



ASSOCIATION OF CONSULTING ACTUARIES

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30 August 2018

Beverley Davies
HMRC

By email only to: beverley.davies@hmrc.gsi.gov.uk Cc: pensions.policy@hmrc.gsi.gov.uk

Dear Beverley

I am writing with a request for two legislative changes. I hope these can be encompassed in the Finance Bill if that is the appropriate route (or secondary legislation and/or guidance).

In both cases the key issue is that employers and trustees may be trying to carry out a project to secure DB liabilities in a reasonable and sensible way; but the natural approach to do this would - as the law stands - mean that individuals with valuable lifetime allowance protections would lose them and could thus suffer an additional lifetime allowance charge (potentially of significant amount) through no fault of their own. Where trustees and employers spot a risk that (potentially unknown) members might be in this position, it can add a significant block to the project to secure DB liability.

- Appendix 1 covers how wind ups can prejudice Fixed Protection for pensioners: the matter raised in Rowan Howard's email to you of 18 July (and attached previous letters)
- Appendix 2 covers "partial wind ups" ie how securing DB while DC continues to be held in the scheme prejudices Fixed Protection and Enhanced Protection for non-pensioners.

The Appendices give the details of the two different requests for change in law or guidance to widen the circumstances in which securing liabilities with an insurance company are "Protection-safe".

It is very much government policy to see DB liability safely secured with insured buy-out, and we would expect that, where possible, you would want to remove blocks to this - provided they do not prejudice any other policy intention (and we do not see such prejudice). So these are issues that need resolving.

We know that HMRC needs evidence before directing resources at changes to legislation. The appendix includes evidence specific to the different cases (as well as more specifics of the particular issues and why HMRC should make the change) but the following sets out key high level evidence relevant to both.

The issues we mention impact any wind up involving securing liabilities with an insurance company: when there is a transfer to an insurance company of DB pension in payment, and when there is buy-out of deferred pensions (ie a transfer to a section 32 buy out of DB benefits not yet in payment). **Our main focus is on "solvent" DB wind-ups** - ie a scheme has closed to DB

accrual and reaches sufficient funding level to enable mirror image buy out of DB liability (with the possibility of the interim stage of a buy-in first).

What volume of DB buy-out projects can we expect?

More and more DB schemes/sections have closed to service accrual. Generally, only the largest schemes plan to continue in the long term after closure– most will aim (and are encouraged to do so, by tPR) for securing the DB liabilities and winding up the scheme/section. TPR's Purple Book ¹ shows (page 8) that just taking the year to 31 March 2017 the number of DB schemes reduced by nearly 200 primarily due to scheme wind-ups (the rest will be scheme mergers); and (page 10) 2% of the 5588 schemes covered in the 2017 report were winding up; 86% of the schemes were closed to new entrants for DB; and 39% were closed to any new DB accrual so likely to wind-up in due course. Current market conditions mean a substantial number are under way currently.

How many members in such projects have Fixed or Enhanced Protection?

HMRC have the best statistics on how many individuals overall have applied for Enhanced or a Fixed Protection, but we note in particular (from the recent Freedom of Information ² release from HMRC to Retirement Advantage) that just in 2016/17 there were 61,000 new applications - of which the majority are likely to have been for FP16 (a few will have been for IP14 or IP16). The individuals with EP or an FP are likely to be well spread around the pensioners and deferred pensioners of DB schemes undertaking projects to secure DB liability.

A particularly difficult additional group is those who have not yet applied for FP16 but will want to do so one day in the light of their retirement benefit.

There is a substantial number of individuals with benefits in more than one scheme (eg a deferred pension from a first job, another bigger DB pension from their main career; or a closed DB scheme with DC having accrued thereafter in a separate scheme. So an action taken in one scheme may affect benefits not just in that scheme but in others.

A pensions tax risk for some members has knocks-ons for a whole project to secure DB

If there is a pension tax issue by which some members might lose valuable Protection (and in particular if the trustees cannot be sure they can spot all those at risk), it may mean that full wind-up cannot proceed or has to be substantially reshaped. This

- can create **substantial costs** for the employer that could be better used by the business;
- can, if liability is not exactly matched by a buy-in, leave the scheme at risk to changes in the scheme funding level, so potentially losing an opportunity to secure benefits;
- can leave the scheme open to the risks and costs of **legislative change** during the delay;
- can, if the Trustees do not spot the issue and simply proceed, lead to a member losing their protection - impacting not just benefits in the subject scheme but also benefits elsewhere. This will be through no fault of the member - so leaving the trustees at risk of claims.

The issues are exacerbated by the fact that wind-ups involve the movement of funds without member consent.

In order to wind-up a scheme (or a DB section) completely, it is **necessary** for all benefits to be alternatively secured, which means the trustees have to be able to operate a default process they

¹ https://www.pensionprotectionfund.org.uk/About-Us/TheBoard/Documents/WEB_170407%20-%20PPF_Purple_Book_2017.pdf

² <https://newsroom.retirementadvantage.com/foi-request-reveals-1000-increase-in-tax-take-from-lifetime-allowance>

can apply (subject to certain statutory member protections) ultimately without a member's consent. Trustees are required to notify all members that they will be granted mirror image benefits using a buy-out but:

- Trustees cannot practically offer **pensioners** an alternative to buy-out.
- They will typically give **deferred members** the opportunity to take their benefit to an alternative vehicle eg by transfer to a personal pension of their choice or perhaps to a vehicle arranged by the employer such as a group personal pension (this would inevitably mean the benefit changing from DB to DC).
Where members do not take up such an opportunity the trustees need to be able to proceed to their default (mirror image DB) buy-out.

In the context of a voluntary wind-up, if the default is not "protection safe", it may be that full wind-up cannot proceed.

Finally, it is worth noting that a substantial number of deferred members lose touch with schemes - particularly in relation to a small deferred pension acquired early in an individual's working life. So a non-response to a communication either may mean non-engagement or may mean the intended recipient did not receive the communication.

A comment about insolvent wind ups: Wind-ups are of course also triggered by the insolvency of the sponsoring employer; and (unless the scheme is so underfunded that it goes into the PPF) the trustees have to secure benefits with the assets they have. For these so called "PPF+ wind ups" the trustees have no choice but to proceed as best they can (and may take out insurance for some aspects). Anything that adds to the cost of buy-out (which includes anything that causes delays) reduces the assets available to restore (all) member benefits to full level. So the issues noted above are again very relevant. There are many other complexities not discussed here ³

We hope this demonstrates at high level - before getting into the detail in the Appendices- the need to remove unnecessary pitfalls in securing DB liability.

We would be happy to discuss the request further if that is helpful. Please contact me on 020 7432 6622 (karen.goldschmidt@lcp.uk.com)

Yours sincerely

Karen Goldschmidt

Chair, Pensions Taxation Committee

On behalf of the Association of Consulting Actuaries Limited

³ Additional issues not addressed include: the existence of an assessment period when only PPF level benefits can be delivered for actual claimants; the fact that typically assets will fall short of providing full mirror image benefits so the trustees have to decide on what limited level to provide; and that sometimes this will involve reshape of benefits to a format that is cheaper to buy from an insurer (so that limited assets go further).

APPENDIX 1 – Wind-up - pensioners with a fixed protection

The problem in short

This is covered by Rowan Howard's email to you of 18 July 2018 and her attached letter (and earlier correspondence).

When, in a scheme wind-up, a scheme pension liability is bought out (ie there is an authorised transfer of funds to an insurance company), the provisions of Article 35 of the Transitional Provisions Order clearly mean that enhanced protection survives. So a wind-up is "safe" for a pensioner with Enhanced Protection

Rowan's letter explains that it is Slaughters' reading that the provision has not been extended/made to cover any of the Fixed Protections. So a wind-up would lose a Fixed Protection held by any of its pensioners.

We can think of no policy reason for a difference— a holistic provision is needed to ease wind-ups.

The solution

If you agree Slaughters' reading, they indicate that the change needed to the law is simple. We would ask that this is made retrospective to 6 April 2012 (when the first Fixed Protection became relevant), because we suspect that the flaw is relatively unknown so that there may already have been buy-outs where this issue was not spotted.

Alternatively, it may be that HMRC read that Fixed Protections **are** included, in which case we ask that HMRC issue reassuring guidance on the point, as soon as possible.

Fuller details of the problem's impact and coverage

Most wind-ups of any size necessarily involve securing scheme pensions.

The issue affects any pensioner so transferred who still needs to rely on a fixed protection.

Typically, this would be because they have uncrystallised benefits in another scheme, or have funds in drawdown which have not yet been retested at age 75, but it might be a future BCE3 (eg because of a GMP step up).

The consequences of this particular flaw for such members would be:

From the member's point of view, if the transfer proceeds while they still have funds that need the protection, then it would mean that through an action that was completely out of their hands, those benefits attract an LTA charge that would not have arisen had the wind-up not happened.

From the trustee point of view

- Trustees may need to include a complex additional wording in the letters to ALL pensioners because the scheme will not have needed to know about uncrystallised benefits elsewhere and may not have the latest information on members' protection
This will frustrate the message that a "buy-out is good news, requires no action on your part and does not disrupt your pension arrangements";
- that additional wording would have to explain that members already holding an FP may need to take advice (with the cost that entails) and consider taking action that they had not otherwise wanted to do eg crystallise benefits in other schemes earlier than they might otherwise, before a FP is lost
- the section might have to warn that individuals with benefits elsewhere who have not yet applied for FP16 but are able to do so that they will be unable to do so once the transfer

goes ahead. As above, they may want to take advice on appropriate actions eg apply for FP16 and crystallise those rights held elsewhere before the buy-out (when FP16 would then be lost).

- it would be appropriate to remind members that, because they will be losing their FP, they have a legal obligation to let HMRC know this (see HMRC guidance PTM093400) even if they do not intend to rely on it for any future BCE.
- there is a risk that an affected individual misunderstands this until too late and at the very worst ends up with £200K extra tax (25% x (1.8m (FP12) – unprotected LTA which might have been £1m if protection has been lost already). There may be other impacts, for example in relation to PCLS.
- for trustees who did/do not pick up the point and so do not put appropriate wording in the communications, such members will suffer tax unduly - so a risk of an ombudsman complaint down the line.

Specific thoughts on the extent of this issue in the context described in the main letter:

- **Is this a rare case?** The main body of the letter notes the growing number of members with an FP (or a need for FP16 not yet registered) with benefits in more than one scheme. There is every possibility of a member who draws (or has drawn) their benefits in a DB arrangement (which might be a deferred pension from long past service) still having uncrystallised benefits elsewhere.
Set against this is that a member with any FP cannot have had relevant benefit accrual (so eg DC contributions) since the key date of their protection – so eg an FP16 holder cannot have had new DC contributions paid in after 5 April 2016.
- **Surely the Trustees know who these are so can focus communication on them?**
Trustees will know if LTA protection was used by the pensioner to support the BCE of their retirement in the scheme. But some pensions will have started before A-day so did not involve a BCE; and some FP protections will have been applied for after the scheme BCE.
- **These are pensioners so the Trustees do have a contact with them** (as opposed to deferred pensioners who may fall completely out of contact if they change addresses, until they come to apply to draw their benefit). However see all the points of complexity and cost raised above.

Example

Member X is a scheme pensioner who retired post A-day with pension £1,000 pa (from service some time ago) in the scheme winding up; and uncrystallised DB pension built up from service thereafter in another scheme (opting out in 2011) of £70,000 pa.

He has FP12 so an LTA base of £1.8m.

The winding up scheme secures his £1,000 pa pension with an insurance company. Rowan's reading of the law says this destroys the FP12.

By default the member's LTA base drops to £1.03m, although (taking advice) he could apply for IP16 at £1.25m.

If he does not understand/is not told of the issue and does not ensure that he draws his £70,000 pa pension ahead of the wind up, this will incur an LTA charge of around £40,000 that would not have occurred but for the wind up.

APPENDIX 2 – Fixed/enhanced protection and winding up: members with DC and DB benefits

The problem - summary

DC sections have been set up in existing DB schemes with a view to efficient transition to a solely DC scheme once the scheme is funded well enough to secure the DB liabilities.

But securing those DB liabilities with buy-out policies does not qualify for easements available for a full wind-up of the scheme, so members will lose Enhanced or Fixed Protections if held (or be disqualified from applying for FP16).

The solution

We propose an additional circumstance to the list in FA04 Schedule 36 of when a transfer acquiring DB or CB credits is a “permitted transfer” that does not lose a member’s Enhanced Protection or a Fixed Protection. This is the addition (with the full section shown at the end to give context):

8(ba) where the arrangement is a cash balance arrangement [CB] or a defined benefits arrangement, the sums and assets are transferred pursuant to s169 so as to become held for the purposes of, or to represent rights under, a cash balance arrangement or defined benefits arrangement in a scheme registered in accordance with s153(8) [or whatever is a better reference to a deferred buy out policy] and the benefits secured are identical or virtually identical [and for the avoidance of doubt, if the benefit in the transferring arrangement was a hybrid arrangement which was of DB or CB nature at the time of transfer, mirror image encompasses just the DB or CB benefit]

This provision seems to us not open to abuse, and avoids the pitfalls described below in a number of situations.

Fuller details of the problem’s impact and coverage

It is common in the private sector for employers to have closed off the accrual of DB benefits for employees through an occupational pension scheme, and now to be providing DC accrual instead.

Many employers have chosen to provide that DC through the same scheme as the DB - to avoid the cost of setting up a new scheme, or to continue the reassuring “branding”.

Perhaps more importantly it may have been with a view to the future securing of the DB scheme benefit (a “partial wind-up”). This route meant that the employer could proceed to good funding of the DB section; and if at some stage the funding overshoots because of extra good performance or a cheap market for buy out, the aim was to buy-out the DB liability, and to leave the DC section intact along with the remaining surplus, available to be assigned to members’ funds as future DC accrual. By contrast if the DC arrangement were set up in a separate scheme (eg a contract-based GPP), then if the DB at some point became “overfunded” compared to buy out, the employer would have to choose between winding-up and taking a taxed refund (thereafter funding new DC contributions from those taxed funds) or else winding-up using surplus to top up members’ benefits to an unintended windfall level. So the approach of a DC section in the same scheme as the DB section encourages employers to make sensible funding plans targeting a good chance of DB wind-up.

Schemes are now beginning to reach the levels at which the trustees could buy out the DB section and fulfil the plan of letting the DC section continue. But there is a block to this in pensions tax law.

If the trustees transfer DB to section 32 buy outs (as would be the necessary default to achieve a situation where the scheme is solely left with DC liability but members continue to have DB rights) this counts as a DB to DB transfer.

If the transferring scheme were fully winding up (so that the DC liability too was being moved out of the scheme) the buy-outs would not prejudice the Protections (because of easement in FA04 Schedule 36 para 12(8)(b)).

The fact that the scheme will continue to exist to provide DC means that the scheme is not winding up and the easement does not apply, and a member transferred in this way would lose Enhanced or Fixed Protection held.

Buy-outs simply provide mirror image DB benefits; so it is easy to overlook this pensions tax pitfall.

- Any project that has proceeded/ proceeds in this way will have caused any DB member involved to have lost their EP or FP.

If and when the issue is subsequently realised, when the member come to draw benefits from this scheme or any other they will find themselves with no EP or FP (and perhaps if lucky a fall-back to a much more limited protection they may have such as Primary or Individual Protection 2014 (IP14) , or be able to register for IP16). Particularly for those with EP the additional tax could be considerable.

If the issue is not realised, then the member will be making incorrect statements to the processing schemes, protection will be used invalidly and due LTA charge will not be paid to HMRC. As noted in Appendix 1, members who lose their FP must let HMRC know this – so would be in breach of this requirement too.

- Some partial wind-up projects started in this direction – but then the pensions tax issue is realised. Typically the Trustees will be concerned that they cannot engage with all the deferred pensioners at risk (see the main section of this letter), so the project is completely reshaped.

For example, matters might be rearranged so that the DC is transferred out first to another vehicle. This might be to a new OPS set up specifically to solve the problem; or to a master trust but then the transfer would probably need to be delayed until any surplus has been run-off. This can introduce considerable delay and extra cost for no good reason.

Our proposal would enable the original planned project to go forward in the natural way without having to take artificial steps to avoid the risk of protections being destroyed, and without the members involved having taken any action.

Our proposal is sufficiently flexible to support sensible variations on this.

Full extract of legislation (schedule 36 paras 12(7), 12(8) and 12(8A)) with our proposed addition

(7) For the purposes of this paragraph and paragraphs 13 and 15, a transfer of sums or assets held for the purposes of, or representing accrued rights under, an arrangement is a permitted transfer if-

(b) the sums or assets are transferred so that sub-paragraph (8) applies in relation to them, and

(c) the aggregate of the amount of the sums and the market value of the assets is, applying normal actuarial practice, equivalent before and after the transfer.

(8) This sub-paragraph applies in relation to sums or assets held for the purposes of, or representing accrued rights under, the arrangement if-

(a) they are transferred so as to become held for the purposes of a money purchase arrangement that is not a cash balance arrangement under a registered pension scheme or recognised overseas pension scheme,

(b) where the transfer occurs in connection with the winding up of the pension scheme under which the arrangement is made and the arrangement is a cash balance arrangement or a defined benefits arrangement, they are transferred so as to become held for the purposes of, or to represent rights under, a cash balance arrangement or defined benefits arrangement relating to the same employment as the arrangement and made under a registered pension scheme or recognised overseas pension scheme.

NEW ADDITION PROPOSED ABOVE WOULD FIT HERE

(c) where the arrangement is a cash balance arrangement or a defined benefits arrangement relating to a present or former employment, they are transferred in connection with a relevant business transfer so as to become held for the purposes of, or to represent rights under, a cash balance arrangement or defined benefits arrangement made under a registered pension scheme or recognised overseas pension scheme, or

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(8A) For the purposes of sub-paragraph (8)(c) "relevant business transfer" means a transfer of an undertaking or a business (or part of an undertaking or a business) from one person to another-

(a) which involves the transfer of at least 20 employees, and

(b) in the case of which, if the transferor and the transferee are bodies corporate, they would not be treated as members of the same

30 August 2018

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