

Unintended financial consequences of pensions tax relief restriction

- HM Treasury desire to prevent abuse of system will affect ordinary members of the working population
- Early retirement or ill-health, promotions or redundancy will expose employees whose pay is only slightly higher than average to tax liabilities intended for high earners

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Mercer has outlined its solutions to HM Treasury's concerns on tax avoidance situations arising from its proposals on high earners' pension tax relief. It supports efforts to encourage greater flexibility in scheme design and reduce opportunities to abuse the system. However, Mercer is concerned that the current proposals are inflexible, will excessively restrict the UK's working practices and have unintended financial consequences for ordinary members of the working population – not just high earners.

As part of its consultation process, the Treasury has asked for suggestions on handling events that could provide opportunities for people to avoid tax charges resulting from the proposed tax changes. These events are: larger than expected salary increases, enhanced benefits on redundancy and early retirement.

"We support the rationale behind HM Treasury's plans to restrict the tax relief available on pension saving," commented Dr Deborah Cooper, Head of Mercer's Retirement Research Group. "However, the current proposals could restrict the development of flexible working practices in the UK as well as having severe financial implications for a wide range of employees and not just those who are the target of this tax."

Redundancy

Redundant employees are often compensated with a combination of increased cash and pension benefits. Under HM Treasury's proposals, this would prompt a "double tax hit" both on the redundancy payment – if it is more than the statutory amount – and the pension contributions.

Suppose that a 55-year old man earning £45,000 is made redundant from the job he has held for 20 years. He has been accruing his pension at $1/60^{\text{th}}$ a year so has built up a pension of £15,000 a year. Part of his redundancy agreement is that his pension can be payable immediately with no reduction. Supposing HM Treasury used a factor of 15 to value DB accrual where payment is from age 65, and 25 to value accrual paid immediately from age 55. With an annual allowance of £40,000 the redundant employee would be subject to a pension tax bill of £44,000.

"This is clearly not right or fair," suggested Dr Cooper. "If an employer is trying to do the right thing by its employees, government proposals mean that the taxation of these enhancements will make it financially unviable for an employee to receive benefits at a time when they need them most. To avoid abuse, a possible solution would be that, if the redundancy terms apply to a certain number or category of employees, the potential tax on any enhanced benefit should be waived,"

Early retirement or ill health retirement

Again, suppose a 45 year old woman has been in her £45,000 a year job for 15 years and intends to retire at 65, but is suddenly forced into early retirement due to ill health. She has been accruing her pension at the rate of $1/60^{\text{th}}$ and currently can expect £11,250 a year. Her pension scheme grants an ill-health pension that bases payment on service to her normal retirement age, giving her the larger amount of £26,250 a year. In this case we assume an annual allowance of £40,000 as before, but use a single flat rate factor of 17.5. This employee will be caught by the current HM Treasury proposals and could face a demand for £89,000 in tax – more than three times her pension.

In the case of early retirement (or ill-health retirement), Mercer believes that if an employer, for a number of years, has an established and pre-funded working practice of allowing staff to retire early or for reasons of ill-health, no additional tax should be applied. Instead we expect that the factor used to test against the annual allowance would take the scheme's normal practice into account.

"Where early retirement is a more discretionary option," said Dr Cooper, "we agree that the employees benefiting from this enhancement should, where necessary, pay the appropriate tax charge."

Greater than average salary growth

HM Treasury is also concerned about scope for abuse due to substantial salary rises, which could arise following a promotion. However, provided the factor used to evaluate DB accrual is designed appropriately, Mercer believes that this is the least problematic area of the three.

"Provided the regime is sensitively designed, with age-related factors including an allowance for future salary growth, the number of people caught by this is likely to be small so the information requirements will not be onerous. In any case we would expect many schemes to amend their scheme design such that the impact of any large salary increases is smoothed over time, reducing the circumstances in which an Annual Allowance charge would apply," concluded Dr Cooper.

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Notes for editors

Mercer believes that the coalition government's revised proposals for restricting tax relief on pension savings are an improvement on those presented by the previous government, but that there are four main areas of concerns. These areas need to be addressed to ensure a healthy environment for the UK's retirement system and Mercer suggests how to achieve this in its response to HM Treasury's consultation process. The consultation closes on 27 August.

Mercer believes that the current proposals inhibit the opportunity for employers to provide pension schemes that are strategically right for their business and that support the long-term wealth creation of their staff. The government risks introducing a penal tax law attacking the specific provision of long-term risk sharing / defined benefit provision, which will inhibit employers from doing what is right for their employees. The consultancy believes that increasing the complexity and costs of DB pension provision will encourage employers to dumb down pension provision to the minimum acceptable level, which may not be in the best long-term interests of employers and employees, and the nation.

Mercer's preferred regime would have the following four characteristics:

1. A reduced annual allowance with an annual allowance charge equal to the individual's marginal rate of tax.
2. Age related factors to convert defined benefit accrual into an equivalent 'contribution', which treats all employees fairly.
3. The annual allowance charge should be levied on current accrual only and should not be applied retrospectively.
4. Tax relief should continue to be granted at an individual's marginal rate.

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