SLAUGHTER AND MAY

# Pensions and Employment: Pensions Bulletin

12th May, 2016 / Issue 06

Legal and regulatory developments in pensions

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For more information, or if you have a query in relation to any of the above items, please contact the person with whom you normally deal at Slaughter and May or Rebecca Hardy.

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# I. Watch list

The Watch List is a summary of some potentially important issues for pension schemes which we have identified and where time is running out (or has recently run out), with links to more detailed information. New or changed items are in **bold**.

| No. | Topic | Deadline | Further information/ action |
|---|---|---|---|
| 1. | Reduction in annual allowance for high income individuals<br>Note: Up to £80,000 annual allowance for tax year ending 6th April, 2016 | Applies for tax years starting on or after 6th April, 2016 | Summer Budget 2015 Supplement |
| 2. | Severance payments and tapered annual allowance pitfall | From 6th April, 2016 | This Pensions Bulletin |
| 3. | Reduction in Lifetime Allowance from £1.25 million to £1 million | 6th April, 2016 | Pensions Bulletin 15/19 |
| 4. | Members who intend to apply for Fixed Protection 2016 ("FP 2016") must have stopped accruing benefits | 6th April, 2016 | Pensions Bulletin 15/16 |
| 5. | Abolition of DB contracting-out: practicalities | 6th April, 2016 | Pensions Bulletin 15/16<br>5.1 Employers to notify affected employees of change in contracted-out status "at the earliest opportunity" and in any event by 6th May, 2016.<br>5.2 Schemes to notify affected members before, or as soon as possible after, 6th April, 2016 and in any event by 6th July, 2016.<br>5.3 Change template contracts of employment for new joiners to remove references to contracted-out employment.<br>5.4 Update, where applicable, pensions section of employee handbook to cover consequences of contracting-out ending. |
| 6. | Abolition of DB contracting-out: Rule amendments needed<br>Note: Statutory power to amend, retrospective to 6th April, 2016, expires on 5th April, 2017 | 6th April, 2016 | If your scheme was contracted-out on 6th April, 2016 and currently has active members accruing benefits (and who continued to accrue benefits after 5th April, 2016 in the scheme), then your scheme will, more likely than not, require a rule amendment effective from 6th April, 2016 to prevent the inadvertent addition of an additional underpin to the accrued GMPs of those active members. See further Pensions Bulletin 16/03 |
| 7. | Abolition of DB contracting-out: Compliance with auto-enrolment requirements | 6th April, 2016 | If employer is using COSR as a "qualifying scheme" for auto-enrolment purposes, scheme will need to satisfy either:<br>• "test scheme standard", or<br>• alternative "cost of accruals" quality test<br>if it is to continue as a "qualifying scheme".<br>Pensions Bulletin 16/05 |
| 8. | Requirement to provide risk warnings when member provided with means of accessing DC benefits | 6th April, 2016 | Pensions Bulletin 16/04 |

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| 9. | Put in place register of persons with significant control (“**PSC**”) for trustee company where trustee is a corporate | 6th April, 2016 | Pensions Bulletin 16/03 |
| 10. | Ban on member-borne commissions in DC schemes used for auto-enrolment | 6th July, 2016 at the latest | DC scheme trustees must notify “service providers” if the scheme is being used as a “qualifying scheme” for auto-enrolment purposes. Pensions Bulletin 16/04 |
| 11. | EU/US Privacy Shield for transfers of personal data to US | May, 2016 | To consider if transferring personal data to US. Also review transfers of data outside the EEA for compliance with the EU data protection directive. Pensions Bulletin 16/02 |
| 12. | Cyclical re-enrolment | Within 6 month window by reference to third anniversary of employer’s staging date | For example employers with a March 2013 staging date must complete cyclical re-enrolment process between December 2015 and June 2016.<br>Publication available to clients on request from usual pensions contact. |
| 13. | First Chair’s annual governance statement | Within 7 months of end of scheme year (for scheme years ending on or after 6th July, 2015) | For example, schemes with a 31st December year end must submit statement by 31st July, 2016.<br>Client note dated June, 2015 available from Lynsey Richards. |
| 14. | Data protection: New Regulation | 25th May, 2018 | Pensions Bulletin 16/05 |
| 15. | “Brexit” | Referendum on 23rd June, 2016 | Consider potential impact on pension schemes. Client publications available on Slaughter and May website |

# New Law

## II. Secondary annuity market

### A. Overview

1. HMRC, the Treasury and the FCA have each published consultations regarding the secondary market for annuities. That market is intended to come into operation on 6th April, 2017. The changes proposed will allow individuals to:

   1.1 receive all of the sale proceeds as a taxable lump sum,

   1.2 arrange for the buyer to pay all of the sale proceeds into a flexi-access drawdown fund, or

   1.3 arrange for the sale proceeds to be used to buy a new flexible annuity.

2. The new regime will allow members of DB and DC schemes to assign or surrender annuities payable to them, whether currently treated as lifetime annuities or scheme pensions.

3. The previous consultation, published in December, 2015 (Pensions Bulletin 15/20) stated that the market would not extend to DB scheme annuities that remained within an occupational pension scheme.

   **Comment:** It is important to distinguish between scheme pension and annuities.

   **Scenario 1:** Where a scheme (DB or DC) pays scheme pension without purchasing an annuity, the regime **clearly will not** apply.

   **Scenario 2:** Where a DC scheme uses a member’s money purchase pot to buy an annuity, the regime **clearly will** apply.

   **Scenario 3:** Where a scheme (DB or DC) pays a scheme pension but has chosen to invest in an annuity to provide this, **it is not yet clear** whether the regime will apply: we would expect not, as the annuity is a scheme investment. But the consultation document merely states *“it is intended that schemes*

*should be able to assign annuities in their name to members":*

## B. HMRC consultation published 20th April, 2016

1. Subject to meeting certain conditions, HMRC is proposing that payments will be "authorised" for tax purposes where individuals assign or surrender rights to payments under annuities that were bought with sums and assets from a registered pension scheme (including deferred annuities that have yet to come into payment).

2. Individuals will be able to assign or surrender annuities that were bought in respect of money purchase or defined benefit arrangements, regardless of whether the annuity being assigned or surrendered is treated under the current tax rules as a lifetime annuity or a scheme pension, or represents rights in respect of a beneficiary under an annuity that is a dependants' annuity, a nominees' annuity, a successors' annuity or a dependants' scheme pension.

3. Schemes will be able to assign annuities held in their name to members (but note the comment in **A.** above). Those assignments will be "authorised" for tax purposes as long as:

   3.1 the annuity contract provides the benefits that would otherwise have been paid by the scheme, and

   3.2 bar the change of ownership, the annuity is unchanged following the assignment to the member, who continues to receive the same payments under the annuity.

4. Where the proceeds are paid to the member as a lump sum, that payment will be treated as pension income liable to tax at the member's marginal rate of income tax.

5. The £10,000 money purchase annual allowance will apply to:

   5.1 individuals who surrender or assign their annuity rights in return for taxable lump sums, and

   5.2 individuals receiving payments under a flexible annuity or drawing income from a flexi-access drawdown fund acquired with proceeds from the assignment or surrender of the original annuity.

6. But there will be a "de minimis" threshold (below which the money purchase annual allowance will not apply) for individuals surrendering or assigning "low value annuities" – a term yet to be defined - bought before 6th April, 2016 in return for taxable lump sums.

7. There will also be a new benefit crystallisation event for individuals who have reached normal minimum pension age and who surrender or assign deferred annuities that have not yet come into payment in return for a lump sum. The amount crystallised by the new BCE will be the amount of the proceeds paid to the individual.

8. Any money remaining from a taxable lump sum received by an individual for assigning or surrendering their annuity will form part of that individual's estate for inheritance tax.

9. Funds put into a flexi-access drawdown fund following the surrender or assignment of an annuity will be treated in line with the recently introduced rules for drawdown. Where that individual dies below age 75 any unused funds held in a flexi-access drawdown fund will pass free of income tax to any beneficiary who is an individual.

10. New information requirements will apply to (i) insurers who issued the annuities being surrendered or assigned, (ii) entities buying

the annuities, and (iii) individuals assigning or surrendering their annuities.

The consultation closes on 15th June, 2016.

## C. Treasury consultation published 21st April, 2016

1. The Government intends to restrict buyers in the secondary annuity market to FCA authorised buyers engaging in a "regulated activity".

2. The Treasury's consultation paper seeks comments on the legislation that will be needed to amend the secondary legislation under the Financial Services and Markets Act 2000 to create new specified activities for

   2.1 firms intending to purchase annuities or to act as intermediaries in the secondary market, and

   2.2 annuity providers intending to 'buy back' annuities they have issued.

3. The Government proposes that buy back should take place through an intermediary, as consumers will be unlikely to shop around when seeking to sell their annuity income. This will also mitigate the risk of potential public pressure forcing firms to buy back large volumes of their annuities that might risk their solvency. The Government is, however, considering allowing annuity providers to buy back "lower value" annuities directly, in order to avoid incurring intermediaries' fees.

The deadline for responses to the consultation is 2nd June, 2016.

## D. FCA consultation published 21st April, 2016

1. The FCA is consulting on proposed rules and guidance aimed at protecting consumers wishing to sell their annuities. Although the secondary annuity market is not scheduled to come into operation until 6th April, 2017, the FCA wants the rules outlined in this consultation to apply as soon as they are made (anticipated to be Autumn 2016). Annuity sales will fall within the scope of both the Financial Ombudsman Service and the Financial Services Compensation Scheme.

2. The FCA wants brokers to set out their charges upfront and agree them with the consumer, rather than being paid by commission from firms acting as buyers.

3. To help consumers assess the value of their annuity income, the FCA has proposed that buyers and brokers making an offer for a seller's annuity income will be required to present their offer alongside the 'replacement cost' of the annuity income, if it were to be bought new on the open market.

4. Firms will be required, at the earliest opportunity, to give consumers who are considering the sale of their annuity specific risk warnings, and to recommend that they seek regulated financial advice or guidance from Pension Wise. Firms will also be required to recommend that sellers shop around.

5. Annuity providers will only be able to recover "reasonable" costs when charging to facilitate an annuity income sale.

The FCA consultation is open until 21st June, 2016.

**Comment (1):** The Government estimates that up to 300,000 of the 5 million people currently in receipt of annuities will choose to sell them.

**Comment (2):** The ability of schemes to assign annuities currently held in the trustee's name to members will be subject to the terms of the annuity, and any restrictions in the trust deed and

rules; the HMRC consultation paper states that the new tax rules will not override these.

### III. Data protection: New regulation published

The General Data Protection Regulation ("**GDPR**") was published in the Official Journal of the European Union on 4th May, 2016.

The GDPR will come into force on 20th day following that of its publication and so will apply directly in all Member States from 25th May, 2018.

Comment: For a reminder of the key facts about the GDPR, and steps organisations should be taking to prepare themselves, please see the client publications on Slaughter and May's website.

## Tax

### IV. Annual allowance taper and taxable termination packages: pitfall to watch out for

From 6th April, 2016 onwards, the £40,000 annual allowance for tax-relievable employee pension contributions is reduced for high income individuals. The annual allowance reduces by way of a taper, to a minimum of £10,000 for those with income of £210,000 or more.

The income tests used to identify affected individuals relate to UK taxable income. In order for the taper to apply, an individual must have, in the tax year 2016/17:

- "threshold" income of more £110,000, and
- "adjusted" income of more than £150,000.

Any **taxable** element of a termination package counts towards both threshold and adjusted income. The tax free element (currently £30,000) does not.

**This is a very real pitfall point for members whose employment is terminated. A taxable termination payment could catapult an individual over the £150,000 limit, causing the member to incur a tax charge on pension provision already made.**

There may be some scope for timing taxable termination payments to straddle tax years but there are anti-avoidance provisions[1] which would need to be considered carefully if this course of action is contemplated. For more information, please get in touch with your usual pensions contact at Slaughter and May.

[1] Finance Act 2004, Section 228ZB

**Action point:** Review termination procedures to build in a process to identify and manage this point.

## Cases

### V. DB schemes: Bulk transfers without consent: Pollock v Reed

#### A. Overview

1. On 3rd May, 2016, the High Court published its judgment in a case involving a proposed bulk transfer without consent of the assets and liabilities of an underfunded DB scheme to a new DB scheme. The transfer was part of a restructuring of the pension arrangements of a "heavily insolvent" employer, whose US parent was refusing to provide further support for the scheme. The benefits were to be the same in both schemes except in relation to future increases to pensions in payment and deferment.

2. The Court's decision was given on 18th December, 2015 but has only recently been published due to privacy restrictions.

3. The Court (Asplin J.) confirmed that the scheme actuary **should not** take into account the fact that the benefits in the receiving

scheme were more secure than those in the transferring scheme when giving his actuarial certificate.

4. As a consequence, the actuary was unable to give the certificate and the transfer could not go ahead.

## B. Facts

1. The trustees made a Part 8 application asking the Court to bless their decision to enter into a proposed transfer of the assets and liabilities of the Halcrow Pension Scheme (“**HPS**”) to a new scheme, (“**HPS2**”) to be established for that purpose.

2. HPS is a DB occupational pension scheme with approximately 3,300 members, in “severe deficit” (on a PPF basis, of £226 million).

3. Halcrow Group Limited (“**HGL**”), the Principal Employer, is itself “heavily” balance sheet insolvent and is only able to continue as a going concern because of substantial support from its American parent. The parent had indicated that it no longer intended to support HGL in a way that would enable it to contribute to HPS at an acceptable level.

4. It was suggested that, unless the transfer was completed, HGL would be placed into administration and HPS would in all likelihood go into the PPF, resulting in a reduction in members’ benefits.

5. The restructuring involved:

   5.1 HPS being wound-up and all of its assets and liabilities transferred to HPS2,

   5.2 HGL being the sponsoring employer for HPS2,

   5.3 the benefits under HPS2 being the same as under HPS but for the fact that future increases to pensions in payment and deferment would be at the statutory minimum rather than the higher level prescribed in HPS’ current rules,

   5.4 HPS2 would be closed to future accrual and subject to a “PPF underpin” to ensure no member would receive less than the PPF compensation which he or she would have received had HPS entered an assessment period as at the date of the transfer,

   5.5 the American parent would guarantee HGL’s payment obligations subject to a cap, and

   5.6 following the transfer, the HPS trustees would calculate a Section 75 debt in HPS in respect of HGL at nil and release other group companies from guarantees provided to HPS.

6. The point at issue was whether, when determining whether the transfer credits in HPS2 were “broadly no less favourable” for the purposes of the actuarial certificate to be issued under the Preservation Regulations[2], the actuary was able to take into consideration the security of the benefits in each scheme and, therefore, the likelihood of the benefits being paid.

## C. Decision

1. After a detailed consideration of the legislation, Asplin J. held “with some reluctance”, that the actuary’s assessment should not include the security of benefits as one of the factors to be taken into account.

[2] Regulation 12(3)(a) of the Occupational Pension Schemes (Preservation of Benefit) Regulations 1991.

2. She noted that the certificate was neither authorisation for, nor a recommendation to, the trustees to make the bulk transfer. It was a statutory precondition for such a transfer, but the decision whether to transfer remained with the trustees, who were required to exercise it in accordance with their fiduciary duties. When doing so, the trustees could take account of the relative security of benefits.

4. If the security of benefits was part of the certification carried out by the actuary, there would be little left for the trustees to determine. The bulk of the discretion would already have been exercised by the actuary, who owed no fiduciary duties to the scheme members.

5. The position would be no different if the transferring scheme was in winding up.

6. Although her decision meant that the actuary could not now give the certificate, so the transfer could not go ahead, Asplin J. went on nevertheless to consider the propriety of the trustees' decision to transfer. She noted that the trustees had taken account of a broad range of professional advice in reaching their conclusion and that the trustees were entitled to rely upon this and were not required to "second guess" it in any way.

"*It is clear to me that the trustees undertook a careful and proper review of all of the relevant issues and took full and proper professional advice… The minutes of their numerous meetings and the evidence before the Court reveals a careful and proper consideration of those issues and that advice*".

**Comment (1):** It is surprising that this issue got as far as the High Court: our advice has always been that security in the receiving scheme is not an issue for the actuary, but is something to be taken into account by the trustees in considering the propriety of the transfer.

**Comment (2):** If the post-transfer benefits are the same apart from materially lower pension increases, by definition, they will be lower in value ignoring security (i.e. the likelihood of those benefits being paid). On the facts of this case, by definition, the post-transfer benefits could NOT be "broadly no less favourable". So the scheme actuary could not give his certificate.

**Comment (3):** Following the abolition of DB contracting-out on 6th April, 2016, it is currently no longer possible for pension schemes to be restructured in the way proposed, even where the actuary can give the necessary certificate. Transfers of contracted-out rights can currently only be made to former contracted-out schemes and it is no longer possible to set up a new COSR scheme.

## VI. Early retirement factors: Ombudsman's determination in relation to Mayo

This Deputy Pensions Ombudsman determination (dated 18th March, 2016) concerns the unfortunate timing of a member's early retirement.

The member, M, was employed by Kodak and was a member of the Kodak Pension Plan. He applied to take early retirement after Kodak's US parent filed for Chapter 11 US bankruptcy protection. The trustees had told him that early retirement factors would, as a result, be less generous and that the scheme might enter the PPF. But shortly after M took early retirement, the trustees, Kodak and the US parent agreed to set up a new scheme with, after a temporary moratorium, more favourable early retirement factors.

M argued that the trustees should have worked out whether the timing of his early retirement was in his financial best interests, rather than automatically granting his request. The trustees should have imposed the moratorium earlier (he would have

received a substantially higher pension had he delayed his early retirement by one month). The trustees continued to communicate regularly with members. But they did not explain that the early retirement factors in the scheme were now worse than those applied under the PPF. M claimed that he felt pressured into retiring early as he thought this would protect him from entering the PPF.

The Deputy Ombudsman decided that, at the point of M's application for early retirement, the trustees could not have foreseen the future position (under which more generous early retirement factors became available). They had acted in line with their standing policy of automatically accepting early retirement applications. They had provided the member with accurate information about his benefits at the time of his application. Despite M receiving a pension that was £7,185 lower than it would otherwise have been using the more generous factors, the cliff edge date from which the more generous factors were available was a reasonable date to have selected. That was the date on which it became clear that the Regulator and the PPF had agreed to a new scheme being established.

**Comment (1):** This is another reminder of the importance of clear and accurate communications with members.

**Comment (2):** Trustees are not under an obligation to maximise a member's benefits but must act impartially. The trustees here did not exercise their discretionary power to increase M's pension because this would set a precedent and might jeopardise the security of the other members' benefits.

# Points in Practice

## VII. FCA policy statement about pension reforms - feedback on CP15/30 and final rules and guidance (PS16/12)

On 25th April, 2016 the FCA published final changes to its rules and guidance to reflect the 6th April, 2015 pension flexibilities. The changes focus largely on promoting competition (provider firms will not be allowed to send application forms with wake-up packs and reminders, for example) and consumer protection (via cancellation rights, communications such as retirement risk warnings, and FCA guidance about using pension savings to repay debt, for example).

The requirement for FCA-regulated providers to provide personalised retirement risk warnings (the "**second line of defence**") is relaxed to allow providers to ask consumers questions ahead of their accessing their pension savings: this will allow providers to tailor the warnings more easily to the particular consumer. The requirements are further relaxed for consumers with pension pots of £10,000 or less.

## VIII. Auto-enrolment - Pensions Regulator fines Swindon Town FC

The Pensions Regulator has fined Swindon Town Football Club £22,900 due to the Club's failure to comply with its auto enrolment duties. It took 2 years from the Club's staging date of 1st February, 2014 for it to comply and to then settle with the Regulator. Had the Club engaged early on and done what was required of it when first contacted by the Regulator, it would have faced a fixed penalty notice of only £400.

## IX. Financial Services Compensation Scheme: Changes confirmed

The FCA has confirmed, in Policy Statement 16/14 published on 6th May, 2016, the changes to the Financial Services Compensation Scheme ("**FSCS**") Sourcebook proposed in November, 2015 (Pensions Bulletin 16/01). The changes took effect on 29th April, 2016.

They will allow members of occupational DC pension schemes to claim on the FSCS even where the sponsoring employer is "large".

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A “large” employer is one that meets 2 of the following criteria:

- turnover of more than £6.5 million,
- balance sheet total of more than £3.26 million, and
- more than 50 employees.

As a consequence, all members of DC schemes will have the same protection irrespective of the size of the employer. The maximum compensation is £50,000 per claim. The change also brings master trusts within the ambit of the FSCS.

**Comment**: The FSCS is of relevance to occupational pensions in 2 respects:

- in relation to investment by trustees in insurance policies and on buy-outs where benefits are secured by insurance companies, when the insurance company providing the policy is in default. In these circumstances, assuming the pension trustee is an eligible claimant, it is, in general, entitled to claim compensation of 100% of the sum insured with no limit, and
- in relation to **non-insurance investments**, in which case compensation is restricted to £50,000 per claim. For DB schemes, the claimant is the trustee; for DC schemes the claimant is the member.

**Note** that the changes referred to above affected only compensation in relation to **non-insurance investments**.

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If you would like to find out more about our Pensions and Employment Group or require advice on a pensions, employment or employee benefits matters, please contact **Jonathan Fenn** jonathan.fenn@slaughterandmay.com or your usual Slaughter and May adviser.

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