Meeting future workplace challenges: improving transfers and dealing with small pension pots

Department for Work and Pensions consultation

Response by the Low Incomes Tax Reform Group

1. Executive summary

1.1. LITRG welcomes the opportunity to comment on this DWP consultation on dealing with small pension pots. It is right to acknowledge that small pots could be more prevalent in future due to auto-enrolment. Our experience has shown that people find the rules about how to deal with small pension pots confusing and we continue to press for improvements to 'trivial commutation' rules, in respect of both policy and administration.

1.2. This response recommends the following:

1.2.1. Although moves to amalgamate small pots might in future reduce the need for people to commute individual small pension pots as lump sums, those approaching retirement in the shorter term will still need to avail themselves of these rules. Therefore, the definition of a small pot should be increased from the current £2,000 for commuting small occupational pensions (shortly to be extended to up to two personal pensions) – possibly up to £5,000 and this should be up-rated automatically each year thereafter.

1.2.2. Similarly, the lifetime 'trivial commutation' limit currently fixed at £18,000 should be considered for an immediate increase and automatic annual up-rating.

1.2.3. Any central database of pensions, whether run by Government or the pensions industry, should be consistent with other systems as to how pension-holders are identified. The

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National Insurance number should be central to such a system and it should be capable of interacting with both HMRC and DWP systems to validate data and maximise its potential use.

1.2.4. More thought needs to be given to the situation of migrant workers and we recommend that an exemption be introduced to retain the ability to receive a short service refund in those cases.

1.2.5. Finally, our experience is that people's inertia in dealing with pensions stems both from the complexities of pensions and the difficulties of understanding taxation consequences of one's actions. We therefore suggest that regulations and guidance should be reviewed for possible areas of simplification as a step towards helping people to engage with the system.

2. About LITRG

2.1. The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes.

2.2. The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it - taxpayers, advisers and the authorities.

3. Our comments on this consultation

3.1. *LITRG's work on small pensions*

3.1.1. LITRG takes a keen interest in small pension pots – in particular, the taxation consequences of commuting them for a lump sum. There is much confusion for pensioners taking trivial commutation payments, either within the £18,000 overall lifetime commutation limit, or within the separate 'small pots' rule for occupational schemes valued up to £2,000.

3.1.2. We very much welcomed the extension of the latter rule to personal pensions, but we would have preferred for it not to have been limited to two such small pots per person, in their lifetime. We have submitted comments on the draft Regulations published for consultation by HMRC in December 2011[1].

[1] See our response on the LITRG website: http://www.litrg.org.uk/submissions/2012/commutation-of-small-pensions-up-to-gbp2000-litrg-comments

3.1.3. LITRG's interest in the current consultation is limited to those areas which we feel are of interest in a tax context. We have therefore not answered the specific questions in the consultation; but, where possible, we have referenced our comments below to the relevant consultation document paragraphs or questions.

3.2. ***Dealing with residual small pots, even in the light of a new transfer scheme***

3.2.1. Section 1.4 of the consultation reads as follows:

> **'1.4 Small personal pension pot commutation rules**
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> 24. The Government recognises that even with a much improved transfer system for small pots, there remain existing issues for individuals left with very small pots at retirement. These can become effectively stranded if such a pot is too small to annuitise, cannot be combined with other pensions savings, and an individual does not have the lifetime trivial commutation option open to them.
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> 25. Examples include where an individual has already taken lifetime trivial commutation, but later discovers a remaining small pot (or receives a late payment into a pension), or where an individual has a defined benefit (DB) pension in payment which puts their wealth above the trivial commutation threshold, but also has a remaining small DC pension pot.
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> 26. Since 2009, tax rules permitted individuals with small occupational pension pots of £2,000 or less to be commuted as a lump sum payment from age 60, regardless of other pensions wealth held and outside the lifetime trivial commutation limit. Recognising that there are cases where small personal pension pots can become similarly stranded, the Government has recently announced, alongside the draft Finance Bill 2012 that it will extend these rules to allow individuals to commute up to two small personal pension pots of £2,000 or less as a lump sum in their lifetime. Draft legislation has been published and is open to comments on the HMT website, and the reform will take effect from April 2012.'

3.2.2. It is helpful that the consultation document acknowledges that there could still be issues with some small pension pots, even after any proposed new scheme is put into place.

3.2.3. This is particularly the case for those who are now in their late 50s or early 60s who might hitherto have amassed little in the way of pension savings but will start to do so in the next few years as a result of automatic enrolment. Such individuals, and others in future who for example may have limited capability to work and therefore amassed only small pensions even under automatic enrolment, will still need the benefit of administrative easements provided by the trivial commutation rules.

3.2.4. It is for that reason that we believe it appropriate to point out again that the existing rules could be improved.

3.2.5. First, the £2,000 limit referred to in paragraph 26 of the consultation, reproduced above, has been fixed since 2009 and while there is provision in the statute to up-rate it, there is no automatic mechanism to ensure that its appropriateness is reviewed over the passage of time. Similarly, now that the lifetime trivial commutation limit has been decoupled from the lifetime allowance, it has been fixed at £18,000 – again, with no automatic mechanism for it to be up-rated in future.

3.2.6. The fixing of these limits will therefore devalue their benefit over time and we recommend that this matter be addressed at the earliest opportunity. Indeed, a figure of £5,000 rather than £2,000 might be more realistic to define a small pot, as we believe it is likely that most pension companies would be reluctant to accept a transfer in of smaller amounts, or bear the administration cost of paying out the resulting annuity. Therefore, we recommend a one-off increase followed by annual up-rating should be considered.

3.2.7. In a similar context, the consultation document asks about setting a transfer limit for small pots (question 18, chapter 5; and question 21, chapter 6) if proceeding with either option 1 or 2 as outlined. Again, whatever limit is chosen, we recommend that due consideration should be given to adjusting it annually for inflation.

3.2.8. Finally on this topic, we note that paragraph 25 of the consultation document, as reproduced above, refers to a pensioner later discovering a further small pension after having taken a lifetime trivial commutation. The root of this problem is that there is a 12-month window within which to commute all small pots within the maximum allowance of £18,000 and often the discovery of another pension is after the expiry of that window.

3.2.9. Whilst the extension of the supplementary £2,000 small pots rule to up to two personal pensions will provide some additional flexibility, this will not help those who commute one pot of, say, £12,000 then later discover a further pot valued at £2,500.

3.2.10. For this reason, and on the basis there is already an overriding monetary value of £18,000, we have previously recommended that the 12-month rule be extended or preferably removed altogether. Again, we recommend that the Government reconsider this proposal as part of the overall package of reform for dealing with small pension pots.

3.3. *A central database – questions 22 and 23 of the consultation document*

3.3.1. In the context of pensions moving with people from job to job, we note that questions 22 and 23 of the consultation document refer to the potential creation of a central database to match members with their pension pots.

3.3.2. We have strong concerns over the creation of such a database and how it would identify members, particularly given the problems there have been within the Government's own systems in identifying taxpayers and benefits claimants and matching their records together.

3.3.3. For example, when retirement annuity contracts were brought into the PAYE system, most of the difficulties stemmed from the fact that the industry did not use National Insurance numbers (NINOs). This made data-matching extremely difficult – even when trying to match up that a single taxpayer had several annuities with the same pension provider.

3.3.4. A further example is that it is only now that the DWP and HMRC are working together to put in place a system where state pension data from the DWP is matched to HMRC data by way of an electronic rather than a manual process[1]. And we know that HMRC still have some way to go in cleansing their own databases to ensure that they have accurate records for taxpayers – indeed we have expressed concerns that inaccuracy could remain, even under the 'real-time information' (RTI) system of PAYE to be introduced in the not-too-distant future[2].

3.3.5. Therefore, even though DWP, HMRC and employers all use a common identifier for taxpayers – the NINO – there are still gaps in the system. With this background, we are concerned as to how the pension industry would work together to produce a database which is correct and complete and which delivers its intended task.

3.3.6. However, we do believe there are opportunities to exploit if we look to the existing systems.

3.3.7. For instance, the PAYE system already has processes in place which aim to follow the taxpayer from job to job. Whilst even this has had problems in keeping up with an individual's movements, in future, the availability of RTI might improve its ability to do so (with HMRC having data available much sooner than is currently the case).

3.3.8. We therefore ask: how would a pensions database keep track of an individual's movements? Would employers be required to give some separate means of notification to the central pensions database when they part company with an employee? Similarly, would new joiners to their staff need to be so notified? And when a pension is drawn, would the pension company need to notify this to the database so the record is removed?

3.3.9. This would seem to be a heavy compliance burden in addition to the requirements of RTI and auto-enrolment coming on board. Many – particularly the smallest employers, including individuals who employ staff to help them with care needs in their own home – are likely to struggle to meet such requirements unless their interactions with the database are seamless.

3.3.10. With that in mind, it would seem to be preferable if some form of link could be made to HMRC's work on RTI, so that notification of an employee leaving or joining is made to any central pension database at the same time as it is made to HMRC for PAYE purposes. Such a central database would therefore need to be designed with similar data validation criteria – for example using the individual's NINO as the main identifier.

[1] Section F.2, Chapter 3 of the Office of Tax Simplification's 'Review of pensioners' taxation – interim report' http://www.hm-treasury.gov.uk/d/ots_review_of_pensioners_tax_060312.pdf

[2] See our response to consultation on RTI regulations, paragraph 6.2ff http://www.litrg.org.uk/Resources/LITRG/Documents/2011/12/LITRG_response_to_RTI_Regs_consultation_9January2012_final.pdf

3.3.11. Furthermore, with plans to modernise the personal tax system currently under review[1], which include the future possibility of pre-filling data on people's tax forms, it would make sense for the DWP and the pensions industry to work with HMRC so that any pensions database were designed with the ability to link to HMRC's systems. This would be useful in terms of validating data, tracing small pots to taxpayers who might have temporarily dropped out of view of the system, and possibly allowing HMRC to pre-fill pension contribution information on taxpayers' returns or annual PAYE reconciliations.

3.3.12. We therefore recommend that early consideration is given to how any new database could best be designed so that it integrates with existing Government systems. This could also have the added benefit that burdens on employers are minimised, if any notifications to a pensions database could be linked into existing requirements such as those under PAYE (and RTI in due course).

3.4. *Migrant workers*

3.4.1. Another area of concern is the position of people who come to the UK to work on a temporary basis, or perhaps residents who start their working life in the UK but then emigrate. Such workers might amass small pots in the UK and it does not seem that the consultation document addresses the issues for them.

3.4.2. In terms of defined contribution schemes, such workers might have hitherto taken advantage of the rules allowing a refund of contributions in the case of short service. They would therefore be affected by the proposed abolition of this rule and we would strongly recommend that an exemption be introduced to retain the ability for short service refunds in the case of migrant workers.

3.4.3. This matter is also important in the context of the proposed changes to the rules for Qualifying Recognised Overseas Pensions Schemes which potentially make it more difficult for a migrant worker to transfer accumulated benefits from a temporary period of contribution to a UK pension arrangement to a home country pension scheme without tax penalty. Our colleagues at the Chartered Institute of Taxation have commented separately on this issue[2] to HMRC and their comments are supported by LITRG.

3.4.4. It is also difficult to see what the options in chapters 5 and 6 of the consultation document for an aggregator scheme or pensions following workers from job to job would deliver in the context of migrant workers. We recommend that much more detailed consideration is given to this area before developing proposals further.

[1] See http://www.litrg.org.uk/submissions/2012/modernising-the-personal-tax-system-tax-transparency-for-individuals-the-litrg-response

[2] See http://www.tax.org.uk/Resources/CIOT/Documents/2012/02/120201_FB12_QROPS_CIOT.pdf

3.5. ***Barriers to Transfer - Inertia***

3.5.1. The consultation mentions, in several places, the question of individual inertia as a barrier to individuals dealing with transfers of small pension funds[1].

3.5.2. In our experience, and that of Tax Help for Older People[2], one of the key factors in individual inertia is the relative complexity of the regulations dealing with pensions generally and the taxation thereof in particular. As a consequence, the paperwork which is provided to individuals by pension providers can be very difficult to follow and time-consuming to complete.

3.5.3. We strongly believe that review of these regulations and related DWP and HMRC guidance thereon with a view to simplification would be a significant help in removing that barrier.

LITRG
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[1] Paragraphs 9, 14, 17, 19, 60, 63, 64, 77, 78, 84 and 90.

[2] See www.taxvol.org.uk – Tax Help for Older People is a service run by the charity Tax Volunteers, helping low-income pensioners with their tax affairs. It was created out of an original pilot project by the Low Incomes Tax Reform Group.