

**STATE, OCCUPATIONAL AND PERSONAL PENSION  
ARRANGEMENTS IN THE UNITED KINGDOM**

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## **STATE, OCCUPATIONAL AND PERSONAL PENSION ARRANGEMENTS IN THE UNITED KINGDOM**

### **THE UNITED KINGDOM PENSION SYSTEM**

The United Kingdom operates a state contributory social security scheme which is compulsory for employed and self-employed people with earnings above a certain level. People who are not working or whose earnings are below the level at which National Insurance contributions (NICs) become due (and who are not credited with NICs) may also contribute to the scheme on a voluntary basis.

The scheme operates on a pay-as-you-go basis. Earnings-related NICs are payable by employed persons and their employers. Self-employed persons pay flat rate NICs plus a percentage of their earnings above a certain amount. Most people who are unable to work because of sickness or unemployment receive credits which count toward State Pension and certain other benefits administered by the state. Credits are also available in other situations.

NICs from employed persons go toward the provision of State Pensions and bereavement benefits, as well as providing benefits during periods of sickness and unemployment. Voluntary NICs and NICs from self-employed people count toward State Pension but not to the same range of benefits as NICs from those who are employed. The State Pension and some bereavement benefits payable under the scheme have two elements; a basic, flat-rate pension and an additional pension which is earnings-related. Both are subject to certain NICs conditions.

In addition to the state social security scheme, there are supplementary non-state pension arrangements which, with few exceptions, operate on a funded basis. The exceptions are in the public sector – for example the civil service, National Health Service, and teachers' schemes.

Non-state pensions are either occupational pension schemes, which are established by employers or groups of employers for their own employees, or personal pension schemes, which are established by financial institutions (principally insurance companies) and are open to most people in the United Kingdom. Employers may also offer personal pensions as a 'group personal pension' arrangement for their employees. These are administered under personal pension rules, rather than occupational pension rules.

Stakeholder pensions are a form of personal pension. Since October 2001, all employers with five or more employees who do not offer a suitable alternative (either an occupational pension or a group personal pension with a 3 per cent employer contribution) have to designate a stakeholder pension for their employees. They must also advertise the arrangement and deduct employee contributions from the payroll where the employee chooses to contribute. People who are not employed may also take out a stakeholder pension. For new members from April 2005, charges are capped at 1.5 per cent of fund value per year for the first ten years then reduce back to 1 per

cent. For those people who already hold a stakeholder pension at 5 April 2005, the cap remains at 1 per cent.

Pensions paid under such schemes supplement pensions paid under the state social security scheme and, in the great majority of cases, replace the earnings-related element of the state scheme.

However, for a variety of reasons, some people do not manage to achieve a State Pension and/or private occupational pension which is above a level set by Parliament. If these people do not have other provision for their retirement, the Government may step in with income-related assistance. Pension Credit tops up an older person's income to a guaranteed level, which may be higher if the pensioner has severe disabilities, caring responsibilities or relevant housing costs. Pension Credit also rewards people aged 65 and over who have made modest provision for their retirement. Additionally, low-income pensioners can get help with their rent and/ or council tax through Housing Benefit and Council Tax Benefit.

## **PENSIONS UNDER THE STATE SOCIAL SECURITY SCHEME**

Social security legislation provides for people over State Pension age who satisfy contribution conditions to receive a State Pension. This may consist of a flat rate basic State Pension and an earnings-related additional State Pension.

### State Pension age

State Pension age is currently 65 for men and 60 for women. Under the provisions of the Pensions Act 1995, women's State Pension age will gradually rise to 65 over a 10 year period between 2010 and 2020.

### Categories of State Pension

There are 4 categories of State Pension.

**Category A Pension** is payable to people who satisfy the conditions for State Pension entitlement based on their own National Insurance contributions (NICs) record.

**Category B Pension** is payable to married women, and certain widows and widowers who either do not qualify for a State Pension based on their own NICs or qualify for a State Pension which is less than the normal Category B Pension rate. It is based on the NICs record of the husband or deceased spouse. Married women receive about 60 per cent of their husband's Category A basic State Pension; where applicable, widows and widowers get the State Pension which would have been payable to the deceased spouse.

**Category C Pensions** were paid to people who reached State Pension age before 5 July 1948 or their surviving spouse.

**Category D Pensions** are non-contributory and amount to about 60 per cent of the Category A basic State Pension rate (plus an age addition of 25p per week). Category D Pension is payable to people aged 80 and over who satisfy residency conditions and who have either no entitlement to any other category of State Pension or whose rate of State Pension is less than the Category D rate.

People who satisfy the conditions of entitlement to more than one category of State Pension, can only receive the highest single State Pension rate.

People who are in receipt of a State Pension qualify for an additional flat rate payment of 25p per week when they reach age 80. All those receiving a State Pension (and/or certain other state benefits on the first Monday in December) qualify for a £10 Christmas Bonus payable in December.

## **Category A Pension**

The basic State Pension is payable at a rate of £82.05 per week from April 2005 to people who have paid NICs at the requisite level for at least 90 per cent of the years of their working life (A working life is currently from 16 years of age to 59 years of age for a woman and from 16 years of age to 64 years of age for a man. The length of Women's working life will equalise at the same time as the State Pension age is equalised. Men and women can work past State Pension age but will not pay any further NICs). Years in which the requisite NICs have been paid are called "qualifying years". Individuals who have qualifying years of less than 90 per cent, but have sufficient to get at least 25 per cent of the basic State Pension receive a pension at a proportionally reduced rate; those with less than 25 per cent (10 qualifying years for a woman and 11 for a man) are not entitled to a Category A basic Pension.

However, if a person is a national of another Member State of the European Union or European Economic Area and during their working life has been subject to the social security legislation of the United Kingdom and another Member State, that person may become entitled to a British State Pension at a rate of less than 25 per cent of the basic weekly rate under the aggregation and apportionment provisions of the European Union's Regulation (EEC) No. 1408/71 on social security for migrant workers.

For a year to count as a qualifying year for the purposes of the contribution conditions for a Category A or a Category B Pension, a contributor must have paid, have been deemed to have paid or been credited with, NICs from which are derived in aggregate an "earnings factor" of at least 52 times that year's lower earnings limit (LEL) (the contribution threshold, £82 per week from April 2005). An "earnings factor" is a notional sum derived from earnings upon which NICs have, or are deemed to have, been paid, or from flat rate contributions paid by self-employed or non-employed people (one flat rate contribution being deemed to be a week's earnings at the LEL).

People who have been widowed or divorced and who have not remarried before State Pension age may substitute their former spouse's National Insurance Contribution record up to the tax year the marriage terminated, if this is better than their own.

### **Claiming State Pension after State Pension age**

People who continue working beyond State Pension age may receive a State Pension irrespective of earnings and without any reduction to take account of earnings. If, however, a person defers claiming their State Pension and does not claim other State benefits in its place, they may be able to receive either a one-off lump sum payment or a higher pension when they do claim.

Up to 5 April 2005, a person had to defer claiming their State Pension for at least 7 weeks up to a maximum of 5 years. In return, they received a higher weekly pension, increased by approximately 7½ per cent of their normal weekly pension for each year of deferral.

In the Pensions Act 2004 the Government introduced a new option for people choosing to defer claiming their State Pension for at least 12 months and made important changes to the existing rules. From 6 April 2005 people deferring in this way will be able to:

- receive a lump sum payment equivalent to the amount of pension they could have received, plus interest, provided they defer for at least 12 months; or
- receive their weekly pension but at an enhanced rate. The higher weekly pension will be calculated at 10.4 per cent of their normal weekly pension for each year of deferral, provided the person has given up their pension for at least 5 weeks.

The maximum time limit of five years for earning a higher pension has also been removed. This means they can continue to earn extra State Pension or a lump sum payment however long they defer claiming their State Pension.

### **Annual Increases**

The legal requirement is to uprate State Pension by at least the Retail Prices Index (RPI) each year and this is what normally occurs. However, the Government chose to increase the basic State Pension by more than RPI in 2001, 2002, and 2003.

### **Category B Pension**

A married woman is entitled to a Category B Pension of about 60 per cent of her husband's Category A Pension. This is on condition that she and her husband are both of State Pension age, and he has claimed, and been awarded, a Category A Pension. If his Category A Pension is reduced because of insufficient NICs, her Category B Pension is subject to an equivalent reduction. She cannot simultaneously receive a Category A Pension and a Category B Pension. But if her entitlement to her Category A Pension is less than the full rate of Category B Pension, she may receive a combined State Pension – her Category A Pension will be increased by the lesser of:

- i) the difference between the full rate Category B Pension and the Category A Pension to which she is entitled or
- ii) the weekly rate of the Category B Pension to which she is entitled.

From 2010 a man will be entitled to receive a Category B Pension on the basis of his wife's NICs record, provided that his wife was born after 6 October 1950.

Widows and widowers over State Pension age may receive a Category B Pension based on their deceased spouse's NICs record. This may be at the rate at which their late spouse was, or would have been, entitled to a Category A Pension.

A Category B Pension is increased annually in line with the Retail Prices Index. Postponement of a claim to Category B Pension can provide an increase in the rate at

which it is put into payment provided that the pensioner has not been in receipt of another state benefit, such as Category A Pension or Widow's Pension.

### **Protecting entitlement to the State Pension**

There are additional statutory provisions to help people to qualify for a State Pension.

NICs are credited for periods of unemployment where the person is actively seeking work or periods that they are incapable of work through illness. Credits are also available with certain benefits and payments such as Carer's Allowance, Statutory Maternity Pay and Statutory Adoption Pay, Maternity Allowance and Working Tax Credit. They may also be awarded in other circumstances - for instance, undertaking jury service or for a prison sentence for a conviction which is subsequently quashed. Furthermore, a person can be credited with contributions automatically for the tax year in which he reaches age 60 and the four succeeding years if he has no liability to pay Class 1 or 2 contributions and is not absent from Great Britain for more than 182 days in any tax year.

For those who have not worked or whose earnings were low for some years because of home responsibilities, such as looking after children or sick or disabled relatives, or from 2003, being registered as a foster carer, the working life for the basic State Pension contribution condition is reduced by the number of years of home responsibilities. However, for a full rate basic State Pension the number of years cannot be reduced below 20. Thus whereas a woman would normally be required to have at least 39 years (90 per cent) as qualifying years out of a working life of 44 years to obtain a full basic Category A Pension, a woman who was not working for 10 years to look after children would be required to have at least 29 years out of a working life of 34 years for such a State Pension. The minimum number of qualifying years will rise to 22 for men from 2010 and will begin to increase for women until both men and women need 22 years by 2020.

On reaching State Pension age, a person who has been divorced or widowed and not remarried may substitute the deceased or former spouse's NICs record, if more favourable, for the years of the marriage, or for the whole working life until the year of the termination of the marriage.

In certain circumstances, at State Pension age, a widow or widower may receive a Category B Pension based on their spouse's NICs record.

### **Increases for Dependents**

A man in receipt of a Category A Pension is entitled to an increase of the pension, in respect of his wife who lives with him or whom he maintains, provided she does not earn above a prescribed level. The increase is payable at the full rate at the same rate as a married woman's Category B Pension. Normally when the wife attains State

Pension age, he loses the increase as she becomes entitled to a Category B Pension which is not subject to the earnings rule.

A wife is currently entitled to an increase of her Category A Pension for her husband only if before she attained State Pension age she was entitled to an increase of Incapacity Benefit for him. The legislation to equalise State Pension age will permit a wife to obtain an increase for a dependent husband under the same conditions as a husband may obtain an increase for a dependent wife.

A person in receipt of a Category A Pension which started before April 2003 is entitled to an increase of the pension in respect of dependent children, but the increase is reduced if the pensioner's spouse earns over a specified level. For claims that start after 6 April 2003, the needs of children are met through the Child Tax Credit.

### **Additional State Pension (SERPS and Second State Pension)**

The second-tier element of the State Pension is called the Additional State Pension. People can contract out of additional State Pension through an occupational pension scheme or an appropriate personal pension scheme. In return for lower National Insurance payments, or a rebate of NICs, such schemes deliver the benefits of the additional pension, rather than the state.

**From 1978 to 2002**, the additional State Pension element of the State Pension was delivered under the **State Earnings-Related Pension Scheme (SERPS)**.

Under SERPS, a pensioner receives an additional State Pension calculated on a formula in relation to contributions and earnings paid after the start of the scheme in 1978.

Additional State Pension is worked out on the basis of complete tax years. The first step is to work out for each complete tax year from 1978/79 until the end of the tax year before the person reaches State Pension age, the total of a person's earnings on which he or she paid standard-rate Class 1 NICs. The qualifying level of earnings for the basic State Pension, ie. the lower earnings limit for NI purposes, applicable to each of these tax years is deducted from the annual earnings. Those earnings are revalued to reflect changes in average earnings.

The resulting surplus earnings in the tax years from 1978/79 to 1987/88 are multiplied by 25 per cent and then divided by the total number of years between 1978/79 (or the tax year in which the person reached age 16 if later) and the one ending before the one in which State Pension age was reached.

The resulting surplus earnings for the tax years from 1988/89 to the one ending before the person reaches State Pension age are multiplied by a figure between 20 and 25 per cent and then divided by the total number of years between 1978/79 (or the tax year in which the person reached age 16 if later) and the one ending before the one in which State Pension age was reached. The figure to use is to be reduced from 25 per cent for

people reaching State Pension age in 1999/2000 by a half percentage point each year. The figure of 20 per cent will then apply to people reaching State Pension age in 2009/10 or later.

The two amounts are then added together and divided by 52 to give the weekly rate of additional State Pension under SERPS.

Widows and widowers can inherit up some of their late spouse's SERPS depending upon their circumstances. The maximum amount they can inherit depends on the day that the bereaved person reached, or is due to reach, State Pension age. Those who reached State Pension age before 6 October 2002 will be able to pass on a maximum of 100 per cent SERPS. Those who reach State Pension age on or after 6 October 2010 can pass on a maximum of 50 per cent. There is a sliding scale for those who reach State Pension age between these dates.

For periods before April 1997 where a person was contracted-out of SERPS it was still possible for them to accrue small amounts of additional State Pension, payable in addition to the pension they received from their occupational or personal pension. From April 1997 to April 2002, a person contracted-out of the additional State Pension scheme could not accrue rights to additional State Pension.

**From April 2002, the Government reformed SERPS through State Second Pension.**

State Second Pension provides a more generous additional State Pension to employees on low or moderate earnings than SERPS. The different bandwidths for State Second Pension are as follows:

<b>Bandwidths for 2005/06</b>	<b>Percentage rates April 2002 – 5 April 2010</b>	<b>Percentage rate from 6 April 2010</b>
<b>Band 1</b> £4,264 – £12,100	twice relevant SERPS percentage	40%
<b>Band 2</b> £12,101 – £27,800	half relevant SERPS percentage	10%
<b>Band 3</b> £27,801 – £32,760	same as SERPS Percentage	20%

For the first time, State Second Pension allows certain carers and people with a long-term illness or disability, whose working lives have been interrupted or shortened to build up an additional State Pension.

A reduced rate of State Second Pension can be paid even if the employee contracts out into an occupational or personal pension scheme, depending on their level of earnings.

Additional State Pension in payment is increased annually in line with prices and increases are payable if a pensioner postpones claiming State Pension. A person who has surpluses in one or more years, but has insufficient qualifying years to obtain entitlement to a basic State Pension, may receive an additional State Pension even though there is no basic State Pension entitlement.

### **Payment of State Pension**

State Pensions, including State Second Pension are normally paid directly into a bank or building society account. An alternative of weekly cheques which can be cashed at a post office is available to those people for whom direct payment is not suitable. Other benefits to which the pensioner may be entitled, such as Attendance Allowance or Disability Living Allowance for disabled persons needing care and assistance, or the income related Pension Credit, which guarantees income at a prescribed level, can be paid with the pensioner's State Pension.

### **Benefits for Widows and Widowers**

Most widows and widowers under State Pension age are entitled to a Bereavement Payment of £2,000. Widows and widowers with dependent children may be entitled to Widowed Parent's Allowance. Those who do not have dependent children but are aged between 45 and State Pension age may receive Bereavement Allowance payable for 52 weeks. These benefits cease if the widow or widower remarries and are not payable while the widow or widower lives with a partner to whom he or she is not married.

Although in most cases Bereavement Allowance or Widowed Parent's Allowance will have ceased some years before the widow or widower attains State Pension age, some State Pension may be payable on the basis of the deceased spouse's contribution record to those who qualified for Bereavement Allowance or Widowed Parent's Allowance above the age of 45, provided that they have not remarried.

## **NATIONAL INSURANCE CONTRIBUTIONS**

There is no liability for National Insurance contributions (NICs), that is contributions to the State social security scheme, either for employees or employers, in respect of employees who earn in any week (or if they are paid monthly or other than weekly a sum averaged weekly at) less than the Lower Earnings Limit (LEL), currently £82 per week. This figure is set at the current weekly rate of Category A basic State Pension, rounded, if necessary, to the nearest £1 below. Accordingly, the LEL is increased each April, subject to the rounding, in line with increases in the State Pension rate. A person who has paid no NICs because he or she earns less than the LEL will not build up entitlement to contributory benefits, unless that person chooses to pay voluntary Class 3 NICs (see below).

Where an employee's earnings reach or exceed the LEL but do not exceed the Primary Threshold (currently £94 a week, in line with the income tax personal allowance), he or she will not actually pay NICs. But in order to protect his or her entitlement to contributory benefits, that employee will be deemed to have paid a contribution. Those employees with earnings between the Primary Threshold and the Upper Earnings Limit (UEL) – now £630 a week – are liable to primary Class 1 NICs at the standard rate of 11 per cent. Employees are liable to contributions of 1 per cent on earnings above the UEL, which is now set at between 6.5 to 7.5 times the Primary Threshold.

Employers are currently liable to pay secondary Class 1 NICs on employees' earnings above the Secondary Threshold of £94 a week with no maximum limit. These contributions are due at the rate of 12.8 per cent. As with the Primary Threshold, the Secondary Threshold is in line with the weekly equivalent of the income tax personal allowance. This means that no income tax or employee's and employer's NICs are payable on earnings below this limit.

Employers are also liable for Class 1A NICs on benefits in kind provided to employees (for example, company cars and fuel) and for Class 1B NICs on any items included in a PAYE (Pay As You Earn) tax settlement with the Inland Revenue. Both are due at the same rate as secondary Class 1 NICs (12.8 per cent).

No NICs are payable in respect of persons aged under 16 and employees are not required to pay if aged above State Pension age. Employers remain liable for secondary Class 1 NICs for persons over State Pension age.

Where an employee is contracted-out of the State Second Pension, the Class 1 NICs rates are reduced. Also, there is a residual right for married women and widows who obtained the right before 1977 and continued to pay such contributions thereafter to pay reduced rate contributions at 4.85 per cent of earnings between the Primary Threshold and the UEL and 1 per cent on earnings above the UEL, but these contributions give no right to benefit.

The Class 1 NICs rates are shown in Annex A. Liable for "contracted-in contributions" means that the contributors are either members of the State Second Pension or members of an appropriate personal pension (APP) scheme (but see section below on APPs); liable for "contracted-out contributions" means that the contributors are

members of a contracted-out occupational pension scheme.

Self-employed people are liable to pay flat rate (Class 2) NICs currently at a weekly rate of £2.10, but those with low earnings (currently £4,345 per year) may apply to be exempt from liability. Self-employed people must also pay earnings related (Class 4) NICs at a rate of 8 per cent where their taxable profits in a tax year exceed the Lower Profits Limit (currently £4,895, in line with the annual income tax personal allowance) and up to the Upper Profits Limit of £32,760 and 1 per cent on profits above £32,760. Class 2 NICs give entitlement to a range of contributory benefits, except contribution-based Jobseeker's Allowance and State Second Pension. Class 4 NICs do not give any benefit entitlement.

People who have no liability to pay Class 1 or Class 2 NICs (eg because they are neither employed nor self-employed, or because their earnings are below the LEL, or who in any year have paid insufficient Class 1 or 2 NICs for that year to be a "qualifying year" for benefits purposes) may pay flat rate (Class 3) NICs (currently at the rate of £7.35 per week). This is intended to make good any deficiency in their contribution record for the year in question regarding entitlement to State Pension.

The contributions are paid into the National Insurance Fund which is used to pay the basic State Pension and State Second Pension, and other contributory benefits - bereavement, unemployment and short-term and long-term incapacity benefits.

## Rates of Class 1 Contribution for 2005/2006

<b>PRIMARY CONTRIBUTION (EMPLOYEE)</b>			
<b>RANGE OF WEEKLY EARNINGS</b>	Not Contracted Out Rate %	Contracted - Out Rate (COSR and COMP schemes)(1) %	Reduced Rate for Married Women and Widow Optants %
<b>Below £82.00</b>	Nil	Nil	Nil
<b>£82.00- £94.00</b>	Nil (3)	Nil (3)	Nil
<b>£94.01- £630</b>	11%	9.4%	4.85%
<b>Over £630</b>	1% on all earnings		

<b>SECONDARY CONTRIBUTION (EMPLOYER)</b>			
<b>RANGE OF WEEKLY EARNINGS</b>	Not Contracted-Out Rate %	Contracted-Out Rate COSR schemes (1) %	Contracted-Out Rate (2) COMP schemes (1) %
<b>£0.00 - £94.00</b>	Nil	Nil	Nil
<b>£94.01 - £630</b>	12.8%	9.3%	11.8%
<b>Over £630</b>	12.8%		

### Notes

1. COSR = Contracted - Out Salary related.  
COMP = Contracted - Out Money purchase.
2. An additional age-related rebate also applies to COMP schemes. This is paid direct to the scheme following the end of the tax year.
3. No employee contributions are actually payable in respect of earnings between the LEL and the Primary Threshold but, to protect benefit entitlement, contributions are treated as having actually been paid.

## Rates of Classes 2, 3 and 4 Contributions for 2005/2006

<b>CLASS 2 (SELF-EMPLOYED RATE)</b>	£2.10 a week
<b>CLASS 2 SMALL EARNINGS EXCEPTION</b>	£4,345 a year
<b>CLASS 3 (VOLUNTARY CONTRIBUTIONS)</b>	£7.35 a week
<b>CLASS 4 (SELF-EMPLOYED RATE)</b>	8% between £4,895 and £32,760 pa; 1% on earnings above £32,760 pa

## **NON-STATE SCHEMES (PRIVATE SCHEMES)**

### **OCCUPATIONAL PENSION SCHEMES**

#### **Legal Position**

Pension provision is voluntary, and so it is up to an employer (or more rarely a group of employers, usually in a single industry) to decide whether to set up a scheme and, if he does, in the light of actuarial and cost considerations, what the provisions of the scheme should be: for example, the rates of contributions and benefits, who is liable to pay the contributions and when benefits are payable. Usually an employer consults with trade unions and employee representatives before setting up a scheme and drawing up scheme rules, but this is not obligatory.

Some employers operate a number of separate schemes, eg for factory workers, office staff and executives; others provide a single scheme for all their employees; while others may provide a scheme for only certain of their employees, eg by restricting pension arrangements to executives or salaried staff or to employees who have worked for the company for at least 2 years. Equal treatment requirements mean that part-time staff, and more recently, fixed term workers have to have access to schemes.

For tax reasons only employees of the employer who establishes a scheme may belong to the scheme. A company with a number of subsidiaries may establish a single scheme covering employees in them all or each subsidiary may establish its own scheme.

#### **Voluntary Membership**

Before 6 April 1988 employers could make membership of an occupational pension scheme a condition of employment, but from that date the Social Security Act 1986 prohibited this from being a requirement. This means that employee membership is voluntary. Some employers require employees to be members of their scheme unless they "opt out" of the scheme (eg the Civil Service); others require them formally to "opt in" before they can become members (eg the Post Office).

Some schemes impose a requirement for an employee to have attained a specified age, or to have completed a specific length of service, before becoming eligible to join the scheme, but pension rights statutorily vest after 2 years' service in pensionable employment, including periods of prospective membership which subsequently count towards the calculation of the pension. From April 2006, employees who leave the scheme after having been members for at least three months but less than two years will be able to receive either a refund of contributions less tax, or a cash equivalent transfer value which can be transferred to another occupational scheme or a personal pension.

#### **Industry-Wide Schemes**

A few occupational pension schemes are operated by, or on behalf of, a number of employers in a particular industry. These "industry-wide schemes" operate particularly where an industry consists of a large number of small employers and fairly mobile workforce, eg the plumbing and mechanical services industry. Individual employers in the particular industry are not obliged to participate in an industry-wide scheme. They may establish their own scheme or make no provision at all.

### **Statutory Obligations where an Occupational Pension Scheme is Established**

If an employer (or group of employers) sets up an occupational pension scheme, certain statutory obligations must be met:

- There must be equal treatment between men and women as regards eligibility for membership of the scheme, rates of contributions and benefits, and the age at which, and circumstances under which benefits are payable.
- Members who have left pensionable service, whether by leaving the employment or simply opting out of the scheme, have the right to a transfer of their pension rights from one occupational pension scheme to another, or to a personal pension scheme, or to be used to purchase an annuity from an insurance company.
- Schemes must preserve the pension rights of those who leave the scheme before normal pension age unless those rights are transferred to another form of pension provision.
- A scheme must satisfy prescribed conditions to obtain tax approval and thus obtain tax advantages in relation to employer and member contributions and to investment income and capital gains. These include maximum levels of benefit, minimum age for pension and maximum member contributions.
- A scheme used for contracting-out of the State Second Pension must satisfy prescribed requirements (see below). It is not necessary to contract out to operate an occupational pension scheme, but in practice the vast majority of schemes are used for contracting-out.)
- Scheme trustees and managers have a statutory obligation to disclose information about the scheme to members and prospective members, spouses of members and of prospective members, beneficiaries under the scheme and independent trade unions recognised to any extent for the purposes of collective bargaining in relation to members and prospective members of the scheme. They must obtain and disclose audited accounts annually and, if a defined benefit scheme, an actuarial valuation every three years.
- From April 2006 it will no longer be a requirement for obtaining the tax advantages that go with the registration of a pension scheme, that a surplus

of assets over liabilities, has to be removed from the scheme in order for full relief to be enjoyed.

## **TYPES OF OCCUPATIONAL PENSION SCHEME**

Schemes may be established on either a defined benefit (DB) (salary related) basis or a defined contribution (DC) (money purchase) basis. The trust deed and scheme rules will determine which.

### **Defined Benefit (Salary Related) Schemes**

Defined benefit schemes usually calculate pensions on a specified fraction, eg 1/60 or 1/80 or 1/120, of the member's final salary for each year of service. For tax reasons the total will not normally exceed 2/3 of final salary. "Final salary" may be defined as the individual's actual salary when pensionable service ceases, or the average salary over (or best year in) the last 3 or 5 years of service (For directors the pension is not permitted to be determined on the basis of salary during a single year to avoid a disproportionately high level of salary being awarded for the final year to obtain a high pension.) Such schemes are known as "final salary schemes".

Less commonly, defined benefit schemes can base the pension on a specified fraction of the member's earnings (normally annually indexed in some way) which the member received during the relevant employment. Such schemes, which are known as "average salary schemes", benefit workers whose maximum earning capability is not at the end of their service.

### **Defined Contribution (Money Purchase) Schemes**

Defined contribution schemes do not specify in advance at what rate the pension will be. Contributions to these schemes are based on a specified percentage of the member's earnings, or a cash amount, and can also be dependent on members' contributions (matching arrangements) and/or age and length of service. These contributions and the investments that accrue from them are used to purchase a pension or annuity on retirement. The amount of pension is based on the sum which has accrued and average life expectancy, although it also depends on interest rates and availability of gilts to underwrite the contract.

Some schemes reduce the volatility of investments by using fixed amounts of investment return or "bonuses". Bonuses are added to the member's fund each year. The bonus cannot be taken away and at retirement the total accrued fund is then used to provide the pension. This is a "with profits" policy.

There is a trend towards defined contribution schemes rather than defined benefit arrangements. At least part of this is because of administrative complexity of providing defined benefit and/or occupational pensions, but in the most part the trend seems to be

a result of longevity, poor market returns, and a growing risk awareness amongst employers. Each of these factors has either had a downward pressure on assets or upward pressure on liabilities or both. However the trend has been ongoing since the 1960s.

### **Mixed Benefit Schemes and Hybrid Schemes**

Some schemes have both defined benefit and defined contribution elements. A **hybrid scheme** provides a member with a pension which is based on the better of the defined benefit pension or the defined contribution pension calculated by reference to that member's service and contributions. A **mixed benefit scheme** has two sections, one defined benefit and the other defined contribution. Scheme rules will say which employees can join each section and the circumstances in which members can move between sections.

### **Tax Free Lump Sum**

Although pensions under occupational pension schemes must for tax reasons be paid periodically - normally they are paid monthly into the pensioner's bank account - the Inland Revenue (tax authority) permits a proportion of the pension of a defined benefit or defined contribution scheme to be commuted to a tax free lump sum not exceeding 3/80 of final salary for each year of service. In practice, almost all schemes take advantage of this provision with or without the option for commutation.

## **CONTRIBUTORY AND NON-CONTRIBUTORY SCHEMES**

An occupational pension scheme may be "non-contributory" which means that only the employer pays contributions, or "contributory" which means that the employee members contribute as well. The employer, in setting up the scheme, will determine and lay down in scheme rules whether members must contribute and, if so, at what rate. To satisfy tax requirements employers must contribute to the scheme. (Note that this does not apply to Group Personal Pensions, although the employer will usually contribute.)

In a defined contribution scheme, whether contributory or not, the employer will pay into the scheme a fixed percentage of the earnings or a cash amount of each employee member. Under a defined benefit scheme the employer meets the "balance of cost". This means that the employer will have to make good any shortfall if there are not enough assets in the scheme to meet its liabilities. The actuary is required to undertake a valuation of the pension scheme at intervals of not more than three years.

## **WHICH TYPE OF OCCUPATIONAL PENSION IS CHOSEN AND WHY?**

### **Defined Benefit Schemes**

Employees in a defined benefit scheme know before retirement what their pension rate will be in relation to their earnings and will have a guarantee of that rate.

The actuary in making a valuation and report will take into account the existing assets of the scheme, the value of the contributions to be paid by the employer, and where payable, by the employees, and what is likely to accrue from them and also the current and future liabilities of the scheme. He will have made assumptions as regards life expectancy, the labour market, the future prospects for investments and trends in earnings, and will have been informed by the employer about future prospects for the company, eg whether the company will increase its workforce or lay off workers in the years ahead.

In the Pensions Act 2004 new scheme funding requirements replace the Minimum Funding Requirement with a scheme specific funding framework. This will allow each scheme the flexibility to adopt the most appropriate funding strategy for meeting its specific pension commitments.

Unlike the Minimum Funding Requirement, scheme-specific requirements will allow individual schemes to adopt funding strategies and contribution levels appropriate to their specific circumstances. With a new focus on partnership between trustees and sponsoring employers, we would normally expect agreement to be reached on issues fundamental to the ongoing viability of the scheme.

Under the new arrangements trustees and employers will be required to determine an appropriate period over which funding deficits will be corrected, taking into account the particular circumstances of their scheme. Important factors will include the age profile of the scheme's members.

Defined benefits schemes with the obligations they place on employers, regardless of market and investment conditions, mean that smaller employers are less willing to take on the risks associated with providing their employees with a guaranteed level of pension compared with final earnings. Increasing pressures of FRS17 and market under performance means that we are seeing this reluctance to bear the risk of provision spreading up the scale to larger employers as well.

### **Defined Contribution Schemes**

Under a defined contribution scheme employers and employees who are liable to contribute, will always know precisely what their future contribution liability will be. The 'risk' is on the individual – in that the individual will have to meet the difference between the value of their pension and the amount of pension they had hoped to retire on. The advantage associated with this type of scheme is mobility. The contributions and investment income can be tracked throughout the period they are building up, and more easily move with the employee from job to job. Good fund management is needed in

order to minimise the risk of fluctuations in fund value close to retirement and to ensure that the best deal is got in purchasing an annuity.

### **Which to Choose**

Employers who wish to set up a new scheme or change to a different type of scheme, need to consider various factors when deciding which one will best meet their requirements. These include the average age of the workforce, the effects of changes in the employment market and employment practises, and how much they can afford (or are willing) to contribute. Many employers operate more than one type of scheme, but these are usually designed to cater for different sections of the workforce. Employees therefore, are not generally offered a choice of schemes but where they are, they should seek independent advice before reaching a decision.

The Pension Act 2004 makes a statutory obligation on employers to consult prospective and affected active members of pension schemes before making major or significant changes to future pension arrangements. These employees and/or their representatives will have a process to feed in their views about proposed changes to their employer for consideration, before a decision is made about future pension arrangements.

### **HOW THE SCHEME IS FUNDED AND ITS ASSETS ADMINISTERED**

It is a condition for a scheme to obtain tax approval that it is set up as an irrevocable trust. Under trust law the assets of the scheme are held by trustees who have a duty of trust to use the assets for the benefit of the beneficiaries of the trust (ie employees with rights accruing in the scheme, former employees with deferred pension rights, existing pensioners and survivors with rights on the members' deaths) as laid down in the trust deed. The trust is established entirely separately from the sponsoring employer(s) by whom it is set up. If the sponsoring employer becomes insolvent or goes into liquidation, company creditors cannot claim against the pension fund and the scheme may continue to provide benefits to present and future beneficiaries or its assets used to purchase annuities for members and pensioners..

#### **Trustees**

The scheme's trustees are appointed in accordance with the trust deed setting up the trust. The trust deed will invariably provide for the employer to be represented among the trustees. This is to ensure that the trustees' actions do not lead unduly to additional liabilities that the employer may ultimately be required to pay.

The trust deed may also provide for the appointment of trustees nominated or elected by employee representatives (frequently through, or after consultation with, trade unions) or more rarely, nominated by pensioners. Under DWP rules, scheme members are allowed to choose at least one-third of the scheme's trustees. If all the trustees of the scheme are companies, rather than individuals, the members can select at least one-third of the directors of each trustee company. Occasionally a trust deed may

provide/require that there should be a trustee with no connection with either the employer or employees, and this is a condition imposed by the tax authorities for schemes established for company directors.

The Pension Act 2004 requires trustees to be conversant with relevant scheme documentation, and have appropriate knowledge and understanding of pensions and trust law and of the principles underpinning investment and funding. It imposes the same requirements on individuals exercising trustee functions on behalf of a corporate trustee. The Regulator will issue a Code of Practice to give practical guidance on the sorts of knowledge required. The aim is to ensure that trustees are competent and confident in carrying out their duties.

Following the removal (by the Finance Act 2004) of the requirement on occupational schemes to run down excessive actuarial surpluses in order to keep tax advantages, the Pensions Act modifies existing restrictions on payments to the employer from such surpluses. Regulations will specify that such payments can only be made where sufficient funds remain in the scheme to cover the accrued rights of all beneficiaries.

Regulations require there to be an independent trustee in a scheme where the sponsoring employer has become insolvent. This is to protect the members and ensure the pension fund is secure against the ex-employers' creditors. A scheme can also invite an independent trustee to be involved the scheme at any time, depending on the trust deed, typically to provide expert advice or support.

In acting as trustee the employer and employee representatives have a legal obligation to act not in their own interest, nor as representatives of those who nominated them, but in the interest of beneficiaries of the trust in accordance with the terms of the trust deed.

The trustees must, unless exempted, set out in a statement of investment principles the strategy they have adopted for the investment of scheme assets. Alternatively, they may arrange for the assets to be paid over to an insurance company under an insurance policy or annuity contract. For most investments, the trustees (other than a corporate trustee) will normally leave the day to day management of the investments to an authorised fund manager as they will not be authorised under the Financial Services and Markets Act 2000 to make such investments. Trustees may also delegate their discretion to make decisions about investments to the fund manager.

### **Trust Deed and Scheme Rules**

The trust deed establishes the scheme: the scheme rules will lay down how the scheme is to operate and will state what benefits are payable and when, but they may give the trustees discretion in certain areas, eg whether to pay pensions before pension age to those giving up work on ill health grounds, or whether to pay increases of pensions in payment over and above any statutory obligations. Whether they exercise their discretion may depend on the current state of fund assets. Beneficiaries under the trust may legally enforce their rights under the trust (but not expectations as to the exercise of discretion) and they may take action against the trustees, if the latter act other than in

the fiduciary interest of the beneficiaries.

## **SELF-ADMINISTERED AND INSURED SCHEMES**

### **Self-Administered Schemes**

A "self-administered" scheme operates its own pension fund. The trustees lay down guidelines on the proportion of fund assets to be invested in particular categories of investment, eg equities, Government bonds, managed funds established by insurance companies or other financial institutions, unit trusts, real property (land), bank deposits. Day to day investment decisions are taken either directly by investment managers employed by the trustees and authorised under the Financial Services and Markets Act, or by a bank, investment company or insurance company with whom the trustees have a contract.

Trustees regularly compare the performance of different fund managers when deciding which investment company (or different companies for different categories of investment, or proportions of the fund) to choose. Self-administered schemes will employ administrative staff to perform the administration of the scheme and normally pay pensions directly to pensioners from their own assets, but may purchase an annuity from an insurance company on a member's retirement.

### **Insured Schemes**

Where the scheme is an "insured scheme", the trustees enter into a contract with an insurance company, either under a defined benefit scheme to provide the benefits laid down in scheme rules, or under a defined contribution scheme to invest the contributions paid. In the former case, the insurance company will specify the premiums which the employer needs to pay (in addition to the employee contributions).

Either pensions will be paid from the assets of the insurance company, or more usually the trustees will purchase an annuity from either the insurance company with which the assets have been accruing or another insurance company. For example, one insurance company may provide better investment returns, but another provide better annuity rates.

### **Annuities**

If the scheme does not itself pay pensions from its own assets, an annuity will be bought on retirement from the sum which has accrued in respect of the beneficiary. It will be calculated actuarially on the basis of life expectancy laid down in mortality tables; normally annuities for women are lower than for men with the same sum accrued because of their longer average life expectancy. (In a defined contribution scheme this means that over an average retirement the man and woman will receive the same amount.)

Annuities may be established to pay pensions at a flat rate for life, or may make provision for indexation, but with a lower initial rate. They will normally terminate at death - this means that payment may be for 40 years or only a week, with the latter subsidising the former and with no sum available to be inherited if the pensioner dies early - or also provide for a pension for the pensioner's survivor, or without tax advantages they may be for life with a fixed guarantee so that if the annuitant dies in less than 5 or 10 years there will be an outstanding sum available as part of the deceased's estate.

## **PUBLIC SERVICE SCHEMES**

Public service schemes, ie schemes for employees of national or local government, the National Health Service (NHS), armed forces, police and fire services, and teachers, are set up under Acts of Parliament. They are not required to satisfy the conditions for tax approval to have tax exemption and, except for local government schemes, are not set up as irrevocable trusts and are not funded. Benefits under some public service schemes are provided directly from taxation; others, such as local government, are fully funded on the same basis as private schemes or, as with NHS and teachers, are notionally funded.

## **UNAPPROVED SCHEMES**

Exceptionally some private pension arrangements are neither actuarially funded, nor set up under a trust and do not have tax approval. They are usually set up for highly paid executives to run alongside the tax approved, funded trust pension scheme. This is because tax legislation places a "cap" or restriction on the earnings for which there may be tax approval, £105,600 for 2005/2006, and also limits the rate of accrual. Where no tax advantages exist, employers may select arrangements which suit themselves and individual employees.

## **RELATIONSHIP WITH THE STATE SOCIAL SECURITY SCHEME**

There are two ways in which an employer's occupational pension scheme can affect someone's entitlement to the State Pension - where the occupational scheme is used to "contract out" its members of the State Second Pension; and/or where it is an "integrated scheme".

## **CONTRACTING OUT**

The additional State Pension (known as the State Earnings Related Pension Scheme (SERPS)) was introduced on 6 April 1978 and, from that date, employers have been able to contract out their employees into an occupational pension scheme. Up to 5 April

2002 all of the second-tier pension provision built up by employees contracted out into their employers' scheme would have derived from the occupational scheme and not the State.

However, when State Second Pension reformed SERPS on 6 April 2002, the contracted-out rebate for low and moderate earners did not fully reflect the more generous additional State Pension given up through contracting out. So, from that date, low and moderate earners have been able to build up small amounts of State Second Pension in addition to the benefits being built up in their contracted-out occupational pension scheme. This provision is intended to ensure that people are not placed at a disadvantage through contracting out into an occupational scheme.

**There are two main types of contracted-out occupational schemes:**

- Contracted-out Salary Related (COSR) Schemes — also known as Defined Benefit Schemes; and
- Contracted-out Money Purchase (COMP) Schemes — also known as Defined Contribution Schemes (it is only since 6 April 1988 that employers have been able to contract out their employees into this type of scheme).

With a COSR scheme, both the employer and employee pay a reduced rate of National Insurance contributions (NICs) which are commonly referred to as “rebates”. The rebates apply to all earnings falling between the Lower Earnings Limit and the Upper Earnings Limit and are currently set at 3.5 per cent for the employer and 1.6 per cent for the employee.

With a (COMP) scheme, the rebates are currently set at 1 per cent for the employer and 1.6 per cent for the employee. A further rebate is then paid by the Inland Revenue direct to the scheme for investment on behalf of the employee. The rebate increases with age and is paid at the end of the tax year to which the relevant earnings relate.

The rebate rates are determined by the Secretary of State following advice from the Government Actuary and must be reviewed at least every five years. In broad terms they are to compensate for the additional State Benefit given up and are set at a neutral rather than generous level. They are not intended to act as an incentive to contract out.

**COSR SCHEMES: Pre - April 1997**

Prior to 6 April 1997, in order for an employer to contract out his employees into a COSR scheme, the employment had to be covered by a certificate issued by the then Occupational Pensions Board. As a condition of contracting out, the scheme had to pay a guaranteed minimum pension (GMP) providing benefits broadly equivalent to those given up in SERPS. The GMP cannot be paid before State Pension age. A further condition requires that the scheme must provide a widow's pension set at half the member's GMP entitlement in the event that the member dies before his spouse. This

provision was extended to widowers in respect of all GMPs accrued on or after 6 April 1988 and is shortly to be extended to civil partners.

Schemes may postpone payment of GMPs to persons working beyond State Pension age but, except in certain prescribed circumstances, postponement may only take place with the member's consent. Where payment is postponed the scheme must provide increments to take account of the GMP forgone.

There is no requirement for GMPs to be increased once they are in payment providing that they were built up between 6 April 1978 and 5 April 1988. However, to ensure that the GMP retains its purchasing power, any annual percentage increase in the Retail Prices Index (RPI) will be matched by a corresponding increase to the additional State Pension. GMPs in payment that derive from pensionable service on or after 6 April 1988, must be increased by the annual percentage increase in the RPI capped at 3 per cent. Increases in RPI above that are met through an increase to the additional State Pension.

#### **COSR SCHEMES: Post - April 1997**

The conditions that schemes had to meet in order to contract out changed from 6 April 1997. From that date schemes no longer have to provide a GMP as a condition of contracting out. Instead they have to meet an overall test of scheme quality known as the "Reference Scheme Test". Schemes do however have to pay a GMP in respect of pensionable service built up before that date.

Some of the key conditions set out in the reference scheme test require that there must be an accrual rate of at least 1/80<sup>th</sup> of final salary for each year of service and that pensions in payment deriving from pensionable service on or after 6 April 1997 must be increased by the annual percentage increase in RPI capped at 5 per cent. From the same date the link with the State scheme was broken and people no longer receive an increase to their additional State Pension when the annual percentage increase in RPI exceeds the new cap. However, the breaking of the links with the State scheme applies only to post-April 1997 pensionable service.

#### **COSR SCHEMES: Post - April 2005**

The only significant change to the contracting-out conditions from 6 April 2005 relate to the rate at which schemes must increase pensions in payment. Increases to pensions deriving from pensionable service built up on or after that date must still be made by reference to the annual percentage increase in RPI, but the cap is reduced to 2½ per cent. Having to increase pensions up to a guaranteed minimum imposes a significant cost on schemes and the higher the guarantee, the higher the costs. Consequently, reducing the cap to 2½ per cent eases the financial burden on schemes and helps to balance the cost imposed by the Pensions Protection Fund (PPF). The PPF was established by the Government on 6 April 2005 to provide greater protection for members of occupational salary-related schemes.

## **COMP SCHEMES: Pre - April 1997**

The main contracting-out conditions that applied to schemes pre-April 1997 were:

- for the employer to pay a "minimum payment" direct to the scheme within a prescribed period. The minimum payment is set at a level equivalent to the combined employer/employee contracted-out rebate;
- for the protected rights part of the fund to be used to purchase a pension or annuity that is increased by the annual percentage increase in RPI capped at 3 per cent. Protected rights derive mainly from the minimum payments and the age-related rebates paid by the Inland Revenue;
- that the protected rights fund could not be used before age 60;
- that use of the protected rights fund could not be deferred beyond age 65 without member consent;
- that where the scheme member was married at the time the protected rights fund was used to provide a pension or annuity, the pension or annuity must make provision for a survivor's pension;
- that all pensions and annuities deriving from the protected rights fund must be calculated on a unisex basis (in general, annuities are lower for women because, on average, they live longer than men).

As with COSR schemes, where the annual percentage increase in RPI exceeds 3 per cent, the excess is met through an increase to the additional State Pension.

## **COMP SCHEMES: Post - April 1997**

The main changes in the contracting out conditions from that date were:

- pensions or annuities deriving from all rights (including the non-protected rights) built up on or after 6 April 1997 must be increased by the annual percentage increase in RPI capped at 5 per cent;
- from the same date the link with the State scheme was broken and scheme members no longer receive an increase to their additional State Pension when the annual percentage increase in RPI exceeds the new cap. However, the breaking of the links with the State scheme applies only to pensions derived from rights built up on or after 6 April 1997.

## **COMP SCHEMES: Post - April 2005**

There is only one major change in the contracting-out conditions. From 6 April 2005 there is no longer a need for schemes to increase pensions or annuities coming into payment on or after that date. This applies to all pensions or annuities deriving from all rights, irrespective of when those rights were built up.

## **INTEGRATED SCHEMES**

Integrated pension schemes have been in place since National Insurance Contributions and State Pensions were introduced in 1948. A number of employers who offered occupational pension schemes felt that there was some duplication between the two types of provision. To ensure that they and their employees did not have to increase their pension contributions, some employers, who operated salary-related occupational pension schemes, took account of some or all of the State Pension when calculating the occupational pension payable. The amount of reduction was based on either the State Pension rate or, alternatively, the rate of the lower earnings limit. The aim was to provide, overall, the same level of benefits.

This is also called 'claw back' – as the scheme may deduct all or part of the value of the State Pension and has been the subject of much criticism from Trades Unions.

## TAX TREATMENT OF OCCUPATIONAL PENSION SCHEMES

A retirement benefits scheme (more commonly referred to as an occupational pension scheme) which satisfies all the strict conditions laid down by statute will receive approval under section 590 of the Income and Corporation Taxes Act 1988 (ICTA 1988) (known as "mandatory" approval). If the scheme is not set up under trust it will receive "bare" approval. This means there are no automatic tax reliefs but the employee is relieved from any tax charge on the employer contributions that would otherwise arise under section 386 of the Income Tax (Earnings & Pensions) Act 2003. If the scheme is set up under irrevocable trust it will receive "exempt approved status". This means that contributions paid by the employer or employees qualify for full tax relief (from corporation tax or income tax as the case may be). Income derived from investment of those contributions is exempt from income tax and the gains obtained from disposing of those investments are exempt from capital gains tax. .

To be approved under section 590 ICTA 1988 a scheme must satisfy all the following conditions (known as the prescribed conditions):

- Benefits for employees must be a pension on retirement at a specified age not earlier than 60 nor later than 75, which does not exceed 1/60 of the employee's final salary for each year of service to a maximum of 40 years (ie 2/3 of final salary), subject to a salary "cap", £105,600 in 2005/06.
- Any widow's/widower's benefit on death after retirement must not exceed 2/3 of the pension payable to the deceased.
- Any benefit for an ex-spouse, or the widow or widower of an ex-spouse, is a benefit in relation to the scheme which satisfies the conditions set out in subsection (3A) of section 590 ICTA 1988
- An employee on retirement may commute part of the pension to provide a lump sum not exceeding 3/80 of final salary for each year of service to a maximum of 40.
- The scheme is set up with the sole purpose of providing relevant benefits which must be in respect of the member's service as an employee and payable to the member, survivor, children or personal representative.
- The scheme must be recognised by the employer(s) and employees to which it relates and details must be provided to all employees eligible to become members.
- There must be a person resident in the UK responsible for the duties imposed on the administrator.
- The employer must be a contributor (but need not be the only one). The scheme may also permit employees, but not the employer, to pay additional voluntary contribution to acquire additional benefits, subject to the limits on benefits set out above (This is an obligation under non-tax legislation).

- The scheme must be established in connection with some trade or undertaking carried on in the UK by a person resident in the UK
- No contributions may be refunded to employees.

The vast majority of occupational pension schemes are submitted for approval under section 591 ICTA 1988 which gives HM Revenue and Customs discretion to approve schemes that do not satisfy the “prescribed conditions” described above and allows for more generous benefits than those available under section 590. General guidance on how this discretion is exercised is set out in the Occupational Pension Schemes Practice Notes (IR12). Like section 590 schemes, tax treatment of section 591 schemes depends on whether they are set up as non-trust schemes (in which case they receive “bare” approval) or, trust schemes (in which case they receive “exempt” approval)

- The maximum contribution, including additional voluntary contributions, which an employee may pay in any year to an occupational pension scheme is 15 per cent of salary, subject to the earnings cap. There is no restriction on the amount which an employer may pay, but there are restrictions on the level of assets which a scheme may hold in relation to its liabilities - this must not exceed 105 per cent. Inland Revenue permits the surplus to be reduced over a 5 year period by increasing benefit rates (subject to the maximum of 2/3 of final salary), providing additional benefits, reducing contribution rates or providing a "contribution holiday" for employer and/or employees, or making a refund (taxable) to the employer.

### **Simplification of tax regimes**

From 6 April 2006, Pension simplification will replace the current existing tax regimes for personal and occupational pensions with a single universal regime for tax-privileged pension savings. The numerous controls in the current regimes will be replaced by 2 key controls in the new regime;

- A lifetime allowance on pension savings, set initially at £1.5m.
- An annual allowance set initially at £215,000. Contributions will be given tax relief on the higher of 100 per cent of relevant earnings (up to the annual allowance) or £3,600.
- A tax charge on benefits paid which are valued as being in excess of the lifetime allowance. This charge is 25 per cent of the excess if paid as pension and 55 per cent if paid as lump sum. Pension savings increased within a tax year by more than the annual allowance are taxed at 40 per cent of the excess.
- In order to value the capital worth of defined benefits for the purpose of the lifetime allowance, there will be a single valuation factor of 20:1. A valuation factor of 10:1 will be used to measure the deemed annual increase for the purpose of the annual allowance. Pensions already in payment at 5 April 2005

will be treated as having used part of an individual's lifetime allowance and will be valued at 25:1

- All Schemes will be able to pay tax-free lump sums of up to 25 per cent of the value of the pension rights. The maximum permissible tax-free lump sum rises, under simplification, to £375,000 (25 per cent of lifetime allowance). Lump sum rights for pre simplification can also be given transitional protection.
- Transitional arrangements will protect pension rights built up before 6 April 2005. There will be two options for transitional protection from the Recovery charge:
  - **Primary Protection** which will be given to the value of the pre-April 2005 pension rights and benefits in excess of £1.5 million. This value will be indexed in parallel with the indexation of the statutory lifetime allowance up to the date that benefits are taken; or
  - **Enhanced Protection** which will be available to individuals who cease active membership of approved pension schemes before April 2005. Provided that they do not resume active membership in any registered scheme, all benefits coming into payment after April 2005 normally will be exempt from the recovery charge.

## **PENSIONS OMBUDSMAN AND PENSIONS COMPENSATION SCHEME**

All private pension provisions fall under the jurisdiction of the Pensions Ombudsman. The Pensions Ombudsman is appointed under Act of Parliament and is independent of the Government. He can investigate and rule on claims of maladministration and disputes of fact or law between scheme members and their pension scheme; trustees of different schemes; and employers and schemes. The Ombudsman will issue a determination on all cases he investigates which is enforceable through the courts.

### **The Pension Protection Fund**

The Pension Protection Fund (PPF), which went live on 6 April 2005, is a non-departmental public body which will protect members of defined benefit schemes by paying compensation if their employer becomes insolvent and the pension scheme is under funded.

The PPF will ensure people still have the secure retirement they were expecting by paying:

- 100 per cent level of compensation for people who have reached the scheme's pension age and for those under the scheme's pension age who are either in receipt of survivors' benefit or already in receipt of pension on the grounds of ill-health;
- 90 per cent for people below that age, subject to an overall benefit cap.

In order to have sufficient funds to pay compensation, the PPF will charge compulsory annual levies on all defined benefit schemes and take in the remaining assets of any insolvent company's scheme that enters the PPF.

## **REGULATION**

### **The Pensions Regulator**

Under the Pensions Act 2004, from 6 April 2005, the new Pensions Regulator replaced the Occupational Pensions Regulatory Authority (Opra). It builds on Opra's expertise and experience, and introduces a new proactive and risk-based approach to regulation. The Pensions Regulator will concentrate its resources on schemes where there is the greatest risk to the security of members' benefits.

### **The Pensions Regulator's objectives**

- Protect the benefits of members of work-based pension schemes;
- Reduce the risk of situations arising that may lead to claims for compensation from the Pension Protection Fund;
- Promote the good administration of work-based pension schemes.

### **The Pensions Regulator's powers**

The Pensions Regulator inherits Opra's powers, and has additional new powers, including the power to:

- Freeze a scheme, for up to six months, thus protecting members' benefits or scheme assets, while the Pensions Regulator investigates the problem;
- Issue improvement notices or third party notices to schemes, directing them to remedy the problems identified, within specific timescales - a failure to comply may result in a civil penalty;
- Disqualify, prohibit (or impose fines on) trustees; appoint independent trustees;
- Impose a statutory obligation on certain persons involved with a scheme to report suspected breaches of legislation and certain notifiable events, which are specified in regulations, to the Pensions Regulator;
- Increased powers to gather information, including issuing scheme return notices which will enable the Pensions Regulator to identify schemes that are most likely to present a risk to members' benefits;
- Request reports by skilled persons;
- Use measures to combat pension liberation and to ensure that liberated funds are repatriated to a member's pension scheme where possible;
- Issue Contribution Notices to a person or a company involved in a deliberate act to avoid pension liabilities, directing them to put a specified amount of money in the pension scheme;
- Issue Financial Support Directions to an associate of an employer, requiring that the recipient put in place appropriate financial support for an occupational pension scheme, where the sponsoring employer of the scheme is a service company, or is insufficiently resourced;
- Issue clearance statements, which give assurance to a person that a particular act, failure to act, or set of circumstances related to that person during the relevant period, will not lead to the issue of a contribution notice or a financial support direction, thus enabling certainty during business transactions. However, if there is a material change in circumstances, or the circumstances described are not real when the application for clearance was made, the Pensions Regulator is not bound by the clearance statement.

The Pensions Regulator will issue codes of practice and guidance to help trustees, employers and others understand how to comply with legislation.

### **Governance of the Pensions Regulator / Functions**

The governing board of the Pensions Regulator comprises one non-executive chair, five non-executive members, the chief executive, and three executive directors. The non-executive members make up the Non-executive Committee established by the Pensions Regulator, and discharge its non-executive functions.

The Determinations Panel, appointed by the Pensions Regulator is responsible for carrying out determinations related to individual cases, where the Pensions Regulator seeks to use its powers. It is independent of the Pensions Regulator and

it is not involved in the investigation of cases. The Determinations Panel chair and members are people with legal, business or pensions knowledge.

The Pensions Regulator may authorise any member of its staff, any executive member, and any of its committees to exercise, any functions on behalf of the Pensions Regulator. The staff of the Pensions Regulator can make some decisions.

The Pensions Regulator Tribunal is an independent body, set up to hear references on determinations issued by the Pensions Regulator. Any directly affected person is able to refer a determination to the tribunal. The Pensions Regulator must act in accordance with the direction of the tribunal.

### **The Financial Services Authority (FSA)**

The FSA received its full powers under the Financial Services and Markets Act. Among other things, it is responsible for the regulation of investment products, including personal pensions. This means that it regulates the sales process of personal pensions, and also various other parts of the personal pension regime.

## **PERSONAL PENSIONS**

Personal pension schemes are established by financial institutions (principally insurance companies) and, therefore, joining is not restricted to employees of a specific company.

### **Appropriate Personal Pension Schemes**

An appropriate personal pension (APP) scheme is a personal pension scheme which an individual may join in place of State Second Pension. To get an appropriate scheme certificate from the Secretary of State, the scheme must satisfy certain conditions about the provision of "protected rights" (which are explained below).

Where the employee joins an APP scheme, the employer and employee continue to pay National Insurance contributions at the full rate as if they were paying into State Second Pension. On receipt of the employer's end of year return, the Inland Revenue pays an amount, based on the earnings on which National Insurance contributions have been paid, called the "minimum contributions", direct to the APP scheme.

The current legislation requires that these percentages are reviewed at least once every five years.

The minimum contributions, certain transfers and other payments and tax rebates and the investments that accrue from them become protected rights. From age 60, the APP scheme member may elect to draw an income from the protected rights element of their fund or buy an annuity. The APP scheme must also provide an annuity for widows and widowers who have children or who are aged at least 45 when their spouse died.

Part of the non-protected rights may be paid, not as a pension, but on retirement as a tax-free lump sum.

A member of an occupational pension scheme which is not used for contracting-out of State Second Pension may at the same time be a member of an APP scheme provided that the only contributions paid to the scheme are the minimum contributions paid by the Inland Revenue. A member may not otherwise contribute simultaneously to an occupational and PP scheme in respect of the same employment (although individuals earning less than £30,000 pa can now contribute to a stakeholder pension as well as an occupational pension).

A member may continue to contribute to an APP scheme if he changes jobs. This is in contrast to an occupational scheme, under which a person may be a member only while employed by the sponsoring employer.

### **Tax rules**

The tax rules on personal pensions place limits on input (contributions), rather than output (emerging benefits). With defined benefit occupational schemes, the tax rules broadly cap output at 2/3 final salary. In personal pensions, the limit is instead on contributions as a proportion of current salary – which increases with age bands ranging

from 17.5 per cent to 40 per cent of earnings.

Also, personal pension holders can claim a tax-free lump sum of up to 25 per cent of the value of their fund. Benefits may be taken between 50 and 75 without the need to actually retire, and with the lump sum an annuity or a pension in the form of income withdrawals from an invested fund is paid. (This 25 per cent feature actually means that the lump sum can have a higher relative value in personal pensions than occupational pensions. This is because the rules on occupational pension lump sums are 3/80 for each year's service or 2.25 times the pension— ie usually up to a maximum of 1.5 times final salary with a 2/3 final salary pension. Assuming average life expectancy in retirement, 1.5 times final salary can be worth less than a quarter of the total pension 'pot' paid out in retirement.)

### **Group Personal Pension (GPP) schemes**

A GPP scheme is a collection of individual personal pension contracts usually where an employer has obtained a special deal with a single provider, and agrees to make a contribution to each contract held by the employees. Personal pension contracts under the group umbrella may be contracted-out but this will depend on the circumstances of the individual. In practice employers GPP schemes are very similar to defined contribution occupational schemes, but the provider, not the employer, meets the administrative cost, usually deducted from contributions before their investment.

GPPs have become increasingly popular in recent years, particularly for small and medium employers. Stakeholder pensions have gone some way towards forcing down the charges in these arrangements as well.

## **STAKEHOLDER PENSIONS**

The Welfare Reform and Pensions Act 1999 provided the legislative framework for flexible, portable, funded stakeholder pensions for those who cannot join a good company pension scheme and for whom other personal pensions may be unsuitable. The first stakeholder schemes began operating from 6th April 2001.

Stakeholder pension schemes are intended primarily for people on moderate earnings, although they are an option for others, including non earners who may be thinking about taking out a private pension. They are set up by financial service organisations as well as some representative organisations (such as trade unions or trade associations.)

Schemes are required to be flexible and portable so that participants can vary or stop contributions without paying a penalty charge. The portability is of particular benefit to people in the modern labour market, many of whom move regularly between employers and occupations and who, at different times, may be self-employed, employed on a limited-term contract or working under a permanent contract.

Management charges in each year must not amount to more than the charge cap as set down by law – for people who join a stakeholder pension scheme on or after 6 April 2005 the cap is an annual management charge of 1.5 per cent for the first 10 years, which will reduce to 1 per cent from then onwards if these members remain in the scheme. The annual charge for members who purchased their stakeholder pension scheme before 6 April 2005 will remain at 1 per cent for as long as they remain in the scheme. However, if such members move to another stakeholder pension scheme on or after 6 April 2005, the new charge cap of 1.5 per cent will apply for the first ten years of membership of that new scheme.

Under the tax arrangements for stakeholder pensions, a simple £3,600 pa contribution limit has been introduced for most people. Tax rules also open the scheme to non-earners thus helping carers and disabled to build their own pensions, and to give most occupational scheme members the option of paying into a stakeholder pension as well.