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TRANSFERRING DEFINED BENEFIT PENSION SCHEMES

Defined Benefit Scheme (DBS) or final salary schemes have previously been common in the United Kingdom, although more recently many employers have been phasing them out.

A DBS sets the level of benefits that will be received in the future (i.e. the scheme offers £10,000 a year for a member when they reach retirement). The level of benefits will usually be a function of the length of service of the member and the final salary of the employee.

Because a DBS sets a level of future payments the valuation of the scheme prior to retirement is defined by a series of complicated factors, including:

- Length of time until retirement starts
- Average life expectancy of all members in the scheme
- Current and future projected interest rates, to name a few

There has been much written, in the UK, about the fact that in the majority of instances transferring out of a DBS into a Personal Pension Scheme (PPS) is more often than not a bad move. We do not question that line of thinking for inter UK transfers. This is because in the UK when you transfer out of a DBS it will be into PPS and you will typically lose all the benefits of the DBS, such as inflation indexing, partner benefits on your death etc.

The arguments for transferring out of a DBS into a UK PPS are:

- The member is no longer exposed to the risk their company scheme will dissolve in the event the company fails (although the Pension Protection Fund has been set up to reduce this risk)
- You take investment control of your own funds

However, with a transfer to New Zealand the swap is not like for like…

If the member of a DBS has moved to New Zealand they need to consider a slew of other factors, including:

- Exchange rates
- Tax consequences in both jurisdictions
- Investment options
- Current valuation levels of the members DBS

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Exchange rates are fickle – meaning the members benefits are hardly defined.

If a member ends up purchasing an annuity from a DBS they are then at the mercy of currency fluctuations between the British pound and New Zealand dollar. This means in some years their income may be higher than others (you only have to look at the performance of the dollar to the pound over the last 20 years which ranges between $3.5 to a pound to $1.85 to a pound). This puts considerable stress on any retiree as they are unsure of how much income they will be receiving year on year – hardly defined benefits.

The tax consequences of leaving a pension in the UK are high

Under the Inland Revenues proposed tax regime the member's lump sum will be taxable (ranging from 0% to 33% in tax) and the remaining income will be taxable at the members' marginal rate. Meaning that at least 75% (i.e. the non lump sum payment) will be taxable as income at a rate of up to 33% - this is the equivalent of paying 24.75% on the value of the members pension fund.

Investment options in defined benefit schemes are non-existent

While this is a tested argument in the UK, that is, the scheme can manage the finances better than the individual (so don't give up your benefits and transfer out) it is often not the case where the member is overseas.

The member ends up with little investment control and what's more the decisions on benefits are made in a country where they are no longer resident. Having control over the investment in a region in which you understand what is going on is crucially important. The member cannot be expected to live and breathe changes in UK DB S(the list of which have been enormous over the last two years alone – such as two recent changes to recalculation methodologies for government pensions).

Current valuations of defined benefit schemes are high (well in most instances)

Where a member has a government backed DBS, such as an NHS pension, local government scheme, teachers pension etc, the valuations of these schemes are at the time of writing extremely high. The reason for this is that gilt yields in the United Kingdom are the lowest that they have been in decades and the lower the gilt yields the higher the value of the pension. Why? Put as simply as possible the economics work a little bit like those of a mortgage – when the interest rates are lower you can borrow more because your monthly repayments can service a higher amount of debt.

As gilt rates in the UK will probably not drop any lower (in fact yields on inflation adjusted long term UK gilts are negative) the valuations are unlikely to increase. However, if in the future UK gilt rates go up the value of a member's funds will drop significantly (despite the fact that their benefits will stay exactly the same – just like the fact that a person with a mortgage cannot effectively afford to borrow as much when interest rates increase.)

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So if members do not transfer whilst the gilt values are low the value of their funds could fall significantly in the future as gilt yields potentially increase.

However, on the other side of this coin are non-government backed schemes, where they do not have the government printing press backing their values. These, largely company schemes, have often found in recent times that they have insufficient funds in them to support the level of pension payments required to be made. This is because the low gilt rates have pushed up the value required to fund future pension obligations and most of the funds do not have sufficient investments to match the value required.

Therefore, many of the schemes have committed to topping up the funding of these schemes. However, it must be remembered, as described above should UK gilt rates increase the value required to fund obligations will drop and the topping up requirements will lower. This is a complicated area to say the least.

In most instances a pension transfer to New Zealand can eliminate the issues described above and lock in high valuations...

A pension transfer to New Zealand will do the following:

- Allow exchange rate management
- Crystallise tax obligations (if any)
- Give increased investment management flexibility
- Let the member take advantage of current high transfer valuations

Enabling exchange rate management through sterling funds

Most good QROPS in New Zealand will offer sterling denominated funds this means a member can transfer in their funds and invest in sterling denominated assets, then when the time is right for them, convert those investments into New Zealand dollar investments. This provides significantly more certainty and manageability for the member.

Crystallise tax obligations (if any)

A transfer to New Zealand will cause any tax obligations to crystallise at the point of transfer. In most instances if the member is a transitional resident in New Zealand there will not be a tax obligation on the transfer of the funds. Furthermore, if the member transfers their funds into a zero-rate PIE they will be able to continue to their transitional resident status while invested in that particular superannuation scheme.

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Furthermore, once the member's funds are in New Zealand they will not have any New Zealand tax obligations on payments made out of the scheme and provided they have transferred into a QROPS non-KiwiSaver scheme should not have any future UK tax obligations. Therefore, there is a large tax saving available compared with previously described situations.

Providing increased investment management flexibility to the member

A transfer into a well structured and managed New Zealand superannuation scheme should allow the member to invest in higher yielding investments denominated in both sterling and dollars. This flexibility combined with sound financial advice will allow better management and control of the members' funds.

Allow the member take advantage of high current transfer valuations

The member will get the advantage of low gilt yields leading to higher defined pension valuations (as previously described). These valuations will give considerably higher benefit streams into the future if they are invested wisely in New Zealand through a combination of good investment returns, exchange rate management and minimised tax bills.

Charter Square can provide a calculator that allows these benefits to be shown based on individual circumstances.
Please contact us for further information at info@chartersquare.co.nz