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Busy Pension Protection Fund

The Pension Protection Fund (PPF) was launched in April 2005. It was designed to protect benefits when a sponsoring employer failed and left an underfunded Final Salary pension scheme 'stranded'.

In the days of fiscal scrutiny and an approaching General Election, the fortunes of the PPF have gained a wider audience. It was established, in effect, as a defined benefit scheme which would accept transfers of failed schemes subject to specific criteria. It is managed like a private scheme and funded by a scheme levy.

Some commentators have started to wonder out loud about the viability of the scheme against a background of difficult economic circumstances and a general retreat from defined benefit schemes.

When the 2004 Pensions Act was making its way through Parliament, the Government made it clear that it would not guarantee the liabilities of the PPF. Now the Conservatives have suggested much the same thing. This leaves the options of increasing the levy or reducing the benefits if the fund runs into a crisis.

Schemes in the PPF

The PPF accepted three schemes in November 2009 and this gave it an opportunity to provide us with an update based on the state of play at 10 December 2009:

- The three new schemes brought the total to 107 schemes in the PPF;
- 31,729 people were receiving or would receive compensation in the future;
- the Fund paid £6.8 million in compensation between 1 November and 30 November 2009;
- the average yearly payment was £4,000 per person;
- the oldest recipient was 104 and the youngest 7;
- there were 358 schemes in its assessment period and a total of 199,789 members.

The PPF subsequently published a policy statement which is an indication of where levies will go in the near future. It attempted to strike a balance between a viable levy and a sympathetic response to difficult trading conditions. The main proposals are:

- after allowing for indexation, the levy estimate is £720 million. This keeps the levy stable even though there has been a decline in scheme funding and therefore more risk for the PPF to absorb;

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St. James's Place UK plc: Registered Office St. James's Place House, 1 Tetbury Road, Cirencester, Gloucestershire, GL7 1FP, United Kingdom

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www.sjp.co.uk

Busy Pension Protection Fund (continued...)

- the risk-based levy cap will reduce from 1% of liabilities to 0.5% to help the weakest 10% of schemes. The number of schemes that benefit from the cap will also increase;
- levy taper boundaries and the funding level at which no risk-based level is payable will be kept

at the same level as in 2009/10 to maintain stability;

- the scheme-based levy multiplier will be 0.000145 and the levy scaling factor 1.64.

The numbers are large, but the policy statement does not suggest undue

concern. There still remains a nagging doubt though: if there are more failed schemes in these difficult times and there are fewer schemes from which to collect the levy, what confidence should we have in a stable levy or stable benefits if they are not backed by the Government?

High Earners Hit Again

The 2009 Finance Act brought us the 'special annual allowance', in practice of course more of a restriction than an allowance.

In its original form it applied to anyone whose adjusted income (not just earnings) in this tax year or the previous two years, was at least £150,000. If the contribution over a tax year exceeded 'the normal pattern of saving' and the special annual allowance, the excess would be taxed at 20% (30% when the new rate of 50% is introduced).

The normal pattern of saving was described as a commitment to pension contributions payable at least quarterly before 22 April 2009 and continued without significant interruption or, in the case of a defined benefit scheme a continuation of the same rate of benefit accrual. The special annual allowance was set at £20,000.

If contributions to a money purchase scheme were payable less frequently than quarterly (by definition this could not be a normal pattern of saving), the annual allowance was the contribution averaged over the three tax years to 2008/09, but capped at £30,000.

The rules have been changed again with effect from the date of the Pre-Budget Report (9 December 2009). The most significant change has been to reduce the income threshold to £130,000.

Changes in 2011

This was only the appetiser, though. The main rule changes are scheduled for April 2011. The current rules are described as 'anti-forestalling' rules and intended to prevent prior avoiding action.

The good news about 2011 is that the rules become simpler. The bad news is that they are much harsher. Simpler is a relative term however and a 124-page Treasury consultation document is testament to that.

In short, the special annual allowance will apply to an individual whose total, annual income exceeds £150,000 (any employer contribution must be included within this figure if income is at least £130,000). There will be a tax charge of up to 30% on

any contributions paid by the employer and tax relief on individual contributions will be restricted. The tax charge will increase with income over £150,000 to a maximum charge if income is £180,000 or more. The consultation document discusses how this taper might work.

Another issue that the consultation addresses is how to determine a notional contribution under a defined benefit scheme for these purposes. The document considers flat valuation factors, cash equivalent transfer values and age related factors varying with age and normal pension age. These factors have yet to be agreed but it is likely that for many ages the factors will be more than the current flat rate factor of 10:1.

The definition of income for the purposes of the 2011 rules will change: in particular, charitable donations may not be deducted and neither will it be possible to deduct personal pension contributions. What does remain constant is that salary



High Earners Hit Again (continued...)

sacrifice arrangements will not take income below the threshold and there is a rigorous anti-avoidance regime.

Little scope for planning

The proposed rules and the current anti-forestalling regime leave little scope for imaginative retirement planning. Those who can, should consider maximising contributions until 2011, but what happens to high

income individuals then is anyone's guess. Those in defined benefit schemes will probably 'take the hit' which will mean a detrimental adjustment to their tax code (after all, they have a significant income). Basic rate relief is still available and of course they will value the inherent value of the defined benefit. But some will look to alternative means of building their retirement 'nest

egg' in addition to the £20,000 a year being allocated to pensions.

Then, of course, there is always the General Election when the Finance Bill will have only been half-debated...!

The Government's Argument

HM Treasury has published a 124-page consultation document on how to introduce the 2011 changes. The document takes the opportunity to explain the reasons behind the reform.

The document contends that the UK is the only major industrialised country that currently provides the combination of high limits on tax deductible contributions to private pensions as well as partial taxation of pension payouts. This assertion is reinforced by some very large numbers.

According to HM Treasury, pensions tax relief is estimated to be worth £28.4 billion gross in 2008/09. This is about 2% of GDP compared to the 17% of GDP that income tax and NIC receipts represent. Employer contributions are not subject to NIC and the cost of this 'relief' is £8.2 billion.

The rub is that in 2008/09 higher rate taxpayers received 65% of the tax relief on pension contributions although this group only represents 19% of pension savers.

In a rather explosive paragraph, HM Treasury says:

'Ahead of the A-Day reforms the proportion of tax relief on pension contributions going to those on incomes of £150,000 and over was relatively stable, between 8%-12% (from 1988/89 to 2005/06). This proportion grew to 21% in 2006/07. It has since risen further, so around 2% of pension savers affected by the restriction of tax relief now receive around a quarter of all tax relief on contributions. This amounts to an average of around £20,000 per person which is in stark contrast to the average of £1,000 of tax relief for basic-rate pension savers.'

The problem will be exacerbated, ironically, when the top rate of tax increases to 50% from 6 April 2010.

The document claims that a

maximum of £51,000 tax relief is still available to those affected by the special allowance charge in 2011/12. The calculation assumes a maximum personal contribution within the annual allowance of £255,000.

HM Treasury put a compelling case, but some of the facts to support the argument are worthy of debate and little time has been spent on discussing the tax on pensions.

Possibly the biggest argument against the new regime is the perceived iniquity of receiving tax relief against a tax rate of 20% and paying tax on a pension at a rate of 40%. The government makes a strong case for the principle of change, but not for the first time in relation to pension tax matters, practitioners and employers are left wondering why it all had to be so complicated.

Meanwhile, the Low Cost Option

A few years ago, the Government launched stakeholder pensions in a worthy attempt to wean savers off the State scheme and on to private saving. They failed in that objective, much of the new business apparently being recycled from existing schemes.

Then we were introduced to a new idea: the National Pension Savings Scheme, albeit that this was a working title. This morphed into Personal Accounts and now the Personal Accounts Delivery Authority has rebranded the 'consumer facing' brand as the National Employment Savings Trust (NEST).

The cost of rebranding was apparently £363,000.

Source : Professional Pensions magazine 28th January 2010.

NEST will be operated by the NEST Corporation. This will be a not-for-profit trustee corporation.

Of course, what distinguishes NEST from its stakeholder predecessor is that the employer will be required to make a guaranteed minimum

contribution to the scheme or to provide a suitable alternative which can either be funded on a money purchase or defined benefit basis.

The immediate problem is the false sense of security that the proposal gives. It is not enough to be a member of a scheme, it is also essential that it is adequately funded. There will be a very limited take-up in 2011 and compulsion follows in 2012, but only in respect of the larger employers. For very practical reasons, compulsion will be phased and some members will not be enrolled until 2017.

Employers will be assigned a date for starting automatic enrolment: larger employers will start before smaller employers.

The message from all commentators and the Government is not to delay and not to be satisfied with the minimum contribution. NEST is a backstop or perhaps an acknowledgement of past failure.

* of qualifying earnings

	Employer contribution* (inc. tax relief)*	Employee contribution
Years 1 – 3	1%	1%
Year 4	2%	3%
Year 5 (2017)	3%	5%

A Reminder about Cash Inducements

Not so long ago, a disbelieving pensions world was told by HM Revenue & Customs that where an employee was offered a cash inducement to give up rights in a pension scheme, then the payment could be tax-free in certain circumstances. Such arrangements, a relatively well-kept secret, attracted a great deal of attention as employers looked at ways to get rid of defined benefit schemes without necessarily having to pay the full buy-out cost.

The tax-free status was based on an HMRC view which changed in early 2007.

Since then, we have had the 2008 Pensions Act which, at section 54, bans the employer from offering inducements in respect of all work-based schemes.

The ban is supervised by the Pensions Regulator who has power to order retrospective reinstatement with

payment of contribution arrears and possibly, financial penalties.

Clearly, the ban was introduced to complement the new rules on automatic enrolment and NESTs (see above), but it has general application.



Beware the Rush to Early Retirement

The pension simplification rules, effective from 6 April 2006, established a normal minimum pension age of 50 that would increase to 55 from 6 April 2010. The only exceptions were made for some members with pre-2006 rights. Early retirement on grounds of ill-health was also retained. Pity then the individual who turned 50 on 6 April 2010, or so it seemed at the time.

Now there is a chorus of commentators warning against unnecessary early retirement.

There are probably three supporting arguments. The first is that few individuals can afford to retire earlier than 55 – the danger is that they are seduced by the tax-free lump sum and then spend the next 30 years or more regretting their impetuosity.

The second argument is that although we have no insight into the future, the economy appears to be in a parlous state and with it, asset values. Many people would prefer to wait until some kind of recovery is under way before encashing money purchase funds. Of course if there is a choice, it generally makes more sense to encash taxed investments rather than tax-advantaged investments such as pensions.

Actuarial deductions

Under a defined benefit scheme, there will probably be an actuarial deduction of as much as 6% for each year of early retirement and although this simply reflects a longer payment

period, it will directly affect the pound in the pocket.

Finally, annuity rates are lower at younger ages and have in any case been driven down by low interest rates. Again, nobody can predict the future, but many will wait for a recovery in gilt yields and therefore annuity rates. One way to mitigate the problem is to defer the annuity purchase and drawdown income from the fund, but this option must be exercised with caution.

HM Revenue and Customs has published a short guide to head off some of the questions and concerns of those who are thinking of taking benefits early. It includes some useful questions and answers. The main points to emerge are:

- it is up to schemes to decide when and how to move to the new minimum pension age, but of course any payments made before the statutory minimum will be unauthorised;
- the upper age of 75 for starting benefits does not change;

- pensions already taken when the minimum pension age was 50 may continue to be paid;
- members who wish to take benefits on the basis of the minimum age of 50 should make it clear to administrators to ensure that the pension starts before 6 April;
- if the member's birthday falls in the Easter holiday and arrangements cannot be made until 6 April, HMRC accepts that the arrangements should be treated as having been made on the actual birthday;
- Taking pension benefits' should be taken to mean finalising arrangements for taking benefits (e.g. purchasing the annuity);

Taking benefits can be an administratively intensive process. The message is not to leave it to the last minute if you wish to retire before 55.