

Company pension schemes

Companies are not obliged to set up their own company (or occupational) pension schemes, but the Government has said it intends to encourage company schemes as the best way of providing pensions for employees.

Changes in legislation, as well as demographics, mean that company pensions are expensive to provide. The increase in the minimum age at which pensions can normally be taken (from 50 to 55 in 2010), the introduction of a 'default' pension age at 65 in April 2006 and moves to encourage employees to work longer, may make things easier. In any case a pension scheme is a selling point in attracting and retaining employees.

This briefing explains:

- The different options.
- The costs to an employer.
- Where to get help.

1 The options

A single tax regime for pensions introduced in April 2006, replaces the eight previously in force. This may stimulate the development of new types of pensions but for now the old legal framework for the differing types of schemes still applies.

1.1 Money purchase schemes (or 'defined contribution' schemes) have become popular with employers, as they involve a predictable financial commitment.

- There is no guarantee about the size of the pension payments you will receive.

The pension is based on the money paid in, the growth in your pension funds and annuity rates at the time of retirement.

- Most pensions from money purchase schemes are restricted to two thirds of final salary and the tax-free lump sum will from now on normally be limited to 25 per cent of the total fund.
- When the employee retires (or after retirement, if the scheme's rules allow), the scheme's trustees must provide an annuity. This provides the member with pension payments for the rest of his or her life. Costs are normally taken out of the fund.

1.2 Group personal pensions (GPPs) provide an alternative for small and medium-sized businesses which want to offer pensions to attract and retain good employees, but are daunted by the Pensions Act.

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- An individual pension plan is set up for each employee who joins. Both employer and employee can contribute to the plan.
- The pension paid on retirement depends on the level of contributions paid, the fund's investment performance, policy charges and annuity rates at retirement.

Contracting out

A The **State Second Pension** (formerly SERPS) benefits lower-paid workers.

- Schemes that meet certain requirements can contract out of the State Second Pension. Employers and employees can then pay reduced National Insurance contributions (NICs). See **National Insurance and state pensions**.

B Rules for **final salary** schemes are:

- A NI contribution is paid, equal to 9.4 per cent of earnings for the employee and 9.3 per cent for the employer based on earnings between £105 and £770 a week (the primary threshold and upper earnings limit). In the current tax year this represents a NI saving of 1.6 per cent for the employee and 3.7 per cent for the employer in the form of NI rebates. The rebate is also given on an amount equal to earnings between £90 and £105 a week (the lower earnings limit and the primary threshold).
- Benefits must be equal to or better than those offered by the 'reference scheme' — a model devised by the Government. This provides for a pension and a 50 per cent widow's (or widower's) pension.
- Any pension paid must increase annually by the lower of inflation or 1 per cent.

C Rules for **money purchase** schemes are:

- A flat-rate NI rebate (1 per cent of the employer's NI contributions and 1.6 per cent of the employees') is paid, plus an age-related rebate rising from nothing at 16 to 7.9 per cent at 52 and above. As with final salary pensions, a rebate is also given on an amount equal to earnings between the lower earnings limit and the primary threshold. Rebates are used to create 'protected rights' and give a pension and a widow's (or widower's) pension, inflation-protected.

- Charges to employees are often lower than those under individual pension plans.
- Most of the administration and disclosure is handled by the pension provider.

1.3 If some employees do not qualify for membership of your existing company scheme, or if you do not offer a scheme at all, you may have to offer access to a **stakeholder pension** at the workplace.

- Stakeholder pensions are designed to be simple, secure, low-cost arrangements.
- You have to designate a scheme and pass details of it on to your employees.
- If asked by employees who have joined your designated scheme, you have to deduct employee's contributions from pay.
- You do not have to contribute to stakeholder pensions, but may do so.
- You cannot be held responsible for the performance of the scheme.
- Employers with fewer than five employees, or whose employees all earn less than the lower earnings limit (£90 a week), need not offer stakeholder pensions.

See **Stakeholder pensions**.

1.4 Final salary schemes (or 'defined benefit' schemes) have largely been replaced by money purchase schemes for new employees, as running final salary schemes has become very expensive for employers.

- Pensions are based on the final salary at (or near) retirement, and on how long the employee has been in the scheme.
- Pension payments are financed from the pension 'fund', normally created from employer and employee contributions.
- If the scheme's investments under perform, the employer will usually have to make increased contributions.

The costs of running a scheme are usually borne by the employer.

1.5 Hybrid schemes provide a mixture of final salary and money purchase benefits.

2 The costs

2.1 Employers typically pay between 3 and 7 per cent of employees' pay into their company money purchase schemes. Employees typically contribute a matching amount, deducted from their pay packets. Employers' contributions to a final salary scheme average between 10 and 15 per cent of payroll with employees contributing about 5 per cent of salary.

➔ Since 5th December 2005 civil partner employees must be treated in the same way as married employees. If a benefits package (such as pension survivor benefits) is available to an employee's spouse, it must also be available to an employee's civil partner.

A civil partner who is treated less favourably than a married person in similar circumstances will be able to bring a claim for discrimination on grounds of sexual orientation.

- As long as the scheme is approved by HM Revenue & Customs, employer contributions can be set against corporation tax.
- Some schemes are non-contributory. Only the employer pays into the fund.
- Employers are not obliged to make contributions to stakeholder pensions, but they may if they choose to do so.

2.2 There are several ways to **reduce costs**.

But take advice first. You could:

- Consider closing your final salary scheme to new members and offer a less expensive money purchase or stakeholder scheme to new employees.
- Limit membership to people who have been with you for a given time.
- Increase employee contributions.
- Consider taking a contributions holiday if a final salary scheme is in surplus.

2.3 There will be **ancillary costs**.

- A scheme manager should be appointed to deal with day-to-day enquiries. He or she is normally an employee.

Top-up arrangements

A Reform of the tax system (see 3.1 above) has also simplified top-up provision.

- Employees can use any form of HM Revenue & Customs-approved pension scheme to obtain tax relief while topping up their arrangements.
- Tax relief is available on up to 100 per cent of annual earnings, up to the annual allowance (£235,000 in 2008/09).
- It is also available on up to £3,600 p.a. of unearned income.

B Highly paid executives, those with substantial unearned income, and those whose pension funds have performed particularly well, might need to consider other forms or pension provision.

- To the extent that their contributions exceed the annual allowance (£235,000 for earned income in 2008/09, or £3,600 for unearned income), they will be taxed at the same rate (40 per cent) whether they go into HM Revenue & Customs-approved schemes or not.
- But unapproved schemes might allow more freedom of action, and better returns from capital gains, than their approved counterparts.

- A final salary scheme will have to be valued on a regular basis to make sure the assets are sufficient to meet the liabilities.

3 The rules

3.1 The significant tax relief available on pension schemes means there are **limits** on how much tax relief employees can claim on the amounts paid in for pensions.

- Individuals can contribute annual earnings of up to £235,000 (the annual allowance for 2008/09) free of tax.
- To the extent that the employee's plus employer's annual contributions, or the annual growth in the value of the employee's pension funds exceed the annual allowance, they will be taxed at 40 per cent.
- There is also a lifetime allowance set at £1.65 million for 2008/09.
- To the extent that total savings exceed the lifetime allowance when benefits are taken, they will be taxed at 25 per cent (if taken as income) or 55 per cent (if taken as a lump sum).
- Unearned income can also be paid into pension arrangements, but only the first £3,600 in any year can be paid in free of tax.

3.2 Special considerations apply when **new employees** join a company.

- Schemes may accept transfers from other company schemes or personal plans.
- Tell employees about your scheme but do not make any direct recommendations.

3.3 Occupational schemes must offer employees who **leave employment** several options.

- Those with three months' service or more, who leave employment within two years can choose to have their contributions transferred to an occupational or personal pension scheme. Or they can have a refund of contributions minus a tax charge to repay tax relief given.
- Employees who change jobs after two years' scheme membership can defer their pension entitlements into a new employer's pension scheme or a personal pension scheme, or defer them by leaving them in the company scheme.
- Deferred final salary pensions must grow over the period of deferment by the lower of inflation or 5 per cent.
- Deferred money purchase pension

schemes get the full benefit of investment growth between leaving and retirement.

3.4 All pensions paid out by company schemes must be increased by the lower of **inflation** or 5 per cent each year, in respect of contributions or service after 5 April 1997.

3.5 Schemes must not be **discriminatory**.

- Men and women must have equal pension ages. Most schemes have equalised at 65.
- Companies must not exclude part-time employees from membership.

3.6 Scheme members must be provided with the following **information** on request.

- Details of the scheme rules.
- The scheme's annual report and accounts.
- An annual statement detailing the pension benefits the employee is entitled to. Statements must be issued automatically for members of money purchase schemes.

4 Protecting members' interests

Trustees and advisers must be appointed to protect occupational scheme members' interests.

4.1 Trustees must ensure that the pension fund is run for the benefit of its members, in accordance with the scheme's rules.

- Members must be offered the opportunity to elect at least one third of the trustees. The remaining trustees usually come from management.
- Trustees appoint the investment manager (or managers), actuary and auditor.
- Trustees risk severe personal penalties if they are remiss in carrying out their duties.

4.2 The fund manager invests the scheme's funds in line with the trustees' Statement of Investment Principles.

- Schemes usually appoint one or more investment management firms. If investment performance is poor, they may decide to switch to another firm.
- Charges are normally taken from the fund.

4.3 In final salary schemes, trustees must appoint an **actuary**, who calculates whether the value of the fund is sufficient to finance the company's future pension obligations. If not, the employer must make up the difference.

- Actuaries also set the calculation guidelines for transfer values when employees leave and want to take their pensions with them.

4.4 The trustees must appoint an **auditor**.

- Audits must be carried out within seven months of the scheme year end.
- The auditor will check that the fund holds the investments shown in its books. He or she will also verify that correct contributions have been paid.
- Trustees and managers are also required to notify any shortfall in payments to the Pensions Regulator if it is likely to be material.

4.5 As an employer, you are **legally** obliged to consult members of occupational or personal pension schemes you offer if any significant changes to the scheme(s) are planned.

- For example, an increase in the pension age.
- Or a change in the rules, to prevent new admissions.

5 Getting help

5.1 Take **professional advice** from an employee-benefits consultant or financial adviser to assess different types of scheme.

- A company's agent or sales person will recommend plans from the company's portfolio or that of other partner providers, which they believe to be suitable. Independent financial advisers will search a variety of providers and recommend a suitable plan.
- Some will receive a commission if you buy from them, while others will charge a fee.
- Check with the Financial Services Authority that the company or adviser is regulated under the Financial Services Act (0845 606 1234 or www.fsa.gov.uk).

5.2 HM Revenue & Customs can give guidance on setting up schemes to qualify for **tax relief** and provide help with obtaining approval (www.hmrc.gov.uk).

5.3 Information on **setting up** a company pension scheme can be obtained from:

- The Pensions Regulator (0870 606 3636; www.thepensionsregulator.gov.uk).
- The National Association of Pension Funds (NAPF) (020 7808 1300; www.napf.co.uk).
- The Association of Pensioner Trustees (0131 624 8618).

Further help

There are other Directors' Briefing titles that can help you. These briefings are referred to in the text by name, such as **National Insurance and state pensions**.

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