Sackers

The Quarterly

June 2011

Highlighting significant developments in pensions law, covering key areas such as pensions reform, regulatory developments, new legislation and cases.

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Abbreviations commonly used in the Quarterly:

Alert/News: Sackers Extra publications (available from the Sackers Extra area of our website or your usual contact)

AA: Annual Allowance

A-Day: 6 April 2006

DB: Defined benefit

DC: Defined contribution

DWP: Department for Work and Pensions

HMRC: HM Revenue & Customs

HMT: HM Treasury

LTA: Lifetime Allowance

PIP: Pension Input Period

PPF: Pension Protection Fund

RPI: Retail Prices Index

SPA: State Pension Age

TPR: The Pensions Regulator

Pensions reform

Budget 2011

George Osborne's 23 March 2011 Budget brought no immediate headaches for occupational pensions, but a few key points emerged for schemes.

The Government intends to:

Budget: no immediate headaches for occupational pension schemes

- introduce a measure of automation into the process for reviewing SPA;
- make "disguised remuneration" subject to income tax;
- consult on limiting the amount of tax relief available to employers making asset-backed contributions to DB schemes; and
- consult with public sector workers, unions and others on the Hutton report's recommendations for the reform of public sector pension schemes.

Further details on all these proposals are set out below.

Finance (No.3) Bill 2010–11

The Finance Bill (the "Bill") will implement the Government's plans for restricting pensions tax relief announced on 14 October 2010.[1]

New Annual and Lifetime Allowances

AA reduced to £50,000 from 6 April 2011

The AA limits the amount of tax relief available on pension savings paid by or in respect of an individual to a registered pension scheme in any tax year. Where pension savings exceed the AA, an AA charge applies.

From 6 April 2011 (when existing "anti-forestalling provisions"[2] fell away), the AA is £50,000. For measuring "deemed" contributions to DB schemes (for the purposes of testing against the AA), the Bill will increase the factor from 10 to 16.[3]

LTA to reduce to £1.5 in 2012

The LTA will be reduced from 6 April 2012 from £1.8 to £1.5 million. The Bill also includes a new protection regime ("fixed protection") which will allow individuals to apply to retain an LTA of £1.8m, provided they no longer contribute actively to a DC arrangement or build up additional pension above an allowable "relevant percentage" in a registered DB or cash balance scheme.

Individuals already entitled to primary protection and/or enhanced protection will continue to receive their current levels of protection, but will not be eligible to apply for fixed protection.

AA charge payment option

High AA charges may be met from scheme benefits

As a result of the reduced AA, potentially far more pension savers will be subject to an AA charge.

The Government expects that most individuals and schemes will adapt their pension savings behaviour to avoid incurring a charge. However, following consultation,[4] it has decided to allow certain affected members to meet high AA charges from their pension savings.[5]

1 Please see our Alert: "The Finance Bill rides again" dated 1 April 2011

2 Please see our Alert: "Finance Act 2009 – This time its personal" dated 24 July 2009

3 In practice, this broadly means that an increase in annual pension benefit of £1,000 would be deemed to be worth £16,000

4 "Options to meet high annual allowance charges from pension benefits: a discussion document" (November 2010)

5 Please see our Alert: "Annual allowance charge payment option confirmed" dated 8 March 2011

Facility to apply to charges arising in the tax year 2011/12 and beyond

The eligibility threshold for meeting the AA charge from pension savings will be set at £2,000 and will apply to total pension savings across all schemes. It will be open to all schemes (except those in a PPF assessment period) to offer this facility although it will be mandatory for a scheme to do so where a member's savings in that particular scheme exceed the AA in any given year.

Schemes will have the flexibility to set the terms on which they offset AA charges through reductions to pension benefits and will also be able to dictate their own timetable for doing so, subject to overarching requirements.

The facility will apply in connection with charges arising in the tax year 2011/12 and beyond. But this option will not be available to individuals who retire between 6 April 2011 and the date on which the Finance Bill receives Royal Assent.

Pension Input Periods

A PIP is used to assess annual increases in the value of members' pension savings for the purpose of testing against the AA. Increases are measured against the AA for the tax year in which the PIP ends.

For PIPs ending in the tax year 2011/12 which began on or after 14 October 2010, the AA of £50,000 applies. PIPs ending in 2011/12 which started before 14 October 2010 are subject to transitional rules. This means that many individuals will already be affected by the reduced AA.

Finance Bill changes

Due to a quirk in the drafting of the Finance Act 2004, where trustees of DB or cash balance schemes in existence at A-Day have not nominated their own PIP, the scheme will generally have a default PIP ending on 6 April (i.e. in the 2011/12 tax year).

New default PIP

The Bill proposes an amendment to the Finance Act 2004 to align default PIPs with the tax year going forward. Although this change is only due to come into effect after the Bill receives Royal Assent, it is likely to simplify administration in the future for those in the default position.

Nomination

Nominating PIPs

In their Newsletter No. 46, HMRC confirms "that a valid nomination for a particular PIP end date is made where the pension scheme administrator provides notice of this in a form that is available to all members". This may be achieved, for example, by setting out the nominated date in the pension scheme rules, in the pension scheme handbook, or by a notice placed on the pension scheme's (or in the case of an occupational scheme on the employer's) internet site. Provided the notice is made in this way, there is no requirement to send a letter to each member telling them of the nominated date.

Trustees (or trustees / members in DC arrangements) will still be able to nominate their own PIP, but not retrospectively once the Bill receives Royal Assent.

Disguised remuneration

In a bid to prevent tax avoidance, the Bill includes provisions aimed at tackling "disguised remuneration" (namely, "arrangements involving trusts and other vehicles to avoid, reduce, or defer liabilities to income tax on rewards of an employment or to avoid restrictions on pensions tax relief").

Tax avoidance measures

Originally very widely drafted, the Bill has now been amended with the aim of limiting its impact. However, the Government has confirmed that the measures are intended to catch employer-financed retirement benefit schemes or "EFRBS".

Pensions reform (continued)

Changes to benefits available under pension schemes

Removal of compulsory annuitisation at age 75

Also included in the Bill are provisions to deal with the cessation of compulsory annuitisation at age 75.

From 6 April 2011, individuals with DC pension funds will no longer be required to purchase an annuity before the age of 75. Capped drawdown[6] will be available to anyone over the age of 55, with individuals who satisfy a "Minimum Income Requirement" ("MIR") able to draw down unlimited amounts from their pension pots. The MIR is intended to ensure that individuals have sufficient secured income to avoid the possibility of them "exhausting savings prematurely" and subsequently falling back on the State. The MIR will initially be set at £20,000 and will be reviewed at least every five years.

Lump sums can be paid to members age 75 or over

Also with effect from 6 April 2011, most of the rules which prevent registered pension schemes from paying lump sums, such as pension commencement lump sums, to members who have reached the age of 75 will be removed.

Green Paper on reform of the state pension system

With the ultimate aim of providing "a better foundation for saving", in its latest Green Paper[7], the DWP sets out proposals for overhauling the state pension system.[8]

Proposals

Reform of state pension

The current state pension system comprises the basic state pension, the additional state second pension (now known as S2P but formerly SERPS), which is linked to earnings, and the pension credit (a means tested benefit). The DWP puts forward two broad options for delivering reform:

1. accelerating existing reforms so that S2P becomes a flat rate structure more quickly; or
2. moving to a single-tier flat rate pension.

Each option aims to provide individuals with an estimated pension of around £140 a week.

DB contracting-out

End of DB contracting-out?

The end of DB contracting-out is by no means a foregone conclusion; it depends on the reform of the state pension system.

If the Government chooses option one in the Green Paper, it would remain, although national insurance rebates paid to contracted-out schemes would reduce over time. Under option two DB contracting-out would eventually disappear completely, but this will take time to achieve.

Many pensioners would therefore ultimately receive their single-tier pension through a combination of their state pension and contracted-out scheme provision. The consultation is light on detail on this issue but notes that, in theory, scheme rules could be changed to reduce the benefits payable in order to prevent employers being affected by the loss of national insurance rebates.

6 The cap will be set at 100% of the equivalent annuity, broadly the single-life level annuity that could have been bought with the pension fund using annuity rates set by GAD, and will be subject to review

7 "A state pension for the 21st century" (April 2011)

8 Please see our Alert: "A State Pension for the 21st century?" dated 6 April 2011

Proposals for "more automatic" review of SPA

State Pension Age

As trailed in the Budget, alongside the review of state pension, state pension ages may also increase beyond the currently planned rise to age 66. To streamline the process, the Government is proposing to move to a "more automatic mechanism" for addressing continuing changes in longevity. It is considering either (or a combination of):

- a formula which would automatically adjust SPA to reflect revisions in projected longevity; or
- a regular, scheduled review of SPA.

In determining the best approach, the Government intends to balance the need to provide people with sufficient notice of their SPA, against the changes in longevity.

Early Access to Pension Savings

In December 2010, HMT issued a call for evidence[9] on early access to pension savings, asking whether it could provide an effective incentive for individuals to make private pension savings. It also asked for views on the trivial commutation rules and evidence on the barriers to transferring smaller pension pots.

No early access to pension savings

Response

The Government has concluded[10] that early access to pension savings should not be considered at the present time. However, it intends to explore reform to trivial commutation rules to improve flexibility for those with very small personal pension savings and will announce further details on this in the autumn.

Public Sector Pensions

Hutton publishes final report

In June 2010, an independent commission was set up to review public sector pensions. Chaired by John Hutton, the former Labour Secretary of State for Work and Pensions, the commission published its final report on 10 March 2011.[11]

CARE scheme proposed for future service

Recommendations

Aiming to achieve a balanced deal between public service workers and the taxpayer, the Commission recommends retaining DB benefits but moving away from final salary to Career Average Revalued Earnings ("CARE").

Other key recommendations to the Government are to:

- protect accrued rights and allow current members to retain their final salary link for past service;
- link "Normal Pension Age" to SPA in most public service schemes; and
- set a "clear cost ceiling" for public service schemes with "automatic stabilisers" to keep future costs under more effective control.

9 "Early access to pension savings" (December 2010)

10 "Early access to pension savings: A summary of responses to the call for evidence" (April 2011)

11 Please see our Alert: "Hutton recommends new career average scheme" dated 10 March 2011

Legislation

Bribery Act 2010

Coming into force on 1 July 2011, the Bribery Act 2010 is set to modernise the criminal law of bribery, providing a consolidated scheme of bribery offences which cover bribery both in the UK and abroad.[12]

Offences

New bribery offences

The Act creates four offences:

- offering, promising or giving a bribe[13] (active bribery);
- requesting, agreeing to receive or accepting a bribe (passive bribery);
- bribing a foreign official; and
- a "relevant commercial organisation"[14] failing to prevent bribery.

In the event of prosecution, for individuals there is a maximum penalty of 10 years' imprisonment and/or an unlimited fine, while companies are liable to unlimited fines.

Commercial organisation

In the Government's view a "relevant commercial organisation" will include any organisation engaging in commercial activities "irrespective of the purpose for which profits are made". Unfortunately, this appears to catch a corporate trustee.

Recognising the difficulty that preventing bribery poses for any business, it is a full defence to any prosecution under the fourth offence if an organisation can show it had "adequate procedures" in place to prevent bribery. Guidance[15] has been published to help organisations devise such measures.

Genuine corporate hospitality should not be affected

Corporate hospitality

The guidance confirms that the Act does not intend to criminalise genuine corporate hospitality. However, acknowledging that corporate hospitality is sometimes offered as a bribe, it hints that the more lavish the hospitality, the greater the possibility of bribery being inferred.

In the unlikely event that corporate hospitality does trigger the provisions of the Act, the guidance notes that prosecutors "will consider very carefully what is in the public interest before deciding whether to prosecute".

Impact on trustees should be limited

Impact on pension scheme trustees

All trustees will be subject to the first three offences, with corporate trustees also subject to the fourth. However, given the nature of the offences, the impact on trustees should be limited.

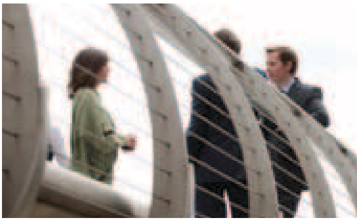
To decrease the likelihood of decisions being called into question and as part of their governance regime generally, trustees should consider developing a policy on corporate hospitality.

12 Please see our Alert: "Bribery Act 2010" dated 19 April 2011

13 A bribe is referred to as a "financial or other advantage"

14 This includes any corporate body or partnership carrying on a business in the UK

15 "The Bribery Act 2010 – Guidance about procedures which relevant commercial organisations can put into place to prevent persons associated with them from bribing (section 9 of the Bribery Act 2010)"



Regulatory

HM Revenue & Customs

Consultation on changes to tax rules for asset-backed contributions due this spring

Employer asset-backed pension contributions

As announced in the Budget, the Government intends to consult on changing the tax rules in relation to employers making asset-backed contributions to their DB pension schemes, to ensure that the tax relief given accurately reflects the increase in fair value of pension plan assets.

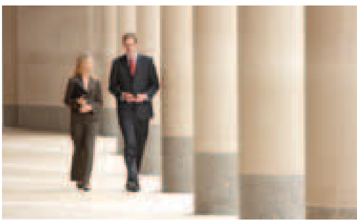
Its aim is to preserve the flexibility of such arrangements for employers and schemes, while attempting to limit unintended tax relief that may arise from the way in which these contributions are structured.

Pension Protection Fund

Levy ceiling and compensation cap for 2011/12

Pension protection levy/cap

The pension protection levy ceiling for the financial year beginning 1 April 2011 is £892,092,092 (up from £871,183,684 in 2010), whilst the PPF compensation cap for the year beginning 1 April 2011 is £33,219.36 (up from £33,054.09).



European Court of Justice

Sex-based factors unlawful in insurance contracts with effect from 21 December 2012

Association Belge des Consommateurs Test-Achats ASBL and others

This case[16] challenged the validity of an exemption in the EU Directive which implements the principle of equal treatment between men and women in the access to and supply of goods and services (the "Gender Directive").[17]

Background

The Gender Directive provides a framework for combating discrimination based on sex regarding the access to and supply of goods and services. Its preamble indicates it does not apply to men and women "in matters of employment and occupation", as this is dealt with by the Equal Treatment Directive.[18]

The Gender Directive generally prohibits the use of sex as a factor which would result in different premiums and benefits being used for men and women in insurance products. However, when implementing the Gender Directive, Member States were able to take advantage of an exemption under article 5(2) permitting "proportionate differences" in individuals' premiums and benefits, "where the use of sex is a determining factor in the assessment of risk based on relevant and accurate actuarial and statistical data".

The Belgian Government had taken advantage of this exemption for life assurance contracts. Test-Achats (a non-profit making consumer organisation) brought an action for annulment on the basis that the law was incompatible with the principle of equal treatment for men and women.

ECJ decision

Although the Gender Directive is silent as to how long the exemption itself would continue, it required Member States taking advantage of this exemption to review their decision by 21 December 2012 (five years from the original implementation date of the Gender Directive).

The ECJ considered that this lack of "temporal" limitation worked against the achievement of both the Gender Directive's and the EU's objective of equal reatment between men and women. Consequently, the ECJ declared that, with effect from 21 December 2012, article 5(2) will no longer be valid.

Comment

Effect on occupational pension schemes not yet clear

As the UK Government also took advantage of the exemption in the Gender Directive, the Government will need to give effect to the ECJ's decision. From 21 December 2012, it therefore seems certain that insurers will need to use sex neutral factors for assessing premiums and benefits under new insurance contracts.

Currently occupational pension schemes may use sex-based actuarial factors to determine, for example, funding requirements, transfer values and commutation. This is permitted because of a similar exemption in the Equal Treatment Directive which has been adopted by regulations made under the Equality Act 2010. The Government will need to decide whether this legislation also needs to be amended in the light of the ECJ's decision.

16 Please see our Alert: "Is it the end of the road for sex-based actuarial factors?" dated 2 March 2011

17 2004/113/EC

18 2002/54/EC

Prudential Staff Pensions Limited v The Prudential Assurance Company Limited and others[19]

Employer's duty of good faith

This case challenged the right of the sponsoring employer to change, unilaterally, the basis on which discretionary increases to pensions in payment were granted. It is the first substantive case since *Imperial Tobacco*[20] in 1990 to consider the employer's duty of good faith in connection with occupational pension schemes.

Background

The Prudential Staff Pension Scheme (the "Scheme") was established in 1918. At the time of the hearing, the Scheme operated in two parts - a DB section and a DC section.

The DB section (the focus of this case) was closed to new members in 2003. It was governed by rules adopted by a deed of variation dated 23 June 2005 (effective from 1 July 2005) and had net assets as at 5 April 2010 in excess of £5 billion.

Under the rules, statutory increases were payable on pensions in payment in respect of service on or after 6 April 1997. Increases in respect of pre-April 1997 service were payable solely at the discretion of the Employer and were subject to the payment of such additional sums as the Scheme Actuary certified were necessary.

Increases historically in line with RPI

Historically, the Scheme had paid increases in line with RPI, except in times of high inflation. During the 1970s when inflation was particularly high, increases fell below RPI. However, a catch-up exercise was undertaken in the 1980s with the effect that, overall, these pensions were broadly fully index-linked.

In 2005, the Scheme's actuarial valuation showed a deficit and a decision was made by the Prudential board to provide these discretionary increases at RPI subject to a cap of 2.5%.

The Members' challenge

The members argued that Prudential's decision to impose a 2.5% cap on pension increases in respect of pre-April 1997 service was a breach of its obligation of good faith (statutory increases applied to post-1997 service). They argued that, whilst members were aware that such increases were discretionary, it had always been understood that Prudential would pay increases in line with RPI unless there was a good reason not to do so, such as a period of high inflation.

Prudential, on the other hand, argued that the obligation of good faith did not require an employer to reach a substantively "fair" decision when exercising its power under the Scheme rules. For the obligation of good faith to be breached, it argued that the conduct in question must be serious and likely to destroy the relationship of trust and confidence between employer and employee.

The Court's decision

Limitation of increases not "irrational or peverse"

The judge considered that the test for a breach of the obligation of good faith was whether Prudential had acted irrationally or perversely in changing its practice of granting increases in line with RPI. Newey J found that Prudential's 2005 decision to limit discretionary increases to RPI capped at 2.5% was not irrational or perverse.

Prudential was entitled to have regard to its own interests when deciding on the level of increases to be awarded. This was the case, despite the members' strong and reasonable expectations that the practice of granting increases in line with RPI would continue.

Comment

The case makes it clear that for a pension scheme employer to fall foul of the obligation of good faith, it is necessary for their decision to be irrational or perverse. This can be a high threshold for members to hurdle. Indeed, the judge himself said in his conclusion that the members may "feel they have been treated unfairly by the Prudential". But nonetheless the Prudential were entitled to take the decision to limit increases.

Sackers acted for the representative beneficiaries in this case – please see our press release for more information.

19 [2011] EWHC 960

20 [1991] 2 All ER 597

Futter v Futter; Pitt v Holt[21]

Declaring that a much relied on line of case law is incorrect, the Court of Appeal has restated the so-called "rule in *Hastings-Bass*".

Background

The decision in the case of *Re: Hastings-Bass*[22] led to the formulation of a principle that, it was thought, allowed trustees to set aside certain decisions on the basis that they had unintended (generally fiscal) consequences.

Decision

"Rule in Hastings-Bass" restated

Finding that each set of trustees had validly exercised their discretion, Lloyd LJ commented that the law had taken a "seriously wrong turn" due to the lower courts consistently misapplying the original judgement. He explained that the "correct" principle in *Re: Hastings-Bass* is that:

- acts which are outside the scope of trustees' powers are void;
- acts which are within the scope of trustees' powers but which fail to take account of a relevant factor, or take into account an irrelevant factor, are voidable, on application by a beneficiary, if they amount to a breach of fiduciary duty.

In both instances the trustees had not failed to take into account relevant factors (or taken into account irrelevant factors). They had taken advice as to the tax consequences of their decisions. Unfortunately, the advice they received was incorrect.

Acts with unintended consequences cannot be set aside by trustees

Although, had they been correctly advised, they would have exercised their discretions differently, they could not use the rule in *Hastings-Bass* to have their decisions set aside. The appropriate remedy in such circumstances is a claim for damages for professional negligence.

Comment

We understand that part of the decision may be appealed. Until then, with the ability to set aside amendments severely curtailed, trustees in a similar position may now look to a negligence action against their advisers.

21 [2011] EWCA Civ 197

22 [1975] Ch 25

In the pipeline

June / July 2011	Pensions Bill receives Royal Assent?
June / July 2011	Finance Bill receives Royal Assent?
1 July 2011	Bribery Act 2010 comes into force
Autumn 2011	Court of Appeal decision in Nortel / Lehman expected
6 April 2012	Abolition of DC contracting-out
6 April 2012	LTA reduced to £1.5m
1 October 2012	Auto-enrolment starts to be phased-in
December 2012	TPR's record-keeping target date

Sacker & Partners LLP
20 Gresham Street
London EC2V 7JE
T +44 (0)20 7329 6699
F +44 (0)20 7248 0552
E enquiries@sackers.com
www.sackers.com

Sackers

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