Newsletter

BURGES SALMON

Pensions

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Welcome

Welcome to Pensions, our bimonthly newsletter keeping you informed of developments in pensions law.

To find out more about how we can help you with pensions issues, please email richard.knight@burges-salmon.com or call him on 0117 939 2259.

In brief

Legal

CPI for RPI

More schemes may now be able to switch to CPI for revaluation and pension increases.

Investment and non financial issues

When investing, trustees should take account of environmental, social and governance factors where they are financially material, says the Law Commission.

No breach of duties of good faith

An employer did not breach its duty of trust and confidence to members when it decided not to continue a 20 year practice of granting an annual discretionary pension increase, the Pensions Ombudsman has found.

DC: Independent Governance Committees

The Financial Conduct Authority has made proposals about the constitution and duties of the independent governance committees (IGCs) providers of contract-based workplace schemes will be required to have in place by April 2015.

Regulatory

Regulator settles with Lehman

A £184 million settlement with the administrators of the Lehman bank group after six years of legal action has shown the bargaining strength in the Regulator's anti-avoidance powers. But still now, ten years on, little is known about their true scope.

Tax

Taxation of Pensions Bill

A Bill to enact the flexibilities announced in the Budget will start to go through Parliament soon. For DC savers it will create two new forms of authorised payment, introduce an new DC annual allowance and relax the rules on lifetime annuities.

55% tax on DC funds at death abolished

The Chancellor has announced the 55% tax rate on many lump sum death benefits will cease to exist from 6 April 2015.

Annual allowance charge

Anomalies in the way the annual allowance charge works will be resolved by amending regulations HMRC is working on.

Legal

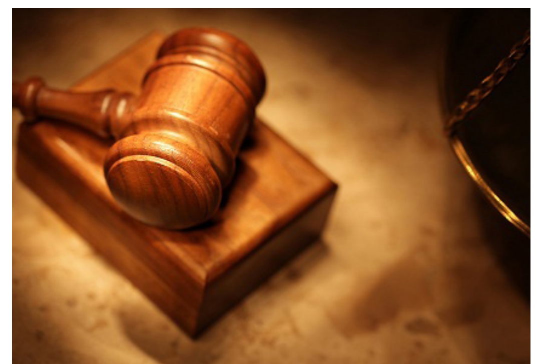
CPI for RPI

After a court decision, more schemes may now be able to switch from RPI to CPI for revaluation and pension increases. The change can reduce scheme liabilities substantially.

The High Court's decision in the *Arcadia* case may be helpful to schemes with similarly worded rules that are considering the change.

The scheme rules provided for revaluation and pension increases to be based on an index defined as "the Government's Index of Retail Prices *or any similar index satisfactory for the purposes of [HMRC]*".

It is quite common for rules to define the reference point for inflation in a way that allows for it to change. But, unlike others, these rules did not say who was to select any new measure.



Even so, on the facts of the case, the judge was willing to imply a decision-making process into the rules, exercisable jointly by the trustees and the employer. He also held:

- they could make a change even though RPI continues to exist,
- CPI was a "similar" index to RPI and
- there were no grounds on which HMRC could consider CPI "unsatisfactory".

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Finally, the judge agreed with the decision in the *QinetiQ* case a couple of years ago that s.67 of the Pensions Act 1995 did not prevent the change being made in relation to benefits already accrued. That section of the legislation, he said, protected members' rights to rates of revaluation and pension increases consistent with the scheme's definition of "index", but not specifically to rates based on RPI.

In *QinetiQ* the court allowed a change to CPI where the measure for inflation was defined as "RPI …. or any other suitable cost of living index selected by the Trustees".

Arcadia goes further than *QinetiQ* in reading in machinery for making a change and in deciding HMRC would have no grounds for considering CPI "unsatisfactory".

Schemes with rules that have the same or similar wording to the Arcadia scheme may want to review the possibility of switching indices.

Investment and non financial issues

When carrying out their duties on investment, trustees should take account of environmental, social and governance (ESG) factors where they are financially material, the Law Commission says.

The Commission says trustees are required to balance returns against risks: "When investing in equities over the long-term, trustees should consider, in discussion with their advisers and investment managers, how to assess risks. This includes risks to a company's long-term sustainability". ESG risk factors, like many other kinds, can go to an investee company's ability to prosper in future.

But the law, the Commission says, does not prescribe a particular approach: "It is for trustees' discretion, acting on proper advice, to evaluate which risks are material and how to take them into account". The Commission observes that the ESG label is ill-defined and is conventionally taken to cover a wide range of risks. For trustees, the key distinction is whether a risk is financially material, not whether it is categorised as ESG.

The Commission's guidance note "Is it always about the money? Pension trustees' duties when setting an investment strategy" is brief, clear and, for trustees in particular, well worth reading: **http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties_guidance.pdf**

The guidance goes on to consider how the law stands on ESG considerations influencing investment decisions for non-financial reasons e.g. to mark disapproval of a particular industry.

The Law Commission is an independent statutory body tasked with reviewing whether the law in particular areas is fit for purpose and recommending changes. It is highly respected and courts are likely to take its views to be authoritative.

No breach of duties of good faith

The Pensions Ombudsman (PO) has rejected a claim that an employer breached its duty of trust and confidence to scheme members when it decided not to grant a discretionary annual pension increase after 20 years of doing so.

It would have been surprising if the decision had gone the other way. Schemes depend on a balance between duties and discretions, and need the distinction to be recognised. To have found a breach of the duty of trust and confidence here would have lowered the threshold too far.

The PO decided that neither the history of increases nor an alleged oral assurance of their continuation raised members' "reasonable expectations" that they would continue in future. Had the employer engendered such expectations, it would not have been lawful for it to thwart them. This is the argument that succeeded in the *IBM* case but here it failed, apparently by a margin.

Elements of the PO's decision included:

- under the scheme rules, pension increases were clearly discretionary, unlike the benefits IBM sought to change. As a result, it was hard for the complainant to argue the employer had acted with the irrationality or perversity required to breach its duty of trust and confidence,
- a history of discretionary increases was insufficient on its own to raise any "reasonable expectations" of their continuation,
- there was no documentary evidence of the assurance (said to have been given eight years before increases ended) other than the complainant's recollection,
- nor would a mere statement of intention to continue increases without some additional commitment or guarantee have been sufficient to ground the claim and
- although the scheme was big and the covenant strong, the employer was entitled to consider its own interests in exercising its discretion. Notably there was a deficit of some £700 million.

DC: Independent Governance Committees

If the Financial Conduct Authority's (FCA) proposals are adopted, the main duties of the independent governance committees (IGCs) providers of contract-based workplace schemes will be required to set up from April 2015 will be:

- to act in the interests of scheme members;
- as their main focus, to assess value for money for members;
- to raise concerns within the provider, including (if the IGC sees fit) with the firm's board;
- as the case may be, to escalate concerns to the FCA, to scheme members and employers, and to make its concerns public.

Where the IGC raises concerns, the provider will have a "comply or explain" obligation.

IGCs are among a number of measures due in force in April 2015 designed to raise the governance and performance of DC schemes.

Consultation on the FCA proposals closes on 10 October. It aims to publish its requirements in final form in January 2015.

Trustees of occupational DC schemes will be subject to a parallel set of requirements promulgated by the Pensions Regulator. The idea is to have a core set of minimum governance standards across trust and contract-based schemes.

In more detail

In gauging value for money, IGCs will:

- consider the amount and transparency of all costs and charges;
- consider whether default investment strategies are designed in the interests of members, with a clear statement of aims and objectives;
- ensure the provider reviews regularly the characteristics and net

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performance of investment funds available to members, and makes any necessary changes and

- check a scheme processes its financial transactions promptly and accurately.

IGCs will have a minimum of five members, with a majority, including the chair, independent of the provider. "Independent" will mean not being an employee in the last five years and not having had a material relationship with provider for three years.

Smaller providers with less complicated workplace schemes will have less intrusive "governance advisory arrangements" to comply with.

Regulatory

Regulator settles with Lehman

As we have reported before, a £184 million settlement with the administrators of the Lehman bank group after six years of legal action has shown the Regulator's mettle and the bargaining strength in its anti-avoidance powers.

The Regulator fought off some procedural challenges during the early stages of its move for a financial support direction (FSD) but, in the end, no FSD was issued. The settlement for the full deficit suggests the administrators recognised the Regulator had a strong hand.

When the Regulator's powers to issue FSDs and contribution notices were created, there was a lot of comment on their strength and their radical nature (e.g. effectively to pierce the corporate veil). Ten years on, despite some court action exploring certain aspects, we still know little about the true scope of the powers.

For a few more comments on this topic, see out earlier bulletin: **http://www.burges-salmon.com/Practices/pensions_and_incentives/News/13474.aspx**

Tax

55% tax on DC funds at death abolished

The Chancellor has announced the 55% tax rate on many lump sum death benefits today will cease to exist from 6 April 2015.

A new regime (sketched in the table) will apply to payments made from DC savings on or after that date even if the death happened before.

Broadly, DC funds are "crystallised" if the member began to draw from them before death.

The changes may stimulate scheme redesigns in favour of lump sums over pension, and member preferences for flexible access over transferring out and annuities.

DC may also gain new advantages over DB e.g. a survivor's DB pension following a death before age 75 will be taxed at the recipient's marginal rate while income from a drawdown pension would be tax free.

Benefit options will be subject to scheme rules. Some DC schemes may offer more flexibility than others.

The Treasury and HMRC plan to consult the industry over the details before finalising changes to the legislation.

<table>
<tr><th colspan="3">Tax on DC savings following member's death</th></tr>
<tr><th colspan="3">Death below age 75</th></tr>
<tr><th></th><th>Crystallised funds</th><th>Uncrystallised funds</th></tr>
<tr><td>Today</td><td>Can be paid as
■ lump sum: 55% tax
■ drawdown pension: tax at dependant's marginal rate</td><td>Can be paid as
■ lump sum: tax free (subject to LTA)</td></tr>
<tr><td>From 6/4/15</td><td>Can be paid as
■ lump sum: tax free
■ drawdown pension: tax free</td><td>Can be paid as
■ lump sum: tax free (subject to LTA)</td></tr>
<tr><th colspan="3">Death at age 75 or above</th></tr>
<tr><th></th><th colspan="2">Crystallised funds and uncrystallised funds</th></tr>
<tr><td>Today</td><td colspan="2">Can be paid as
■ lump sum: 55% tax
■ drawdown pension: tax at dependant's marginal rate</td></tr>
<tr><td>From 6/4/15</td><td colspan="2">Can be paid as
■ lump sum: 45% tax (but marginal rate from 2016/17)
■ drawdown pension: tax at recipient's marginal rate</td></tr>
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Taxation of Pensions Bill

A Bill to enact the flexibilities announced in the Budget will start to go through Parliament soon. For DC savers it will create two new forms of authorised payment, introduce an new DC annual allowance and relax the rules on lifetime annuities.

Importantly, it will remove the need for amendments to scheme rules by giving trustees statutory permission to pay benefits flexibly regardless of what their rules say.

From 6 April 2015, the new authorised payments for those aged 55 or more will be:

- the *flexi-access drawdown fund* designed chiefly for those who want to draw income as and when. When the member designates saving to such a fund, they will be able to take up to a third of the amount designated as tax free cash. The remaining amount will be taxed as pension when drawn down. The legislation will not restrict how much can be drawn or how frequently, but scheme rules (or a provider's terms) are likely to set limits.
- the *uncrystallised funds pension lump sum* for drawing lump sums. A quarter of each lump sum will be tax free and the balance will be taxed as pension. There will be no limit on the amount that can be drawn but the member must have LTA still available. Members with certain forms of tax protection will not be able to take this type of lump sum.

Annual allowance

To prevent unfair tax advantage from recycling, the first of either of these payments will trigger an annual allowance (AA) for future DC saving of £10,000 and an AA of £30,000 for non DC saving. The DC AA cannot be increased with unused allowance from earlier years; nor can any unused amount be carried forward.

Lifetime annuities will be allowed to decrease year by year and a longer guarantee period will be permitted.

Trustees will be allowed (but not required) to make the new forms of flexible payment even if, as will often be the case, this would be contrary to their scheme's rules. Before doing this, trustees will generally want to agree their plan with the employer. This is a helpful measure that will remove pressure to amend scheme rules in the short term.

Some other changes:

- current capped and flexible drawdown rules will not apply to funds first drawn after 5 April,
- members already in flexible drawdown will be switched automatically into flexi-access and those in capped drawdown will have the option to switch (subject to scheme rules),
- small lump sums (up to £10,000, previously £2,000) will be payable five years earlier at age 55,

- the limit for a trivial commutation lump sum death benefit increases from £18,000 to £30,000.

Guidance and DB to DC

The guidance guarantee for those taking benefits flexibly and the conditions for DB to DC transfers will be legislated for in the separate Pension Schemes Bill already making its way through Parliament. Provisions on the guarantee and DB to DC transfers will be added to the Bill as it progresses.

Annual allowance charge

Certain anomalies in the way the annual allowance (AA) charge works will be resolved by regulations HMRC is working on. They include the following.

- *Transfers:* on transfers of DB or cash balance rights between schemes, the intention is that the changes in value in an individual's benefits in each scheme should be neutral for AA purposes. But current legislation fails to achieve this where the value of the assets transferred does not fully match the value of the benefits credited in the receiving scheme.
- *Scheme pays:* in a DB or cash balance scheme, an AA charge can be higher or lower according to whether the member pays personally or via "scheme pays". This unintended difference will be removed. Snags with the process of electing for "scheme pays" will also be addressed.
- *Deferred members:* the general principle is that deferred rights can increase within defined limits, e.g. for inflation, without counting for AA purposes. Several provisions that run counter to this are being addressed, including some that mean pre 2006 deferreds who later resume active scheme membership can find the full value of their deferred benefits counting for AA purposes, not just the increase in value.

The regulations are still in draft. Having arisen out of the Finance Act 2011, many of the changes will be backdated to tax year 2011/12.

Visit our website at www.burges-salmon.com

In the office

We welcome **Amy Davies** and **Stacey Yon** who have joined the pensions team on qualifying as solicitors after training with the firm.

We also greet **Charlotte Osmond** who has joined us after training with a City firm. She too has qualified recently.

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