RadcliffesLeBrasseur

BRIEFING

Occupational Pensions
What now?

CORPORATE BRIEFING

Overview

This year and next year see well over 1,000 A4 sized pages of legislation, regulation and codes of practice come into force.

The reason for all this paper is that two major reforms are coming in at very much at the same time. First, there is tax simplification and, separately, major changes designed to improve the security of defined benefit pensions.

Tax Simplification …

At present, different pension arrangements, such as personal and occupational pension schemes, are subject to different tax rules. In future, there will be one set of rules. Pensions will still be tax-advantaged, but there will be limits. One set of limits will apply to money going in, the other to money going out.

Looking at money going into the Scheme, there will be a lifetime allowance and annual allowances. These are set at levels such that, unless they are eroded by inflation, they are unlikely to cause major problems for most employees.

Looking at what can come out of a pension scheme, the two big changes are, first, the ability to draw a pension and carry on working and, secondly, greater potential for tax-free lump sum payments.

… but more regulation

But if the tax regime has become simpler, the Department of Work and Pensions has done its bit to remedy the balance, particularly for defined benefit (final salary) schemes. The Pensions Act 2004 runs to 366 pages. The key change is the creation of a safety net for pension scheme members of failed companies which takes the form of the Pension Protection Fund ("PPF"). However, having now created the Fund, the Government is clearly terrified that it is going to run out of money and protecting the protection fund is a major aim of policy. The logical consequence of this is more regulation to increase scheme funding levels and improve administration. One way or another, the cost of running defined benefit occupational schemes is going to go up unless action is taken.

What should I do?

Your priority, if your company runs an occupational pension scheme, is to ensure that you are properly briefed on the changes being introduced. If your scheme is defined benefit, even if it is closed to new members or new accruals, then a briefing on the changes is more or less vital. This briefing is intended to give you a flavour of the changes from the legal perspective and is <u>not</u> intended to be a full compliance checklist. We do not envisage providing a briefing on stakeholder or personal pension schemes where we expect your pension provider to give you support.

We will be happy to provide a more comprehensive briefing in the form of presentations whether to employers, trustees, or scheme administrators.

If you would like us to assist, then please contact Robert O'Donovan on 020-7227-7278 or email: robert.o'donovan@rlb-law.com.

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To give you a feel for the changes, here is our selection of five possible issues.

1. Windfall Gains for Senior Executives

Whether or not the chance of a windfall gain strikes you as a good thing or not probably depends on whether you are receiving it or paying for it.

Changes in tax legislation effective on 6 April 2006 could result in windfall gains in pension rights for defined benefit scheme members earning over £105,600.

At present, earnings over this figure, which is called the “earnings cap” (or sometimes the “permitted maximum”) are disregarded for members of Occupational Pension Schemes who joined on or after 1 June 1989. This Revenue rule has had to be incorporated as a term of the Deed in most schemes. A typical rule might read as follows:-

> “Earnings over the permitted maximum as defined in Section 590C(2) Income and Corporation Taxes Act 1988 shall not be treated as pensionable earnings”.

From April 6 2006 Section 590 will cease to exist. So what happens when there is a cross reference to a non-existent section? No one knows for certain but our view is that there is a strong argument for thinking that the restriction on earnings will simply disappear. Leaving aside the joys of academic debate, this is obviously the sensible approach to take to avoid the windfall gain.

The impact would be felt in Defined Benefit Schemes. Pensions here are often calculated by reference to Final Salary and in rough terms an Executive earning £150,000 per year might see his pension rise by around 50% as, for pension purposes, his salary rose from £105,600 to £150,000. From the point of view of shareholders this could represent a significant and unwanted cost.

An alternative view might be that the earnings cap remains fixed at £105,600 indefinitely. Better for the shareholders, but not so good for the senior executives.

So the question is do you retain some sort of earnings cap and what should it be?

H M Revenue and Customs may introduce regulations to cover anomalies such as the earnings cap but they have not yet published their proposals and, in any event, any transitional cover will be of limited duration, probably five years.

Even if regulations are introduced they may not cater for every scheme. We strongly recommend that all scheme rules are reviewed between now and 6 April 2006 and amended, if appropriate, even if only by a “holding” Deed designed to alleviate the worst anomalies and/or take advantage of the new flexibilities.

2. “Power to the People”

More accurately, watch out for power going to pension scheme members. You may remember that the Pensions Act 1995 made provision for member nominated Trustees (or Directors in the case of a company being a Trustee). It was possible to opt out of the statutory regime and all our clients did so although some created their own systems of member participation.

So if you are reading this your scheme probably has no member Trustees or Directors or, if it does, then there are probably restrictions on who may act, such as being a current employee or perhaps having accrued a given period of service. Pensioner and Deferred Pensioner Members were usually, but not always, excluded form standing for election.

All this is set to change. Although final details are not known we expect that all Occupational Schemes, whether Defined Benefit or Money Purchase, whether open, closed or in winding up, are likely to have to make provision for member representatives totalling at least a third of the Board of Directors or Trustees.

The duty to achieve this is placed on the Trustees. This is significant because Trustees have a duty to act fairly between different classes of member. This means that Deferred and Pensioner members are almost certainly going to be included. This could have surprising consequences. In 1997 one of our clients introduced its own system, which allowed pensioners to stand for election. It then turned out that the pensioners were rather better organised than the employee members and <u>all</u> new Trustees turned out to be pensioners.

To avoid such unequal representation, we suggest that Trustees consider whether there should be separate constituencies for different classes of member. Based on our experience gained during the last round of elections in 1997 we can help in designing election systems and have acted as scrutineers.

You may have heard of the Government proposal, announced at the Labour Party Conference in 2004, that the number of member nominated Trustees or Directors should be increased to 50%. Although the legislation exists to cover this the Government has announced an indefinite delay.

However, in the future the Chairman’s casting vote may be the only way in which an employer can keep control of the pension scheme and employers do need to check that they control the appointment of the Chairman.

3. TKU aka Trustee Knowledge and Understanding

The Government, acting through its enforcer, the new “pensions regulator” is introducing rules requiring Trustees to have minimum levels of understanding of their own pension scheme, the legal background to Trusteeship, and the world of investments. Although this sounds fairly woolly there is a 14 page draft Code of Practice giving a fairly clear indication of what is or is not required and Trustees who fail face fines of up to £5,000.

So what do you do? At a practical level the answer is that all Occupational Schemes should work out what training each individual Trustee requires and then assess whether the training is best provided by sending delegates to specialist training courses or linking Trustee meetings with training sessions. It seems to us that linking training sessions with Trustee meetings is a sensible and efficient use of time particularly for the smaller scheme.

In practice we think the Regulator would be very reluctant to fine individual Trustees unless perhaps an individual has been ordered to take up training and failed to do so. More worrying perhaps than the fines themselves is the likelihood that Pension Scheme Trustees will be assumed to have a higher level of competence as a result of training. If something goes wrong, therefore, it will be more difficult for Trustees to say that it was an innocent mistake and Trustees personally are more likely to be at risk.

We have provided Trustee training since 1993 and again will be happy to assist in this area.

4. Greater exposure for company directors

While increasing the responsibilities of trustees, the changes in legislation have made it more difficult to protect directors of group companies from innocent mistakes they might make as a pension scheme trustee or a director of a corporate trustee. This is not a direct result of pension legislation, but a result of the tightening of controls on directors introduced following the collapse of Enron and WorldCom.

Fortunately, claims against trustees or directors of a corporate trustee are few and far between. But what if there were either a fine or penalty imposed by the Regulator or a claim from a group of members. Assume that there is no insurance (and in any event, insurance is not necessarily the best means of defence), what protection can the legal draftsman offer?

There are two main devices. First, he can create an exclusion clause in the trust deed which limits or excludes liability. Secondly, the trust deed can contain an indemnity from the sponsoring employer.

Anyway, suppose our director friend is fined £5,000 by the Regulator for an error made by him in his capacity as an individual trustee. Exclusion clauses don't work against the Regulator, so he turns to his employer for an indemnity. If the indemnity had been given in 2004, the employer would simply have paid up. However, this is now 2005 : a similar indemnity is void and the employer company could quite legitimately tell the director to pay out of his own money.

Meanwhile, his co-trustee, who happens not to be a group company director, gets indemnified in full.

Changes also affect the working of exclusion clauses. Suppose a member brings a claim against an individual trustee, who happens also to be a group company director. In 2004, an exclusion clause under the deed might well have been effective. This year, the exclusion clause would probably be void.

Again, for another individual trustee not being a group company director, the exclusion would work!

In short, legislation has now created the situation where there is a conflict between the interests of trustees who are group company directors and those who are not. For those who are group company directors, the best structure is probably to use a corporate trustee. For those who are not group company directors, it is probably best if they act as trustees in their individual capacity. Can you reconcile this conflict?

Please let us know if you would like us to explain our reasoning and consider what is best for your scheme. At the same time, you could always ask us what we think about trustee protection insurance…

5. Forms, forms and yet more forms

Finally, by way of light relief, this doesn't require you to do anything … at least not yet. In a world already dominated by all forms of form, the Pensions Act introduces a new requirement which it may be all too easy to forget.

The thinking behind this goes back to the need to protect the Protection Fund. The idea is that the Pensions Regulator should spot companies likely to run into trouble at an early stage and then has the possibility of taking action to protect the Fund. (Time will tell whether this means that the Pensions Regulator has a secret ingredient for converting loss into profit.)

In order to monitor what is going on, the Regulator has introduced reporting requirements. Some matters are to be notified by the trustees of a scheme and some by the employer. The fact that reporting requirements are imposed on the employer is something of a surprise and may catch some employers out.

The main events reportable by trustees are unsurprisingly a decision to compromise a debt, but major transfer payments, either into or out of the scheme, also get reported.

The employer has more to report. For example, a report should be made if the employer has received advice that it is trading wrongfully. (Given the problems that there will no doubt exist if this condition is satisfied, it will be a wonder if any employer remembers this amongst all the other things that will be going on.)

Secondly, a breach of a banking covenant, unless the bank agrees not to enforce the covenant.

Third, a decision by a controlling company to relinquish control of the sponsoring employer. At first, we thought that this was the same as change in control, but actually it is more demanding. You may be surprised to discover that a controlling company is a company holding as little as 1/3 of the voting shares in the employer company. You may also be surprised that a transfer of ownership of the employer company within a group of companies will be caught.

Finally, if the Chief Executive and Finance Director both change in a 12 month period, notification is required. This is not a comprehensive list. However, in practice, the Regulator has indicated that he will not require notification if the employer is up-to-date in making contributions and the Scheme is adequately funded, which for the time being means funded at the MFR level, but, in future, will mean at a higher level.

So, to finish, no action needed now but, if in doubt, give us a call.

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For further information on pensions law, please contact Robert O'Donovan or Kerry Scott-Patel by telephone or email.

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