Simplifying the taxation of pensions: increasing choice and flexibility for all

ABI response to the pensions tax simplification consultation paper.

April 2003
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SUMMARY

The key messages from this response are:

1. The ABI supports and welcomes the Government’s bold proposals for simplifying the pensions tax regime.

2. The proposals will make it easier for consumers to understand pensions and cheaper for employers to provide them. Importantly, the elimination of the different tax treatment of different types of pension should cut the cost of advice.

3. Provided the simplification process focuses on stripping out unnecessary administration, it will facilitate the future distribution of simple, good value products in an era of low charges.

4. The ABI believes that a lifetime fund limit is workable subject to the following crucial modifications:
   - Indexation of the lifetime limit in line with earnings to ensure that it continues to benefit over 99% of people.
   - Regular reviews of the limit to take into account changes in longevity and investment conditions.
   - Introduction of a robust lifetime limit from the outset of £1.8 million.
   - A fairer, better targeted recovery charge rather than a ‘one size fits all’ approach.
   - Introduction of 25% ‘headroom’ for those who have more than the lifetime limit or who are approaching it at ‘A Day’ to ameliorate the retrospective effect of the changes.
   - Sufficient time to enable the transition to go smoothly – at least a year from the finalised legislation being made available to the industry is required, which probably makes April 2005 the earliest possible date.

5. These modifications will ensure that the transition from old to new regime is as fair as possible without compromising simplicity. They will ensure transition is a success and that the success is ongoing.

6. The industry is disappointed that the approach to simplification of the accumulation phase has not been applied to the ‘decumulation’ phase of pensions provision. The proposed treatment of death benefits post vesting adds complexity to the existing regime rather
than simplifying it.

7. Money-back guarantees should not be limited to age 75 for annuities. Introduction of a graduated neutralising tax charge should alleviate Government concerns about the use of pensions to pass on large assets.

8. A return of the fund, subject to the same graduated tax charge, should be available with ‘unsecured income’ as value protection is not a concept suited to this type of product.
INTRODUCTION

1. The Association of British Insurers (ABI) welcomes the opportunity to respond to these bold proposals for simplification of the pensions tax regime. As the main trade association for the insurance industry in the UK\(^1\), the ABI is keen to work in partnership with the Government to achieve a pensions environment where insurers are able to sell good value products that people want to buy, in an environment where they are encouraged to do so. This consultation, along with others currently underway, will be instrumental in achieving such an environment.

2. The ABI has consistently called for simplification of the pensions regime – both the tax regime administered by the Inland Revenue (IR) and the ‘social’ elements administered by the Department for Work and Pensions (DWP). Most recently, we called for simplification of the pensions tax regime in our pre-budget representations, where we echoed Ron Sandler\(^2\) in asking for simplification to: be radical; reduce the number of pensions tax regimes to as few as possible, preferably one; and limit either contributions to pensions or the benefits paid out, but not both. We are extremely pleased that our (and Sandler’s) criteria have been almost completely met by the consultation proposals, as regards the accumulation phase, (the only exception being the proposal to have different types of limit, namely contribution limits – the personal and annual limit - and a fund limit - the lifetime limit). We are however disappointed that the same approach to simplification has not been applied to the ‘decumulation’ phase of pensions provision. The proposed treatment of death benefits post vesting adds complexity to the existing regime rather than simplifying it.

3. The main body of this response inevitably focuses on areas where we believe the proposals being consulted on can be improved. This does not detract in any way from our general support of the proposals. In the suggestions we make, our aim is to assist the Government in implementing its policy (as we interpret it) in a way which best fits consumer needs and which minimises administration costs for pension providers so that good value, simple products, of the type envisaged by Ron Sandler\(^3\), can be offered and distributed to consumers.

4. We are disappointed that the radical simplification proposed by the IR is not echoed in the DWP’s pensions Green Paper so that Alan

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\(^1\) Every day UK insurance companies pay out £140m in pension benefits. This compares to the £127 million paid out daily by the UK government in pension provision. In 2001, net premium income totalled £54 billion (of which £25 billion accounted for individual pensions and £29 billion other pensions). £210 billion is invested in insurance administered occupational pensions, and a further £350 billion in insurance administered personal pensions. The ABI represents over 400 insurance companies operating in the life and general insurance markets.

\(^2\) Ron Sandler set out his criteria for a simplified tax regime in his report ‘Review of Medium and Long-Term Retail Savings in the UK’, July 2002.

\(^3\) See ‘Review of Medium and Long-Term Retail Savings in the UK’, by Ron Sandler, July 2002.
Pickering’s vision of “a pension is a pension is a pension” could be fully realised. The IR proposal of one tax regime for all pensions will not reduce the number of pension products unless other forms of regulatory arbitrage, such as the different treatment of contracted-out and non-contracted out rights, are removed by the DWP. A joined-up approach is required if pensions are to be thoroughly and consistently simplified and the opportunity must be taken to do this now.

5. We also believe strongly that the pensions regime must be bolstered through the introduction of further incentives, including incentives to encourage new employer contributions. Simplification alone will not bring about the step change in savings behaviour required to close the savings gap and eliminate the number of people seriously undersaving.

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4 See ‘A simpler way to better pensions’, an independent report by Alan Pickering, July 2002.
RESPONSE TO CHAPTER 4 - THE ACCUMULATION PHASE

The concept of a lifetime fund limit achieves simplicity and consistency across all pensions. Although it has potential drawbacks as compared to a lifetime limit on contributions, it is probably the one type of limit which can be made to successfully apply across all types of pensions. In order to do this it must:

- Increase in line with earnings and be reviewed regularly;
- Start at £1.8 million;
- Not be introduced until April 2005 at the earliest;
- Tax any excess at a fair, targeted rate;
- Allow extra headroom for those who have more than the lifetime limit and those who are approaching it at ‘A Day’; and
- Strip out unnecessary administration so that simple, good value products can be provided at low cost.

6. The ABI warmly welcomes the proposed simplification of the accumulation phase of saving for retirement in a pension. The introduction of one tax regime for all pensions will sweep away the present complexities in the pensions tax system, leaving individuals and employers in a position, finally, to understand pensions. This will remove an important disincentive to saving and to employers setting up schemes - research\(^5\) carried out for the ABI demonstrates that complexities, including the tax rules, deter employers from offering and contributing to pension schemes.

7. We agree with the Government that the reforms should:

- allow many people to save more, if they can afford to;
- make it easier for employers to set up and run pension schemes;
- have an impact on financial advice, as advisers will no longer have to consider the tax differences between different schemes; and
- introduce scope for flexibility and innovation in scheme design.

8. We recognise the need for the retrospective nature of the reforms which will do away with the current layering effect – the core cause of the complexity. However, this could have some quite severe repercussions on a number of savers. We have therefore made some suggestions below which will ameliorate these effects to ensure as fair a transition as possible without re-introducing complexity.

9. We believe that simplification of this nature, provided it is focused on stripping out as much administration as possible, particularly for

\(^5\) *What makes people save?*, a research report by Graham Vidler, December 2002 (available from the ABI’s website www.abi.org.uk).
pension providers, will be one of the crucial components in ensuring the successful distribution of simple, good value products in an era of low charges. In such an era, it will be important that as little as possible is wasted on unnecessary administration to ensure value for money. For this reason, we urge the Government to take a more risk-based approach to tax avoidance than the current proposals take, particularly regarding the checking and reporting required of pension providers.

**Recommendation 1:** The simplification process should focus on stripping out unnecessary administration so that pension providers can distribute simple, good value products in a low charge environment.

**Will a lifetime limit on tax relieved saving be a satisfactory way of integrating the taxation of pensions?**

10. We believe that a lifetime fund limit is workable, subject to the introduction of some crucial safeguards, outlined below. We understand that the rationale behind the lifetime limit is to ease application across all pension types. In particular, a lifetime limit approach will be easier for final salary schemes to administer than the contribution-type limit more suited to money-purchase schemes. While we would support a lifetime fund limit for this and other reasons, it is important to bear in mind the relative advantages and disadvantages of such a limit as compared to a contribution limit. We would consider these to be:

**Lifetime Fund Limit**

- it would be relatively simple for final salary schemes to apply;
- it would be easier to establish fund amounts in existing schemes than contributions made, making transition easier; and
- it would be easier to apply such a limit to death benefits as well as retirement benefits; but
- it could encourage people to delay starting a pension, hoping to catch-up later;
- it could have the detrimental effect of encouraging people to stop saving and/or switch to lower return, lower risk investments, with more certain terminal values, when they get close to the limit. Such a distortion of investment portfolios away from equities, if it occurs to a serious degree, could impact the capacity for risk-bearing in investment markets and thus the economy at large; and
- it may encourage people to take their benefits early (via drawdown, drawing minimal income) in order to benefit from investment growth in the post-benefit environment, after the limits test has taken place, though this is balanced by the poorer death benefit provision proposed post retirement.
Contribution limit only

- it would encourage the discipline of regular saving (if annual);
- it would furnish providers with a marketing tool to persuade people to contribute the maximum each year, before that year's allowance of tax-free savings is "lost" (if annual); and
- it would not penalise investment growth or distort investment choices; but
- it would impose additional annual costs on final salary schemes; and
- historic information on transition would not be available in many schemes, particularly final salary schemes.

11. The ABI does not favour two different limits, such as a contribution limit for money-purchase schemes and a fund limit for final salary schemes, as this would perpetuate the different tax treatment of different pension vehicles bringing a need for advice on the tax treatment of pensions back into the equation. Transferring between pension schemes would also be attractive, in certain circumstances, were two types of limit to apply and again this would mean higher administration and advice costs. Instead we favour improving upon the lifetime limit to make sure it works.

Vital improvements

Timing

12. This will be the first time that changes on so wide a scale, affecting all of the pension schemes and arrangements in the UK, will act both prospectively and retrospectively. In addition, it is not just the underlying structure of the pension benefits that is changing, but also the form of the benefits. It will be crucial that employers, pension providers, financial advisers and existing pension savers are given a reasonable amount of time, once the full details of the changes are known, to make sure that the transition from the old to the new regime can be conducted smoothly. We set out in more detail in our response to chapter 6 of the consultation paper the myriad changes which pension providers will have to implement and communicate to customers.

13. The practical implementation of these changes will not be understood until they are published in their full and final form – this means both primary legislation and the regulations supplying the detail. The Pensions Act 1995 which took effect in 1997 set a good precedent and enabled a smooth implementation. The introduction of stakeholder pensions on the other hand, where the final regulations were made available only shortly before the launch of the product, meant the industry was unable to offer the quality of service to customers it would have liked as systems were still being developed at product launch. Also, the rushed legislation introducing personal pensions in 1988
caused severe administrative problems, contributing to pensions mis-selling. ‘A Day’ should be set at least one year from the date the changes in their full and final form are available. This means April 2005 at the earliest.

14. These Inland Revenue proposals should be implemented at the same time as the various proposals in the Department for Work and Pensions’ pensions Green Paper. In addition to this, it is important that the Government considers these changes alongside the other ongoing consultations and proposed changes to pensions and the savings industry (in particular those outlined at paragraph 87. Implications of these other proposals will need to be dovetailed with the pensions tax simplification proposals to ease the burden of implementation on all parties concerned.

Recommendation 2: ‘A Day’ should be set at least one year from the date the primary legislation and underlying regulations setting out the changes are available to the industry.

Indexation and Regular Reviews

15. One of the most important aspects of the proposed lifetime limit regime is its focus on the majority who do not save enough for retirement, rather than on the minority who are able to save “too much”. The consultation paper makes the point very well - “over 99 per cent of people saving in pensions will be able to save more in pension form with tax relief if they can afford it”\(^6\). We think this is a crucial statement and it will be extremely important to ensure its continued veracity. This is vital for long term savings - people must have confidence about the principles that will apply when they come to draw their pensions.

16. In considering the impact of a lifetime fund limit, it is vital that the Government considers its potential reach across the whole population of pension savers. Figure 1 illustrates, in broad terms, the extent to which a lifetime limit could affect people at different ages/earnings levels.\(^7\) There are two groups whose ability to save could be endangered – those who might be affected by a lifetime limit set too low at the outset, and those who might be affected by an indexation method which fails to keep pace with rising living standards.

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\(^6\) ‘Simplifying the taxation of pensions: increasing choice and flexibility for all’, p 17

\(^7\) Assumptions: national average earnings grow by 2%pa in excess of RPI; individual earnings growth matches national average.
17. To ensure that the lifetime limit achieves simplification without unduly limiting people’s ability to save, the following measures are necessary:

- The lifetime limit must be indexed in line with earnings rather than prices, otherwise it will affect increasing numbers of people. In addition, these people will be encouraged to vest their benefits early as investment growth post vesting in income drawdown is not subject to the recovery charge, even if the fund exceeds the lifetime limit. This goes against the Government’s policy aim of encouraging people to stay in work for longer. An earnings index is the most appropriate due to the fact that pensions are designed to replace earned income. The fact that the current earnings cap increases in line with the Retail Prices Index (RPI) should not be used as a reason to justify increasing the new limit only in line with prices. Indexation of the current cap is a flaw in the current system, resulting in increasing numbers of people being caught by that cap. That flaw should not be perpetuated in the new regime, particularly because even more people than have been caught by the RPI indexation of the current earnings cap will be affected due to the lifetime limit acting as a cap/tax on both earnings and investment growth. If the limit is not increased in line with earnings, the Government will be giving out the message that it wishes to reduce the role of private pension saving in the long term.

- As the Box 1 exemplifies, if the lifetime limit is indexed in line with prices rather than earnings, it will effectively immediately cap the tax relieved savings of an additional 800,000
people – e.g. people in their 30s earning over £50,000 and in their 40s earning over £60,000.\(^8\) These people are those in the top band of Figure 1 above.

- The lifetime limit must be regularly reviewed to take account of improvements in longevity and changes in investment conditions, including changes in the yields on gilts and bonds. As life expectancies continue to rise, the amount of income which can be purchased with the lifetime limit will reduce. It may also be appropriate for intervening reviews to be triggered if there are extreme changes in investment conditions.

- All other limits - the annual contribution limit, the personal contribution limits and the triviality limit - should be similarly indexed and reviewed.

- The lifetime limit should be robust from the outset - £1.8 million would be a more appropriate figure than £1.4 million (the following paragraph discusses this in more detail).

**Recommendation 3: The lifetime limit should be indexed annually in line with earnings and reviewed regularly to take account of changes in longevity and investment conditions. All other limits should be indexed consistently with the lifetime limit.**

**A robust lifetime limit from the outset**

18. It is important that the lifetime limit is robust from the outset. According to the consultation paper, the figure of £1.4 million was chosen because it is “broadly equivalent to a maximum pension under the current occupational pension rules for a man aged 60 drawing an indexed pension and providing a surviving spouse’s pension.” However, improving longevity and declining long-term gilt yields have resulted in annuity rates in the market which would not support the targeted level of income. To clarify:

- A 60 year old man in an occupational pension scheme could currently receive a maximum income of 2/3 of £97,200 (the earnings cap for 2002/03). This amounts to £64,800 income per year (indexed and with a spouse’s pension).

- The consultation paper envisages that it would cost £1.4 million for the same 60 year old man to buy an annuity paying £64,800 per year (indexed and with a spouse’s pension).

In fact however, under current annuity rates, £1.4 million would only buy about £55,000 of income per year for a 60 year old man with a

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\(^8\) ABI estimate based on earnings/age distribution from *New Earnings Survey 2002* and *Survey of Personal Incomes.*
spouse’s pension and indexation. This is the top conventional annuity rate available for such a person on the market. A 60 year old woman could buy even less income with £1.4 million and a 55 year old less again. A more realistic figure would be £1.8 million.

19. This anomaly has come about because we understand that the Inland Revenue has applied a conversion factor of 20 to the maximum income available under the 1989 regime, to reach the figure of £1.4m (i.e. 70,000 approx. X 20 = £1.4m). This conversion factor will also apply to convert final salary pension benefits to a lifetime fund on vesting. However annuity conversion rates on the market (which convert money-purchase funds to a pension income) are closer to 25 as demonstrated above.

20. We understand that the reason behind this is to guard against overvaluing final salary funds because this could lead to transfers between final salary schemes and money-purchase schemes just before vesting.\(^9\) However we do not feel this justifies unfairly reducing the income which can be purchased by a money-purchase scheme on the market. We suggest that a lifetime limit of £1.8 million be applied to both final salary and money-purchase schemes. If this results in a higher pension income (than the maximum under the current rules) being allowable for final salary schemes (due to the use of a conversion factor of 20) that will be the necessary quid pro quo for ensuring that it does not become attractive to transfer. That is the correct quid pro quo rather than reducing the amount of income which a money-purchase scheme can purchase to below the current maximum.

21. Those earning between around £75,000 and £100,000 (in today’s prices) at retirement – a level which those earning around £40,000 at age 30 and £50,000 at age 40 might expect to reach - who are currently in money-purchase schemes will be affected if the limit is not set at the correct rate. These people are in the middle band of Figure 1 above.

Recommendation 4: The lifetime limit should be robust from the outset - £1.8 million would be a more appropriate figure than £1.4 million.

Policy Intention

22. It appears from the consultation paper, (paragraph 4.10), that the policy intention behind setting a lifetime limit of £1.4 million is to allow for a maximum pension at age 60 of around £65-70,000 – broadly the maximum pension income available under the current 1989 regime. We strongly recommend that a policy statement outlining this intention to allow a level of pension to be accumulated/purchased is included in

\(^9\) This might be done in order to reduce or remove a recovery charge if the defined benefit rights are valued too high.
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the legislation implementing these changes. This will provide an important reference for the regular reviews which we recommend at paragraph 17.

**Recommendation 5:** The Government should set out in legislation its policy intention that a target level of pension income can always be accumulated/purchased by the lifetime limit.

**Recovery Charge**

23. Another objective in the consultation paper which we commend, is that those who wish to save more than the lifetime limit should enjoy the flexibility to do so, but without tax relief. A recovery charge which would roughly neutralise tax relief is proposed. This is a reasonable approach in principle, however, the proposed rate of 33%, combined with compulsion to take the excess as either a taxed lump sum (25%) and a taxed income (75%) or a taxed income (100%) - effectively a 60% tax charge for higher rate taxpayers - seems far too high if it is to apply to everyone, regardless of the circumstances which led to them breaching the limit. It would fail to deliver the stated policy intentions described above. It would also adversely affect investment behaviour because people are likely to switch to cash and gilts to avoid going over the limit and paying the recovery charge. This is because investing in equities carries with it a risk – people are prepared to take this risk where they will benefit as much from the ‘up side’ (good equity returns) as they will suffer from the ‘down side’ (poor equity returns) i.e. the risk is balanced. They are unlikely to take this risk where they will benefit only partially from the ‘up side’, due to the recovery charge, but will suffer in full from the ‘down side’ (poor equity performance).

24. We understand from the Inland Revenue that the recovery charge assumes funds have been invested and benefited from gross roll up for 15 years. The Inland Revenue have themselves acknowledged that this amounts to a penal tax charge on the individual who breaches the limit perhaps inadvertently, just before retirement, as a result of investment growth (‘First Category’). However, they cite the example of a person accruing a vast sum by age 40 and leaving it to roll up until age 65 (‘Second Category’). Someone in the Second Category will gain a tax advantage even under the current proposals. It should be borne in mind however, in ascertaining the likelihood of someone choosing to fall into the Second Category, that at least 75% of those funds will have to be taken in income form. We know from the media coverage that pension annuities have received over the last couple of years that wealthy people are strongly opposed to taking their fund in income form, so we would suggest they are unlikely to deliberately save significantly in excess of the lifetime limit in a manner which forces them to turn it into income.

25. In any event, we believe that measures can be introduced which better cater for the different types of saver who will breach the limit than the
Inland Revenue’s ‘one size fits all’ approach, without compromising simplicity. A menu of options is set out below:

Option 1

26. A threshold above the lifetime limit could be introduced where the excess is subject to a lighter recovery charge because it is likely that people in the first category will have funds in this area. Funds above the threshold, likely to be in the Second Category which the Inland Revenue is targeting, would be subject to the full 33% recovery charge. An example of this in graduated form would be to apply a 10% recovery charge to funds between £1.4 and £1.5 million; a 20% recovery charge to funds between £1.5 million and £2 million and a 33% recovery charge to funds over £2 million. This is our preferred option as it is less administratively complicated than the options below.

Option 2

27. An individual’s fund limit at the end of each of the three years preceding vesting could be checked and if the lifetime limit was exceeded only in the final year, a lighter recovery charge would apply. This could be tapered depending on how many of the final 3 years the lifetime limit was ‘breached’ during. If attractive to the Inland Revenue, this option would have to be implemented so as to necessitate the least amount of administration possible on the part of the pension provider, otherwise costs will be driven up. This approach would be complicated where multiple funds are concerned and where flexible vesting over a period of years is operated.

Option 3

28. As soon as a saver breaches the lifetime limit by a threshold amount, they would have the option to withdraw the excess at a much less penal tax charge because it would be extremely unlikely that 15 years tax-advantaged investment roll-up had occurred. A threshold would have to be set to protect people against withdrawing money and then suffering a fall in their funds due to stock market falls. This could be optional so that the onus would be on the individual to monitor their pension arrangements in aggregate to determine if and when they exceed the lifetime limit. If they choose not to do this, they will be subject to the full recovery charge at vesting.

Recommendation 6: A fairer, better targeted recovery charge should apply rather than a ‘one size fits all’ charge based on an investment scenario of 15 years. Our preferred option is the most simple – a lighter recovery charge for excesses up to a threshold amount, say £2 million, with a heavier recovery charge above that amount.
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Fairer transitional arrangements

29. In order to ameliorate the effects of the retrospective nature of these changes, we recommend that those with more than the lifetime limit or approaching it at ‘A Day’ be allowed to register their fund size and be given additional head room of say 25% of the fund size to allow for investment growth. If this is not done, these people will suffer a recovery charge due to investment growth on monies they have legitimately built up under the current regime, even if they do not contribute a single penny after ‘A Day’. This is because investment growth is likely to be greater (7% under current Financial Services Authority assumptions) than either the growth in prices (around 2.5%) or in earnings (around 4.5%).

30. This can best be demonstrated by means of an example:

- **Example 1**
  Someone registers £1.8m on ‘A Day’ and takes their benefits five years later. Assuming investment growth of 7% pa, the fund will have grown to £2.525m. Their lifetime limit will have increased with inflation (assuming 2.5% inflation) from £1.8m to £2.037m. The difference between the two, £488,000, will be subject to the recovery charge and thereafter taxed as income. Under our proposals £450,000 of headroom would be available so that only £38,000 of the excess would be subject to the recovery charge.

- **Example 2**
  Someone has a fund of £1.2m on ‘A Day’. This is subject to the £1.4m lifetime limit and does not need to be registered. They take their benefits five years later. Assuming investment growth of 7% pa, the fund will have grown to £1.683m. The lifetime limit will have increased in line with inflation (assuming 2.5% inflation) to £1.584m. The difference between the two, £99,000 will be subject to the recovery charge even though no further contributions have been made. Under our proposals £300,000 of headroom would be available so that only £99,000 excess would not be subject to the recovery charge.

31. An alternative approach would be to again allow those with more than or approaching the lifetime limit at ‘A Day’ to register their funds but then to disregard future investment growth (money-purchase) and salary inflation up to a maximum (final salary), provided no extra contributions are made (money-purchase) or years accrued (final salary).

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10 These assumptions are consistent with those used in the pensions Green Paper
32. In order to maintain simplicity, these transitional protections should only apply in the scheme in which they accrue. A transfer should result in the loss of these protections otherwise complicated records will have to be kept.

**Recommendation 7:** Those with more than the lifetime limit or approaching it at ‘A Day’ should be given extra headroom of around 25% to allow for investment growth on their funds.

**Important Improvements**

**The Annual and Personal Limits**

33. The personal limits of 100% of earnings or £3600 gross and the annual limit of £200,000 are unnecessarily complicated, particularly for final salary schemes to operate. They also introduce two types of limit into the equation where one would be far simpler and preferable. Both Ron Sandler, and the ABI in our pre-budget representations, called for only one type of limit to apply.

34. The consultation paper indicates that the reason behind the personal and annual limits is to limit the leakage of tax relief which could occur through improper extraction of the proceeds. We understand that of particular concern to the Inland Revenue and HM Treasury is the possibility that large amounts could be paid into a UK pension scheme and then transferred to a pension scheme in an EU country which does not tax pension benefits. This would mean that the tax relief given on the pension contributions would not be retrieved via taxation of the benefits (as would happen if the benefits were taken in the UK). We understand this concern but believe there are better ways of addressing it than through personal and annual contribution limits and would be happy to explore these further with the Inland Revenue.

35. One possibility is that the taxation of overseas life policies may set a precedent for allowing the UK to treat pension transfers to some EU countries differently to transfers within the UK i.e. more stringently, while still falling within the ‘tax coherence’ doctrine. Appendix 1 outlines the details of the approach applied to the taxation of overseas life policies.

36. We suggest that the same arguments could be used to apply controls on pension transfers to EU countries, where such controls do not apply to transfers to UK pension schemes, if those countries do not apply the same tax treatment to pension benefits as is applied in the UK. If the same tax treatment is accorded, the controls will not apply.

37. If the personal and annual limits are not removed, we believe that the legislation will have to be generous in describing situations where no benefit in kind would apply, e.g. ill health retirement, long service
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member receiving salary increase close to retirement, retirement following redundancy.

Recommendation 8: The proposed annual and personal limits should not be introduced and an alternative means of allaying Inland Revenue concerns about ‘trust busting’ should be developed.

Inheritance Tax

38. The consultation paper does not deal with the inheritance tax treatment of death benefits. The treatment proposed in the ABI’s pre-budget representations should be introduced, namely:

“Under current practice, the award of lump sum death benefits (including the return of accumulated funds) under pension schemes is generally made subject to the discretion of the trustees. This is in order to prevent the benefits from being treated as part of the deceased’s estate for inheritance tax purposes. It would be simpler, and so make pension schemes more cost effective to administer, if a statutory exemption from inheritance tax could be provided for death benefits paid by approved pension arrangements. This would fit well with a new, simpler tax regime.”

39. This treatment should apply to all death benefits whether in lump sum or income form and whether paid out during the accumulation or ‘decumulation’ phase.

Recommendation 9: A statutory exemption from inheritance tax should be introduced in respect of death benefits paid by approved pension arrangements. This should apply to all death benefits – lump sum or income – whether paid during the accumulation or ‘decumulation’ phases

Limits checking

40. As far as possible, all limits checking should be between the individual and the Inland Revenue and communication between insurers regarding limits should be kept to a minimum. Bearing in mind that the majority of savers will not be affected by the lifetime limit, ideally providers should be able to accept a member’s written confirmation that their total funds will not be above the lifetime limit. In addition, the Inland Revenue should be able to alert providers to potentially excessive benefits by reference to the number of schemes that the person is a member of, plus their records of the aggregate payments that have been made. Reporting requirements and self-assessment forms should allow the Inland Revenue to do this.

41. Similarly the amounts payable on death as a result of life cover purchased within personal pensions could be aggregated by the Inland Revenue and ‘at risk’ members notified to providers.
42. The exact detail of how these limits should be checked, and how any recovery tax should be applied, should be agreed through further consultation.

Recommendation 10: As far as possible all limits checking should be between the individual and the Inland Revenue.

How much will this approach encourage additional saving?

43. Complex rules put people off saving in a pension. Other investment vehicles like Individual Savings Accounts and residential property are more easily understood than pensions and hence more attractive to consumers. Therefore a simpler framework for pensions could encourage more saving. However, simplification by the Department for Work and Pensions (DWP) is also required if pensions are truly to become simple. Two key areas on which the DWP needs to focus are the different treatment of contracted-out and non-contracted out benefits and the interaction between pension savings and means-tested benefits. We make proposals in our response to the pensions Green Paper about how these should be simplified.

44. Although simplification of the entire pensions framework could encourage some additional saving, we believe the Government needs to go further if they are to tackle the overriding problem that people are not saving enough for retirement. Whether the Government’s estimate that 10 million people are not saving enough or the ABI’s own analysis showing a £27 billion savings gap is looked at, it is clear that the deficit is substantial. Both this consultation paper and the pensions Green Paper fail short of addressing the ‘pensions crisis’ by failing to suggest ways of incentivising people to save. While simplification will continue the progress the industry has made in improving the supply of pensions, both consultations fail to make proposals that will address the demand for pensions. Increased incentives are needed to promote a step change in pension saving.

45. The ABI’s Pension Contribution Tax Credit\(^\text{11}\) would reward employers who made contributions in respect of a sufficiently wide coverage of employees, via a reduction in employer national insurance contributions. Independent research commissioned by the ABI found that 13% of employees join a pension scheme where there is no employer contribution whereas take-up runs at 69% where the employer makes a contribution of 5% or more.\(^\text{12}\) So employer contributions do have a big impact on pension scheme take up and are worth encouraging.

\(^{11}\) See ‘Closing the Savings Gap - Carrots and Sticks’, June 2002, for further details (available from the ABI’s website www.abi.org.uk.)

\(^{12}\) ‘What makes people save?’, a research report by Graham Vidler, December 2002, for full details (available from the ABI’s website www.abi.org.uk).
46. The other crucial element which ABI research\textsuperscript{13} has identified as encouraging people to save is financial advice. Therefore incentives targeted at employers who pay for financial advice in the workplace could encourage greater savings.

\textit{Recommendation 11: Simplification alone will not close the savings gap. Further incentives, focused on employers, are required to bring about the necessary step change in savings behaviour.}

47. While we support the Government’s aim of better communicating the value of current tax relief to consumers, we would caution that consumers could be misled if the full picture is not presented to them i.e. that the tax relief on contributions is not absolute but largely a deferral of tax as 75% of the ultimate fund is taxed as income.

\textit{How much will compliance costs fall overall?}

48. Once the new tax regime is implemented - which will be expensive and come at a time when insurers are not well placed to meet such costs due to the economic climate in which they are currently operating - compliance costs should drop. It is difficult to estimate by how much without the next layer of detail, but 5\% seems a reasonable estimate and it could be more, particularly if some of our suggestions are taken on board.

49. Some products will be more expensive than at present under the current proposals, e.g. Retirement Annuity Contracts (RACs) and Section 32 policies. RACs are held on old legacy systems which have become obsolete because they have not been developed. As a result, implementing the requirement for contributions to RACs to be paid via relief at source, moving the taxation of RACs in payment from Schedule D to Schedule E and implementing the new reporting requirements for RACs will be expensive. This could be ameliorated if a lead in time of significantly beyond April 2005 is allowed for RACs. Personal pension administration costs should fall. The cost savings will ultimately hinge on light-touch regulation and self-assessment.

\textit{Recommendation 12: Light-touch regulation and self assessment are essential components of a low-cost compliance regime.}

\textsuperscript{13}See ‘The Future Regulation of UK Savings and Investment’, a research report by Oliver, Wyman & Company, September 2001
RESPONSE TO CHAPTER 5 – THE ‘DECUMULATION’ PHASE

It is disappointing that the simplification applied to the accumulation phase has not been emulated in the proposals on the ‘decumulation’ phase. The proposals on post-vesting death benefits create rather than reduce complexity and will result in a need for more advice. The Government should:

- Allow money-back guarantees which are not limited to age 75 for annuities. Introduction of a graduated neutralising tax charge should alleviate Government concerns about the use of pensions to pass on large assets.
- Allow a return of the fund, subject to the same graduated tax charge, with ‘unsecured income’ as value protection is not a concept suited to this type of product.

Tax-free lump sum

50. We very much welcome the Government’s recognition of the value of the tax-free lump sum in encouraging people to lock their money away in a pension until age 50/55. The ABI warned of the dangers of removing the lump sum prior to the publication of this consultation paper and we are pleased to see that the Government recognises these risks. The extension of the simple rule that 25% of the pension fund can be taken as a tax free lump sum to cover all pensions is also eminently sensible.

Flexible Retirement

51. We also welcome the Government’s proposals to allow flexible retirement so that people can combine work and retirement towards the end of their working lives. The inability to continue working for the company with which you have an occupational pension, while at the same time drawing that pension, has long been an anomaly of the occupational pension tax regime and we are pleased that the opportunity has been taken to remedy this.

Flexible Income

52. We welcome the increased flexibility in levels of income which can be paid out under an annuity (secured income) and under income drawdown (unsecured income) within the parameters of the proposed general benefit rules. We set out in paragraph 75 the different types of income streams which could be offered if full flexibility is permitted.
Trivial Commutation

53. We welcome the expansion of trivial commutation to amounts, in aggregate, up to £10,000. This should be indexed in line with the lifetime limit. However, we do not understand why this is limited to age 65 and over as many people will be unable to choose to defer retirement. It is difficult to purchase an annuity on the open market for amounts of less than £10,000 so this rule could result in disappointment for those who are encouraged to shop around for their annuity (and it is Government policy to encourage this) only to find they cannot procure one. And it may be more difficult to find an annuity on the open market with a small pension fund at younger ages because annuities pay out a smaller income to those at younger ages.

54. The existing facility whereby trivial commutation can be exercised on scheme wind-up, regardless of the member’s age, should be retained as this simplifies wind-ups. The new amount (sums of up to £10,000) should apply for consistency.

 Recommendation 13: Trivial commutation of amounts below £10,000 should be available from age 55.

Death benefits (before vesting)

55. We welcome the proposal to simplify benefits within approved arrangements by reference to the lifetime limit test, which will apply both to cover arranged through approved occupational schemes and to that arranged by individuals through personal pension products with term assurance. We particularly welcome the proposal to allow purchase of life cover within a personal pension up to the lifetime limit and expect this to stimulate interest in providing term assurance products, following the fall in the offering of such products since April 2001. The new proposals will allow providers to devise benefit solutions which best meet the needs of customers, largely free of legislative constraint. One potential problem will be in respect of individuals with a number of pension arrangements, as death benefit entitlement will have to be taken into account along with pension fund accumulation to guard against exceeding the lifetime limit.

56. As regards death in service benefit, under the current rules the family of an employee in an occupational pension scheme can receive up to four times the deceased’s final salary as a tax-free lump sum, as well as a maximum of 4/9th salary as an income. Under the new proposals a tax-free lump sum and/or a taxed income can be provided but both must be under the lifetime limit if the recovery charge is not to apply. This could be quite constraining on some final salary schemes. Where a scheme currently provides survivors’ pension based on earnings and potential scheme membership (rather than service to date) the lifetime limit will not go very far. If the lump sum alone were limited by
reference to the lifetime limit, and a taxed income could be paid over and above, that this could be alleviated.

57. Transitional arrangements will be needed for existing death in service benefits to ensure that pre-1989 members of occupational pension schemes, in particular, do not suffer a serious reduction in their promised benefits.

Recommendation 14: The death in service benefit should be a tax-free lump sum of the lifetime limit with a taxed income allowable in addition.

Death while receiving benefits

58. While we welcome proposals to allow value-protected annuities, which the ABI has campaigned for, the proposals do not go far enough. As a result of this, the proposed treatment of post-retirement death benefits is not coherent and will confuse consumers. Rather than simplifying the ‘decumulation’ phase (leading to a reduction in advice needed and therefore the cost of advice as the accumulation phase proposals do) these proposals increase complication and the amount of advice needed.

Lifetime ‘Conventional’ Annuities/secure income

59. As regards lifetime annuities, the difference in post vesting death benefits permitted before and after age 75 is complicated. In particular, the restriction of value protection up to age 75 and the retention of the 10-year guarantee option is likely to confuse consumers. It will be difficult for them to compare the two, particularly as age will be a factor in determining which is the best option for a particular person. This will lead to a need for more advice, which experience shows consumers are not always willing to take/able to afford.

60. Money-back guarantees without the age 75 limit, which would allow the difference between the annuity purchase price and the income paid to date, to be paid out on death, should be permitted, regardless of the age of death. This would achieve real simplification while addressing the main concern that people have about annuities – getting value for money in the event of early death. If this option were available, people would not be put off saving in a pension because of the need to buy an annuity which then dies with them. Money-back guarantees, without the age 75 limit, are the option most popular with consumers.  

61. It would be just as cost-effective to provide value protection beyond age 75 as up until age 75 i.e. an annuitant’s level of income would not

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14 Independent research on annuities commissioned by the ABI found that almost half of annuitants would be interested in the option to purchase a money-back guarantee and would be willing to give up a reasonable amount of income for it. See Annuities – the consumer experience, a research report by Julie Stark, October 2002.
reduce significantly as between an annuity value protected until age 75 and one value protected beyond that. In fact the costs of identifying the age 75 cut-off for each individual would probably be more than the cost of allowing value protection to continue beyond age 75.

**Recommendation 15: Money-back guarantees without the age 75 limit should be available with lifetime annuities in order to properly address the concerns which the mass market have about annuities.**

Income Drawdown/unsecure income

62. A money-back guarantee/value protection is not a concept suited to income drawdown. In particular, insurers are not willing to retain money on the death of a drawdown member who has not chosen value protection/is over age 75 and has no dependants to receive an income. Return of the fund on death is the only appropriate mechanism for income drawdown. To prevent excessive funds being accumulated or maintained under this approach, we would be willing to have a minimum withdrawal of more than £1 imposed.

63. Maintaining 'return of the fund' for unsecure income in this way will have the additional advantage of consistency with the current drawdown position. If value protection were introduced instead, this would create problems as to the treatment of pre ‘A Day’ drawdown policies. Presumably these would be allowed to continue on the current basis which would lead to administrative complexity in separating and treating pre and post-‘A Day’ drawdown contracts differently.

**Recommendation 16: Return of the fund on death should remain for income drawdown and be allowed past age 75, as value protection is not a concept suited to this benefit.**

Guarantee Periods

64. Guarantee periods should be retained to allow people to take death benefits in income form as, for example, this is likely to continue to be an attractive option for final salary schemes. There should be no cap on the number of years for which an income can be guaranteed. Providers could then offer guarantee periods based on the average life expectancy of a scheme member retiring at a particular age (as well as e.g. the standard 5 year guarantee at any age). If the Inland Revenue were concerned about abuse in allowing such flexibility, perhaps a requirement that the maximum number of years for which an income could be paid should be determined by reference to a particular mortality table, could be introduced. Alternatively, a maximum age of 85 or 90 could be set. Such guarantees could be made available for both annuities and income drawdown (an income level would have to be agreed for the latter).
Recommendation 17: Guarantee periods should be retained but there should be no cap on the number of years that income can be paid for.

Suggested modifications to meet the Government’s concerns about the wealthy using pensions to pass on assets

65. As regards the lump sum paid out under an annuity with a money-back guarantee, or paid out as a return of the fund with income drawdown, we suggest that a graduated tax charge sufficient to drive behaviour be introduced. The aim of the charge would be to steer those with large funds towards guaranteed income rather than lump sum payments, due to the better tax treatment. The tax charge would be graduated depending on the size of the lump sum payable. The tax levels should have a neutralising effect and might be 20% for sums of £50,000 or less, 35% for sums of £50,000 to £100,000 and 45% for sums above £100,000 (we believe these rates are roughly tax neutral). Given that information supplied by ABI members suggests that 2/3 of annuitants have £20,000 or less to spend on their annuities, this proposal would benefit the mass market while guarding against abuse by high earners.

66. The tax thresholds should be indexed and reviewed in line with the lifetime limit. For simplicity, they could be expressed as a percentage of the lifetime limit.

67. A process would need to be developed to cater for those with more than one annuity or drawdown policy, which in aggregate would take them into the higher tax threshold, for example (using the example of four lump sums of £40,000):

- Each lump sum of £40,000 would be taxed at 20% and this could be administered in the same way as currently applies to the 35% tax charge on death in drawdown.

- As the lump sums in aggregate amount to £160,000, £50,000 of which should be taxed at 20%, £50,000 at 35% and £60,000 at 45%, the additional tax could perhaps be collected via the self-assessment system or settlement of the estate or similar.

This should not be too frequent an occurrence as, for example, annuity research commissioned by the ABI suggests that 2/3 of people purchase just one pension annuity with only 16% purchasing two and 13% purchasing three.

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15 See Figure 3 of Reforming Annuities: Big Bang or Softly, Softly?, Julie Stark and Chris Curry, January 2002.
16 This route could be facilitated by a requirement that lump sums on death after vesting be paid to the member’s legal representatives. Inheritance tax treatment should be as per paragraphs 38 and 39 of this response.
17 See Chart 16 of Annuities – the consumer experience, a research report by Julie Stark, October 2002.
Recommendation 18: Both annuities and income drawdown should offer money-back guarantees and return of the fund respectively, with no age 75 restriction. A neutralising tax charge should be applied to the monies returned, which will be higher for larger funds.

Benefits of ABI solution

68. The ABI’s solution – value protected annuities without the age 75 limit and return of the drawdown fund at any age, both subject to a graduated tax charge - would get around the ‘cliff edge’ approach which the proposals in the consultation paper would bring about. Just as the accumulation proposals in the consultation paper seek to eliminate the retirement ‘cliff edge’ by introducing flexible retirement, so should the decumulation proposals aim to avoid the introduction of ‘cliff edges’, such as completely different death benefit treatment before and after age 75.

69. Although the Government may be concerned from a PR perspective about how heavily taxing (wealthy) ‘dead people’ might be perceived, we believe there is a higher likelihood of adverse press comment should the proposals in the consultation paper be introduced. In particular, if someone with a value protected annuity dies the day after their 75th birthday, the surviving spouse is likely to be very upset about the less favourable death benefit payable.

70. While the accumulation proposals focus on helping the majority by targeting what few rules there are on the higher paid only, the ‘decumulation’ proposals apply to everyone rules which are designed to guard against abuse by the wealthy. A consistency of approach should be adopted. Our solution would support the Government’s policy aim of helping the mass market.

71. Our approach would also support the Government’s policy aim of encouraging people to work for longer, whereas the current proposals encourage people to retire early – the earlier you take benefits, the longer the value protection lasts.

72. An annuity already exists which allows a return of funds in lump sum form on death beyond the age of 75 – the open annuity. This is a complicated product which involves the purchase of a share in a Gibraltar company. Surely it would be preferable to allow people to ensure they receive value for money, subject to a fair tax charge, through regular UK annuity or drawdown products rather than drive them towards a complicated Gibraltar product.

Limited Period Annuities

73. Under the simplified drawdown rules proposed in the paper, various investment models could achieve the same result as a limited period annuity (LPA). We are concerned therefore that LPAs will add
unnecessary complexity to the ‘at retirement’ market. Two options – lifetime annuities and simplified drawdown – would be easier for consumers to understand (as these two are complicated enough) than three.

**Recommendation 19: Legislation should not specifically provide for limited period annuities.**

Is there a case for any special transitional rules for people in occupational schemes whose normal retirement age is lower than 50?

74. There may be a case for allowing those aged over say 30 or 35 to retire at or close to their expected retirement date, given that they have started saving in the expectation that they can draw benefits at a given age and may have planned accordingly, e.g. to use the expected tax-free cash sum to purchase a business and the pension income to supplement earnings in the initial years. Transitional rules could allow this for individual schemes with a proviso that the new minimum age is moved to by a later date (say 2010).

**What sort of pension patterns might pension schemes and pension providers choose to offer under the proposed general benefit rules?**

75. We hope that sufficient flexibility will be available under the proposed general benefit rules to allow providers to develop annuity products offering income streams that better fit the needs of those in retirement. A typical example might be payment of a lower income initially while an annuitant continues to work part-time, with this income rising as work is phased out. This might be followed by payment of a relatively high level of income while the retiree is in good health and able to travel abroad and participate in active past-times. Following this, a lower income may be required for a period during which the retiree is less active followed, ultimately, by a higher income to help fund long-term care needs. This sort of typical lifestyle pattern, throughout an increasing retirement period, cannot be catered for under current annuity products.

76. We would appreciate confirmation that income levels under secure income products can vary in this way under the proposals.

**Should index-linked pensions take account of falls in the Retail Prices Index?**

77. This should be left to providers to determine. The index-linked assets purchased to back annuities do take account of falls in the Retail Prices Index (RPI) however annuities linked to RPI may not actually reduce. Providers need the freedom to decide whether annuity income should remain static or fall in such circumstances. This freedom is already constrained under legislation e.g. under limited price indexed (LPI) annuities the assumption is that such an annuity will not reduce. However, in a low-inflation, possibly deflationary, environment it would
be reasonable for these as well as regular indexed annuities to decrease, subject to the scheme rules.

Should the general benefit rules specify any further detail?

78. Generally, the Inland Revenue should set the minimum number of parameters that satisfy its purpose to ensure that pension savings are being properly used. This will give retirement income providers the maximum opportunity to innovate within these parameters. That said, early clarification of the acceptable parameters would be helpful. As we have made suggestions which would radically change the parameters currently proposed, we will await the Government’s further consideration of what the parameters should be before seeking that clarification (though note the clarification requested in paragraph 76).

Will the general benefit rules allow the annuity market sufficient scope to develop new products to meet users’ needs?

79. The rules appear to allow development of flexible products of the nature of that outlined in paragraph 75 above. In addition, the following product features are a possibility:

- a stepping up or stepping down of annuity income per year on selected dates;
- provision of one-off payments from the fund to fund major medical expenses;
- an increase in income when long term care is needed (a similar innovation could also be incorporated into income drawdown if the maximum income payable could be increased to that based on an impaired life annuity rate when a long-term care need arises);
- the ability to add or remove escalation; and
- an annuity that changes on lifestyle events such as death of a partner or spouse

Would there be value in allowing people with modest pension savings to aggregate all their savings, including protected rights, before buying an annuity?

80. This would be helpful if coupled with deregulation of the type of income which has to be purchased with contracted-out monies. Generally, a far greater proportion of the fund built up in a personal pension relates to non-contracted-out contributions so the protection of a spouse’s pension and indexation apply only to a very small portion of the pension pot. This is of little benefit to the spouse or member. If contracted-out benefits were treated the same as non-contracted-out benefits many customers would have a large enough single personal pension fund to access a wider range of providers and/or improved rates. Providers would be able to spread the fixed administration cost of providing an annuity over a larger amount and this benefit could be passed on to customers in the form of better rates.
81. This would also assist the Financial Services Authority (FSA) in constructing their comparative tables on annuities and make the tables more relevant. At present, if an individual were to enter their personal pension fund value into such a table, in order to identify the best annuity rate, they would not appreciate that part of their fund (the protected rights element) might actually have to be used to purchase a separate, specific type of annuity. Therefore the annuity income suggested by the table would be inaccurate and, in fact, an annuity with the company suggested may not be available for the smaller protected rights fund. This would make the table less helpful than it could otherwise be.

82. We would urge the Inland Revenue and Treasury to influence the Department for Work and Pensions’ thinking on this as far as possible, as true simplification of private pensions is otherwise impossible.

**Recommendation 20:** the Department for Work and Pensions requirement to take contracted-out benefits in a different manner to income purchased from the rest of the fund should be removed.

When value protected pension benefits are available, is demand for guaranteed pensions likely to change?

83. Demand is likely to change but will not disappear. For example, a guaranteed income is likely to remain attractive to final salary schemes. It will be important therefore to retain the option of a guaranteed income and we recommend that there be no cap applied to this as providers are best placed to determine an individual’s life expectancy and so offer an appropriate guarantee period.
RESPONSE TO CHAPTER 6 – MAKING IT HAPPEN

Implementation of these changes will be costly and time consuming for pensions providers. Pensions literature and scheme documentation will have to be re-written, staff will have to be trained, advisers will have to be educated and policy holders, trustees and employers will have to be informed. Large scale systems changes will be required at a time when many other initiatives will also be requiring system changes.

The Government should:

- Set ‘A Day’ at least one year from the date the primary legislation and underlying regulations setting out the changes are available to the industry.
- Allow a significant lead in time beyond April 2005 for implementation of the changes for Retirement Annuity Contracts.
- Encourage the Department for Work and Pensions to adopt the same ‘clean slate’ approach to pension reform as the Inland Revenue if true simplification is to be achieved.

How would operators and other users of pension schemes choose to design them if the tax rules imposed almost no limitation at all on scheme design? What would be the objectives and advantages of this style of design? Does the pension reform envisaged in this document allow schemes to be reshaped to meet these objectives?

84. Our members will respond to you directly about how they might design schemes if there were no limitations imposed by tax rules. However, we would say that it is likely that Department for Work and Pensions rules would have to alter to the same extent as the Inland Revenue proposals for the full benefit of simplification to be felt. For example, the artificial division of pension benefits brought about by the contracting-out rules hampers the objective of ‘no limitation at all on scheme design’.

Which changes in scheme design are the most pressing?

85. The main change that is needed is the removal of all artificial differences between different tranches of benefit. The aim should be ‘a pension, is a pension, is a pension’. It is important that the Department for Work and Pensions adopts the same ‘clean slate’ approach to pension reform as the Inland Revenue.

Is it feasible to implement the new tax arrangements by April 2004?
86. No. An implementation date of 2004 is over-optimistic as explained at paragraphs 12 and 13 of this response.

87. Finalised legislation is required before it will be possible to agree a timescale. A significant lead-in time of at least a year from the laying of all the relevant legislation is needed. This is because major system changes, over a number of legacy systems, will be involved. A list of the changes under the proposed new tax regime which will require systems to be changed to take account of them is provided at Appendix 2 to this paper. Many other changes will require IT resource around that time, including:

- the introduction of “Sandler” products;
- the proposed new point of sale disclosure regime (due to come in for personal pensions in August 2004);
- the FSA’s polarisation reforms;
- the lighter touch sales regime proposed in FSA Discussion Paper 19;
- FSA’s CP 160 and the proposed move to bring general insurance and mortgage products within FSA regulation;
- the potential adoption of the euro; and
- the possible introduction of an online Retirement Planner.

88. Firms have only one IT resource for all these changes. In addition, schemes will need to rewrite pensions literature and scheme documentation, train staff and educate advisers about the changes. Customers will also need time to arrange their affairs. Therefore April 2005 would be feasible, for example, provided all the relevant legislation (including underlying regulations) is available by April 2004.

89. Some product types will be more difficult to convert to the new regime than others. In particular, the conversion of Retirement Annuity Contracts (RACs) to grant basic rate tax relief at source will be very problematic as the contracts are antiquated and often on systems which are unsuitable for this degree of change. In addition, providers do not have National Insurance numbers for RACs at the moment. Perhaps the Government could assist with this by supplying national insurance numbers from their databases. A much longer lead in time, beyond April 2005 would be sensible for RACs to comply.

90. Some of our members have suggested that some preliminary simplifications could be introduced in the meantime but the industry is divided as to whether this would be beneficial. It may be that such incremental changes would only confuse customers and ultimately add
to implementation costs. Nevertheless, the following are possible candidates for early implementation should this appeal to the Government:

- The need to check increases generated by annuity policies at each anniversary against the Inland Revenue maximum, should be scrapped. This arises where the annuity has been purchased with a fixed rate of escalation in excess of 3%.

- Where money has been held back under an annuity policy (because the increase generated by the policy at previous anniversaries has exceeded Inland Revenue limits), the amount retained by the insurer could be paid out as a one-off additional annuity payment. This would put an end to considerable amounts of protracted correspondence with elderly clients who feel they are being cheated by the insurer.

- The introduction of money-back annuities.

- The abolition of surplus and headroom checks on FSAVCs.

- Including limits in buy-out policies could be abolished, as this would be particularly beneficial for those cases where payment cannot be made in normal circumstances before the new regime is implemented.

- Abolition of the requirement to provide lump sum certificates.

- Introduction of the new triviality rules.
RESPONSE TO ANNEX A – PARTIAL REGULATORY IMPACT ASSESSMENT

Is the estimate of 5% (£80 million a year) administrative savings for the pensions industry realistic? Might the savings be greater?

91. In the short-term initial implementation costs will swamp any administrative savings. It is difficult to give an industry-wide response as it will depend on the product mix of each provider and the range of contracts offered. However, once the transitional work is done, then provided the legislation is kept simple, 5% is probably realistic as a general figure and the savings could be greater for some.

What are the one-off implementation costs to the industry likely to be?

92. There will be high initial costs in implementing the changes, in particular:

- requiring contributions to Retirement Annuity Contracts to be paid via relief at source;
- moving the taxation of Retirement Annuity Contracts from Schedule D to Schedule E;
- the introduction of reporting requirements for Retirement Annuity Contracts and occupational schemes;
- implementation of the new rules to existing policyholders’ future contributions; and
- the process around checking fund value for registration purposes.

These costs will be ameliorated if the much longer lead in time suggested for Retirement Annuity Contracts is allowed. It is likely that between £15-25 million per (large) company will need to be spent on systems and other (e.g. staff training, changing documentation and educating advisers) changes. Appendix 2 outlines a list of the changes which will require work on systems.
RESPONSE TO ANNEX B – THE TRANSITION

Is a simple but broadly fair approach to the transition the most appropriate one?

93. Yes, transitional provisions need to be kept simple and, provided no one type of scheme member or product gains an advantage, this is the best approach. We have made suggestions in this response (paragraph 29 onwards) as to how the transitional arrangements can be improved upon so as to be as fair as possible without compromising simplicity.

Are there any other important factors the Government should consider in drawing up Rules for transition?

94. We think it is important to:

• allow those with more than or approaching the lifetime limit at ‘A Day’ extra headroom of around 25% to allow for investment growth on their funds;
• allow registration of pre-‘A Day’ life cover that is above the lifetime limit;
• allow continuation of waiver of contribution on pre-6/4/2001 personal pensions if it will not be allowed under the new regime; and
• allow a much longer lead in time than April 2005 for implementation of the changes for Retirement Annuity Contracts.

Is three years an appropriate period to allow for valuation of pre-‘A Day’ rights? Could this process be achieved more quickly?

95. In general three years is an appropriate period.

How long do schemes need before A-day to tell the Inland Revenue that they propose to opt-out of the new rules for tax relief?

96. 3 months should be sufficient.

How should pre-‘A Day’ pension rights in with-profits funds be valued?

97. The important thing is that with profits are valued on a consistent basis with other assets to prevent any accusation of product bias. Ideally the transfer value theoretically available on ‘A Day’ should be used. This is the value that could be provided most easily. This would be appropriate if the rule is that all assets must be valued at their market value on ‘A Day’ (including property) as the presumption would then be that the value is the transfer value at ‘A Day’
What is the best way for pension schemes to tell their members what percentage of the lifetime limit their vested pension entails – both at vesting and annually afterwards?

98. It should be left open to schemes about how to do this but it is likely to be by certificate or the electronic equivalent. It should be sufficient for the percentage to be advised at vesting only and for this percentage to be relevant for all future years provided it is made clear to the client the importance of this information. This is because the lifetime limit will affect only a small percentage of clients. This should be discussed further during the next round of consultation as it is important that this should not add significant administrative cost.

Are the suggestions on valuing DB benefits feasible?

99. We agree that the tables should be standard and simple rather than try to cater for every eventuality. However, they should be more consistent with annuity rates available to members of money-purchase schemes. We acknowledge the need to guard against making transfers from DB to DC schemes too attractive (to maintain simplicity) but the conversion rates should not be too low or result in unfair treatment for DC schemes (such as too low a lifetime limit from the outset). We may want the tables to be updated more frequently than every three to five years and would like to see them as soon as possible. They could be updated at the same time as income drawdown tables.

Can the pensions industry develop standard arrangements to deal with cases of simultaneous vesting?

100. Possibly – but it would be difficult, requiring close co-operation between a number of disconnected entities including employer schemes, life assurance, Government agencies and self invested personal pension schemes. This could also lead to delays in the payment of benefits whilst final fund values are awaited. We would prefer the onus to be placed on the Inland Revenue and the individual to minimise costs and delays. If this is not possible, then at the least the onus should be on the member to tell the provider if their total fund value is likely to be above the lifetime limit so it limits the number of cases which are delayed in payment because information is required from providers.

Are the proposed rules about which contributions can qualify for tax relief appropriate and feasible?

101. Yes, on the understanding that contributions towards life cover will attract tax relief. In order to minimise the impact of over contributions on providers where relief at source is operated, we suggest that any excessive basic rate tax relief claimed on over contributions should be reclaimed direct from the individual via self-assessment. This will avoid
providers having to repay the Inland Revenue and alter members’ records retrospectively to reflect a partial repayment as the ‘net contribution’ would be retained in the scheme, unlike at present where it would have to be refunded.

102. We also recommend that the higher of this year’s and last year’s earnings be acceptable for testing against the 100% of earnings limit. This will help with planning for the self-employed and also the roll over of ISA money into pension for older lives.

Are the proposed rules about contributions to UK based pension schemes by non-residents appropriate and feasible?

103. Based on likely volumes it may not be feasible to admit or retain non-UK residents as members of personal/stakeholder pension plans if they will not get relief at source on some or all of their contributions (as additional controls would need to be built into systems and procedures).

Are the proposed regular reporting requirements reasonable and feasible?

104. The requirements are reasonable for personal pensions, including stakeholder pensions as these schemes already comply with similar requirements. However, we have concerns over the cost of introducing reporting requirements onto Retirement Annuity Contracts (RACs) and occupational schemes.

105. RACs are administered on legacy systems which would not easily cater for such reports. It would not be cost effective to change them to match personal pension reporting requirements. As mentioned earlier in this response, an extended timetable for moving these contracts to relief at source would be sensible.

106. Insured occupational pension schemes currently have no regular annual reporting requirement to the Inland Revenue as they are not included within the self-assessment regime. If this requirement were to fall on providers, it would be difficult to comply with because providers will not necessarily have full scheme details since the scheme could hold different policies with several different providers. In addition, providers may not have details of members’ National Insurance numbers, addresses etc. In light of this, regular reporting should be limited to event reporting as it occurs, for occupational pension schemes.

Are the rules for splitting pension rights on divorce appropriate?

107. The spouse who loses pension rights should not be subject to the recovery charge in respect of an excess over the lifetime limit to the extent that that excess is attributable to the pensions debit. Those in
receipt of a pension credit should count this towards their lifetime limit for recovery charge purposes.

Are there any features of SSAS and SIPPs which should be considered for all pension schemes?

108. We are not aware of any features of a SSAS or SIPPs which would be suited to pension schemes across the board.

How could rules about loans from pension schemes to members be established without prejudicing scheme solvency?

109. We do not support this facility and its provision would be inconsistent with a low charge environment.
CONCLUSION

Recommendation 1: The simplification process should focus on stripping out unnecessary administration so that pension providers can distribute simple, good value products in a low charge environment.

Recommendation 2: ‘A Day’ should be set at least one year from the date the primary legislation and underlying regulations setting out the changes are available to the industry.

Recommendation 3: The lifetime limit should be indexed annually in line with earnings and reviewed regularly to take account of changes in longevity and investment conditions. All other limits should be indexed consistently with the lifetime limit.

Recommendation 4: The lifetime limit should be robust from the outset - £1.8million would be a more appropriate figure than £1.4 million.

Recommendation 5: The Government should set out in legislation its policy intention that a target level of pension income can always be accumulated/purchased by the lifetime limit.

Recommendation 6: A fairer, better targeted recovery charge should apply rather than a ‘one size fits all’ charge based on an investment scenario of 15 years. Our preferred option is the most simple – a lighter recovery charge for excesses up to a threshold amount, say £2 million, with a heavier recovery charge above that amount.

Recommendation 7: Those with more than the lifetime limit or approaching it at ‘A Day’ should be given extra headroom of around 25% to allow for investment growth on their funds.

Recommendation 8: The proposed personal and annual limits should not be introduced and an alternative means of allaying Inland Revenue concerns about ‘trust busting’ should be developed.

Recommendation 9: A statutory exemption from inheritance tax should be introduced in respect of death benefits paid by approved pension arrangements. This should apply to all death benefits – lump sum or income – whether paid during the accumulation or ‘decumulation’ phase.

Recommendation 10: As far as possible all limits checking should be between the individual and the Inland Revenue.

Recommendation 11: Simplification alone will not close the savings gap. Further incentives, focused on employers, are required to bring about the necessary step change in savings behaviour.

Recommendation 12: Light-touch regulation and self assessment are essential components of a low-cost compliance regime.
Recommendation 13: Trivial commutation of amounts below £10,000 should be available from age 55.

Recommendation 14: The death in service benefit should be a tax-free lump sum of the lifetime limit and a taxed income allowable in addition.

Recommendation 15: Money-back guarantees without the age 75 limit should be available with lifetime annuities in order to properly address the concerns which the mass market have about annuities.

Recommendation 16: Return of the fund on death should remain for income drawdown and be allowed past age 75, as value protection is not a concept suited to this benefit.

Recommendation 17: Guarantee periods should be retained but there should be no cap on the number of years that income can be paid for.

Recommendation 18: Both annuities and income drawdown should offer money-back guarantees and return of the fund respectively, with no age 75 restriction, but a neutral tax charge should be applied to the monies returned which will be higher for larger funds.

Recommendation 19: Legislation should not specifically provide for limited period annuities.

Recommendation 20: The Department for Work and Pensions requirement to take contracted-out benefits in a different manner to income purchased from the rest of the fund should be removed.
APPENDIX 1

Taxation of overseas life policies

Up until 28 November 1994, any UK holder of a life insurance savings policy with a non-UK insurer was liable to income tax in full on any gain made on the policy (gain = benefits paid out minus premium paid in). By contrast, gains on UK policies are not liable to tax in the hands of basic-rate taxpayers, and only liable to tax in the hands of higher-rate taxpayers at the excess of the higher over the basic rates of income tax (i.e. 40 minus 22 = 18% currently). The rationale for this latter treatment is that the UK insurer has had to pay, annually, basic rate tax on investment return attributable to the policyholder so the latter should receive a credit in respect of that.

With the advent of the Single Insurance Market in 1995, there were concerns in the UK that this difference of treatment might be open to legal attack from non-UK EU insurers. So in the 28 November 1994 Budget, the Government announced a change in the law, effective from that date, and now set out at subsection 6A of Section 547 of the Income and Corporation Taxes Act 1988. The new law said that where an EEA-based insurer had had to pay tax on investment returns in a similar way to a UK one then the policy gains would be taxed in the hands of the customer in exactly the same way as UK policies are. Thus the UK tax law built in explicit reciprocity of treatment. This was considered defensible under the ‘tax coherence’ doctrine established in the ‘Bachmann’ case. Although that doctrine has since been significantly cut back, our understanding is that the UK Government still believes that it is reasonable to limit a favourable UK tax treatment at one stage of a product’s life cycle, by reference to its tax treatment at a different stage.

Most other EU countries do not tax life fund investment return as it accrues. So, if the proceeds of such a gross fund were to get relief from basic rate tax in the hands of a UK policyholder, then UK insurers would be under a severe tax disadvantage in the UK market.
APPENDIX 2

The following changes which would be introduced under the proposed new tax regime, would require systems to be changed to take account of them:

- the change in the age at which benefits can be taken;
- the removal of Inland Revenue maximum limits;
- the introduction of tax-free cash of 25% to those policies/schemes which do not currently have this;
- the identification of those with more than the lifetime limit at ‘A Day’;
- the production of ring fence certificates;
- the production of percentage of lifetime limit certificates;
- structural and procedural changes to income drawdown and annuities; and
- the change to the tax schedule for retirement annuity contracts in payment.