Sackers

What does the future hold for GMP conversion?

March 2022

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Where are we now?

It feels like a lifetime ago that we were handed the Lloyds judgment in 2018 where Mr Justice Morgan confirmed that trustees are under a duty to amend their schemes to address the inequalities arising from guaranteed minimum pensions ("GMPs").

GMP conversion is one of the Court approved methods for effecting GMP equalisation (Method D2) and at first sight it seemed that it would be a popular choice amongst schemes to enable them to completely eradicate the complexities involved in administering GMPs. However, it soon became clear that conversion was by no means simple to achieve and many have been "put off" by the uncertainties of the conversion legislation and the pensions tax implications in particular.

But it now looks likely that we will have new legislation seeking to address some of the key issues with the GMP conversion legislation. We have also had the benefit of conversion "early movers" and helpful guidance from the Pensions Administration Standards Association ("PASA") looking at how some schemes have addressed the tax issues. Though we may not yet have a silver bullet to enable schemes to conquer GMP conversion without careful scheme-specific advice, roads are now forming with clearer paths and it may be that GMP conversion starts becoming a more attractive option again for schemes who haven't yet chosen their equalisation method.

In this article, we will firstly look at the issues with the current GMP conversion legislation that a Private Member's Bill is seeking to resolve. We will then delve into some of the ways in which we are seeing tax issues being addressed by schemes carrying out GMP conversion in practice.

What issues will the Conversion Bill look to resolve?

With effect from 6 April 2009, changes were introduced to the Pension Schemes Act 1993 to enable schemes to convert GMPs into ordinary scheme benefits. The Government stated at the time that the purpose of the legislation was to give schemes an option to simplify benefit structures, subject to certain conditions being satisfied.

However, the conversion legislation was used very rarely in practice, in part due to the many uncertainties surrounding the statutory conditions. The Pension Schemes (Conversion of Guaranteed Minimum Pensions) Bill 2021 is seeking to amend the statutory GMP conversion provisions to clarify the legislation and make it easier to use.

The table below sets out the common issues associated with the current conversion legislation and a view as to whether they will be resolved by the Conversion Bill.

Issue with conversion legislation	Will it be "solved" by the Conversion Bill?
The legislation is unclear as to how conversion applies to survivor benefits.	Yes in the sense that the Bill clarifies that the legislation applies to survivors as well as earners. It also provides a power to set out in regulations the conditions that must be met in relation to survivor benefits. This is positive as the current legislation's precise conditions for survivor benefits have been subject to great industry debate and many trips to Counsel! However, the devil will be in the detail and we will need to await the underlying regulations to see whether all the uncertainties are indeed resolved satisfactorily.
The conversion process requires trustees to get consent from "the employer" to GMP conversion. However, it is unclear who the employer is for these purposes eg whether it could catch former employers.	Hopefully. Again, the Bill provides a power to set out detail in regulations about who must consent to the conversion and so, again, the devil will be in the detail. It would be helpful if the regulations confirmed the pragmatic stance taken by many in the industry to date, namely to require the consent from those employers responsible for funding the scheme under legislation. It would be even more helpful if the regulations could introduce an express power for the principal employer of a scheme to consent on behalf of all employers, as it can in the scheme funding legislation, for example.
The legislation requires schemes to notify HMRC about the conversion exercise, even though the introduction of the new State Pension means that HMRC no longer need to be informed about changes to GMPs.	Yes – the Bill would remove the requirement to notify HMRC.
Under current legislation trustees must take all reasonable steps to "consult in advance" with earners about proposed conversion. It is unclear what form should this take and how long consultation should last.	No. However, there is now a fairly well trodden path in relation to the consultation requirements and this has not been a barrier to carrying out conversion in practice.
The legislation does not expressly cater for the increasingly popular "at retirement" conversion. Although the current legislation can be "made to work" for these exercises, clarification would be welcome on the mechanics for consultation with non-pensioners, the ongoing actuarial equivalence certification process and (ability to withdraw) employer consent.	No. However, these issues have not stopped a number of schemes adopting an "at retirement" conversion process and industry practice is developing quite quickly in this area.

"Tax doesn't need to be taxing"

Having looked at the issues which the Conversion Bill is seeking to resolve, let's now delve into the world of pensions tax which is often a key factor in trustee and employer decisions not to pursue GMP conversion.

Pensions tax is complicated at the best of times. But the combination of pensions tax issues and conversion, which inherently involves some form of change to members' benefits, raises even more questions about how the legislation should apply at a scheme-specific level. So, whilst we hope the following is helpful as a general overview of common key issues, it is not to be relied on at a scheme-specific level and it is crucial that trustees/employers take advice about their own scheme from their own advisers.

Key concepts

The tax implications for GMP conversion are primarily centred around the Annual Allowance ("AA"), particularly the "deferred member carve-out" ("DMCO"), and the Lifetime Allowance ("LTA"), particularly for individuals with any form of LTA charge "protection".

The AA acts as an annual limit on the increase in value of a member's pension savings in any registered pension scheme. If the value of further DC contributions or DB accrual exceeds the AA, a tax charge arises. Pension savings for the purpose of the AA are calculated by reference to a "pension input period" ("PIP") which is now aligned to the tax year.

The DMCO applies to a member who is within the AA regime but has been a deferred member for the whole of a PIP, or is deferred and then becomes a pensioner. An individual subject to the DMCO is treated as having no pension input amount during the PIP for AA purposes, provided that benefits do not increase above a certain amount (intended to allow for scheme and statutory deferred revaluation).

Legislation also specifies a maximum total amount of savings that a member can make in all registered pension schemes without incurring a tax charge. This is known as the standard LTA. When the LTA was introduced on 6 April 2006, and in later years each time it was reduced, individuals were able to protect the earlier higher LTA amount. In return, members were limited in terms of future pension savings.

Why does GMP conversion cause pensions tax issues?

HMRC issued helpful guidance on 20 February 2020 covering some of the pensions tax issues when equalising benefits for the effect of GMPs. However, HMRC made clear that its guidance applied only to "plain vanilla" equalisation (ie a dual records approach) and not conversion.

In the absence of formal guidance from HMRC on tax issues relating to GMP conversion, the potential tax consequences of conversion need to be approached with care. In particular, schemes need to consider whether GMP conversion could give rise to a "pension input amount" for AA purposes (which could result in loss of the DMCO and AA tax charges) and/or cause loss of LTA tax protections (primarily fixed protection and enhanced protection).

Notwithstanding the absence of HMRC guidance specifically dealing with GMP conversion, many schemes have considered ways in which the equalisation guidance and previous HMRC guidance on related tax issues could still assist with the tax issues on conversion. We have also had helpful guidance from PASA which dissects HMRC guidance published to date, providing commentary and practical approaches to dealing with the pensions tax consequences of GMP equalisation.

As with HMRC's guidance, the PASA tax guidance stops short of giving a clear steer on the tax repercussions of GMP conversion. However, industry practice is fast developing and, although pensions tax still requires careful consideration for GMP conversion exercises, we don't believe that it needs to be viewed as a complete barrier to conversion.

What are the potential solutions emerging?

The tables below explain some of the emerging “solutions” for managing pensions tax issues for deferred and pensioner members.

Importantly, HMRC has stated that its equalisation guidance applies where the “reason for the adjustment is solely for GMP equalisation”. For schemes looking to convert GMPs without leading to undesirable tax consequences for its members, we have seen an emerging trend of carrying out GMP conversion as a two-step process, where any uplift is provided at step one (equalisation on a dual records basis) before benefits are then converted. This may not solve all known tax issues, but it could go some way to assist.

Managing the AA issues

Category of member	Issue? If so, what are the potential solutions?
Deferred member (since before 6 April 2006)	HMRC’s guidance confirms that any uplift for GMP equalisation will not count as accrual of benefit (at the point of equalisation) for testing against the AA. Pre-6 April 2006 deferred members should therefore remain outside the AA regime on the basis that any uplift (attributable solely to equalisation) in the year of conversion should not count as “accrual” for tax purposes, provided that conversion does not increase the overall actuarial value of the member’s benefits. PASA guidance indicates that some schemes have obtained non-statutory clearance from HMRC on this point, and this is also consistent with long-standing analysis of pension increase exchange exercises where equivalent reshaping happens, and HMRC responses on those. In subsequent tax years after conversion, provided the deferred pension remains actuarially neutral, pre-6 April 2006 deferred members should remain outside the AA regime.
Deferred member (on or after 6 April 2006)	For post-5 April 2006 leavers who are already within the AA regime and subject to the DMCO, HMRC’s guidance confirms that GMP equalisation will not affect the DMCO as benefit adjustments “are attributable solely” to the application of legislation (namely, the equal treatment requirements under section 67 of the Equality Act 2010), and therefore fall within the statutory increases permitted under the DMCO. However, due to the way legislation requires the opening and closing value of a member’s PIP to be calculated, the act of GMP conversion will invalidate the DMCO in the year of conversion even if there is no increase in the overall £ amount of pension. Depending on whether the annual £ amount of pension is increased at the point of conversion, there may not be an AA charge for affected members. There may be significant additional work required for the scheme administrators due to the DMCO not applying in that tax year, but there may be minimal (or no) impact on members. In terms of how the DMCO is managed for subsequent tax years after conversion, one increasingly popular solution has been to implement conversion “at retirement”. But some schemes, particularly those looking to buy-out, may wish to explore implementing conversion in bulk. Although this should be treated with care, we have seen conversion designs emerging in practice on a scheme-specific basis that seek to avoid any AA issues arising.

Category of member	Issue? If so, what are the potential solutions?
Pensioner member	The AA is not generally relevant for pensioners, except in the tax year in which they start their benefits. This is because the last PIP in which there is a test against the AA is the one in which an individual becomes entitled to their benefits. However, the legislation works in such a way that conversion in the same tax year of retirement should not trigger loss of the DMCO provided the only "uplift" of benefits relates to equalisation and there is no further benefit crystallisation event.

Managing the LTA protection issuess

Category of member	Issue? If so, what are the potential solutions?
Deferred member	**Fixed protection** will be lost if, broadly, there is an increase in the member's benefits which exceeds the "relevant percentage". The "relevant percentage" permits certain rules-based and statutory rates of revaluation. In addition, it permits any increase provided to comply with s67 of the Equality Act 2010. Therefore, it is arguable that fixed protection will not be lost when benefits are converted, provided that any uplift in the amount of deferred pension is solely attributable to equalisation. For bulk conversion in deferment, care needs to be taken to ensure that any future revaluation of the converted benefits does not go beyond that permitted by the "relevant percentage", and the post-conversion design may need to be constrained to ensure that fixed protection is not lost. Some schemes have also mitigated against the risk entirely by implementing conversion for affected members immediately after benefits come into payment (for the reason explained in the row below). However, this may be unnecessary depending on how the scheme's revaluation rules interact with the "relevant percentage". **Enhanced protection** is only tested when a member has a benefit crystallisation event. However, for pre-6 April 2006 leavers (which in practice is likely to cover most, if not all, members with enhanced protection) HMRC has stated that any GMP equalisation adjustment should not be "relevant benefit accrual" for enhanced protection purposes as it will be factored into the value of the member's rights as at 5 April 2006. In any event, there is often a fair degree of headroom in the £ amount of pension to be increased as part of GMP conversion without causing loss of enhanced protection and this can be considered on a case by case basis if necessary.
Pensioner member	**Fixed protection** won't be lost by converting GMPs in payment. HMRC guidance is clear that "benefit accrual" for fixed protection purposes is only relevant to prospective benefits and can only occur when benefits haven't yet come into payment. Although **enhanced protection** could potentially be lost if GMP conversion gives rise to a fresh benefit crystallisation event and there is "relevant benefit accrual", this may not cause issues in practice (for the reasons explained above).

Closing remarks

For those who have managed to read this far, we hope this article has given some reassurance that the common legal issues associated with GMP conversion are often manageable in practice. Having said that, GMP conversion will not be the "right" course of action for all schemes and many will still decide to adopt a dual records method for equalisation.

For those who do go down the conversion path, careful consideration will still be needed on a scheme-specific basis and there are likely to be a number of more "granular" points that need to be worked through by the scheme's advisers on a conversion project. But we're all building up a hefty knowledge bank of experience which will soon mean that knotty issues will probably have been considered by someone else already.

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