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Trustee Quarterly Review

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- What is a "money purchase benefit" and why it matters
- Government plans to change the rules (again) about employer debts to DB schemes
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New tax rules applying to pension schemes

The tighter new tax rules reducing the "annual allowance" for pension saving to £50,000 a year, which the Government announced last year, became law when the Finance Act 2011 received Royal Assent on 19 July. Those rules now apply to pension saving in any "pension input period" which ends – or ended – after 5 April this year.

While the changes to the annual allowance are potentially relevant to all members, the Finance Act also makes some changes which could be of interest to those with larger pensions. It:

- gives members of money purchase arrangements more freedom, from 6 April this year, to draw capital sums down from their DC "pots", instead of using the pot to buy an annuity; and
- provides for a lower "lifetime allowance" of £1.5m to apply from 6 April **2012**.

The Annual Allowance

Background

To recap, the new annual allowance regime reduces to £50,000 the total amount of tax-relieved pension saving that anyone can make through registered pension schemes "for" a tax year. Pension saving counts towards the annual allowance "for" a tax year if it arose during a "pension input period" (or "PIP") which ends in that tax year.

In a money purchase arrangement, a member's pension saving in a PIP is the total of member and employer contributions paid to that arrangement during the PIP.

In a defined benefit arrangement, an active member's pension saving is broadly 16 times the increase in the member's pension (assuming it is taken without any reduction for early payment) from the start of the PIP to its end, after adjusting for CPI inflation. In a final salary arrangement, the increase could reflect both the member's extra year of accrual and the effect of any pay rise on the benefits that the member has built up in previous years.

In a further change from the old annual allowance regime, an enhancement to a member's pension at the point of retirement is treated as new pension saving. The only exceptions are:

- where the enhancement involves only paying the pension without an early retirement reduction;
- where the member becomes entitled to a serious ill-health lump sum because he or she is expected to die within the next year; or
- the member is suffering from suffering from ill-health which makes him or her unlikely to undertake gainful work in any capacity in the future.

In the last two cases, the annual allowance test simply does not apply. In the first, the test is applied, but the calculation takes account only of any increase due to new accrual (and the impact of any pay rises on accrued pension), but does not take account of the increase in value resulting from not applying an early retirement reduction.

Where a member's pension saving for a tax year – i.e. over any PIP which ends in that tax year – exceeds the £50,000 annual allowance, it will attract income tax at the member's marginal rate, except to the extent the member has "unused" annual allowance left over from the last three tax years; in that case, pension saving from the most recent PIP can be offset against the unused annual allowance from the earlier years. (Special rules apply for PIPs that began before 14 October 2010).

If a member has more than £50,000 of pension saving for a tax year under a single scheme and incurs a tax charge of at least £2,000, the member will be able to require the scheme to meet the tax charge on his or her behalf. Where a member takes up this "scheme pays" option, the scheme is then required to adjust the member's benefits to recover the actuarial value of the payment it has made.

In general, the annual allowance will be an issue only for active members of a pension scheme. Deferred members of a pension arrangement are deemed to have no pension saving under it, including in the year when they retire, so long as:

- their benefits are re-valued no more generously than in line with a percentage or index (or a combination of the two) which was set out in the scheme rules on 14 October 2010, and
- there is no discretionary element in the revaluation increases which the scheme rules provided for.

Nor will pensioners who have previously drawn all their benefits have any pension saving afterwards.

Providing information to members

It will be for individual members to declare any liability to the annual allowance charge under the self assessment regime. Legislation will set out a timetable for employers to give relevant information to schemes, and for schemes to give information to individual members, so that members know what "pension saving" they need to declare.

A scheme will have to supply this information to a member automatically only where the member has pension saving under that scheme for the relevant tax year of £50,000 or more. It will also have to be provided where a member requests it. Members will be able to request information about their pension saving not just for the most recent PIP but also for the three PIPs before that one. In general, schemes will have to supply that information to members before the 6 October following the tax year in which the relevant PIP ended. However, for the current PIP, and for PIPs which have already ended, schemes will not be obliged to provide any information before 6 October 2013.

Employers and trustees will need to ensure that their admin systems are geared up to provide accurate and reliable information to members well before that date if they are not to miss the deadline. The information will need to be accurate and reliable. If the figures given are too low, tax might be underpaid and HMRC could penalise the scheme as a result. If they are too high, the member may lose the opportunity to make tax-free pension saving elsewhere, and could blame the scheme for any losses.

In practice, some members are already thinking of supplementing their pensions by paying contributions to a personal pension scheme or AVC arrangement, and are asking schemes to tell them what pension saving they have made in recent PIPs, and what their pension saving is likely to be in their current PIP.

Schemes can of course provide this information voluntarily. But, as often happens when legislation is new, there are still some uncertainties about how the annual allowance regime works, so trustees may wish to ensure that any information which they do supply voluntarily, before the dust settles, goes out with an appropriate health warning.

This is particularly important where:

- an active member has already passed the "pivot age" that the scheme uses to work out early retirement reductions (and, where the scheme applies different "pivot ages" to apply reductions for different periods of service, once the member has passed the earliest such age);
- a member has exchanged pension for a lump sum at the point of retirement; or
- there is a difference between the amount of pension a member has actually accrued over a year if you look at the scheme's leaving service rule and the amount the member might seem to have accrued if you look only at the "headline" accrual rate in the scheme rule dealing with retirement from service at normal retirement date. This can arise in schemes which offer particularly generous accrual rates (or "targeted accrual"), under which a member might otherwise appear to have built up a pension of two-thirds of final salary before normal retirement date.

In these areas, either the legislation itself is unclear or HMRC seems to think that it works in a way that is hard to square with the legislation itself. At least until HMRC gives guidance on these points which can safely be relied on (and in our view that is not yet the position in any of those cases), we think that any information that schemes supply should go out with a caveat, explaining that the figures supplied are only estimates and may need to be revised in light of future HMRC guidance.

Scheme pays

As we said earlier, in some circumstances, members will be able to require a scheme to meet the annual allowance charge on their behalf. This will be the case only where the member's pension saving in that scheme for a PIP goes over £50,000 and the member faces an annual allowance charge of at least £2,000.

Schemes will also be allowed to offer this "scheme pays" facility voluntarily, even where a member does not meet those criteria.

Where a scheme does meet the annual allowance charge on a member's behalf, the legislation requires it to adjust the member's benefits downwards on a basis which is "just and reasonable having regard to normal actuarial practice". However, it will not be possible to reduce GMPs under the "scheme pays" legislation.

HMRC's draft guidance implies that the actuarial reduction must be applied to the member's own pension, rather than to any benefits for his or her dependants.

Lifetime allowance

To recap, the lifetime allowance is being reduced from £1.8 million to £1.5 million from 6 April 2011.

However, the rules which limited "trivial commutation lump sums" to 1% of the lifetime allowance are being changed, so that the trivial commutation limit remains £18,000, rather than falling to £15,000 when the lifetime allowance is reduced.

Individuals who are likely to go over the £1.5 million limit can however opt for so-called "fixed protection" and retain the £1.8 million lifetime allowance. However, to do this, broadly speaking they must opt out of all forms of pension saving under a registered scheme before 6 April 2012. Additionally, their deferred benefits must not be revalued more generously than under the scheme rules in force on 9 December 2010..

Anyone opting for fixed protection must send a completed application to HMRC before 6 April 2012.

Trustees may want to write to active members, particularly high earners who might be affected by the change to the lifetime allowance, to ensure that they are aware of the changes and to invite them to discuss them with an independent financial adviser.

Flexible drawdown

To recap, the tax changes in principle allow members of money purchase arrangements to choose to "draw down" parts of their pot, rather than having to secure it through an annuity, provided that they have a pension income of at least £20,000 from other sources. Other sources which count towards this minimum income requirement include state pensions, annuities provided by insurance companies under personal pension schemes and, normally, pensions from registered occupational pension schemes.

Pensions from an occupational scheme will count towards that £20,000 "minimum income requirement" only if:

- the scheme in question has 20 other pensioner members or
- (in the case of a DB scheme) if the individual belonged to the scheme on 5 April 2011 and it had at least 20 members of any description on that date.

Money purchase schemes and arrangements are not obliged to offer this facility, but overriding legislation gives them the power to offer it – without amending the scheme rules – if their trustees wish to do so.

Trustees of money purchase schemes may wish to consider offering this facility.

This facility is not available under DB arrangements. However, some members have expressed an interest in transferring only a part of their benefit rights under a DB arrangement into a personal pension scheme, while leaving the rest in the DB arrangement. If this was allowed, they could count the part which remains towards the minimum income requirement, while taking the rest to a personal pension scheme where they can take advantage of flexible drawdown.

Partial transfers like this are not unlawful, but few DB schemes' rules currently allow them. They also raise a number of legal and actuarial issues, which trustees should ensure are thought through before this option is made available.

Jonathan Moody

What are "money purchase benefits" and why it matters?

The UK's most senior judges have looked at the grey area between money purchase benefits and defined benefits. In the case of *Houldsworth v Bridge Trustees*, the Supreme Court decided that a scheme can still be a money purchase scheme even if it:

pays pensions itself (rather than securing them externally with an insurer),

makes promises about the way money purchase pots will grow which are not purely referable to investment returns (for example if the scheme promises a guaranteed rate of return); or

offers a money purchase pension with a defined benefit underpin.

The court's ruling means that, although this kind of pension scheme can have a deficit, it is not covered by the key legislative protections for defined benefit schemes. These protections include the scheme funding rules in the Pensions Act 2004 and the Pension Protection Fund.

The Department for Work and Pensions (DWP), which took part in the case, has said it is planning retrospective changes to the law to reverse the effect of the Supreme Court's decision.

So what do pension schemes need to do?

1. Consider whether your scheme provides any of the benefits which were determined to be money purchase in the Houldsworth case.

   These were:

   (a) internal annuities – where a member's money purchase "pot" is converted into a pension paid from the pension scheme, rather than buying an annuity from an insurer;

   (b) guaranteed investment returns – where a scheme provides guaranteed investment returns on the member's pot;

   (c) guaranteed minimum pension underpins – where benefits are the greater of what can be bought from the member's pot and the guaranteed minimum pension for contracting-out;

   (d) other defined benefit underpins – where benefits are the greater of what can be bought from the member's pot and a defined benefit pension.

2. Consider what categorising these benefits as money purchase means for your scheme.

   Categorising these benefits as money purchase means that, even though a scheme can be underfunded, it may fall outside the scope of legal protections which are designed to reduce the risks associated with underfunding. The list of protections that do not apply to schemes which only provide money purchase benefits includes:

   (a) the scheme funding legislation in the Pensions Act 2004. The statutory framework for preparing a statement of funding principles, performing a valuation and preparing a schedule of contributions and deficit recovery plan does not apply to money purchase schemes. Instead, the employer's funding obligations will be governed by the scheme's rules;

(b) the employer debt legislation in s75 of the Pensions Act 1995. The normal requirements for employers to make good all or part of the buy-out deficit on insolvency, winding up or ceasing to employ active members do not apply to money purchase schemes. In theory this makes it easier for employers to walk away from underfunded schemes;

(c) the Pension Protection Fund (PPF). Money purchase schemes are not covered by the PPF and money purchase assets and liabilities are ignored when working out the PPF levy. So members who are receiving a pension from a money purchase scheme would not be able to turn to the PPF for help if their scheme winds up in deficit.

In addition, the statutory winding up priority order in the Pensions Act 1995, which determines the liabilities that have first call on the assets of an underfunded scheme, does not apply to most money purchase assets and liabilities. Instead, the scheme's rules will determine the treatment of benefits on winding up.

3. Watch what the Government does.

It seems sensible to avoid any hasty response to the Supreme Court decision. The DWP issued a press release on 27 July confirming that it plans to introduce retrospective legislation which would reverse the effect of the decision.

The likely result of the planned legislation will be that benefits only count as money purchase to the extent that they are based on employer and member contributions and on investment returns. If other steps are needed to calculate benefits, like applying annuity rates to work out a pension from the scheme, then the benefits will not be money purchase. Schemes which can go into deficit will get the protections described in section 2 above.

However, it is at least possible – though DWP has not yet discussed this – that any new legislation may also take the opportunity to look at some of the other legislation about what does and does not take a scheme outside the scheme funding regime and the PPF legislation. (For example, should a scheme which offers only money purchase benefits and insured risk benefits count as money purchase or not? Current legislation on this question is not always consistent).

4. Consider changes to scheme design and practice.

If the DWP does introduce new legislation, schemes should consider changing the basis on which future benefits are earned so that those benefits are within any amended definition of "money purchase benefits". For example, removing defined benefit underpins, and buying annuities from insurers rather than providing a pension from the scheme, could lead to savings in the PPF levy and avoid greater liability for the sponsoring employer under the employer debt legislation in s75 of the Pensions Act 1995.

Edward Jewitt

Government plans to change the rules (again) about employer debts to DB schemes

The Government is proposing to amend (for a twelfth time!) the rules about employer debt under s75 Pensions Act 1995. The amendments would make it easier to vary the basis on which liability is shared between employers.

Background – the Regulations as they stand

Under a multi-employer DB scheme, each employer is potentially liable to make good a share of any buy-out deficit, either on winding-up or where one employer stops employing active members at a time when other employers continue to employ them. Regulations specify a default basis for determining the employers' respective shares of the buy-out deficit. Under the default basis, an employer's share depends on the scheme liabilities which relate to that employer.

But the shares of employers can be varied, using a so-called scheme apportionment arrangement.

Flexible apportionment arrangements – the next big thing?

Under the Government proposals, the scheme apportionment arrangement option will remain, but it will apply only where another employer agrees to pay a fixed cash sum to the scheme, representing a departing employer's actual s75 debt.

The Government plans to introduce a new alternative – the flexible apportionment arrangement ("FAA") – under which the departing employer's liability is "apportioned" to another employer but the amount which the other employer will have to pay "floats", so that it shrinks if the buy-out deficit shrinks and gets bigger if the deficit itself gets bigger.

In more details, under an FAA, trustees would be able to release an employer ("A") from all of its liability under s75, provided that another employer ("B") agreed to step into A's shoes for the purpose of the Regulations. If and when B subsequently became liable to pay a s75 debt, its share of deficit would be calculated on the basis of scheme liabilities relating to both A and B. So, put crudely, what gets apportioned to B are A's scheme liabilities – whereas, under an SAA, what gets apportioned is an amount of A's s75 debt.

Trustees cannot currently put a scheme apportionment arrangement in place unless a "funding test" is met. A similar rule would apply in respect of FAAs, but the Government proposes that there should be greater flexibility. If a number of FAAs were to take effect at much the same time, trustees might determine that only one funding test was needed.

Other amendments

The Government proposes some other minor amendments to the Regulations. In particular, trustees would be given the option to extend the "period of grace" for s75 purposes, in circumstances where an employer temporarily stopped employing active members. If trustees so chose, the prescribed 12-month period could be stretched to anything up to three years, so that no s75 debt is due from that employer provided that it starts employing active members again some time in that three-year period.

The Government has shied away from addressing some significant ambiguities in the Regulations, for example about what it means for an employer to trigger a s75 debt by ceasing to employ "active members". This was on the agenda last year. But the Government says that, in view of the drive towards deregulation, any bottom-up review of the legislation has been shelved.

Comment

The FAA concept is appealingly simple: one employer agrees to take over the s75 responsibilities of another. Provided the Government gets the small print right, FAAs are likely to become commonplace on corporate sales and restructurings, while old-style scheme apportionment arrangements are likely to be rare.

However, the new FAA concept as described in the consultation is disappointingly inflexible in at least one respect, as it would be available only on an all-or-nothing basis. It seems not to provide for the possibility that the departing employer pays say half of its normal s75 debt and the other employer steps into its shoes for only the other half of the departing employer's liabilities.

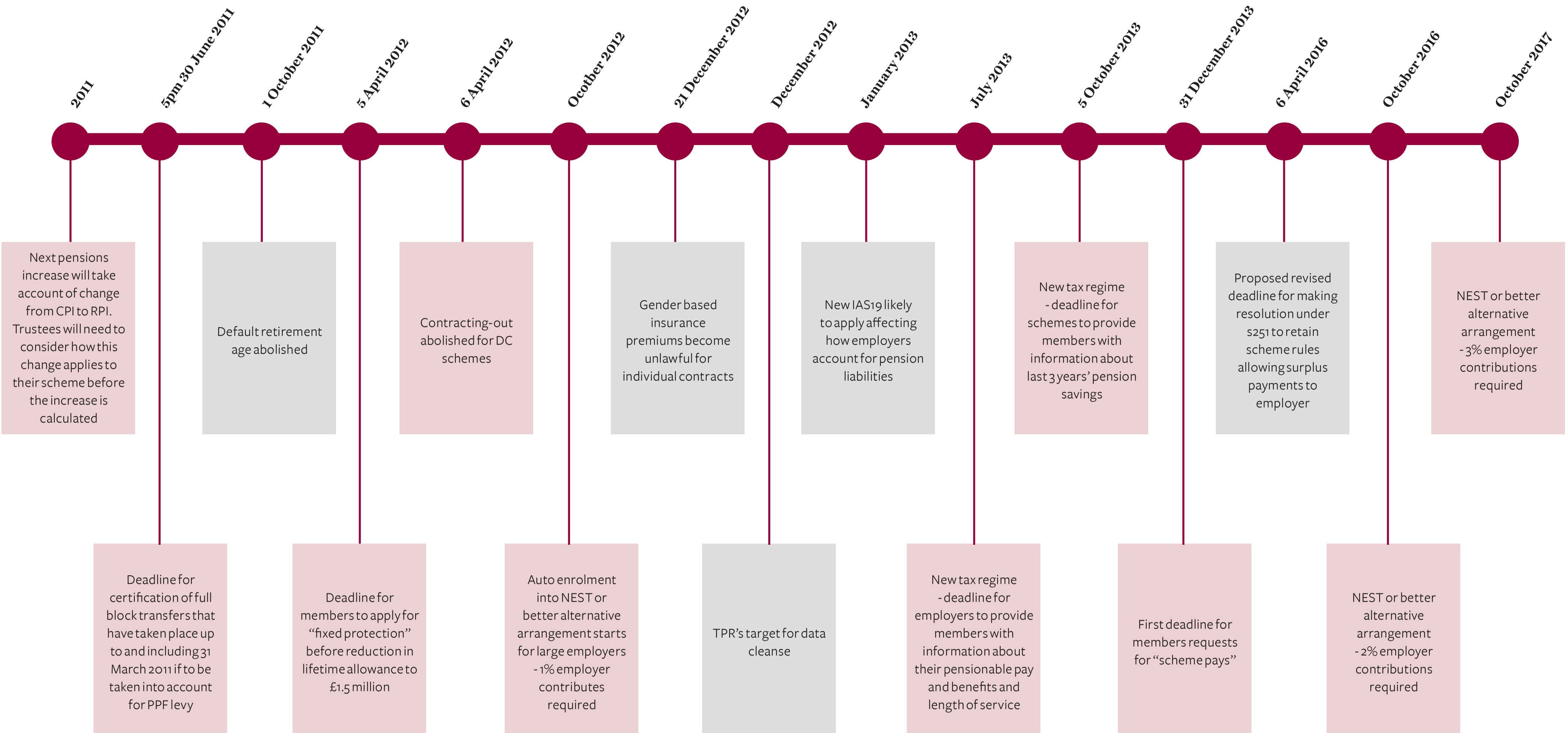
It is also disappointing that the Government has dropped its plan to overhaul the Regulations. They are a confusing hotchpotch, and some key provisions are unclear. If the aim of the deregulatory review is "to make the private pensions framework simpler", the employer debt legislation would be a good place to start.

Although the Government originally hoped that the changes would come into effect on 1 October, recent silence suggests that some delay is possible.

But assuming that something comes of these proposals, trustees of multi-employer DB schemes can expect employer proposals for FAAs to start dropping on their desks in due course.

Sally Taylor

Dates and Deadlines for your diary



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