Summary: Intervention & Options

Department /Agency: HMRC	**Title:** Impact Assessment of widening the scope of authorised payments that may be made by registered pension schemes	
Stage: Final Proposal	**Version:** 1.0	**Date:** 10 March 07
Related Publications:		

Available to view or download at:

http://www.hmrc.gov.uk

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What is the problem under consideration? Why is government intervention necessary?

Finance Act 2004 (FA2004) lists the payments a Registered Pension Scheme is authorised to make to members of the scheme. All other payments are unauthorised and taxable at a rate of up to 70%. The legislation provides the power to describe additional payments as authorised. We have, however, become aware of a number of circumstances where schemes make payments which are currently treated as unauthorised and we would wish to reclassify these as authorised payments. However, the power is not wide enough to describe the tax treatment of these payments. These are payments made in error or small pensions which cannot be trivially commuted.

What are the policy objectives and the intended effects?

To treat tax payers equally and fairly and to ease administrative burdens on pension scheme administrators. To remove from the unauthorised payment rules payments which were not intended to be caught under FA2004, and to ensure these are taxed in the same way as other authorised payments. Changes to the trivial commutation rules should ensure that those at the lower end of income scales would not be adversely impacted. They should not increase exchequer costs and or be open to manipulation designed to avoid the primary purpose of pension saving which is to provide an income in retirement.

What policy options have been considered? Please justify any preferred option.

A number of options were considered to ease the burden on scheme administartors and help prevent stranded pension pots. These included a) do nothing, b) provide regulations under existing powers or c) under new enhanced regulation making powers with retrospective effect. The preferred option c) allows schemes to treat members and/or their dependants fairly by making these payments authorised with effect from 6 April 2006 and provide rules to allow very small stranded pots to be commuted and allow a de minimis limit for occupational schemes.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The impact of the changes will be assessed as part of HMRC's more general plans for monitoring and evaluation of the impact of the pension simplification reforms.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister:

Yvette Cooper..Date: 10 March 08

Summary: Analysis & Evidence

Policy Option: C	Description: Provide regulations under new enhanced regulation making powers with retrospective effect

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	We assume that the measure results in an additional 20,000 trivial commutations annually for pension schemes and HMRC to deal with. In total, administering these extra trivial commutations is estimated to cost pension schemes & HMRC an extra £0.6m p.a., £0.4m of which is likely to be faced by pension schemes.
£		
Average Annual Cost (excluding one-off)		
£ 0.6m		**Total Cost** (PV) £

Other **key non-monetised costs** by 'main affected groups'

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	Pension schemes should benefit from a reduction in the number of PAYE P14's they have to deal with and lower burdens from a reduced need to check that scheme members qualify for trivial commutation. HMRC also benefits from no longer having to deal with the PAYE P14 returns. The benefit to pension schemes and HMRC combined is estimated to build up from an initial £0.5m to around £8m per year after 20 years. Pension schemes are likely to receive around a quarter of this annual benefit.
£		
Average Annual Benefit (excluding one-off)		
£ 4m		**Total Benefit** (PV) £

Other **key non-monetised benefits** by 'main affected groups' Individuals with small, stranded pension pots will be able to take them as lump sums, rather than receiving very small annuities.

Key Assumptions/Sensitivities/Risks Key assumptions are that the de minimis limit for occupational schemes to unilaterally trivially commute will be set at £2,000 and that under the new rules, HMRC and pension schemes will face similar costs for administering a trivial commutation.

There is uncertainty surrounding the figures used burdens faced by pension schemes from the PAYE P14 process, the old trivial commutation process and the proposed new process.

Price Base Year 2008	Time Period Years	**Net Benefit Range** (NPV) £	**NET BENEFIT** (NPV Best estimate) £

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			Royal Assent 2008	
Which organisation(s) will enforce the policy?			HMRC	
What is the total annual cost of enforcement for these organisations?			£	
Does enforcement comply with Hampton principles?			N/A	
Will implementation go beyond minimum EU requirements?			No	
What is the value of the proposed offsetting measure per year?			£0	
What is the value of changes in greenhouse gas emissions?			£0	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)
Increase of £ 0.4m	Decrease of £ 2m	**Net Impact**	£ 1.6m decrease

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Evidence Base (for summary sheets)

1. There are two specific areas that are being addressed in this Impact Assessment, Trivial Commutation and Unauthorised Payments. The full options considered for each are set out below.

Trivial Commutation

Rationale for intervention

2. Substantial and generous tax reliefs are given to support and encourage pension saving. But in return restrictions also apply to how and when a pension fund can be accessed to ensure it is used for the intended purpose. The fundamental underlying policy behind this is that, in the main, money saved within a registered pension scheme must be used to provide an income in retirement.

3. One area of exception to this general policy is that of the rules relating to trivial commutation. These rules allow schemes to pay out all of the funds relating to a member (or dependant of the member) as a one off lump sum, between certain ages in the case of a member (or in the case of a dependant, before the day on which the deceased member would have attained age 75) and where certain conditions are met. This exception is designed as a practical measure to prevent schemes having to pay out very small pensions that are not economic for the scheme to administer and are too small to be of any significant benefit to the member.

4. HMRC had representation from the industry that the administration of these rules can be unduly burdensome in some circumstances, and as a result the Governments' Pre Budget Report in December 2006 announced that HMRC would discuss the concerns raised by the pensions industry.

5. The purpose of the discussions was to explore the way in which the current rules impact across a range of interests, bearing carefully in mind both the potential impact on individual pensioners, pension savers and pension providers, and the way the rules fit with the Government's wider objectives in encouraging pension saving to produce an income stream in retirement.

Policy options

6. Following the discussions around these concerns, a number of options were considered.

Option 1 – Do nothing

7. This option does nothing to reduce the administrative burden. In certain circumstances very small funds can be stranded in schemes where there is no alternative but to pay these funds out as unauthorised payments with tax charges of up to 70%. This was not the original intention of the trivial commutation tax rules.

Option 2 – Raise the commutation limit

8. At present, small funds can be trivially commuted if the aggregate value of all pension funds held by an individual is less than 1% of the standard lifetime allowance. This equates to £16,000 in 2007/08 and will rise to £18,000 in 2010/11. This figure could be increased by a greater amount than currently allowed for.

9. Trivial commutation is an exception to the general policy that tax-relieved pension savings are used to provide an income in retirement. Raising the commutation limit would be a change in the policy and it would not reduce the administrative burden for schemes where members have small funds stranded in two or more pension schemes as the test would still be against the aggregate value of all pension funds. This would not be in line with the intention of the trivial commutation tax rules.

Option 3 – Return to a scheme specific limit

10. Prior to 6 April 2006, trivial commutation was based on the savings in each scheme, rather than on the aggregate of total pension savings. For occupational schemes, this would be a limit based on the pension savings related to each employment a person has held. If the aggregate of total benefits payable to the employee under all schemes providing benefits in respect of the employment did not exceed the value of a pension of £260 per annum, the pensions the sum could be commuted.

11. For personal pension schemes there was a scheme trivial commutation limit which could be used only once. If the savings did not have any contracted-out rights then the commutation limit was £2,500, whereas if the savings included contracted-out rights, then the commutation limit was whether the funds could buy an annuity of £260 per annum. In addition the member could not be a member of another personal pension scheme or in receipt of an annuity from a personal pension scheme.

12. Such a change back to a scheme specific limit would create a class of losers, many of whom are poorer pensioners. Those with savings in total below the current £16,000 limit but who hold funds in an individual scheme above any new limit would lose the right to trivially commute those pots. This kind of limit would also increase the possibility of savers fragmenting pension savings to ensure that all or part of those savings can be paid out as a lump sum rather than as a pension. This would undermine the policy of pension tax relief being there to produce an income in retirement. In addition, even if the rules could limit the number of pension schemes a person could trivially commute from this would still allow some savers to use pension schemes inappropriately. People could set up a single personal pension scheme with the intention of trivially commuting and taking advantage of the generous reliefs given for pension savings to support non pension savings.

Option 4 – Stranded Pots

13. The current trivial commutation rules can still leave very small pots which schemes are unable to trivially commute – for example where the member has two pension funds where one is over the current limit for trivial commutation.

14. Two alternatives were considered.

    a) The first alternative would be to retain the current rules for trivial commutation and then to have a separate additional rule that a pension fund could also be trivially commuted if the funds of an individual in that scheme were below a de minimis level. However personal pension schemes can be set up easily and so under this option there is a very real risk of substantial abuse through fragmentation of savings and using pensions tax relief to fund a general savings vehicle.

    b) The second alternative would be to develop regulations which allow these pots to be trivially commuted depending on the particular circumstances that create the problem. This would allow administrative savings without risking abuse through fragmentation of pension savings.

Option 5 – Occupational Pension Schemes

15. Occupational pension schemes have certain features that make trivial commutation more problematic for them.

    - It is very much more difficult to transfer funds in connection with a defined benefit occupational scheme. Defined benefit schemes generally do not accept transfers as these add to the funding risks for employers and it is often not advisable to transfer out of a secure defined benefit scheme. This makes dealing with trivial funds more difficult.
    - Individuals often have multiple small occupational schemes because of employment patterns rather than as a result of a conscious pattern of saving. If a person has a number of jobs over a working life (perhaps on a part time basis), then a number of small occupational pension schemes may inevitably be built up.

16. It was considered with the pensions industry whether it would be possible to set a separate de minimis limit for occupational pension schemes. This would sit alongside the current overall aggregate limit of £16,000 and would enable small occupational pension schemes to be commuted even if the aggregate amount of pension savings was over £16,000.

17. This would result in cost savings for the occupational pension scheme industry and a simpler way of commuting very small pots that would benefit, mainly low income, pension savers. The current £16,000 limit with aggregation across pots would remain in place to ensure that there were no losers in comparison to the existing system.

Decision

18. The recommendation was that the Government pursue option 5 in conjunction with option 4b to deal with stranded pots. These changes would meet the objectives of the discussions held with the pensions industry reducing the administrative burden on pension schemes whilst at the same time fitting in with the Government's wider objective in encouraging pension saving to produce an income stream in retirement.

Costs and Benefits

19. It is difficult to determine precisely how many individuals with small pension pots will seek to trivially commute their funds as a direct result of this measure. We have inevitably had to make assumptions based on the best available evidence to date. The key assumptions underpinning the estimated costs and benefits are as follows.
20. Firstly, it is assumed that this measure will lead to an extra 20,000 pension pots being trivially commuted each year (based on the number of small pension pots and a £2,000 de minimis limit for occupational pension schemes to trivially commute).
21. Secondly, based on available internal management information, HMRC estimate the cost of administering pensioners' PAYE P14's at around £15 per case per year. On average, it is more costly for HMRC to process P14 forms dealing with pensioners than the average P14 form. This is because pensioners are often multiple income source individuals and are more likely to contact HMRC regarding their tax coding. This means that, on average, more time is spent dealing with a pensioner's P14 form than with a P14 form from a working age individual.
22. Data from HMRC's Standard Cost Model (for further information on the SCM approach to estimating administrative burdens go to www.hmrc.gov.uk/better-regulation/kpmg.htm), indicates that pension schemes face a cost of around £5 per form (based on a the time taken being 15 minutes per case) in submitting and checking P14 returns, giving a combined pensions scheme and HMRC cost of £20 per case. ONS life expectancy statistics also show on average annuities on small private pension pots are paid for around 20 years.

23. Thirdly, HMRC estimate that the cost of administering a trivial commutation is around £10 (again based on internal management information). SCM data indicates that the one-off cost to a pension scheme of administering a trivial commutation is around £20 (based on the process taking schemes an hour in total).

24. Using these assumptions gives the following estimates.

i. Total Pension Scheme and HMRC cost for administering PAYE P14 returns:

£20 per case (£5 Pension Schemes and £15 HMRC) **x** 20 years = £400 per case

ii. Total Pension Scheme and HMRC saving on not administering 20,000 extra PAYE P14's by year:

Year	PAYE P14's avoided	Annual Saving
1	20,000	£400,000
2	40,000	£800,000
3	60,000	£1,200,000
4	80,000	£1,600,000
5	100,000	£2,000,000
6	120,000	£2,400,000
7	140,000	£2,800,000
8	160,000	£3,200,000
9	180,000	£3,600,000
10	200,000	£4,000,000
11	220,000	£4,400,000
12	240,000	£4,800,000
13	260,000	£5,200,000
14	280,000	£5,600,000
15	300,000	£6,000,000
16	320,000	£6,400,000
17	340,000	£6,800,000
18	360,000	£7,200,000
19	380,000	£7,600,000
20	400,000	£8,000,000

iii. To calculate the extra cost to HMRC of administering the extra trivial commutations:

20,000 extra trivial commutations **x** £30 per trivial commutation (£20 pension providers, £10 HMRC) = £600,000 p.a.

25. The table above shows that by year 20, there will be an annual reduction of 400,000 PAYE P14's for pension schemes & HMRC to administer, giving an annual saving of £8m. This is assumed to be the steady state level going forward.

26. The estimates of the impacts on the Admin Burden Baseline are calculated as follows:

i. Extra trivial commutations for pension schemes to administer

20,000 **x** £20 = £400,000 p.a.

ii. Reduction in P14 forms to administer (builds up to 400,000 per year after 20 years)

400,000 **x** £5 = £2 million p.a.

Unauthorised Payments

Rationale for intervention

27. Under the tax rules, payments made by registered pension schemes to their members are either authorised or unauthorised. Generally, authorised payments are tax-free or taxable at the member's marginal rate and usually tested against the lifetime allowance, but unauthorised payments are taxable at a rate of up to 70% - designed to ensure that all of the tax reliefs that have built up the fund are reclaimed.

28. Following consultation between HMRC and the pensions industry, a number of situations have been identified where pension schemes make payments, often in innocent error, that are categorised as unauthorised, but which were not intended to be caught as such under the post-A-day rules.

29. The situations identified are:
    i) An overpayment of an ongoing pension
    ii) A pension which continues to be paid after the member has died
    iii) Certain payments made after the member has died where payment before death was not possible

Policy options

30. A number of options for each were considered.

    i) An overpayment of an ongoing pension

31. Pension schemes sometimes pay someone too much pension in error. One of the requirements under the new rules is that a "scheme pension" must not reduce from one year to the next, except in certain limited specified circumstances. This is to prevent people artificially inflating the initial amount of their pension to create a higher tax free lump sum. If the scheme does not recoup the overpaid element then that part of the payment is an unauthorised payment. If the scheme treats the increased pension as the members pension and then subsequently reduces the rate of pension to the correct level future pension payments would be 'unauthorised'

32. Recouping overpaid parts of pensions can be difficult, disproportionately costly and sometimes undesirable. When the pensions were originally paid, they would have been treated as normal pension payments and taxed accordingly so a recovery could involve repayment of that tax to the person who accounted for it and then a separate tax charge being levied.

Option 1 – Do nothing

33. The unauthorised payment tax charge can be averted only if the overpayments are recouped. The individuals however, may not have been aware that they were receiving too much pension and these types of errors may not come to light for many months or even years. The do-nothing option risks significant tax charges arising if repayment is not pursued.

Option 2 -Provide regulations under the existing powers

34. The current power under section 164(f) Finance Act 2004 can be used to make the overpayment element and subsequent reduction to the correct level into an authorised payment. This change however could only relate to payments made after the regulation came into force. Any payments made before that date will still be unauthorised payments and taxed as such. Furthermore, any payment which was made authorised regulation would

not automatically be taxable in the same way as other authorised payments from pension schemes, so some payments may escape tax all together

Option 3 - Amend the existing regulation making power and draft a regulation under this power to enable the payments to be authorised and taxable in the same way as other payments from a pension scheme

35. This would enable the overpaid pension to be treated as an authorised payment and taxed in the same way as other payment a scheme is authorised to make. This would enable all such payments to be taxed in the same way as other authorised payments from a registered pension scheme from an earlier date.

ii) A pension which continues to be paid after a member has died

36. Often after the death of a pension scheme member there is a delay in reporting this death to the pension payer. This need only be for a short period for payments to continue to be paid after the death of the member. Schemes will sometimes recoup these but often, given the amounts of the payments and the financial circumstances of the deceased's relatives, recouping funds is difficult and undesirable. If the pension instalments paid after death are not recouped, these are unauthorised payments.

Option 1 – Do nothing

37. The unauthorised payment tax charge can be averted only if the overpayments are recouped. However, this type of error is common, and may not come to light for many months. If repayment is not pursued significant tax charges could arise on relatively small amounts.

Option 2 - Provide regulations under the existing powers

38. Existing powers under section 164(f) Finance Act 2004 could be used but these will only relate to payments made after the regulation comes into force. Any payments made before that date will still be unauthorised member payments and taxed as such. Also any such payments that are made authorised will not be taxed in the same way as other authorised payments from pension schemes. This option may result in behavioural changes, for example payments could become a standard tax free bonus on death.

Option 3 - Amend the existing regulation making power and draft a regulation to enable the payments to be authorised and taxable

39. This would treat the payment as if it were the taxable income of the deceased member and would ensure that all such payments were taxed in the same way as other payments from registered pension schemes.

iii) Payments made after the member has died but where payment before death was not possible

40. When benefits become payable to a member, a scheme may not have information on the member and it may take some time before they can contact them. Where that person dies before these pension payments can be made, some scheme rules oblige the scheme to pay what would have been the member's arrears of pension, and any tax-free pension lump sum. Usually payments made in respect of the death of a member are authorised payments. However payments of pension and lump sum arrears in these circumstances can be caught as unauthorised payments.

Option 1 - Do nothing

41. These payments are currently treated as unauthorised payments. To do nothing would disadvantage those dependents that are due to receive these payments.

Option 2 - Provide regulations under the existing powers to include these payments as authorised payments

42. This would not allow regulations to apply to payments that have already been made and would not allow any arrears of lump sums to be tested against the lifetime allowance which would provide an unduly advantageous result.

Option 3 - Amend the existing regulation making power and draft a regulation which would enable the payments to be authorised, taxable as income and subject to the lifetime allowance test

43. This option allows schemes to treat members fairly and does not disadvantage the families of those who should be entitled to benefits resulting from the deceased's employments that they could have left some years before retiring. This change will allow schemes to pay a member's pension and pension commencement lump sum which is taxed in the same way as if the member had not died before payment.

Decision

44. For all scenarios the recommendation is that the Government pursue option 3, and amend the existing regulation making power within Section 164(f) Finance Act 2004 to
    - allow regulations to have effect for payments already made provided it does not increase the person's liability to tax;
    - describe in regulations how these payments must be treated for income tax purposes and who the tax charge should apply to and
    - ensure that payments can be tested against the lifetime allowance if necessary.

Costs and Benefits

45. This measure should provide scheme operators with certainty over the treatment of certain payments and should allow a slight reduction in administrative burdens. It is not expected that schemes will face any significant costs as a result of these changes.

46. It is assumed that there will be no impact on the Exchequer from these changes as they chiefly amend legislation to ensure that pension payments are taxed in the same way as other authorised payments from pension schemes.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	No	No
Small Firms Impact Test	No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No