Pensions for senior managers

There has never been more choice and flexibility for senior managers when it comes to pension saving. Since the tax rules governing pensions were simplified two years ago, most employees can contribute more to their retirement fund, exercise greater control over drawing their income and invest in a wider range of assets.

At a time where life expectancy is increasing and there is less certainty about future financial security, a good pension scheme can be an invaluable benefit.

This briefing outlines:

- The benefits of providing pensions for senior managers.
- How to contribute to managers' pensions, including potential costs.
- The run-up to retirement, including retirement planning.
- Where to get advice.

1 The benefits

Occupational pension schemes are expensive but the value they create usually makes the outlay worthwhile.

1.1 By offering a superior occupational pension scheme, a firm **differentiates** itself from its competitors and attracts the best staff.

1.2 Providing attractive employee benefits **retains** key senior individuals who are crucial to the survival of a business.

1.3 Good employees should be **rewarded** and pensions are seen as a valuable benefit. Ensuring staff are well looked after creates loyalty.

1.4 Delivering robust benefits for senior employees **motivates** upcoming talent.

1.5 Company pensions help provide financial **security** in increasingly uncertain times.

1.6 In reality, a pension scheme is no more than **deferred** salary.

2 The options

Under the reform set out in the Pensions Bill 2007, all employers have to contribute to a company pension scheme unless workers opt

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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.

out. The new system of Personal Accounts, set for introduction in 2012, will set minimum employer contributions at three per cent, employees at four per cent, while one per cent comes from tax relief. Total annual contributions are capped at £3,500 meaning businesses should look outside Personal Accounts to provide benefits for their employees.

2.1 The most common forms of an occupational pension plan are defined benefit (DB) and defined contribution (DC) schemes (see box, page 2), but there are a number of supplementary and **alternative** schemes available.

2.2 Additional voluntary contributions (AVCs) are DC schemes that allow members to **top-up** their main pension plan.

- There are two types of AVC: an in-house AVC run by the employer; and free-standing AVCs which are run by an external provider.
- Annual payments to AVCs are limited to £235,000 or 100 per cent of salary, whichever is lower.
- AVC schemes offer the members tax relief.

2.3 Personal pensions can also be used to top-up **occupational** plans although they can also form the main retirement plan.

- Stakeholder personal pensions must be made available by any company employing more than five staff. These are usually cheap to set up and run.
- Employer contributions are deductible against corporation tax.
- Group Personal Pensions (GPPs) combine individual personal pensions into one plan, allowing for cost efficiency. They operate under the same rules as individual personal pensions.
- Personal pensions are DC plans which means the individual rather than the employer bears the investment risk.
- Minimum retirement age for personal pensions will rise from 50 to 55 in 2010.

2.4 Executive Pensions Plans (EPPs) are defined contribution plans provided by the **employer** and run by a life assurance company.

- Employer contributions are deductible against corporation tax.
- Employees are not liable to income tax or National Insurance contributions (NICs) on payments made to an EPP.
- Contributions are subject to tax relief limitations (see box, page 3).

- Members can transfer existing plans into their EPP.
- The frequency and amounts payable to an EPP are usually flexible.

2.5 Self-invested Personal Pensions (SIPPs) are similar to standard personal pensions but allow greater investment **freedom**.

- SIPPs are governed by the same tax, contribution and eligibility rules as personal pensions.
- SIPP investors can control their investment strategy and hire a fund manager or broker to carry out investment decisions.
- SIPPs are run under trust law although the member can be the trustee if the plan is overseen by an independent administrator.
- Administration costs can be high.

2.6 Small Self-administered Schemes (SSASs) are **occupational** plans usually made up of directors and senior managers.

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.
- 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. 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.

- Set up under trust deed, SSASs encourage greater control over investments and assets.
- SSASs can be expensive to set up with adviser, trustee and management fees.
- Employer contributions are deductible against corporation tax.
- A SSAS can lend money to the employer provided the loan does not exceed 50 per cent of the net value of the scheme's assets.

2.7 Pensions salary sacrifice allows employees to **exchange** earnings for non-cash benefits which means both employer and employee make National Insurance (NI) savings.

- Employee pension contributions are converted into employer contributions which do not incur NI.
- The employer can pass NI savings to employees as a bonus contribution to the plan.
- Pensions salary sacrifice can see contributions rise by 30 per cent at no extra cost to the employer.

2.8 Funded Unapproved Retirement Benefit Schemes (FURBS)/Employer-Financed Retirement Benefits Scheme (EFRBS) were set up to provide **benefits** for employees earning more than the salary cap.

- The tax reforms in 2006 have replaced maximum salary with a lifetime allowance making FURBS/EFRBS less relevant.
- Contributions do not attract tax relief but for funds accumulated prior to 6 April 2006, the entire sum can be taken tax free.

3 Nearing retirement

A pension pot can represent as much as 40 years of saving which means the final stages of retirement planning must be executed carefully.

3.1 Employees no longer have to **retire** to claim their pension.

- It will become increasingly common to start drawing a pension while still employed, possibly just part-time.
- Encouraging experienced senior managers to continue working could benefit your business as a whole.
- Make sure core employees understand the cost of taking benefits early.

3.2 If you are a member of a final salary scheme your only options are to take a tax-free **lump sum** and an income. The income is guaranteed until you die.

3.3 Defined contribution members can take a tax-free **cash sum** of 25 per cent of the total fund and either choose an annuity or income drawdown.

3.4 It is no longer compulsory to purchase an annuity at **retirement**. Income drawdown plans offer an alternative.

- Income drawdown allows members to vary the timing and amount they withdraw from their pension depending on changing circumstances.

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.

- If you die before age 75, income drawdown can provide a fund for a surviving partner. If taken as a lump sum, there is a 35 per cent tax charge.
- Income drawdown plans usually invest in stocks and shares which carry investment risk. Take advice before opting for income drawdown.

3.5 Consider offering senior employees a **detailed** financial review to help them make the best decisions at retirement.

- Contact employees at least six months, but no earlier than one year, before their retirement.
- Under Age Discrimination legislation, you must inform them of their right to work beyond the default retirement age (65 for men, currently 60 for women).
- Provide a comparison of options available to senior managers.
- Make sure all the company pension booklets are up to date and available to scheme members.

4 Getting advice

4.1 You should always seek **professional** advice when setting up a retirement scheme or assisting employees in making pension arrangements. Before contacting a fee-based adviser, basic information can be obtained from:

- The National Association of Pension Funds (www.napf.co.uk; 020 7808 1300).
- The Pensions Advisory Service (www.pensionsadvisoryservice.org.uk; 0845 601 2923).
- The Pensions Regulator (www.thepensionsregulator.gov.uk; 0870 606 3636).
- HM Revenue & Customs (www.hmrc.gov.uk/pensionschemes/index.htm; 0115 974 1600).

4.2 Employers should **consider** paying for financial advice for employees.

- Pensions advice worth up to £150 a year can be offered as a tax-free benefit to employees.
- Ensure that your adviser is regulated. Contact the Financial Services Authority to check (www.fsa.gov.uk).

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