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

December 2002

HM TREASURY

Inland Revenue

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

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Foreword

This Government is committed to enabling all pensioners to share fairly in the rising prosperity of the nation, to tackling poverty among older people, and to providing security, dignity and comfort for people in their old age. Key to this is enabling people to plan effectively for retirement.

But for too many people, pension planning has been an incomprehensible maze. In particular, the complexity of the currrent tax rules have made pensions hard to understand even for experts.

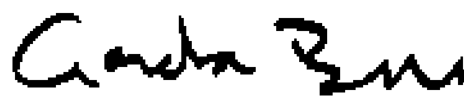
There are currently no fewer than eight different sets of tax rules in use for pensions, imposing unnecessary inflexibility, driving up costs, and – worst of all – discouraging people from saving.

So in this document we are setting out proposals for a radical simplification of the tax rules for pensions, sweeping away the existing pension tax regimes, and replacing them with a single lifetime limit on the amount of pension saving that can benefit from tax relief.

These proposals for radical simplification will enable people to make clear and confident decisions about pension saving. They will mean far greater individual choice and flexibility about when and how much to save in a pension. And they will reduce administrative burdens on employers and pension providers alike.

We will match this increased flexibility on when and how much to contribute to a pension with increased flexibility on when and how people can draw benefits from their pension. In particular, our proposals will allow all those who want to work for longer to do so if they choose.

This consultation document defines the direction the Government proposes to take. It is important that these plans for reform are developed in partnership with those who will use the new rules so that they are simple, durable and readily understood. Pension reform matters to so many people – employers, workers, savers and financial services, as well as pension professionals themselves. The Government seeks responses from all these groups and their representatives.



Gordon Brown
Chancellor of the Exchequer

Ruth Kelly
Financial Secretary to the Treasury

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About this consultation

i. This consultation document explores how the taxation of pensions can be made simpler. With the green paper on pensions, *Simplicity, security and choice: working and saving for retirement*, published alongside this document, it aims to develop legislation about pensions to help people provide for a good retirement with confidence.

ii. The Government wants an informed debate about the proposals in this document. It is important that the issues are considered in a broad social and economic context, taking account of several recent reviews of pensions and retail financial services. These include Ron Sandler's report, *Medium and Long-Term Retail Savings in the UK- a reveiw*; Alan Pickering's report, *A Simpler Way to Better Pensions: an independent report*, both published in July 2002; and Paul Myners' report, *Institutional Investment in the UK*, published in March 2001. Copies of these reports can be found through the websites of HM Treasury and the Department for Work and Pensions:

www.hm-treasury.gov.uk

www.dwp.gov.uk

iii. There is a draft regulatory impact assessment at Annex A and questions for feedback are at Annex C. Because of the (unavoidably) technical nature of this consultation, there is a glossary at Annex D.

iv. Please reply by 11 April 2003. Please note that your reply will not be treated as confidential unless you ask.

v. For enquiries about this consultation or to obtain further copies, contact either the HM Treasury Public Enquiry Unit or the Inland Revenue Pensions Simplification Team. If requesting a copy by e-mail, please include "**subscribe simplification**" in the subject field.

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vi. You may respond either by post to the Inland Revenue address above or by email to pensionsconsult@ir.gov.uk. Please put the phrase "**response pensions**" in the subject line of your email. If you respond by email with an automatic confidentiality disclaimer, for the avoidance of doubt please say in the email whether you are content for your response to be published.

vii. If you have any complaints about the consultation process, please contact:

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viii. You may wish to refer to the Government's Code of Practice on written consultations. You can find it through the Cabinet Office website at:

www.cabinet-office.gov.uk/servicefirst/index/consultation.htm

1 SUMMARY

1.1 This document proposes radical simplification of pension taxation.

Complexity of the current rules

1.2 The complexity of the tax rules for pensions has come about because each successive set of changes has overlaid the previous rules, which have been allowed to continue for people who stay in the same pension scheme. There are now eight different tax regimes governing pensions, each with overly complex rules limiting the amount an individual can contribute to a pension scheme and the benefits a scheme can pay out. These rules restrict choice and flexibility for individuals, employers and pension providers alike.

1.3 As a result, pensions tax relief has become so complicated that people are put off saving for retirement and employers have become reluctant to sponsor workplace pensions. The complex rules add to the costs faced by individuals, employers and pension providers, and distort the advice people get. So they restrict what people actually save for their retirement. And that can mean they are disappointed with the income they achieve in retirement.

1.4 To address this problem, in March 2001 the Government launched a review by the Inland Revenue, working with informed help from the pensions industry. This review looked at a wide range of pensions issues, and drew on the advice in the Sandler review of retail savings[1]. This consultation document sets out how the Government proposes to take forward the review's recommendations.

Principles of reform

1.5 In reshaping the tax rules for pensions, the Government seeks to achieve a transparent, consistent and flexible system which can be readily understood. Simplicity should hold compliance costs down, deliver clearer incentives to save and so encourage real competition among suppliers of pensions in the retail savings market.

The main proposals

1.6 Unlike previous changes to the taxation of pensions, this reform proposes a clean break. Pension rights built up before the reform is implemented will be respected. All pension saving after implementation will follow a single set of rules which will apply to saving in all kinds of pension schemes. And there will be a single set of simple rules about how pension savings are turned into benefits.

1.7 In the new system the current limits on annual pension contributions and benefits will be replaced by a single lifetime limit on the amount of pension saving that can attract favourable tax treatment. So people will be able to choose when and how much to save in order to achieve the retirement income they want. The Government intends to set this limit at £1.4 million per person for introduction in 2004 and indexed thereafter. Tax relief at the contributor's marginal rate will continue to be available.

1.8 This lifetime limit will be complemented by a light touch compliance regime with an annual limit on inflows of value to an individual's pension fund – both contributions and growth in pension rights in occupational schemes. The proposed level for introduction in 2004 is £200,000, which will also be indexed thereafter.

Pensions in payment

1.9 There will also be a single, consistent set of rules about delivery of pension benefits, whether they come from a scheme sponsored by an employer or a private scheme. The maximum tax free lump sum will be set at 25 per cent of the value of matured pension savings – appreciably more generous than now for many.

[1] *Medium and long-term retail savings in the UK: a review*, Ron Sandler, July 2002.

Flexible retirement

1.10 The proposals also drop the outmoded rule preventing people in occupational schemes from mixing work and retirement. Where scheme rules allow it, people will be able to begin to draw benefits from their pension while continuing to work, perhaps with reduced hours or responsibilities. Flexible retirement in this sense is intended to encourage those who can to work longer – allowing the economy to benefit from the skills and experience of older workers and encouraging them to save more to boost their retirement income.

1.11 As part of the introduction of flexible retirement, the Government intends to raise the minimum benefit age from 50 to 55 years of age by 2010. This change recognises the considerable improvements in life expectancy which have taken place over the last century. The concept of normal retirement age will vanish from tax legislation.

1.12 Greater flexibility about taking benefits from pension savings built up with the advantages of tax relief will also foster further development in the annuities market. The new rules will permit and indeed encourage innovation. Among the new kinds of annuity which will be possible are limited period and value protected annuities.

Advantages of simplification

1.13 The proposed new tax rules for pensions will impose little real constraint on pension savers and pension schemes. For the vast majority of people, the tax system will simply cease to be a consideration when planning for retirement. Instead they will be free to concentrate on the real issues – deciding when and how much to save. This approach will afford scope for substantial innovation in design of pension schemes. Radical simplification should also generate significant savings in administration costs, feeding through to better value for pension savers with real opportunities for financial services firms to streamline their operations.

1.14 These proposals for radical simplification will transform the tax rules for pensions. By cutting administration costs and stripping out unnecessary controls, they will give everyone using pensions choice and flexibility.

The way ahead

1.15 This document defines the direction the Government proposes to take. It is important that the plans for reform are developed in partnership with those who will use the new rules so that they are simple, durable and readily understood. Pension reform matters to so many people – employers, workers, savers, and financial services firms as well as pensions professionals themselves. The Government seeks responses from all these groups and their representatives.

1.16 Taking account of feedback, the Government will set out detailed proposals next year, if possible with draft clauses for primary legislation. If this timetable proves feasible, legislation to bring about simplified taxation of pensions could be included in Finance Bill 2004, to take effect from April 2004.

1.17 The Government now invites an informed debate about the way forward.

2 The Complexity of the Current Rules

There are eight different sets of tax rules currently in use for pensions. These rules impose unnecessary inflexibility on the pension system by limiting inflows to pensions, specifying how pensions can grow, and regulating pension benefits. So the tax rules have made pensions hard to explain and hard to understand. Costs are driven up to no real benefit. Financial services firms providing pensions and employers sponsoring pensions for their employees face higher costs and more administrative work than can be justified. Worst of all, complexity discourages people from saving and restricts individual choice and flexibility.

The Government's approach to pensions

2.1 The Government wants to provide security, dignity and comfort for people in their old age; enabling pensioners to share in the country's rising prosperity and tackling poverty among older people.

2.2 The Government is providing security to all pensioners through increases in the basic state pension. It was raised by more than inflation in each of the last two years, and will rise again by more than £100 a year (£160 for couples) in April 2003. In future years, the Government has guaranteed to increase the basic state pension by at least 2.5 per cent, even if the September Retail Prices Index is below this. Around 11 milion people aged 60 or over continue to benefit from the tax free winter fuel payments, set at £200 for the rest of this Parliament. Older households are also entitled to free TV licences, currently worth £112 a year. The age-related personal tax allowances wil increase by more than inflation from April 2003, ensuring that no pensioner aged 65 or over will pay tax on income of less than £127 a week.

2.3 For poorer pensioners, from next April the Minimum Income Guarantee (MIG) will entitle single pensioners to an income of £102.10 a week (£155.80 for couples). And from October 2003 the Pension Credit will incorporate the MIG into a single credit that will provide a guaranteed income while rewarding pensioners with modest incomes or savings above the basic state pension.

Simplicity, security and choice: working and saving for retirement

2.4 As the Green Paper *Simplicity, security and choice: working and saving for retirement* explains, the Government also seeks to encourage today's workers – tomorrow's pensioners – to save for their retirement. People should be able to design the retirement packages that suit their circumstances and needs in privately provided pensions.

Private pensions

2.5 To encourage people to save in a pension, the Government awards favourable tax treatment to pension savings which people must use to provide a secure income in retirement. Most of the savings built up in this way must be used to generate a taxable retirement income. In effect, pensions defer current income, usually from earnings, in return for security in retirement.

2.6 The complexity of the current system makes these generous tax incentives difficult to understand. The reforms outlined in this document are intended to bring out the value of tax relief for pensions more strongly. Removing complexity will reduce costs and make advice on pensions more straightforward and comprehensible. So simplification will put people in a better position to make informed choices about what they are prepared to save and how.

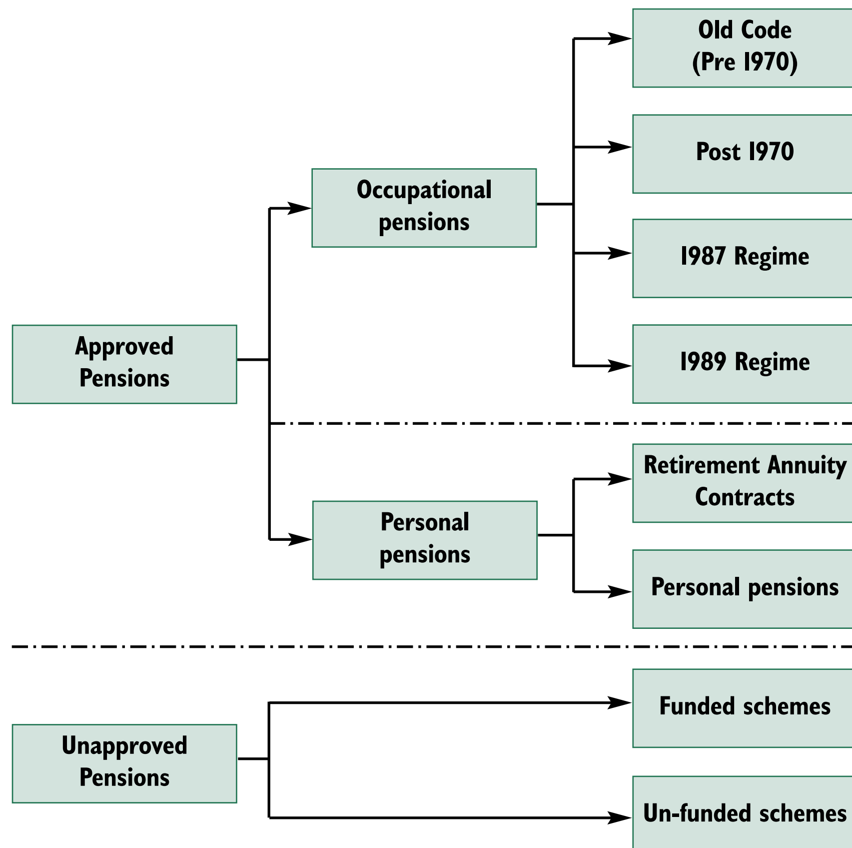
2.7 As the Sandler review of retail savings also recognised, the complexity of the current tax rules hampers everyone involved with pensions:

- it makes pensions inflexible and hard to understand, so tending
  - to reduce how much people save;
  - to add to the cost of personal financial advice; and
  - to prevent some people, especially the less well off, from saving at all;
- it biases advice on saving because advisers seek to maximise tax advantages;
- it adds to administration costs because of the cumbersome compliance requirements it imposes; and
- it acts as a serious obstacle to entry into the pensions business, thereby damaging competition that could help drive down prices and improve choice.

The current tax regimes for pensions

2.8 The complexity in the pension tax rules has arisen as the tax system has developed to reflect changing and increasingly more diverse demands for different kinds of pension provision. Most such developments have been incremental – that is, allowing people to continue to save using the previous rules until retirement, rather than using the new rules introduced by any change. As a result there are now no fewer than eight different ways of saving for a pension, summarised in Chart 2.1.

Chart 2.1: Current pension tax regimes



Source: Inland Revenue.

Occupational schemes

2.9 For people in occupational schemes, the main set of tax rules is the 1989 regime. Its main features are:

- employees may contribute, with tax relief, up to 15 per cent of remuneration up to the earnings cap (£97,200 in 2002-03);
- no specific limits on employer contributions with tax relief, but restrictions on overfunding;
- total benefits, including any lump sum, limited to two-thirds of final remuneration up to the earnings cap after 20 years' service;
- the tax free lump sum at retirement is limited to 2.25 times initial pension or 3/80ths of capped final remuneration for each year of service up to 40 years;
- retirement at any age from 50 to 75; and
- scheme members must either be active (working) or retired from work with the sponsoring employer; it is not possible to contribute and draw benefits simultaneously.

2.10 There are three other sets of tax rules which may apply to people, who joined an occupational scheme before 1989. People in this position were allowed in each case to continue to contribute and get benefits under the superseded tax rules so long as they remained in that scheme. The main features of these older rules are outlined below:

2.11 Old code rules may still apply to people who joined a scheme before 1970. There are different rules for trust funds and pension schemes. The rules include:

- no limit on tax exempt employer contributions;
- employee contributions get tax relief up to 15 per cent of remuneration;
- in trust funds, pension benefits up to two-thirds of final remuneration after 20 or more years of service, with no right to commute any of this to a tax free lump sum; and
- in pension funds, benefits the same as trust funds, with some rights to commute.

2.12 Post 1970 rules, sometimes called new code, have similar restrictions on contributions but different rules for benefits:

- pension up to two-thirds of uncapped final remuneration after 10 years of service;
- tax free lump sums limited to 1.5 times uncapped final remuneration for 20 years of service;
- specific rules for early leavers, and early and late retirement; and
- certain retained benefit rules, namely restrictions depending on the benefits available from pension rights from previous employments.

2.13 The short lived 1987 regime had much in common with the new code rules but different benefit rules, including:

- pension up to two thirds of uncapped final remuneration after 20 or more years of service; and
- tax free lump sums limited by a formula with an upper limit of £150,000.

Personal pensions

2.14 For people in personal pensions, the tax rules date from 1988, with some updating in 2001 when stakeholder pensions were introduced, allowing non-earners to participate. The main features are:

- relief on contributions up to the higher of £3,600 a year or a percentage of capped earnings, irrespective of who makes the contributions. The percentage depends on age – 17.5 per cent for people under 36, rising to 40 per cent for people over 60;
- no limits on the size of pension benefits; and
- tax free lump sums of up to 25 per cent of matured pension savings.

Retirement Annuity Contracts

2.15 Before personal pensions there were retirement annuity contracts, to which some people who were using them in 1988 can still contribute. Their rules are similar to those for personal pensions, with some differences. The main rules are:

- relief on contributions up to a percentage of uncapped earnings. The percentage depends on age – 17.5 per cent for people under 50, rising to 27.5 per cent for people over 60;
- matured pension savings must be used to buy an annuity; and
- tax free lump sums allowed according to the size of the annuity.

Unapproved pension schemes

2.16 When the earnings cap was introduced in 1989, employers sought ways to continue to offer generous pension benefits to highly paid employees whose pensions would otherwise have been restricted. Hence two types of unapproved retirement benefit schemes are used, with less generous tax treatment. The main features of these schemes are:

- employer contributions count towards the employee's taxable income, with no limit, and they also count as a business expense against the employer's tax liability;
- employee contributions are unlimited, but do not attract tax relief;
- no limits on benefits, which may be paid as
  - tax free lump sums and/or
  - taxable income.

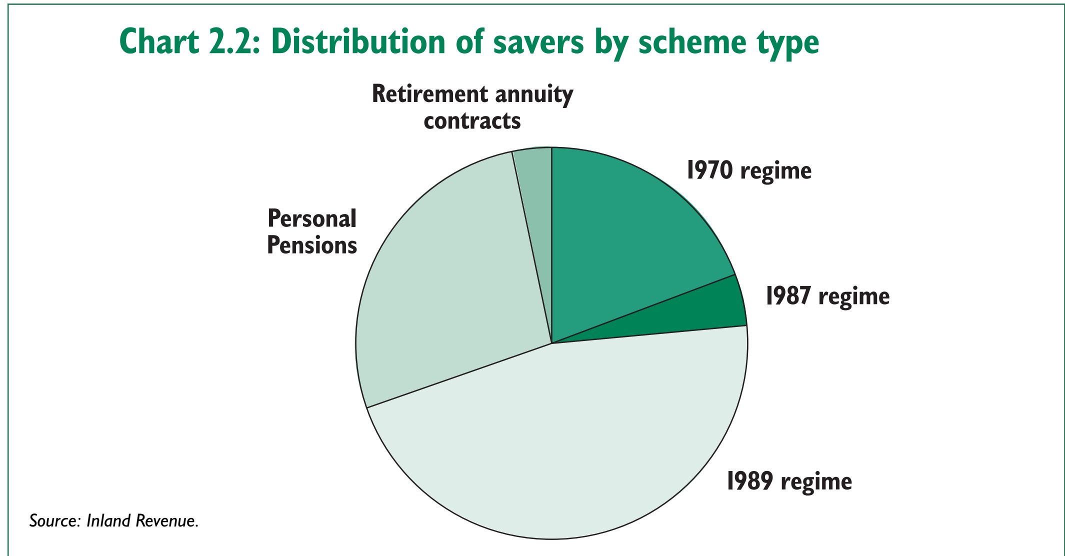
2.17 Unapproved retirement benefit schemes may be funded (FURBS) or unfunded (UURBS). In FURBS, there are contributions during the member's working life, but not in UURBS. So UURBS work because the employer meets the cost of benefits to the employee, when they are payable, out of current income (pay as you go).

2.18 Pension provision is now scattered among these various different kinds of scheme. Chart 2.2 summarises the distribution of members between the different tax regimes. The sheer proliferation of different kinds of pension shows starkly how fragmented pensions in the UK now are.

2.19 Moreover, none of the rules for the different kinds of schemes are simple in themselves. Put together, the sheer existence of so many sets of rules, applying to different people depending on when they started contributing, or depending on their income, makes for a complex web of tax rules, which most people struggle to penetrate without help.

2.20 It is easy to appreciate that the tax rules have grown up to meet particular issues as they have arisen. Viewed in the round, however, the rules are clearly more restrictive than necessary. There are controls on the amount of contributions that can qualify for tax relief; controls on how much can be held in tax privileged pension funds; and controls on the amount of pension that can be paid. These multiple restrictions throw up anomalies and distortions, which are hard to justify.

Chart 2.2: Distribution of savers by scheme type



Source: Inland Revenue.

2.21 The distortions caused by the tax treatment of pensions should now be removed.

Saving for pensions

2.22 There must clearly be some limit to how much people can save for pensions with tax incentives to ensure that the relief system is sustainable. The present rules do not however appear to determine what people do actually save overall. Recent research carried out by the Inland Revenue on a sample of occupational schemes showed that fewer than 1 per cent of people in occupational pension schemes in practice get benefits right up to the tax limit. Overall, taking account of personal pensions, no more than 5 per cent of people save up to what the tax rules allow.

2.23 So in fact the tax rules, which affect everyone, with all the damaging consequences outlined in the Sandler review, only act as a brake on the saving of a small proportion of pension savers. Recent research for the National Consumer Council[2] shows that about 70 per cent of people are concerned about whether their pensions will be adequate and the complexity of the decisions they have to make to save for retirement. So persisting with complex rules imposes confusion and compliance costs on everyone in order to limit tax relief for a few.

2.24 Another important weakness of the tax rules is that they have not kept pace with evolving social and economic patterns. The labour market now is very different to conditions when the main features of the tax rules were established. In particular, the different tax regimes act as a barrier to labour market flexibility.

2.25 Today people rarely stay in the same job for a lifetime. Research carried out for the National Association of Pension Funds[3] shows that people now stay in a job for about 5½ years on average. At any one time some 7 per cent of people are in temporary jobs or employed on fixed term contracts and about 28 per cent of people have worked for their current employer for 2 years or less. Both employers and employees have come to value flexibility in employment patterns, since it can offer everyone advantages.

[2] *Running Risks: Summary of National Consumer Council research into consumers' views on risk,* October 2002.

[3] *The flexible labour market: implications for pension provision,* National Association of Pension Funds, May 1999.

2.26 As the green paper notes, it will often make sense for people to adopt different working patterns toward the close of their working lives. Where it is possible to combine work flexibly with retirement, people may be able to work and save more, so securing better retirement savings for a more comfortable old age.

2.27 There is clearly room to establish the rules for tax relief in a way which can provide greater flexibility and choice and cut administration costs. Simpler limits will themselves be more meaningful, ensuring that the generous incentives to save in a pension are transparent and clear.

2.28 The next chapter sets out the principles that have guided the Government's reforms in this area.

3 Principles of Reform

The Government is proposing a radical simplification of the tax rules for pensions so that they are transparent, straightforward and conducive to efficient saving. These new tax rules should strip away the layers of complexity to make pensions more transparent and easier to understand and to deliver significant administrative savings. This will greatly increase choice and flexibility for individuals, employers and pension providers.

Reform objectives

3.1 The Government wants people to be able to save with confidence for a comfortable retirement. Yet the current tax rules on pensions frustrate people who want to save for retirement or who want to adjust their working patterns toward the close of their working lives. The complexity of the current rules makes it difficult for people to establish what means of saving will best suit their circumstances. These rules also make it impossible for some people to achieve a transition from work to retirement in a manner suited to their skills and capacity.

3.2 The Government intends to sweep away complexity and outdated rules, replacing them with a pensions system designed to encourage workers and their employers to make rational decisions in harmony with the commercial needs of the labour market. In turn, this should support the Government's objective to boost the long run rate of productivity growth of the whole economy.

3.3 As the green paper explains, the Government wants to see more people making use of good quality pension schemes of all kinds to provide for their retirement. To achieve this, the process of saving must become easier for savers to understand, and easier and cheaper for those running pension schemes to operate.

3.4 Simplifying and deregulating the tax rules for pensions should encourage people to save. Everyone involved in pensions stands to gain if this can be done successfully.

3.5 In seeking to simplify the existing tax rules for pensions, the Government's key objectives are:

- **transparency**: so that people can readily understand their pension rights and opportunities, making it easier to make decisions about saving for retirement;
- **consistency**: to give people confidence that everyone has equivalent rights and opportunities;
- **flexibility**: so that people can develop working patterns suited to their changing needs and the shifting demands of the labour market;
- **proportionality**: to keep compliance costs within reasonable bounds and so to encourage employers sponsoring occupational schemes and providers of commercial pensions to offer good value;
- **incentives**: to encourage people to defer current spending in order to provide for their older years
- **competition**: streamlining the rules should encourage new providers to enter the market, and thus help push costs down and widen choice; and
- **affordability**: the cost of the incentives in terms of tax relief must be within current fiscal projections.

The way ahead

3.6 The reform plans set out in this consultation document are intended to achieve these objectives. The new tax system will wipe out most of the current intrusive tax controls, reducing costs, perhaps dramatically. By eliminating the complexity of multiple sets of overlapping rules, people will be freed to make clear and confident decisions about savings for retirement without the need for expensive advice. In the new single, unified regime there will be no need to distinguish between defined benefit and defined contribution schemes, allowing savers and employers sponsoring schemes to make arrangements for pensions to suit their career patterns and the needs of the labour market.

3.7 The next two chapters set out the Government's simplification proposals. Chapter 4 deals with the saving phase of pensions while Chapter 5 covers how benefits can be taken from a pension scheme.

4 THE GOVERNMENT'S PROPOSALS FOR SIMPLIFICATION

The Government proposes to remove most tax controls on pensions, allowing people to concentrate on deciding what and how to save for retirement. The remaining controls will be light touch:

- **a single lifetime limit on the amount of pension saving that can benefit from tax relief; complemented by**
- **a light touch compliance regime using an annual limit on the value of inflows to each person's pension savings that can gain tax relief.**

This radical approach should also lead to substantial savings in administration costs.

4.1 The Government proposes a radical simplification of the tax rules for pensions. This overhaul will sweep away most tax controls on pensions.

4.2 Instead of the current plethora of limits, people will be able to get full tax relief on all contributions to pensions. The current limits on annual pension contributions and final benefits will be replaced by a single lifetime limit on the total amount of pension savings that can benefit from tax relief. This will be complemented by a light touch compliance regime with an annual limit on the value of the increase in each person's pension rights that qualify for tax relief.

4.3 These rules will only limit the amount of tax-privileged pension. Those who wish to save more will enjoy the flexibility to do so, but will not benefit from the additional tax reliefs in the longer-term. This removes the requirement on pension schemes to carry out regular checks against tax limits. Instead, schemes will carry out one single test against the lifetime limit, levying a recovery charge on any pension savings that exceed this limit in order to recoup tax relief. Pension savers will be responsible for checking inflows into their pension funds against the annual limit and, in the few cases where these limits are exceeded, account for any tax due.

4.4 In practice most people saving into pensions, including employers sponsoring pension schemes, will simply be able to save, with tax relief, whatever they can afford and whatever suits their circumstances.

4.5 This method of dealing with pension saving will be very different from the current rules. It will mean:

- the same opportunity to save in a pension for everyone;
- the same tax treatment for defined benefit (DB) and defined contribution (DC) pension schemes;
- greater freedom about design of pension schemes;
- very little Inland Revenue intervention in most people's pensions; and
- appreciably lower administration costs.

4.6 The current burden of regular assessments and checks will be replaced by:

- streamlined Inland Revenue controls exercised only when benefits are drawn from pension schemes, with certain limited controls on inputs into pension schemes, but only for relatively few people with extensive pension rights.

4.7 Some familiar features of pension schemes will remain in a simplified form:

- employees, employers and the self employed will get tax relief on contributions to pension schemes of all kinds up to 100 per cent of earnings or £3,600 a year, whichever is the higher;
- most employees will not pay tax on employer contributions to pension schemes;
- the investment growth of pension schemes will still be largely tax free, as now; and
- when benefits are drawn, there will still be scope to take a tax free lump sum of 25 per cent of the capital value of the pension .

4.8 For most people the new tax rules will place no constraints at all on their pensions. Everyone will be able to save in as many pension schemes as they want. People with irregular income will be able to save as and when they can afford to do so. For members of occupational schemes, pension benefits will depend on what the scheme and its sponsoring employer can afford. The objective is to liberalise tax controls on pensions so that for most people the tax rules will simply cease to be a consideration when planning for retirement.

The lifetime limit

4.9 The tax rules for pensions must allow people to make informed choices about their saving for retirement, so that they can take a long-term view of their needs and aspirations. There must be some control on how much each person can draw as tax privileged pension benefits, but this control should not drive people's important decisions about planning for their future. The Government believes that the way to achieve this outcome is a single lifetime limit on the amount of pension saving that can benefit from favourable tax treatment. This approach will give people flexibility to plan their saving to suit their career needs, in tune with the long term nature of pension provision.

4.10 The Government intends to set the control level for the value of an individual's pension fund at retirement at £1.4 million. This amount is broadly equivalent to a maximum pension at the date of implementation under the current occupational pension rules for a man of 60 drawing an indexed pension and providing a surviving spouse's pension. It will be indexed to keep pace with inflation – as the earnings cap is now. For most people this limit will be well above the pension they expect to get at retirement.

4.11 To make this reform work, it will be crucial to establish a common and consistent method of valuing pension rights, whatever form they take. Using this method each pension saver will add up a single integrated figure for their total pension savings to test against the lifetime limit when they draw their pension benefits. The Inland Revenue will publish actuarial tables determining the capital value of defined benefit (DB) pension scheme rights for people of different ages in different kinds of schemes.

Testing against the lifetime limit

4.12 For people who choose to draw all their pensions benefits at once, the process will be a one-off test:

- calculate all the person's pension rights, from all sources using the published conversion tables where necessary;
- compare the total with the lifetime limit;
- if the total is less than this limit, the benefits can be paid in accordance with the rules discussed in Chapter 5 – up to 25 per cent as a tax free lump sum and the remainder as taxable retirement income;

- if the total benefits are above the lifetime limit, any amounts above the limit will face a recovery charge of one third of the excess before they can be drawn as income; and
- any amounts drawn from the fund slice above the lifetime limit will then be taxable as income.

Recovery charge

4.13 The recovery charge on funds above the lifetime limit, together with income tax on any amounts withdrawn from the part of the fund above the limit, will roughly neutralise the tax relief given initially on contributions and then on the growth of funds during investment. In the interest of simplicity, the recovery charge will not be personalised to make exact recovery of the tax relief obtained by each person's pension savings built up above the lifetime limit.

4.14 The impact on incentives to save is discussed later in this chapter.

4.15 Some people may not choose to draw all their pension benefits at once. For them there will need to be a check at each point at which benefits are taken. Again, most people will not find the tax controls a real constraint. Annex B explores how this process will work, with examples. The policy objective is to ensure that people will face the same real aggregate lifetime limit on their total pension benefits built up with tax relief, irrespective of when they choose to take their pension benefits.

Compliance

4.16 An important feature of making the lifetime limit work must be effective enforcement. There are already improper, sometimes illegal, efforts to extract capital from pension schemes by bogus transfers – an activity known as trust busting. Without an effective compliance regime, the incentive to use pension schemes in this way could rise under a lifetime limit scheme because perpetrators might seek to make contributions, gather substantial tax relief, and then withdraw value quickly.

The annual limit

4.17 There will be a light touch compliance regime including an annual limit on value inflows to each person's pension savings. This annual limit will be designed not to constrain most savers. Its prime purpose will be to limit the leakage of tax relief which could occur if a determined opportunist tried to wash contributions through a pension fund quickly, planning to extract the proceeds improperly.

4.18 The Government is minded to set this annual limit at £200,000. Like the lifetime limit, this figure will be indexed.

4.19 Such a high annual limit will be quite academic for most people. No one can get tax relief on personal pension savings of more than about £40,000 a year now; and very few people in occupational schemes, probably fewer than 1,000, have their pension rights raised by £200,000 or more in a single year. So this limit will not affect the vast majority of people. Even for the limited group of people who will need to check whether they are liable for more tax on the annual increases in their pension rights, the process of calculating the liability will be made as straightforward as possible.

4.20 To make the annual limit on value inflows work fairly, it must take into account:

- someone's total contributions into defined contribution (DC) schemes; and
- the whole annual increase in the value of their defined benefit (DB) pension rights in any scheme sponsored by their employer.

4.21 So that both parts of this calculation can be done fairly, the Inland Revenue will publish actuarial tables valuing increases in DB pension rights. In this way it will be possible for each pension saver to measure up their total increases in value inflows against the annual £200,000 limit.

4.22 The mechanism for enforcing the annual limit will use the established self assessment (SA) system, which will apply a new income tax charge on any value inflow that exceeds the annual limit in any given year. All those concerned will already be paying their tax through SA. So it will be possible to identify those with more tax to pay through an adjustment to the SA return. This adjustment will be designed to help people to establish whether the increase in their pension rights is large enough to mean that they have more tax to pay. Annex B sets out in more detail how this will work in practice.

4.23 The purpose of the annual limit on value inflows to pensions is to guard against tax leakage. If it proves possible to assure recovery where necessary in a proportionate way without applying an annual charge, the Government would be willing to reconsider this feature of the proposals. For example, developments in mutual assistance arrangements with other countries might provide some additional assurance.

Other controls

4.24 Beyond these limits, no other controls on the tax treatment of pensions will be necessary.

Incentives to save

4.25 Perhaps because the basic principles of taxation of pensions are so well established, the generosity of the current tax rules is easily taken for granted or even overlooked. As the green paper explains, the Government intends to rebrand tax relief to bring out its value more strongly. This process will bring out the fact that for every £100 of after tax income that someone saves into a pension, the Government will provide a further £28 on top. When that enhanced sum is invested for growth, the tax benefit can be very powerful indeed.

4.26 Under the new tax rules, people will find it most advantageous to save within both the annual and lifetime limits. Box 4.1 shows a stylised comparison designed to draw out the relative benefits of saving long-term in different ways once the new rules have been introduced. Some of the methods of saving are within pensions and some not. Each case in the table relates to a single contribution to a largely equity based saving vehicle, attracting the same rate of return before the effect of tax or tax relief is applied. The comparison assumes the saver is a higher rate taxpayer because people in this category are most likely to be able to save more than the proposed lifetime or annual limits in the new tax rules.

4.27 Box 4.1 shows clearly that saving in a pension within the proposed regime offers the best rate of return – indeed the effect of tax relief boosts the gross return in the fund. Someone able to sustain strong saving flows within the annual limit may also generate an attractive return even if they save beyond the lifetime limit by the time the fund matures. But saving above the annual limit will rarely be worthwhile, and certainly not if the lifetime limit is also exceeded.

Box 4.1: Rates of return compared – pensions and other saving

Real post tax rates of return (per cent)	Years invested 10	20	30	40
(a) saving in a pension within both the annual and lifetime limits	7.1	5.2	4.7	4.4
(b) saving in a pension within the annual limit but not the lifetime limit	1.2	2.4	2.7	2.9
(c) saving in a pension within the lifetime but not the annual limit	–0.1	1.7	2.3	2.6
(d) saving in a pension above both the annual and lifetime limits	–5.5	–1.1	0.4	1.2
(e) saving in a mutual fund invested in equities (not a pension)	2.2	2.3	2.5	2.5
(f) saving 60 per cent in equities and 40 per cent in interest bearing securities (not a pension)	1.7	1.8	1.9	1.9

assumptions for the calculations:

- *3.5 per cent gross real return on pension investments (net of corporation tax on dividends);*
- *of which, two thirds taken as dividends;*
- *2.5 per cent inflation; and*
- *the saver is a higher rate taxpayer both when contributing and when retired.*

Source: Inland Revenue.

4.28 These calculations are naturally hypothetical. In real life, people's saving patterns will rarely be entirely regular. And annual rates of return on investments will vary over a working lifetime. Nevertheless the comparisons have some value in illustrating how the incentive structure will operate. The key conclusion is that for those who can afford to, pensions are the most efficient long-term investment vehicle.

Assessment

4.29 This reform will sweep away much of the complexity in the current tax treatment of pensions that currently acts as a major barrier to saving. To be specific:

- administration costs should fall, providing savers with better value, improving efficiency and hopefully tempting in new providers, stimulating competition and encouraging innovation;
- 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;
- by applying the same tax rules to defined benefit and defined contribution pensions, the artificial distinctions will vanish, leaving employers sponsoring pensions free to decide which best suits their circumstances and the needs of their workforces;
- most people will need less advice about what they can save in tax relieved pension form, and most of the advice can concentrate on the important issues of pension choice and suitability; and
- building on a measure introduced in 2001 with stakeholder pensions, the reform achieves what the industry has come to call full concurrency – that is everyone in DB schemes will be free to save in separate DC schemes too if they want to and can afford it.

4.30 The Government has carefully considered the impact of these proposals on tax revenues. While recognising that a lot will depend on behavioural effects and the final design of the new regime, which will be decided in light of this consultation process, the Government is confident that the impact will be affordable.

4.31 While these reforms will mean that over 99 per cent of people will be free to save more in a pension overall, they will limit the amount of tax favoured pension saving that a small minority of well paid people can make during their working lives. Only some 5,000 people have personal pension schemes worth more than £1.4 million. And while there are some 90,000 people earning more than £200,000 a year, probably fewer than 1,000 will be affected by the annual limit.

4.32 In practice, people affected by the new limits are likely to adjust their employment packages and saving patterns to make best use of the saving opportunities available to them. Anyone in this fortunate position may well be able to renegotiate their employment benefits if it would be advantageous for them to do so. They are also very likely to have significant other resources too.

4.33 It is important to see these effects in perspective: they are not a major feature of the proposed reform. Its critical quality is the freedom from intrusive and unnecessary regulation it will bring to the overwhelming majority, with all the consequential benefits that should surely follow.

QUESTIONS FOR FEEDBACK

- *Will a lifetime limit on tax relieved saving be a satisfactory way of integrating the taxation of pensions?*
- *How much will this approach encourage additional saving?*
- *How much will compliance costs drop overall?*

5 SIMPLIFYING PENSIONS IN PAYMENT

The new tax rules for pensions will also apply the same principles of flexibility, transparency and consistency to how pension benefits can be drawn. The Government intends to remove the arbitrary distortions which are a feature of the current tax treatment of pensions, and introduce transparency and flexibility, notably about mixing work with retirement and the range of income patterns which can be used with different kinds of pensions. There will be no change to the key principle that tax relief is awarded to encourage savers to build up funds primarily to provide income in retirement, and not to establish capital for estate planning.

5.1 Just as there will be a single consistent set of tax rules about saving for pensions, there will also be a single consistent set of tax rules about how benefits can be drawn from matured pension savings. For both phases of people's use of pensions, the Government seeks to promote simplicity, flexibility and choice for everyone.

5.2 This chapter looks at the different kinds of benefits that can be drawn from pension savings built up with the benefit of tax relief:

- retirement lump sums;
- benefits while still working toward the close of a career;
- retirement income;
- death benefits; and
- annuities – which in future will follow the same rules as those for other retirement benefits.

5.3 The current multiple sets of tax rules specify a variety of different ways in which matured pension benefits can be turned into retirement income. There is no rationale for these variations. In the reformed regime, the single set of consistent rules for benefits will apply to all benefits drawn from savings made after the new rules start. All pension rights accumulated before then will be respected, subject to any limits which are in place before the new rules apply.

Retirement lump sums

5.4 Pensions receive favourable tax treatment in order to encourage people to save for their retirement. The deal between the Government and the pension saver is that this favourable tax treatment is conditional on using most of the savings built up in this way to generate retirement income and not for other purposes.

5.5 Generous as tax relief is, the Government recognises that people do need encouragement to lock away their money, perhaps for decades, until they are ready to begin to draw benefits from their pension savings in their later years. The tax free lump sum provides that encouragement. It can provide a substantial capital sum, perhaps allowing people to put their financial affairs into good order when they retire. It may even offer once in a lifetime opportunities such as visiting family members in other countries or paying for home improvements to make retirement more comfortable.

5.6 The reformed tax treatment of pensions will therefore keep the opportunity to take a tax free lump sum. As now, if scheme rules allow it, people will be able to choose whether to draw all their pension benefits as income or to take part as a lump sum of up to 25 per cent of the value of the pension fund. For someone whose matured pension savings are less than the lifetime limit – over 99 per cent of people – this lump sum will be tax free.

5.7 In practice this will mean that many people in occupational schemes will be able to draw larger tax free lump sums than now from their matured pension funds if their scheme will allow it. Any existing rights to larger tax free lump sums than the new rules would allow will be respected if they have been built up before the date of implementation. Annex B goes into more detail about how these rights will work.

Flexible retirement

5.8 A major advantage of the reform of pensions taxation will be flexible retirement. As the green paper discusses, people should be able to combine work and retirement toward the end of their working careers irrespective of the kind of pension they have, provided the rules of the scheme allow it. At the moment the tax rules for occupational pension schemes, though not personal pensions, force people to make an all or nothing choice about retirement. In future, the concept of normal retirement age will no longer feature in the tax rules – though some pension schemes may choose to continue with it if they find it makes sense to do so.

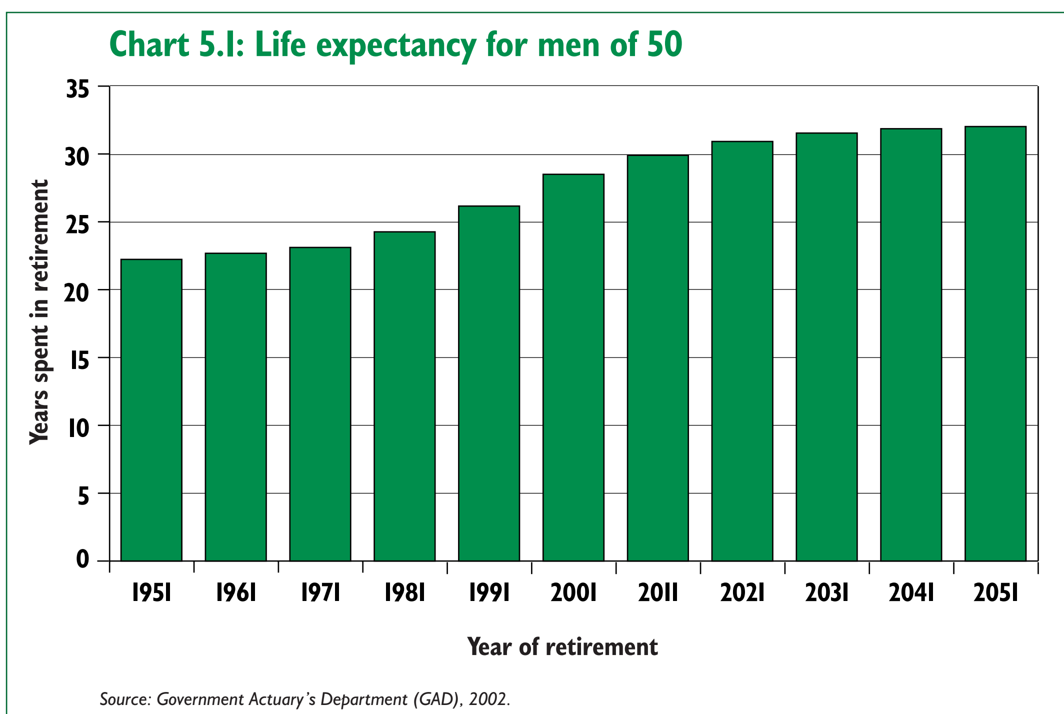
5.9 This fresh approach is intended to encourage those who can to work for longer. As the green paper, *Simplicity, security and choice: working and saving for retirement*, explains, many able people with valuable skills stop work in their fifties. Yet many people are willing and able to work well beyond this age range if they can reduce their regular commitment to work gradually. The new tax rules will apply consistent treatment to how all pension schemes deliver benefits, allowing people to draw pensions *and* work if they want to and the rules of the pension scheme allow it.

5.10 This means that employers and employees will be free to consider how working patterns through a working life can be structured, providing scope for a more sensitive and considerate passage from work into retirement – perhaps a progression rather than a single leap. People will be able to phase out work to keep pace with their changing expectations and commitments. It will also enable people to work on past the age at which they might once have expected to retire, so that they can build up savings for a more comfortable retirement.

5.11 To underpin this additional flexibility, the Government intends to reform the tax rules about when retirement benefits can be taken from pension savings built up with tax relief, in line with improvements in life expectancy.

5.12 At the moment the tax rules permit pension schemes to allow early retirement for people as young as 50. This age was set when life expectancies were much shorter. As Chart 5.1 shows, someone of 50 can now expect to live for around a further 25 years – considerably longer than even in the recent past. And the projections suggest that life expectancy could continue to rise so that in a further half century men of 50 might be able to look forward to 30 more years on average, perhaps as long as the time spent working.

Chart 5.1: Life expectancy for men of 50



Source: Government Actuary's Department (GAD), 2002.

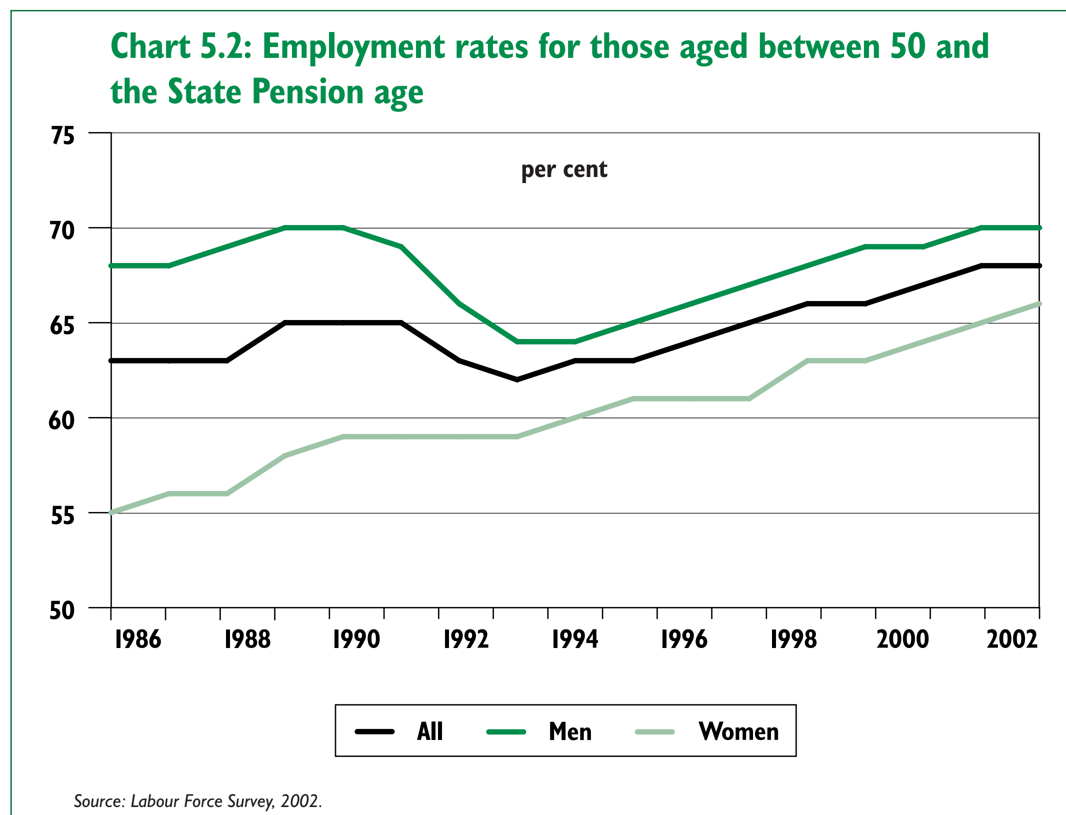
5.13 It is increasingly difficult for people to fund good pensions for such lengthy retirements. It is all too easy for people not to realise that their pension provision is not enough to sustain a prolonged retirement in comfort until it is too late for them to work and save more.

5.14 There are some signs that people are starting to recognise the advantages of working longer. After a sustained period when people approaching State Pension age (SPA) worked less, the tide turned in the mid 1990s. Now people in this older age group are more inclined to work than was the case just a few years earlier. Chart 5.2 shows this trend. There would be gains for many if this emerging trend could continue. Working longer offers the opportunity to build up more savings to provide a more generous income during retirement.

Minimum benefit age

5.15 So, as part of the reform of tax rules for pensions, the Government intends to set the minimum age at which tax privileged pension benefits can be drawn – the minimum benefit age – at 55 in 2010. This measure is intended to encourage people to work and to save for their retirement for longer. By giving people notice of the change, younger working people will have time to rearrange their plans if they need to do so.

Chart 5.2: Employment rates for those aged between 50 and the State Pension age



Source: Labour Force Survey, 2002.

5.16 There is a good case for leaving it up to each pension scheme to make its own choices about how any necessary adjustments to its rules are to be made. For example, occupational schemes may prefer to overhaul their rules to comply with equal treatment requirements at the same time as adjusting the scheme's minimum benefit age, if they need to do so. Or they might want to take advantage of the opportunity to redesign the pension scheme opened up by the new rules for taxation of pensions. For example, they might consider moving to an average salary scheme, or even something more innovative.

5.17 Alternatively, the tax rules could prescribe a phased rise in the minimum benefit age from implementation to 2010. This could allow pension scheme rules to follow a specific pattern in adjusting minimum benefit age upwards. It would be helpful to have feedback on which approach would make operational sense for those running pension schemes.

5.18 In the new tax rules, the minimum benefit age will apply to all pension schemes which qualify for tax relief, including those special schemes for particular trades where people may retire at a relatively young age – for example some professional sportspeople. From 2010, people in these schemes will not be able to draw benefits until age 55, whether or not this is the point at which they stop work in that line of business. This approach will fit what many people in these sorts of employment choose to do: often they embark on a second career after stopping working at the first kind of employment, and only retire altogether appreciably later.

5.19 The Government is considering the position of members of the pension schemes for the armed forces, police and fire services. It is essential that the entitlements to draw pension benefits before age 55 that people have already built up in these schemes are fully protected. It would be helpful if feedback could discuss whether there is a case for any special transitional rules for any other group of people whose normal retirement age is below 50 under the current rules.

5.20 Moving the minimum benefit age to 55 will not of course prevent pension schemes offering retirement at earlier ages to people who have severe health problems. That will still be permitted, as now.

5.21 Nor will this change prevent people stopping work younger than 55 if they can afford to do so using resources other than pensions. Many people already save for their retirement using other savings vehicles, for example Individual Savings Accounts (ISAs). Raising the minimum age for taking benefits from tax privileged schemes is, however, an important signal. It conveys that people cannot expect other taxpayers to help support them through pensions built up with tax relief until age 55. If they choose to stop work at a younger age, they must rely on other sources of funding until age 55.

Retirement income

5.22 The new tax system will set consistent rules about how people can turn the remainder of their pension savings into retirement income after taking any lump sum. The key requirement will be that pensions which attract tax relief must provide benefits in the form of secure income for the life of the scheme member. This is the understanding on which tax relief is, and will be, awarded to pension savings.

5.23 The current tax rules for pensions allow several different ways in which pension schemes may pay retirement income:

- an occupational scheme may pay a flow of income out of its own fund to its retired members, or it may buy annuities in order to do so;
- matured pension savings in a personal pension or retirement annuity contract must be used to buy an annuity by age 75, either from the firm through which pension savings were built up or from another provider;
- before age 75, personal pensions and some occupational pensions allow drawdown – that is a limited right to take annual payments within defined limits from matured pension savings, leaving the residual lump sum invested; and
- a member of an occupational scheme may be able to transfer pension rights out and buy an annuity on the open market.

General benefit rules

5.24 Whichever of these routes is used to pay pension income, after the date of implementation, the same general benefit rules will apply to the pattern of the income stream drawn from pension savings built up with tax relief. Once any lump sum has been drawn, the remainder of matured pension savings must be used to provide pension income. The rules about pension income will be more liberal than now. It must:

- start no later than age 75;
- until 2010, not start before age 50, or by 2010 not before age 55, with an exception for ill health retirement;
- last for the remainder of the person's life;
- be paid in instalments at least annually;
- not be assigned to anyone other than the permitted beneficiaries;
- not be guaranteed for more than 10 years;
- up to age 75, not offer a capital guarantee of more than value protection;
- lie between certain maximum and minimum income limits, if it is not underwritten by an insurance company or promised by an occupational scheme; and
- be taxed as income in the normal way – that is, under schedule E.

5.25 Many features of these general benefit rules are familiar from the present pension rules. For instance, the rule preventing assignment of pension rights makes sure that people get the benefit of their pension savings. And the age 75 rule is to ensure that pension savings built up with tax relief are used efficiently – that is, that the influence of mortality drag is not too great. This issue was discussed in depth in the Government's consultation document *Modernising Annuities* published earlier this year.

5.26 Once the proposed reform is implemented, all pension schemes will have more flexibility about the pattern of paying retirement benefits, reflecting one of the key themes of the Pickering report[4]. It makes no sense to allow the current inconsistent rules for different kinds of scheme benefits to continue. Subject to what the scheme rules permit, in future all pension schemes will be able to allow:

- until age 75, payment of benefits in stages not necessarily all at once – known in the industry as staggered vesting;
- more flexible income patterns than a pension or annuity can currently provide within the general benefit rules;
- until age 75, payment of a limited taxable death benefit offering value protection – that is, a final payment on death of no more than the value of the retirement savings used to establish the income paid by the scheme less the actual amount of pension paid before death, and subject to a tax charge of 35 per cent; and
- survivors' benefits.

5.27 This considerable, additional flexibility in the proposed new general benefit rules will mean that the same range of choice about income patterns can be available for members of both occupational and personal pension schemes in the future. At the moment people with pension savings in occupational schemes have appreciably less flexibility than people with personal pensions. As with other tax limits for pensions, it will be up to schemes to determine what benefits are actually available.

[4] A simpler way to better pensions: an independent report, Alan Pickering, July 2002.

5.28 The simplified general benefit rules are intended to allow pension schemes to pay benefits to meet their members' needs. They are set out in broad terms to leave scope for the pensions industry to develop new products to meet the evolving needs of pension savers and their employers. This is a change of approach. In future the legislation will set out what schemes can achieve, rather than saying what specifically is allowed.

Death benefits

5.29 Simplification of the taxation of pensions will also set a consistent set of rules about what kinds of benefits pension schemes may pay on the death of a member. As now, the actual death benefits available will be set in scheme rules.

5.30 The existing tax rules all permit, but do not require, pension schemes to pay benefits on the death of a working scheme member. This is to recognise that working people often have dependants who will need support. The rules about the death benefits which schemes may pay have developed over the years. Like many of the other tax rules for pensions, they do not always make a coherent picture.

5.31 The reformed tax rules will allow all pension schemes to pay the same range of benefits if scheme members die before vesting their pension savings, namely:

- unlimited tax free lump sums, except for the recovery charge; and/or
- taxable income benefits for survivors or dependants.

5.32 Whichever mix of benefits is to be paid, the funds providing them must first be tested against the lifetime limit.

Death while receiving benefits

5.33 For scheme members who die after starting to receive benefits from the scheme, the tax rules will allow:

- up to age 75, limited lump sums, taxable at 35 per cent, of no more than the value of the vested funds used to provide the pension income less the sum of the pension payments paid before death; and
- taxable income benefits for survivors or dependants.

5.34 These new rules reflect the fact that pensions get favourable tax treatment so that they can establish income in retirement. This is why it will not be possible to pay any capital sums past age 75, the age by which pension savings must be used to deliver retirement income. They also signal that pension tax relief is not provided to encourage estate planning.

Trivial commutation

5.35 The reform proposals will extend a valuable existing concession in order to help people with relatively small pension savings. It can be administratively inconvenient, and correspondingly expensive, to turn such small funds into pension income. The current rules do permit some small benefits to be paid as a lump sum rather than as an income stream – a process known as trivial commutation.

5.36 These rules, which allow conversion of all pension rights to lump sums for funds smaller than would deliver benefits of £260 a year, are overdue for reform. In future the new rules will be more liberal. They will allow people over 65 whose total matured pension funds from all sources amount to no more than £10,000 in value to take them, if they wish, as a lump sum. The first 25 per cent of the lump sum will be tax free, and the remainder taxed as income. The Department for Work and Pensions (DWP) will need to make matching changes to its rules.

5.37 It will be important for this rule to apply to accumulated funds from *all* of someone's matured pension savings, including any part which represents protected rights – that is, funds saved by people who pay lower national insurance contributions by contracting out so as not to receive the state second pension. This measure is not intended to be a way of allowing people to fragment their funds in order to extract capital from pension savings built up with tax breaks. So it will not be possible to commute funds in this way more than once.

5.38 Relaxing the commutation rules will help people on lower incomes who will find larger lump sums attractive. It will end the practice of forcing people to buy small protected rights annuities, which rarely offer good value since relatively few providers are willing to accept very small funds for turning into annuity income.

Serious ill health commutation

5.39 It will also be possible for people in very poor health to take serious ill-health commutation. Under the current legislation, only certain kinds of scheme can offer this choice. After the date of implementation, all pension schemes will be able to do so. It will allow people younger than 75 with unvested pension rights, who have severely reduced life expectancy, to withdraw all the value of their pension as a tax free lump sum if the pension scheme rules allow it. This approach is intended to help seriously sick people manage their financial affairs more easily.

Annuities

5.40 People who use annuities to provide their retirement income can achieve considerable control over how their income is paid. Under the proposed reform, they will have an even wider range of choice about how they use their pension savings.

5.41 As now, people will be able to take all their pension benefits at once, when they stop work and retire. They can obtain a tax free lump sum and use the remainder to buy an annuity to last for all their retirement. Or they can vest their pension savings in stages.

Consolidating funds before buying an annuity

5.42 Under the present rules, it can be difficult for people to make the best of this approach. They may have to split their pension savings into two funds, one for protected rights and one for the remainder. The feedback on *Modernising Annuities* earlier this year suggested that for some people it would be advantageous to allow all pension rights, including protected rights, to be aggregated so that people could get best value by buying an annuity from a single fund of pension savings. The Government recognises the importance of this issue and is keen to find ways in which it could be simpler and easier for people to choose annuities to provide good value.

5.43 It is important that people select annuities suitable for their personal circumstances. First they need to choose which kind of annuity: for example, whether to take a flat or an indexed annuity, and whether to build in benefits for any surviving dependants. Then they should consider the value of shopping around to find the annuity product of their choice at a competitive price. The Financial Services Authority (FSA) has recently made it easier for people buying annuities to be made aware of their rights and opportunities. The green paper discusses this key process in greater depth.

Drawdown

5.44 Another way of vesting pension savings, again already available, is drawdown. Someone with personal pension savings can vest some or all of their fund, take a tax free lump sum within the normal rules, place the remainder into a drawdown account with a financial firm, and draw an income stream within certain limits. By the time they reach age 75, all the remaining fund must be used for pension income. This approach gives people a good deal of control over the pattern of their retirement income, at the cost of some financial inefficiency. Some people with larger funds find this trade-off acceptable or even attractive.

The age 75 rule

5.45 The Government's proposals retain the age 75 rule. That is, all pension funds built up with the benefit of tax relief must be drawn as benefits by that age. However, in line with the general principles about retirement benefits, there will be more flexibility about how people may determine the pattern of their income, including income in drawdown. These general benefit rules will take the place of the existing limits on the amount of annual drawings. They will clearly need professional financial advice about how best to husband their pension savings, taking due account of their other resources.

Death in drawdown

5.46 If people decide to use drawdown, and die before age 75, there is a residual fund of unused pension capital left at death. This residual capital has been built up with tax relief to provide retirement income. This tax relief was not awarded to encourage people to build up capital for legacies. So any residual paid into someone's estate on death bears a tax charge of 35 per cent before it is paid into the retired person's estate. This charge will continue, but the amount of payment will be limited by the general benefit rules.

5.47 In future the same tax charge of 35 per cent will apply to any payments of capital up to age 75 on death after vesting pension benefits. As set out in the general benefit rules, such payments will only be possible up to age 75. If someone older than 75 dies, the only residual benefits their pension fund can pay will be income benefits to survivors or dependants.

Different kinds of annuity

5.48 Annuities provide an efficient way of using capital to produce income because they benefit from pooling retired people's longevity risks. In effect, annuities return not just interest income on the capital paid for the annuity but also some element of capital in line with the life expectancy of the group of annuitants using the same annuity provider. This is because annuity providers pool risk across all annuitants.

5.49 The Government has encouraged flexibility in the use of annuities for tax privileged pensions. For example, it is possible to use various kinds of investment linked annuity. The key requirement is that the income generated by the annuity must be sustainable for the pensioner's life.

5.50 The new simplified benefit rules are intended to allow for further development of the annuity market. Annuities will still have to meet the essential criterion of providing a secure and permanent lifetime income. Within that boundary, and the general pension benefit rules, the industry will be able to develop new kinds of annuity to meet customers' needs. They might, for instance, have significantly different income profiles than are available now, perhaps with upward steps at certain ages or contingent on certain events.

Limited period annuities

5.51 In particular, the new benefit rules will permit limited period annuities. This idea, discussed in *Modernising Annuities*, is essentially a development of drawdown. It would permit someone vesting a personal pension fund to use part of the fund to provide an annuity for a predetermined period, perhaps three or five years. At the end of this period the pensioner could use the remainder of the fund, with any capital growth, to buy another limited period annuity or to buy a lifetime annuity.

5.52 Used in this way, limited period annuities will be an alternative to drawdown which some people may find attractive. So if someone dies before age 75 while receiving income from a limited period annuity, the residual part of the pension fund will be taxed at 35 per cent, the same as if someone dies in drawdown.

Value protected annuities

5.53 The feedback on *Modernising Annuities* showed some interest in value protected annuities. This kind of annuity could make a residual payment on the death of the annuitant before age 75, equal to the difference between the amount paid for the annuity and the stream of payments made under the annuity before death. Of course, some annuitants will stand to get no such payment because they survive longer than average. And anyone using this kind of annuity will receive a lower income because of the cost of buying the implied insurance. So value protected annuities may not suit everyone.

5.54 After pension simplification, the new benefit rules will allow this kind of annuity too. Where someone below age 75 dies in circumstances which mean that a residual payment is made, there will be a 35 per cent tax charge on the residual, as for drawdown and limited period annuities.

5.55 With the introduction of value protected annuities, it is possible that demand for guaranteed annuities may decline. These annuities undertake to pay out a stream of income for a period of up to ten years whether the purchaser survives or not. Feedback earlier this year suggested that this kind of annuity is found cumbersome and unsatisfactory. Nor does it offer a consistent level of protection, since annuity rates vary. It would be helpful if feedback could discuss whether demand for guarantees is likely to change after the pensions tax reforms are introduced.

Innovation

5.56 The general benefit rules are intended to set a framework within which pension schemes and pension providers can develop retirement benefits to suit those who will receive them. It would be helpful if feedback could explore how this freedom could be used to the advantage of pensioners and their employers.

5.57 Some more detailed points about how the proposed reforms could work are explored in Annex B.

QUESTIONS FOR FEEDBACK

- *Is there a case for any special transitional rules for people in occupational schemes whose normal retirement age is lower than 50?*
- *What sort of pension patterns might pension schemes and pension providers choose to offer under the proposed general benefit rules?*
- *Should index linked pensions take account of falls in the Retail Prices Index?*
- *Should the general benefit rules specify any further detail?*
- *Will the general benefit rules allow the annuity market sufficient scope to develop new products to meet users' needs?*
- *Would there be value in allowing people with modest pension savings to aggregate all their savings, including protected rights, before buying an annuity?*
- *When value protected pension benefits are available, is demand for guaranteed pensions likely to change?*

6 Making it happen

The reformed legislation will provide a clear and firm framework for the future tax treatment of pensions, avoiding the extensive use of discretion on which the current rules rely. This will give everyone involved in pensions greater clarity and certainty about what is required and what is allowed. This streamlined style of legislation will support the considerable savings in administration costs expected. It will also allow and encourage the pensions industry to develop its products to meet the needs of users. The Government now looks forward to an informed debate on the proposals for reform.

Achieving the transition

6.1 For the future the Government proposes a new set of tax rules which will apply to all pension savings after the date of implementation (A-day). This date will very probably be at the start of a tax year.

6.2 This is a new approach to pension reform. It will mean that everyone saving for pensions will use a new set of tax rules for pension saving from A-day onward. Their pension rights built up before that date will be respected, subject to the limits in place at A-day, but not their ability to continue saving under the previous rules.

6.3 Building on the established principles for pensions, this fresh approach offers a huge advantage. Once people's pension rights at A-day have been valued in a straightforward way, all pension administrators will have a single set of tax rules from which to work. This method of implementation should cut compliance costs significantly. This aspect is discussed further in Annex A.

Maintaining pension schemes

6.4 The current system of tax approval for occupational pension schemes operates in a very different fashion to how it works for other savings vehicles. Taxation of pensions relies primarily on prior approval of occupational schemes' rules, with the threat of withdrawal of tax relief if schemes do not keep to their rules.

6.5 By contrast, providers of ISAs are simply required to register as managers and respect the rules about what investments qualify for tax relief. Auditing then picks up and corrects any errors. The great advantage of this approach is that providers of ISAs can readily establish for themselves what kind of scheme qualifies for tax relief and what does not.

6.6 Simplification affords an opportunity to apply the same basic approach to pension schemes.

Discretion

6.7 A major feature of the current tax system for pensions is that it gives the Inland Revenue discretion about approval of pension scheme rules, and subsequent rule changes. When it was established, this approach was intended to offer pension schemes some flexibility in setting up their rules

6.8 In the modern world it would be more efficient to set clear and firm rules for schemes that can qualify for tax privileges. Then there will be no need for prior approval of pension schemes or rule changes, and no doubt about what will be allowed for pensions.

Style of the new legislation

6.9 So the reforming legislation for pensions will set a straightforward system of rules for pensions that will qualify for tax privileges. As for ISAs, there will be a system of registration for tax approval for pension schemes and pension providers. People running pensions will be able to work out for themselves whether they qualify. Inland Revenue staff will of course be available for advice, as happens now for ISAs.

6.10 This fresh approach will enable the Government to sweep away hundreds of pages of pensions legislation, together with approaching a thousand pages of guidance. The new legislation will provide pension schemes with clarity and certainty about what will qualify for favourable tax treatment.

6.11 Legislation for the reformed pensions rules should be much shorter than the present morass of powers, supplemented as they are by extensive detailed guidance notes. Wherever possible, the new powers will be:

- easy to understand;
- easy to enforce;
- easy to implement; and
- prescriptive *without* scope for the Inland Revenue to apply discretion.

6.12 So this style of legislation will:

- help keep costs down;
- provide people saving for pensions with better value;
- give everyone using pensions greater certainty about what is allowed; and
- encourage innovation in pension scheme design, to meet the needs of modern working practices.

6.13 In particular, this will mean that schemes can readily understand what features of a pension scheme will qualify for favourable tax treatment:

- who can set up a tax privileged pension scheme and how;
- how tax relief can be claimed;
- what contributions qualify for tax relief;
- how the pension scheme can get tax relief;
- what benefits paid by the scheme are acceptable; and
- how the compliance process will work, including rights of appeal.

6.14 In the new legislation, the Inland Revenue will seek to adopt a clear and transparent approach – as with the Tax Law Rewrite project. This challenging objective should be a real advantage to people using pensions, for example employers setting up, adapting, or simply running, occupational pension schemes.

Process

6.15 The Government wants the ideas in this consultation document to facilitate an informed debate. The proposals in Chapters 4 and 5 are described in general terms so that readers can concentrate on the overall shape of the proposed reform without distraction into detail. Feedback will then help the Government decide how best to take forward the proposed reforms.

6.16 When the Government has considered the responses, the Inland Revenue will firm up supporting details for a further round of consultation. Some further details are set out in Annex B. However, this document does not cover every facet of the future tax treatment of pensions because it makes better sense for now to explore the broad principles of the intended reform.

6.17 The Government intends further consultation in 2003. Legislation to implement the new scheme could be then included in the 2004 Finance Bill. This could allow A-day to be 6 April 2004.

Challenges for the future

6.18 The new rules for taxation of pension schemes will give occupational pension schemes, and private sector pension providers, a great deal more scope to design pensions to meet perceived needs than now. In practice most current schemes echo the main features of the tax rules. In future that will rarely be necessary.

6.19 So people interested in pension design – employers sponsoring occupational schemes, private sector scheme providers, pension savers and their representatives – should begin now to consider how they could develop pension schemes when the tax rules are more liberal. This is an opportunity to modernise pension schemes, perhaps rebalancing risk between employers and employees. In the round, it should allow pensions to offer more choice, flexibility and value.

6.20 It would be helpful if feedback could discuss this subject, even in general terms. It will help the Government decide how to modernise tax legislation for pensions to have some idea of how pension schemes might use the intended new freedoms.

Advantages of reform

6.21 The Government believes that these proposals offer substantial advantages for nearly everyone involved in pensions:

- 99 per cent of savers will be able to save more into a pension if they want to and can afford it, and will find it easier to arrange to do so;
- many people in occupational schemes will stand a chance of a larger lump sum if their scheme's rules permit it;
- everyone approaching retirement will be able to negotiate about flexible retirement, helping employers manage their businesses responsively in modern fast moving markets;
- lower costs will make it easier for employers to establish and support pension schemes, and to redesign them to meet their and their employees' evolving requirements; and
- financial services providers will be able to concentrate on running their businesses without complex administration to comply with tax rules, feeding savings through to better value and/or better support services for savers.

The way ahead

6.22 The Government wants a good future for pensioners. Retirement should offer security, dignity and independence. This document is about how tax privileged pension savings can help people achieve that.

6.23 There is no escaping the key message that securing a comfortable retirement now means saving more and perhaps working for longer. The Government accepts that this means that people need to understand more readily how pensions operate, to maximise incentives to save. Simplifying taxation of pensions will also reduce the compliance burdens that all providers of pensions must face.

6.24 This consultation exercise should be seen in the context of several recent Government commissioned reports into different aspects of savings and pensions by Paul Myners[5], Ron Sandler and Alan Pickering. These reports all emphasise the importance of common sense about saving, investment and planning pensions. In order to secure the transparency they advocate, it will be essential to sweep away the complexity which can so easily obscure the underlying processes. The objective is to boost people's confidence in the quality of their pensions. That will be a sure foundation to encouraging more saving for retirement.

6.25 Complementing the green paper published at the same time, the proposals in this document are a critical step forward in the programme of reforms foreseen in these three reports. They are intended to bring about radical simplification of one of the major impediments to saving for retirement. In partnership with employers and the financial services industry, the Government seeks to bring about a more rational environment in which people can plan for retirement with confidence.

QUESTIONS FOR FEEDBACK

- *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?*
- *Which changes in scheme design are the most pressing?*
- *Is it feasible to plan to implement the new tax arrangements by April 2004?*

[5] *Institutional Investment in the UK*, Paul Myners, March 2001.

A PARTIAL REGULATORY IMPACT ASSESSMENT

A1 This document proposes radical simplification of the taxation of pensions. The purposes of the reform are:

- to replace the eight existing tax regimes with a single, universal regime, thereby increasing choice and flexibility for those saving in pensions; and
- to reduce administration and compliance costs for sponsoring employers and pension scheme administrators.

A2 In order to deliver the single tax 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 cost of the transition will be recouped quickly by the savings arising from the simpler new arrangements.

Purpose and intended effect

A3 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 pension. Once these are in place, all increases in future pension rights will follow these rules. All existing pension rights under the old rules will be crystallised and protected.

Risks

A4 The main risk of *not* introducing significant simplification is that the pension industry is overburdened with the complexity of the current rules and continuing high administration costs. It is clear that the existing rules discourage pension saving and discourage employers from sponsoring pension schemes.

A5 There are also some risks in applying radically different rules to the well established system of taxation of pensions, in which a lot of advisers are expert. The Government intends that the new set of rules should be so simple that the additional work they will face will not pose a barrier to helping people to save.

Policy proposals

A6 This document 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.

A7 The new rules will set a single, lifetime limit on the amount of pension savings that can benefit from tax relief. In practical terms this will mean that most people can make pension contributions with tax relief up to what they can afford. When the new regime starts, anyone who builds up pension rights worth more than the proposed lifetime limit of £1.4 million will bear a recovery charge of one third when they draw down any funds in excess of the lifetime limit.

A8 Alternatively, the current tax rules for pensions could be retained and the new regime introduced only for new pension scheme members. This 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, because it would not tackle the complexity of the current tax rules and the restrictions, distortions and unnecessary compliance burdens it creates. 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.

Benefits of the proposed reform

A9 To be more specific about the advantages of the proposed reform:

- for industry – scheme administrators and sponsoring employers – a recent Inland Revenue sample survey suggests cost savings of at least 5 per cent or about £80 million a year. Since the question asked was at that stage necessarily vague and theoretical, it is possible that this figure may be an underestimate;
- employers will gain because the new rules will allow flexible retirement, helping them retain experienced staff and encouraging staff to stay on longer in work;
- pension scheme savers will nearly all be able to save more with tax relief if they wish, the exceptions being a small number of high earners;
- members of occupational pension schemes should have more opportunities to use their pension rights flexibly, to mix work and retirement toward the close of their careers; and
- people not yet saving for a pension will find it easier to get started since 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.

A10 In addition, the new regime will allow for greater flexibility over scheme design. This will mean more choice for industry, pension scheme members and employers alike.

Implementation costs

A11 The pensions industry will have one-off transitional costs for systems changes, documentation and training. These costs will not be heavy and the Government will work with industry to keep them to a minimum. It would be helpful if feedback could discuss what would be involved and its likely cost.

Other impacts

A12 The Government will also have one-off implementation costs of some £5 million to set up new systems. In addition there will be costs related to new documentation and retraining. The Government will also have lower ongoing costs in administering tax reliefs for pensions when the rules are simpler. It will be possible to quantify these in light of consultation.

Competition

A13 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 considering offering 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.

Compliance

A14 The present compliance regime for pensions is old fashioned by current standards. The new tax rules will provide an opportunity to establish modern and proportionate arrangements for awarding tax relief and preventing abuse. There will be graded penalties for non-compliance, taking proper account of the size and gravity of breaches or mistakes, and the willingness of those concerned to disclose and cooperate with enquiries. Tax approval for schemes will be withdrawn only in the most serious of cases.

Impact on small business

A15 Simpler tax rules, with lower administration and compliance costs, will be particularly helpful for small businesses. It will be easier and cheaper for them to sponsor or contribute to a pension scheme for their employees.

A16 Those small businesses using small self-administered pension schemes (SSASs), could face some additional transitional costs. These will be minimised by allowing existing investments to run their course. In the long run, these businesses will gain by having a more secure basis for the investments of their pensions.

A17 Those small businesses that provide administrative or pension trustee services to SSASs could be affected by the proposals. We will assess the possible impact of these proposals in the light of responses to the consultation.

QUESTIONS FOR FEEDBACK

- *Is the estimate of 5 per cent (£80 million a year) administrative savings for the pensions industry realistic? Might the savings be greater?*
- *In particular, could pension scheme administrators estimate, ideally both in financial terms and as a percentage, the potential long term savings?*
- *What are the one-off implementation costs to industry likely to be?*
- *In particular, could pension scheme administrators estimate the likely transition costs?*
- *What will be the impact on small businesses of bringing the special investment rules for SSASs and self-invested personal pensions (SIPPs) in line with the prudential norm for other pensions?*

B TECHNICAL DETAILS

B1 This document sets out the direction which the Government proposes to take in reforming and simplifying taxation of pensions. It does not offer a complete blueprint for change. Only when the shape of the reformed scheme for the taxation of pensions is clear will it make sense to set out the full proposals, with draft legislation.

B2 Nevertheless, there are some details worth exploring at this stage. This Annex identifies some of the main issues which the next round of consultation will cover in greater depth. It does not pretend to offer a full specification of the proposed reform. But it may clear up some key questions which the main body of this document does not discuss since not every reader will find them of interest.

B3 In considering the issues in this Annex, it is important to appreciate that the Government intends to achieve a reformed tax structure for pensions which applies a single coherent set of rules to every kind of pension qualifying for favourable tax treatment. This will inevitably mean that some existing features of pension schemes will not survive.

B4 Pension experts will recognise the issues discussed here as important. It would be helpful to have some preliminary feedback at this stage to help the Government develop the reform scheme in full. This Annex begins by looking at some transitional issues, then goes on to some more detailed points about the administration of the proposed arrangements for taxation of pensions.

Transition

B5 There have been a considerable number of changes to the taxation of pensions over the years. Each change has been justifiable in its own terms. But often changes have added to the complexity of the taxation of pensions by giving long-term protection to people building up pension rights under previous rules. This process is usually called grandfathering.

B6 Protection of this kind can of course be justified. It means that people who started saving in one pension scheme can continue to get the same level of tax relief and rights to pension benefits as when they started to save, so long as they stay with the same pension scheme.

B7 Each time this kind of protection takes place, however, pension schemes have to maintain another set of rules. It does not take many rounds of change before most schemes have several layers of similar but subtly different rules to operate. To do this accurately, each scheme must record which set of rules applies to each member (see Chapter 2 for an account of the different kinds of rules which may apply).

B8 Apart from complicating administration and adding to costs, this approach can make people reluctant to move jobs. A potential new employer may be unable to match someone's pension rights in their existing job. In the long run this effect damages employers' ability to manage their workforces efficiently and effectively. It may also prevent people developing their careers and reaching their full potential.

B9 So the radical reform proposed in this consultation document will not take this route. It is important that pension schemes of all kinds can look ahead to the prospect of a common set of rules for all members in the future.

Principles of the transition

B10 At this stage it is important to focus the debate on the essentials of the reform ahead. Its inherent direction should not be determined by the detail of the transitional regime – important though that will be.

A different way to reform

B11 The Government will make decisions on the precise course of the transitional arrangements in the light of this consultation. The Government intends, where possible, to adopt a simple approach to transition using general rules to reduce administration. In practice this means that, provided they are within the pre A-day tax rules, pension rights beyond the lifetime limit will be indexed and honoured. Any further rights built up through savings after A-day will be determined under the new rules.

B12 Only the few people with pension rights at A-day above the new lifetime limit will need to value all their funds. Once this valuation process has been completed, there will be no need for schemes to keep track of pension rights established under previous tax regimes. The Government intends that no one will lose in this process. Indeed many will gain because the new rules will allow greater tax privileged saving than the current rules.

Large pension rights at transition

B13 People whose total pension rights at A-day, whether they are vested or not, exceed the lifetime limit will be able to get any unvested rights in full. To make this possible some special one-off valuation procedures will be necessary.

B14 For people in this position, who are already receiving some pension income from either a tax approved scheme or a buy-out policy, there will be a special procedure using simplified rules to assign a capital value to their pensions in payment. Then, when they begin to draw any unvested pension rights, the aggregate of their rights accumulated before A-day can be protected. As for people with invested pension rights, this procedure will involve registering with the Inland Revenue the total of someone's pre A-day rights. For defined benefit schemes the simplified calculation will be the value of pension rights payable at the scheme's normal retirement age based on the individual's pre A-day service and pensionable salary revalued with inflation up to retirement age and discounted appropriately using standardised actuarial factors. The Government will strive to ensure this process is straightforward.

B15 There may be a particular difficulty about valuation of with-profits funds, since a significant portion of the investment growth can be paid as final bonuses. It would be helpful to have experts' views on how this issue could be approached without undue complexity.

B16 People who turn large pre A-day pension rights into benefits will not face any tax charge on these registered rights. Of course any additional pension rights they may have built up after A-day will be subject to the proposed new rules for the taxation of pensions. People in this fortunate position will, in effect, secure a larger lifetime limit by registering their pre A-day rights.

B17 Measuring and recording each person's A-day rights will of course take time. The Government proposes to allow pension scheme members three years for this process. Schemes will therefore be expected to provide valuations of pension rights at A-day on request until the third anniversary of A-day.

Protecting lump sums

B18 It will clearly be important that people's existing rights to tax free lump sums built up before A-day are respected. The existing tax rules apply several different sets of limits to what pension schemes rules may allow to be paid in this form. Some of these limits are themselves complex, for example the limits on lump sums for occupational scheme members who joined after 1989 allow the choice of two different formulae.

B19 Setting comprehensive rules to protect every detail of these limits would be complex. Instead the Government proposes to allow the tax free lump sum to be the higher of:

- 25 per cent of the person's total pension rights both pre and post A-day; or
- an exact valuation of pre A-day lump sum rights, which would have to be carried out within three years of A-day, and indexed; or
- 3/80 for each year of service up to A-day multiplied by salary in the tax year to A-day, subject to the relevant limits in the tax regime governing the person's existing pension rights, and indexed.

B20 To make this calculation straightforward, the salary used for the third option would simply be that quoted on the person's P60 for the year before A-day. Using the P60 makes for ready compliance since it is a form that every employed person gets so they can settle their tax liability for the tax year immediately past. The actual lump sum allowed in any given pension scheme will of course be subject to what the scheme rules allow.

B21 For many people in occupational schemes this would mean that, if their pension scheme allows it, they could get a bigger tax free lump sum when they draw their pension benefits. It would also mean that the differences in rights to lump sums in the present rules would vanish – taking away one of the reasons why people are sometimes advised to move their pension rights shortly before retirement.

Helping pension schemes through the transition

B22 It will clearly be important that all pension schemes can adopt the reformed tax rules easily. But the process will not be automatic. Some pension schemes may choose to step aside from the new rules. These schemes are likely to be in the minority, but the Government wants to offer them the choice.

B23 So the new tax rules will give those running pension schemes – trustees or commercial operators – the opportunity to avoid being approved under the reformed tax rules for pensions. They will have a notice period of at least three months before A-day to get this position registered with and acknowledged by the Inland Revenue. Without an acknowledgement, any pension scheme approved under the current Inland Revenue rules will automatically be treated as registered under the new rules – and therefore expected to comply with them.

B24 Pension schemes, which opt out of the new tax rules for pensions, will be treated as funded unapproved retirement benefit schemes (FURBS). All pension rights paid from such a FURBS after A-day will be taxed. Full details of the tax treatment of these schemes will be developed for the next round of consultation.

The lifetime limit

B25 Chapter 4 explains that the lifetime limit will come into play when someone vests their pension rights from an approved scheme. The value of these rights will be compared to the lifetime limit to see whether the pension rights can be paid out as benefits in full without any further ado. If the rights exceed the lifetime limit, a recovery charge will apply.

B26 It will be important to apply the test against the lifetime limit to tax privileged pension rights coming into payment from all sources. Without complete coverage in this way some people would in effect get a higher lifetime limit because of the way that their pension provision had been arranged. So, for example, pension rights from buy-out policies and unvested funds when someone dies in service will also be tested against the lifetime limit.

B27 When pension schemes carry out the test against the lifetime limit, they will have to tell the Inland Revenue what percentage of the lifetime limit the person in question has used. The scheme will also need to tell the person receiving the pension benefits this percentage and to remind them of it every time they send an annual statement of payments and tax.

B28 This arrangement will help people with several sets of pension rights to vest their benefits. When they come to draw unvested benefits, they will readily be able to identify how much of the lifetime limit they have already used. The scheme running the pension the person proposes to vest, can then add the rights about to be vested to the amounts already vested to compare the total against the lifetime limit. The examples in Box B1 illustrate what is intended.

Box B1: Examples of flexible retirement

Example 1: Robert decides to draw benefits of £700,000 from his pension fund. This is well below the lifetime limit. His pension provider sends him a certificate to verify that he has used up 50 per cent of the £1.4 million lifetime limit and the Inland Revenue registers this. Some years later, Robert decides to make use of the remainder of his pension fund, amounting to £150,000. The lifetime limit is now £1.5 million so the second drawing of pension benefits is 10 per cent of the limit at that time. The two slices of the pension fund have provided benefits together worth 60 per cent of the lifetime limit (50 per cent plus 10 per cent) so Robert has no additional charge to pay.

Example 2: Barbara decides to use £1.12 million of her pension rights, using up 80 per cent of the lifetime limit of £1.4 million. When she comes to take the remainder of her pension benefits some years later, she has £750,000 – 50 per cent of the then lifetime limit of £1.5 million. She can take £300,000 of this (20 per cent of the current lifetime limit, namely the limit less the 80 per cent she has already used) subject to the standard rules for drawing pension benefits in Chapter 6. But Barbara must bear a recovery charge of 33 per cent on the remaining £450,000. After the recovery charge there is a residual fund of £300,000. This can be paid as a lump sum of up to £75,000 plus a pension from the remaining £225,000. Both the lump sum and pension will be taxed at Barbara's marginal rate.

B29 For people who have some pension income already being paid at A-day, the procedure will work in much the same way. The only real difference will be that the value of any pensions already in payment at A-day will need to be taken into account before benefits from a second or subsequent slice of pension rights can begin to be drawn. There will be a standard simplified conversion process to measure the capital value of pensions in payment.

B30 To make this process work effectively, it will be important to establish standard industry-wide routines from the outset. Adapting existing forms to identify how much of the lifetime limit has been used might be a good start. The Government is seeking feedback on how good practice could best be encouraged.

People with several pension schemes

B31 Some people may have saved using several pension schemes and may want to turn the matured savings into pension benefits all at once – a process which might be called simultaneous vesting. In the interest of fairness it will clearly be important that people in this position are treated in line with the rules for people who have saved for their pension in a single scheme.

B32 There will be a similar issue for people who have rights in several pension schemes and die before taking benefits from any of them. It will be important to make sure that the test against the lifetime limit is carried out fairly when death benefits are paid.

B33 The Government would welcome ideas from pension professionals about how this consistent outcome could be achieved. One possibility would be an industry protocol about communications among pension schemes – an approach which need involve little regulation if all parties can agree.

The annual limit

B34 Chapter 4 explains that the annual limit of £200,000 will apply to value inflows into someone's pension rights during a tax year and will be applied through the self assessment (SA) return.

B35 To make this approach work fairly, the SA return will need to use a consistent approach to measuring value inflows. They will include:

- all contributions to any defined contribution (DC) pensions, whoever makes them;
- the increase in value of any defined benefit (DB) rights in a scheme sponsored by the person's current employer, for any reason;
- the increase in value of any deferred DB benefits in excess of the greater of any statutory revaluation and national average earnings; and
- any discretionary increases in a pension already in payment that exceed indexation.

B36 In practice the SA process to enforce this could work as follows:

- a new worksheet will be provided with the SA return for pension scheme members. This will use an approximate filter – using DC contributions and approximate values of DB benefits based on length of service, scheme accrual rates and remuneration recorded on the SA return – to identify who would need to carry out a check. Perhaps 3 million people might need to consider this test;
- of these, the approximate calculation in the filter will probably suggest that some 5,000 people might have a value inflow of more than £200,000 in the last tax year. Only this much smaller group would need to obtain precise information from their pension schemes. Since all the employees concerned must have substantial remuneration packages, and quite possibly be directors of businesses, employers might well already have this information to hand for the requirements to report directors' remuneration, as recommended by the Greenbury report, in their published accounts;
- the 5,000 people concerned will then use this specific personalised valuation, which might well not be the same as the actual contributions into DB schemes, to calculate the actual value inflow using standard published valuation factors; and
- on carrying out the calculation, probably fewer than 1,000 people a year might then have to pay more tax.

B37 Employees already have the right to request statements of their pension rights – for example they may need this information on moving jobs. There is a good case for encouraging employers to issue these statements for employees routinely as standard practice. They could become a crucial ingredient in helping people saving for pensions to make informed decisions. Annual statements of this kind would highlight the significance and value of rights in occupational pension schemes, and provide a means to help savers compare different kinds of pension scheme. People getting annual statements of this kind would find filling in their SA returns easier.

B38 The examples in Box B2 help to explain how this aspect of the new tax rules for pensions would work in practice.

Box B2: Working the annual charge

Example 1: Pauline was a member of a DC scheme in the last tax year. She contributed £30,000 and her employer £90,000. These contributions are not caught by the filter conditions and so Pauline has nothing to put into her SA return.

Example 2: Christina is 50 and earns £600,000 a year. Last year she was in a DB scheme which accrues benefits at 1/30th a year of final salary. So last year her pension rights rose by £20,000 a year. The valuation tables give the value of a rise in the pension rights of a 50 year old woman at £11 per £1 of income. So her additional pension rights last year are valued at £220,000 (£20,000 x 11) and her employer tells her so. Christina must enter a benefit in kind of £20,000 (£220,000 – £200,000) on her SA return and will have additional income tax to pay on this amount.

Defined benefit (DB) pension rights

B39 The new pension rules will call for valuations of DB pension rights for two purposes: for comparison against the lifetime limit when benefits are drawn; and to check against the annual value inflow limit. There is a choice about how to approach these valuations:

- either accurately reflecting market conditions; or
- using simplified rules to make the calculations quick and easy.

B40 The Government proposes to set a standard actuarial table of age sensitive conversion factors to express DB pension rights as capital values. The table would be set by order and updated from time to time, perhaps at intervals of 3 to 5 years.

B41 This table of factors will make standard stylised assumptions, producing robust rounded factors which would not pretend to accuracy for all users of the test. For simplicity, the factors will be unisex and assume that pension rights include a survivor's pension set at half of the member's pension and rights to RPI indexation of the pension.

B42 It would of course be possible to make these conversion tables quite complex by allowing for a whole variety of potentially relevant factors such as gender, marital status, the range of survivors' benefits, and so on. To do so would lose sight of the fact that neither the lifetime nor the annual limit will affect many people. It makes better sense to use a standard default valuation procedure which is roughly, though not exactly, right for everyone. Using it will enable most people to establish quickly whether they are close to the relevant limit(s).

B43 Anyone who needs a more exact valuation, perhaps because their scheme offers benefits well out of line with the assumptions used for the standard tables, will need to agree the terms of the valuation with the Inland Revenue. The population of pension users likely to need to do this will be small. The next round of consultation will go into greater detail about how non-standard valuations could be done with least trouble all round.

B44 Sometimes pension rights are generously enhanced when they are brought into payment. Or the scheme may apply discretionary changes without altering the underlying rights. These enhancements will form part of the value of someone's pension rights that must be tested against the lifetime, or annual, limit if the enhancement exceeds the benefits assumed in the valuation factors.

Delivering tax relief

B45 There are two well established methods by which pension schemes can obtain tax relief on contributions to pensions. These will continue:

- pension schemes established by employers will still be able to use the *net pay arrangements*. That is, they will still be able to deduct pension contributions from employees' gross pay before applying income tax; and from their own contributions before tax and national insurance liability is determined. This arrangement has the effect of giving employees who are members of these schemes tax relief at their marginal tax rate; and
- other pension schemes will still be able to get *relief at source*. That is, they will still be able to gather contributions from their customers' take home pay or savings and reclaim basic rate tax relief by making an aggregate claim to the Inland Revenue for all personal contributions paid in. Higher rate taxpayers, who contribute to these schemes, will still be able to claim higher rate relief through their self assessment returns.

B46 In future, both ways of obtaining tax relief will be available, provided they apply to *all* of a scheme's members. So, schemes that have members who are self-employed must operate relief at source. A pension scheme only for employees may choose which approach it prefers. It would be helpful to have feedback on how this approach could best be made to work.

Who can contribute with tax relief

B47 Under the current tax rules, there are complex restrictions about which kinds of contributions to pension schemes can gain tax relief. The new rules will be simpler so that people can readily establish whether they can claim tax relief on contributions. The Government wants people to save in pensions without having to make regular checks against the tax limits.

B48 The new rules will treat any contributions to a pension scheme by someone who is not the scheme member's current or former employer as the scheme member's own personal contributions. Another key rule applying to all contributions will be that they can be made only by or for people under age 75.

B49 The rules for people who are resident and ordinarily resident in the UK, or who have some income chargeable to UK tax – the majority – will be straightforward:

- their own personal contributions will get tax relief on the higher of £3,600 (gross) or 100 per cent of UK chargeable earnings;
- employer contributions will get automatic tax relief except for contributions for directors and connected persons where the normal rules on deductions will apply; and

- there will be no limit on tax relieved contributions from current or former employers.

B50 The rules for people who are not resident and ordinarily resident in the UK and who are not chargeable to UK tax on their earnings, but who choose to contribute to UK based pension schemes, are less generous:

- they will be able to make unlimited personal contributions, but without tax relief; and
- their employers, current or former, will be able to make unlimited contributions, but only UK tax resident employers will be able to get tax relief on them.

B51 The rules for people who are not resident and ordinarily resident in the UK and who are not chargeable to UK tax on their earnings, but who have been resident and ordinarily resident or have had UK chargeable earnings in the last 6 years, are similar but slightly more generous:

- they will be able to make unlimited personal contributions, with the first £3,600 (gross) a year eligible for basic rate tax relief if their contributions go into a scheme which operates relief at source; and
- their employers will be able to make unlimited contributions, but only UK tax resident employers will be able to get tax relief on them.

B52 Some employers who are not UK tax resident may have employees who are pension scheme members in each of these three groups – for example, a UK based branch of a non-UK employer. Employers in this position will need to arrange for their contributions to be actuarially apportioned between those where tax relief can be claimed and those where this is not possible.

National insurance rebates

B53 National insurance rebates will not count against an individual's contribution limit or value inflow. However, all funds regardless of source will be tested to see if the recovery charge applies.

Operational issues

Who can establish a pension scheme

B54 The new rules will specify who may set up a pension scheme that may claim tax relief. As now, those permitted will include both employers and financial firms, subject to appropriate prudential regulation, selling pensions direct to savers. The next round of consultation will cover this in more detail. In the meantime, it would be helpful to have feedback from any new group which thinks it might be able to offer pensions and should be recognised for this purpose in the new legislation.

Legacy schemes

B55 As Chapter 2 explains, there are a number of kinds of pensions which are no longer open to new members but which linger on to some extent. For the avoidance of doubt it may be helpful to spell out how the new rules will apply to them.

Old code

B56 The operation of old code, pre 1970, schemes will not be affected, except any pension rights will count towards the lifetime limit and any recovery charge due will be collected directly from the member. As now, it will not be possible to make contributions to old code schemes.

Retirement annuity contracts

B57 After A-day contributions to retirement annuity contracts (RACs) will follow the same rules as for all other pensions. As for other schemes, pension rights above the lifetime limit built up under their rules before A-day will be honoured. The carry forward and carry back rules will no longer apply since the lifetime limit will offer more flexibility. The Government also intends that, as for all other pensions in payment, pensions paid from RACs will be taxed as income under schedule E. It would be helpful to have feedback on any practical issues about how this should be achieved.

Buy-out policies

B58 After A-day, buy-out policies, also known as section 32 policies, will need to be fitted into the new rules. The Government is minded to require life offices providing new buy-out policies to provide these under an approved scheme, rather than making them free standing as now. Benefits from pre A-day buy-out policies will count towards the lifetime limit.

Personal pensions

B59 Personal pensions will fit very well within the new tax rules for pensions. Simplification will mean that one existing feature will go – the facility to carry back certain contributions. The generous lifetime and annual limits make that facility quite unnecessary.

Reporting requirements

B60 The new pension rules will need new reporting requirements. The Government will establish these as part of this consultation process. The Government's initial view is that the following information will form the core of the future annual reporting requirements:

- data to identify the scheme member, for example: name, address, national insurance number, gender and date of birth;
- whether the scheme member is resident and employed in the UK;
- contributions for any scheme members – either individually or as part of a group – getting tax relief under the relief at source arrangements;
- vested benefits, or, in other words, matured pension scheme savings converted into benefits in the relevant year; and
- any transfers of pension rights out of UK tax approved pension schemes into schemes elsewhere which do not have a UK resident administrator.

B61 It would be helpful to have feedback on whether these reporting requirements would be feasible.

Pensions on divorce

B62 The present tax rules allow people who divorce to split their pension rights when dividing their assets. The fact that this is possible can affect the terms of the divorce settlement, without actually disturbing the pension arrangements of the people involved. This feature will remain. It will be necessary to establish some rules about the division of pension rights on divorce under the new pension rules.

B63 In the reformed pension rules, the requirements will be:

- a former spouse, who receives pension rights under a divorce settlement, will not have to count these transferred rights against his or her lifetime limit under the new rules; and
- correspondingly, someone who transfers pension rights on divorce to a former spouse will have her or his lifetime limit reduced by the value of the transferred rights.

Prudential standards

B64 As for other features of the new tax rules for pensions, the Government intends to apply a single set of investment requirements to all pension schemes. The rules will mean that the same quality of prudential standards will apply to all schemes. Box B3 below illustrates that the prime purpose of providing retirement benefits is not always the main consideration when schemes plan their investments. Recent corporate events in the US, for example, have emphasised the relevance and value of having such rules.

B65 This approach would mean that the emphasis would be on building up retirement benefits rather than using the tax reliefs for tax advantaged investment in the sponsoring employer company. The new rules will set:

- limits on the holding of shares in the sponsoring employer's company so that the current 5 per cent requirement for larger occupational schemes would apply to all;
- limits on loans to employers; and
- limits on loans to scheme members.

B66 These investment rules will apply to new investments. There will be transitional rules to protect schemes from having to make urgent disposals of assets incompatible with the new rules.

Box B3: Small self administered pension schemes (SSASs)

A representative sample of the 33,000 active SSASs registered with the Inland Revenue shows that:

- **42 per cent have outstanding loans to the scheme's sponsoring employer;**
- **5 per cent hold investments in the sponsoring employer, which will often be illiquid; and**
- **39 per cent own commercial property used by the business of the sponsoring employer.**

It is hard to resist the conclusion that many, perhaps most, SSASs have assets that provide only limited protection for the pensions of scheme members in the event of the failure of the sponsoring business. The way the schemes are advertised confirms this: providers stress their tax efficiency not their quality as pension schemes. In other words, SSASs are not using tax breaks to help people develop secure retirement income, as they are intended.

Source: Inland Revenue, 2002

B67 The Government recognises that these rules will affect schemes with special arrangements now – notably small self administered schemes (SSASs) and self-invested personal pensions (SIPPs) which would have to adopt the new and consistent limits in due course. The single set of rules will have common prudential standards of a reliable quality. Bearing in mind that whatever rules are introduced on prudential investments will have to apply equally to all schemes, it would be helpful if feedback could suggest the restrictions that should apply to loans to employers, loans to scheme members, and commercial property transactions with the sponsoring employer.

Surpluses

B68 The Government's proposed reforms will not limit benefit payments. So the concept of a surplus in defined contribution schemes will generally not apply. However, for defined benefit schemes a surplus of assets over promised benefits may still arise.

B69 So there could still be circumstances in which a sponsoring employer might want to extract funds from a pension scheme because it had more than sufficient funding to meet its foreseeable liabilities. The Government does not in principle object to allowing sponsoring employers to extract value from a pension scheme in these circumstances, subject as now to a tax charge of 35 per cent.

B70 It will clearly be important for the rules about how such extraction of funds can take place to accord with developments in the rules about scheme solvency – essentially, the successor to the minimum funding requirement (MFR) discussed in the green paper. It would be helpful if feedback could discuss how this might work.

Other benefits

Income from unsecured funds

B71 Most income drawn from pension rights is likely to continue to take the form of benefits promised to be paid for the duration of the member's life. These income streams will usually be provided by a pension scheme or financial institution as secured benefits. The new general benefit rules will, however, allow more innovative kinds of pension income for people, known as unsecured benefits, because there is no guarantee that they will continue for life. For these, the successors to drawdown in the present rules, there will need to be some simple rules to prevent matured pension savings being drawn down too quickly.

B72 Income from unsecured funds will allow:

- a minimum annual income of £1; and
- a maximum annual income related to the annuity that the funds supporting the pension could achieve on the open market;

provided that

- the maximum income taken is reviewed at intervals of no less than 5 years, or annually after age 75; and
- all income arising from unsecured funds in a year is tested against the maximum income that can be drawn.

B73 Anyone taking this approach will clearly need regular financial advice about the best way of deploying their pension savings, bearing in mind that value protection will cease at the earlier of age 75 or when payments have exceeded the initial value of the pension.

Value protection

B74 Under the new rules, members' pensions, whether secured or unsecured may be value protected. This can take one of two forms:

- an income guaranteed for a minimum period so that even if the member dies, the remaining pension instalments will be paid for a period not exceeding ten years from the start of the income; or
- an undertaking to return the capital value of the vested pension fund up to the value of the fund providing pension income less any income instalments paid, less a tax charge of 35 per cent and only if the pensioner dies before age 75.

B75 There will need to be some light touch rules about how value protection can be applied:

- once income benefits have begun to be drawn, value protection cannot be introduced; and
- if someone chooses to use the protecting the capital value option at the outset of drawing benefits from their pension rights, they cannot subsequently choose to arrange for their income benefits to pay a guaranteed stream of income.

Survivors' pensions

B76 As Chapter 5 explains, the new rules will not limit the taxable income benefits that pension schemes may pay to survivors on the death of a member. It will of course be important for the value of any survivors' income benefits to be taken into account when pension rights are valued for comparison against the lifetime and annual limits.

B77 To be more specific:

- it will be for pension scheme trustees and administrators to determine who is eligible for a dependant's pension – provided that those concerned are real people rather than legal persons, and that there was some financial interdependence with the scheme member before their death if the person concerned is not a spouse or minor;
- where survivors' benefits are paid as income to an adult dependant, they must continue for life with scope for the scheme to stop them if a spouse remarries;
- where survivors' benefits are paid as income to a dependant who is not an adult, the income must stop at age 23 unless the person concerned is dependant because of ill health;
- any residual funds remaining on the death of a member or a dependant receiving income from unsecured funds may be paid as income to a dependant; and
- survivors' pensions cannot be value protected to ensure that tax relief is primarily directed, as has always been intended, to providing income benefits in retirement – and not for estate planning.

Life assurance

B78 The new rules permit death benefits up to the age of 75 for members of pension schemes. For the avoidance of doubt, these may be arranged by using pension funds to buy life assurance, provided the scheme rules allow it. Any proceeds of such contracts will be checked against the lifetime limit.

QUESTIONS FOR FEEDBACK

- *Is a simple, but broadly fair approach to the transition the most appropriate one?*
- *Are there any other important factors the Government should consider in drawing up rules for the transition?*
- *Is three years an appropriate period to allow for valuation of pre A-day rights? Could this process be achieved more quickly?*
- *How long do pension schemes need before A-day to tell the Inland Revenue that they propose to opt out of the new rules for tax relief?*
- *How should pre A-day pension rights in with profits funds be valued?*
- *How should simplified rules for defined benefit pension rights be set?*
- *What is the best way for pension schemes to tell their members what percentage of the lifetime limit their vested pensions entails – both at vesting and annually afterwards?*
- *Are the suggestions on valuing defined benefit (DB) benefits feasible?*
- *Can the pensions industry develop arrangements to deal with cases of simultaneous vesting?*
- *Are the proposed rules about which contributions can qualify for tax relief appropriate and feasible?*
- *Are the proposed rules about contributions to UK based pension schemes by non-residents appropriate and feasible?*
- *Are the proposed regular reporting requirements reasonable and feasible?*
- *Are the rules for splitting pension rights on divorce appropriate?*
- *Are there any features of SSASs and SIPPs which should be considered for all pension schemes?*
- *How could rules about loans from pension schemes be established without prejudicing scheme solvency?*

C

Questions for Feedback

This Annex gathers together the questions for feedback listed at the end of the relevant chapters and annexes of this document. If you are replying to this consultation, it is not essential to stick to these questions or indeed to attempt to cover each of them in your response.

Questions from Chapter 4

- *Will a lifetime limit on tax relieved saving be a satisfactory way of integrating taxation of pensions?*
- *How much will this approach encourage additional saving?*
- *How much will compliance costs drop overall?*

Questions from Chapter 5

- *Is there a case for any special transitional rules for people in occupational schemes whose normal retirement age is lower than 50?*
- *What sort of pension patterns might pension schemes and pension providers choose to offer under the proposed general benefit rules?*
- *Should index-linked pensions take account of falls in the Retail Prices Index?*
- *Should the general benefit rules specify any further detail?*
- *Will the general benefit rules allow the annuity market sufficient scope to develop new products to meet users' needs?*
- *Would there be value in allowing people with modest pension savings to aggregate all their savings, including protected rights, before buying an annuity?*
- *When value protected pension benefits are available, is demand for guaranteed pensions likely to change?*

Questions from Chapter 6

- *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?*
- *Which changes in scheme design are the most pressing?*
- *Is it feasible to implement the new tax arrangements by April 2004?*

Questions from Annex A

- *Is the estimate of 5 per cent (£80 million a year) administrative savings for the pensions industry realistic? Might the savings be greater?*
- *In particular, could pension scheme administrators estimate, ideally both in financial terms and as a percentage, the potential long term savings?*
- *What are the one-off implementation costs to industry likely to be?*
- *In particular, could pension scheme administrators estimate the likely transition costs?*
- *What will be the impact on small businesses of bringing the special investment rules for SSASs and SIPPs in line with the prudential norm for other pensions?*

Questions from Annex B

- *Is a simple, but broadly fair approach to the transition the most appropriate one?*
- *Are there any other important factors the Government should consider in drawing up rules for the transition?*
- *Is three years an appropriate period to allow for valuation of pre A-day rights? Could this process be achieved more quickly?*
- *How long do pension schemes need before A-day to tell the Inland Revenue that they propose to opt out of the new rules for tax relief?*
- *How should pre A-day pension rights in with profits funds be valued?*
- *How should simplified rules for DB pension rights be set?*
- *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?*
- *Are the suggestions on valuing DB benefits feasible?*
- *Can the pensions industry develop standard arrangements to deal with cases of simultaneous vesting?*
- *Are the proposed rules about which contributions can qualify for tax relief appropriate and feasible?*
- *Are the proposed rules about contributions to UK based pension schemes by non-residents appropriate and feasible?*
- *Are the proposed regular reporting requirements reasonable and feasible?*
- *Are the rules for splitting pension rights on divorce appropriate?*
- *Are there any features of SSASs and SIPPs which should be considered for all pension schemes?*
- *How could rules about loans from pension schemes to members be established without prejudicing scheme solvency?*

D Glossary of Technical Terms

A-day the implementation date of the proposed reforms

additional voluntary contributions (AVCs) extra payments an *occupational pension* scheme member can choose to make to their scheme (or an outside supplier) to obtain greater benefits

annuity an insurance contract that guarantees to pay annual amounts for a fixed period. Pension annuities must guarantee payments for life

average benefit scheme a pension scheme that defines a person's retirement benefits for each year of membership of a *DB* pension scheme in relation to their pensionable earnings for that year rather than the level of their salary immediately preceding retirement

benefit in kind non-cash benefit provided as remuneration for an employment, *taxed as income*

buy-out policy a deferred annuity provided instead of preserving rights in an occupational pension scheme

carry back the right to make pension contributions in a current year greater than the normal limits by making use of all or part of a previous year's unused rights to contribute with tax relief

commutation conversion of pension rights into a lump sum payment

concurrency simultaneous active membership of both a *personal pension* and an *occupational pension*

defined benefit (DB) pension scheme a type of *occupational pension* scheme where the scheme rules define the benefits payable independent of the level of contributions and the scheme's investment returns. Includes final salary schemes.

defined contribution (DC) pension scheme a type of pension scheme where the size of members' retirement benefits are determined by the level of contributions to the scheme and their subsequent investment growth

drawdown the facility for a pension scheme member to draw a retirement income directly from their pension fund and postpone *annuity* purchase up to a maximum age of 75

earnings cap the maximum annual level of earnings that may count towards calculation of pension scheme benefits or limits, normally indexed by price movement. The cap was set at £97,200 for 2002-03

employee share scheme a scheme which allows employees to own shares in the company they work for, usually on favourable terms

final remuneration the level of earnings in a period close to retirement, used to calculate a person's retirement benefits from an occupational pension scheme

Financial Services Authority (FSA) the independent regulator for financial services business, including some private pensions. Empowered under the Financial Services and Markets Act 2000

flat annuity an *annuity* that provides level payments for its whole term

flexible retirement the facility for people to phase in the transition from work to retirement

general benefit rules the proposal that after *A-day* the same rules will apply to retirement benefits paid out of all types of pension scheme

grandfathering where a set of rules is preserved intact within later legislative reform in order to maintain people's original rights and expectations

Greenbury statement information on directors' remuneration required to be disclosed in company accounts, now in force through legislation

group personal pension an arrangement for employees of a particular employer to participate in a *personal pension*, usually on common terms and conditions with an employer's contribution

guaranteed annuity an *annuity* where payments are guaranteed to continue for an agreed period of up to ten years even if the annuitant dies before expiry of the period

indexed annuity an *annuity* where payments increase at regular intervals in line with a specified index, usually prices

Individual Savings Account (ISA) an account which can include cash, equity and insurance products with no income tax or capital gains tax on investment returns

life expectancy the most likely length of life at a particular age. May be based solely on the general population or take additional account of factors such as lifestyle and illness

limited period annuity a pension *annuity* designed to provide payments for a fixed period rather than for life

marginal rate someone's highest rate of income tax

minimum benefit age the youngest age at which a pension scheme may normally allow a member to take benefits

minimum funding requirement the requirement for the assets of a *defined benefit pension scheme* to match its liabilities, defined under the Pensions Act 1995; to be replaced following recommendations in the *Myners report*

Minimum Income Guarantee (MIG) state support to ensure that no pensioner's income is below a minimum level; to be absorbed into the *Pension Credit*

Modernising Annuities consultation document on developing the pension annuity market published jointly by the Inland Revenue and the Department for Work and Pensions on 5 February 2002

mortality drag the combined effect of deferral of *annuity* purchase, income *drawdown* and the tendency for *life expectancy* to rise with age – so that eventually investment returns cannot keep pace and it becomes impossible to secure the life-time income which could have been achieved by annuitising at the outset

Myners review a review of institutional investment, commissioned by the Chancellor, published 6 March 2001

net pay arrangement the facility for employers to deduct pension contributions from employees' pay before applying income tax so that employees receive tax relief at their *marginal rate*

normal retirement age the age specified in a pension scheme's rules at which a member is normally expected to retire

occupational pension scheme a scheme organised by an employer to provide retirement benefits for employees; can be *DB* or *DC*

Pension Credit financial reward from the state for pensioners on low and modest private incomes or; will absorb the *MIG* when it starts in October 2003

personal pension scheme an individual pension scheme that is not dependent upon employment

Pickering report a report on possible simplification of pension regulation, commissioned by the Secretary of State for Work and Pensions, published 11 July 2002

protected rights part of a person's pension, funded by a rebate in national insurance contributions in return for state subsidy arising from forgoing state earnings related pension (SERPS) or the second state pension (S2P) – and required to provide retirement benefits in specified form

prudential standards investment and other rules designed to protect the stability of a financial institution in the public and its customers' interests

recovery charge the tax charge to be levied on any pension fund above the lifetime limit when benefits are to be drawn

relief at source the facility for individuals to make contributions to a pension scheme net of income tax. The pension scheme then claims basic rate tax relief from the Inland Revenue.

retained benefits retirement benefits deriving from an earlier period of employment or self-employment

retirement annuity contract (RAC) a pension *annuity* contract between an individual and an insurer predating the *personal pension scheme* arrangements that were introduced in July 1988

Sandler review a review of medium and long-term retail investment, commissioned by the Chancellor of the Exchequer, published 9 July 2002

self-invested personal pension (SIPP) a *personal pension scheme* where the member has some freedom to control investments

serious ill-health commutation the facility for people with severely reduced *life expectancy* to withdraw the full value of their pension fund as a *tax free lump sum*

small self administered scheme (SSAS) an *occupational pension scheme* which manages its own investments and has fewer than 12 members

staggered vesting the commencement of benefits from a pension scheme in stages

stakeholder pension a type of *personal pension scheme* which meets set criteria, including low charges and flexibility

surplus rules rules setting out the methods for reducing pension scheme assets when their value significantly exceeds that required to match the scheme's liabilities

tax free lump sum the benefits from a pension scheme that can be taken as a cash payment at *vesting*. Normally up to 25 per cent of the value of the pension fund

taxable as income taxable under Schedule E

trivial commutation the facility for people to convert small aggregate mature pension funds to a lump sum; the proportion above the normal *tax free lump sum* element is taxed as income

value inflows the value added to a pension scheme by contributions and other increases in pension rights; proposed annual limit of £200,000

value protection a guarantee that a person will receive at least the value of their pension fund paid out in retirement. In the case of an *annuity*, early death of the annuitant would return the difference between the original purchase price and the total of annuity payments made before death. Capital payments are to be taxed at 35 per cent.

vesting the point at which benefits are drawn from a pension scheme