Guide from

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Pensions for employees

Major reform is sweeping through occupational pension provision and it affects every employer in the UK.

From 2012 all businesses will be obliged to contribute to their employees' pension schemes, and with tough measures proposed for companies that fail to comply now is the time to set up an occupational plan.

This guide considers:

- **Benefits of providing pensions for employees.**
- **Reforms in the system and the implications for employers.**
- **Providing and contributing to employee pensions.**
- **The likely costs and risks.**
- **Assisting your employees as they approach retirement.**
- **Where to get advice.**

1. The benefits

There is no escaping the cost of providing occupational pensions, but retirement schemes can deliver a number of benefits.

1.1 Providing a pension scheme will help you comply with the law.

- If you employ five or more people, unless you have your own company pension fund, you are required to provide access to a stakeholder pension scheme.
- If employees decide to contribute, you must offer to collect contributions and forward them to the pension provider.
- It is proposed that from 2012 you will no longer be required to offer a stakeholder scheme but you will have to pay pension contributions for almost all staff, unless they specifically opt out (see 2).

1.2 Any contribution will be subject to tax relief as it is treated as a business expense.

1.3 A competitive pension scheme is an invaluable employee benefit.

- Providing a good company pension helps retain existing employees.
- It can improve your business' reputation as an employer and help you attract and capable new employees.

1.4 By offering an occupational pension scheme you can help employees save for a more adequate retirement.

- The basic state pension is £95.24 a week for a single person and £152.40 for a couple.
- To qualify, employees must have paid National Insurance contributions (NICs) in full for 39 years for a woman and 44 years for a man (though both are due to fall to 30 years from 2010).
- There is a pension credit guarantee payable from age 60 of £130 for a single person and £198.45 for a couple. This is means-tested.

- The introduction of age discrimination legislation has given employees the right to ask to continue working beyond the default retirement age (currently 65). State pension age is 60 for a woman, but rising in stages to 65 between 2010 and 2020. By offering a good occupational pension scheme, you can help employees avoid the need to work beyond normal retirement age.

2. Pension reform

From 2012 it is proposed that every worker in the UK aged over 22 and earning more than £5,000 a year will be entitled to a contributory occupational pension under a system of Personal Accounts. Personal Accounts, as set out in the Pensions Bill 2007, are aimed at lower and middle-earners, ten million of whom are not paying into a retirement plan according to government estimates.

Under the new rules:

2.1 Employers must automatically enrol all qualifying workers into either Personal Accounts or their own equivalent or superior pension scheme.

- Personal Accounts will operate as a low-cost, nationwide, trust-based occupational pension scheme.
- A qualifying worker is aged between 22 and state pension age, whose salary falls between the lower and upper earnings limits (currently £5,035 and £33,540 respectively).
- If a worker is less than 22 years old or above state pension age, you will not be obliged to contribute to their Personal Account, but may do so if you wish.
- Those above state pension age can contribute from their pre-tax earnings and, provided that the total fund amounts to less than a given sum (currently £16,500), take it as a lump sum on retirement.
- Qualifying workers will have to contribute at least four per cent of their salary. You can encourage workers to pay more than this, which will be indexed in line with earnings.

2.2 All employers must contribute at least three per cent of salary to the pension arrangements of qualifying workers.

- It is likely that employer contributions will be phased in, with one per cent payable in 2012, two per cent in 2013 and three per cent from 2014 onwards.

2.3 Companies are responsible for ensuring that both employer and worker contributions are transferred into Personal Accounts.

2.4 Employers must make transfers into Personal Accounts on behalf of any qualifying workers who opt-in, including those excluded from the employer contribution on age grounds (ie below 22 or above state pension age).

2.5 Workers may decide to opt-out, but must make a positive decision to do so.

- Those who do opt-out will be automatically re-enrolled after a given time.
- Workers' contributions will be set at a minimum of four per cent.
- Workers may opt back in, but employers will not be required to accept opt-ins more than once every 12 months.
- Employers who fail to comply with legislation potentially face fines up to £50,000, with daily charges of up to £10,000 thereafter or even imprisonment.

3. Further options

Employers can offer alternatives to Personal Accounts but they must be as good as, or superior to, the nationwide scheme. Offering a better scheme than Personal Accounts can attract and retain key staff.

3.1 You can continue to manage an existing defined benefit or defined contribution scheme (for definitions, see box, page 2).

- Employer plus worker contributions to personal pensions is expected to be eight per cent.
- DB schemes must be based on 1/80th of final salary per year served, or more.

3.2 You can set up a new scheme.

- A DB (or final salary) scheme could be a risky choice for small to medium-sized businesses. Unless you are certain of reliable long-term profits DB schemes could prove too expensive.
- A growing trend is for group personal pension schemes (GPPs). These combine the benefits of personal pensions (particularly portability) with the benefits of group schemes (lower costs).
- Depending on the level of contributions and costs, setting up a new scheme could prove cheaper than maintaining existing plans but the benefits could be lower.

3.3 If you are planning to set up a new scheme, check how much administration will be done by the pension provider. You should take responsibility for:

- transferring the employee and employer contributions to the pension provider
- raising or reducing employee contributions, as requested (preferably at set intervals)
- dealing with enquiries from employees about payments in or out

3.4 Provided that you meet qualifying criteria, you can decide:

- What benefits you want to offer, eg death in service benefits, or ill-health retirement pensions.
- When you want to start contributing. Making contributions for two extra years could make a 20 per cent difference to the pension of those due to retire in 2030.
- The rate of contributions by increasing your contribution to four per cent and employee contributions to six per cent. After 20 years an employee on an average wage could have a pension fund of almost £120,000 (assuming a seven per cent investment return), compared to £80,000 with both of you contributing the minimum.

4. The run up to retirement

4.1 Contact employees at least six months, but no earlier than one year, before their retirement.

- Under Age Discrimination Legislation, you are obliged to alert employees to their imminent retirement.
- You must inform them of their right to work beyond the default retirement age (set at 65 under age discrimination legislation).

4.2 Provide employees with a pensions forecast.

- Combined Pensions Forecasts are available free of charge from the Pensions Service (0845 60 60 265; www.thepensionservice.gov.uk/employer/home.asp). They show how much employees are likely to receive from their state and occupational pensions.
- Your pension provider should be able to provide a reliable forecast of the employee's pension.

4.3 Offer your employees independent financial advice (see 5.1).

5. Getting advice

5.1 If you want to set up a new scheme or amend an existing one, contact an Independent Financial Adviser (IFA).

- You can find details of IFAs in your area on www.unbiased.co.uk.
- Pensions advice worth £150 a year can be offered as a tax-free benefit to employees. However, if the cost exceeds £150, the whole amount will be taxed.

5.2 To amend existing arrangements, approach the current pension provider.

- Be aware that they are likely to promote only their own products or those of a limited number of suppliers.

5.3 Contact the Pension Service (www.thepensionservice.gov.uk) for advice and information.

The new tax regime

Since A-Day on 6 April 2006, there have been significant changes to the pensions tax regime. The simplifications include:

- Individuals will be allowed a tax-free standard lifetime allowance (SLA) of £1.65 million increasing to £1.8 million in tax year 2010/2011. This rate will continue to apply for a further five tax years, ie up to and including the tax year 2015/16.
- The total value in all registered schemes will be tested at the time benefits are taken or at age 75. Any excess above the SLA will be taxed at 55 per cent.
- Tax-free lump sums of up to 25 per cent of total pension savings can be drawn.
- Benefits may be drawn after age 50 (rising to age 55 in 2010) but all lump sums must be drawn by age 75.
- Members do not have to retire or leave service to take pension benefits.
- There is no statutory requirement to buy an annuity.
- There are no restrictions on transferring between pension schemes.
- Individual contributions of £3,600 or 100 per cent of annual earnings, whichever is higher, will receive full tax relief subject to the annual allowance.
- The annual allowance for individual contributions will be £255,000 by tax year 2010/2011. This rate will continue to apply for a further five tax years, ie up to and including the tax year 2015-16. Contributions in excess of the allowance will be subject to tax.
- Restrictions on the types of investments made by registered schemes are limited. For example, members can invest in residential property, art and antiques.

Types of occupational scheme

A. Defined benefit schemes (DB or final salary schemes):

- DB schemes place the responsibility for funding pensions on the employer.
- They promise a pension related to earnings at retirement.
- Employees can hope to retire on two-thirds of final salary, though most will retire on considerably less.
- The schemes are revalued to ensure they still have enough assets to pay pensions far into the future. Asset values are affected by certain factors, particularly stock market performance.
- Market volatility, increasing life expectancy and escalating costs have seen private corporate DB schemes disappear as the main form of occupational scheme in the UK.

B. Defined contribution schemes (DC or money-purchase schemes):

- DC schemes place the risk of underfunding on the employee.
- Employees are usually expected to select their own investment strategy for the scheme.
- Most schemes offer a default which most employees invest in.
- They promise a lump sum at retirement with which employees can buy an annuity (see box, page 4), or from which they can 'draw down' cash. For example, withdraw income directly from the pension plan within limits each year, delaying the purchase of an annuity until interest rates are sufficiently attractive (see box, page 4).
- The size of the lump sum (capped at 25 per cent) depends on market conditions, the investment strategy and level of contributions.

C. Hybrids/Risk Sharing Schemes are neither pure DB nor pure DC and allow for risk sharing between employer and employee.

- Hybrid schemes include career-average plans and cash balance plans.
- Seen as a compromise between DB and DC, hybrids are gaining a place in occupational pension provision but remain the exception rather than the norm.

Annuities

Whether a pension is to be drawn from a defined benefit or a defined contribution scheme, normal practice is for the assets to be converted into an annuity.

- The scheme member can generally take up to 25 per cent of their pension pot as a tax-free lump sum. The rest must be used to provide incremental pension benefits.
- The size of the benefits will depend on the value of the assets at retirement and on the prevailing interest rates.
- When interest rates are high, pensioners will get a comparatively high return on their assets. When they are low, the return will be poor.
- Although in theory interest rates will be high when asset values are low, this will not always be the case and it is hard to predict how significant the benefits from an annuity will be.
- It is possible to offset these problems by postponing taking an annuity and 'drawing down' capital from the fund instead.
- With all personal pensions, it is now possible to do this until the age of 75, and with most personal pensions it will be possible to carry on doing it thereafter. With Personal Accounts, however, annuities will have to be purchased no later than age 75.
- Scheme members should shop around for the best annuity rate using the Open Market Option and not automatically opt for the product offered by their pension provider.

Experts' quotes

"Many employees want to save for their retirement but are put off because they are not sure where to go to gain more information."
Frances Corbett, Project Manager,
PENSIONSFORCE

Expert contributors

Thanks to: Ian Price, Divisional Director, Pensions (St James's Place; 08000 138 137); Aegon Scottish Equitable (08456 01 20 67/88/10).

Further Help

ACCA's advisory website is dedicated to meeting the needs of ACCA members in practice. www.accaglobal.com/advisory contains a wide range of information prepared by qualified accountants and is updated by ACCA's Technical Advisory team.

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