11 Raven Wharf, Lafone Street, London, SE1 2LR Tel: +44 (0)20 7403 5959 Fax: +44 (0)20 7403 3111
Email: gba@greenback-alan.co.uk Web: www.greenback-alan.co.uk

Published in The Daily NNA UK
September and October 2008

Pensions in the UK

The populations of both Japan and the UK are ageing rapidly causing concern over funding of pensions in both countries. In the UK this has led to a widespread move in both the public and private sectors away from the traditional defined benefit schemes towards defined contribution and similar schemes. It also prompted the UK Government to launch a long consultative process on pension reform which culminated in the Pensions Act 2007.

Likewise in Japan the demographic changes and severe under-funding in a succession of corporate and public schemes which have come to light in recent years have fuelled moves towards reform. Defined contribution schemes were legislated for in 2001 although as a whole Japan has been much slower to move away from defined benefit arrangements.

Both public and private pensions remain a hot topic in both countries. Bureaucratic problems in Japan's social security agency affected over 50 million contribution records and may have contributed to the unseating of Prime Minister, Shinzo Abe last year and in Britain a strike by workers at Grangemouth Oil Refinery in defence of their final salary pension scheme also received much media attention. Intense scrutiny at all levels makes it more important than ever that management has clear understanding of the local pension systems.

This article concentrates on the basic principals underlining the UK system and draws some comparison with the Japanese schemes.

UK State Retirement Pensions

The UK state pension may be compared directly with Kokumin Nenkin, in that it is intended to provide a basic pension income for all at retirement age.

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The UK state pension comprises of two elements; the basic component, which is not earnings related and an additional component, similar to kosei nenkin hoken, which is currently only available to employed individuals and is currently earnings related. To be eligible for a full basic pension, currently £90.70 per week for a single person and £145.05 for a married couple, the individual must have qualifying years for at least 90% of the individuals working lifetime. A qualifying year is one where at least the minimum levels of contributions are made. A working life is normally 49 years for males, however it should be noted that full credits are given when an individual is a student or when undertaking certain family responsibilities. If an individual has insufficient qualifying years a reduced pension may be paid provided there is a minimum of at least 10 qualifying years.

The additional component was introduced in the early 1960's and has gone through various transformations since then. It is currently known as the State Second Pension (S2P) and it is intended that it will move away from the current earnings related supplement to a flat rate scheme by 2030. It is proposed that for each working year completed an additional £1.50 per week will be given to top up the basic pension. The maximum top up will be £60 per week.

There are also proposals to reduce the number of qualifying years for a basic state pension to 30 years but also to increase the retirement age from 65 to 68 by 2044.

For employees it is also possible to contract out of the S2P scheme through membership of a suitable alternative pension scheme. The main two variants of this facility are occupational schemes (see below) similar to kosei nenkin kikin, and a contracted out defined contribution scheme, although the latter must provide for certain protected rights. The contracting out is affected by both the employer and employee electing for part of their national insurance contributions to be re-directed into a contracted out scheme. These defined contribution schemes are often run by insurance companies which receive a rebate of national insurance contributions made to the state scheme equivalent to the contracted out element.

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Private Pension Arrangements

The UK has specific legislation to enable an individual to make a private provision for a pension in addition to his entitlement under the state scheme. The state encourages private pensions by allowing generous tax reliefs for contributions to qualifying schemes. Recent legislation has brought the various rules for each type of scheme closer together, culminating in the Pensions Act 2007.

There are two basic types of pension scheme:

- Occupational Pension Schemes
- Personal Pension Schemes

Occupational Schemes

These are employer sponsored pension schemes similar to kigyo nenkin kikin. These are either, defined benefit schemes which promise a specific pension at retirement for example; $1/80^{th}$ of $1/60^{th}$ of final salary for each year of service or, money purchase schemes where the contributions are specified but not the final benefits. Historically many of the occupational schemes were defined benefits although the current trend is for money purchase schemes. Indeed many defined benefit schemes are in the process of converting to money purchase.

Defined benefit schemes are characterised by the promise to provide a certain level of benefit on retirement or death. The key is the promise given by the scheme to pay a fixed percentage of final remuneration of up to a maximum of 2/3rds after twenty or more year’s services. Employees may or may not be required to contribute in such schemes.

On the other hand, money purchase schemes are established on the basis that the contributions are fixed and these are then invested often through professional and independent investment managers to provide a pension “pot” available at retirement to provide benefits to the employee. These benefits are often in the form of a lifetime annuity.

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The fundamental difference between the two types of scheme is that the defined benefit scheme undertakes to pay out a pension based on a percentage of salary which is underwritten by the employer whereas under a money purchase scheme, the employee bears the investment risk. It is therefore easy to understand why there is a move towards money purchase schemes.

Occupational pension schemes are generally governed by trust law and the trustees need to ensure that H M Revenue & Customs rules are applied so that pension monies cannot be diverted for improper purposes. Provided the occupational scheme is registered with H M Revenue & Customs, it will enjoy a significant number of tax privileges. Essentially these are freedom from income tax, corporation tax and capital gains tax on any income and capital gains which arise on the investment contributions. Employers also receive corporation tax relief on contributions into the scheme and employees are able to claim tax relief on their contributions at their marginal rate of tax provided they do not exceed 100% of gross earnings in any year.

At retirement a proportion of the fund can normally be taken as a lump sum, tax free. This is normally up to 25% of the value of the fund, the balance is then used to provide pension income. This lump sum is the closest equivalent to the Japanese retirement allowance, taishokukin, which do not exist in the UK. Unlike Japan there is no separate funding for an employee retirement allowances.

Personal Pension Schemes

Before July 1988, self employed individuals and employees not in an employers' occupational scheme, could only make private pension provision by establishing retirement annuity policies. Concern through the 1980's about the unfairness of the occupational scheme arrangements, led to the introduction of personal pension schemes on 1 July 1988. Reforms in subsequent years have led to a so called simplified regime of stakeholder pension schemes which fall into the umbrella of defined contribution schemes. There are a number of variations to personal pension schemes and these are briefly covered below.

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Stakeholder Pensions

Although the introduction of personal pension schemes made the provision of pensions more flexible and widely available, there were still concerns in the late 1990's. As a result, stakeholder pensions were introduced with effect from 2001 for businesses employing 5 people or more which was an initial attempt to bring together the various strands of pension schemes. Stakeholder schemes must meet various standards which include a maximum administrative charge of 1.5% of the fund per annum within the first 10 years and 1% thereafter. No other charges are allowed. New employees must be offered access to a stakeholder pension scheme within 3 months of starting service. However it should be noted that there is no obligation for the employer to contribute to such schemes.

Group Personal Pension Schemes

Some employers have adopted the personal pension scheme regime to provide pension provision for their employees. A group personal pension is a series of individual employee pension plans grouped together for administrative convenience. They are therefore often an alternative to occupational pension schemes. Individual policies belong to the employees but there is normally one provider and consequently communication and administration is simplified. In addition, the employer can make its own contribution far more efficiently. If membership of a group personal pension scheme is offered, then employees can be exempt from the stakeholder pension requirements. To be exempt, the employer must contribute at least 3% of basic pay, allow entry within 3 months of joining and the scheme must not have exit penalties. An employer can insist that the employee pays a matching 3% contribution however, they may not make membership of the group personal pension scheme compulsory.

Self Invested Pension Plans

These schemes are becoming more popular particularly for higher earning self employed individuals or partners in partnerships or LLP's. These self investing pension plans (SIPPS) are set up with an appropriate provider and differ from stakeholder type pensions in that the individual can appoint investment managers to invest in a range of investments. The individual can therefore have a high degree of influence on the investment policy followed by the schemes trustees. There are of course stringent rules laid down by H M Revenue & Customs on the type of investments which are permitted.

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All schemes are now subject to a lifetime allowance which was set at £1.5million in 2006/07 and due to rise to £1.8million by 2010/11. This standard lifetime allowance is the maximum anyone can have invested across there pension funds. Any benefits in excess of the lifetime allowance would be subject to a penal recovery charge.

Individual Pension Accounts

These schemes are part of the pension reform which is currently passing through Parliament. The intention is to give all eligible individuals between the ages of 22 and the state retirement age an opportunity to save in a pension plan with contributions from their employer. From 2012 it is planned that all eligible workers would automatically be enrolled in either a good quality workplace pension scheme or into the personal account scheme. The personal account scheme would be a simple low cost pension saving scheme aimed at middle to low income workers who currently do not have access to occupational pension schemes. There will be a duty on employers to provide either a workplace pension scheme or a personal account for their employees and also contribute a minimum of 3% (on a band of earnings) to employees pensions. This will sit alongside 4% from the employee (on the same band of earnings) and around 1% from the Government in a form of tax relief. Despite Government efforts to simplify pension arrangements, it can be seen from the above that it is still a very complex area. Individuals and companies should seek professional advice from a qualified independent financial advisor.

It would be remiss not to mention that in 2001, the UK and Japan entered into a reciprocal agreement regarding social security contributions. The agreement is aimed primarily at an expatriate seconded from one state to work in the other and essentially allows the expatriate to remain within his home state social security scheme for a period of up to 5 years. This is clearly of great importance to a Japanese expatriate working in the UK on a temporary basis. Without this reciprocal agreement National insurance contributions would be payable in both countries. On the whole secondments last for a period of less than 5 years and without the agreement, both employer and employee could be making contributions into the UK system as well as Japan without any corresponding benefits as the contribution period in the UK would be below the deminimus limit. It is also possible to obtain an extension to the initial 5 year period although these are rare. It should be noted that the exemptions can also apply to self employed individuals.

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