Flexibility: the details take shape

Taxation of Pensions Bill

The Government’s proposals to overhaul the tax rules for members of defined contribution (DC) pension schemes continue apace, following the introduction of the Taxation of Pensions Bill to Parliament after a public consultation.

Here is a summary of some of the notable changes set out in the Bill.

There will be two new ways benefits can be paid from DC and cash balance arrangements:

• A flexi-access drawdown option effectively makes the current flexible drawdown provisions available to a much wider group of individuals by removing the minimum income requirements. This would allow individuals to designate funds for drawdown and take a separate tax-free pension commencement lump sum of up to one-third of the funds designated. When payments are made from the designated funds they would be taxed as income.

• An uncrystallised funds pension lump sum option would enable funds to be paid as a lump sum provided certain conditions are met. One-quarter of each payment of the lump sum would be tax-free, with the remainder being taxed as income.

Funds will be tested against a member’s lifetime allowance, in the usual way, under either option.

If an uncrystallised funds pension lump sum is paid or income is taken from a flexi-access drawdown fund, a lower alternative annual allowance of £10,000 will apply for contributions to DC and cash balance arrangements. This is intended to counter the possibility that these payments might be used as a means of tax avoidance. Broadly, once triggered, the alternative annual allowance charge for each tax year will be the higher of (a) the standard annual allowance charge and (b) an annual allowance charge calculation based on the amount by which the contributions to the individual’s DC and cash balance arrangements exceed £10,000.

Continued on next page
Members will still be able to purchase lifetime annuities if they wish, and the Bill removes some restrictions on the rules for these. There will no longer be a requirement for members to be able to select the annuity provider, it will be possible for annuities to go down as well as up and there will be no maximum guarantee period.

There will be new disclosure requirements for scheme administrators and individuals. These are intended to ensure that, where an individual has flexibly accessed their pension savings, all schemes of which they are a member are aware of this so that the right amount of tax is calculated and paid.

The Bill provides trustees with a power to make payments under the new options outlined above, even if their scheme’s rules contain provisions that prevent such a payment.

An increase in the threshold for trivial commutation lump sum death benefits, to £30,000, is amongst the other amendments set out in the Bill.

**Taxation of DC pension funds on death**

As indicated earlier this year, the Chancellor has announced significant changes to the taxation of unused DC funds on death, which are included within the Taxation of Pensions Bill.

At present, there is a tax charge of 55% on all lump sums paid from drawdown funds (regardless of the member’s age), as well as from untouched DC funds where the member is aged 75 or over. (In all these cases the funds can be paid as income to dependants, subject to income tax). Where the DC fund has not been used but the member is under the age of 75, it can be paid out as a tax-free lump sum up to the lifetime allowance (currently £1.25 million).

Under the new system, for payments made after 5 April 2015:

- anyone who dies before age 75 will be able to pass on any remaining DC funds tax-free, whether taken as a single lump sum, or accessed through drawdown. This will not apply to income from dependant’s annuities or scheme pensions, which will continue to be taxed at the beneficiary’s marginal income tax rate. (Where a lump sum is paid from undesignated DC funds, it will still need to be tested against the lifetime allowance and a charge will apply to any excess.)

- if the member dies aged 75 or over, funds accessed through drawdown will be charged at the recipient’s marginal rate of income tax. Alternatively, beneficiaries may take the funds as a lump sum payment taxed at 45%. The Government intends that from 2016/17 lump sum payments will be charged at the recipient’s marginal rate, but it needs to liaise with the industry over how to implement this regime.

**Action point**

Consider whether your scheme should offer some or all of the new flexibilities directly, and what process changes would be needed to facilitate this.

Consider the extra information and support you may need to provide for members with DC funds, including AVCs.

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**Other pensions tax issues**

**Bulk transfers and the annual allowance**

In November 2012, HM Revenue & Customs (HMRC) published draft regulations that affected annual allowance charge calculations. As reported in the May 2013 edition of In Sight, consultation responses identified a disagreement over the interpretation of the requirements of existing legislation in relation to bulk transfers. This uncertainty has led to a delay in some bulk transfers taking place.

HMRC has now revised its draft regulations in a way that aims to address the bulk transfer issue so that the rules work as intended and further refines the existing legislation, as outlined in the original consultation. The proposed changes for bulk transfers will have retrospective effect, provided they do not increase tax.

**Individual Protection update**

On 6 April 2014 the standard lifetime allowance went down from £1.5 million to £1.25 million.

Individuals with benefits valued in excess of £1.25 million at 5 April 2014 can now apply for a new option to protect them from the lifetime allowance, up to an overall maximum of £1.5 million. This new option – individual protection (IP14) – must be obtained by 5 April 2017. HMRC has published a tool on its website to help individuals assess whether they may need to apply. Individuals who decide to apply can do so online. The address is www.hmrc.gov.uk/news/individual-protection.htm.
Independent Governance Committees

We previously reported that from April 2015 contract-based defined contribution pension schemes will be required to have independent governance committees (IGCs) to oversee quality standards and protect members’ interests.

The Financial Conduct Authority (FCA) has been consulting on proposed rules for IGCs, which cover the minimum requirements for their format and operation, as well as their role within a provider’s governance framework.

The FCA has been working with the Department for Work and Pensions (DWP) and the Pensions Regulator on consistent minimum standards for contract-based and trust-based pension schemes.

IGCs will be required to act in the interests of scheme members, rather than the provider, to provide a credible and effective challenge on the value for money of workplace personal pension schemes. Their key duties would be:

- to act in the interests of relevant members
- to assess the value for money of the provider’s workplace personal pension schemes
- where the IGC finds problems with value for money, to raise concerns (as it sees fit) with the provider’s board
- to escalate concerns to the FCA, alert relevant scheme members and employers, and make its concerns public, and
- to produce a publicly available annual report of its findings.

A comply or explain approach has been proposed, requiring the provider to address the IGC’s concerns or explain why it does not intend to do so.

Latest news

Shortly before going to press, the Government began a consultation on draft regulations on governance and charges for trust-based DC schemes, which are expected to apply from April 2015. These will be featured in the next edition of In Sight.

Here are some key future developments likely to affect pensions.

January 2015

- FRS102 to replace FRS17 (and other UK GAAP standards)

April 2015

- New flexibility for DC pensions
- Minimum quality standards for all DC schemes
- Charge cap for DC default funds used for auto-enrolment

April 2016

- Introduction of single-tier state pension and end of contracting-out
- Framework for defined ambition and collective schemes may be introduced

April 2017

- NEST contribution limits and transfer restrictions to be removed
Accounting for surpluses

The new UK GAAP, FRS 102, comes into force shortly, applying for accounting periods beginning on or after 1 January 2015. It is based closely on the International Financial Reporting Standards for Small and Medium-sized Entities which, in effect, means IAS 19 for pensions.

In order to clarify certain aspects of pension accounting for defined benefit pension plans under FRS 102, the Financial Reporting Council (FRC) has issued an exposure draft, FRED 55 Draft Amendments to FRS 102 – Pension obligations. FRED 55 addresses concerns over whether or not an entity applying FRS102 should have regard to the principles of IFRIC 14 – guidance issued previously by the International Accounting Standards Board. The draft amendments propose to clarify that:

- for entities already recognising assets or liabilities for defined benefit plans in accordance with FRS 102, no additional liabilities need to be recognised in respect of an agreement to pay future deficit contributions (in excess of the accounting deficit) under a schedule of contributions.
- the effect of restricting the recognition of surplus in a defined benefit plan, where surplus is not recoverable, shall be recognised in other comprehensive income, rather than the profit and loss.

The deadline for comments on FRED 55 is 21 November 2014. If adopted, the amendments would be effective for accounting periods beginning on or after 1 January 2015. The FRC expects to issue final amendments early in 2015, which will be after the effective date of FRS 102 but prior to the preparation of the relevant financial statements required for UK GAAP.

This clarification would alleviate some concerns around the financing of defined benefit plans otherwise having adverse balance sheet implications. However, companies reporting under UK GAAP will still only be able to recognise an asset in respect of any plan surplus to the extent that they are able to recover the surplus either through reduced contributions in the future or through refunds from the plan.

Switching inflation indices

The High Court has concluded that the rules of two of the Arcadia Group’s defined benefit pension schemes allow for a switch from using the Retail Prices Index (RPI) to the Consumer Prices Index (CPI) for calculating deferred revaluation and increases to pensions in payment.

This ruling has its roots in the Government’s decision to switch from using RPI to CPI as the statutory measure of inflation for uprating pensions back in 2011. This move was controversial because, on average, CPI increases are expected to be lower. The implications for a pension scheme depend on its rules’ requirements for indexation and revaluation.

In this case, the pension schemes’ rules require the increases to be based on “the Government’s Index of Retail Prices or any similar index satisfactory for the purposes of the Inland Revenue”. The Court ruled that CPI is a similar index and could be used for both past and future service. The Court also found that the trustees and the company would need to jointly exercise the power to change the index used.

This judgment follows on from the QinetiQ case, which we reported on in August 2012, in which the High Court concluded that the particular scheme rules gave the trustees the power to switch to using CPI as a suitable inflation measure.

Again, this judgment turns on the specific rules of the schemes. However, as the definition in the Arcadia schemes’ rules originated from historic Inland Revenue wording, other schemes may find they have similar provisions in their rules.

Action point

Trustees and employers may wish to consider obtaining legal advice as to whether such a change is possible and if it is appropriate for their own scheme.
Pension Protection Fund levies

The Pension Protection Fund (PPF) has confirmed its framework for calculating PPF levies over the next three years and is now consulting on the detailed levy rules for 2015/16. The underlying principles of the existing calculation remain, but there will be significant changes to individual schemes' levies as a result of the move to Experian for measuring insolvency risk.

Experian PPF-specific scores

As reported in the August edition of In Sight, Experian has developed a PPF-specific model to calculate insolvency risk. The model has received strong support and has been improved in response to feedback. The changes include:

- a better method for identifying ultimate parent companies (including those overseas)
- reducing the scope for companies to choose between different scorecards
- amending some of the variables in the calculation where they may unfairly penalise some businesses
- allowing more detailed financial data to be used even if it is not held by Companies House.

The PPF is consulting further on changes to how the model treats secured charges (ie mortgages) and is proposing that certain charges can be ignored.

Other changes

The proposals for asset-backed contributions, Type A contingent assets (group company guarantees) and last man standing schemes are being implemented, but with some modifications.

Impact on schemes

The PPF proposes that the formula for calculating individual schemes’ levies will use a risk-based levy scaling factor of 0.65 and a scheme-based levy multiplier of 0.0021%. These are expected to apply for the next three years.

For 2015/16 this is expected to raise £635 million in levies, some 10% lower than 2014/15, which is intended to reflect the amount the PPF would have raised had there been no changes to the levy framework. The PPF expects its levy income to fall further over the following two years if claims on it reduce and scheme funding improves in line with its expectations. However, the new insolvency scores mean that some schemes will see a significant increase in their levy.

Action point

Schemes can start estimating their likely 2015/16 levy. Although detailed estimates will not be possible until market conditions and Experian scores up to 31 March 2014 are known, schemes can start to consider any appropriate mitigating action.

As a minimum, all schemes and employers should check that Experian are using the correct information to calculate their PPF-specific scores.

Historic ETV findings

A Financial Conduct Authority (FCA) review of more than 300 enhanced transfer value cases carried out between 2008 and 2012 has indicated large variations in the standard of advice that independent financial advisers (IFAs) gave to members. In its review the FCA investigated the suitability of the advice and recommendations made to occupational pension scheme members as part of the enhanced transfer value offer.

The FCA found that the advice was unsuitable in 34% of cases. It also concluded that the standard of IFAs’ communication with members was unacceptable in 74% of cases, although this rating did not necessarily result in unsuitable advice to the member. The review noted that the shortcomings included IFAs’ failure to tailor their advice to reflect members’ specific circumstances.

The FCA will be liaising directly with certain regulated firms on what needs to happen now.

Details of the IFAs included in the review have not been published. It is possible that schemes or employers might receive questions from former members who transferred out as part of historic enhanced transfer value exercises, but these should be referred to the relevant IFA.
Action on pension scams

Awareness of pension scams
The Pensions Regulator and HM Revenue & Customs (HMRC) are continuing to target pension liberation schemes that offer to help members access their pension savings earlier than they would otherwise be entitled. They are now referring to such schemes as pension scams, emphasising that such arrangements may be illegal, in an effort to control the problem.

The Regulator has updated its scorpion campaign material, warning people not to get stung by pension scams. This includes a revised leaflet and longer booklet, which it asks schemes to include with annual benefit statements or in other member communications and when issuing transfer packs to members. Trustees are encouraged to send regular and clear information about the risks. There is a new action pack for trustees and administrators, including a checklist to help schemes spot scams, with advice on what to do if there are concerns.

Where a pension scam is detected, the Regulator suggests that members are directed to Action Fraud (the UK’s national fraud and internet crime reporting centre). The Pensions Advisory Service can give further advice on the potential consequences of an unauthorised transfer.

Fit and proper person guidance
HMRC’s work to tackle pension scams has been bolstered by new legislation that allows it to refuse to register a scheme – or to de-register an existing scheme – if it appears that the scheme administrator (the person responsible for the tax affairs of the scheme – usually the trustees) is not a fit and proper person.

As the legislation does not define ‘fit and proper’, HMRC has published guidance setting out some of the factors it will consider. Under normal circumstances, it will assume all scheme administrators are fit and proper persons, unless it holds or obtains information which calls that assumption into question.

Action point
Trustees should read the Regulator’s action pack on pension scams and confirm that the scheme’s processes pick up the issues set out in the checklist, which may indicate a scam.

In members’ interests
A Law Commission report has concluded that there is no need to introduce legislation to cover how fiduciary duties (eg the duty to act in the best financial interests of beneficiaries) apply to pension fund trustees. However, it acknowledges that trustees need more guidance in certain areas about the practicalities of their fiduciary position – for example taking into account non-financial factors such as ethical principles when considering investments.

The Law Commission has made a number of recommendations that it believes will help clarify the position. Its report included guidance for trustees on their duties when considering an investment strategy.

It also recommends that the Pensions Regulator includes this guidance in one of its codes of practice, and that the Financial Conduct Authority adopts it in relation to Independent Governance Committees (see page 3) for contract-based schemes.

The Commission’s findings follow a review that was carried out at the Government’s request in the wake of the Kay report on the way the UK equity markets function. The Government has yet to respond to the recommendations.

Removal of NEST saving limits
The Government has confirmed its intention to lift the restrictions on contribution limits and transfers to and from the National Employment Savings Trust (NEST).

NEST was set up to support automatic enrolment and restrictions were originally imposed to ensure that it focused on its target market of low to moderate earners and smaller employers.

The pensions minister has announced that the annual contribution limit – currently £4,600 a year – will be removed on 1 April 2017, along with restrictions on transfers in and out of NEST. There was a short technical consultation on draft legislation in October.
### Changes to scheme returns

The Pensions Regulator has published details of its scheme return forms for 2014, including a checklist of new information that defined benefit schemes will have to provide. This includes:

- Value at Risk (VaR) information – this calculation is a common method for assessing the level of financial risks over a given time horizon
- Asset-backed contribution (ABC) structures, and
- Financial assumptions for schemes in surplus.

The VaR information is likely to be of particular interest to trustees (and sponsors) and is very much in line with the Regulator’s view that trustees should take an integrated approach to risk management. The Regulator suggests that if trustees have not heard of a VaR calculation, then they should discuss it with their scheme actuary.

The Regulator normally sends annual scheme return requests for defined benefit and hybrid schemes between November and January.

### Revamped Trustee Toolkit

The Regulator is encouraging trustees to refresh their knowledge and understanding and get up to speed with recent developments, after overhauling its online trustee training toolkit.

The content has been restructured to allow trustees to focus on modules that apply to them and there is a new learning needs analysis tool to help trustee boards. The Regulator has added four new modules focused on trustee governance and investment and has significantly updated the content of existing modules. Two of the new modules cover defined contribution issues, including scheme investments, and the other two are for all trustees.

You can find the toolkit online at https://trusteetoolkit.thepensionsregulator.gov.uk/

**Action point**

Trustees should discuss VaR with their scheme actuary before they submit their scheme return.

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### Sharing parental leave

Couples with babies due on or after 5 April 2015 will be able to share parental leave, under new regulations that are due to come into force in December 2014. Similar arrangements will apply in relation to children placed for adoption from the same date.

The regulations for shared parental leave and pay are extensive and complex, but can be summarised as follows:

- There is no change to the current default position, which provides an entitlement of up to 52 weeks of maternity leave, of which up to 39 weeks can be paid.
- Under the new rules, couples who meet certain qualifying conditions will be able to opt into the shared parental leave system and share up to 50 weeks of untaken maternity leave, of which 37 weeks could potentially be paid.
- The mother must still take off the first two weeks after the baby’s birth as a recovery period and then must elect to end her maternity/adoption leave before the remainder of her entitlement can be shared.
- Couples will be able to take it in turns to care for the child, or have time off together, provided the total amounts of leave and pay do not exceed the total jointly available. Leave should be taken in minimum blocks of one week, but otherwise may be taken as a continuous period, or separate blocks.
- Since shared parental leave will be available, additional paternity leave and paternity pay will be abolished, but fathers will retain their existing entitlement to two weeks of ordinary paternity leave and pay.
- Employees have the right to return to work after a period of shared parental leave with “the employee’s seniority, pension rights and similar rights as they would have been if there had been no absence”.

The Government has published a technical guide for employers on shared parental leave and pay, which is available on the gov.uk website.

**Action point**

Employers should be aware that from January 2015, they may start to receive notices from employees announcing their intention to take shared parental leave.
Seminars and events

Unless it says otherwise, all courses and events take place in central London.

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<tr>
<th>Courses</th>
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<tr>
<td>Defined Benefit – part 1 (one day)</td>
<td>2014 – 9 December</td>
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<td>2015 – 14 January, 10 February (Leeds office),</td>
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<td>3 March, 22 April, 2 June, 8 July, 8 September (Leeds office), 21 October, 8 December</td>
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<td>2016 – 13 January</td>
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<td>Defined Benefit – part 2 (one day)</td>
<td>2014 – 17 December</td>
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<td>2015 – 24 February (Manchester office), 25 March,</td>
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<td></td>
<td>20 May, 15 July, 22 September (Manchester office), 15 December</td>
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<td>2014 – 19 November</td>
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<td>2015 – 24 March, 1 July, 18 November</td>
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<td>PMI Award in Pension Trusteeship (two days)</td>
<td>2015 – 11 to 12 February, 17 to 18 June; and</td>
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<td>30 September to 1 October (Hartsfield Manor, Woking, Surrey)</td>
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Other events

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<tr>
<td>Current Issues for Trustees Seminars 5.30pm</td>
<td>2014 – 18 November</td>
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Key Contacts

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