DRAFT EXPLANATORY MEMORANDUM TO

The Finance Act 2004 (Registered Pension Schemes and Annual Allowance Charge)(Amendment) Order 20XX

20XX No. [XXXX]

1. This [draft] explanatory memorandum has been prepared by Her Majesty's Revenue and Customs [and is laid before the House of Commons by Command of Her Majesty].

2. Purpose of the instrument

2.1 This instrument helps ensure the changes to the annual allowance legislation made by Finance Act ('FA') 2011 work as intended. The changes include provisions to

- ensure that pension scheme administrators do not normally have to test deferred benefit rights against the annual allowance,
- address unintended outcomes for the 'scheme pays' facility and the treatment of certain transfers of pension pots,
- ensure that the legislation applies fairly to individuals who may be subject to an annual allowance charge.

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 This Order includes provision having effect for times before this Order is made which does not increase any person's liability to tax, in accordance with section 282 of the Finance Act 2004.

4. Legislative Context

4.1 This Order is to be made under section 238A of the Finance Act 2004. Section 282(1A) of that Act states that no Order may be made under section 238A which increases any person's liability to tax unless a draft of the statutory instrument containing it has been laid before, and approved by, a resolution of the House of Commons. This Order does contain provisions which may increase a person's liability to tax, identified in paragraphs 7.17 and 7.27.

4.2 Finance Act ('FA') 2004 introduced two controls over the amount of tax relief available to individuals, the lifetime allowance ('LTA') (sections 214 to 226) and the annual allowance ('AA'), (sections 227 to 238). In FA 2011, for tax year 2011-12 onwards, the AA was reduced from £255k to £50k. Alongside the reduction in the AA, a number of other amendments were made in Schedule 17 to FA 2011 to the AA legislation in FA 2004.

4.3 Where an individual's total pension input amount (section 229 FA 2004) for a tax year, exceeds the AA, a charge, known as the AA charge (section 227) applies to the excess. Sections 230 to 237 of FA 2004 set out how the pension input amount is

calculated depending on whether the arrangement that the pension savings are in is a defined benefits, cash balance, other money purchase or hybrid arrangement. A pension input amount for a tax year for an arrangement is calculated for the pension input period (section 238 FA 2004) ending in the tax year.

4.4 Where an individual is a deferred member of a cash balance or defined benefit arrangement, sections 230 and 234 of FA 2004 respectively set out that the pension input amount is nil in certain prescribed circumstances.

4.5 Sections 231 and 232 for cash balance arrangements, and sections 235 and 236 FA 2004 for defined benefits arrangements set out various adjustments to the opening and closing value when calculating the pension input amount, to take account of such events as transfers between arrangements.

4.6 Paragraph 15 of Schedule 17 to FA 2011 inserted new sections 237A to 237F into FA 2004 enabling members of registered pension schemes to require, in certain circumstances, the scheme administrator to pay an AA charge. Section 237E provides that a consequential adjustment must then be made to the member's benefits.

4.7 Paragraph 17 of Schedule 17 to FA 2011 inserted new section 238A into FA 2004 to provide that the Treasury may by order modify the provisions relating to the annual allowance in sections 227 to 238 FA 2004. This instrument is made under these powers.

4.8 This instrument makes a number of modifications to the AA legislation including provisions to extend the circumstances when deferred benefit rights are not tested against the AA, to ensure that where transfers occur there are no unintended pension input amounts arising as a result of the transfer and to ensure that that where an individual notifies their scheme that they want it to pay their AA charge, that tax charge will be the same as if the member had paid the charge.

5. Territorial Extent and Application

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Financial Secretary (David Gauke MP) has made the following statement regarding Human Rights:

"In my view the provisions of the Finance Act 2004 (Registered Pension Schemes and Annual Allowance Charge)(Amendment) Order 20XX is compatible with the Convention rights."

7. Policy background

7.1 The Government provides tax relief on pension savings to encourage individuals to take responsibility for retirement planning and to recognise that pensions are less flexible than other forms of saving. However, the cost of tax relief on pensions doubled in the decade prior to 2010 so to support a system of pensions tax relief that is fair, affordable and sustainable, the level of the AA was reduced from £255,000 for the 2010-11 tax year to £50,000 for the 2011-12 tax year onwards, affecting more individuals than previously. With effect for tax year 2014-15 onwards, the AA was further reduced to £40,000.

7.2 Alongside the reduction in the AA a number of other changes to the AA legislation were introduced in FA 2011. These changes included provisions that;

- reduced the need for deferred member's benefits to be tested against the AA to save the cost of administration,
- helped individuals manage any potential AA charges though the introduction of the facility to carry forward unused AA from the previous years, and
- allowed individuals to elect for their pension scheme to meet part or all of their AA charge from their benefits in certain circumstances.

7.3 Following the changes in FA 2011, a number of circumstances have been identified where administrative burdens can be further reduced and where other technical improvements could be made to ensure that the legislation works as intended.

Deferred members

7.4 These are individuals who have accrued benefit rights under a pension scheme but are not building up any further rights, commonly because they are no longer employees of the company providing the benefits but have not yet retired.

7.5 To minimise administrative burdens, special rules for defined benefits and cash balance schemes ensure that a deferred member's accrued rights may increase each year up to specific limits (the Consumer Price Index, for example) without counting towards the AA.

7.6 Pre 2006 deferred members (Articles 10, 11(a) and 14(a)): There is an anomaly under current legislation which in certain cases can impact on individuals who became deferred members before 6 April 2006 but subsequently became active members of the scheme after this date.

7.7 The effect of the anomaly is that the total value of the accrued pension "pot" may count towards the AA in the year of re-joining, rather than just the increase in the value of that "pot" in that year. The provision is intended to correct this anomaly and measure only the increase in value of the 'pot' in any year, with consequential adjustments to the rules for carrying forward unused AA from earlier years.

7.8 Transfers (Articles 11(b) ("5BC") and 14(b) ("5BD")): The aim of this provision is to ensure that the easement for deferred members of a defined benefits or cash balance scheme is not lost simply because an individual's rights are transferred between schemes and a consequential credit arises in the receiving scheme (rather than any subsequent accrual).

7.9 Other increases to deferred benefits (Articles 11(c)(i) and 14(c)(ii)): This provision is again intended to mirror treatment provided for the LTA. It would allow pension schemes to increase the value of deferred members' rights by reference to changes in the Retail Price Index (or a lower cap) instead of the Consumer Price Index, without those increases counting towards the AA. This provision caters for those schemes that sought to maintain the position for deferred members, making a change their rules by 6 April 2012 to refer specifically to RPI instead of the 'statutory rate' (which since Pensions Act 2011 relates to CPI instead of RPI related increases).

7.10 Statutory Increases (Articles 11(c)(ii) and 14(c)(iii)): These provisions are intended to mirror changes introduced for the LTA in Finance Act 2013 and extend the deferred member easement so that certain statutory increases to the value of a deferred member's rights under a defined benefits or cash balance scheme are not included in the pension input amount tested against the AA limit.

7.11 Defined benefits arrangements – winding-up (Article 14(b) ("5BC")): When a defined benefits scheme winds up it is common for scheme members' benefits to be provided through a deferred annuity contract, with those benefits promised at a set rate. Indexed annuities are generally used to provide benefits at the set rate and are backed by indexed gilts, usually RPI-linked gilts. Use of such gilts means that the increase in the value of new deferred annuities may exceed the current threshold and be excluded from the current deferred member easement, so would need testing against the AA.

7.12 The effect of this provision is to extend the deferred member easement to include the increase in value of such deferred annuities so long as the increase in value is provided by the terms of the contract and does not exceed CPI or RPI.

7.13 **Commencement:** All of the changes flagged in points 7.6 to 7.12 will have effect for 2011-12 and subsequent years.

Scheme Pays:

7.14 The 'scheme pays' rules were introduced in FA 2011 to mitigate the impact on individuals of reducing the AA from £255,000 to £50,000. The rules allow individuals to meet AA tax charges from their pension scheme, in return for a reduction in their eventual benefits under the scheme.

7.15 Year of retirement (Articles 12(g) and 15(f)): Where a member of a defined benefits scheme (or cash balance scheme) is subject to an AA charge in the year they take all benefits from the scheme, the amount of the charge is less if they use the 'scheme pays' facility than if they pay the tax charge themselves.

7.16 This provision is intended to remove the unintended advantage for defined benefits schemes (and cash balance schemes), and ensure that the amount of the AA charge payable is the same as if the member had not relied on the 'scheme pays' facility. By removing the unintended advantage, this provision may increase tax and so applies only in relation to AA charges arising on or after the date on which this Order comes into force.

7.17 Election for 'scheme pays' (Article 16(a)): Legislation currently requires members to make an election for their AA charge to be met through the 'scheme pays' facility before taking all their benefits. This is intended to give members and scheme administrators the opportunity to reduce the member's benefits proportionately before they come into payment.

7.18 However, there are certain situations in which the legislation does not allow for an election to be made before all benefits are taken and in these cases members may be denied access to the 'scheme pays' facility. This provision is intended to correct the unintended defect but to give time to make necessary adjustments, the provisions will have effect for elections made six months from the date on which this Order comes into force.

7.19 Transferred schemes (Article 16(b)): It is intended that an individual's AA charge under one pension scheme may be met by a different scheme into which the member's rights have been transferred. However, an anomaly in the current rules means that this facility may only apply where every member's rights under the original scheme have been transferred to the new scheme.

7.20 This provision is intended to remove the restriction and allow the 'scheme pays' rules to apply following individual transfers of members' rights. The provision will have effect in relation to transfers on or after the date on which the Order comes into force.

Other Issues:

7.21 Refund of excess contributions lump sum (Article 13): Where a member has paid relievable pension contributions in a tax year of more than the maximum amount eligible for tax relief, the excess contributions can be repaid to the member as a tax-free lump sum.

7.22 This provision is intended to prevent these excess contributions from being counted for the AA, and to minimise administrative burdens for pension scheme administrators. The change will affect those refunds made in pension input periods that end in tax year 2014-15 and subsequent years.

7.23 'Underfunded' transfers between schemes (Articles 12(a) to (d) and 15(a) to (d)): Where the pension rights of a defined benefits or cash balance scheme member are moved from one scheme to another, specific rules make adjustments to the rights under the "transferring" and "receiving" schemes, with the aim of making the effect of the transfer broadly neutral across the two schemes..

7.24 With no adjustment, the closing values for “transferring” and “receiving” schemes would generally be under and overstated respectively. Current legislation therefore requires an adjustment to add back to the closing value of the “transferring scheme”, the reduction in the value of the pension sum because of the transfer. An opposite adjustment also deducts from the closing value of the “receiving scheme” the increase in the value of the pension because of the transfer.

7.25 The adjustments are made to the extent that these reductions/increases are supported by reason of money or assets transferred from the old to new scheme. This means that any augmentation to the value of a member’s rights in the receiving scheme would correctly be tested for AA purposes.

7.26 However, some pension schemes may be ‘underfunded’ at a particular point in time, usually for defined benefits schemes where the scheme does not have 100% of the money needed to cover current pensions and those that will be paid out in the future. In some cases, particularly for pension scheme reorganisations or mergers, transferring available funds to new schemes may not be enough to support a member’s promised benefits in a receiving scheme.

7.27 As a consequence, unintended AA input amounts may arise, even though the value of a member’s rights may be the same before and after the transfer. For these large scale ‘underfunded’ transfers, it is also administratively difficult for schemes to determine the input amount, given that the amount of any such ‘underfunding’ may not be easily attributable to individuals.

7.28 Given these difficulties, the provisions are intended to;

- clarify how current legislation applies – maintaining the long standing approach of applying opposite adjustments to minimise the effect of the transfer for AA purposes across transferring and receiving schemes. This clarification will apply in relation to transfers arising on or after the date on which this Order comes into force.

- apply a different treatment for ‘underfunded’ defined benefits (and cash balance) block transfers where the value of scheme members’ benefits is virtually the same immediately before and after the transfer. This treatment will provide the same outcome as for transfers between ‘fully funded’ defined benefits (and cash balance) schemes so removing the potential for AA distortions.

- minimise the need to disturb treatment that has already been applied for such ‘block’ transfers – so the provisions affecting these transfers will have retrospective effect from 2011-12. For the transferring scheme, the provisions will have retrospective effect from 2011-12 (rather than in relation to transfers arising on or after the date on which this Order takes effect) so long as the effect across the revised adjustments is not to increase tax.

7.29 Consolidation: The instrument does not amend another instrument so consolidation is not appropriate.

8. Consultation outcome

This draft Order has already been the subject of a four week period of consultation, and is to be the subject of a further similar consultation.

9. Guidance

Draft changes to the Registered Pensions Scheme Manual have been published for comment alongside the draft Order and this draft Explanatory Memorandum.

10. Impact

10.1 The impact on business, charities or voluntary bodies is not expected to be significant.

10.2 The impact on the public sector is not expected to be significant.

10.3 A Tax Information and Impact Note covering this instrument was published on 9 December 2010 alongside draft legislation for Finance Bill 2011 concerning the restriction of pensions tax relief. This was updated on 3 March 2011 to reflect further decisions relating to the restriction of pensions tax relief and is available on the HMRC website at http://www.hmrc.gov.uk/thelibrary/tiins.htm. It remains an accurate summary of the impacts that apply to this instrument.

11. Regulating small business

11.1 The legislation applies to small firms. It is expected to impact on small and large firms in the same way and the impacts are not expected to be significant.

12. Monitoring & review

12.1 The policy will be monitored through information collected from HMRC databases, tax returns and other statistics.

13. Contact:

email: pensions.policy@hmrc.gsi.gov.uk, for any queries regarding the instrument.