UK Pensions Update: July 2015

1. Potential radical reforms: a consultation on pensions tax relief

During the Summer Budget delivered on 8 July 2015, it was announced that the Government intends to focus on those who are starting to save for a pension and a consultation paper has been published to seek views on whether there is a case for reforming pensions tax relief to incentivise pension saving. The Government says it is approaching the consultation with an "open mind", rather than putting forward a specific proposal for reform (and this is reflected in the consultation paper itself, which is light on any real detail).

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The Government is asking for views on various options for reform. One proposal is to move to an ISA-style "Taxed-Exempt-Exempt" ("TEE") system (i.e. away from the "Exempt-Exempt-Taxed" ("EET") system we currently have). Under a TEE system, individuals would lose tax relief on contributions into a pension scheme, but withdrawals would be tax-free (and in between, savings would receive some form of top-up from the Government – although it is not yet clear what the extent of this top-up would be). Other proposals suggest retaining the current system, but altering the Lifetime Allowance and Annual Allowance.

According to the paper, any reform should meet the following key principles (although, noting that some may have to be prioritised over others): (i) it is simple and transparent; (ii) it allows individuals to take personal responsibility for ensuring they have adequate savings for retirement; (iii) it builds on the success of auto-enrolment; and (iv) it is sustainable. The Government accepts that the conclusion of the consultation may be that maintaining the current system best meets these principles. The consultation closes on 30 September 2015.

In order to encourage people to save for retirement, there needs to be an incentive which makes it more attractive than other, short-term, savings. Therefore, it is difficult to see why moving to a TEE system is being considered as an incentive for long-term saving. If put on an equal footing with ISAs (and depending on what kind of top-up would be provided by the Government during the investment phase), query why savers would not prefer to contribute to an ISA instead (at least up to their ISA savings limit), which they can access much more freely, without the restrictions on withdrawing before normal minimum pension age. Indeed, depending on the level of the Government top-up, a move to a TEE system could leave pension savers significantly worse off than they are now – by effectively removing the benefit of the 25% tax-free lump sum currently available on retirement.

Thought would also need to be given as how a TEE system would work for DB schemes versus DC schemes. Whilst the impact on DC schemes might not be so significant (as, ignoring the 25% tax-free lump sum, the overall benefit provided to DC members under a TEE or EET system works out broadly equal), the impact on DB schemes could be significant. If a TEE model would mean both member and employer contributions no longer receive tax relief (and the consultation is silent on this), this could significantly increase DB scheme deficits, unless employers stump up extra funding or are able to impose higher contribution rates on members. It seems that this could be a motivator for further DB scheme closures.

2. The Annual Allowance ("AA") taper

Also announced during the Summer Budget, was the AA taper, which will come into effect from 6 April 2016. This will, generally, only be relevant for high earners, although there is a risk that others may be drawn into it due to one-off payments (see below). The AA taper will operate so that for every £2 of "adjusted income" over £150,000, an individual’s AA will be reduced by £1, with a maximum possible reduction of £30,000. (Therefore, anyone with adjusted income of or above £210,000 will have an AA of £10,000 for 2016/2017).

An individual's "adjusted income" will include, broadly, their taxable income (less certain reliefs e.g. donations made to charity), plus all pension contributions in respect of them (both employer and member contributions). To ensure this measure is focused on those high earners who currently get the most benefit from pensions tax relief, the tapered AA will not apply to individuals whose taxable income (less certain reliefs), excluding pension contributions, is £110,000 or lower, regardless of the level of their adjusted income (a 'net-income threshold'). However, to tackle potential anti-avoidance, any contributions made by way of a salary sacrifice arrangement set up on or after 9 July 2015 will be included in this net-income threshold.

In order to implement the new AA taper, all schemes will be required to align their pension input periods or "PIPs" (the period over which an individual's pension saving is tested against the AA) with the tax year. Essentially this means that all PIPs open on 8 July 2015 will be closed on that date, the next PIP will run from 9 July 2015 to 5 April 2016 and all subsequent PIPs must be concurrent with the tax year after this). Therefore, some individuals may have contributed pension savings of more than £40,000 prior to the Summer Budget on the expectation that these savings would be tested against the AAs for 2015/2016 and 2016/2017, but which will now only be tested against the AA for 2015/2016. In order to deal with this issue, legislation is being introduced so that everyone will be given a transitional total AA of £80,000 for the 2015/2016 tax year (plus any available carry forward), but subject to a £40,000 allowance for savings from 9 July 2015 to 5 April 2016.

The AA taper could cause significant issues for schemes from next year. As well as affecting consistently high earners, due to the way in which adjusted income is calculated, it also means that some individuals could be affected by the AA taper due to a one-off event in a particular tax year. For example, if they receive a large redundancy payment or a bonus.

High earners who become subject to the AA taper will incur significant tax charges if their pension savings exceed their new tapered AA. For individuals accruing DB benefits, it is highly likely, particularly for those subject to the full reduction, that a year's worth of DB accrual will exceed the tapered AA, because both pensionable service and increases in pensionable salary (above CPI inflation) feed into the calculation of an individual's "pension input amount" for testing against the AA. There is also a certain level of difficulty in monitoring pension savings in DB arrangements due to the way in which the "pension input amount" is calculated.

One of the key problems with the new regime is that the AA for a tax year is dependent on the person's taxable income for that tax year. As a result, some people will not know with any certainty what their income is and therefore what their AA is until the end of the tax year, by which point it is too late.

Employers of high earners may well be approached and asked to put in place measures to ensure these individuals are not subjected to the penal tax charges which result from exceeding the AA. In terms of the options for dealing with this, high earners should make the most of their AA for this tax year if they have not already done so (including making use of any carry forward from the previous three tax years). (Note that carry forward will continue to be available post 6 April 2016). Employers may then consider whether to offer their high earners alternatives to continued benefit accrual – for example, giving members the option to opt-out of benefit accrual and receive a cash allowance instead or put in place measures to allow a temporary suspension of benefit accrual and offer a non-pensionable cash allowance for the period of suspension. There are likely to be a number of issues to work through if considering offering these kinds of options, including amendments to scheme rules.

3. Abolition of contracting-out –final regulations published

HMRC published its ninth issue of its "Countdown Bulletin to the end of Contracting-out" last week, serving as a keen reminder that the abolition of DB contracting-out is rapidly approaching.

This was swiftly followed by the Government's long-awaited response to the consultation on the ***Occupational Pension Schemes (Schemes that were Contracted-out) Regulations*** (the "**Regulations**"), which was published, together with the final form Regulations, on 16 July 2015.

The Regulations will, for the most part, come into force on 6 April 2016 and deal with the protection of accrued contracted-out rights; setting out the rules which former contracted-out schemes must comply with from 6 April 2016. ***The Pensions Act 2014 (Savings) Order 2015*** has also been published and will come into force on 6 April 2016, providing for a number of provisions of the Pension Schemes Act 1993 which are being repealed by the Pensions Act 2014 to be saved for a three year period for the purposes of allowing scheme trustees and HMRC to carry out any "necessary activity" relating to any period of contracted-out employment which occurred before 6 April 2016.

Key points coming out of the consultation response include:

- Confirmation that DWP and HMRC are working to provide guidance for scheme administrators. This guidance should be ready for publication in 'early 2016'.
- Confirmation that DWP does not intend to introduce a power for schemes to modify scheme rules which make reference to contracted-out concepts to reflect the State Pension Reforms where the scheme rules do not allow this (on the basis that such a power should not be needed).
- Confirmation that DWP will not address GMP conversion and equalisation in the Regulations, but that these issues are 'being explored separately'.
- Confirmation that schemes will not be required to have a protection rule (i.e. a rule confirming that, although having ceased to be contracted-out, as the scheme continues to hold contracted-out rights, the total benefits under the scheme for each member will not be less than the sum of their contracted-out and contracted-in rights) because no scheme ceasing to contract-out on 6 April 2016 will be subject to approval arrangements by HMRC.

A number of amendments have also been made to the draft Regulations, including amendments to clarify the position on GMP revaluation where a member has ceased to be in contracted-out employment at some point **before** 6 April 2016, versus a member who ceases to be in contracted-out employment **on** 6 April 2016 (to ensure that members who ceased to be in contracted-out employment before the abolition date can continue to have their GMPs revalued in line with the fixed rate method).

However, it seems that the picture is still far from being complete and DWP has confirmed that it still intends to consult on / revisit a number of related issues, including: (i) how best to ensure the reference scheme test is preserved for DC schemes with a reference scheme test underpin where the underpin is defined by reference to the relevant provisions of the Pension Schemes Act 1993 (such provisions will be saved until 6 April 2019 to address this issue in the short-term, but DWP notes that this issue is more complex than first thought); (ii) further consequential changes to the **Contracting-out (Transfers and Transfer Payments) Regulations 1996** to take account of transfers between former contracted-out schemes; and (iii) the issue of whether employers will be required to notify and consult with members in advance of the end of contracting-out in a further consultation which deals with required changes to the ***Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013***.

This all follows the publication of the ***Occupational Pension Schemes (Power to Amend Schemes to Reflect Abolition of Contracting-out) Regulations 2015***, which were finalised and came into force on 6 April 2015.

These regulations contain the "statutory override" power to allow employers to amend scheme rules, without trustee consent, to recoup the increase in NICs they will face when contracting-out ends. They also set out the framework for such amendments, stipulating how the actuary is to calculate and certify that the value of the amendments will not be greater than the increase in the employer's NICs.

The final regulations differ in a number of respects from the draft regulations that accompanied the Government's consultation in May 2014, in particular, by making the unilateral power more practicable for employers to use.

4. High Court confirms the use of extrinsic contracts to cap pensionable pay

Conclusion has finally been reached on the long-running case of ***Bradbury v British Broadcasting Corporation***.[1] In 2011, the British Broadcasting Corporation ("**BBC**"), in a bid to reduce its pension scheme liabilities, consulted with members of the scheme and unions to cap future increases in pensionable earnings to 1%. The BBC sought to implement this reduction by means of an external contractual agreement with the members, rather than under the pension scheme, which would necessitate trustee consent.

The High Court endorsed the validity of extrinsic contracts for the purposes of capping pensionable earnings but stated that in order for such contracts to be enforceable, the employer must ensure that it complies with the implied duty of good faith and mutual trust and confidence when implementing the proposed changes. As this issue had not been properly considered by the Pensions Ombudsman, Mr Justice Warren remitted this question back to the Ombudsman.

The Ombudsman concluded, in light of the judicial guidance, that the BBC had not breached its implied duties of trust and confidence towards Mr Bradbury. In particular, the Ombudsman did not consider that the BBC’s decision to impose the cap was irrational, perverse or one that no reasonable employer in its position would have adopted. Neither was there any evidence that Mr Bradbury had been subject to improper coercion by the BBC. Furthermore, whilst Mr Bradbury might have had a reasonable expectation of future salary increases which would have been treated as fully pensionable, he did not have a right to such expectation. Finally, it was clear on the evidence that the BBC's objective for imposing the cap was to address the scheme's deficit and not for the alleged collateral purpose of encouraging long-serving staff to leave the BBC altogether.

Mr Bradbury appealed to the High Court against the Ombudsman's determination on the basis that the Ombudsman had failed to consider the overall position, focusing only on whether the individual factors Mr Bradbury had identified amounted to a breach in themselves.

He also argued that his 'Reasonable Expectations' (as defined in the ***IBM***[2] judgment in 2014) were disappointed. Although the issue had not been raised before the Ombudsman, the Judge concluded that the evidence put forward did not create any 'Reasonable Expectations' that would have been engendered by the BBC on the part of Mr Bradbury, and dismissed the appeal.

The decision is a helpful restatement of the validity of extrinsic contracts to effect a change to pension benefits where this is not pursued through amendment to the pension scheme rules.

5. EMIR extension – a further two years' grace for pension schemes

On 5 June 2015, the European Commission issued a draft Regulation extending the current exemption for pension schemes from central clearing requirements until 16 August 2017. In the February 2015 edition of our Pensions Update, we reported that the EU regulation on over-the-counter ("**OTC**") derivative contracts, central counterparties and trade repositories which provides a temporary exemption from the clearing obligation for certain contracts entered into by pension scheme arrangements (an obligation which applies directly to pension scheme trustees) was due to expire in August 2015.

However, on the recommendation of the Commission for a further two-year extension which was published in a report to the European Parliament and the EU Council on 3 February, pension schemes will continue to enjoy an exemption from the clearing obligation (once in force) for all OTC derivative transactions which are “objectively measurable as reducing investment risks directly relating to the financial solvency of pension schemes”.

Provided the OTC derivative transaction falls within the scope of the exemption, trustees should consider whether they wish to delay the clearing of OTC transactions in reliance on the exemption.

6. DC governance and charges

Governance

New minimum quality standards applicable to trust-based DC schemes came into force on 6 April 2015. Essentially, they require trustees to assess the "good value" represented by the scheme's charges and transactions costs.

Firms operating contract-based workplace pension schemes are also required to set up independent governance committees, which must assess and raise any concerns about the "ongoing value for money" of a provider's DC scheme.

An annual governance statement which will form part of the scheme's annual report and which has to be signed off by the chairman of the trustees, on how governance standards have been met in their scheme, will need to include an assurance on the extent to which the charges represent good value as well as confirmation that the "Trustee Knowledge and Understanding" requirements have been met in the course of the year.

Charges

With effect from 6 April 2015, a cap limiting charges to 0.75% of funds under management (excluding transaction costs) has been introduced in relation to default arrangements under DC schemes used for auto-enrolment. Guidance for trustees has been issued by the DWP in relation to how these charges should be assessed and to identify the default arrangement.

The Financial Conduct Authority has published similar guidance/rules on charges for firms operating workplace pension schemes.

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[1] [2015] EWHC 1368 (Ch)
[2] IBM UK Holdings Limited and another v Dalgleish and others [2014]