EXPLANATORY MEMORANDUM TO

THE FINANCE ACT 2004 (REGISTERED PENSION SCHEMES AND ANNUAL ALLOWANCE CHARGE) (AMENDMENT) ORDER 2015

2015 No. [XXXX]

1. This 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

This instrument helps ensure that 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.

3.2 The articles in the first four bullet points below will increase a person's liability to tax, so the Order ensures that they will only have prospective effect. The articles in the last bullet point do not increase tax and merely put the meaning of the legislation beyond doubt prospectively. If that were wrong the articles would increase tax for some persons on a prospective basis.

- 12(b)("5BC") and 15(b)("5BD") – points 7.8 and 7.13
- 13(g) and 16(f) – points 7.15 to 7.17 below
- 13(b)("(4A)(a))") and 16(b)("(4A)(a)") – points 7.28 and 7.29
- 13(f) – point 7.32
- 13(e) and 16(e) – point 7.27

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.

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 benefits 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 amendments 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 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 2015 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 11, 12(a) and 15(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 12(b) ("5BC"/ "5BD") and 15(b) ("5BD" / "5BE")):** The aim of this provision is to ensure that the easement for deferred members of a defined benefits or cash balance scheme (no amount is measured against the AA limit for certain small value increases in value) 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). This treatment is subject to the condition that the value of a member's rights immediately after the transfer is not greater that the value immediately before (in the case of "block transfers"), or that the value of an individual's rights after the transfer is not greater than an amount supported by the sums or assets transferred (in the case of individual transfers).

7.9 **Other increases to deferred benefits (Articles 12(c)(i) and 15(c)(ii)):** This provision is intended to mirror treatment provided for the lifetime allowance (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 totheir 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 12(b) "5B(b)", 12(c)(ii), 15(b) "5B(a)(ii)" and 15(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 15(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 further for such deferred annuities by also including an increase in value that does not exceed 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, with the exception of the condition flagged in point 7.8 above, which will have the effect of increasing tax. This condition will apply from the date that the Order takes effect (article 3(1) and (2)).

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 13(g) and 16(f)):** Where a member of a defined benefits 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) by adding back to the closing value the reduction to an individual's pension or lump sum as a consequence of using the 'scheme pays' facility, where the reduction is made before entitlement to all benefits arises. This will ensure that the amount of the AA charge payable is the same as if the member had not relied on the 'scheme pays' facility.

7.17 By removing the unintended advantage, this provision will increase tax and so applies only in relation to AA charges arising on or after the date on which this Order comes into force, where elections to use the "scheme pays" facility have been made on or after the date on which the Order comes into force (articles 5 and 7).

7.18 **Election for 'scheme pays' (Article 17(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.

7.19 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 the point at which individuals do take all their benefits, where that point is six months or more from the date on which this Order comes into force (article 8).

7.20 **Transferred schemes (Article 17(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.

7.21 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 (article 9).

Other Issues:

7.22 **Transfers between pension schemes (Articles 13(a) to (e) and 16(a) to (e)):** 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..

7.23 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 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.

7.24 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.

7.25 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.

7.26 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 reorganisation. 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.

Given these difficulties, the provisions are intended to;

7.27 Clarify how current legislation applies (articles 13(e) and 16(e)). This will maintain 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 (article 3(4) and (6)).

7.28 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 administrative burden of identifying the level of underfunding that may relate to each scheme member, and the potential for AA distortions (articles 13 (a) to (d) and 16 (a) to (d)).

7.29 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 (where the adjustment increases the amount that is measured against the AA limit), 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) only where the effect across the revised adjustments in both transferring (adding back to the closing value) and receiving arrangements (deducting from the closing value) is not to increase tax (articles 2(b) and (d), and 3 (3) and (5)).

7.30 **Cash Balance – adjustment to closing value (Article 13(f):** Where an individual becomes entitled to take benefits from a cash balance arrangement, the closing value of their rights under the arrangement is lower than it would otherwise be. To ensure any increase in the value of an individual's rights is correctly measured for the period in which the entitlement arises, an adjustment is made to the closing value to add back the reduction in the value of the rights.

7.31 This article is intended to correct a technical defect and ensure that where entitlement to a pension arises or where that entitlement is increased, the consequential addition to the closing value is the reduction to the amounts available to provide the benefits, not the rate of benefits themselves.

7.32 This change increases amounts that will count towards the AA limit and so could increase tax charges. To ensure that the correction does not have retrospective effect, the change will apply in relation to Benefit Crystallisation Events (where an individual becomes entitled to a pension, for example) arising on or after the date on which the Order comes into force (article 4).

7.33 **Refund of excess contributions lump sum (Article 14):** 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.

7.34 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 (article 6).

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

8. Consultation outcome

This draft Order has been the subject of two periods of consultation.

9. Guidance

Draft changes to the Registered Pensions Scheme Manual were published for comment on 29 July 2014 as part of the second period of consultation, and are expected to be published by the time or shortly after the Order takes effect.

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, which is intended to ensure that the changes to the Annual Allowance rules made by FA 2011 work as originally intended.

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.