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Quarterly Review

Trustee Quarterly Pensions Review

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Changes to the tax treatment of high earners

Overview

The Government has now announced its proposals for the tax treatment of high earners. In broad terms, they will limit individuals' tax-relieved pension saving for any tax year to £50,000.

The immediate issues for pension scheme trustees are:

- The new rules do not require changes to the benefits provided by the scheme - they simply impose tax charges on some members.
- But employers may well wish to change the remuneration packages they offer to better-paid employees. Trustees may be asked to agree benefit changes as a result.
- The proposals give a new importance to the concept of a scheme's "pension input period". This is because a scheme member's pension saving for a tax year will be his or her pension saving in the pension input period which <u>ends</u> in that tax year. Pension input periods are not necessarily aligned with the tax year; even within a scheme they may vary from member to member. As there are complex rules for determining what a member's pension input period is, and whether it can be changed, trustees should check that their administrators can in fact identify it.
- Where different pension input periods do apply to different members, trustees may want to align all members' pension input periods for administrative convenience. That option will probably cease to be available when the Finance Act 2011 receives Royal Assent, probably in July or August next year. So any steps to align pension input periods – where the scheme still has the option of doing this – should be taken before then. Members will need to be notified of any change.
- Trustees and employers will have to provide more detailed information in future, so as to identify any members whose accrual in the scheme for any year brings them within the scope of the tax, and so that the tax due when pension saving goes over the allowance can be calculated. The full force of these requirements will not be felt until 2012.
- Trustees will want their administrators to investigate the practical steps and system changes to be made, and to report back that they will be able to do what is required in time.
- There is likely to be an upfront administration cost and higher costs can be expected in future, unless administrators are willing to absorb the cost of standardising the new procedures and system changes.

In more detail

By and large, the announced changes are more generous to members than the proposals the Government trialled in July. As a result, in practice the new annual allowance charge should "bite" less often than many feared. For example:

- the new annual allowance – the maximum amount of tax-free pension saving a member will be able to make for any tax year – will be £50,000 (which is above the range of £30,000 to £45,000 suggested in July);
- the factor used to value defined benefit pension saving against the allowance will be 16:1 (towards the lower end of the 15:1 to 20:1 range proposed in July); and
- members who do not use up their entire annual allowance in one year will be allowed to "carry forward" the unused part for up to three tax years, in order to offset any later "spike" in their accrual due, say, to a one-off pay rise. For example, if a member has pension saving of only £20,000 for three successive tax years, he or she will have £30,000 of unused annual allowance for each of those years. The "carry forward" rule means that, for the fourth year, the member could have up to £140,000 of pension saving – £50,000 plus 3 x £30,000 – before attracting a tax charge.

There will be full tax relief on pension saving below the annual allowance: the Government is not pursuing the suggestion that marginal tax relief should be restricted to 40% for very high earners. Pension saving above the annual allowance will be taxed as income in full.

The current general exemption from the annual allowance in the year when benefits are drawn is being removed. But a number of specific exemptions will still apply:

- The "enhancement" involved in paying benefits early without actuarial reduction will not trigger an annual allowance charge.
- The annual allowance will not apply in the year in which a member dies or is diagnosed with *terminal* ill-health. So any pension enhancements paid in these circumstances will not give rise to an annual allowance charge.
- The Government has also accepted that, at least the case of retirement due to "major" ill heath, payment of enhanced benefits – for example a pension that allows for potential future service to normal pension age - should not be caught by the annual allowance. But the detail of what counts as major ill-health is still awaited. The intention seems to be that the charge should not apply where a member is unlikely to be able to work again in <u>any</u> occupation. This lack of detail creates uncertainty for cases that are already in the pipeline, particularly where the new regime effectively comes into play sooner than April 2011(see below).
- However, there will be no special exemption for enhancements triggered by a member's redundancy, or for members who wish to "sacrifice" a termination bonus by paying it into a pension scheme.

Some other aspects of the Government's announcement may be more unwelcome to higher paid members.

The Government also announced a reduction in the lifetime allowance ("LTA") from the current figure of £1.8m to £1.5m (though the 20:1 factor used to value defined benefit pensions for testing against the LTA will remain in force). This change is likely to take effect from 6 April 2012.

For some schemes and individuals, aspects of the new annual allowance regime effectively came into play from 14 October. That will be the case if their "pension input period" is due to end after 5 April 2011. For many others, whose "pension input period" ends before 5 April 2011, the new regime will come in as soon as the next input period starts. Trustees, members and employers may consider this fact, and the new importance of pension input periods generally, unfortunate for a number of reasons.

- First, the early start of the new regime may mean that pay rises already awarded to some members of DB schemes already bring them within the scope of the new tax charge (though in many cases the "carry forward" arrangements will mitigate this).
- Second, much of the detail of the new annual allowance regime was only announced on 14 October and some aspects have not been announced even now, so few schemes will have adjusted their benefit structures already to avoid the tax issues that may arise.
- Third, as mentioned earlier, for annual allowance purposes a member's pension saving under an arrangement for a given tax year is not his or her pension saving <u>in</u> that tax year. It is the member's pension saving in the pension input period which <u>ends</u> in that tax year. Schemes will therefore be expected to provide information about the value of members' pension saving over pension input periods, not tax years. As pension input periods may vary from member to member, trustees will need to ensure that individual pension input periods can be identified, and they may wish to consider whether they can align them now for administrative convenience. If trustees decide to align pension input periods and can still do so, members will need to be notified.

To read our fuller client briefing on the new annual allowance, please go to <u>http://www.mayerbrown.com/pensions/articl.asp?id=9838&nid=11078</u>

Jonathan Moody

The Government's review of the rules about auto-enrolment

Review of Auto-enrolment

As we explained in our Autumn 2009 edition, in October 2012 the first employers will be required to enrol employees automatically into a "qualifying scheme" unless they actively opt out. That scheme may be the "NEST" – a money purchase scheme which is being set up by legislation – or another occupational scheme or personal pension arrangement which meets certain minimum standards.

A Government-commissioned review of the automatic enrolment requirements has now been completed, and the Government look likely to endorse its recommendations.

Key features of the new regime seem likely to remain as summarised in our Autumn 2009 edition. In particular, the requirement to enrol staff automatically in a qualifying scheme will come in over a staggered period from October 2012, depending on the size of the employer.

Of the suggested changes the ones most relevant to Trustees are as follows:

When might rule changes be needed?

Trustees of schemes with large sponsoring employers (who will be impacted first by the new regime) should note that employers may be allowed to enrol workers automatically as early as July 2012. This may bring forward the timing for rule changes, where an employer wishes to adapt its current pension arrangements to ensure that they meet the requirements of a "qualifying scheme".

What rule changes may be necessary?

When the new requirements apply, there will now be:

a three-month period in which employers can automatically enrol workers (although workers can opt in earlier); and

a higher than anticipated earnings threshold for workers to be included in the new regime, which will be aligned with the income tax personal allowance (although some workers with lower earnings can opt in).

Employers are likely to want to take advantage of this relaxation, and look to reflect this in rule amendments. Over a longer time horizon, there will also be more flexibility in relation to re-enrolment requirements every three years.

Following calls from the pensions industry, the review has proposed a far simpler test allowing DC schemes to self-certify that they meet the qualifying requirements. This may impact upon the design of DC arrangements. There will be three possibilities, as follows:

	Pensionable Earnings	Minimum employer contributions	Minimum total contributions
Option 1	Basic pay	4%	9%
Option 2	85% of total pay	3%	8%
Option 3	Total pay	3%	7%

Unfortunately no change is expected to the detailed information that will have to be provided on automatic enrolment or to the complexity of the opt out process.

Wider issues for trustees

The review recommends as a matter of urgency that the Government considers how it can simplify the transfer of defined contribution pots when workers move employment.

The review also highlights some perceived unfairness between occupational and contract-based schemes. Only occupational schemes can provide a refund of contributions to members who leave within two years, and only they can offer favourable commutation terms for pots of less than £2,000. Further changes are possible in these areas of benefit design.

Richard Goldstein

The switch from RPI to CPI

The Government has defended its plans to use the Consumer Prices Index rather than the Retail Prices Index for minimum increases to deferred pensions and pensions in payment.

With regard to the claim that the change breaches members' accrued rights, the Government has said that legislation requires increase orders to be made, not by reference to a particular index, but by reference to the Secretary of State's assessment of the rise in the general level of prices. The Government has argued that what is needed is an inflation measure that matches the effect of inflation on pensioner spending. In its view the RPI does not do this and the CPI is a better measure of what households do when prices go up, as it better reflects the fact that people are likely to change their pattern of spending if some prices rise more than others.

We await draft legislation clarifying whether trustees whose scheme rules currently link increases to the RPI will be given an overriding power to link future increases to the CPI. However, the Government has indicated that this is at least on the cards, and that it may even allow trustees to make that change for benefits that have already accrued in past service. If such a power is given we expect it will be permissive, not mandatory, and that ultimately the decision to change will be one for the trustees not the sponsoring employer.

Helen Parrott

Opening the door to "e-disclosure"

From 1 December, new rules will allow trustees to use electronic means ("e-disclosure") to provide some of the information they are required to give to scheme members and others,– though only if prescribed conditions are met. These changes are being made by amendments to the Disclosure Regulations, and they apply only to the information and documents ("relevant information") which trustees are required to provide, automatically or upon request, under those Regulations.

Trustees will have the option of providing relevant information via email or a website. However, there are a number of wrinkles:

- Trustees must be satisfied that their e-disclosure arrangements will let members access and store or print relevant information, and that the arrangements take account of the needs of disabled people.
- A member will be able to "opt out" of e-disclosure, and insist on receiving relevant information by post. If trustees wish to use e-disclosure for pre-December 2010 members, they must first notify the members of their right to opt out.
- If trustees provide members with relevant information via a website, they must send the members notice by post or email. On the first occasion, the trustees must explain how members can access the relevant information. Thereafter, the trustees must tell members each time further relevant information is provided via the site.

There are also some minor changes to the rules about statutory money purchase illustrations (**"SMPIs"**) – the statements which trustees have to send each year to members with money purchase benefits. For example, in future it will be possible to provide some of the prescribed "health warnings" separately from the SMPIs themselves.

Comment

The changes will potentially enable trustees to use e-disclosure to provide:

- information traditionally included in scheme booklets
- benefit statements, including SMPIs

In practice, not all duties to provide information to members arise under the Disclosure Regulations. The new e-disclosure rules will apply only where the duty to disclose arises under the Disclosure Regulations themselves. So trustees should not assume that e-disclosure is allowed for all purposes.

Richard Evans

Update on s251: common sense prevails

As mentioned in our May 2010 edition, s251 Pensions Act 2004 has been causing a good deal of debate in the pensions community because it appears to be drafted more widely than intended – restricting payments to employers. The DWP have now responded to lobbying on this issue and we are pleased to report that common sense has prevailed. The headline points in the DWP's response are:

- Refunds on winding up are not meant to be caught by s251
- Nor are repayments of expenses or other administrative payments
- s251 was intended to apply only to refunds of surplus to employers from an ongoing scheme (in other words, payments subject to s37 Pensions Act 1995)
- A commitment to amend the legislation to clarify the position in due course, though that may not happen before the current 6 April 2011 deadline
- A proposal to extend the deadline by 5 years, to 6 April 2016

For many schemes this means that no further action is required.

The implications for your scheme will depend on the particular circumstances. Please get in touch with your usual contact in the Mayer Brown pensions team if you want to discuss the appropriate next steps.

Giles Bywater

New rules, and a new statement on employer related investment

Regulations have been made which mean that the normal rules which limit employer related investment will now apply where the investment is made by pooled funds. The Pensions Regulator has also issued a statement on employer related investment.

The new Regulations

The Pensions Act 1995 imposes a limit that no more than 5% of a scheme's assets can be invested in "employer related investment", such as shares of the sponsoring employer. In addition there is an absolute bar on loans to the employer.

Before 23 September 2010, an exception meant that investments made by a collective investment scheme (CIS) run by a UK authorised person could be ignored when checking whether the restrictions on employer related investment are breached.

This exception has now been removed. This means that where a CIS invests in an employer related investment, you have to count a proportion of that investment as employer related investment for the pension scheme. The proportion which counts as employer related investment is the same as the proportion of the assets of the CIS which is attributable to the pension scheme.

For example, a pension scheme might own 10% of a CIS, which then buys shares in the sponsoring employer worth £1m. Under the new rules, the pension scheme must treat £100,000 of the shares in the sponsoring employer as employer related investment.

We recommend that trustees ask the pooled funds in which they invest to provide regular notifications of any employer related investment to allow the trustees to check that the limits are not breached.

In addition, some rarely-used exceptions for historic employer-related investments over the 5% limit have been removed.

Regulator's statement

At the same time the Pensions Regulator has issued a statement on employer related investment. This gives some examples of what the changes discussed above mean for schemes.

It also discusses the risk that some funding structures, including limited partnerships, *could* breach the employer related investment restrictions. The Regulator notes that this has not been tested in Court. Where these arrangements might be illegal the Regulator says that trustees should ask for an "under-pin" which would provide an alternative source of funding if the original structure had to be unwound.

The note sets out a list of matters that the Regulator will take into account when deciding to take action about breaches of the employer related investment rules, including whether the breach was unintentional and whether it has been remedied.

Edward Jewitt

Removing the age 75 cliff-edge for pension saving

The Coalition Government has been consulting on some radical proposals to change pensions tax law by "scrapping the age 75 annuity requirement" from April 2011. As an interim step, the Government has already changed the rules so the current requirements to use DC funds to buy an annuity apply at age 77, not age 75 as before.

Once the final details of the legislation are published, trustees of DC arrangements will need to consider carefully with sponsors whether they want to offer the new options, or whether they will insist on members transferring to other providers if they want to access them.

The Government's proposals

Although it has not been compulsory to buy an annuity by age 75, the only alternative (called "alternatively secured pension", or "ASP") that has previously been available for people reaching that age is unattractive for most people.

One of the Government's two new proposals is to remove ASP entirely, and instead to extend to the over-75s the more flexible income drawdown option (called "unsecured pension" or "USP") which is currently available to the under-75s. The government calls this new option "capped drawdown" because, once a member has designated DC funds as available for USP, he or she can withdraw from them each year up to 120% of the income that would have been provided by an equivalent annuity. As part of the consultation, the Government has indicated that it may review the 120% annual drawdown limit.

The Government also has a more radical proposal – "flexible drawdown". It is considering allowing anyone aged 55 or more to withdraw as much or as little of their remaining DC pot as they wish in any year (subject to marginal income tax), provided they have first secured some minimum level of income for the rest of their lives (and provided that that income increases by some minimum amount each year to protect against inflation). The Government has not yet decided what minimum level of income will have to be secured before an individual can take "flexible drawdown", but it is unlikely to exceed £300 a week in today's prices.

The minimum income requirement could be met by any mixture of state pension (which could itself be up to around £250 per week), increasing occupational pension and increasing lifetime annuities.

This flexibility could offer real potential advantages to members of DC arrangements. Rather than being forced in effect to buy an annuity and a fixed income stream at 75, flexible drawdown will let them leave part of their pension saving invested, to be withdrawn as and when they want or need it. But this flexibility also opens up new risks of underperformance and perhaps mis-selling, which – even with the minimum income requirement – could leave members poorer in retirement.

Clearly, capped or flexible drawdown won't be appropriate for every individual. Some people won't be able to meet the minimum income requirement. Others will prefer the certainty and security of an annuity to the risks of drawdown. But schemes which offer DC benefits may be asked whether they will offer this option. And members of DB schemes who want to take flexible drawdown in a separate DC arrangement may also start to ask if they can "rebuild" their DB pension so that it enjoys the increase rights that let it count towards the minimum income requirement.

Ian Wright

Some dates and deadlines for your diary

- **14 October 2010** - for some scheme aspects of the new annual allowance regime comes into play
- **1 December 2010** - Trustees will be able to provide information to members by electronic means where prescribed conditions are met
- **2011** - next pensions increase will take account of change from CPI to RPI. Trustees will need to consider how this change applies to their scheme before the increase is calculated
- **5pm 31 March 2011** - deadline for certification and recertification of contingent assets
- **6 April 2011** - Revenue limits will be lifted unless written into the scheme rules. To retain these limits trustees must pass a resolution **before** this date
- **6 April 2011** - Any retriction on amendment power which requires IR approval will come back into force. Trustees can resolve to remove this, before or after 5 April
- **5pm 7 April 2011** - deadline for certification of deficit reduction contributions if to be taken account for PPF levy
- **June 2011** - may be last month to notify members of a new "pension input period" for the annual allowance
- **5pm 30 June 2011** - deadline for certification of full block transfers that have taken place up to and including 31 March 2011 if to be taken account for PPF levy
- **October 2011** - default retirement age may be abolished
- **April 2012** - contracting out abolished for DC schemes
- **October 2012** - auto enrolment into NEST or better alternative arrangement starts for large employers 1% employer contributions required
- **January 2013** - new IAS19 likely to apply affecting how employers account for pension liabilities
- **July 2013** - new tax regime - deadline for employer to provide members with information about their pensionable pay and benefits and length of service
- **6 October 2013** - new tax regime - deadline for schemes to provide members with information about last 3 years' pension savings
- **6 April 2016** - proposed revised deadline for making resolution under s251 to retain scheme rules allowing payments to employer
- **October 2016** - NEST or better alternative arrangement - 2% employer contributions required
- **October 2017** - NEST or better alternative arrangement - 3% employer contributions required

Red squares - important dates to note
Green squares - for information

Joanna Myerson

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