

REPLACEMENT OF PERSONAL PENSIONS TRANSFER REGULATIONS

REGULATORY IMPACT ASSESSMENT

17 JANUARY 2001

INLAND REVENUE

Introduction

1. This Regulatory Impact Assessment considers the costs and benefits of repealing the existing (1988) regulations that govern transfer payments between Occupational Pension Schemes (OPS) and Personal Pension Schemes (PPS) and their replacement, with effect from 6 April 2001, by new regulations: *The Personal Pension Schemes (Transfer Payments) Regulations 2001*.

Purpose and Intended Effect

2. When PPS were launched in 1988, regulations were also introduced to control transfers of funds and benefits between PPS and other tax approved retirement benefit arrangements, such as private OPS and equivalent statutory schemes.
3. The new regulations simplify and clarify the existing rules and target them more effectively. As a result, the vast majority of OPS and PPS members will be removed from the ambit of the regulations altogether, and estimates suggest that overall ongoing administrative costs will be reduced by some **£36m** per year.

Risks

4. The Inland Revenue needs to regulate transfers between OPS and PPS because the rules governing the tax relief available under each type of scheme differ:
 - The Inland Revenue applies limits to the **benefits** that can emerge from an OPS, while allowing unlimited total contributions (although there are funding controls to keep the scheme fund within bounds).
 - Under PPS there is no limit on the emerging benefits (other than the proportion of the fund which may be taken as a tax-free lump sum). Instead, the **contributions** are limited to an age-related percentage of earnings. (From 6 April 2001 contributions of £3600 pa may be made regardless of earnings, with higher amounts tied to earnings, as before.)
5. The OPS funding controls allow some leeway because the benefit limit rules at retirement would prevent excess benefits being paid out. But unrestricted transfers from OPS to PPS can result in funds which have built up excessively in the benefit limited environment being paid out on vesting without limit.
6. The 1988 transfer regulations currently apply a *valuation test* to determine whether the transferring OPS is over-funded in relation to the maximum benefits it can

provide, and special rules where the *tax-free lump sum* or *death benefit limits* of the OPS would be avoided by the transfer.

7. Where scheme members are able to control the amount of their own retirement benefits, these risks increase. For this reason controlling directors (i.e. directors with shareholding control of their companies) will remain within the scope of the new regulations.

8. Others earning more than the "earnings cap" (the maximum amount of earnings on which pensions can be based - set at £91,800 for 2000/01) are also likely to be in a position to influence their retirement provision. But because they are unlikely to have accumulated maximum benefits before age 45, the new *death benefits*, *tax-free lump sums* and *valuation test* regulations will apply only to those with earnings above the earnings cap who are over age 45 at the point of transfer.

Benefits of the New Regulations

Current Rules

9. Under the 1988 regulations, restrictions on *death benefits* currently apply to every individual for whom a transfer is made. There are around **10.5m** OPS members, and it is estimated that some 2.5% (**0.26m**) transfer to a PPS each year and are potentially affected.

10. Controls on tax free *lump sums* currently apply to:

- controlling directors
- those earning more than the allowable maximum, and
- all others age 45 or more.

11. There are estimated to be around **4.3m** OPS members in the second and third categories. An unknown proportion of these will be controlling directors. If 2.5% transfer to a PPS each year, the *lump sum* regulations mean that PPS administrators have to ring-fence the transfer payment and apply different rules to it when it ultimately comes into payment for some **0.1m** people a year..

12. The *valuation test*, which prevents a proposed transfer going ahead if its value exceeds the sum calculated on a prescribed basis, currently applies to:

- controlling directors, and
- those earning more than the allowable maximum.

There are around 100,000 OPS members in the second category of whom a proportion will be controlling directors. 2,500 a year might be affected.

13. If no action were taken to amend the current regulations then some 0.26m individuals a year would still be subject to one or more of the controls on transfer of benefits between PPS and other tax approved retirement benefit arrangements. It is not possible to amend the existing rules and achieve the desired simplification and re-focusing by non - regulatory action. We have therefore introduced revised regulations to achieve the aim.

The changes

14. The new regulations concerning *death benefits, tax-free lump sums* and the *valuation tests* will from 6 April 2001 generally apply only to:

- controlling directors,
- those age 45 or more who are also earning more than the allowable maximum.

There are around 50,000 OPS members in the second category. A proportion will also be controlling directors. If 2.5% of a potential 50,000 members transfer to a PPS each year, around 1,250 people a year will be affected by the new rules.

15. These changes will target the controls more effectively on those with high incomes who are most likely to be funded for maximum benefits under the OPS and those who themselves have some influence over the benefits which are provided for them. The vast majority of pension scheme members, will, in future, be able to transfer retirement benefits between OPS and PPS without restriction. This means that pension scheme administrators will be saved time and cost when transfers take place in future.

16. The administrative savings will directly benefit scheme administrators, insurance companies and financial advisers. Scheme members and their employers will also benefit as these reduced expenses are passed on in lower charges and reduced administration.

Costs/Savings

17. As controlling directors remain within the scope of the new regulations as before, the compliance costs when their benefits are transferred from OPS to PPS should not be materially affected.

18. Feedback from the pensions industry on the estimated costs of complying with the current regulations varies, but indicates that costs attributable to the death benefit restrictions are at least £100 per case. A cost of £100 per case is also indicated for the tax-free lump sum restrictions. The cost of carrying out a valuation test is estimated by the Government Actuary's Department to be around £120 per case. This is also the average of industry estimates which range from £40 to £200 per case.

19. The number of OPS members subject to death benefit restrictions on transfer to a PPS is estimated to fall from 0.26m to about 1,250 per year. At an estimated cost per head of £100, this translates into estimated administrative savings of **£26m** per year.

20. The number subject to tax-free lump sum restrictions is estimated to drop from 0.1m to about 1,250 per year, with estimated administrative savings at £100 per head of **£9.8m** per year. (Note: "nil" lump sum certificates will continue to be required for all transfers to PPS. For these the new regulations will neither increase or reduce administrative costs.)

21. The number subject to the new valuation test is estimated to reduce from 2,500 to some 1,250 per year. Allowing for £120 per case the administrative savings are estimated to be around **£0.15m** per year.

22. The Government Actuary's Department estimates that that the actuarial work needed to change systems to implement the new valuation test should not exceed £1000 per pension provider. In addition there will be start up costs from the need to amend documentation and procedures, as well as staff training. Estimates of the overall implementation costs of the regulations vary from provider to provider, depending on their size and current systems, from £10,000 to £100,000. The figure most suggested is £10,000. On the basis of an average system change cost of around £40,000, the one-off implementation costs might amount to **£5.6m** across the insurance industry. Against this the new regulations should produce ongoing annual administrative savings of about **£36m**.

Securing Compliance

23. The regulations will be laid and published about 11 weeks before the new requirements come into effect. Guidance on the new valuation method which schemes will have to adopt from 6 April 2001 will be published before the regulations are made. Further written guidance in the form of amendments to Inland Revenue Guidance Notes (IR 76) will be in the public domain (on a consultation basis) at least 6 weeks before the effective date, with the final version published before that date. Permanent help-lines are now open to ensure that the operation of the new rules are understood.

Impact on Small Business

24. All employers including small businesses will benefit indirectly by the reduced requirements. Where they have a pension scheme and their employees transfer to a PPS it is likely that the reduction in the pension scheme's administration expenses will feed through to reduce the contributions which the employer needs to make to the pension scheme. The extent to which a business can benefit will depend on how many employees it has and how often such transfers occur.

Results of Consultations

25. Consultations on the draft regulations were undertaken in July and November 2000. Comments were received from the main pensions representative bodies, including the Association of British Insurers, the National Association of Pension Funds, the Society of Pension Consultants, the Association of Pensioner Trustees, the Association of Consulting Actuaries, the Investment & Life Assurance Group and the Self-Invested Personal Pension Provider Group. Comments were also received from the Institute & Faculty of Actuaries and the Chartered Institute of Taxation as well as many individual insurance companies, firms of lawyers, accountants, actuaries and other pensions practitioners.

26. A number of minor changes have been made to reflect comments received. But most comment focused on those who would be affected by the regulations and the method of valuing the benefits to be transferred.

27. Where the 1988 regulations applied to those earning more than the allowable maximum, the new regulations which were put out to consultation were to apply to

those earning more than *half* the allowable maximum. However, in response to representations, we accept that this would have considerably increased the administrative burden on pension scheme administrators, and the original earnings limit has therefore been restored. Additionally the regulations will now apply to those earning more than the allowable maximum only if they are also aged over 45 at the point of transfer. (See paragraphs 14 and 15 above.)

28. A number of respondents argued that some of the actuarial factors in the valuation test were out of date. Similar factors are prescribed by the Surplus regulations (SI 1987/412) and also form the basis of calculations used for OPS funding controls, and it would not be appropriate to use different factors for the transfer valuation test alone. However, this will be reconsidered at the same time as any general review of actuarial factors that might be undertaken in the future for surplus or funding purposes.

Monitoring and Evaluation

29. Monitoring of compliance with the new regulations will form part of the Inland Revenue's normal compliance audits of pension schemes. The impact of the regulations will be evaluated in the light of the results of the audits.

Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Melanie Johnson
Economic Secretary to the Treasury
17 January 2001

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Note: sources include the "1995 Government Actuary's Department survey of occupational pension schemes", and the "1998-99 Family Resources Survey".