SIMPLIFYING THE TAXATION OF PENSIONS: THE GOVERNMENT'S PROPOSALS

PARTIAL REGULATORY IMPACT ASSESSMENT

1 This partial RIA updates the one published alongside the December 2002 consultation document *Simplifying the taxation of pensions: increasing choice and flexibility for all*, taking into account consultation responses received. It should be read in conjunction with *Simplifying the taxation of pensions: the Government's proposals* (published on 10 December 2003), which sets out in detail how the simplification of the taxation of pensions will be implemented.

2 The radical simplification of the tax rules will be achieved by replacing the six existing tax approved regimes with a single, universal regime for tax-privileged pension savings, and rationalising the taxation bases of the two existing unapproved regimes. This will lead to:

- improved choice and flexibility for individuals saving in pensions, employers and pension providers;
- improved competition among financial services firms providing pensions;
- greater encouragement for individuals to save for retirement; and
- reduced administration and compliance costs for sponsoring employers, pension scheme administrators, providers, and advisers.

In order to deliver a single tax-privileged regime for pensions, there will be a transition process. This process will impose some short-term costs on everyone running pension schemes as well as on the Government itself. The Government believes that the costs of the transition for schemes will be recouped relatively quickly by the administrative savings arising from the simpler new arrangements.

Purpose and intended effect

3 The Government wants to encourage today's workers, tomorrow's pensioners, to save for their retirement and offers generous tax incentives to encourage people to save in a pension.

4 This reform will modernise and simplify the tax rules for pensions. The objectives are to increase individual choice and flexibility and cut industry costs by tackling the complexity and fragmentation caused by the current rules. There will be a single coherent set of rules applying to all kinds of tax-privileged pension scheme. Once these are in place, all future tax-privileged pension savings will follow these rules. All existing pension rights under the old rules will by crystallised and protected, including an option to protect future investment, or earnings, growth.

Risk

5 The complexity of the current rules increases administration costs for the pensions industry. It also acts as a barrier to entry to financial service providers wishing to provide pension services and products, to individuals investing in pensions and to employers sponsoring pension schemes. The risk is that these costs and barriers act as a break on pension saving, with the possibility that individuals will not have sufficient private pension provision in retirement, and be more reliant on state support.

6 Radically simplifying the rules will help remove these barriers and reduce this risk.

7 Applying such radically different rules to the well-established system of taxation of pensions brings its own risk. Existing advisers and pension providers have built up expertise in the current system and will need to become familiar with the new rules to properly advise individuals who wish to invest in pensions. The Government will limit this risk by ensuring that the new set of rules are simple so that any familiarisation required will not pose a barrier to helping people to save.

8 The Government's objective in introducing flexible retirement for occupational schemes (bringing them into line with personal pensions) is to remove the cliff-edge of retirement. The Government wants to enable a gradual shift from work to retirement, thus increasing the supply of labour over employees' lives. There is a risk that some people would take this opportunity to reduce work effort earlier than they otherwise would have. The net impact of these competing effects is difficult to predict precisely.

Options

9 The Government is convinced of the need to act to remove the barriers and constraints that the current pension rules place on everyone involved in pensions i.e. employers, individuals, pension providers and advisers.

10 There is a choice between:

- retaining current tax rules for existing pension scheme members and introducing a new regime for new members only, or
- introducing a single unified set of tax rules for all future pension savings qualifying for tax relief.

11 Whilst retaining the current rules would reduce transitional costs – and be in line with past changes that have introduced new regimes on top of existing ones – the Government sees no value in this approach. It would not tackle the complexity of the current tax rules and the restrictions, distortions and unnecessary compliance burdens it creates, which have arisen largely because each previous change has overlain existing rules. It would also be an opportunity missed because pension savers would continue to face serious problems in understanding what they can save for their retirement, and how.

12 Responses to the December 2002 consultation were overwhelmingly in favour of the proposals to end the existing regimes when the new rules take effect, subject to adequate transitional protection of benefits already built up. *Simplifying the taxation of pensions:*

the Government's proposals now sets out improved transitional protection proposals in Annex C (Pre A-Day Pension Rights and Transition).

Policy proposals

13 *Simplifying the taxation of pensions: the Government's proposals,* proposes a single unified set of tax rules for all pensions qualifying for tax relief. Most of the tax restrictions and reporting requirements on pension contributions fund build-up and benefits will be scrapped.

14 The main proposals for the new regime, which is planned to start on 6 April 2005 ("A Day"), are

- A single, lifetime allowance for the amount of pension savings that can benefit from tax relief, of £1.4 million, indexed by RPI;
- An annual allowance of £200,000 (indexed by RPI) for the amount of tax relieved contributions and/or increased benefits. Tax relief on individuals' contributions will be given on the higher of £3,600, or 100% of earnings.

In practical terms this will mean that most people can make pension contributions with tax relief, up to whatever they can afford. When the new regime starts, anyone who builds up pension rights worth more than the proposed lifetime allowance of £1.4 million will bear a recovery charge of one quarter when they first draw down from any funds in excess of the lifetime allowance.

15 An employer will be able to make unlimited contributions to a registered scheme on behalf of an employee or former employee. Except in very limited circumstances, contributions will qualify as a tax deduction for the employer.

16 Minimum pension age will be increased from 50 to 55 from 6 April 2010. But there will be protection for certain people who have pre-existing rights to draw benefits from age 50, or to a low normal retirement age. Pension savings must be converted into a guaranteed income stream by age 75.

17 New schemes will no longer need to seek formal approval from the Inland Revenue. There will be a registration process, which it is hoped will be available electronically, and it will no longer be necessary to submit scheme rules and amendments for approval. Existing approved schemes will automatically be registered, unless the scheme opts out. Annex B (Administrative Issues) of *Simplifying the taxation of pensions: the Government's proposals*, sets out the administrative proposals in detail.

18 There will be a single set of investment rules for all pension schemes, setting limits on holding shares in the sponsoring employers' company, and loans to employers, and banning loans to scheme members. The new rules will allow investment in assets, such as residential property or works of art, from which members may derive a benefit. Such benefit, if not paid for by the member at a commercial rate, will be taxed on the member.

19 There will be a single set of pension benefit rules for the new regime that will cover all tax-privileged schemes. The general benefit rules will outline the characteristics of pension benefits without prescribing the precise means of delivery.

20 Schemes that are currently funded, or unfunded, unapproved retirement benefits schemes (known as FURBS and UURBS) will be allowed to continue outside the new tax-privileged regime, subject to transitional arrangements. There will be changes to the taxation rules for employers' contributions, and on the benefits paid, as set out in Annex A (Technical details) of *Simplifying the taxation of pensions: the Government's proposals.*

Numbers affected

21 **Current members** - over 10 million individuals are currently accruing rights in an occupational scheme, with around 5 million making some contribution, individual, or employer or both, to a personal or stakeholder pension. In addition around half a million are still contributing to retirement annuity contracts, the forerunners of personal pensions. Over three-quarters of these are already in either the post-1989 occupational pension regime, or in personal pension schemes, which are both limited by reference to the statutory earnings cap, which the new lifetime allowance broadly mirrors[1].

22 **Current schemes** - there are currently over 100,000 Occupational Pension schemes with two or more members, with the vast majority of members concentrated in very few schemes – around two thirds in the 300 or so largest schemes. Table 1 below shows the distribution of members across existing pension schemes. In addition there are around 200 personal and stakeholder providers.

Self-administered schemes have around £700 billion[2] of assets under management, with insurance administered and personal pension schemes having another £550 billion[2]

Table 1: Occupational pension schemes and members

Size of Scheme (members)	Number of active members accruing benefits (millions)
10,000 or more	6.8
5,000 - 9,999	0.6
1,000 - 4,999	1.2
100 - 999	1.0
12 – 99	0.3
2 – 11	0.2
Total	**10.1**

Source: Occupational Pension Schemes 2000- Eleventh survey by the Government Actuary, Government Actuary's Department.

1 The new lifetime allowance of £1.4 million is broadly based on the statutory earnings cap, introduced in 1989 for both occupational and personal pensions. Since then the maximum pension that can be earned in an occupational pension scheme is of final salary, subject to the earnings cap of (currently) £99,000, i.e. £66,000. The LTA is set at a level that broadly replicates the maximum that an individual can accrue over a working lifetime under the current occupational pension rules.

2 Research Update: How much in funded pensions in 2001? Insurance Trends July 2003, Association of British Insurers

Benefits

23 The benefits of the proposed reform will be felt by everybody involved in pension savings and provision:

- the pensions industry (sponsoring employers, scheme administrators, providers and advisers): a 2001 Inland Revenue sample survey suggested administrative cost savings to the pensions industry of at least 5 per cent, about £80 million a year. Respondents to the December 2002 consultation varied in their precise views of the cost savings, generally noting the difficulties of estimating them without the sort of detailed proposals now set out in *Simplifying the taxation of pensions: the Government's proposals*. The Government would now welcome more informed estimates of the effects of simplification on administration costs;

- employers: the new rules will permit flexible retirement, helping employers retain experienced staff and allowing staff to stay on longer in work; and those employers that have previously been deterred from setting-up schemes, because of the cost and complexity, may now decide to do so;

- members of occupational pension schemes: should, like members of personal pensions currently, have more opportunities to use their pension rights flexibly, to mix work and retirement toward the close of their careers;

- pension scheme savers: will nearly all be able to save more with tax relief if they wish. They will have increased flexibility in the amount they can save and the potential of a more generous tax-free lump sum. The exception to this will be a small number of high earners not subject to the 1989 earnings cap, whose future tax privileged pension saving will be capped by the lifetime allowance;

- people not yet saving for a pension: will find it easier to get started as they will need less advice and face lower costs. In turn this should mean that they have better retirement incomes. It is difficult to quantify this possibly significant behavioural response.

- Independent financial advisers: will need less detailed knowledge of different tax regimes, reducing their training costs. One industry representative suggested savings in training costs for this group alone could amount to £10 million per year.

24 More generally, the new regime will allow for greater flexibility over scheme design. This will mean more choice for the industry, pension scheme members and employers alike. The numbers who will potentially benefit are large.

Impact on pension savers

25 As set out above, the vast majority of pension scheme savers will benefit from the new regime. Central to the new regime is the concept of a lifetime allowance on tax-relieved pension savings. This will initially be set at £1.4m and increased in line with the RPI.

26 It is estimated that around 5,000 individuals currently in pre-1989 uncapped regimes will be affected by the lifetime allowance on its introduction. This estimate has been derived using a number of data sources, including those on contribution rates, accrual rates and length of service. Looking further forward, it is estimated that the lifetime allowance will perhaps affect around 1,000 further individuals a year, who were previously in pre-1989 regimes, over the next 10 years. Over the next 30 years up to 100,000 individuals could be affected, although the majority would have been in the 1989 regime and would have been similarly restricted by the earnings cap.

27 An analysis of the distribution of current pensions in payment shows that there are over 5 million taxpayers drawing pensions, but less than 0.5% of these have a pension of greater than £60,000 (see table 2 below). This is close to the maximum level of pension income from a post-1989 occupational scheme and to the maximum tax-relieved pension that an individual will be able to get under the new regime. It is difficult to gauge the extent to which current pensions in payment may usefully indicate the distribution of income from this source in future. However, the latest quinquennial survey from the Government Actuary's Department[3] shows that the number of pensions in payment from occupational schemes has remained broadly flat between 1995 and 2000, perhaps indicative of a growing number of occupational schemes reaching maturity. If this were true then current pensions in payment may have reached a fairly steady state with the distribution remaining broadly similar over time.

Table 2: Private Pensions in payment for taxpaying individuals

Private Pension amount (£ per annum, lower limit)	Number of individuals (thousands)
Less than £50,000	5, 340
£50,000+	8
£60,000+	5
£70,000+	3
£80,000+	2
£90,000+	1
£100,000+	4
Subtotal of those with £60,000 or more	**15**
Overall total	**5363**

Source: Survey of Personal Income 2000-01

Impact on small business

28 Simpler tax rules, with lower administration and compliance costs, will be particularly helpful for small businesses. It will be easier and cheaper for employers to sponsor or contribute to a pension scheme for their employees. And, for the self-employed, the significantly more generous personal contribution limits will provide greater flexibility from year to year without the need for complex carry-back provisions.

29 Those small businesses using small self-administered pension schemes (SSASs), and self-invested personal pensions (SIPPs) will be able to benefit from the more liberal investment rules e.g. investing in residential property. There are approximately 38,000 SSASs and over 90,000 individuals with SIPPs, many of whom will be running small businesses.

30 The small businesses that provide pensioneer trustee services to SSASs may be affected by the proposals as their appointment will no longer be mandatory. (There are

3 Source: Occupational Pension Schemes 2000- Eleventh Survey by the Government Actuary, Government Actuary's Department.

approximately 280 approved pensioneer trustees, although many of these also provide other services and not all are small businesses.) The Government will assess the possible impact of those proposals in the light of responses.

Equality Impact

31 Work to assess the equality impact of the proposals is ongoing, and will be summarised in the full Regulatory Impact Assessment, to be published with the 2004 Finance Bill.

Cost of implementing

32 The pensions industry will have one-off transitional costs for systems changes, documentation and training, and for individual advice about transitional protection. We believe these costs will not be too heavy, although, again, many respondents to the December 2002 consultation said they could not realistically estimate them without detailed proposals. These are now set out in *Simplifying the taxation of pensions: the Government's proposals*. The Government would now welcome estimates of the transitional costs in the light of these proposals.

33 Most individual members of pensions schemes will not need to be concerned about the tax consequences of pension savings decisions, beyond knowing that they are getting tax relief on their pension contributions and that their pension income is taxable. A small number of people will need to declare, on their Self Assessment return, recovery charge liability (if they have vested benefits exceeding the lifetime allowance) and income tax liabilities if they have exceeded the annual allowance, or had any taxable benefit from scheme investments.

34 The Government will also have one-off implementation costs of some £20million to set up new systems. In addition there will be costs related to new documentation and retraining. But, post-transition, the Government will have lower ongoing costs in administering tax relief for pensions, when the rules and procedures are simpler.

Exchequer effects

35 In 2002-03 the net tax relief for tax-approved private pension schemes was around £13 billion. This represents the up front relief on contributions plus the relief on schemes investment income, net of tax, on current pensions in payment. This is in addition to around £5 billion relief given in exempting employer contributions from National Insurance.

36 The proposals will ensure these tax advantages will not only continue – but will grow. Current estimates of the Exchequer cost of the simplified pension regime are; 2005-06: £15 million, 2006-07: £50 million and 2007-08: £135 million. These costs include the likely impact of increased pension savings from those who are constrained by the current rules, as well as the increased flexibility offered by the new regime, such as the ability for some to take a higher tax-free lump sum than under the current regime. However, the costs will depend to a large extent on behavioural changes and these figures are therefore best estimates. The range of uncertainty of the direct revenue effect of the measure increases the further into the future we look.

Competition

37 The proposed reform is intended to improve competition among financial services firms providing pensions. The current complex rules pose a significant barrier to entry for firms wanting to offer pension products. Anecdotal evidence suggests that firms are reluctant to begin to offer pensions because of the investment in systems and expertise required. If simpler rules can encourage more suppliers it should foster innovation and help drive down prices.

38 It is not expected that there will be any adverse competition impacts. As the measures are significantly deregulatory there should be positive impacts on competition through lowering entry costs to the retirement savings market, or on diversifying to other sectors of it.

Compliance Costs

39 The present compliance regime for pensions is outdated by current standards. The new tax rules will incorporate modern and proportionate arrangements for awarding tax relief and preventing abuse. For both schemes and members there will be a self assessment approach, with a "process now, check later" regime. There will be tax-geared penalties for non-compliance, that will be mitigated to take proper account of the size and gravity of the matter, and the willingness of those concerned to disclose and co-operate with enquiries. Tax registration of schemes will be withdrawn only in the most serious of cases.

40 Replacing the requirement to submit scheme rules, and all subsequent amendments, for approval, with a simple registration system will reduce schemes' administration costs. While recognising the need to maintain an effective compliance regime, the Government intends to consult with pension industry representatives about minimising the content, and targeting, of the new information returns, to ensure that schemes' compliance costs are kept as low as possible.

QUESTIONS FOR FEEDBACK

41 The Government is keen to assess the impact the new regime will have on all those affected. Responses to the December 2002 consultation document indicated that respondents found estimating the likely implementation costs and longer-term administrative savings difficult, in the absence of detailed proposals as to how the new regime would operate. Now the detail has been set out in *Simplifying the taxation of pensions: the Government's proposals*, we would welcome answers to the following questions:

A. *What do you estimate the transition cost of simplification to be, i.e. new systems, documentation, training staff, educating and providing for advice to members etc?*

B. *What would you estimate are the potential long-term savings in operating the new regime? What are the absolute savings (i.e. in financial terms) and the percentage of your total administration costs these represent?*

C. *What do you estimate to be the benefits for employers of extending flexible retirement to occupational schemes? It would be helpful, if you are answering this as an employer, if you could indicate the approximate number of employees you have;*

D. *What will be the impact on providers of pensioneer trustee services of removing the mandatory requirement for pensioneer trustees from SSASs?*

E. The move from an approval to a registration process for setting up schemes offers a unique opportunity to modernise delivery of services. In line with its commitment to e-business, the Government is seeking views on making e-business the mandatory method of registering and subsequently amending and reporting scheme details. *If this proposal is adopted what do you estimate your transitional costs and long term savings will be?*