EXPLANATORY MEMORANDUM TO

THE TAXATION OF PENSION SCHEMES (TRANSITIONAL PROVISIONS) (AMENDMENT) (NO. 2) ORDER 2011

2011 No. 1782

1. This Explanatory Memorandum has been prepared by Her Majesty's Revenue and Customs ("HMRC") and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 This instrument makes a number of consequential amendments to The Taxation of Pension Schemes (Transitional Provisions) Order 2006 (SI2006/572) ("the Order"), to reflect changes made by the Finance Act 2011 ("FA 2011") to the pensions tax regime in Finance Act 2004 ("the Act") which remove the effective need to take an annuity by age 75 and reduce the amount of tax relief an individual can receive on their pension savings.

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

3.1 None.

4. Legislative context

4.1 This instrument is one of a group of instruments which are part of the changes made to the pension tax regime introduced by FA 2011. The annex to the Explanatory Memorandum for The Registered Pension Schemes (Miscellaneous Amendments) Regulations 2011 (S.I. 2011/1751) shows the full list of instruments that are expected to be laid following the coming into force of FA 2011.

4.2 Part 4 of the Act came into force on 6 April 2006, and makes provision for registered pension schemes. The Act put in place a single regime for tax privileged pension saving, with a number of key controls including the lifetime allowance which acts as an overall cap on tax-relieved saving – section 218 of the Act. Section 160 of the Act provides that the only payments that a registered pension scheme is authorised to make to or in respect of a member are set out in section 164 Section 166 and 168 make further provision about lump sum payments. Payments that are not authorised are unauthorised payments and are subject to certain tax charges set out in sections 208 to 210 and section 239 of the Act.

4.3 Paragraph 2 of Schedule 18 to Finance Act 2011 amends section 218 of the Act and reduces the lifetime allowance from £1.8m in the 2011-12 tax year to £1.5m from the 2012-13 tax year.

4.4 Schedule 29 to the Act provides details of the various lump sum payments that a registered pension scheme can make to a member. One of these is a tax free lump sum, known as a pension commencement lump sum (“PCLS”). Paragraphs 1 to 3 of Schedule 29 set out the conditions for a PCLS to be paid to a member. The maximum PCLS is 25% of the pension fund value subject to an overall limit of 25% of the lifetime allowance. Under the pension tax rules in force on 5 April 2006, some individuals had a right to a lump sum greater than 25% within a specific pension scheme (“a protected PCLS”). These rights are protected under paragraphs 31 to 34 of Schedule 36 to the Act. These paragraphs also set out the maximum protected PCLS that can be paid which is linked to the level of the lifetime allowance.

4.5 Where an individual with a right to protected PCLS transfers their pension rights to another scheme, articles 21 to 23 of the Order, amend the permitted maximum that can be paid as a protected PCLS which is linked to the level of the lifetime allowance. The changes to the level of the lifetime allowance in Finance Act 2011 would, without this consequential amendment, mean that the maximum protected PCLS that can be paid under the Order would be reduced.

4.6 Paragraphs 7 to 9 of Schedule 29 to the Act set out the conditions for pension pots to be taken out as a lump sum if an individual’s aggregate pension savings are below a specified limit, (“a trivial commutation lump sum”). Article 23C of the Order sets out further circumstances when a small pension pot of less than £2,000 can be commuted to a lump sum subject to a number of conditions, one of which is the member must not have reached age 75 when they become entitled to the payment.

4.7 Under the pension tax rules in force on 5 April 2006, some individuals had a right to take 100% of their fund value as a lump sum. This right is protected under articles 25 to 25D of the Order subject to a number of conditions, one of which is the member must not have reached age 75 when they become entitled to the payment.

4.8 Schedule 16 to Finance Act 2011 removes the upper age limit of 75 for certain lump sums, for example paragraph 29 of Schedule 16 does so for trivial commutation lump sums. However because the rules for payment of stand alone lump sums and small stranded pots are set out in secondary legislation/Treasury Orders, without this consequential amendment, payment of a stand alone lump sum or small stranded pot where the member has reached age 75 would not be authorised and would result in unauthorised tax charges arising.

5. Territorial Extent and Application

5.1 The instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 As the instrument is subject to the negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- ***What is being done and why***

7.1 The Government provides tax relief to encourage individuals to take responsibility for retirement planning and in recognition that pensions have been traditionally less flexible than other forms of saving. However, the cost of tax relief net of income tax on pensions doubled over the past decade to an annual cost of around £19bn by 2008-09. Reform to pensions tax relief is an integral part of the Government's deficit reduction package and as part of these reforms the Government has introduced restrictions to the amount of tax-free pension savings that can be made to ensure that pensions tax relief remains fair, affordable and sustainable.

7.2 The level of the annual allowance has therefore been reduced from £255,000 to £50,000 for the 2011-12 tax year onwards and the lifetime allowance has been reduced from £1.8m to £1.5m for the tax year 2012-13 onwards. The maximum amount that can be payable for certain pension lump sums is set by reference to the lifetime allowance. In order to preserve the value of these rights consequential changes are needed to the Order.

7.3 Alongside the restrictions on relief, the Government has made reforms to pension benefits, which are intended to make pension saving more flexible and attractive and encourage people to take greater responsibility for their financial future. Ending the rules that create an effective obligation to purchase an annuity by age 75 and removing the age 75 cap which applies to most authorised lump sum payments made from registered pension schemes supports the Government's objective to re-invigorate private pensions and provides people with greater flexibility to choose the retirement options that are best for them.

7.4 The amendments in this Order which remove the upper age limit of age 75 ensure that payments of stand alone lump sums and trivial commutation to members over age 75 are authorised under the pension tax rules.

- ***Consolidation***

7.5 There are no plans to consolidate the instrument that is being amended.

8. Consultation outcome

8.1 The Government held an informal consultation which concluded on 27 August 2010 on its proposed approach to restricting pensions tax relief, involving reform of existing allowances. A discussion document on the subject "Restriction of pensions tax relief: a discussion document on the alternative approach" was published in July, inviting views on a range of issues around the precise design of any such regime. A summary of responses to this consultation was published on 14 October 2010.

8.2 A consultation document "Removing the requirement to annuitise by age 75" was published on 15 July 2010, inviting views on the issues around the precise design of the new rules required to do so. The formal consultation concluded on 10 September 2010. A summary of responses to this consultation was published on 9 December 2010.

8.3 The draft Order was published for comment on the HMRC website on 23 May 2011. No responses were received on the proposed draft legislation.

9. Guidance

9.1 Draft guidance on the lifetime allowance has been available on the HMRC website since 9 December 2010 at www.hmrc.gov.uk/pensionschemes/lifetime-allowance/index.htm.

9.2 Draft guidance on the age 75 changes was published on the HMRC website on 31 March 2011 at http://www.hmrc.gov.uk/budget-updates/march2011/pensions-draft-guidance.pdf.

9.3 All the guidance will be updated at the next available opportunity to reflect the final legislation.

10. Impact

10.1 The impact on business, charities or voluntary bodies is negligible as this instrument provides certain transitional relief to prevent individuals being disadvantaged by the pension reforms.

10.2 The impact on the public sector is negligible.

10.3 A Tax Information and Impact Note ('TIIN') covering the restriction of pensions tax relief was published on 9 December 2010 alongside draft legislation for the Finance (No.3) Bill 2011. This was updated on 3 March 2011 to reflect further decisions relating to the restriction of pensions tax relief. A separate TIIN covering the removal of the effective requirement to annuitise by age 75 was also published on 9 December 2010. Both TIINs are available on the HMRC website at www.hmrc.gov.uk/thelibrary/tiins.htm. They each remain an accurate summary of the impacts that apply to this instrument.

11. Regulating small business

11.1 The legislation does apply to small businesses.

11.2 The impact on small firms has been considered as part of the consultation. It would however not be appropriate for the policy to apply differently according to the size of firms within which the affected individuals operate.

12. Monitoring & review

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

13. Contact

Paul Cottis at HMRC, telephone: 0115 974 2420 or email: pensions.policy@hmrc.gsi.gov.uk, can answer any queries regarding this instrument.