

B

Reducing the LTA

B.1 As explained in Chapter 2, the Government has decided to reduce the LTA to £1.5m. However, reducing the LTA creates a transitional challenge for individuals who may have already built up pension pots on the expectation that the LTA would be at its current level of £1.8m. A protection regime is therefore needed to accommodate such cases appropriately. The Government plans to introduce the reduced LTA from April 2012.

Designing a protection regime for the reduced LTA

B.2 The Government believes that a number of principles should guide the design of a new protection regime. The new regime should aim to:

- **not be retrospective** – tax charges should not newly arise as a consequence of activity in the past that individuals cannot now amend;
- **respect the long-term nature of pension planning** - the protection regime should provide appropriate support for individuals that have already made pension saving decisions based on the current level of the LTA;
- **be easy for individuals to understand** – the regime should be as straightforward as possible, so that individuals can easily understand the implications for themselves and make appropriate choices accordingly; and equally so that advisors can provide accurate and well-informed advice with minimal need for additional training;
- **minimise administrative burdens for pension schemes, employers and HMRC** – the regime should minimise administrative burdens, ideally be capable of operating in a light-touch manner, and reduce the potential for schemes to be over-burdened with requests for pension valuations;
- **support the stability and predictability of the UK pensions tax system** – any changes should be for good reason and the overall regime should instil confidence in peoples' expectations around the Government's commitment to tax stability.

B.3 In designing the protection regime around the reduced lifetime allowance, the Government will also want to ensure this is in keeping with the spirit of restricting pensions tax relief, and the priority of protecting the public finances, and does not provide opportunities for individuals to be better off than they would have been under the previous regime. It will be mindful of the revenue and behavioural implications of the proposed approach and will want to limit opportunities for individuals to excessively increase their pension savings in anticipation of the reduced limit being introduced. Such opportunities are currently limited in 2010-11 by the existing anti-forestalling provisions, including the general anti-avoidance rule within that, the earnings limit on individuals' contributions, and the AA.

B.4 The Government believes that in order to meet these principles it will be necessary to design a protection regime that ensures anyone with pension pots currently in excess of £1.5m has that excess protected from any tax charge (subject to a cap at the level of the existing LTA of £1.8m). This will ensure that the new regime is not retrospective.

B.5 The Government also believes that individuals who are currently protected by primary protection (PP) and/or enhanced protection (EP) should continue to receive these protections. Individuals were given the opportunity to apply for PP and and/or EP when the LTA was first introduced at its initial level of £1.5m in 2006. Preserving these protections is important to demonstrate the Government's commitment to the stability and predictability of the UK pensions tax regime.

B.6 The Government will also look to design the new protection regime to ensure that individuals currently in the existing forms of protection also do not face retrospective charges as a result of the LTA being reduced. For example, the Government will look to ensure that the current 'personalised LTAs' of those in PP are not reduced as a consequence of the standard LTA being reduced.

B.7 Besides the level of pension pots at the point at which the LTA is reduced, a crucial consideration for the protection regime is the expected growth in the value of a pension over time. If individuals have planned for their pension to grow to a level of £1.8m, but no more, between now and the point of retirement, it could be regarded as unfair for such growth to be caught by an LTA charge when the LTA is reduced to £1.5m. The Government recognises this issue of 'pension growth protection' and is minded to offer some protection in these cases, and welcomes views from the industry on the form this could take.

B.8 One option for providing 'pension growth protection' which the Government believes would meet its principles is to give anyone the opportunity to apply for a personalised LTA set at a fixed level of £1.8m, on condition that they must be neither making any further contributions to a DC scheme, or acquiring any further active benefits in any DB scheme (i.e. they must be a deferred member of any schemes in which they have entitlements). The standard LTA would apply to these individuals if they subsequently were to become an active pension member at any point in the future. The Government would welcome views on this proposal, and any other suggestions on the appropriate design of a protection regime for the LTA that would be in line with the principles set out above.

Other policy issues

B.9 Besides the protection regime, the Government has considered a number of other aspects of the policy issues around reducing the LTA.

B.10 At the moment, a factor of 20 is used to value DB pensions for the purposes of testing DB pension value against the LTA (i.e. the level of annual pension is multiplied by 20 to derive the deemed value of the pension pot). This is set at a higher level than the AA DB valuation factor, reflecting the fact that a given level of annual pension entitlement is more valuable to an individual at retirement than prior to that. Given changes to the DB valuation factor proposed for the purposes of assessing pension accrual against the AA a case could be made to review the LTA DB valuation factor. A case could also be made for making the LTA valuation factor age-related, so that the overall value of early retirements are picked up by the pensions tax regime.

B.11 The Government's provisional view is that changing the DB valuation factor used for assessing pension accrual against the LTA could complicate any potential protection regime, and have adverse knock-on impacts for the tax free lump sum. The Government is therefore minded to make no change and for the LTA valuation factor to remain at 20, but welcomes views.

B.12 Currently, funds in excess of the LTA are charged at 25 per cent of the excess amount if this is paid out in the form of a pension (and the pension is then taxed as income at marginal rates), and 55 per cent if paid out as a lump sum (on which no further tax is due). The Government does not see a pressing reason for amending these charges, and is therefore minded to keep the charge set at these levels, but welcomes views.

B.13 The pensions tax rules currently allow pension funds beneath a specified limit to be taken out as a lump sum (“trivial commutation”). The limit is currently set at 1 per cent of the LTA (£18,000). To prevent unintended consequences here for individuals on modest incomes with small pension pots, the Government intends on de-linking the basis on which the trivial commutation limit is set at the same time as reducing the LTA, and to set it at its current level of £18,000.

B.14 When a pension is drawn a tax-free lump sum of up to 25 per cent of the value of funds can be paid up to a maximum of 25 per cent of the standard LTA. Any reduction in the LTA would consequently reduce the maximum tax-free lump sum that could be paid. The Government’s view is that the value of the tax-free lump sum should continue to be determined in this way.

Responding on the policy issues around reducing the LTA

B.15 We will work with interested parties on these issues over the coming weeks, and would welcome any representations on the issues by 29 October 2010. The Government will make a final decision on the nature of the protection regime for a reduced lifetime allowance later in the year. It plans to include draft clauses as part of the consolidated draft clauses planned for Finance Bill 2011, due to be published for consultation towards the end 2010.