

Change on the horizon

From 6 April 2006, or "A-day" as it is known in pensions circles, new rules introduced by the Finance Act 2004 become law. They aim to give pension scheme members more choice and simplify the framework of pension legislation in the UK.

As a result, employers in the UK are reviewing their current pension arrangements and considering whether any action is required, and there are a variety of areas which need to be considered as the countdown to A-day gathers pace.

To begin, the maximum salary on which contributions and benefits can be based (for members who joined after 1 June 1989) is currently set by HMRC at £105,600 for the 2005/06 tax year. This is known as the "Earnings Cap" and overrides any definition of pensionable earnings contained in the scheme rules.

From 6 April 2006, the Earnings Cap is to be abolished; replaced by an annual limit on the value of pension contributions and a "Lifetime Allowance" (LTA) applied to the total value of all pension benefits.

Although the Earnings Cap will be abolished, it

If your organisation offers an occupational pension scheme, you are no doubt aware of the rule changes coming into force in April next year. As 2005 nears its end and "A-day" fast approaches, where should you be in your preparations for dealing with the new pension landscape? Logan Anderson runs through the areas for consideration

will be possible to limit pensionable earnings in the scheme rules and effectively maintain the current position.

It is important to consider what effect this will have on your scheme by asking yourself the following questions:

- If no change is made, will your employees earning in excess of the earnings cap see an immediate increase in pensionable earnings? If so, can you afford this?
- Should you put a notional earnings limit on pre-A-day service?
- Should you put a notional earnings limit on future service as well?
- Or, should you abolish the Earnings Cap retrospectively and see immediate benefit increases for members affected?

The decisions made will impact on the cost of the scheme for members and employers. For final salary schemes, decisions will also have an impact on funding levels and for high earners with service already built up taking no action could be very costly indeed, even if their salaries are not yet capped.

You may have in place separate arrangements for high earners currently caught by the earnings cap. If so, the new limits on contributions may mean that you will be able to handle all of the required arrangements under one scheme.

Tax-Free Cash

One of the attractions of pension scheme membership is the ability to exchange some of your pension for tax-free cash. The maximum amount of tax-free cash that can be taken is dependent on salary and service.

From A-day, the cash option has a new name – the Pension Commencement Lump Sum (PCLS) – and a new formula. The maximum PCLS a member will be able to take will be up to 25 per cent of the value of their total pension rights up to the Lifetime Allowance (set at £1.5 million in 2006-07).

This new method generally allows for a higher level of cash to be taken by members, allowing a greater range of pension/cash options at retirement.

Your scheme is not obliged to move to the new basis and can continue to allow cash calculations on the existing basis. This is subject to a maximum of 25 per cent of the value of total pension rights for service after 6 April 2006.

It is certainly worth remembering that restricting tax-free cash to the amount available under current rules may prove unpopular with your members.

Members Affected by Lifetime Allowance

Some employees may be affected by the new Lifetime Allowance. If so, they need to consider taking action to protect their benefits. This may include making no



pensions simplification

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further contributions to a pension scheme. Again, you need to consider the following:

- If you have employees caught by the Lifetime Allowance, will you look to compensate them in a different way?
- Will your scheme administrator identify these employees?
- Some employees not in the pension scheme or who recently joined may have significant pension benefits from previous employment.
- You should consider identifying and warning these employees that action may be necessary. You and your pensions administrator might not be able to identify all of these just by looking through your salary records, as the third sector has many philanthropic employees who are putting something back, in return for a modest income.
- Employees caught by the Lifetime Allowance may wish to seek independent financial advice.

Death in Service Benefits

Under current legislation, the value of death in service lump sums is currently limited to four times salary plus a refund of members' contributions. Under the new legislation, the value of any potential payment will be limited only by the Lifetime Allowance.

This means schemes have scope to pay all of the death benefit as a higher lump sum rather than as a lump sum and a spouse's pension. This sounds very attractive. You could save all the hassle of administering spouses' benefits by letting the bereaved beneficiary make their own choice. But consider the following:

- On the plus side, taxation treatment differs for a lump sum (tax-free) and a spouse's pension (taxed as annuity). If you maintain current death benefits, there may be criticism that the member is being forced to take a tax inefficient option.
- Provision of a higher lump sum will place a large sum of money into the dependant's hands at a very difficult time.
- Maintaining a death in service pension for spouses provides reassurance that the deceased's partner will be provided with a pension for life (or into adulthood for dependent children).

Flexible Retirement

Currently, a member must have ended their employment before they draw their occupational pension. From A-day, if the scheme rules allow it, your members can continue to work and accrue benefits.

So, will you change the rules and give employees more choice? After all, this is a “flagship” of the new regime. Well, most employers haven't rushed into making changes and neither should you. As pensions are part of an overall package, you need to think about the following:

- Does flexible retirement fit in with your current or

future HR strategy?

- How popular an option (for both you and your employees) will this be?
 - Depending on the basis that you allow flexible retirement (and there are several ways that you could do this, as your administrator will tell you) someone who elects to take all their accrued benefits while remaining in full time employment will face a significant fall in income when they finally retire. Pensions are designed to stop this from happening, not make it worse.
- Whatever decisions you take, you or your administrator must be pro-active in keeping your staff informed of the changes that are on the way. At The Pensions Trust, all our employers and members have received a specific communication relating to the Finance Act and this has been followed up with regular information in our magazines to employers and members.
- Ideally decisions relating to A-day should be well under way and will have been discussed with your scheme administrator. For those still considering, see the box below for some areas to keep an eye on.

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A-day Checklist

1. Ask your administrator to check current rules for areas that need consideration.
2. Take decisions as soon as possible, although you should be aware that some decisions, flexible retirement for example, can wait. Consider the risks and costs involved when making your decisions.
3. Changes to calculation routines etc will take time so the earlier the decision the better. Decisions made on 5 April 2006 will not be implemented in time – this will lead to higher costs as calculations are carried out manually.
4. Making things complicated (e.g. on flexible retirement) will make it more expensive. Make sure the administrator can deliver what you want and make sure you understand the cost.
5. Check employee handbooks/staff guides/web-sites for references to the pension scheme and check if any changes need to be made.
6. Ensure any scheme booklets and promotional material reflect decisions made.
7. Take decisions on high earners. Will you look to compensate them in a different way if pension benefits are now limited?
8. Make high earners aware that the responsibility to apply for protection lies with them. Although not your responsibility, employee relations will not be helped if your highest earning employees feel they haven't been kept fully informed.
9. Encourage general awareness of the new regime among employees.
10. Communicate. Changes to scheme design need to be communicated to members. A-day does provide you with opportunities to give your staff more choice, so be sure to tell them if you do this.