Summary: Intervention & Options

Department /Agency:	Title:	
HMRC	**Impact Assessment of Technical Improvements for Taxation of Pension Schemes**	
Stage: Final Proposal	**Version:** 1.0	**Date:** 10 March 2008
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?

The introduction of the simplified regime for tax-privileged pension savings from 6 April 2006 has swept away much of the structural complexity under which pension schemes previously operated. However, discussions with the pensions industry have identified several areas of the new regime where the application of the rules could be improved or simplified to reduce compliance burdens for industry.

What are the policy objectives and the intended effects?

The objective is to ensure that the Pension Simplification reforms introduced from 6 April 2006 work as intended. The Government also seeks to simplify aspects of the Pension Simplification legislation that are found to unduly hamper industry in applying the new rules.

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

There are four specific areas where options for reform of the current rules are being considered: (i) Lifetime Allowance Test - Benefit Crystallisation Event 3 test; (ii) Tax Free Lump Sums; (iii) Scheme Investments, and (iv) Lifetime Allowance Test - Dependant's Scheme Pensions. Further details on these areas are presented in Annex 1. In each case, we have considered a number of options to address the problem, including a 'do nothing' option. In the three areas where changes are proposed, the preferred option seeks to lessen the burden under the current rules.

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 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 2008

Summary: Analysis & Evidence

Policy Option:	Description: Technical Improvements

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	There are no new costs arising from the measure, as it is aimed at enabling pension schemes to apply the rules with greater ease. In particular, we anticipate that scheme administrators will accommodate the change in the rules as part of their updating of IT systems following the introduction of Pension Simplification.
£ 0		
Average Annual Cost (excluding one-off)		
£ 0		**Total Cost** (PV) **£ 0**

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**	Defined Benefit scheme administrators will benefit from lower admin burdens generated by an easement in obligations for calculating and reporting chargeable events.
£ Neg		
Average Annual Benefit (excluding one-off)		
£ 0		**Total Benefit** (PV) **£ Negligible**

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

The clarification of the rules also gives the industry more certainty about the circumstances under which pension schemes must undertake certain calculations and report information to HMRC.

If the 'Do Nothing' option was taken, the cost to firms would build up to around £20m p.a. after 10 years.

Key Assumptions/Sensitivities/Risks

The estimates above are based on plausible modelling assumptions, though a lack of robust quantifiable evidence and difficulty in modelling behaviourable effects imply a degree of uncertainty.

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

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?			£ Neg change	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			N/A	
What is the value of the proposed offsetting measure per year?			£ N/A	
What is the value of changes in greenhouse gas emissions?			£ N/A	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro 0	Small 0	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 Decrease of £ 0 **Net Impact** £ 0

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

Evidence Base (for summary sheets)

Evidence Base

In each of the four specific areas where options for reform of the current rules are being considered, we have assessed the impact on industry – in particular the effect the proposals are likely to have on the administrative burdens of pension schemes. In aggregate, we envisage that the proposals will generate a significant saving in the administrative burdens of pension schemes over time, compared with if the rules were not amended. The overall savings are estimated at around £20 million per annum after 10 years. The changes to the rules should also make it easier for HMRC to undertake its obligations (including engaging with schemes about their submitted returns) but without any signficant impact on its costs. Further details of our assessment for each proposal are presented below.

(i) Lifetime Allowance Test - Benefit Crystallisation Event 3 (BCE3) test

<u>Rationale of Intervention</u>

At the Pre Budget Report in December 2006, the Government announced a consultation that aimed to identify any improvements that could be made to two lifetime allowance tests one of which was the Benefits Crystallisation Event 3 (BCE3) test. The purpose of the consultation was to assist scheme flexibility, provide greater clarity to scheme administrators and members, to smooth the operation of the new pensions tax regime for both pension schemes and their members and so reduce costs.

The BCE 3 test aims to prevent people avoiding the lifetime allowance charge by deliberately taking an initially small pension which is then greatly increased. The rule works by counting these increases as well as the initial pension against the available lifetime allowance an individual has, so ensuring that a charge applies to any excess. But the rules are complex and the in-built filters don't always eliminate enough of the vast majority of pension scheme members who are not attempting any abuse. Pension schemes have therefore been finding administration of this rule costly.

<u>Policy Options</u>

Following the consultation exercise, the responses were analysed and the three options were considered.

<u>Option 1 – Do nothing</u>

This option does not provide any of the objectives identified at the start of the consultation process. Administrative burdens on schemes would not be reduced.

<u>Option 2 – Legislative changes</u>

Four key changes were identified during the consultation exercise which could ease administrative burdens and costs whilst maintaining the integrity of the rules. They are

- Widening the circumstances in which schemes are exempt from the test. Currently, large schemes paying the same increase to all scheme members at the same time are exempt. Widening this exemption to apply where at least 20 members have been paid the same increase at the same time. This should allow more flexibility for schemes without losing the deterrent effect.

- Exempting increases in pensions from the test as long as they don't exceed a normal rate of increase in a pension in a 12 month period – using the standard measure of "normal" increases as 5%, or RPI if higher. This change would better focus the rule on abnormal increases, where there is risk of abuse.

- Changing the reference month for RPI used, so that schemes don't have to wait for official RPI figures to come out for the actual month in which the pension is increased before deciding whether the test is needed. Schemes can use the figure for the RPI to any month, which is within 12 months before the increase in pensions. This should ease administration of the rule.

- A limit on annual increases in pension whereby if the annual increase in pension was less than £250 they will be removed from the requirement to test

All of these changes should assist scheme flexibility by reducing the number of times schemes are required to carry out BCE3 tests. This should reduce their costs and make the rules easier to understand for administrators.

All of these changes however will require changes in legislation. In addition a technical defect around how relief is given for previous BCE3's could be corrected as well as indexation of previous crystallisation events being introduced.

<u>Option 3 – Accept all of consultation responses</u>

In addition to those key changes in option 2 above, a number of other changes were discussed with industry as follows;

- A specific carve out of GMP/statutory increases from the BCE3 test.

- BCE 3 test would not be required where the level of pension remains below a de minimis figure after the increase.

- Rebasing rate of pension after each increase over the permitted margin.

- The purchase price of a scheme pension plus any pre-commencement lump sum is valued/tested against the lifetime allowance at the outset.

- Averaging of 5%/RPI increases over say a 5 year period.

- Standard crystallisation factors greater than 20:1 to allow for higher increases than 5% to be allowed for at the time of the original BCE to remove the need for any BCE3 tests.

The changes in option 2 remove the advantages that these other options would bring on their own. In addition, some of the options, for example the suggested de minimis figure change could lead to avoidance of the lifetime allowance charge in larger funds through fragmentation.

<u>Decision</u>

The recommendation was that the Government pursue option 2. These changes would meet all of the objectives set out in the consultation document by being de-regulatory, reducing administration burdens, increasing the flexibility of scheme and overall ensuring the benefits of pension simplification are realised.

Costs and Benefits

There are currently around 15,000 Defined Benefit pension schemes in operation with around 16 million active (and deferred) members. A majority of these will be affected to some extent by the current requirement to apply the BCE 3 test. The proposal for widening the circumstances in which schemes are exempt from applying a test will mean that the majority no longer face an administrative burden from this aspect of the pensions legislation. The new rules will mean that a test will only need to be applied in case where the increases are outside excepted circumstances or exceeds a 'normal' rate of increase (the proposal is for a test to apply in cases where the rate of increase exceeds 5%). As part of the proposed changes to the rules, the new test for cases where the increase in pensions exceeds the proposed 'normal' rate will be made less onerous for affected pension schemes to comply with.

The precise scale of savings in pension schemes' administrative burdens is difficult to predict at this stage, given we have no firm evidence of the current burdens faced by those affected, or how these would develop in the absence of any change in the rules. However, on a range of plausible assumptions, we estimate that the aggregate savings to industry could be of the order of £20 million per annum after 10 years (relative to the costs businesses would incur in the absence of the proposed rule changes).

Further details on estimated admin burden savings

- HMRC have completed an analysis of the admin burdens of the UK tax system based on Standard Cost Methodology assumptions (details available at www.hmrc.gov.uk/better-regulation/kpmg.htm).

- Among the regulations on pensions tax relief, the current estimate for admin burdens associated with schemes submitting details to HMRC of any 'chargeable event' in a tax year is around £1 million. This admin burden relates to an estimated 10,000 occupation pension schemes.

- In 2005 there were around 15,500 private sector Defined Benefit (DB) occupation pension schemes out of a total 70,000 (around 22%). But the distribution of scheme members was heavily weighted toward DB schemes - around 16 million were in DB schemes (87%) out of a total of 18.5 million active and deferred members in all private sector occupational schemes. There are also a further 7 million active and deferred members in public sector DB pension schemes.

- We assume that in practice, in the absence of any change to the rules, scheme administrators would need to undertake a BCE3 test computation for determining a chargeable event in (a) around 750,000 new cases each year (assuming roughly 1/30th of 23 million DB scheme members have a benefit crystallisation each year); and (b) all DB members receiving an increase in their pension. The aggregate number of members getting a DB pension in payment since April 2006 and in receipt of a subsequent increase in their pension will grow year by year. We estimate that the total number of scheme members for whom scheme administrators would need to do a BCE3 test computation could reach up to 7.5 million within 10 years.

- We have no hard evidence on the cost to schemes with cases requiring a Benefit Crystallisation Event 3 (BCE3) test. The actual cost to schemes will generally depend on the number of cases involved and their specific characteristics. However, in estimating the aggregate burden of the proposed reform to the existing rules, we assume that in the absence of any change to the rules the average cost across all scheme providers would be around £3 per case. This reflects a view that larger scheme administrators would most likely invest in IT to significantly reduce their costs of complying with their obligations, relatively to the practice of manual calculations. This average cost also equates roughly to a quarter of a man hour per case expended at the average wage of a office/wage clerk (based on HMRC Standard Cost Model rates).

- On this basis, we tentatively estimate that in the absence of the proposed rule changes the admin burden to business from the BCE3 test would be around £22 million per annum in 'steady-state' (and 'steady-state' would be reached in around 10 years from the implementation of Pension Simplification, April 2006). The cost in 2006-07 would be around £2.5 million (750,000 cases at roughly £3 per case).

- HMRC's proposed changes will mean that, in most cases, scheme administrators will no longer need to produce a calculation at all. Also, for those cases in which a calculation is still required, the average burden should be much less than at present. Assuming henceforth only around 25% of DB scheme members require a BCE3 computation (i.e. around 190,000 new cases per annum) and that the time and resources scheme administrators must devote to this activity falls by around 80% of the current estimated burden (i.e. to £1 per case), the total saving in industry admin burdens is estimated around £20 million per annum in steady-state (i.e. after 10 years). In addition, the corresponding saving in 2006-07 estimated admin burdens would be around £2 million.

(ii) Tax Free Lump Sums

<u>Rationale of Intervention</u>

Under the new tax regime the maximum value of the tax-free lump sum, generally taken on retirement, is standardised at 25% of the pension fund. However, before A day some members of occupational schemes were entitled to lump sums of more than 25% and these rights are protected in the new regime. The rules also allow such an individual an additional tax-free sum on the basis of 25% of any accruals of pension rights since 5 April 2006.

Representations have been received that this rule is complicated to apply for defined benefit schemes. Often these lump sums are paid to lower paid workers and the application of the rule means that scheme administration is complex leading to potential mistakes in calculating lump sums.

<u>Policy Options</u>

<u>Option 1 – Do nothing</u>

This option would mean that complicated calculations remain with the possibility of schemes making errors and paying pensions the wrong tax free lump sums.

<u>Option 2 – Legislative changes</u>

A straightforward change would make calculations simpler and thereby give administrative easements to large occupational pension schemes. The revision would remove the condition of further benefit accrual when calculating an entitlement to any additional tax free lump sum built up after 5 April 2006.

<u>Decision</u>

The recommendation was that the Government pursue option 2 as it will remove potential unfairness for some individuals as well as reduce the administrative burden on schemes. The change should not lead to any increase in costs nor should it open up any significant areas of abuse.

The Government's proposals cover all schemes however they should make it easier, in particular, for the administrators of Defined Benefit schemes to undertake the necessary calculations in cases where scheme members have protected rights to a tax free lump sum in excess of the standard 25% permitted under Pension Simplification. The revision to the rules will remove the condition of an entitlement to an additional tax free lump sum that is built up after 5 April 2006 from the calculation.

Costs and Benefits

We do not know precisely how many cases of this sort are currently being handled by pension schemes, but it is only likely to be a concern in a relatively small fraction of private sector DB scheme cases where members are approaching retirement. The number of cases should also reduce over time as no new entitlement to a tax free lump sum in excess of 25% is granted under Pension Simplification. Accordingly, while firms affected may experience a genuine saving from this change, the overall impact on industry admin and compliance burdens will be small. The analysis summarised below indicates an estimated admin and compliance burden saving of around £25,000 per annum.

Further details on estimated admin burden savings

- There are an estimated 16 million active and deferred members of private sector Defined Benefit occupational pension schemes (members of public sector schemes are unlikely to have a tax free lump sum in excess of 25%).

- Based on typical working lifespans (30-40 years), there could around 500,000 members of private sector schemes approaching retirement. Only a very small fraction of this group are likely to have preserved rights to a tax free lump sum pension in excess of the 25% limit stipulated under Pension Simplification. We assume it is no more than around 5% of members approaching retirement – that is, around 25,000 scheme members.

- We do not have any firm evidence of typical costs incurred by pension scheme providers in meeting their obligations under this aspect of the pensions tax rules. A plausible assumption could be to assume a cost per case of around £50 (equating to roughly to 2 man hours expended at the average wage of a tax expert/qualified accountant (based on HMRC Standard Cost Model rates). For 25,000 cases that generates an existing admin burden of around £50,000 per annum.

- The proposed measure should make calculations easier for scheme administrators, who will no long need to factor in any entitlement to an additional tax free lump sum built up after April 2006 in their calculations.

- We assume this change will reduce admin burdens by 50% in each case, implying an aggregate admin burden saving of around £25,000 per annum in steady-state (i.e. 2-3 years from the Pension Simplification start date). The measure also provides pension scheme administrators with clarity about the rules, which may also serve to lessen their overall compliance burden, though this effect is secondary to the main admin burden savings and we assume a negligible overall effect.

In summary, taking the estimated savings for the two above measures in the round, we estimate total admin burden savings of around £20 million per annum in steady-state (i.e. after 10 years).

(iii) Scheme Investments

Rationale of Intervention

The Government introduced legislation in 2006 to remove tax relief from pension scheme investments in taxable property such as residential housing, paintings or vintage cars with potential for private use. It was intended that this will only apply where members could influence what types of property the scheme invests in for their benefit. Representations from the pensions industry have been made that these rules may, in certain circumstances, catch large occupational schemes even though none of their members can influence the scheme to invest in taxable property.

Policy Options

Option 1 – Do nothing

This option may lead to some schemes being inadvertently caught by the rules.

Option 2 – Legislative changes

Repeal the rule which causes the inadvertent impact on large schemes.

Decision

The recommendation was that the Government will pursue option 2. The legislation will then work as intended so that the taxable property legislation will only apply where members can influence what types of property the scheme invests in for their benefit.

Costs and Benefits

The Government's proposal to repeal the existing rule that inadverently catches large pension schemes with investments in property assets should have little net impact on aggregate burdens faced by schemes, given that very few schemes are believed to be currently affected. The estimates reported in the previous section assume a negligible saving from this aspect of the package of reforms.

(iv)Lifetime Alllowance Test - Dependant's Scheme Pensions

Rationale of Intervention

The second part of the consultation announced at Pre Budget Report in December 2006, was aimed at identify any improvements that could be made to Dependants' Scheme Pensions test.

The rule is intended to prevent people avoiding the Lifetime Allowance charge by reducing their own pensions and paying larger dependents scheme pensions. The rule applies to members who die after age 75 with a scheme pension in payment.

The objective of the consultation was to identify any improvements which would assist scheme flexibility, provide greater clarity to scheme members and smooth the operation of the new pensions tax regime.

Policy Options

Option 1 – Do nothing at present

No clear consensus emerged from the consultation and a previous regulatory change means that the rules on dependent scheme pensions only affect scheme pensions commenced after A Day, therefore few current pensions are affected by this rule.

Option 2 – Minor Changes

Some very minor changes could be made to ensure that the rules are operated slightly more efficiently. These changes on their own would not result in administrative easements and leave open the possibility of further changes in the near future.

Decision

The recommendation was that the Government pursue option 1 and allow further time for the responses to the consultation exercise to be considered.

Costs and Benefits

As with the changes to the BCE3 test above, the Government is seeking to remove any unnecessary compliance burdens posed by the Dependant's Scheme rules in relation to the Lifetime Allowance Test. At this stage, there are no firm proposals for reforming the rules in this area. However, the existing test only impacts on a small number of Defined Benefit pension schemes at the moment, and so, accordingly, we have assumed the savings to industry would be negligible at present.

Competition Assessment:

The proposed changes apply to all schemes across the whole economy. Accordingly, the Government does not anticipate any material impact on competition.

Small Firms Impact:

The proposals apply to all pension schemes, though there will be proportionately more scheme members in large pension schemes that are affected. Small firms will not be any worse off as a result of the proposed changes.

Specific Impact Tests: Checklist

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

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	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