

To: Salaries and Wages Departments
Human Resources
Pension Contacts

Circular 12/2010
18 October 2010

At: All Employing Authorities

Dear Colleagues,

Pension and Taxation Reforms

1. Purpose of this Circular

At present there are unprecedented numbers of reviews of pensions, taxation and related areas which may lead to changes that impact on pensions and payroll in general, and the Local Government Pension Scheme (NI) (LGPS (NI)) in particular. This circular has been issued to update employing authorities on the changes proposed by the new coalition Government, changes which have been confirmed, as well as changes that were proposed by the preceding labour administration and are now under review.

2. Changes proposed by The Emergency Budget on 22 June 2010 and other consultations

The Chancellor of the Exchequer's Emergency Budget proposed the following changes or reviews to pensions. Each of these proposals and outcomes of consultations, where appropriate, is outlined in more detail in the following sections. I have concentrated on those proposals which are of particular relevance to the LGPS (NI); these are in bold below.

- **Public service pensions are to increase in line with the Consumer Price Index (CPI) instead of the Retail Prices Index (RPI).**
- Public sector pay will be frozen for two years unless the worker earns less than £21,000 per annum.
- **An independent commission, headed by John Hutton, will undertake a fundamental structural review of public service pensions and will consider the case for short-term savings in time for the Spending Review.**

- **The restriction of tax relief on pension contributions by high earners introduced in the Finance Act 2010 will be repealed and the Government will consult on alternative ways of recouping £3 billion to HM Treasury.**
- The link to increases in average earnings will be restored to increases in the Basic State Pension from April 2011.
- The Government will review when the State Pension Age will increase to age 66. This will be no earlier than 2016 for men and 2020 for women.
- The Government will consult on how quickly it will remove the default retirement age after April 2011.
- The Government will consult on the details of the removal of the requirement for individuals to buy annuities by age 75.
- The Finance Bill will include changes to pensions' tax legislation to enable the National Employment Savings Trust (NEST) to register as a pension scheme for tax purposes. Further legislation will remove tax charges on late contributions following auto-enrolment.
- Legislation will be introduced to tackle arrangements which reward employees and seek to avoid, defer or reduce liability of employers to income tax, National Insurance Contributions or to avoid restrictions on pensions' tax relief.
- **The coalition Government is supportive of auto-enrolment proposed by the previous administration and will review the proposals.**

In addition to the above consultations and reviews, the Government issued a consultative document on 27 July 2010 on PAYE. This consultative document proposes moving to a system that collects information on PAYE deductions at the time employers pay individuals (Real Time Information) and proposes a more radical system of centralised deductions.

3. Spending Review

The Chancellor will set out the Government's four-year public spending plans in the Spending Review at 12:30 on Wednesday 20 October 2010. It is expected that one area of this review will be plans for savings and reform of public service pensions including an increase in public sector employees' pension contributions.

4. Pensions Increases change from RPI to CPI

4.1 Implementation

In the LGPS (NI) the regulations governing pensions' increases refer to the Pensions Increase (Review) Orders and it is possible to effect the change by

using future Pension Increase Orders based on CPI rather than RPI without Scheme regulatory amendments.

The implementation process for private sector schemes is more complicated than for public schemes and in some cases it may be prevented by individual trust deeds.

4.2 Differences between RPI and CPI

The main difference between the two indices is that RPI includes housing costs e.g. mortgage payments. There is also an underlying difference in the two methods of calculations – RPI uses arithmetic weighting and CPI uses geometric weighting.

Historically RPI has been on average about 0.75% higher than CPI. However, as you can see from the table below CPI has been higher than RPI in the last two years.

Year	CPI (%)	RPI (%)
2000	1.0	3.3
2001	1.3	1.7
2002	1.0	1.7
2003	1.4	2.8
2004	1.1	3.1
2005	2.5	2.7
2006	2.4	3.6
2007	1.8	3.9
2008	5.2	5.0
2009	1.1	-1.4

Up until now the annual RPI figure for September has been used to set the pensions increase which applies at the following April. If the same basis is used to set pension increases in April 2011 pensioners and deferred members will receive an increase of 3.1%. This is 1.5% lower than what they would have received under RPI.

4.3 Impact

The main impact on deferred members and pensioners is that their pensions will increase more slowly while deferred or on pension. This effect will compound over the years.

The move from RPI to CPI has reduced future cash payments to be made by pension funds with an immediate reduction in liabilities and a consequential improvement in funding levels. Early actuarial advice is that this could increase current funding levels by 5%. The actuary will be taking this change into account during the current triennial valuation.

This change in indices has had a knock-on effect on the factors used by the Scheme to calculate transfer values and provide figures which value pensions on divorces. The factors used in these calculations have been revised by the Government Actuary's Department (GAD) and new factors and methodology are effective from 1 October 2010. In general the new factors have reduced transfer values payable from the Scheme by between 10% and 30%. Updated factors are still outstanding for some types of transfers in to the

Scheme and regrettably, in the absence of these factors, we cannot process these benefits.

5. Public sector pay frozen

Public sector pay is to be frozen for two years unless the worker earns less than £21,000 per annum. This has implications for the funding of the LGPS (NI) and the actuary has indicated that this should improve the funding level of the Scheme.

6. The Hutton Review of Public Sector Pensions

6.1 Background

On 20 June 2010 the Chancellor announced an independent commission, headed by John Hutton, would undertake a fundamental review of public service pensions and consider the case for short-term savings by September 2010 in time for the Spending Review. Following this announcement NILGOSC sent a written submission to Lord Hutton on the LGPS (NI) and responded to Lord Hutton's requests for information on the Scheme. It should be noted that the average pension paid to LGPS (NI) pensioners is £3,984 and 91% of pensioners receive an average pension of £2,966. These levels of pensions are much lower than the media reports which implied that public sector pensions are gold plated.

6.2 Interim Report

Lord Hutton published his interim report in October 2010 which is available at: http://www.hm-treasury.gov.uk/d/hutton_pensionsinterim_071010.pdf The LGPS (NI) falls within Lord Hutton's terms of reference but any changes to the Scheme will be a matter for the Department of the Environment and the Northern Ireland Assembly.

The interim report sets out its case for changes to public service pensions in that people are living longer, the current final salary schemes are unfair as they reward high flyers disproportionately, there is an imbalance between taxpayers and employers and contributions do not reflect the value of benefits received. The report considers options for short-term savings and sets out its ideas for long-term structural reform.

The report confirms that, after considering other options, the most effective way to make short-term savings is to increase employee contributions but it is for the Government to decide the manner and level of any increase. It is expected that the Spending Review will confirm whether these increases are imminent.

The report confirms that long-term structural reform is necessary and states that the Commission plans to examine a range of schemes where the risk is shared between the employer and employee. The range of schemes, which are under consideration, is listed at Appendix 1.

The Commission will also consider elements of Scheme design such as:

- Ensuring normal pension ages are in line with latest developments in longevity;

- Reviewing rules concerning when pensions are drawn before or after normal pension age, in order to increase market flexibility;
- The implications of different indexation options for pension costs and incomes over time; and
- Accrual rates in different schemes.

Importantly, the Commission has concluded that the LGPS should remain a funded scheme. The interim report makes it clear that pension awards already made would not be changed and neither would years of pensionable service built up by those already accruing pension rights. However, protecting accrued rights does not extend as far as protecting current terms for future pension accrual. The Commission also confirms that it is wrong to say that public sector pensions are gold plated.

Finally, the Commission has stated that the transitional arrangements for moving from current to new structures result in:

- The protection of the range of accrued entitlements provided by pension schemes;
- Effective transition to new ways of providing for retirement pensions and protections against ill-health, death and redundancy; and
- The ability to practically implement reforms, taking account of the wide range and diversity of public service groups that will be affected.

This will require appropriate planning, timetabling and administrative resources, both in personnel and systems.

6.3 Final Report

The Final Report is expected in March 2011. In this Report the Commission will make recommendations on the range of options to the Government which can then establish an appropriate framework for future public service pensions.

It is expected that NILGOSC will shortly be asked to provide more information on the Scheme to the Commission.

7. Restriction of High Earners Tax Relief on Pension Contributions

7.1 Background

In the Emergency Budget the Government announced that its intention was to repeal the restrictions on tax relief on pension contributions for high earners which had been introduced under the Finance Act 2010. It was felt that the previous administration had introduced a complicated system of taxation for high earners. The Government issued a consultation document on an alternative approach to the restriction of pensions' tax relief in July 2010. This document, amongst other things, proposed reducing the annual allowance. The annual allowance limits the amount that can be saved tax efficiently each year in registered pension schemes i.e. pension contributions which attract tax relief. Currently an annual limit of £255,000 applies and the proposal was to reduce this to within the range of £30,000 - £45,000. The consultation ended on 27 August 2010 and the Government confirmed its intended approach on 14 October 2010. All documents relating to this consultation are available on http://www.hm-treasury.gov.uk/consult_pensionsrelief.htm.

7.2 The Ministerial Statement dated 14 October 2010 and Summary of the Discussion Document Responses

These statements confirm the following:

- From April 2011, the annual allowance for tax-privileged saving (i.e. pension contributions to a defined contribution scheme or 'deemed contributions' to a defined benefit scheme) will be reduced from £255,000 to £50,000.
- The lifetime allowance (LTA) will be reduced from £1.8 million to £1.5 million from April 2012. The lifetime allowance is the value of pension benefits which an individual can accrue over his/her lifetime without incurring a tax charge.
- The 'deemed contributions' to a defined benefit (DB) scheme, such as the LGPS (NI) will be calculated using a 'flat factor' of 16. This means that an increase in annual pension benefit of £1,000 would be deemed to be £16,000.
- In recognition of one-off spikes in pension accruals under DB schemes it is proposed that unused allowance from up to three previous years can be carried forward to offset the excess contribution. An allowance of £50,000 will apply to each of the previous years.
- A consultation on a range of options for payment of any tax charges incurred will follow. It is suggested that, in some cases, the charges could be paid from the pension fund and the member's benefits reduced accordingly.

7.3 How to value defined benefit contributions

The following two examples are purely to illustrate the impact of a reduced annual allowance on a member of a DB scheme such as the LGPS (NI).

Example 1 – assuming a 1/60th scheme, a flat factor of 16 and an annual allowance of £50,000

Tony is 55 with 30 years' membership and a pensionable pay of £25,000 (increased from £24,000 the previous year)

Value at end of current tax year

Pension: $30 \times 1/60 \times £25,000 \times 16 = £200,000$

Value at end of previous tax year revalued by CPI of 3.1%

Pension: $(29 \times 1/60 \times £24,000 \times 16) \times 1.031 = £191,354$

Total deemed benefit growth = £8,646

This is within the annual allowance of £50,000 and no tax charge applies

Example 2 – assuming a 1/60th scheme, a flat factor of 16 and an annual allowance of £50,000

Jane is 55 with 30 years' membership and a pensionable pay of £40,000 (increased from £24,000 the previous year following a significant promotion).

Value at end of current tax year

Pension: $30 \times 1/60 \times £40,000 \times 16 = £320,000$

Value at end of previous tax year revalued by CPI of 3.1%

Pension: $(29 \times 1/60 \times £24,000 \times 16) \times 1.031 = £191,354$

Total deemed benefit growth = £128,646

This growth is in excess of the annual allowance of £50,000 and Jane would have to see whether she had sufficient unused allowance from the three previous years to offset against the excess contributions. In the majority of cases it is expected that there would be sufficient unused allowance and a tax charge would not apply.

7.4 Other considerations

The Government has stated that it will look to exempt ill-health benefits from the annual allowance regime but has made it clear that there will be no exemption for individuals in the case of redundancy, those with enhanced protection or in the year benefits come into payment.

7.5 Implications for members of the LGPS (NI)

While clarification is needed in several areas, particularly in relation to how AVC contributions are valued, it appears that mainly high earners are affected by these new restrictions. However, more lowly paid members receiving large increases in the value of their benefits could incur tax charges. These large increases could arise due to significant increases in pensionable pay and award of additional years (augmentation of membership) combined with lengthy periods of membership.

7.6 Implications for employers participating in the LGPS (NI)

Employers will need to review their processes to provide NILGOSC with critical member data within the new guidelines. Employers must provide information about employees' pensionable pay, benefits and membership to pension schemes by 6 July following the end of the tax year. In the first year only, employers and pension schemes will be given an additional 12 months to provide the required information. At present, annual returns are due before the end of May each year so this should not pose a problem for the majority of employing authorities.

Employers should also consider whether there is any impact on redundancy terms.

8. Link to National Average Earnings for State Pensions

In the Emergency Budget the Chancellor announced that the link to increases in average earnings will be restored to increases in the Basic State Pension from April 2011. The increase in Basic State Pension will be the highest of the increase in average earnings, the increase in RPI and 2.5%.

9. Increase in State Pension Age

The Chancellor announced that the new coalition Government would review when the State Pension Age will increase to age 66. This will be no earlier than 2016 for men and 2020 for women.

A Call for Evidence was produced by the Department of Work and Pensions in June 2010 and can be read at <http://www.dwp.gov.uk/docs/spa-inc-to-66-call-for-evidence.pdf>. This review closed on 6 August 2010.

10. Removal of Default Retirement Age (DRA)

The Government stated its commitment to phasing out the default retirement age of 65. A formal joint Department for Business, Innovation and Skills (BIS) and Department for Work and Pensions (DWP) consultation document was issued on 29 July 2010 on how the DRA might be phased out. The closing date for submission of views on the consultation is 21 October 2010. The consultation is available at <http://www.bis.gov.uk/retirement-age>.

The key points are:

- The DRA will be abolished from 1 October 2011
- No new notices for compulsory retirement using the DRA procedure will be permitted from 6 April 2011
- After 1 October 2011 any use of retirement age will have to be objectively justified and will be subject to claims of age discrimination and subject to challenge at tribunal.

It is not expected that any regulatory amendments will be required for the LGPS (NI) as members can currently work on and accrue pension benefits beyond age 65.

11. Removal of requirement to buy annuities by age 75

Following the Chancellor's Emergency Budget the Treasury launched an eight week consultation on plans to remove, from April 2011, the requirement to purchase an annuity by age 75. The consultation paper (available at http://www.hm-treasury.gov.uk/d/consult_age_75_annuity.pdf) proposes that the age 75 limit that applies to the purchase of annuities, the payment of a pension commencement lump sum and the payment of a trivial commutation lump sum should be abolished. Tax relief on pension contributions would stop at age 75. The closing date for responses to the consultation was 10 September 2010.

Depending on the outcome of the consultation the age 75 restrictions on payment of benefits may have to be removed from the LGPS (NI). At present, NILGOSC must pay out all benefits by age 75.

12. NEST becomes a registered pension scheme

NEST is the new workplace pension scheme that is being designed specifically to meet the needs of low-to-moderate earners and their employers. Its creation is linked with auto-enrolment. Auto-enrolment is described briefly in section 14.

The proposals in relation to the National Employment Savings Trust (NEST) are to enable it to register as a pension scheme for tax purposes.

More information on NEST is available at <http://www.nestpensions.org.uk/>.

13. Prevention of avoidance of tax

Legislation, effective from April 2011, will be introduced to tackle arrangements which reward employees and seek to avoid, defer or reduce liabilities of employers and directors to income tax, National Insurance contributions or to avoid restrictions on pensions' tax relief.

14. Auto-enrolment

14.1 Background

The previous government proposed auto-enrolment which means workers being automatically enrolled into their employer's pension scheme. Auto-enrolment will be introduced from 1 October 2012 and although the new duties come into effect on that date, the duties of individual employers will be introduced gradually over the following four years, based on the size of the employer, typically by PAYE size.

As you will be aware the LGPS (NI) already has auto-enrolment, however, there are still several actions required for employers who participate in the LGPS (NI). These are briefly listed in section 14.4 below.

14.2 Review of auto-enrolment

The new Government announced a review of auto-enrolment and stated that it remained committed to auto-enrolment but wanted to review the 'costs and benefits' to individuals and employers and value for money for HM Treasury. The main features to be re-evaluated are:

- The earnings threshold for the application of auto-enrolment;
- The introduction of a minimum contributions level for the application of automatic enrolment;
- The age group to which the automatic enrolment will apply; the size of employer to which automatic enrolment will apply; and
- Whether employees should be automatically enrolled on the day employment commences or at a later date.

The review is available at <http://www.dwp.gov.uk/docs/making-automatic-enrolment-work-tor.pdf> . It commenced on 6 July 2010 and closed on 13 August 2010.

14.3 More information for employers

The Pensions Advisory Service has produced a helpful guide and auto enrolment planner for employers. It can be accessed at <http://www.pensionsadvisoryservice.org.uk/future-pension-reforms/auto-enrolment>.

14.4 Actions required by employers

I am sure that many employers have already begun to consider auto-enrolment and its implementation. It is estimated that employers need to allow 18 months to plan and prepare for auto-enrolment.

The draft regulations can be downloaded from http://www.opsi.gov.uk/si/si2010/draft/ukdsi_9780111490655_en_1 and indicative commencement dates for employers can be found on the Pension Advisory Service website mentioned above.

Employers should assess their likely start date for auto-enrolment and begin putting together an action plan both in terms of the implications of the legislation and the potential impact of the additional pension costs.

The next stage will be to consider other key issues such as the administration and interfacing between Human Resources, Payroll and NILGOSC. The legislation will require changes in current systems, processes and member communications. The employer will have to contact and auto-enrol employees who have currently opted-out of the Scheme and also have to write to all employees who participate in the Scheme advising them that they are auto-enrolled.

Due to the sheer volume of information being transmitted it is probable that NILGOSC will require all information relating to auto-enrolment in electronic format e.g. notification of new members, optants out etc. We will be testing electronic receipt of information over the next few months with a view to offering this as an alternative means of receiving information.

15. PAYE Review

15.1 Consultation Document

The Government issued a consultation document on Improving the Operation of PAYE on 27th July 2010. This consultation closed on 22 September 2010. A copy of the consultation document is available at http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.ortal?nfpb=true&pageLabel=pageLibrary_ConsultationDocuments&columnns=1&id=PREVIOUS_HMRC_CONSULTATIONS .

In summary, the document proposed moving to 'real time information'. This proposes that, as a first stage, employers would report payments and deductions for individuals to HMRC at the time of each payment. The document also suggests that the second, more radical stage, would be 'centralised deductions'. Under centralised deductions the employer would send the gross payment through the electronic system to a central calculator at HMRC where the deductions are calculated by HMRC and made automatically e.g. tax, national insurance and student loan repayments. The resulting net payment would then be sent to an individual's bank account and the deductions would be paid directly to the Government.

15.2 NILGOSC Response

NILGOSC responded to this consultation as it currently runs a payroll for 25,000 pensioners and these proposals could have significant impact in programming terms for payroll software. In its response NILGOSC welcomed the move to real time information but stated its concerns regarding centralised deductions.

Finally, as you can see, it has been a hectic few months of consultations, responses and outcomes. I realise that this is a very long circular and some of the content is complex, so please contact me if you need any clarification. Without doubt, there will be many more circulars over the coming months as some of the proposals become reality.

Yours sincerely

A handwritten signature in black ink that reads "Zena Kee". The letters are cursive and fluid, with the first letter of each name being capitalized and larger than the others.

Zena Kee
Pensions Manager

Appendix 1

Examples of the range of pension schemes available

- A Career Average Defined Benefit (DB) Revalued Earnings model.
- Notional unfunded Defined Contribution (DC) schemes which will determine the value of the pension at retirement by an assumed return on contributions and annuity rates. This is similar to an innovative international model operated in Sweden.
- Collective funded DC schemes where all contributions are placed into one fund that is managed on behalf of members. Pensions will vary according to the value of the underlying investments. This is similar to a model operated in the Netherlands.
- Cash balance schemes where the employer puts a notional amount into the member's pot every year which is then guaranteed. The credit can be expressed as a percentage of salary for each year worked. If cash contributions from the employee and employer, plus investment returns, do not match the "notional credit" then the employer will have to meet the shortfall. The cash balance is used to purchase a pension annuity on retirement.
- Sequential hybrids which are schemes where members can earn both a DB pension and a DC pension during their career although they can only earn either DB or DC benefits at one time.
- Capped DB schemes where there is a limit on the amount of earnings that counts for pension purposes or on pension payments from the scheme.
- Combination hybrids, where members simultaneously earn benefits that are part DB and part DC. For example, a capped DB pension, based on earnings up to a certain level and a DC benefit on earnings above this level.