R04 2020/2021
Final Salary Schemes
Part 1: Overview and accumulation phase

This section will look at final salary or defined benefit schemes. The good news is that the A Day reforms brought them under the same tax rules as money purchase arrangements. Because a DB scheme has one fund for all its members some of these rules, particularly the calculation of the member's Pension Input Amount and the calculation of the PCLS are applied in a different way.

The milestones for this part are to understand:

- How a defined benefit is structured
- The typical benefits offered by a final salary scheme
- The definition of a contracted out pension
- The key differences between defined benefit and money purchase funding
- How to calculate the member's Pension Input amount

Defined Benefit scheme structure

A DB scheme is an occupational pension scheme set up by an employer. Most companies in the private sector no longer allow new employees to join the scheme but existing members can still build up benefits. In practice the number of active members will steadily decline as they either retire and take benefits or leave the company.

A DB scheme has one fund for all its members and for large schemes these can contain billions of pounds of assets. When a member becomes eligible to take a pension this will be paid directly from the fund.

The scheme will be set up as a trust and administered by trustees whose prime responsibility is to ensure that members are paid their promised benefits.

Most schemes are contributary and members will pay a set percentage of their pay into the scheme. The employer also contributes but this isn't linked to the member's salary but is an amount determined by how much fund needs to pay its promised benefits.

In the state sector some schemes are unfunded, The members make a contribution but if this is insufficient to pay the benefits the Government makes up the difference.

The main benefits offered by a final salary scheme

Final salary or defined benefit schemes are often described as "gold plated" pensions and it is easy to see why this is the case, at least from the member's point of view.

It promises a pension based on a percentage of the member's final salary. This is based on an **accrual rate** which typically in the private sector is 1/60th. This means that if they are a member for 30 years they will get 30/60th or ½ their final salary.

This makes it much easier to plan since whilst a member's retirement may be 15 years away an adviser can calculate their potential pension based on current salary and discuss with the client whether it would be adequate.

Moreover, when the pension comes into payment the scheme must increase at least part of it every year and it will usually offer a spouse or dependant's pension.

In addition, many schemes offer a further range of benefits:

A lump sum death in service benefit.

Typically, this is based on a multiple of salary at time of death. If the multiple is 4 and the member's salary was £40,000 then the amount paid would be £160,000. This is almost always paid under a discretionary trust. The member cannot demand the benefit is paid to a specific person but can complete an expression of wish. This can be overruled by the trustees and whilst rare it may be exercised in the case of marital breakdown.

Peter died and left an expression of wish asking the trustees to pay the benefit to his partner Sandra. The scheme contacted Peter's manager and found out that he had left his wife Carol and children two years earlier. Based on that information the trustees may decide to pay all or part of the benefit to Carol

Paying a beneficiary through a discretionary trust is advantageous because the money will not be part of the deceased's estate and can be made very quickly. Most schemes will usually try and get the money paid out within a matter of days of being notified of the member's death.

Spouse's pension Pre and post retirement

Once the member has retired their spouse or civil partner will normally receive a part of this (typically 50% or 66%). This is compulsory on any Guaranteed Minimum Pension and benefits accrued since April 1997. For same sex couples the scheme is only legally obliged to pay a pension based on benefits accrued since December 2005.

The scheme may also pay an additional pension on behalf of any minor children until they are 18 or completed higher education.

A spouse's/dependant's pension from a scheme pension is always taxable regardless of the age of the member on death.

Many schemes will also pay a pension if the member dies before retirement. The best will base this on the member's prospective service.

Jim's scheme pays a spouse's pension of 50% of salary at date of death based on potential service. The accrual rate is 1/60th.

Jim died aged 45 having been a member for 10 years. The scheme retirement age is 65. His salary was £40,000.

His potential service was 30 years so his pension is calculated as 30/60 of £40,000 which is £20,000. The scheme pays 50% of this so his widow would receive a pension of £10,000 a year.

HMRC will allow both the pre and post pension to be paid to anyone regardless of marital status but the scheme rules may only allow this to be paid to a legal spouse or civil partner. A scheme can have more restrictive rules than HMRC but they cannot be more generous.

Ill health pension

Subject to HMRC requirements being met the scheme will usually pay an ill health pension. This may be based on potential service to retirement.

Let's say in the previous example that Jim did not die but qualified for an ill health pension. This would be calculated as follows:

Salary £40,000 x 30/60 = £20,000

Contracted out schemes

Prior to tax year 2015/2016, a final salary scheme could elect to contract out of the additional state pension. This dates back to 1978/79 with the introduction of the **State Earnings Related Pension Scheme (SERPS).**

Schemes argued that their members would get better benefits than SERPS and were allowed to contract out of the system so schemes were described as being either contracted out or contracted in.

If the scheme contracted out both the employer and employee paid a lower rate of National Insurance but members would build up any credit for SERPS. A contracted out scheme had to offer its members a **Guaranteed Minimum Pension (GMP)** which in broad terms meant they would be no worse off than if they had been receiving SERPS.

The requirement to offer a GMP was abolished from the start of the 1997/1998 tax year and replaced with a less onerous test.

The ability to contract out was removed from tax year 2015/16 but members of such schemes and their right to a GMP still has a significant influence over the way benefits are paid.

Differences between final salary and money purchase

The majority of FS schemes in the private sector are closed to new employees. Instead they will be offered a DB scheme. In this comparison we'll how the pensions for employees in the closed final salary scheme and the money purchase scheme differ.

- Members of both will pay a percentage of their basic pay into their pensions. The employer will also contribute but in an MP scheme it is a fixed percentage of the employee's pay whereas there is no set amount in the FS scheme.
- Money purchase members must choose their own funds although there may be a default fund or guidance from the employer. All investment decisions in the FS scheme are taken by the trustees.
- Members of the money purchase scheme will have their own individual funds whereas in the final salary scheme has one fund for all members.
- At retirement MP members must choose how these are taken. For the FS member it is a "seamless" transition as they will receive their pension directly from the scheme.
- In the MP scheme all the risks are carried by individual members. The employer takes all the risk in the final salary scheme.

Calculating the Pension Input Amount

A member's PIA is the total of their and their employer's contribution. In a money purchase scheme this is straightforward as both will pay a percentage of their basic pay. In a final salary scheme whilst members usually pay a fixed percentage of their pay, the employer makes large contributions to the whole scheme.

The basic principle is that the PIA is calculated by multiplying the increase in the member's rights by 16 although in practice it's slightly more complicated.

The pension benefits at the beginning and end of the input year (now the same as the tax year) are calculated. The benefit at the start of the input year is increased by CPI at the previous September and both figures are multiplied by 16. The difference is the PIA. An example will make this simpler.

Larry is a member of a 60th scheme and at the start of the year had 20 years' service and a salary of £30,000. At the end of the year his salary had increased to £36,000.

His pension at the end of the year was 21/60 x £36K = £12,600
This is multiplied by 16 to give £201,600

His pension at the start of the year was 20/60 x £30K = £10,000
This is then increased by the rise in CPI as at the September in the previous year. Let's assume this is 2%

£10,000 + 2% = £10,200. This is multiplied by 16 to give £163,200

The Pension Input amount = £201,600 less £163,200 = £38,400

This figure includes both employer and mandatory employee contributions so it doesn't matter if Larry's contribution is 3%, 5% or it's a non-contributory scheme, the PIA remains £36,800

For members of state sector pensions where the benefits are based on pensions + cash for both the start and the end of the year you must multiply the pension by 16 and add the PCLS. The difference is the PIA.

Currently the increase in benefits would have to be more than £2,500 (16 x £2,500 = £40,000) for the PIA to exceed the Annual Allowance. If this happens carry forward can be used.

Kate had been a member of her employer's final salary scheme for 10 years. At the start of 2018/19 her salary was £30,000. This gave her a pension of £10,000. CPI was 3% so this equates to £164,800. (£10,000 x 16+ 3%)

Following a promotion her salary had increased to £42,000 at the end of the tax year so her pension rights had increased to 21/60 x £42.000 = £14,700. Multiplied by 16 = £235,200.

Her PIA is £70,400. (£235,200 less £164,800) This would normally incur an annual allowance charge but she can avoid this by carrying forward unused allowances from the three previous years.

If there is still an Annual Allowance Charge after using carry forward the member can ask the scheme to pay the charge. The rules are:

- The charge must be more than £2,000.
- Any available carry forward must be used
- The pension input from the scheme must be the reason an AAC has been incurred. For example, if the PIA from the scheme is below the AA but the member has made an additional contribution elsewhere then the scheme cannot pay the charge.
- Notice must be served on the scheme no later than 31st July in the following tax year

- The member's benefits must be reduced accordingly

Calculating how much more the member can contribute

A final salary member can still make tax relievable contributions of 100% of NRE.

Fatima's salary is £30,000 and she has no other earnings. She is a member of her employer's Final Salary scheme and there is a mandatory contribution of 5% (£1,250)

Her **maximum tax relievable contribution** is £30,000 less £1,250 = £28,750

Her **remaining annual allowance** is £40,000 less the PIA into her scheme. Fatima's PIA was calculated as £16,000 which give a remaining annual allowance of £24,000

This is the maximum she can contribute without incurring an AAC, assuming carry forward isn't available

Put another way the final salary member's maximum tax relievable contribution is the lesser of:

- NRE less mandatory contributions into the scheme.
- Annual Allowance less PIA into the scheme.

The member can do this through a PP or SIPP but most schemes offer an Additional Voluntary Contribution (AVC) scheme. These are usually money purchase arrangements but in the state sector it may be possible to buy extra years.

An AVC scheme may be attractive because:

- Charges may be lower than in a PP/SIPP
- The employer may match all or part of the contributions.
- Depending on the scheme rules it may be possible to fund the PCLS from the AVC fund. This will be looked at in the next section.

That concludes this part so you should now understand:

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