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Annuity Consultation
Insurance and UK Regulatory Authorities Team
HM Treasury
Horse Guards Road
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Dear Sir/Madam

Creating a secondary annuity market: Call for Evidence

Please find attached as an Appendix our comments on the proposals set out in the Call for Evidence, published on 18 March 2015 (the Consultation Document). We are grateful for the opportunity to provide our comments on the consultation, which we have restricted to the changes in tax rules question in the Consultation Document (question 8, reproduced below). We are responding solely on the likely PAYE issues which we expect will arise for individuals accessing their annuities in the way proposed.

We would be happy to discuss our concerns. If you would like to do so.

Yours faithfully

Ernst & Young LLP
United Kingdom

Appendix

Q8. Do you agree that the design of the system outlined in Chapter 3 achieves parity between those who will be able to access their pension flexibly and those who will be able to access their annuity flexibly? Are there any other tax rules which the Government would need to apply to individuals who had assigned their annuity income?

We believe that there will be parity between those accessing their pension and their annuity flexibly on the basis that, according to the Consultation Document, amounts received will be subject to income tax at the individual's marginal rate, with tax deducted at source through PAYE. This mirrors the treatment of Uncrystallised Funds Pension Lump Sums (UFPLSs) and flexi-access drawdowns, introduced under the 2015 changes, albeit without the 25% tax-free element that applies in both these cases. Individuals with an annuity will of course already have been able to take their tax-free lump sum.

However, as with the April 2015 changes to pensions, we are concerned that PAYE is an imperfect means for collecting the tax due on lump sums or drawdowns under the proposed new annuity rules and will not achieve the aim of taxing individuals at their marginal rate. There are no further details in the Consultation Document regarding precisely how PAYE will be applied, specifically the code to be used, but if the approach taken by HMRC is the same as the April 2015 changes, providers will be required to operate a Month 1 code, likely to be the emergency code.

As was highlighted by various parties prior to the recent changes coming into effect, this will mean that many individuals will suffer deductions of tax at the additional rate of 45%, when in fact their marginal rate might only be the basic or higher rates. In the case of an individual taking a lump sum, this over-deduction can only be corrected by the individual completing a refund claim form, filing a self-assessment return or waiting for HMRC to reconcile his/her tax position after the end of the tax year. Until such a correction is made, the individual will not have been taxed at his/her marginal rate.

Taking example Case A in the Consultation Document:

Ms A has a company pension income of £20,000 per year and an annual State Pension of £6,000. She assigns the annuity she has for £19,000 and takes this all as a lump sum. Her total income for the year is £45,000 so, based on 2016/17 bands and rates, she will pay 40% tax on £2,300 of her income.

In reality, if the lump sum is subject to PAYE using the emergency code on a Month 1 basis, the tax paid by Ms A will initially be calculated as follows:

£19,000 taxable lump sum
Less: £900 personal allowance = £18,100
£2,658 at 20% = £531
£9,842 at 40% = £3,937
£5,600 at 45% = £2,520
Total tax due = £6,988

Ms A will therefore not be paying tax at her marginal rate and would be due a refund.

The guidance provided by HMRC in relation to the April 2015 changes stated that if the pension provider did not have a tax code for the individual, for the correct year, the emergency code should be operated. The proposal in the Consultation Document is for an individual to be restricted from assigning an annuity to the existing provider, which will mean that whichever party the annuity is assigned to will have no details for the individual, such as his/her tax code. The exception may be if the individual assigns an annuity to a provider with which he/she already has a pension, and that provider is able to aggregate the income from both "products". The above example is therefore likely to be replicated many times over.



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Anecdotal evidence and qualitative research conducted with our clients in the industry suggests that customers have found the operation of PAYE on a Month 1 basis very difficult to understand and have been frustrated to find that they either need to wait for over a year to recover overpaid tax, or submit a claim to HMRC. Many of these customers have only paid basic rate tax through PAYE during their working lives and so have had little or no direct contact with HMRC until now. The discovery that the amount of tax deducted might not be the amount they will eventually owe has come as a shock to many customers and they seem to be reacting to the need to make a reclaim with trepidation, concern and sometimes suspicion.

Some individuals have made formal complaints against their pension providers, who are caught in the unenviable position of not only having to explain the tax consequences of flexibly accessing a pension, but also trying to provide useful guidance around individuals' financial requirements when their true net position may not be known for a matter of months. It can be imagined that an individual assigning an annuity to a new provider will incur charges and may be subject to a further assessment of their health and lifestyle. Adding to this the complexities of PAYE compared to their actual, ultimate tax liability does not make for a happy customer experience and will once more likely place providers in a very difficult position.

Ahead of the changes in April 2015, we put forward various suggested options to HMRC and HMT of how PAYE could be applied more effectively and more accurately and how the process of managing overpayments of tax could be simplified and expedited. Pleasingly, one such suggestion appears to have been acted on, namely the introduction of a new refund claim form (P55), but the underlying issue remains that applying PAYE on a Month 1 basis is likely to be more inaccurate for a greater number of people than, say, a BR code or a code generated by a set of questions an individual could answer, in advance of receiving a payment, about his/her sources of income. This is an issue which we consider should be addressed.

HMRC and HMT could take the opportunity presented by changes to annuities tax rules to consider improvements to the PAYE system generally as it relates to flexibly accessed pensions. That would achieve parity for 2016/17 and future years and would address the problems which have arisen since April 2015 with the operation of PAYE.

