Papers

Pensions tax simplification – The impact on scheme design

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Abstract This paper considers the longer-term impact of simplification, once the industry has got past the transitional complexities. It argues that simplification will have a significant influence on scheme design, continuing the trends away from traditional final salary schemes and towards greater employee choice.

Keywords: *pension scheme design; flexible retirement; flexible benefits; cash commutation; death benefits; taxation*

Introduction

The UK government's programme for simplification of pensions taxation was set out in the Finance Act 2004 and will come into effect on 6th April, 2006.

The new regime introduces a number of radical changes, with greater choice and flexibility in many areas. In the personal pension sector, providers are enthusiastically embracing the marketing opportunity. But what about the occupational sector — what impact will simplification have on pension scheme design?

In the short term, perhaps the answer will be: not much. In the run-up to implementation of the simplification programme, most attention has focused on doing what is necessary to comply with the new regime, and in particular on benefits for highly paid individuals whose pension will or might exceed the lifetime allowance and who will need to

make decisions about the transitional protections.

Hewitt carried out a survey in 2004, asking clients what action they intended to take in response to simplification. Only a few per cent of our respondents were planning on fundamental benefit change. This reflects the fact that with so many 'must-do' activities in advance of A-day there has not been much scope for more blue-sky initiatives. So it is not surprising that large scale scheme design has not been a priority in companies' responses to simplification.

Nevertheless it can be expected that employees will increasingly demand access to what the new regime offers. Once the initial rush has died down, there will be significant impact on occupational pension design. This paper will illustrate this by commenting on some specific issues where the simplification changes have direct impact,

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Table 1: Illustration of maximum cash lump sum in occupational pension schemes

	Current tax regime	New tax regime
Defined benefit scheme	£27,000	£51,500
Defined contribution scheme	£27,000	£25,000

Notes:

- Retirement at age 65 after 20 years' service
- Final salary £36,000
- DB accrual: 60ths of final salary
- DC aggregate contribution 10 per cent, fund at retirement £100,000

and then considers how these changes may affect benefit design in broader terms. The focus will be on the issues for the vast majority of employees for whom the lifetime allowance is not a relevant consideration.

Retirement cash

The new system should be really simple: 25 per cent of the fund at retirement can be taken as a cash lump sum (which is tax-free). For defined contribution (DC) schemes it will be that simple. For defined benefit (DB) schemes it is not quite so straightforward because the 'fund' needs to be calculated, by valuing the pension payable on the statutory factor of 20:1, and in most cases the pension payable depends on how much cash an individual takes and on the scheme's terms for exchanging pension for cash ('commutation factors'). But in any event it will be simpler than under the old system with its mix of rules for determining maximum cash.

Table 1 gives an illustration of the maximum cash available for someone retiring from typical DB and DC schemes. In the DB example the maximum cash will be considerably higher (assuming of course that the scheme amends its rules to permit members to take that amount of cash), whereas in DC there is little change. This is really nothing to do with whether a scheme is DB or DC — it is a function of the generosity of the

scheme. Most DC schemes have relatively low contribution rates so the current regime cash formula 3/80ths of salary is typically a large proportion of the fund. Indeed, for many DC members, the new regime may permit less than the maximum cash in the current regime, ignoring of course the transitional protections that may apply in such cases.

One thing this illustrates is that the current regime was not designed for DC schemes, and DC schemes did not fit very well into it. If your scheme had a low contribution rate, you might be able to take most of your benefits as tax-free cash (not what the Inland Revenue intended!); if it had a generous contribution rate, you would probably have cash restricted far below 25 per cent. The current regime limits are DB in nature — DC schemes have to carry out complicated calculations to test compliance, so DC administration will be much easier in the new regime.

A couple of specific points to add in relation to DC schemes:

- (a) In the new regime, retirement targeting will be more difficult. With the current regime, you could estimate the maximum cash fairly accurately and set aside (say) £27,000 for that, investing the rest of your fund in bonds to give a fairly predictable pension (subject to the insurance companies not changing their expectations of mortality). In

the new system this does not work — you could invest 25 per cent of the fund in cash and the rest in bonds, but your cash at retirement will be 25 per cent of whatever the fund is then, which will be largely dependent on bond prices at that time.

- (b) If annuity costs are less than £20 per £1 pension, DC members could get more cash by converting their fund into a DB pension. (This is the opposite of the opportunity for DC members with funds over the lifetime allowance who could reduce tax by converting to DB if annuity costs are over £20.)

To pick up on this last point, maybe we will see more arrangements that allow easy conversion between DC and DB at retirement. Cash balance schemes (DB schemes where the benefits are defined as a lump sum rather than a pension) fit the bill here — because they are DB, but permit easy transfer to DC.

What about the implications for final salary DB schemes? An initial point is that benefit costs could fall if schemes allow members to take higher cash sums — because for most schemes the commutation factors are lower than the underlying cost of providing pensions. On the other hand, the new regime will allow members to take additional voluntary contributions (AVCs) as cash — so actually the amount of scheme pension being commuted may fall for some members (and these may be quite significant as AVC payers tend to be higher earning members with larger pensions).

We can expect more attention to be paid to the commutation factors. For example, if members receive only £12 cash for each £1 pension, they will want to understand why this is so much lower than the statutory 20:1 factor. Of course

there are some good reasons — such as, commutation factors do not include the value of dependants' benefits — but these do not generally give a complete justification for the difference. A longer term reaction might be a move towards a system where commutation factors are set out in scheme rules, to avoid such arguments. But the immediate impact of an increase in commutation factors would be to increase pension costs, probably wiping out any saving from higher proportions being commuted.

In conclusion, the new regime for maximum cash will make life easier for DC schemes but may make it more expensive for final salary schemes. In this respect, the trend towards DC would be strengthened.

Death benefits

Simplification will bring big changes to the benefits that can be paid in the event of a scheme member's death. It will be possible to provide a lump sum up to £1.5m free of tax through the approved scheme. This benefit can be paid to the member's dependants, and if the dependants want a secure income they could use the lump sum (or some of it) to buy a pension from an insurance company (a 'purchased life annuity' [PLA]) and only part of this pension would be subject to income tax. Alternatively, the scheme could provide a pension directly to dependants — but such a pension would be subject to income tax in full.

This has prompted a lot of speculation that schemes will switch to provide lump sum death benefits, in order to maximise tax efficiency. In principle, the lump sum route is quite attractive:

- (a) The lump sum is tax-free, or in effect partly tax-free if the recipient buys a pension with it.

Table 2: Example changes to death benefit designs

	Current design	New design
Example 1	<ul style="list-style-type: none"> • Lump sum 3 times salary, plus • Dependant's pension 30 % of salary 	<ul style="list-style-type: none"> • Lump sum 8 times salary
Example 2	<ul style="list-style-type: none"> • Lump sum 4 times salary, plus • Dependant's pension 50% of member's pension at normal retirement age (based on prospective service) 	<ul style="list-style-type: none"> • Lump sum 4 times salary, plus • Lump sum 20% of salary for each year of prospective service

- (c) The recipient has flexibility as to what to do with a lump sum — spending it, saving it, using it to pay off debts, using it to buy a pension, etc.
- (c) There is more flexibility as to who can receive the lump sum — whereas scheme pensions can only be paid to people falling under the Inland Revenue's definition of 'dependant'.
- (d) For the sponsor, there is generally less risk in providing a lump sum than a pension.

Income tax is not payable on the capital element of a PLA, which is generally around 50 per cent of the total (depending on factors such as the individual's age and whether they buy an increasing pension). So if a basic-rate taxpayer started with enough money to purchase a pension of £10,000 a year gross, he would only pay around 11 per cent tax (ignoring allowances), whereas if the trustees had bought that pension for him he would have to pay 22 per cent tax. Against this, insurance companies generally offer marginally worse rates for a PLA than for a trustee-purchased pension ('compulsory purchased annuity' [CPA]), but even so, most individuals could receive a higher net pension from a PLA than they would if the trustees purchased a CPA. Of course it depends on the individual — there is no tax advantage for a non-taxpayer, and the

benefit is greater for a higher-rate taxpayer.

At present it is quite common for a scheme to provide both lump sum and pension. Table 2 gives a couple of examples of how scheme design might change in order to provide a larger lump sum instead. Example 1 has a simple eight times salary lump sum. Example 2 has a more complicated formula to keep the link to prospective service. Of course there is nothing to stop a scheme with a design like example 2 moving to the new design in example 1, and vice versa.

How easy is it to make the transition to a purely lump sum death benefit?

As with any benefits transition, it is hard to avoid winners and losers. There are cross-subsidies in most current designs (to those with spouses, children, etc) — if you move to the lump sum basis, would you maintain the cross-subsidy by providing a higher lump sum benefit for married employees?

You could attempt to provide a benefit that provides the same gross pension for an average employee (that is, say, one who is 60 per cent, married and has 1.2 children) — accepting that employees with more dependants than average will get lower gross pension, and may get lower net pension depending on their tax status, but hoping that this is outweighed by the other advantages of the lump sum approach.

Even if you come up with a new design that provides the same expected

benefits as the current one, it won't actually provide the same in all cases — annuity rates change, so you can't predict exactly what pension the lump sum will purchase. As a result, it is almost certain that some dependants will end up unable to buy back the same level of benefits as in the current design, even after tax, unless the employer's cost goes up.

Another issue is that dependants may not know what to do with a large lump sum, at a time of bereavement (so it is not just the financially unsophisticated who might struggle). How much secure income will they need? It often takes a long time before dependants can make proper financial plans: what do they do with the money in the meantime? Few employers will want to offer financial advice here, but some support such as an annuity broking service may be appropriate.

When talking of death benefits, one should always consider the insurance aspects. Most schemes insure their lump sum death benefits, but not their dependants' pensions. It would be advisable to check that the proposed benefits are insurable before changing the benefit design. For example, higher lump sum benefits may take more employees over the free cover limit (typically £1m), or insurers may impose restrictions if employees are allowed to choose the level of death benefit. So, the lump sum approach might be beneficial for many employees but the transition would not be easy for many existing schemes.

Employers need to rethink their objectives for benefit provision before deciding whether to change. A key issue is whether they want to have cross-subsidies, targeted at employees with greatest need, or to offer a package that is worth the same to all employees.

There is not a single answer to what is the best design of death benefits for all

employees — it depends on each individual's circumstances, for example:

- how many dependants;
- how big a mortgage or other debts;
- what other pension or insurance policies?

For these reasons there has been a trend to give employees more choice about the level of death benefit, whether through a formal flex programme or not. Simplification helps that, by enabling the flexibility of the lump sum approach.

Wider flexibility

As well as permitting some redesign of particular benefits, the new regime permits much more flexibility throughout an individual's pension 'life cycle' by changing:

- (a) how contributions are paid;
- (b) how funds are invested;
- (c) how benefits are taken at retirement.

The new regime will remove all the existing limits on contributions to registered pension vehicles. Instead there will be an annual allowance of £215,000 on which tax relief can be claimed (so paying more than this is unlikely to be tax-efficient). And this allowance does not apply in the year before benefits vest, so it does not restrict people who receive a generous retirement settlement (on ill-health or redundancy for example).

There will not be many employees who want to pay more than £215,000 a year regularly — for the vast majority of people, simplification effectively eliminates annual contribution limits.

Potentially, this reform will have the biggest impact on pension scheme design. It allows us to move away from the idea of paying steady percentages of

salary every year. It will allow people to make lots of contributions in some years, and nothing in others.

- (a) For example, this suits those whose earnings are volatile from year to year — they could pay contributions only in the good years.
- (b) Or people can plan pension saving over a lifetime, paying relatively more when they have lower commitments to mortgage, childcare, etc.
- (c) It allows adaptation to changing needs — an individual could pay more contributions if other retirement savings turn out badly, or could reduce contributions if they decide to retire later, say.
- (d) Or people could even make savings outside a pension plan, in order to maintain access to their savings, and then wash those savings into the pension in the years coming up to retirement, when they are more definite about how much pension they want.

Investment is beyond the scope of this paper, but it should be noted that simplification will remove restrictions on which type of pension vehicle people can use — they will be able to contribute to a combination of occupational scheme and personal pension, and will have a lot of choice as to what type of assets they invest in (prompting much interest in using residential property, for example).

Turning to retirement flexibility, the simplification changes fit into a swathe of legislative changes:

- (a) Pensions may be drawn whilst still in the employment to which the scheme relates — avoiding the absurd situation that a Tesco employee could get a job with Sainsbury and draw

his Tesco pension, but could not draw his Tesco pension if he stayed in his job at Tesco.

- (b) Part of an accrued pension may be brought into payment whilst further accrual continues, so facilitating partial retirement with a period of part-time work during which an employee receives income from both employment and from pension.
- (c) The income drawdown (or ‘unsecured pension’ in the new jargon) rules are being relaxed so that an individual can take a cash lump sum but leave the rest of the fund invested without starting to take an income from it.
- (d) There will be more choice about the format of annuities — for example ‘value-protected’ annuities.
- (e) The introduction of ‘alternatively secured pension’ permits unsecured pension to continue indefinitely, even beyond age 75.
- (f) The minimum age for drawing a pension will be increased to 55 from 6th April, 2010.
- (g) The government is making it more attractive for individuals to defer receipt of state pensions.

In addition, we will shortly have legislation against age discrimination which will make it harder to force people to retire solely on grounds of age, and the Turner commission will make further recommendations about retirement ages when it reports later this year.

The government’s purpose here is generally to make it easier for people to work later in life, perhaps on a part-time basis. To a large extent this is prompted by demographic shifts, with the economy needing more people in work for longer as the baby boom generation reaches its 60s. But at the same time it is recognised that not all older people will want, or be

able, to do full-time work or to continue in stressful jobs. And of course, it is recognised that not all people have the same needs or desires — there is more emphasis on individuals being able to choose the retirement arrangements that suit them best.

From an employer's point of view, there are a number of pros and cons with this initiative. The prime focus will be on the employment issues:

- (a) *Workforce planning* — if employees can choose the hours they work and when they retire, it will be more difficult to assess how many employees you will need next year; but on the other hand, these changes might allow employers to retain older, more experienced workers who would otherwise have retired.
- (b) *Productivity* — will older workers be as productive? Maybe not if employees are simply 'working until they drop', but this can be avoided if employees can take on suitable roles, and this would reduce the risk of industrial injury and stress.
- (c) *Employee engagement* — this may be increased if older employees feel more in control, but will employers then be obliged to offer the same flexibility to younger employees?

Like it or not, the trend to flexible retirement seems set to continue, with government support. So the challenge will be to devise systems that permit the employer to keep control as far as possible, and which are practical.

Of course, employers will not have to establish a pension arrangement that can offer all of the bells and whistles permitted in the new regime. For example, it may not be practical for pensions administration systems to offer income drawdown or partial vesting. But as a minimum, it seems likely that

pension schemes will have to cope with more flexible retirement/working/contribution patterns.

This has a number of consequences for pension schemes.

- (a) There will be a lot more administration — for example, keeping track of members who are at the same time active employees and pensioners.
- (b) There will be governance issues — scheme rules will need to change, and to set out how these decisions will be made.
- (c) Employers need to decide what benefits to offer people who are working beyond traditional 'normal' retirement age.

There are some pointers for benefit design:

Final salary schemes do not fit well with flexibility — 'final salary' may not be representative of what an individual has earned during his career or what they expect for retirement income, if an individual moves to part-time work or to a less remunerated role. Of course it is possible to operate part-timer adjustments, but these do not pick up role changes and are not simple to communicate and administer.

Career-average DB schemes fit better with part-time working and with employees opting in/out of pension, because benefits are based on what an individual earns throughout their career (usually with an inflation-linked adjustment). Like final salary schemes, however, they have the problem that benefits are payable at a fixed retirement age. What benefits do you pay if people draw their benefits earlier or later? What benefits do you offer people who are still working after 'normal retirement'? Quite simply, who knows when employees now aged 30 will retire?

Cash balance schemes share some of these problems too, but it is more straightforward to adjust a lump sum benefit than a pension if an individual wants flexible retirement.

DC schemes fit well with flexibility — it is easy to change contribution rates, or to draw part of a DC pot and leave the rest. The new investment flexibility and the new drawdown/annuity alternatives are designed for the DC environment.

Of course, we have already seen a substantial move towards DC schemes, as employers have sought to reduce their risk levels. It is an open question as to whether employees are well-placed to take large amounts of pension risk themselves. Simplification illustrates this for high earners — those close to the lifetime allowance may not want to take on risks if they bear any underperformance in full but would pay 25 per cent tax on any outperformance. The challenge is to devise DC options with an acceptable level of downside risk for employees.

Conclusion

So what are the overall implications for future benefit design?

There will still be a mixture of designs. As always, employers need to review what they provide in the light of their own circumstances:

- (a) the employer's objectives in providing benefits;
- (b) their employee profile;
- (c) the cost and risk associated with each option.

Also, simplification is best seen as a facilitation measure rather than as a direct

prompt to new benefit designs. Nevertheless it is possible to pick out some themes.

- (a) First, simplification makes DC more attractive — the administration of occupational DC schemes will become much easier, and DC fits very well with flexible retirement and flexible contributions.
- (b) Secondly, simplification encourages the trend towards employee choice. The new regime gives employees much more choice about when and where they save, when they retire (how many times they retire!) and what sort of benefits they can take. This will increase the trend towards flexible benefit packages.
- (c) Finally, I do not believe it is realistic for most occupational pension plans to offer the full range of options permitted in the new regime. That does not mean that there is no role for occupational pension plans, but employers might sponsor a basic occupational plan intended to cater for core retirement saving needs only, and then facilitate a personal pension that can offer more complex options — and perhaps employers will offer a non-pension saving vehicle too, to recognise that not all employees will want the commitment of a pension plan.

In all this a key area for the employer to add value will be communication: explaining to employees how these various options work and enabling them to make the best of the new regime. 'Simplification' may not be the most accurate description of the new regime, but it seems set to play its part in a fundamental change in UK retirement provision.