Pensions Management Institute
ACHIEVING PENSIONS EXCELLENCE

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Core Unit 4 – Financing and Investing for Retirement Provision

Assignment 1 Notes

(Part 1 – Funding and Taxation)
Recommended Time: 1 hour

1. **Explain the reasons why companies typically choose to fund in advance for pension provision. Many public sector occupational schemes are different in this regard; which schemes does this apply to, how are they different and why?**

10 marks

One factor is **scheme design**. In defined contribution schemes (money purchase schemes) the employer promises to pay a defined level of contributions on behalf of the employee, which are invested and in due course used to purchase retirement benefits for the employee. It is essentially implicit for such schemes to be funded in advance. In defined benefit schemes the employer promises employees a defined level of pension, and the overall cost of providing the pension is uncertain. While many defined benefit schemes are funded in advance, some are unfunded.

A major reason for funding in advance is to provide **security** for members by building up a fund of assets in advance, which should enable a scheme to meet the cost of benefits promised to members.
The funds are held in a trust which is separate from the employer who is financing the scheme, providing an additional level of security. The accumulated fund remains available to finance benefits even if the employer goes out of business.

A further reason is to achieve **stability** and to manage **cash flow.** If benefits were not funded in advance they would have to be paid by the employer as they fell due. For a defined benefit scheme this could lead to large variations in the cost for the employer from year to year, which could cause problems. For example, a growing company with a young workforce would have very little outgo initially, but the cost of providing benefits would increase in later years as members of the initial workforce began to retire. A declining company could face difficulties if its retirement commitments became large relative to its available cash flow.

Taxation is a further factor. Both employer and employee contributions made to a registered pension scheme currently receive tax relief when they are paid. Registered defined benefit schemes must be funded in advance. This does not necessarily mean that funded arrangements are more tax efficient for the employer though, since benefit payments made from unfunded arrangements generally attract company tax relief when they are paid. Funding the benefits in advance changes the timing of tax relief for a company rather than necessarily offering a tax advantage.

Finally, the **accounting** requirements of the sponsoring employer provide a strong reason for funding benefits, because any pension promise that is not fully funded must be reflected in the company accounts. This is because one of the fundamental principles of accounting is that liabilities should be provided for as they fall due.
Many public sector occupational pension schemes are unfunded, although the employer (and in some cases the employees) pay contributions to the Government and the Government pays out the benefits due to members (the "pay as you go" system). These schemes are covered by an underlying guarantee from the Government that benefits will be met. One exception to this is the Local Government Pension Scheme, which is a funded scheme.

The statutory schemes are now primarily the Principal Civil Service Pension Scheme and other nationwide schemes such as those for the armed forces, teachers, police, fire fighters and the National Health Service Superannuation Scheme, all unfunded but often contributory.

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Also, there are statutory occupational schemes for public sector employees which are set up by legislation and which do not take the form of a trust.

(The relevant section of the Study Manual is Part 1, Chapter 1.1)

2. **Pension schemes that are registered with HMRC are subject to certain rules. Describe the rules regarding the following:**

   a) The age when benefits can be taken and the form of benefits (cash lump sum, annuity or other)
   b) The extent to which tax relief on contributions is limited
   c) The Lifetime Allowance

10 marks

a) The minimum age at which a member of a registered scheme can start to draw benefits is 55. The member can take a maximum tax free pension commencement lump sum of 25% of the fund that is being ‘crystallised’ (coming into payment). The rest of the fund can be used to provide a pension or purchase an annuity, or kept invested as a ‘crystallised fund’ from which the member can ‘draw down’ income.

From 6 April 2015 a defined contribution scheme member can access the whole of their pension fund as a single lump sum. The amount that exceeds the maximum tax-free amount will be subject to income tax. From that date, there is no longer a requirement to purchase an annuity at any age.

b) Tax relief is provided on pension contributions to a registered scheme provided they do not exceed the Annual Allowance. For the 2018/19 tax year the Annual Allowance is £40,000, except for the tapered reduction for higher earners. This reduction applies for those whose ‘threshold income’ (taxable income less employee gross pension contributions plus those made through salary sacrifice) exceeds £110,000 and whose ‘adjusted income’ (taxable income plus employer pension contributions) exceeds £150,000. The reduction in Annual Allowance is £1 for each £2 by which adjusted income exceeds £150,000, the maximum reduction being £30,000. Hence the Annual Allowance is £10,000 for those with adjusted income of £210,000 or more.

The Annual Allowance applies across all schemes to which an individual belongs and includes contributions paid by the employer as well as the individual. In most circumstances it is possible to bring forward any unused Annual Allowances from the previous three tax years, to reduce the Annual Allowance charge to a lower amount or to remove it completely.

If contributions exceed the Annual Allowance, the excess contribution is subject to income tax. If the tax charge exceeds £2,000 a member can ask for the pension scheme to pay the charge from their benefits.

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For defined benefit schemes, the amount to be tested against the Annual Allowance is the amount by which the value of pension has increased over the year. For this purpose, pensions are multiplied by a factor of 16 to derive a value, and allowance is made for the effect of inflation on the start-year pension to offset the increase in value.

The period over which the Annual Allowance is measured is the Pension Input Period (PIP). From 6 April 2016 the PIP is the tax year for all schemes. Previously schemes could elect a PIP; some chose the tax year and others the scheme anniversary date.

A lower, so called Money Purchase Annual Allowance of £10,000 (£4,000 for the 2018/18 tax year) applies for members of defined contribution schemes who have (a) taken flexible benefits which include income, such as an 'Uncrystallised Funds Pension Lump Sum or flexible drawdown with income and (b) withdrawn more than the 25% tax free pension commencement lump sum. It is not then possible to carry forward prior years' unused Annual Allowances.

c) The Lifetime Allowance is the total amount of pension benefits that an individual can draw from their pension arrangements without incurring an extra tax charge.

The Lifetime Allowance was introduced in 2006 at a level of £1.5 million. After increasing to £1.8 million in 2010 it was subsequently reduced in stages to £1 million. In 2018/19 the Lifetime Allowance is £1.03 million. Each time the Lifetime Allowance was reduced, there were transitional arrangements available for people to protect their Lifetime Allowance at their existing level, provided they made an election by a specified date.

For a defined benefit scheme, the pension is multiplied by a factor of 20 in order to derive a value for the pension that is tested against the Lifetime Allowance. The maximum tax-free pension commencement lump sum that can be taken from a defined benefit scheme is 25% of the value of pension using the same factor of 20.

When an individual's benefits from a scheme exceed the Lifetime Allowance, the excess is subject to an additional tax.

(The relevant section of the Study Manual is Part 1, Chapter 2.1)

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3. **What is meant by an unauthorised payment, how are they taxed and how must they be reported?**
10 marks

The tax rules specify the conditions that need to be met for payments to be authorised. Any payment that doesn't meet these conditions is an unauthorised payment. Some examples of unauthorised payments are:

- Pension payments continuing incorrectly after death, and which are not recovered
- Lump sum death benefits paid more than two years after the scheme administrator was told about the member's death
- Pension payments before the age of 55 where the member is in normal health
- Small payments to correct benefit errors, where this is deemed commercially more acceptable than setting up an additional benefit payment from the scheme
- Pensions paid incorrectly under the triviality rules
- An overseas transfer that is not to a Qualifying Registered Overseas Pension Scheme.

Where a genuine error occurs, which is identified and corrected as soon as possible and the relevant payments are repaid by the recipients, those payments are not deemed unauthorised.

If a scheme makes an unauthorised payment, both the scheme and the recipient will be subject to tax charges. The person receiving the unauthorised payment will be taxed at 40% (and in some cases 55%) of the amount of the payment

The scheme making the payment will also have to pay tax of 40% of the unauthorised payment. This is called the **scheme sanction charge**. However, this is reduced to 15% if the person receiving the unauthorised payment has paid their tax charge to HMRC by the time HMRC come to issue the tax invoice to the scheme. The tax can be paid in one of two ways:

1. The scheme can make the payment gross, without deduction of tax
2. Both the scheme and the recipient must then report the payment to HMRC. Once HMRC have processed these reports they will issue an invoice for the tax due.

As an alternative, HMRC allow the scheme to pay the recipient's unauthorised payment charge on their behalf, by deducting the charge from the unauthorised payment and then sending the tax to HMRC. By doing this the scheme can ensure that the scheme sanction charge will be at 15%. The recipient of the payment must sign a mandate authorising the scheme to deduct the tax if this approach is to be followed.

Unauthorised payments must be reported to HMRC on the **event report**, which the Scheme Administrator must provide each year, relating to certain events (which are set out in legislation and in the Registered Pension Schemes Manual - RPSM) that have occurred during the tax year to which the report relates. With one exception, the event report must be submitted to HMRC no later than 31 January after the end of the tax year to which it relates.

(The relevant sections of the Study Manual are Part 1, Chapter 2.1 & 2.4.3)

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4. **What is meant by "scheme pays" and how does it work?**

5 marks

The reduction in the Annual Allowance (AA) from 6 April 2011 and further reduction from 6 April 2014 has meant that many more members are potentially subject to the annual allowance charge. These charges could be significant and members affected may find it difficult to pay them out of their current income or savings.

HMRC have, therefore, introduced legislation requiring the member's pension scheme to settle the member's liability for this charge if requested, provided that the charge exceeds £2,000 and the member's pension input amount in that scheme exceeds the AA. This is known as '**scheme pays'** and applies to annual allowance charges due for the tax year 2011/12 onwards. The scheme must reduce the member's benefits to reflect the charge paid.

A member wishing to make use of scheme pays must make an irrevocable election and send it to the scheme no later than the second 31 July following the end of the tax year to which the AA charge relates. The scheme must then account for the tax to HMRC on the Accounting for Tax return no later than the following 31 December.

For example, if the AA charge relates to the 2018/19 tax year, the member must make their election by 31 July 2020 with the scheme accounting for the tax no later than on the Accounting for Tax return for the quarter ending 31 December 2020.

A scheme may also pay an annual allowance charge voluntarily on a member's behalf even though they are not obliged to do so under HMRC legislation, but the deadline for any voluntary payments is 31 January following the end of the tax year to which the charge relates.

(The relevant section of the Study Manual is Part 1, Chapter 2.4.5)

5. **What are employer-financed schemes and how are they taxed?**

5 marks

Employer-financed retirement benefits schemes (prior to 6 April 2006 known as unapproved schemes) enable the employer to provide benefits in addition to a registered scheme. They are subject to different tax rules than registered schemes which can be attractive be in certain circumstances.

Employer's contributions to the equivalent unapproved schemes made before 6 April 2006 count as employment income of the employee. There is no equivalent charge for contributions to an employer-financed scheme made after 5 April 2006.

All lump sum payments out of non-registered schemes counted as employment income of the recipient. For employer financed schemes, only 'relevant benefits' count as employment income.

The charge on lump sums paid out may be reduced where prior employer contributions have been taxed and where the employee has made contributions.

A pension from any of these schemes is charged separately as pension income.

(The relevant section of the Study Manual is Part 1, Chapter 2.5)

6. **Investment income and capital gains are tax exempt in a registered scheme. Explain the following:**

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a) The circumstances under which tax exemption is not available
b) How pension schemes investing in insurance policies obtain their tax exemption.

10 marks

a) If the investment income or capital gains arise from activities that are deemed to be trading in investments, then the tax exemption does not apply. HMRC may (but does not necessarily) consider any trading activity as being inconsistent with the registered status of the scheme and may therefore remove such status.

Stock lending fees and income derived from futures and option contracts might normally be considered trading income. However, subject to special rules, such income in relation to registered pension schemes can qualify for tax relief.

Income derived from investments or deposits held by a registered pension scheme as a member of a property investment LLP is not tax exempt.

Pension schemes are unable to reclaim withholding tax on dividends from UK shares.

b) Schemes that pay premiums on insurance policies have no rights of ownership to the assets that underlie the policies. There is an exemption from corporation tax on the income and chargeable gains from that part of an insurance company's life assurance fund that is identifiable as pension business, and the pension scheme obtains tax relief in this way.

To qualify for pension business treatment, policies taken out by a scheme must be 'so framed to satisfy the **correspondence requirement**, which is that the liabilities undertaken by the insurance company under the contract correspond with liabilities against which the contract is intended to secure the scheme' liabilities. As this statutory wording implies, it is not necessary for the policy to secure the whole of the scheme's liabilities. Normally the life office will ensure that the correspondence requirement is satisfied by agreeing the terms of the policy in relation to a standard form of scheme rules, laid down by HMRC.

A policy intended as an investment vehicle for any scheme may also be treated as a corresponding policy, irrespective of the form of its rules. Such a policy needs to satisfy four basic requirements:

- It must be in the name of and held by the trustees or administrator of an scheme
- It must be a contract to provide scheme benefits rather than just the means to secure those benefits, i.e. not purely an investment medium for the administration of the scheme's assets by a life office (e.g. deposit administration). It should be clear from the terms of the policy that the underlying assets are owned by the insurer
- It must include provision for the payment of annuities, if the scheme benefits include annuities
- It should include an overriding provision of correspondence, such as 'the benefits payable under this policy shall correspond with the liabilities of the grantees under the scheme insofar as these liabilities are, or are intended to be, secured by the policy. Any options or provisions in the policy will be exercised only in such a manner and to the extent permitted by the scheme provisions and in the form and at the time permitted by the scheme provisions.'

(The relevant section of the Study Manual is Part 1, Chapter 2.3)