Sackers

Corporate briefing

July 2023

Highlighting the latest developments in pensions for employers and corporate investors

Welcome

With summer here, we shine a light on what 2023 has given employers and their pension schemes to date, and what the rest of the year may bring.

Although the market turmoil last autumn made for a bumpy ride for some DB schemes, the knock-on effects for others meant that they are in a better funding position than they might have expected. This leaves some employers facing a question they are unlikely to have encountered in many years – is there going to be a trapped surplus in my DB scheme? On pages 1 and 2 we explore the potential issues with overfunding a scheme, and look at some of the options available to employers in this position. We also take a broader look at what sponsors of well-funded DB schemes should be thinking about on page 3.

The Chancellor announced some significant changes to the pensions tax regime in the Spring Budget in March. We look at what these changes are and the potential impact on employers and their employees on page 4.

We wrap up by looking at what is still to come in the world of pensions.

Finally, we are absolutely delighted to let you know that we have won Best Pensions Law Firm at the Corporate Adviser Awards for the second year in a row.

How to solve the “problem” of a well-funded DB scheme

Some DB schemes are in surplus

After many years in hibernation, surpluses in DB schemes started to resurface following the mini-Budget in October 2023. With some DB schemes already at or beyond full funding on a buy-out basis and others approaching it, employers are becoming increasingly concerned about “overfunding” their DB schemes and what would happen to any surplus funding.

What do we mean by “trapped surplus”?

What constitutes a surplus may be viewed differently by employers and trustees.

Under scheme funding legislation, employers are required to make good any technical provisions deficit in a DB scheme. As such, employers may consider that any level of funding above that is a surplus.

Trustees, on the other hand, may view a surplus as only arising if there are amounts remaining in the scheme following buy-out of the scheme’s liabilities and winding up of the scheme.

In either case, a “trapped surplus” for the purpose of this briefing is one that cannot be returned to the employer or can only be returned subject to a tax charge.

How to solve the "problem" of a well-funded DB scheme cont.

Paying a surplus to the employer

Although there is no absolute restriction on paying any surplus to an employer (whether in an ongoing scheme or a scheme in wind up), it isn't the most straightforward of processes, for instance:

- there must be a valid power in the scheme rules to pay any surplus to the employer. The power may be a joint or trustee power, which would require the trustees to agree to any such payment
- there are strict conditions as to when a surplus can be paid to an employer
- any surplus payment to an employer is subject to a 35% tax charge, except in limited circumstances (eg if the employer is a charity).

Can you stop paying contributions?

If the employer is party to a schedule of contributions which requires the payment of contributions into the scheme, it is under a legal obligation to continue to pay those unless otherwise agreed by the trustees.

If the scheme is at or above full funding on a technical provisions then trustees may be willing to agree that contributions can stop, or that any further contributions can be paid into a structure outside the scheme, such as an escrow/charged account arrangement or a reservoir trust.

There are alternative structures to paying cash into a scheme

There are different types of structures available for this, but each has the same goal. Cash contributions (or assets if it is agreed to invest the cash) are held outside the scheme. They are only transferred to the scheme if and to the extent needed, thereby reducing the risk of a surplus arising.

Trustees have the comfort that monies are held in a structure which is ring-fenced for the scheme's benefit, if required. Employers have the comfort of knowing that any remaining monies can be returned them without the issues applicable to payment of a scheme surplus.

Use of a scheme surplus

Options available for using a surplus

If a scheme already has a surplus on a buy-out basis then, potentially, there are options for using that surplus so that it does not become trapped. Examples include the scheme paying scheme expenses which might otherwise be funded by the employer, transferring in an underfunded DB scheme from another part of the employer group or using the surplus to fund DC benefits. This is a complicated area and whether there are any viable options will depend on the scheme rules, legislation and the applicable facts and circumstances in each case. However, it is worth exploring these if trapped surplus is a real concern.

Augmentation of benefits

Employers may be concerned about trustees augmenting benefits where there is a surplus. Whether trustees have the power to do this without the employer's consent will depend on the scheme rules. Even where trustees have a unilateral power to augment benefits on a wind-up of a scheme, it is not necessarily a foregone conclusion that they will do so in all circumstances. The employer may be able to put forward arguments to the trustees as to why it would not be reasonable to do this.

Key takeaway

Sponsoring employers of well-funded DB schemes should consider what options are available to them to manage any potential or actual surplus in their DB scheme to mitigate the risk of it becoming trapped surplus.

What can DB employers do with their well-funded schemes?

Employers are thinking about the "end game"

With many DB employers having a healthy funding level in their scheme, they will need to work out what their plan is for the future. We are finding that DB employers are increasingly taking a more active role in discussions with their trustees on risk transfer and other end game solutions.

De-risking options

The most common risk transfer transactions are buy-ins and buy-outs but there are other options out there, depending on your particular needs and aims.

Buy-ins

A buy-in transaction secures all, or a portion of, deferred and/or pensioner benefits, with a view to continuing to run the scheme. It is essentially a risk-matching investment decision, putting in place a good quality matching asset (ie insurance policy) that is held by the trustees. This may be part of a series of transactions over the long term, leading to buy-out eventually.

Buy-outs

A buy-out secures all members' benefits (pensioner and deferred), with each member having an individual policy with the insurer, usually with a view to winding up the scheme within a relatively short period of time.

Other options

Buy-ins and buy-outs sit alongside a number of different de-risking options in what is a rapidly evolving market:

Several de-risking options are available

Consolidators

A number of providers offer access to economies of scale, high quality governance and professional trustees

Superfunds

These are commercial, regulated consolidators with asset backing, and offer a clean split from the scheme sponsor

Longevity transactions

We are seeing useful standardisation in the longevity market which is making targeted longevity hedging an increasingly viable option

Other models of governance

These include professional trustee services, fiduciary management or an outsourced chief investment officer

It is a good time for certain employers to take a closer look at their end game planning and we can help with an appropriate strategy in this area.

What are the implications of the recent pension tax changes?

The Finance (No. 2) Act 2023 received Royal Assent in July 2023, bringing into force various pension tax changes announced in the Spring Budget. The changes apply retrospectively from 6 April 2023.

Annual allowance ("AA")

The AA limits the total tax-relieved pension savings an individual can make each tax year across all registered pension schemes. From 6 April 2023:

- the standard AA increased from £40,000 to £60,000
- the money purchase AA, which applies to any subsequent DC savings by individuals who flexibly access their DC benefits, increased from £4,000 to £10,000
- the minimum tapered AA increased from £4,000 to £10,000, and the threshold at which the taper applies from £240,000 to £260,000. The taper works by reducing the AA by £1 for every £2 of income over the taper threshold. This means that the minimum £10,000 taper will apply to individuals whose income is £360,000 or more.

Lifetime allowance ("LTA")

The LTA limits the total amount of tax-relieved pension savings that an individual can build up over their lifetime across all their registered pension schemes without incurring an additional tax charge (known as the "LTA charge"). From 6 April 2023:

- the LTA charge is removed
- the maximum potential tax free lump sum is frozen at £268,275 (being 25% of the 2022/23 LTA)
- certain lump sums (serious ill-health lump sums, LTA excess lump sums, DB lump sum death benefits and uncrystallised funds lump sum death benefits) are taxed at the recipient's marginal rate.

Intention is to abolish LTA from April 2024

The plan is to abolish the LTA altogether from 6 April 2024 but this will be the subject of future legislation.

Impact on high earners

When the current pensions tax regime came into force on 6 April 2006 (A-Day), measures were introduced for those whose benefits were already near or exceeded the then LTA. Additional protections have been put in place each time the LTA has been reduced since A-Day. The protections are each subject to certain conditions, including, in some cases, that the individual doesn't build up further pension benefits in a registered pension scheme.

Some high earners may have registered for these LTA protections and others may find that their annual pensions contributions exceed the relevant AA. Some employers set up alternative arrangements for affected employees, such as offering cash sums and/or providing life cover through an excepted group life policy.

Employer actions

- Consider issuing a communication to employees, particularly those who they know have registered for tax protections to explain the changes
- Employers with cash alternative arrangements in place for high earners should check the terms of those arrangements to make sure the changes to the AAs track through as expected
- Don't make any hasty changes to the benefits of affected employees, particularly as a change in the governing political party could affect the proposed removal of the LTA next year, but start thinking about what any changes could look like in the future
- Encourage affected employees to take independent financial advice before taking any action based on the proposed changes.

High Court decision affecting validity of amending deeds

A recent case has considered the validity of past amendments made to rules of schemes that were contracted out of the state second pension on a DB basis after 6 April 1997. In *Virgin Media v NTL Pension Trustees II Limited (and others)*, the High Court ruled that section 37 of the Pension Schemes Act 1993 renders invalid and void any amendment to the scheme's rules which related to certain benefits (known as "section 9(2B) rights") if it was introduced without the required written actuarial confirmation.

In our view, the decision does not expose schemes to any new risks, as the requirement for actuarial confirmation was well understood at the time. The decision is unhelpful, however, in that it leaves unclear the question of how schemes can properly evidence that the confirmation was actually given, as there was no need for a formal certificate.

We understand leave has been given to appeal the decision and, unless a particular query or concern prompts a general review of scheme amendments, we do not believe there is a requirement to look into this issue as a matter of course. However, if you have any concerns following this decision, please speak to your usual Sackers contact.

What's on the pensions horizon?

DB scheme funding

A new DB funding and investment regime is currently expected to come into force in spring 2024. Under the new regime, the finer details of which are still to be finalised, DB schemes will be required to:

- have a funding and investment strategy in place, and
- submit a written statement of that strategy to TPR.

As under the current scheme funding regime, the process will be led by the trustees. However, trustees will have to agree the strategy with the employer and consult with them on certain aspects of the statement.

Automatic enrolment

A Bill is going through Parliament which will give the Secretary of State powers to:

- abolish the lower earnings limit for contributions, so DC contributions are paid from the first pound earned
- reduce the age for being automatically enrolled, which is currently 22.

The Government hopes to consult on the implementation and timetable for expansion "in the autumn".

Pensions dashboards

A pensions dashboard is an online platform where individuals can access information about all of their UK pensions provisions in one place. Originally, occupational pension schemes were due to connect to the "dashboard ecosystem" in stages, starting from spring 2023. However, at the time of writing, amending legislation is going through Parliament to change this to a single statutory deadline of 31 October 2026, with a voluntary staged timetable to be set out in guidance.

Dismissal and re-engagement of employees

The Government has recently consulted on a draft Code of Practice on Dismissal and Re-engagement. The code follows Acas' 2021 guidance on making changes to employment contracts and aims to ensure that an employer takes all reasonable steps to explore alternatives to dismissal and engages in meaningful consultation with trade unions, other employee representatives or the individual employees in good faith.

Notifiable events

The notifiable events regime requires trustees and employers to notify TPR when certain events occur in relation to a DB scheme.

A DWP consultation in autumn 2021 included draft regulations setting out two new notifiable events for employers to report to TPR, relating to material sales and granting or extending certain security. Implementation has been delayed while the DWP considers further changes to the draft regulations. We are still expecting that the regulations will be brought into force, but no timeline for implementation has been given.

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Contact

Sackers is the leading law firm for pension scheme employers, trustees and providers. Over 65 lawyers advise employers on all aspects of their pension arrangements. This includes getting automatic enrolment right, advising on corporate pensions strategy, managing DB risk and funding solutions, advice relating to DC schemes including transfers to DC master trusts, and advising on the pensions aspects of M&A activity and corporate group restructuring. For more information or to arrange training, please get in touch with David Saunders, Philippa Connaughton, Faith Dickson, Fuat Sami, Tom Jackman, Ferdy Lovett or Vicky Carr, or your usual Sackers contact.

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