

TAXREP 13/04

Simplifying the taxation of pensions: the Government's proposals

Memorandum submitted in March 2004 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales (ICAEW) to the Inland Revenue in response to the second Consultation Document on Pensions issued jointly in December 2003 by Inland Revenue and HM Treasury

CONTENTS

	Paragraph
INTRODUCTION	1-3
WHO WE ARE	4-6
GENERAL COMMENTS	7-15
SPECIFIC COMMENTS	16-34

Tax Representation

Simplifying the taxation of pensions: the Government's proposals

INTRODUCTION

1. We welcome the opportunity to comment on the second Consultation Document on Pensions *Simplifying the taxation of pensions: the Government's proposals* issued in December 2003 jointly by the Inland Revenue and HM Treasury.
2. In the first Consultation Document issued in December 2002 the Government stated its intention to develop more detailed plans for reform of the existing pension regime in partnership with those who will use the new rules to ensure that the detailed proposals are simple, durable and readily understood (paragraph 1.15). We welcomed this collaborative approach in our response to that first Consultation (TAXREP 11/03) and we are pleased to acknowledge that the latest Consultation shows clear evidence that the Government has listened and acted on the very many representations it received. The Government issued a summary of the responses to the first Consultation on 10 December 2003 which indicated that in total it had received 366 formal responses.
3. We hope that the Government will continue to take note of the representations that it receives to ensure that the final scheme, if it is introduced, is indeed 'simple, durable and readily understood.'

WHO WE ARE

4. The Institute of Chartered Accountants in England and Wales is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
5. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy (which includes taxation).
6. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members who pay an additional subscription.

GENERAL COMMENTS

Beneficial changes in current Consultation Document

7. We welcome the additional time that has been allowed to consider what is, potentially, a major overhaul of the taxation of pensions regime and that the new

Tax Representation

scheme, if introduced, will not now come into effect until April 2005. We note that whether or not a change is to be introduced is stated to be subject to a report from the National Audit Office (NAO) on the questions set out at the end of the Introduction to the latest Consultation Document.

8. We do not believe it is appropriate to threaten to drop completely the proposal to simplify the taxation of pensions merely because the number of people likely to be affected by the lifetime limit may be different from that estimated by the Government. The simplification will make saving for pensions simpler and more effective for the vast majority of people: it is this majority, and not the small minority who already have significant pension 'pots', who will be significantly disadvantaged if the reforms are abandoned.
9. If the number likely to be affected is significantly greater than the Government's current estimate then we believe there is an even stronger argument for introducing a greater, initial, lifetime limit, and it should not be a reason for dropping the simplification proposal altogether.
10. Amongst the other changes, we welcome the proposed reduction in the recovery charge from 60% to 55%.
11. We also welcome the amendment to the provisions on divorce with regard to the lifetime limit, as we believe the original proposals would have led to extremely anomalous results. We believe the current proposals in paragraphs 3.18 to 3.22 are sensible and reasonable.
12. Similarly we welcome the proposal that the annual allowance should not apply in the year in which the full pension entitlement is taken (paragraph 1.30).
13. We still have reservations about the lifetime limit and the indexation proposal but whatever the final outcome we now believe the proposals in relation to transitional relief are much more acceptable. We also welcome the fact that if there is a recovery charge the excess over the lifetime limit which remains after the recovery charge has been levied can be withdrawn in full (paragraph 1.24).
14. It will be difficult for those individuals whose funds are at or around the lifetime limit to decide whether to carry on investing in their fund and risk a recovery charge or cap their existing fund, make no further contributions to a pension scheme, and be able to take their pension entitlement in the future, whatever the value of the fund, without risk of a recovery charge.
15. We believe that taxpayers in this situation would be more prepared to carry on making contributions to their scheme, and risk a potential recovery charge, if the lifetime limit were to be indexed to earnings rather than the RPI as is proposed at the moment.

Tax Representation

SPECIFIC COMMENTS

Lifetime limit

16. We still believe that the lifetime limit should be set at an amount greater than the current proposed limit of £1.4 million. While £1.4 million may be the actuarial equivalent of the fund required to provide a maximum two-third's pension based on the post 1989 earnings cap of £99,000 we still believe there should be some additional allowance to encourage those who could be affected by the limit to continue to make provision for retirement via an approved pension scheme.
17. If the recovery charge is likely to affect a significant number of people then, apart from the effect on those individuals, there may be a shift in the public perception of the reforms, away from the broad welcome they have received to date, and towards a greater level of worry and suspicion. We believe that the Government ought to do all in its powers to make pension provision both simple and straightforward and also eliminate as far as possible any potential negative aspects. However, as stated above, we do not consider that this issue on its own should be allowed to derail the overall reform.
18. As noted above the lifetime limit of £1.4 million 'broadly replicates the maximum pension, £66,000, that an individual earning at or above the current earnings cap of £99,000 could accrue over a working lifetime under the 1989 rules.' (paragraph 1.9 of the latest Consultation Document). The £99,000 applies to the 2003/04 tax year. If the introduction of the new simplified pension regime is to be delayed until April 2005 the lifetime limit should 'replicate' the 2005/06 earnings cap which means that two further years' inflation adjustment will be required.
19. However for the reasons we have set out above we believe the initial lifetime limit should be set at a higher amount and we would suggest an initial limit of not less than £1.75 million.
20. We continue to be concerned that the proceeds of life assurance taken out through a pension fund may rank against the lifetime limit and cause a recovery charge to be triggered. As we noted in our earlier representation 'term assurance is relatively inexpensive and it is common, particularly in large professional partnerships, to provide high levels of term assurance.'

Annual limit

21. In the first Consultation Document it was noted that eventually it was hoped to do away with the annual limit and keep the lifetime limit as the means whereby the Government would limit the potential for the abuse of pension scheme relief and of pension stripping. We believe that retention of the annual limit will give rise to a considerable number of practical difficulties and we hope the Government will continue to explore ways in which the annual limit could be dispensed with. We repeat what we said in our earlier representation

'We would welcome the opportunity to discuss the most sensible way to introduce measures which satisfy the need to prevent pension stripping and do away with the need for a maximum annual contribution level.'

Tax Representation

Self employed – carry back

22. We are concerned that the proposals in Appendix A.9 will be unfair for self-employed persons who will not know the level of their ‘pensionable’ earnings until after the end of the year and their accounts have been finalised. We would recommend a continuation of the current system whereby such persons can elect up to the time they submit their tax return for the year, or 31 January following the tax year in question at the latest, to treat any payment made up to that time as if it had been paid in the previous year. This would be a practical solution which we believe merits careful scrutiny by the Government.

Indexation

23. For the reasons which we set out in our response to the first Consultation we believe that the life-time and annual limits should both be referenced to earnings and not to the RPI. Pensions are a form of deferred earnings and it seems much more logical to have these important parameters of the new pension regime referenced to a measure which reflects what is happening in the world of earnings.
24. We noted in our earlier responses that over the past period earnings have increased much more rapidly than RPI which means that indexation to the latter would quickly erode the real value of these limits. We believe that the majority of taxpayers would not consider constant erosion of the real value of these limits fair and reasonable.

Value Protection

25. The proposal in paragraphs 3.11 to 3.14, and Appendix A65, is that value protection will only apply up to age 75.
26. We urge the Government to reconsider this proposal.
27. We accept the basic premise that pension savings are to provide a pension for the pensioner and his immediate dependants, and not to create wealth to pass to the next generation. Nevertheless the system ought to be such that the potential pensioner feels that he is likely to get a reasonable return for the funds that he puts aside for his eventual retirement.
28. At age 75 an individual currently has a life expectancy of nearly 10 years. It seems reasonable that the pension system should reflect that situation. If such an individual does in practice die shortly after his 75th birthday the system should allow some return of the underlying fund which in the average case would have secured pension payments over the next ten year period.

Life-time allowance – standard valuation factor

29. The standard valuation factor for any pension scheme is to be 20:1. It is proposed in paragraph 1.16 that more generous schemes should be able to agree a different

Tax Representation

valuation factor than the standard one. There is no equivalent provision for less generous schemes.

30. For instance if a scheme does not provide inflation proofing for the pension in payment and there is no provision for dependent relatives the valuation factor for such a scheme may in practice be, say, 16:1 rather than the standard 20:1. If under the terms of the scheme an individual is entitled to a pension of £80,000 the value based on the terms of the scheme, i.e. the 16:1 factor, would be £1.32 million, which is below the initial lifetime limit. However if that pension is valued by reference to the standard factor of 20:1 its value will be £1.6 million and there will be a recovery charge of £110,000 (£200,000 at 55%).
31. We believe this particular proposal should be reviewed and symmetrical provisions introduced to reflect the fact that some schemes will be less generous than others in terms of the level of benefit provided.

Mandatory e-filing

32. Paragraph B6 suggests that e-filing should be made mandatory. 'Making e-business the mandatory method for registering and subsequently amending and reporting scheme details and information could lead to a step change in service delivery.' While we accept that many businesses will be happy to adopt e-filing it may not be appropriate for all and we would strongly recommend that businesses be left to choose which is most appropriate to their own particular circumstances.

Impact of the state pension

33. This is not the subject matter of the current Consultation but it will have an important impact of people's perception as to what action they need to take to provide adequately for their retirement.
34. The low level of the basic state pension and the increasing number of people who will be entitled to pension credits during the forthcoming years seriously undermine any encouragement to provide personally for one's pension rather than relying on the state. The Government intention was that rather than 60% of pension provision coming from the State, 60% should be personally funded. This is not likely unless there is a review of the state pension scheme, which the Government currently seems unwilling to contemplate. However at some point the conflict between these two policy approaches will be unavoidable, and we therefore recommend that it is addressed before the state pension regime has become too embedded in the country's culture.