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GMP conversion guidance for GMP equalisation

GMP conversion is viewed by many trustees and sponsors of DB pension schemes as a key method of equalising schemes for the effect of guaranteed minimum pensions (GMPs). The existing legislation is lacking in detail, and HMRC has so far declined to publish any guidance on the tax implications of using conversion to achieve GMP equalisation.

The cross-industry GMP Equalisation Working Group has now published guidance on GMP conversion, which provides examples of how GMP conversion is being used for GMP equalisation, explains issues that are being encountered and how they are being addressed. For any trustees or sponsors considering the conversion route to equalise their scheme for the effect of GMPs, this is a very useful piece of guidance.

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Background

The High Court's decision in the Lloyds bank case required schemes to equalise benefits earned in the period 17 May 1990 to 5 April 1997 to correct for the inequalities of GMPs. It also approved a range of methods that could be adopted to achieve equalisation, one of which was GMP conversion.

GMP conversion is an active decision by the trustees which requires employer consent. It requires input from the Scheme Actuary, lawyers and administrator, and consultation with members. It enables trustees to disapply the statutory requirements for GMPs for some or all the members in their scheme, subject to satisfying certain conditions.

1. The post-conversion benefits must be actuarially at least equivalent to the pre-conversion benefits on the conversion date.
2. Pensions in payment immediately before the conversion date must not, as a consequence of conversion, be reduced immediately after conversion.
3. Defined benefits cannot be converted into money purchase benefits.

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4. The scheme must provide survivors' benefits in line with statutory requirements (whether the death occurs before or after normal pension age).
5. The following procedural requirements apply:
 - employer consent must be obtained;
 - the trustees must take all reasonable steps to consult any affected members in advance and to notify all affected members and survivors before, or as soon as reasonably practicable after, the conversion date; and
 - HMRC must be notified by the conversion date that the GMP conversion will occur.

The guidance has been prepared to help show how trustees and employers might undertake GMP conversion, in a proportionate and pragmatic way, in the continued absence of further guidance or legislation from DWP and HMRC. It outlines approaches to the application of GMP conversion that have been adopted, or are actively being considered, by early adopters of GMP conversion to equalise GMPs, together with associated considerations. It is not intended to advocate a particular course of action.

The guidance covers three common situations in which GMP conversion is being used:

1. A bulk one-off exercise for existing pensioners and dependants.
2. An at retirement process.
3. A bulk one-off exercise for members with a deferred pension.

GMP equality

In the guidance, GMP equality is defined as making sure a member with a GMP for pensionable service between 17 May 1990 and 5 April 1997 receives benefits which aren't less than those which would have been provided had the member been of the opposite sex during this period. The guidance provides examples of approaches intended to achieve GMP equality using GMP conversion which, either have been adopted or, are actively being considered.

Where appropriate, the guidance also highlights how GMP conversion differs from a year by year equalisation method.

Which schemes are likely to use GMP conversion?

The guidance assumes that GMP conversion is going to be used to achieve GMP equality and lists some of the ancillary benefits of using GMP conversion such as, reducing the cost and complexity of administration, reducing the cost of buying-out benefits, and helping member understanding and communication by way of benefit simplification.

As such, schemes which may be likely to find GMP conversion attractive include:

- Schemes with complex benefits keen to simplify them.
- Smaller schemes, particularly those seeking to buy-out.
- Schemes with a significant number of lower earners where GMP rules restrict member options.
- Schemes which already have an 'at retirement' Pension Increase Exchange (PIE) option, a bridging pension option, or are seeking to introduce them.

- Schemes where the additional complexity of operating the ‘year by year’ approaches (methods B, C1 and C2) on an ongoing basis would be particularly onerous.

Matters for trustees to consider

Members and benefits in scope

If the objective is solely GMP equality, the members included are more likely to be constrained to only those who accrued a GMP between 17 May 1990 and 5 April 1997 and the dependants of such members. If the trustees have wider objectives, such as simplification, they may be more likely to include all those with a GMP. Which categories of members are included may also depend on the administrative implications of adopting a year by year method of equalisation for different categories of member.

GMP conversion cannot only be applied to GMP accrued between 17 May 1990 and 5 April 1997 and it doesn't just involve the member's GMP. Changes can be made to a member's non-GMP benefits, and indeed such changes are likely to be necessary to achieve GMP equality, because if the GMP is unequal the non-GMP benefits will also be unequal. The conversion process therefore normally involves a member's whole pension accrued to 5 April 1997, including that accrued before 6 April 1978. (Whilst it might be possible to modify benefits accrued after 5 April 1997, in practice, trustees seeking to achieve GMP equality haven't tended to do so, and legal advice should be sought before doing so.)

Nature of post-conversion benefits

Theoretically a wide range of outcomes is possible. Schemes could simply relabel their GMPs, or make more radical changes to the benefits (e.g. something akin to a PIE with changes to pension indexation). In practice, early adopters have taken a cautious approach and not made dramatic changes, but have taken an approach which is more along the lines of relabelling, but removing some of the complexities of GMP.

Where significant reshaping is proposed, the question of member consent and member options should be considered alongside the Code of Practice for Incentive Exercises, even where the exercise is outside its scope.

Minimum post conversion survivors' pensions

The legislation on conversion requires survivors' pensions to be at least half the value of the pension to which the earner would have been entitled. The guidance suggests this should be interpreted to mean:

- In the case of a pensioner, at least half the amount that was in payment to the member at the date of death.
- For non-pensioners, where the member dies after normal retirement date, at least half the amount the member would have been entitled to had they retired immediately before death.
- Where the member dies before normal retirement date, at least half the amount the member would have been entitled to had they attained normal retirement age immediately before death.

This does, however, mean that a scheme could not always:

- apply a reduction to the survivor's pension for a survivor being significantly younger than the member;
- withhold a pension on a 'death bed marriage', or

- divert pension to the same degree where there is a financial dependant as well as a legal spouse/civil partner.

Member communication

There is a requirement to consult with members on the proposed conversion. In order to produce the appropriate member consultation communication trustees and employers will need to decide:

- Which members are to be included.
- Which benefits are to be included for those members.
- The nature of the post-conversion benefits.
- The nature of the actuarial assumptions to be used in the conversion.
- The nature of the member consultation.
- The likely timescale.

Actuarial calculations

Based on initial results from the calculations, the Scheme Actuary will be able to provide advice to the trustees on the assumptions to be used, the impact on individual members and the sensitivity of the results to the assumptions used.

Any issues with the membership data and areas of detail in the pre- and post-conversion benefits which need to be confirmed can also be identified and addressed at this stage. Input from the member consultation can also be considered.

Implementation

The GMP conversion exercise can be implemented with four workstreams running in parallel:

- The Scheme Actuary can complete the calculation of the post-conversion benefits and certify them.
- The lawyers can prepare a deed of amendment or a modifying resolution to document the employer's agreement, the trustees' decision to use conversion, which classes of members are included, and the post-conversion benefits.
- The administrator can update their systems and processes to reflect the post-conversion benefits.
- HMRC can be notified of the conversion.

Once all the legal conditions are satisfied, members can be notified of the conversion and their post-conversion benefits and the conversion will take effect. It's important to allow sufficient time for the new benefits to be implemented on administration and payroll systems.

At retirement process

The process in cases where GMP conversion is being applied 'at retirement' is likely to be similar, with the design of the conversion being agreed up front and the implementation then proceeding over time, as individual members retire.

Trustees adopting this approach would normally run it together with a bulk exercise for pensioners.

Pension taxation

HMRC have said they will not be providing guidance on taxation and conversion in the short term and until they do existing guidance applies.

The guidance provides commentary on the main taxation issues which arise with GMP conversion, which are set out below. The guidance discusses these areas in some detail and gives some example solutions adopted by trustees, however, the guidance stresses this is a complex area and it is essential for trustees to obtain specialist scheme-specific advice.

Annual allowance

Trustees are advised to consider whether their proposals would mean a pension input amount is expected to be triggered and seek to identify those for whom this could be an issue in a proportionate manner. The annual allowance impacts will vary depending on whether conversion is carried out in a one-off exercise, immediately before or after retirement, or in the tax year following retirement.

Lifetime allowance

Members may have protected a higher lifetime allowance through holding either fixed protection or enhanced protection. There is a risk that these protections are lost through conversion.

There are three types of fixed protection which members may hold following past reductions in the lifetime allowance in 2012, 2014 and 2016. These protections can be lost if the member has 'benefit accrual'. There is a risk GMP conversion could trigger benefit accrual and so loss of fixed protection.

In considering fixed protection it is important to note there may be members who are eligible for the most recent form (FP 2016) but have yet to apply for it. In seeking to identify members at risk of loss of fixed protection it may therefore be necessary to seek to identify not just those who hold any of the various forms of fixed protection but also those who might wish to apply for FP 2016 in future.

The circumstances in which enhanced protection can be lost are different from those for fixed protection and relate to 'relevant benefit accrual'.

Loss of enhanced protection could be a very material issue for the few individuals who hold it. The relevant benefit accrual test only applies at the point of a benefit crystallisation event. The risk of loss of enhanced protection on, or because of, GMP conversion is therefore more likely to be of concern for non-pensioners and less likely for pensioners.

Different approaches to conversion may result in a higher or lower risk of adverse pensions tax consequences. The examples in the guidance show solutions adopted in some real-life cases for these issues. These are scheme-specific solutions, where specialist legal advice will have been sought (and in some cases non-statutory clearance from HMRC was sought). However, trustees may take some comfort from the conclusions reached in these cases and may consider similar approaches for their conversion projects.

Comment

Following the decision of the High Court it is disappointing that HMRC has been slow to publish guidance on GMP conversion and its tax consequences. The GMP Equalisation Working Group have acted to fill this gap and this guidance is extremely welcome.

Whilst the guidance does not replace input from HMRC it may give some trustees comfort that, together with legal advice, they can manage the tax risks associated with conversion.

It will be interesting to see if this guidance leads to an increase in interest in the conversion method among trustees and other stakeholders.

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