution could be determined in the following way:

- adjusting the previous year's accrued fund by a revaluation rate;
- subtracting this from the current year's accrued fund; and
- multiplying by the appropriate age-related 'lump sum' factor. The age-related 'lump sum' factor is derived consistently with the ARFs discussed in Chapter 4. Accordingly, the scale of 'lump sum' factors would be based on a factor of one at the expected payment date, discounted for the term until payment by the assumed excess of investment return over the revaluation rate.

Other money purchase arrangements

D.4 In this case, the restriction of pensions tax relief is based on contributions made by and for the benefit of an individual, as described in Chapter 3.

Defined benefit (DB) arrangements

D.5 The tax relief restriction will be applied by calculating a deemed contribution – the proposals for this in the case of a final salary scheme with commutable lump sum are set out in Chapter 4 and Annex C. Some modification or additional specification may be required in certain circumstances – the following situations are discussed further below:

- career average schemes;
- schemes with separate lump sum accrual;
- schemes with variable normal pension age (NPA);
- non-uniform accrual schemes;
- abatement;
- member options;
- Transfer of Undertakings (Protection of Employment) (TUPE) transfers; and
- flexible retirement.

Career average schemes

D.6 For career average schemes that provide revaluation during active membership at least in line with statutory revaluation, the methodologies proposed for final salary DB schemes in Chapter 4 and Annex C will apply unchanged. This is because individuals in career average schemes receive a pension promise from their employer just as those in final salary schemes do, albeit based on career average salary rather than final salary. The methodology for valuing a deemed contribution can be applied to any increase in the annual pension promised by the employer, regardless of how that is calculated. However, there could be an issue for individuals in career average schemes that offer a less generous revaluation basis (while in employment), particularly if they remain in employment for long periods. Such schemes are, however, likely to be relatively uncommon. The Government welcomes views on this issue and whether any separate treatment would be warranted.

Schemes with separate lump sum accrual

D.7 For those DB schemes that provide accrual of a separate lump sum in addition to pension accrual (as opposed to schemes offering lump sums via commutation) the possible valuation methodologies are the same as those for a cash balance arrangement described above. For example, under an ARFs methodology, age-related 'lump sum' factors would be used for lump sum accruals.

Schemes with normal pension age (NPA) dependent on the circumstances of leaving

D.8 Some schemes, most commonly in the public sector, offer an earlier NPA to members retiring directly from active service than to those who leave pensionable service before attaining that age. The difference in NPA can be significant, ten or more years in some cases. When considering how to value an individual's entitlement in such a scheme, the assumption made for payment commencement date (that is, NPA) will have a marked effect on the tax treatment over time. For example, if a one-way ARFs scale were used, a single assumption would be made for NPA, and any shortfall in the restriction would need to be settled in the year of leaving the scheme. Under a two-way ARFs scale, there would be a choice around which NPA assumption to use.

D.9 Using an active member NPA (which is lower than a deferred member NPA) will generally result in higher deemed contributions than using a deferred member NPA over any pension input period. If an individual leaves before attaining the NPA for active members, their actual total pension value at the end of employment (under the proposed year of leaving provisions) might be significantly lower than that assessed at the start of the final input period – therefore, such an individual might be considered to have been unfairly treated. This issue would not arise, however, if the individual remains in employment and draws their pension at the assumed NPA.

D.10 Conversely, using a deferred member NPA will generally result in lower deemed contributions than using an active member NPA. If an individual leaves before attaining the active NPA, they might expect a reasonably stable pattern of charges over their period of employment. However, if the individual remains in employment and retires at the earlier NPA, a sizeable restriction would be likely in the year of leaving, as it would be at this stage that the increased value attributable to the lower NPA would be recognised. An example of this is given in Box D.2. The Government intends to pursue this option since it avoids systematic overcharging and so the potential unfairness highlighted in the previous paragraph.

Box D.2: Normal pension age (NPA) dependent on year of leaving – example based on deferred NPA

Individual Q, aged 54, is in a 1/60ths final salary scheme where benefits are payable unreduced from age 55 if retiring direct from service, or from age 60 if leaving active membership before age 55. She has ten years of service and a pensionable salary of £200,000. In the following year, she receives a 5 per cent pay rise to £210,000 (revaluation is ignored here for simplicity):

- pension accrued at end of previous tax year = £33,333 (=10/60 * £200,000);
- pension accrued to end of latest tax year = £38,500 (=11/60 * £210,000);
- assume that the ARF for age 54 and for NPA 60 (i.e. based on deferred member NPA) = 18; and
- this gives a deemed contribution of (£38,500 - £33,333) * 18 = £93,000.

One year later, aged 55, Q receives a pay rise to £220,000 and subsequently retires from active service with unreduced pension. It is at this stage that the change in NPA from the assumed (deferred) value has to be taken into account:

- pension accrued to end of latest tax year = £44,000 (=12/60 * £220,000);
- assume that the ARF for age 55 and for NPA 60 = 18.5 and that the ARF for age 55 with an immediate pension = 25; and
- this gives a deemed contribution of (£44,000 * 25 - £38,500 * 18.5) = £387,800.

Non-uniform accrual schemes

D.11 In some schemes, particularly in the public sector, members build up pension at differing rates according to their length of service in the scheme e.g. a scheme may offer an accrual rate of 1/60th per year of service for the first 20 years and 1/30th per year of service thereafter. However, pensions legislation requires that entitlement to deferred benefits must accrue at a uniform rate.[2] As a result, active and deferred entitlements will differ – an example of this is shown in Box D.3. There is therefore a question over which to use for the purposes of restricting tax relief on pension contributions. Since using the active entitlement can result in a large restriction on leaving the scheme (when the transfer to the larger, deferred entitlement would need to be accounted for), it is therefore proposed that the deferred entitlement would be used in the valuation process. This is consistent with the proposed treatment of schemes with NPA dependent on the circumstances of leaving (discussed in the previous section). In many cases schemes of this type will have both these features.

[2] Deferred entitlement must be calculated as prospective pension at NPA (based on current salary) multiplied by actual service divided by prospective service to NPA.

Box D.3: Example of active and deferred entitlements in a non-uniform accrual scheme

Individual R is aged 55 with a salary of £200,000. He has 25 years of service in a final salary DB scheme with NPA 60, and an accrual rate of 1/60th of final salary per year of service up to 20 years, and 1/30th for subsequent years. Therefore:

- his 'active' accrued pension reflects his active entitlement based on 20 years of service with a 1/60th accrual rate and 5 years of service with a 1/30th accrual rate, that is:

  'active' accrued pension = (20/60 + 5/30) * £200,000 = £100,000.
- his deferred entitlement = prospective pension at NPA (based on current salary) multiplied by actual service divided by prospective service to NPA;
- at NPA, he would have 30 years of service – 20 of them at a 1/60ths accrual rate and 10 at a 1/30ths accrual rate. This gives a prospective pension at NPA (based on current salary) of (20/60 + 10/30) * £200,000 = £133,300;
- his actual service is 25 years, and his prospective service to NPA is 30 years;
- his deferred entitlement = £133,300 * 25/30 = £111,100; and
- if the restriction were to be based on 'active' accrued pension, an individual would face a large restriction in the year of leaving active service based on the increase in accrual up to the deferred entitlement.

Abatement

D.12 Some schemes have provisions to suspend benefit payments in certain circumstances. For example, in public sector schemes, part or all of an individual's pension payments may be suspended during any period of re-employment. Across the public and private sectors, there are provisions to suspend payments of pensions awarded due to ill health if an individual's health improves, with payments recommencing at a later stage. Chapter 4 welcomes views on whether there may be cases where it is not appropriate for pension enhancements to be subject to the restriction, such as when an individual retires early on ill-health grounds. The Government also welcomes any consideration of the scenarios or circumstances in which abatement could cause issues and whether special treatment in the valuation mechanism would be warranted in such cases.

Member options

D.13 Some schemes allow members to exercise options on drawing benefits, for example to exchange some member pension for additional dependants' rights. On simplicity grounds, it is proposed that the benefits valued will be those applicable before the exercise of any options at retirement.

Conversion of rights on compulsory transfer

D.14 There is potential for inconsistency in the value of an individual's pension rights year to year if there is a transfer of accrued pension rights between schemes associated with a compulsory transfer of employment under the TUPE legislation. This is typically carried out via a "bulk transfer" of affected employees' pension rights, which broadly preserves pension expectations at retirement. Depending on the pension valuation approach adopted for tax relief purposes, the change of schemes could give rise to an apparent change in the value of pension in some circumstances. The Government welcomes views from respondents on whether they agree that it would not be appropriate for these apparent changes to be factored into the valuation of deemed contributions for the purposes of restricting tax relief.

Flexible retirement

D.15 Some schemes have provisions that allow individuals to draw part of their pension entitlement while remaining in active membership and accruing further benefits. It is proposed that the valuation mechanism would consider each element of benefit separately i.e. any vesting benefit would be finally assessed in the pension input period in which it comes into payment. Continued accrual, both in the pension input period in which any other benefit is vested and afterwards, would be valued separately under the normal mechanism.

Hybrid arrangements

D.16 Where an arrangement offers a benefit which is based on the 'better of' two or more options (such as a money purchase scheme with a defined benefit underpin to give a guaranteed minimum level of benefits), then it is impossible to establish the character and level of a pension benefit until it is actually paid. For such an arrangement, when testing against the annual allowance under Finance Act 2004, the value of the pension input amount in any pension input period is determined as the higher of that determined for each option which might apply. A similar treatment is proposed for the purposes of restricting tax relief on pension contributions.

Multiple arrangements

D.17 Under Finance Act 2004, where an arrangement provides more than one kind of benefit (such as both money purchase and defined benefit), then the arrangement is treated as the sum of its constituent parts, that is, as separate arrangements as defined in Box D.1. A consistent approach is proposed for the purposes of restricting tax relief on pension contributions.

D.18 The Government welcomes views on any of the issues raised in this annex relating to different types of pension arrangement, or on any other issues in applying the measure to different benefit designs.

E Impact Assessment

Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury	**Impact Assessment of implementing the restriction of pensions tax relief**	
Stage: Consultation	**Version:** 1	**Date:** 9 December 2009
Related Publications: Implementing the restriction of pensions tax relief		

Available to view or download at:

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

Contact for enquiries: Sarah Miller **Telephone:** 020 7270 5496

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

The cost of pensions tax relief has doubled since 1998-99, disproportionately benefiting those on the highest incomes. Given the severe global recession, with profound implications for the public finances, rebalancing pensions tax relief is necessary. From 2011, tax relief on pension contributions will be restricted for individuals with gross incomes of £150,000 and over; tapered so that it is worth 20 per cent for individuals with gross incomes of £180,000 or over. This will apply to around 2 per cent of pension savers who receive around a quarter of tax relief on pension contributions.

What are the policy objectives and the intended effects?

This change is necessary to ensure that pensions tax relief remains affordable, and to address the disproportionate amounts of pensions tax relief going to individuals on the highest incomes, so that they receive tax relief on pension contributions at the same rate as a basic-rate taxpayer. It will be implemented in a way that treats defined benefit (DB) schemes fairly in relation to defined contribution (DC) pension schemes and personal pensions, and minimises administrative burdens. Around 98 per cent of pension savers will not be affected by the change, and neither will many employers.

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

To ensure consistent treatment across pension schemes, a method is needed to deem contributions to DB schemes (doing nothing is not an option). This consultation Impact Assessment explores the impacts of: (i) age-related factors, which the Government believes strikes the right balance between fairness and simplicity and is its preferred method; and (ii) cash equivalent transfer value; but not flat factors, which was rejected on grounds of fairness. The restriction will be delivered through Self Assesment. Affected individuals are already required to complete a Self Assessment tax return.

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

This consultation Impact Assessment will be updated in light of the responses received.

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:

Sarah McCarthy-Fry

Date: 7/12/09

Summary: Analysis & Evidence

Policy Option: Age-related factors approach for DB valuation	Description: This option estimates the costs of delivering the measure, assuming that deemed defined benefit contributions are calculated via age-related factors (ARFs)

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	Compliance costs for pension schemes, employers and individuals are estimated at **£90 million** for average annual (recurring) costs, and **£305 million** for one-off costs assuming an ARFs option for DB valuations.
£ 305m		
Average Annual Cost (excluding one-off)		
£ 90m		**Over first five years: total cost** (PV) **£ 720m**

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

The Evidence Section discusses potential compliance costs, including the key differences under the two alternative options for DB valuation. Relevant evidence and comments are invited.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	The policy contributes over £3 billion a year to the consolidation of the public finances and helps to ensure that the Government's objectives for ensuring fairness, affordability and sustainability of pensions tax relief are met. Net financial benefits are zero as Exchequer yield is a transfer from affected taxpayers.
£ 0		
Average Annual Benefit (excluding one-off)		
£ 0		**Total Benefit** (PV) **£ 0**

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

The Exchequer yield from this policy is estimated to be in excess of £3 billion p.a. from 2012-13.

Key Assumptions/Sensitivities/Risks

A range of activities that pension schemes and employers will need to undertake to comply with the policy has been identified to inform estimates and underlying assumptions.

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

What is the geographic coverage of the policy/option?	UK tax relief recipients
On what date will the policy be implemented?	6 April 2011
Which organisation(s) will enforce the policy?	HMRC
What is the total annual cost of enforcement for these organisations?	Neg
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

	Micro	Small	Medium	Large
Annual cost (£-£) per organisation (excluding one-off)	**N/A**	**£250**	**£750**	**£4,000**
Are any of these organisations exempt?	No	No	No	No

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

Increase of £ 80m Decrease of N/A **Net Impact** **+£80m**

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

Summary: Analysis & Evidence

Policy Option: CETV approach for DB valuation	Description: This option estimates the costs of delivering the measure, assuming that deemed defined benefit contributions are calculated via a cash equivalent transfer value (CETV) approach

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	Compliance costs for pension schemes, employers and individuals are estimated at **£130 million** for average annual (recurring) costs, and **£345 million** for one-off costs, assuming a CETV option for DB valuations.
£ 345m		
Average Annual Cost (excluding one-off)		
£ 130m		**Over first five years: total cost** (PV) **£950m**

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

The Evidence Section discusses potential compliance costs, including the key differences under the two alternative options for DB valuation. Relevant evidence and comments are invited.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	The policy contributes over £3 billion a year to the consolidation of the public finances and helps to ensure that the Government's objectives for ensuring fairness, affordability and sustainability of pensions tax relief are met. Net financial benefits are zero as Exchequer yield is a transfer from affected taxpayers.
£ 0		
Average Annual Benefit (excluding one-off)		
£ 0		**Total Benefit** (PV) **£ 0**

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

The Exchequer yield from this policy is estimated to be in excess of £3 billion p.a. from 2012-13.

Key Assumptions/Sensitivities/Risks

A range of activities that pension schemes and employers will need to undertake to comply with the policy has been identified to inform estimates and underlying assumptions.

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

What is the geographic coverage of the policy/option?	UK tax relief recipients			
On what date will the policy be implemented?	6 April 2011			
Which organisation(s) will enforce the policy?	HMRC			
What is the total annual cost of enforcement for these organisations?	Neg			
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 N/A	Small £350	Medium £1,100	Large £6,000
Are any of these organisations exempt?	No	No	No	No

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

Increase of £ 120m Decrease of N/A **Net Impact** **+£120m**

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

Evidence Base (for summary sheets)

Background

1. The Government provides tax relief on individual and employer contributions to registered pension schemes. Tax relief is available on member contributions to, and investment growth in, occupational defined benefit (DB) and defined contribution (DC) schemes and personal pensions. Employers also obtain tax relief on contributions they make to schemes set up for their employees, and do not pay national insurance contributions (NICs) on contributions they make for their employees' benefit.
2. The Government provides pensions tax relief to encourage and support pension saving to help individuals produce an income in retirement. Pensions have a more favourable tax treatment in order to encourage people to save, and to promote greater independence in later life. Pensions tax relief is also provided in recognition that pensions are less flexible than other forms of saving, requiring individuals to lock away their savings to produce a retirement income.

Rationale for intervention

3. Pensions tax relief is generous, estimated to be worth around £28.4 billion in 2008-09, roughly 2 per cent of GDP. The cost to the Exchequer net of income tax collected on pensions in payment has doubled since 1998-99. Increasingly, pensions tax relief benefits those on the highest incomes: the restriction will apply to 2 per cent of pension savers or around 1 per cent of working age taxpayers, yet they now receive around a quarter of all tax relief on pension contributions. This amounts to around £20,000 per person, which is in stark contrast to the average of £1,000 of tax relief for basic-rate pension savers.
4. Pensions tax relief needs to be targeted appropriately. It is neither fair nor affordable to grant the biggest incentive to save for a pension to those who need it least. The financial crisis precipitated the most severe and synchronised global recession since the Great Depression, with profound implications for the public finances. As a result it is necessary for the Government to consolidate the public finances over the medium term. The extent of the advantage available to individuals on the highest incomes is not sustainable in the current fiscal context, and it is against this backdrop that the Government has acted to rebalance the system.

Policy objective

5. The Government's aim is a system of pensions tax relief that is fair, affordable and sustainable. The Government's approach has been specifically targeted at those on incomes of £150,000 and over, due to the disproportionate tax relief on pension contributions that is currently given to this group, which would have been exacerbated by the introduction of the 50 per cent tax rate in 2010-11. While the Government remains committed to the provision of generous tax relief to support pension saving, there is a point beyond which it is no longer fair for taxpayers to provide disproportionately large support for pension saving for individuals on the highest incomes.
6. To this end, the Government announced at Budget 2009 that, from April 2011, tax relief on pension contributions would be restricted for those with incomes of £150,000 and over. The value of tax relief will be tapered down until it is 20 per cent for those on incomes of over £180,000 making it worth the same for each pound of contribution to pension entitlement as for a basic-rate taxpayer. This restriction applies to all contributions, including employers' (which already count towards the annual and lifetime allowances).
7. The Government is clear that the restriction of pensions tax relief must apply as fairly as possible to individuals in different types of pension schemes and employment, and with

different remuneration arrangements, while remaining targeted on those on the highest incomes. The Government has therefore announced at the 2009 Pre-Budget Report that the restriction will apply to individuals on gross incomes of £150,000 and over, where gross income incorporates all pension contributions including the value of any pension benefit funded by, or eventually funded by, their employer. This avoids favouring individuals who receive significant pension benefits from their employer in their remuneration packages, and those with most flexibility to rearrange their remuneration package.

8. To provide certainty for individuals around whether they are affected, and to reduce administrative burdens for employers and for pension schemes, the Government is introducing a floor at £130,000 of pre-tax income (including an individual's own pension contributions, and charitable donations). Only individuals with pre-tax incomes at or above this level will need to establish the value of any pension benefit funded by (or eventually funded by) their employer. This also keeps the measure well targeted on those with the highest incomes.

9. The Government aims to implement the restriction of pensions tax relief in a way that ensures that DB pension schemes are treated fairly in relation to DC pension schemes and personal pensions, and to introduce the new system in a way that minimises administrative burdens.

How the policy will work

10. The vast majority of people will be unaffected by the change, which targets individuals on gross incomes of £150,000 and over (around 2 per cent of all pension savers). The key features of the process for those affected by the restriction of tax relief on pension contributions, their employers and pension schemes are detailed below, and fall broadly into three main steps:

    i) determining income, which shows individuals if they are affected and the amount of relief to which they are entitled;

    ii) determining the pension contributions to which the restriction of relief will apply; and

    iii) calculating the size of the restriction and paying any charges to recover excess relief.

11. The restriction of tax relief for individuals with gross incomes of £150,000 and over will be primarily delivered through Self Assessment. This avoids disturbing the net pay arrangements within Pay As You Earn, which operate to give most employees tax relief for their pension contributions at the marginal rate of tax; and enables employer contributions to be brought into tax, as for other benefits-in-kind received by employees. All of the individuals affected are already within Self Assessment.

Determining income

12. The restriction of relief will apply to individuals only if their:
    - pre-tax income, including their own pension contributions and charitable donations is £130,000 or over; and
    - gross income is £150,000 or over, where gross income is their pre-tax income as above together with the value of any pension benefit the individual receives from others, typically that funded by, or eventually funded by, their employer.

13. Individuals with incomes (excluding the value of any employer pension benefit or contributions) of less than £130,000 are unaffected by this change and will continue to receive tax relief on pension contributions at their marginal rate. Some individuals with incomes (excluding the value of any employer pension benefit or contributions) of £130,000 and over will need to provide additional information to HMRC to calculate and report their gross income and any recovery charges arising from the restriction of tax relief on pension contributions.

14. The rate of tax relief from which individuals can benefit is gradually reduced to 20 per cent as gross income rises from £150,000 to £180,000, so that for those on incomes of £180,000 and over it worth the same for each pound of contribution to pension entitlement as for a basic-rate taxpayer.

15. The Self Assessment tax return will collect information required to determine gross income. The Self Assessment calculation will work out the individual's gross income and position on the taper for those who file online. Paper filers who want to self-calculate will be guided through the necessary steps by accompanying help sheets.

Determining pension contributions

16. The restriction of pensions tax relief will apply to all contributions, or deemed contributions for individuals in DB schemes, made in the tax year, including employers'. The total value of contributions from which an individual benefits in a year will also be included in their gross income. Therefore, individuals will need to report details about their own pension contributions and the value of any employer contributions on the tax return. The Self Assessment tax return will be amended to accommodate this information, and HMRC guidance will alert individuals to what they need to do and by when.

17. For DC schemes, it is generally easy to identify contributions made into an individual's pension pot in a given year, by the individual (A) and employer (B). Relief will be restricted on total (A+B) contributions.

18. Individuals in DB schemes will need to obtain information regarding their total deemed contribution (A+B) from their pension scheme. The individual will need to supplement this information with their employee contributions (A) (which individuals in net pay arrangements do not currently need to provide). This will need to be subtracted from the total deemed contribution (A+B) to derive the deemed employer contribution (B). The Government has identified three methods for valuing deemed contributions to DB schemes and two of these options are considered in more detail in the section below.

19. Pension schemes will have three months to produce a statement of pension benefits from any member requesting this. This is an appropriate timeframe for pension schemes to provide this information, since they are currently permitted three months to calculate comparable information upon request where there is a pension sharing order. Employers who provide gross pay and taxable benefits of £130,000[1] or more to an employee will be required to request a statement from the pension scheme on their behalf.

Determining and paying the recovery charge

20. Individuals whose pre-tax income including individual pension contributions (and charitable donations) is at or above the income floor of £130,000 will need to establish and report as appropriate on their Self Assessment tax return any pension contributions that they have made, and any actual or deemed contributions made by their employer (or a third party) for their benefit. Combined with information on income already reported on the Self Assessment tax return, this will enable individuals with pre-tax income including their individual pension contributions (and charitable donations) of £130,000 and over to determine whether their gross income is less than £150,000, in which case they will be unaffected by the restriction; or £150,000 and over, meaning they will be subject to the restriction.

21. Those affected will then be able to determine the overall rate of relief to which they are entitled, and the overall recovery rate, which is applied to total pension contributions to calculate the recovery charge. Help sheets accompanying the Self Assessment tax return

[1] Pay and benefits (not including employer pension benefits) before any income tax, national insurance contributions or other deductions

will guide paper filers who wish to self-calculate through the calculation process. The Self Assessment calculation will automatically work out an individual's recovery charge for online filers and other paper filers.

22. The amount of excess relief to be recovered as a result of the restriction of relief on pension contributions will be added to the Self Assessment tax bill at the final stage of the calculation of tax due and payable for the year by the following 31 January.

23. Where individuals benefit from particularly large pension entitlements in a year, the current tax relief will be particularly high, so the recovery charges from restricting pensions tax relief will be correspondingly large. Individuals incurring recovery charges exceeding £15,000 will therefore have the option of electing that the pension scheme pays the recovery charge on their behalf, with the pension scheme in return reducing their pension pot or their accrued pension benefit for the year by an actuarially appropriate amount. Allowing the scheme to pay a recovery charge on an individual's behalf is already permitted where an individual's pension pot exceeds the lifetime allowance. The election would be reported by the individual through Self Assessment, and would be accounted for by schemes.

24. The individual will be able to elect for the scheme to pay up to the 31 January payment date for Self Assessment. To be sure that the scheme will have accounted for the charge by then, individuals will have to elect for the scheme to pay three months before (by the end of October). If the individual elects for the scheme to pay after the end of October, they will be liable to interest on any late paid tax if the scheme has not received confirmation from them to proceed with the payment by 31 January.

25. To ensure that individuals wishing to take up the scheme pays option have access to it, and to give pension scheme trustees certainty over the response to member requests for the scheme to pay, the Government proposes that it is mandatory for schemes to pay if elected by the member to do so.

26. Recognising that it would not be appropriate to allow some individuals to opt for the scheme to pay in some circumstances, such as where they are in some overseas schemes or very under-funded DB schemes, the Government will also consider whether it may be appropriate to allow individuals in such circumstances to spread the payment of charges exceeding £15,000 over three years.

Expected impacts

27. The restriction of tax relief on pension contributions builds on and adapts existing processes, to facilitate the change and minimise the need for additional administration. This section of the Impact Assessment provides an initial view of the potential impact on affected parties of the way the restriction of pensions tax relief is implemented. It first considers the numbers affected. It then summarises the process for restricting pensions tax relief from the perspective of individuals, employers and pension schemes, estimating the compliance and administrative costs for these groups.

28. The estimation of compliance and administration costs is based on HMRC's Standard Cost Model methodology, as a large volume of evidence exists on the compliance costs of UK tax policy. In broad terms, this involves consideration of the time taken to complete each identified process and the associated unit costs, to determine total cost estimates. The estimates and assumptions are informed by available data from pensions industry sources, including surveys and indicative fees charts. As part of this consultation the Government would welcome views and relevant evidence that could help improve the initial estimates provided in this consultation Impact Assessment.

Numbers affected

29. The restriction of pensions tax relief for those with gross incomes of £150,000 and over will affect around 300,000 individuals. It is estimated that around 110,000 of these individuals will be within DB schemes and 190,000 within DC schemes, with only a few thousand holding both forms of pension. As described in Table 1, we assume the affected individuals in occupational schemes to be spread across 55,000 schemes, of which the majority are small schemes (as defined by the ONS).

30. There are also around 2.1 million employers in the UK, the vast majority of whom are small employers with under 50 employees, as defined in Table 1. Most will not have employees affected by this policy – it is estimated that around 50,000 employers will be affected (including a small proportion that may incur one-off costs in preparing for the change but ultimately have no affected employees within their organisation).

31. There are also around 10,000 financial advisers that may have clients affected by the measure.

32. As a basis for considering the potential compliance burdens generated by the restriction of tax relief on pension contributions, Table 1 outlines assumptions about the number and size of pension schemes, employers and financial providers affected by the restriction of pensions tax relief.

Table 1: Estimated numbers affected

	Total	**Small**	**Medium**	**Large**
Individuals	300,000	N/A	N/A	N/A
Pension Schemes of which:	55,600	45,000	8,250	2,350
Personal*	500	-	200	300
Occupational**	55,000	45,000	8,000	2,000
SIPPs***	100		50	50
Employers****	50,000	25,000	15,000	10,000
Financial Advisers	10,000	8,000	1,000	1,000

Source: HMRC, ONS and FSA Statistics.

* HMRC data shows there are around 100,000 individuals with personal pensions affected by the policy, spread across an estimated 500 providers.

** ONS data from The Occupational Pension Schemes Annual Report, 2007. Size distributions are based on ONS classifications – small schemes are defined as having fewer than 12 members, medium between 12-999 members, and large over 999 members.

*** There are an estimated 0.5 million SIPP policyholders spread across an estimated 100 SIPP providers (source: FSA), assumed to be divided equally between large and medium sized providers. In practice, some of the costs estimated below may be borne at sub-provider level.

**** Based on HMRC data taking PAYE sources as the employer unit. Small (including "micro") employers here are defined as having fewer than 50 employees, medium between 50-249 employees, and large over 250 employees.

Impact on individuals

33. There are around 300,000 individuals with gross incomes of £150,000 and over contributing to pensions, and so affected by the restriction of tax relief on pension contributions. Currently anyone with a total income of £100,000 and over is within Self Assessment and this will not bring any new individuals into the Self Assessment population. Individuals whose pre-tax income including individual pension contributions (and charitable donations)

exceeds the income floor of £130,000 will need to calculate their gross income to determine whether or not they are affected by the restriction. For this group, and for all individuals affected by the restriction, there will be a new requirement as they will need to determine their contributions or deemed contributions and may need to contact their pension provider or employer to get this information.

34. Table 2 summarises the general characteristics of the individuals affected by the restriction of pensions tax relief. The impact is greater on men than it is on women because the majority of those on gross incomes of £150,000 and over are male.

Table 2: Characteristics of individuals affected by the restriction of pensions tax relief

Location:	Around half live in London or the South East
Gender:	Around 90% are male
Industry:	Based on standard industrial classification (SIC), around 55% work in financial intermediation (banking, finance and insurance), real estate and business activities (includes a range of business services). Over 80% are in the private sector.
Type of pension:	Around 45% are in an occupational DC scheme, 37% are in a DB scheme and the remainder have personal pensions

35. The process of determining whether someone is affected, gross income, determining pension contributions, and calculating the size of the restriction that individuals will need to comply with is detailed in the previous sections. Affected individuals will need to report this information to HMRC on their Self Assessment tax return, where necessary requesting specific information from their employers and/or pension scheme. Employees receiving gross pay and taxable benefits of £130,000 or more from their employer will automatically receive the relevant information. Those who are self-employed or whose income is over £130,000 but whose salary is lower will need to request information regarding contributions or deemed contributions from their pension scheme. Currently individuals within net pay arrangements do not report the amount of pension contributions (or those of their employer) on their tax return. This will be a new requirement.

36. The restriction of pensions tax relief will apply to all pension contributions, including those made by employers. In terms of contributions made directly by individuals:

    - for those in net pay arrangements who will automatically be given pensions tax relief at the marginal rate on their employee contributions through Pay As You Earn (PAYE), HMRC will collect an amount equal to the appropriate restriction of relief through Self Assessment. This will ensure that individuals do not obtain too much tax relief;
    - for those in relief at source arrangements, individuals fully affected by the restriction will not receive any further tax relief (since they will already have received the basic rate relief to which they are entitled). Individuals whose income falls on the taper will have the amount of relief above basic rate relief that they can claim determined by where they fall on the taper; and
    - for those making a claim for relief, individuals fully affected by the restriction will be given tax relief at the basic rate and individuals whose income falls on the taper will be given relief at a rate determined by where they fall on the taper.

37. Individuals are not currently taxed on the value of employer contributions made on their behalf, although these are taken into account for the lifetime and annual allowances. Excess relief on employers' contributions will be recouped through Self Assessment.

38. Any recovery charges will need to be paid by the 31 January Self Assessment payment date. Individuals electing for the scheme to pay will need to inform the scheme and record this and the amount on the Self Assessment tax return, and will need to confirm that the scheme should proceed with the payment when details of the offsetting reduction to their pension have been communicated to them by the scheme.

Impact on employers

39. An estimated 50,000 employers will have employees affected by the restriction of pensions tax relief. They will face some one-off and recurring costs, which can be expected to vary considerably according to the size of the firm and the number of affected individuals working within the organisation.
40. The main one-off cost will be around familiarisation with the new rules, to deal appropriately with enquiries from employees who are affected, or who seek information (for example, on their income, including benefits-in-kind) to determine their status in relation to the policy (even if they are not ultimately affected). In many cases, where employees ask about employer contributions to pension schemes, it will be most appropriate to direct employees to their pension scheme for further support.
41. The only new requirement for employers is that, if they provide an employee with gross pay and taxable benefits of £130,000 or more, they must request a pension benefit statement from the pension scheme on the individual's behalf, to be provided to the employee by 6 July.
42. One-off costs for employers will range from negligible in many instances to several thousand pounds in some cases. On average, it is assumed that one-off costs per employer are £500 for familiarisation with the new rules, increasing by an additional 50 per cent as firms seek to provide necessary supplementary information to affected individuals within their organisations.
43. Where firms contain affected individuals, the recurring cost to employers of providing further information and advice annually is estimated at around £100 per case on average. A cost will also be incurred for providing advice to some individuals not ultimately affected (assumed to be around an additional 20 per cent for the 300,000 individuals affected by the policy).
44. Therefore, the estimated one-off cost of complying with the restriction of pensions tax relief is around £40 million, with annual recurring costs of around £40 million.

Impact on pension schemes

45. Most of the current 55,600 pension schemes in operation will be affected by the restriction of pensions tax relief, to varying degrees. DB schemes, which have around 110,000 of the total 300,000 individuals affected by the policy, can expect relatively higher compliance costs, as they will have to provide information regarding the deemed contribution (discussed further in 'Options for valuing DB contributions').

Familiarisation and advice

46. All schemes can expect to incur costs from familiarisation with the new rules and initial changes to staff and customer guidance. While recognising that these will vary considerably according to, for example, scheme size and the number of members affected, it is estimated that initial one-off costs will be around £1,000 per scheme, on average; around £60 million in total.
47. Schemes will need to deal with client enquiries (e.g. from individual members or sponsoring employers). These may emerge not only from those who are affected by the restriction of relief, but from those who have questions about whether they might be affected (an

additional 50 per cent of enquiries from such people is estimated). It is assumed that, on average, schemes will provide around half an hour of advice per affected person, at an assumed cost of £40 per hour, giving an estimated compliance cost of around £10 million per year.

Providing information on pension contributions

48. To determine the size of the charge to recover excess relief, individuals will need schemes to provide them with information regarding their total pension contributions or deemed contributions for the year within three months of being requested to do so by the individual or their employer. This is a new requirement for schemes:

    - DC schemes already provide information about pension contributions to members, though some schemes may need to produce this information to an earlier timescale;
    - generally, DB schemes currently provide pension benefit statements on the basis of projected future pension rights. Both of the options for valuing deemed contributions to pension schemes are concerned with rights accrued over the year; and
    - the pension benefit statements will relate to contributions or deemed contributions made over a tax year, which is the relevant 'pension input period' for the restriction of relief. There may be some additional compliance costs for schemes in transitioning to a new (or additional) pension input period for some or all of their members, and any systems changes. The compliance costs will inevitably vary considerably across schemes, with an estimated one-off cost of £275 per scheme and an average annual cost of £125 per scheme. This gives an estimated one-off cost of £15 million with average ongoing costs of £7 million.

49. Individuals in DB schemes receive an employer promise of a future pension: they do not have a separate pension pot into which their employer contributes. To ensure consistent treatment across DB schemes, a method is needed to value a deemed contribution to a DB scheme. The impacts on DB schemes of different valuation methods to calculate deemed contributions are considered in detail in Options 1 and 2 below.

Scheme paying the recovery charge

50. Where the scheme has been elected to pay the recovery charge on an individual's behalf (an option open to those with recovery charges exceeding £15,000):

    - DC schemes will need to reduce the individual's pension pot by the amount of the scheme pays charge. DB schemes will communicate the actuarially fair reduction to future pension benefits to the individual. Schemes currently undertake such valuations to pensions in a similar way when couples split pension rights on divorce; and
    - when the individual confirms that the scheme should proceed with the payment, the scheme then reports and pays the recovery charge on the individual's behalf via the existing Accounting for Tax route, which will be modified to accommodate this.

51. The cost to schemes of delivering this is assumed to be around £20 million per annum. One-off costs are assumed at around £2,000 per scheme, which gives a total estimated one-off compliance cost of around £110 million.

52. Therefore, the total one-off costs for pension schemes will range from around £265 - £305 million, depending on which of the two DB valuation methods, explained in more detail below, is used. The total annual costs for pension schemes will range from around £50 - £90 million, depending on the DB valuation method.

Options for valuing deemed contributions

53. In DB schemes, employers promise their employees a future pension determined by certain factors, typically salary and length of service. Employers then fund their schemes in aggregate or, in the case of some public sector schemes, operate on a pay-as-you-go basis. A method is needed to value a deemed contribution on which to restrict relief, the equivalent of contributions to a DC scheme, taking due account of investment growth which remains exempt from tax. Since DB and DC schemes are not funded in the same way, there is no unique valuation method. Several valuation options have been identified, and the Government has assessed them against these principles, recognising that any method will involve a trade-off between them:

- Flat factors: currently used for the annual and lifetime allowances, these are simple to understand and administer but will generally deliver less fair outcomes than more tailored methods;
- Cash equivalent transfer value (CETV): this actuarial calculation is also currently used within the pensions industry, primarily for valuing pension transfers. While it takes account of a large number of individual and scheme characteristics, it is a complex calculation that would hinder individuals from pre-planning their tax affairs and lead to variability across schemes; and
- Age-related factors (ARFs): this extends the flat factors approach by creating a fairer scale of factors that vary with age and possibly other variables such as normal pension age (NPA). This would take fewer individual and scheme characteristics into account than the CETV approach, but would reduce variability of outcomes between schemes, and be easier for individuals to understand and calculate.

54. A two-way ARFs scale varying with age and NPA is the Government's preferred way of valuing the deemed DB contribution, as it would give the appropriate balance between fairness and simplicity. This Impact Assessment therefore considers the impacts of ARFs, comparing them with the impacts associated with the alternative CETV approach. The need to ensure fairness means that the Government does not consider that flat factors are an appropriate valuation method, and they are therefore not considered further here.

55. The main burdens created by the need to deem a contribution for individuals in DB schemes are on the pension scheme, but these are reduced under an ARFs approach, as the method is simpler overall and some of the responsibility for carrying out the calculation is shifted to the individual.

Option 1: use the ARFs method for DB valuation (lead option)

<u>Summary</u>

56. The age-related factors (ARFs) method extends the flat factors approach by creating a fairer scale of factors that vary with age and possibly other variables such as NPA. The ARFs method would value the deemed contribution by:

- adjusting the previous year's annual pension entitlement by a revaluation rate;
- subtracting this from the current year's annual pension entitlement; and
- multiplying by the appropriate ARF.

57. The ARFs approach allows other influencing variables to be captured as well as age, such as NPA, pension increases in retirement and dependants' benefits. Technically, these could all be incorporated into the ARFs scale, but the more influencing variables that are included, the more complex the method would become. The ARFs scale could either take the form of a one-way scale that varies only with age, or a two-way scale that also varies with NPA. The Government's current preference is to use a two-way ARFs scale. While one-way and two-way scales should, overall, restrict relief by the same amount over time, a two-way scale achieves this in a more timely manner.

58. The Government does not envisage that ARFs would differentiate on the basis of other individual characteristics such as gender or marital status. Other scheme characteristics could be included in a more average sense, where the published ARFs would be applicable to a defined broad range of values for each scheme characteristic. Where, exceptionally, an individual's scheme fell outside that range (including through avoidance by restructuring of scheme benefits), an adjusted ARF would need to be used.

Expected impacts

59. Under the ARFs method, the scheme would need to provide the individual with details of how their annual pension entitlement has increased, as well as their NPA and information on any scheme characteristics that may influence the choice of ARF. The individual would then be responsible for selecting the applicable ARF from a published table, and multiplying their pension increase (incorporating revaluation) by this factor.

60. The largest impact from the use of the ARFs method is expected to be on pension schemes. Schemes would need to provide individuals with an accurate calculation of their annual pension entitlements at the start and end of the year. For the purposes of producing member benefit statements, schemes currently often do this calculation on a projected basis, making certain assumptions about the future to give the individual an indication of what their future pension might be under certain circumstances. Therefore, it is likely that schemes will incur initial set-up costs to computerise this accurate calculation of accrued benefit. However, this calculation is similar to what is required when an individual leaves a scheme, so this would not be entirely new to schemes. Ongoing costs of producing the calculations for each individual would then involve running the computerised process.

61. Within DB schemes, it is not uncommon for high earners leaving employment to be granted an enhancement to their pension. These enhancements can also be awarded to the individual at any other time, including during active scheme membership, in deferment or after retirement. For example, an individual may take early retirement with no corresponding actuarial reduction in annual pension, or the annual pension may be increased: in both cases, the overall pension value will rise significantly. The Government is committed to ensuring that enhancements are subject to the tax relief restriction where appropriate, which will involve deeming a contribution associated with the enhancement. This is necessary to maintain the fairness of the system since, otherwise, individuals would continue to benefit from marginal rate relief on such enhancements, which can be substantial.

62. In cases of enhancements, the scheme would need to advise the individual, particularly if the enhancement involved early payment of a pension, to ensure that the individual used the correct ARFs. In some circumstances, typically in the year of leaving a scheme, the factor applied to the start of year entitlement would be different to that applied to the end of year entitlement.

63. Use of the ARFs method would place an added burden on affected individuals, as they would be responsible for completing the ARFs calculation. They could either choose to do this themselves, or they could pay for the assistance of a tax adviser.

64. The compliance costs that DB pension schemes could expect to incur will vary across scheme providers according to size, client base and other factors. One-off costs are assumed to be around £4,000 on average per DB scheme under the ARFs approach, giving an estimated one-off compliance cost of £80 million. It is assumed that, on average, providing information needed for the ARFs calculation would cost £120 per case handled. With an assumption of around 110,000 cases per annum, the annual compliance cost is estimated at around £13 million.

Benefits and risks

65. The benefits of using ARFs to value the deemed contribution are that the methodology retains an appropriate level of fairness, while being simple enough that individuals would be able to plan their pension saving with an appropriate knowledge of the tax consequences. Also, the scale of factors (envisaged to be set by HM Treasury advised by GAD) would avoid variability of treatment across similar DB schemes. A risk is that the use of ARFs could introduce some confusion, as schemes are obliged to use a CETV approach in other circumstances, such as transfers out of DB schemes. This means that the valuation approach for the purpose of pensions tax relief could differ from the approach to valuing the pension in different circumstances. However, overall, the Government considers that ARFs offer an appropriate balance between the objectives of fairness and simplicity, with a two-way scale varying with age and NPA capturing accrual in a more timely manner than a solely age-related scale. A two-way scale of ARFs varying with age and NPA is therefore the Government's lead option for valuing the deemed contribution.

Option 2: use the CETV method for DB valuation (alternative option)

Summary

66. The cash equivalent transfer value (CETV) is an actuarial calculation currently used by pension schemes to determine the lump sum value, in today's terms, of DB rights accrued by an individual. It is mainly used to calculate the transfer sum representing an individual's pension rights should they leave the DB scheme and for valuing pension rights on divorce. It is also the basis underlying disclosure of the pension value for certain executives as required in a company's annual report and accounts.

67. The CETV approach could be adapted to value the deemed contribution in various ways, including

- A = actual CETV at the end of the year;
- B = annual pension entitlement at beginning of the year increased by the standard revaluation rate up to the end of the year;
- C = CETV at end of the year based on B; then
- the deemed contribution = A - C.

68. Since CETV amounts will vary depending on the current value of investments, adjusting for market movements could be considered, so as to remove the volatility that these would otherwise create within the CETV framework. To achieve this the trustees could take a view on the market neutral conditions underlying the scheme's CETV calculation, or the Government could stipulate the market conditions to be used, based on a single historical date or an average over time. Neither option would be straightforward.

69. The methodology presented above is therefore not simply a straightforward CETV calculation. It is similar to the process for calculating a Greenbury disclosure for senior executives, for publication in a company's annual report and accounts.

Expected impacts

70. Since individuals would be unable to carry out the CETV-based calculation highlighted above, they would need to contact their scheme to calculate it on their behalf. Therefore, the biggest expected impact would be on schemes. Many schemes are likely to already have the ability to calculate a CETV, since they are obliged to provide one to each member free of charge on request, and CETVs are used for pension transfers and divorce settlements. However, schemes would need to make adjustments to this calculation, as

highlighted above. All schemes would face one-off costs to train staff in this methodology, but schemes may implement the change differently depending on their size.

71. Larger schemes would be likely to computerise this process, resulting in a large one-off initial cost but smaller ongoing costs. The scheme actuary would probably be involved in specifying adjustments to the calculation each year, and the scheme administrator would then run the computerised code in each case. Smaller schemes would be unlikely to computerise, opting instead for a manual calculation carried out by the scheme actuary in each case. They would therefore bear smaller upfront costs, but larger ongoing costs.

72. In cases where individuals have benefited from pension enhancements, the scheme actuary would need to carry out tailored calculations to value the deemed contribution associated with such pension enhancements as they arise. This is likely to be the case in all schemes, regardless of size.

73. In addition to these calculations, schemes would also be likely to receive requests for forecasts to aid individuals' decision-making, since individuals are unable to carry out this calculation.

74. The annual compliance costs that DB pension schemes could expect to incur will vary across scheme providers according to size, client base and other factors. One-off costs are assumed to be around £6,000 under the CETV approach, giving an estimated one-off compliance cost of £120 million. It is assumed that, on average, the cost per case handled would be around £500 under the CETV approach. Given around 110,000 cases per annum, the annual compliance cost of the CETV approach is estimated at £55 million.

Benefits and risks

75. One benefit of using a CETV-based approach to value the deemed contribution is that it would use a methodology schemes already understand and use in a variety of circumstances. It would take into account many individual and scheme characteristics and provides an (arguably) fair comparison with DC schemes, since it uses an accepted mechanism to identify the cash amount that the individual would actually be able to withdraw from the DB pension scheme and invest in a different pension scheme.

76. However, individuals would not be able to calculate the restriction of tax relief themselves since they would not have access to the specific CETV factors used by the scheme. This would hinder them from making informed decisions about their pension provision. Also, a scheme's trustees have a certain level of discretion over the assumptions underlying the CETV calculation. If a CETV-based approach was used for the valuation of deemed contributions, this could result in individuals in different schemes, but otherwise identical circumstances, with different tax outcomes depending on the precise assumptions used by their respective schemes. Variations resulting from differing trustee approaches to essentially the same circumstances arguably undermine the fairness advantage of using a CETV-based methodology. As a result, the Government does not believe that this approach is suitable for the purposes of restricting pensions tax relief.

Pension scheme costs under options 1 and 2

77. One-off costs are assumed to be around £4,000 on average per DB scheme under the ARFs approach and £6,000 under the CETV approach, giving an estimated one-off compliance cost of £80 million for ARFs and £120 million for CETV. Recurring compliance costs under the Government's lead valuation option of ARFs are estimated at around £13 million per annum, compared to around £55 million under the alternative CETV approach.

Competition Assessment

78. The measure applies to all individuals with gross annual incomes of £150,000 and over who opt to make or benefit from pension contributions. Sectors with proportionately more high-income workers will also have proportionately more individuals affected by the policy. However, the policy itself applies in equal measure across firms within any given industrial sector. Accordingly, the Government does not anticipate any material impact on competition.

Small Firms Impact

79. The measure applies to individuals with gross annual incomes of £150,000 and over who opt to make pension contributions and does not seek to differentiate according to the size of firms within which the affected workers operate. Given that around 98 per cent of UK employers operate with less than 50 employees, a majority of the affected firms will be small employers, even though the overwhelming majority of individuals affected (estimated at around 80 per cent of affected individuals) will work for medium and large employers. The compliance costs of small employers may differ substantially from those of relatively larger employers, given differences in systems and processes.

Impacts on Financial services

80. Financial services providers will need to train their advisers so that they are able to provide the appropriate advice on the restriction.
81. Tax agents/advisers will have to understand the new rules and the complexities around how these work and incorporate changes in any software updates.

Impacts on HMRC

82. The restriction of tax relief on pension contributions builds on and adapts existing processes, to facilitate the change and minimise the need for additional administration. HMRC will need to modify both the Self Assessment and Accounting for Tax systems to recover any excess tax relief on pension contributions, and to enable the scheme to pay recovery charges on an individual's behalf.
83. HMRC anticipate incurring additional costs in making systems changes, communicating the reform, and in terms of extra queries from individuals and their advisers, and pension schemes. Staff will need to be trained to deal with such queries. The measure will cost HMRC around £3 million a year to enforce. This will be an integral part of HMRC's ongoing compliance and monitoring activities.

Other impacts

84. This reform was initially assessed for its likely impact on legal aid, sustainable development, health, race, disability, gender or human rights issues, and for its effect on rural areas, and it was concluded that it does not impact significantly. Based on internal and external data available there is no reason to believe that this reform would affect people differently based on their equality group. The Government does not therefore propose to undertake a full equality Impact Assessment but welcomes views on whether this measure could affect people differently because of their equality group.

Specific Impact Tests: Checklist

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

F List of acronyms used

AA: annual allowance

ARFs: age-related factors

CETV: cash equivalent transfer value

DB: defined benefit

DC: defined contribution

EEA: European Economic Area

EU: European Union

HMRC: Her Majesty's Revenue and Customs

GAD: Government Actuary's Department

LTA: lifetime allowance

NICs: national insurance contributions

NPA: normal pension age

OECD: Organisation for Economic Co-operation and Development

PAYG: pay-as-you-go

PAYE: Pay As You Earn

RAC: retirement annuity contracts

RAS: relief at source

RPI: retail price index

UK: United Kingdom

G Glossary

A-Day: 6 April 2006, when new pensions 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 also, *Finance Act 2004*.)

Adjusted net income: the measure of pre-tax income currently used in the tax system to determine when age-related and other personal allowances are withdrawn. It is defined in section 58 Income Tax Act 2007.

Age-related factors (ARFs): a scale of factors which vary with age and possibly other variables such as *normal pension age*, which can be used to calculate the *deemed contribution*.

Appropriate rate of relief: the rate of tax relief to which individuals are entitled on a given tranche of pension contribution where those contributions, in the absence of the restriction, would have received the same *marginal rate of relief*. For individuals on the taper, this is equal to the lower of the *marginal rate of relief* otherwise received on that contribution, and their *taper rate of relief*. For individuals with *gross incomes* over £180,000, the appropriate rate of relief is 20 per cent.

Appropriate recovery rate: the rate by which tax relief on a tranche of pension contributions will be restricted, equal to the difference between the *marginal rate of relief* otherwise received on that tranche and the *appropriate rate of relief* applicable to that tranche.

Annual allowance (AA): the annual limit on tax-privileged inflows of value to an individual's pension fund, via an increase in pension entitlement or contributions made by an individual or for their benefit by an employer or other third parties. This is set at £245,000 for 2009-10.

Annuity: insurance contract that guarantees to pay annual amounts for a fixed period. Pension annuities, that are not limited period annuities, must be 'lifetime annuities' guaranteeing income for life.

Benefit-in-kind: non-cash benefit provided as part of earnings from employment.

Budget Payment Plan: HMRC's National Direct Debit Service Budget Payment Plan allows individuals to set up payments to be made in advance towards a Self Assessment tax liability. The individual can choose how much and how often (weekly or monthly) these payments are made.

Cash balance arrangement: an arrangement where the benefits to be provided are dependent on fund value. The fund value is fixed formulaically and, on drawing benefits, the fund value is used to provide a pension (either by conversion within the scheme, or through annuity purchase, or provision of an unsecured or alternatively secured pension) and an optional lump sum.

Cash equivalent transfer value (CETV): an actuarial calculation used to determine the lump sum value, in today's terms, of the pension rights accrued by a member of a defined benefit pension scheme. It is mainly used to calculate the transfer sum representing an individual's pension rights should they leave the *defined benefit scheme*, and for valuing pension rights on divorce. When producing CETVs, schemes must comply with provisions set out in the Occupational

Pension Schemes (Transfer Value) Regulations 1996 (as amended), which stipulate the method for calculating the minimum amount of any CETV.

Commutation: conversion of a proportion of pension rights into a lump sum payment.

Deemed contribution: used in this document to mean the notional *defined benefit* equivalent of the contribution(s) to a *defined contribution scheme*.

Deferred member: an individual who has ceased active membership of a pension scheme, but has not started to draw benefits.

Defined benefit (DB) scheme: a pension scheme where individuals accrue rights to a future pension, and often a tax-free lump sum payment (usually of up to 25 per cent of the value of the aggregate benefits), either as a separate right or by *commuting* part of the pension for a lump sum. The benefit entitlement is determined typically by reference to a person's earnings and length of service within the pension scheme. Employers who sponsor these schemes will fund the liabilities in aggregate or, in the case of some public sector schemes, meet their liabilities on a pay-as-you-go basis, rather than making contributions on an individual basis.

Defined contribution (DC) scheme: a scheme where entitlement to benefits is wholly dependent on the contributions made to the scheme and investment return. These can be either occupational or personal: in an occupational DC scheme employers and employees contribute an amount, typically a percentage of the employee's salary, into the individual's pension pot, which then grows with investment and later years' contributions; in a personal DC scheme individuals can make regular or irregular contributions to personal pensions, but often without an employer contribution. When benefits are drawn, individuals are usually able to take a tax-free lump sum of up to 25 per cent of the value of their pension pot, the remainder being used to provide an income, most commonly through the purchase of an annuity.

Finance Act 2004: an Act of the UK Parliament, which introduced, among other things, the simplified pensions tax regime effective from 6 April 2006 (see *A-Day*).

Flat factors: for the purposes of this document, this term refers to the factors currently used for testing a *defined benefit scheme* member's accrued pension against the *annual* and *lifetime allowances*.

Gross income: pre-tax income (*adjusted net income*) including an individual's own pension contributions, their charitable donations, and the value of any pension benefit the individual receives from others, typically that funded by (or eventually funded by) their employer. For high-income individuals in *defined contribution schemes*, this benefit is funded directly by employer contributions into their pension pot over the tax year. For high-income individuals in *defined benefit schemes*, the value of the pension benefit included in gross income is the *deemed contribution* minus any actual employee contribution.

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 £1.75 million for 2009-10.

Marginal rate of relief: the rate of relief applicable to a tranche of pension contributions in the absence of the restriction. This is 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.

Net pay arrangement: the method employers normally use to deduct pension contributions to an occupational pension scheme from employees' pay, before operating Pay As You Earn so that employees receive tax relief on pension contributions at their *marginal rate*.

Normal pension age (NPA): defined broadly in accordance with the Pension Schemes Act 1993 definition, i.e. the earliest age at which an individual in a *defined benefit scheme* is entitled to receive benefits on retirement from their employment, disregarding any special provisions for early retirement on the grounds of ill health or otherwise. Where enhancements are granted which have the same effect as reducing an individual's NPA, the intention is that the individual will be treated as having a lower NPA. For deferred members, the NPA is taken to be the age at which the deferred pension is due to commence.

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

Overall recovery rate: a weighted average of the *appropriate recovery rates* applicable to each tranche of an individual's pension contributions, where different tranches have received different *marginal rates of relief*. The overall recovery rate can be determined automatically by the Self Assessment tax calculation given information on an individual's income, their total pension contributions or *deemed contributions*, and the level of their individual contributions.

Overseas scheme: a pension scheme established outside the UK, which is not a registered pension scheme, and where contributions to the scheme are given UK tax relief.

Pay as you earn (PAYE): the system that HM Revenue & Customs (HMRC) uses to collect income tax and national insurance contributions (NICs) from employees' pay as they earn it. It also collects income tax from company and personal pensions when they are paid.

Pension input period: the period over which the accrual of pension benefits for the assessment against the *annual allowance* is currently determined (introduced under *Finance Act 2004*).

Pension sharing on divorce: an arrangement under a pension sharing order, agreement or equivalent provision in accordance with the Welfare Reform and Pensions Act 1999 whereby pension rights are shared between both parties to the divorce.

Personal pension scheme: see *defined contribution scheme*; any pension scheme that is not an *occupational pension scheme*, unless otherwise specified, the term 'personal pensions' also refers to *retirement annuity contracts (RACs)* and includes group personal pension schemes.

Recovery charge: a mechanism for recouping tax in excess of the amount the individual is entitled to after the restriction of tax relief on pension contributions is applied. This is equal to the *overall recovery rate* multiplied by an individual's total pension contributions or *deemed contributions*.

Recovery rate: see *overall recovery rate.*

Relief at source: a method for giving basic rate relief on pension contributions. An individual makes a pension contribution of the full value they wish to make, less an amount equal to the basic rate of income tax. The pension scheme then claims basic rate tax relief from HMRC.

Retirement annuity contract (RAC): as defined in 620 Income and Corporation Taxes Act (ICTA) 1988, this is similar to a personal pension. There have been no new RACs since personal pensions were introduced in 1988. However, existing policy-holders can continue to contribute to them.

Revaluation: the uprating, for *deferred members* of *defined benefit schemes,* of an individual's pension each year until benefits are drawn – at a minimum, this must be consistent with the *statutory revaluation* rate to which the individual has a legal right upon leaving a scheme. In this document, this also refers to the rate of revaluation assumed within the *age-related factors* methodology for calculating a *deemed contribution.*

Scheme pays: an option presented in this document that will be available to some individuals affected by the restriction of relief. The pension scheme pays the recovery charge on their behalf, and reduces the individual's pension pot or their accrued pension benefit for the year by an actuarially appropriate amount.

Self Assessment: the process by which an individual completes an online or paper tax return in order to tell HMRC about income and capital gains (profits on the sale of certain assets), or to claim tax allowances or reliefs against tax bills.

Special annual allowance: a part of the anti-forestalling regime introduced at Budget 2009 that protects the level of an individual's pension contributions attracting higher rate relief. The effect of the anti-forestalling regime is that pension contributions will retain full tax relief up to the level of:

- normal, ongoing pension saving; or
- the lower of £30,000 and average contributions over the past three years, if contributions are less regular than quarterly; or
- £20,000; whichever is highest.

Statutory revaluation: the legal minimum requirement for revaluing a deferred *defined benefit scheme* member's pension. For rights accrued since 6 April 2009, this is inflation capped at 2.5 per cent over the whole period until benefits come into payment.

Taper: the mechanism described in this document that defines an individual's *taper rate of relief* for those within the band of *gross income* from £150,000 to £180,000, thereby gradually restricting relief to the basic rate.

Taper rate of relief: the rate determined by the *taper* that gradually restricts relief available for those on *gross incomes* between £150,000 and £180,000. It reduces gradually from 50 per cent to 20 per cent and determines the *appropriate rate of relief* to which individuals are then entitled on different tranches of their total pension contribution, as above.

Tax-free lump sum: the benefits from a pension scheme that can be taken as a cash payment not subject to income tax, when an individual becomes eligible to draw funds from a pension. Subject to scheme rules, this can normally be up to 25 per cent of the value of the pension fund.

Technical provisions: an estimate, calculated in accordance with Part 3 of the Pensions Act 2004, of the assets needed in a *defined benefit scheme* at any particular time to make provision for benefits already accrued under the scheme.

H The Government's code of practice on consultation

About the consultation process

This consultation is being conducted in accordance with the Government's Code of Practice on Consultation. If you wish to access the full version of the Code, you can obtain it online at: http://www.berr.gov.uk/files/file47158.pdf

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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This document can be found in full on our website at:
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ISBN 978-1-84532-637-1

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