# TAXREP 34/10

# PENSIONS: REMOVING THE REQUIREMENT TO ANNUITISE BY AGE 75

***Comments submitted on 10 September 2010 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales in response to the consultation document issued on 15 July 2010 by HM Treasury***

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# PENSIONS: REMOVING THE REQUIREMENT TO ANNUITISE BY AGE 75

## INTRODUCTION

1. In this document we present the comments of the Tax Faculty of the Institute of Chartered Accountants in England and Wales ('ICAEW') on the consultation document '*Removing the requirement to annuitise by age 75*' ('the condoc') issued by HM Treasury ('HMT') on 15 July 2010 at http://www.hm-treasury.gov.uk/consult_age_75_annuity.htm.

2. We are pleased to have the opportunity to respond to this consultation. We would be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

3. On 8 September 2010 we attended a meeting jointly with other professional bodies with HMT and HMRC, in which we were able to put forward some key comments and concerns and discuss aspects of the discussion document.

4. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals to change the tax system, and which apply pari passu to pensions.

## WHO WE ARE

5. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

6. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

7. The Tax Faculty is the focus for tax within ICAEW. It is responsible for technical tax submissions on behalf of ICAEW as a whole and it also provides various tax services including the monthly newsletter *TAXline* to more than 11,000 members of the Institute who pay an additional subscription, and a free weekly newswire.

## MAJOR POINTS

8. We believe that the regime that is decided upon should be simple and straightforward.

9. We welcome the proposals to enable those aged 75 and over to enter into unsecured pension ('USP') instead of an alternatively secured pension ('ASP').

10. We also welcome the imaginative proposals for flexible drawdown, subject to more work being undertaken before a decision is made as to the form that this will take. This is because we have concerns that, as flexible drawdown is likely to be appropriate only for a limited number of people, mis-selling could result unless there are sufficient safeguards and the regime is simple enough to enable the risks to be explained and understood by an average person. Getting the rules right for flexible drawdown should not hold up implementation of USP for those aged over 75.

11. As an alternative to the proposal for flexible drawdown at any time after becoming 55, we suggest that consideration be given to allowing individuals to draw down income outside the capped USP regime from their pension fund only if as a result of ill health they have to go into a residential or nursing home or need caring for at home.

12. However much some people perceive that annuities are not good value, there are many advantages to buying an annuity and many risks attaching to drawdown. Annuities offer guarantees whereas USP and ASP do not. Additionally, the annuity market now offers many flexible options, including investment-linked annuities which can deliver similar benefits to drawdown but often at lower cost and less risk.

13. We welcome the commitment that the tax-free commencement lump sum will continue and trust that that means that the proportion of the fund which can be received tax-free will remain at 25%.

14. We consider that the proposed rate of recovery tax on funds at death is too high at 55%. We consider that a rate nearer to 35% would be more equitable than a rate of 55%, and which is more consistent with the existing rules. A 55% tax rate can only be described as penal for basic rate taxpayers, and in particular for those currently in USP drawdown who would have budgeted (on behalf of their beneficiaries) on the basis of a 35% claw back.

15. We welcome the proposal that IHT will not ordinarily apply to pension funds that have not been crystallised.

16. We welcome the fact that the zero rate recovery tax for those under 75 who have not vested their funds will remain. We question why those over 75 who have not vested their pension funds should be discriminated against.

17. We also welcome the continuation of a tax exemption where the pension funds are passed on death to dependants but would welcome clarification of certain issues relating to this.

18. We should also welcome the retention of the current rule whereby pension funds left to charity are exempt from a tax charge on death.

19. We do feel that the ideal outcome of this consultation would be legislation that helps close the savings gap. This requires consistency and simplicity and joined-up thinking between HMRC and the main regulators in this area, mainly the Financial Services Authority which deals with advice to the public, and the Pensions Regulator. Across the majority of the population financial literacy is low and this needs to be addressed. People also need to be aware of the changes being introduced under the Retail Distribution Review and its relevance to them as consumers.

20. One way in which the regulators can help people make the right decisions is to ensure that information provided to those who are about to vest their pension funds is in a standard format that explains in terms capable of being readily understood by the average person the available options and recommends that independent advice be taken.

## COMMENTS AND RESPONSES TO SPECIFIC QUESTIONS

### Chapter 2 Developing a new tax framework for retirement

#### *The current tax framework*

21. The proposition in para 2.3 that pension funds are exempt from tax should be moderated by the fact that tax credits on dividend income are not refundable, which has significantly reduced the investment returns within pension funds.

#### *Principles for a new tax framework*

22. We are content with the principles for a new tax framework for retirement outlined in Box 2.A in para 2.10 subject to two points.

23. First, in Principle 4 we particularly welcome the commitment that the tax-free commencement lump sum will continue to be available: we should welcome confirmation that this does mean that at least 25% of the fund (rather than a lesser amount) will continue to be able to be available tax free. Without this guarantee, many will decide that pension saving is no longer viable.

24. Secondly, Principle 5 refers to an exemption from a tax charge on death except where the unused funds are used to provide pensions for dependants. We have been told that this means that the pension fund is transferred to the dependant who can then choose whether or not to vest it and we should welcome confirmation that this interpretation is correct; if it is then we welcome it.

25. We consider that the existing additional exemption for where the funds are transferred to charity, referred to in the third bullet in para 2.7, should remain.

***Options for securing a retirement income***

26. We welcome the proposals in paras 2.12 to 2.16 and 2.17 to 2.19 under which people will be given greater flexibility over whether and if so when they purchase an annuity, the extension of USP arrangements to those over 75 and, subject to certain reservations, the introduction of flexible drawdown subject to demonstrating a minimum income, which together obviate the need for continuing with ASP arrangements.

*USP for all over age 55*

27. Whilst in principle we should like to see implementation of the extension to USP to all those aged over 55 as soon as possible, providers will require sufficient lead time after the legislation is enacted to update their IT systems, procedures and stationery.

*Flexible drawdown*

28. We welcome the imaginative and innovative proposals in the condoc for flexible drawdown, but subject to more work being undertaken before a decision is made as to the form that this will take. This is because we have concerns that, as flexible drawdown is likely to be appropriate only for a limited number of people, this could result in mis-selling unless there are sufficient safeguards, both by the regulatory bodies (eg Financial Services Authority) and by way of limitations as to the circumstances in which flexible drawdown can take place, and the regime including limits etc is simple enough to enable the risks to be explained and understood by an average person, ie anyone who is not a finance or pensions expert. It is vital to get flexible drawdown right including information for policyholders, and the implementation date of the flexible drawdown rules should not hold up the introduction of USP for those aged 75 or over.

29. We believe that the resulting increased flexibility may help to remove a perceived disincentive to saving for retirement by way of a pension fund, namely that annuities offer poor value. However, there are many advantages in buying an annuity and many risks attaching to drawdown. Annuities offer guarantees whereas drawdown does not, and annuity providers now offer a range of innovative, flexible annuity products, including investment linked options.

30. The risks and costs attaching to managing a USP/ASP contract over the medium term are high, and with the costs, impact of mortality drag and unpredictability of asset returns and need for ongoing financial planning and investment advice, the idea should be treated with considerable caution. For people who have policies worth, say, £250k and above and a minimum level of guaranteed income from other sources and, most importantly, the time and expertise actively to monitor their investments, flexible drawdown and the removal of an effective requirement to convert to an annuity is to be supported. However, our support is caveated because of the

investment risks which could diminish the pension fund – and the risk that widening the rules could give rise to a major mis-selling scandal (such as happened when people were given the option to opt out of employer-provided pension schemes). It will therefore be necessary for the regulatory authorities – the Financial Services Authority ('FSA') to take an active monitoring role in this area (see Question A.9), both in respect of advised and non-advised sales.

31. We have no objection to the suggestion that individuals wishing to use flexible drawdown should have a minimum secured income but have concerns as regards to how in practical terms the concept could be implemented, particularly in connection with non-advised sales. .

32. As an alternative to the proposals in the condoc of uncapped or flexible drawdown of an amount treated as income at any time after becoming 55, we suggest that consideration be given to only allowing individuals to draw down an income from their pension fund if as a result of ill health they have to go into a residential or nursing home or need caring for at home. We understand that average life expectancy in such circumstances is normally about three years, so perhaps such individuals could be allowed to draw down all, or say 20-25%, of their pension fund per year, regardless of income or capital on production of appropriate certification, eg from a doctor. Against this idea is the possibility that such individuals (who will perforce be in ill health and potentially vulnerable) who have not planned ahead, eg by entering into lasting powers of attorney, may be unduly influenced by family or third parties into entering into transactions and commitments which are not in their own best interests.

33. We welcome the commitment in Box 2.A that the tax-free commencement lump sum will continue and trust that that means that the proportion of the fund will remain at 25%.

*A.1 The Government welcomes views on the level of an appropriate annual drawdown limit for capped drawdown (para 2.17)*

34. It is proposed that capped drawdown will be able to continue and will be available whether one is aged over or under 75. In general terms, the present rules for unsecured pension USP arrangements, which allow for up to 120% of an equivalent annuity to be withdrawn, provide that the value of one's withdrawal has to be actuarially recalculated every five years. If the investment performance of the pension fund is poor then there is a danger that the pension pot can become seriously depleted or even exhausted during those five years.

35. We think that that anyone contemplating drawdown should take advice: see our reply to Question A.9 for our further comments. Reputable investment advisers normally recommend annual review of the value of the pension pot and warn about the dangers of depleting or exhausting the pot if too much is withdrawn. They also counsel against drawdown other than for those who have sufficient income from other sources or sizeable pension pots. Given present annuity rates which mean that 120% of a small proportion of a pension pot is still a relatively small amount of money that is being withdrawn, we cannot see any case for changing the figure from 120% whatever the age.

***Designing a new tax framework for retirement***

36. Para 2.21 observes correctly that the tax relief on contributions and tax-free investment growth and income (leaving aside the removal of the ability to reclaim tax credits on dividend income) and the 25% tax-free lump sum are significant incentives to save into a pension. However, we should note that these incentives have proved insufficient to increase saving for retirement probably because of the decline over the last twenty years or so in the confidence of ordinary people in the ability of pension investments to provide the quality of returns formerly associated with with-profits investment funds and guaranteed annuity rates. In addition, as pensions planning is for the long term, stability of the rules is essential, but that has been lacking over the past few years. Complicated rules that are frequently subject to review and change confuse savers and add to the cost of advice. We have anecdotal evidence that suggests that financial advisers are of the view that these

factors mean that it is uneconomic to provide advice on pensions to a substantial proportion of the general public.

*A.2 The Government welcomes views on its intended approach to reforming the pensions tax framework, in line with its commitment to end the effective requirement to purchase an annuity by age 75 (para 2.25)*

37. In para 2.22 first bullet we are content with the proposals that pension benefits drawn down under the new arrangements will continue to be taxed at income tax rates. We particularly welcome the commitment that the tax free pension commencement lump sum will continue to be available. We should welcome confirmation that that this will continue to represent 25% of the individual's pension pot.

38. In para 2.22 second bullet we note the proposal that unused funds shall not be subject to a tax charge on death provided that they are used to provide a dependant's pension.

39. First, we should welcome clarification of 'dependant's pension'. We have been informed that although the condoc refers to 'a dependant's pension' (paras 2.10 & 2.22) this actually refers to transfer of the balance of a pension fund as a pension fund but should welcome confirmation. We should also welcome confirmation that the dependants can pass on unused funds tax-free to their dependants (as was the case between 6 April 2006 and 13 December 2006).

40. Secondly, we should welcome clarification of 'dependant'; for example, we assume that it will include a surviving spouse and dependant children (including step-children) who are in full-time education, but should also welcome confirmation that it will include others, for example adult disabled children and other relations who are being wholly or mainly supported by the deceased at death, for example elderly siblings and elderly parents.

41. We should welcome clarification of how the suggested recovery rate of 55% is arrived at. We think that it looks high because tax relief will have been given (at least in recent years and prior to this year) at a rate not exceeding 40%. We consider that for those aged under 75 who are in drawdown (whether by way of a USP or having taken a lump sum) the proposed rise from 35% on death to 55% is penal. Pension planning is for the long term and the decision to draw down benefits would have been made in the knowledge that a 35% charge would arise on the fund if they died before age 75. Under the proposals their funds will now face a 55% charge. Such a large and unexpected tax rise is unfair and seems at odds with the spirit of the proposals as a whole and will discourage people from saving for their retirement by way of a pension scheme.

42. We recall that the present recovery tax rate of 35% with no IHT charge for those aged under 75 who have drawn benefits from their pension fund was based on average tax relief given on contributions, and, subject to any more recent analysis, that seems to us to continue to be a fair and equitable measure.

43. On the basis of the foregoing we consider that either the proposed rate of 55% should be reduced across the board to 35%. If there is to be a rise for those who are in USP and expecting a death rate of 35%, then (at the risk of making the regime yet more complicated) then there should be some form of grandfathering protection, perhaps based simply on the value of pension funds in drawdown at the date that the new regime comes into force.

44. In order to give some relief to basic rate taxpayers, but without wishing to withdraw the zero rate death charge referred to in the next bullet, we suggest as an alternative to a 55% rate that the charge on the unused pension fund be calculated by charging the value of the pension fund to income tax at the deceased taxpayer's marginal income tax rate in the year of death.

45. In para 2.22 third bullet, we welcome the fact that death benefits for those who die before age 75 without having accessed their pension savings will remain tax free. Given that part of this reform is aimed at levelling the playing field between those aged under and over 75, it is anomalous that the tax free treatment is not proposed to be available to those aged over 75 who have not accessed their pension funds. .

46. In para 2.22 fourth and final bullet we are pleased that inheritance tax will not 'ordinarily' apply to unused pension funds in addition to the recovery charge, and should welcome confirmation that this is an undertaking to remove the IHT charge from pension funds for those aged over 75 who are in ASP.

47. We note the government's not unreasonable undertaking to keep this under review. The word 'ordinarily' implies exceptions and we should welcome clarification of the circumstances when IHT might apply to pension funds under the new regime. We trust that the draft legislation promised for later in the year will clarify this and other points.

48. As to the proposals in paras 2.24 and 2.25, we welcome the proposal to do away with the age 75 restrictions on value protection, pension commencement (ie the 25% of fund) and trivial commutation lump sums.

**Chapter 3 Minimum Income Requirement**

***What constitutes secure income***

*A.3 The Government welcomes views on what income should be considered 'secure' for the purposes of the MIR and whether proposals for the life annuity income that can be considered for the MIR are practical and appropriate (para 3.9)*

49. We are content with the principles outlined in paras 3.6 to 3.9 and agree that state and occupational pensions and annuity income should be included provided uprating in all cases is linked to inflation.

50. Many pensioners have flat rate rather than indexed-linked/escalating annuities. We note that footnote 13 says that secured income comprising flat rate annuities will not be excluded but will 'be catered for by technical provisions at a later date'. We suggest that such provisions include a present value formula which can be applied to the future income stream to ascertain whether it will continue to be sufficient to meet the MIR.

51. Given the risks for the majority, we are not convinced that secure income should be widely defined in terms of what can or cannot be deemed to represent secure income. Drawdown is suitable only to a limited number of people who have investment expertise and sufficient genuinely secure income not to expose them to potential financial disaster later in life.

***At what age the MIR can be met***

52. We agree with the proposal that the age range be 55 until death.

***The level of the MIR***

*A.4 The Government welcomes views on what an appropriate level for the MIR should be and how the MIR should be adjusted for different ages (para 3.15)*

53. We do not think it is unexpected that, as noted in para 3.14, the highest levels of expenditure arise immediately on retirement and in the last years of life. We suggest that in setting MIR to meet the government's objective that individuals should not become a burden on the state, regard will need to be had to maximum average annual expenditure levels.

54. We recommend a single non-age related MIR because dates of retirement and death differ between individuals which would render an age-related sliding scale impractical.

*A.5 The Government welcomes views on whether a different MIR should be set for individuals and couples (para 3.17)*

55. This paragraph is in effect raising the question of whether, where the individual is married or has a civil partner, the MIR should be assessed on an individual basis or a joint basis. Personal pension funds are invested on an individual basis and will be drawn down by the owner of that fund, even if the individual is part of a couple. However, we acknowledge that the government is seeking to ensure as far as possible that drawdowns from pension funds are not followed by either the owner of the pension fund or his/her spouse/civil partner subsequently becoming a burden on the state.

56. On first blush, it would seem logical when assessing whether an individual who is part of a couple has sufficient MIR to support a flexible drawdown, that the MIR for that individual should be assessed on the basis of being part of a couple, and the secured income of both individuals should be taken into account. However, this will create complexity, especially where there are problems in obtaining income details of the other spouse/civil partner and will mean that married couples/civil partners will be treated differently from those who cohabit. These factors suggest that the MIR for an individual who is part of a couple should be based only on that individual's own secured income. This is reinforced by the fact that many of those purchasing annuities buy single life annuities.

*A.6 The Government welcomes views on how often the MIR level should be reviewed (para 3.18)*

57. Pension planning is for the long term and so stability of the rules and thresholds is vital. We suggest that MIR be reviewed triennially and changed only if inflation is more than a certain amount. Changes should take effect from 6 April.

***How the MIR should be assessed***

*A.7 The Government welcomes views on how to minimise unnecessary burdens for individuals and industry in the assessment of the MIR (para 3.20)*

58. To obviate the need for a paper trail which involves the individual contemplating drawdown obtaining evidence from secured income providers and sending it to the drawdown provider, it will probably be simplest if drawdown providers can be empowered to seek evidence direct from the providers of secured income on provision of a signed mandate from the individual contemplating drawdown.

**Chapter 4 The UK annuity market**

59. Para 4.13 observes correctly that there are negative perceptions regarding annuities. This is because the perception is that a well-managed investment portfolio may, in the long term, be able to produce a similar return and the capital remains intact. However, as noted above, annuities offer considerable benefits which should not be underestimated. Annuities are normally guaranteed for life and the annuity market now offers many flexible products, including investment-linked options and flexible contracts with capital guarantees. We therefore believe that a balanced view of the relative advantages and disadvantages and risks associated with annuities in comparison to drawdown needs to be maintained.

*A.8 The Government welcomes views on whether other legislative or regulatory barriers remain whose removal would enable industry to provide consumers with more attractive products without incurring fiscal or avoidance risks*

60. We are not commenting on this point.

*A.9 The Government welcomes views on how the industry, Government and advice bodies such as CFEB can work to ensure that individuals make appropriate choices about what to do with their retirement savings in the absence of the requirement to purchase an annuity by age 75*

61. We do feel that the ideal outcome of this consultation would be legislation that helps close the savings gap. This requires consistency and simplicity and joined-up thinking between HMRC and the main regulators in this area, namely the Financial Services Authority, which deals with advice to the public, and the Pensions Regulator. Across the majority of the population financial literacy is low and that this needs to be addressed. People also need to be aware of the changes being introduced under the Retail Distribution Review and its relevance to them as consumers.

62. There is a need to help individuals make appropriate pension decisions on retirement. However, the information that people receive at retirement does not always make all the available options sufficiently clear to the average person.

63. We are concerned that many people do not seek advice and are not aware either of the importance of doing so or that if they pay a fee they may receive better advice.

64. We suggest as a start that the information that people receive at retirement from their pensions insurance company should be in a standard format which enables the average person by reading a relatively simple letter easily to appreciate the options that are available (ie that they can buy an annuity, that there are lots of different sorts of annuities ranging from, for example, flat rate single life to joint life indexed-linked with guaranteed payment periods, that the annuity can be bought from companies other than the one with whom the pension fund is currently held, or they can take a lump sum, or they can leave the pension fund invested, or they can go into drawdown with the attendant risks and advantages) and the need to seek advice. The technical information for the more sophisticated investor can be set out in an appendix.

65. We suggest that imposing such a requirement is not a task for the CFEB but for the Financial Services Authority as the main regulator dealing with retail advice.

*A.10 The Government welcomes views on whether the proposed reforms have unintended consequences that may affect the market's ability to supply annuities at attractive rates or prevent the annuity market being able to meet likely demand for annuities*

66. We have no comments on this question save to observe that the need for secured income to be indexed-linked may increase the demand for indexed-linked annuities over flat-rate annuities by those who are using only part of their pension pots to buy annuities.

PCB
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**APPENDIX 1**

## THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independant tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see http://www.icaew.com/index.cfm?route=128518).



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