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To: Angela Miles, HMRC

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Dear Angela

Annual Allowance and "Scheme Pays" – year of entitlement

This letter replaces the letter we sent you dated 31 January 2012, concerning Scheme Pays in relation to AA charge arising for the tax year of entitlement to benefits.

Our views and concerns here are informed by the draft HMRC guidance on this subject, circulated in confidence to representatives of the Joint Working Group in February 2012. At this time of writing, the draft guidance has yet to be published in final form; and you indicated that some parts would need further review.

As matters stand, we have little certainty of how the Scheme Pays legislative provisions operate for charges for tax years when benefits are put into payment. Even in reading your draft guidance as it stood, it took some work to match this with possible readings of the legislation - there are areas where the reading is non-intuitive and the outcomes appear to be far from stated policy intent.

It is likely that there will be an increase in the number of benefit crystallisations in the run up to 5 April (when the Lifetime Allowance changes) and some of these may have Annual Allowance charges for 2011/12 or indeed for 2012/13, so there is some urgency to schemes and members understanding the issues.

- Appendix 1 of this letter sets out key areas of the legislation where urgent clarification is needed from HMRC if you are not to face many enquiries. We have indicated our readings (following some discussions with you), but we are not lawyers so may have got this wrong, and also we are aware that in some areas there may be ambiguity and our reading may be out of line with HMRC's in this complex area of legislation.

- Appendix 2 highlights a key issue whereby there may be categories of members who are not able to take advantage of mandatory Scheme Pays due to the timing of their retirement and their pension input period (because – if our reading is correct - to do so in the only manner satisfying the mandatory process would result in a scheme pension becoming a stream of unauthorised payments). Individuals who crystallise their benefits in the period between now and 5 April may, depending on the nature of their pension input periods, fall into this category.

Most of the matters in this letter are ones we have raised with you before so I hope are easy for you to review. ACA is likely to be publishing this letter on the Briefing Papers page of its website (which is open to non-members) because we think it may be extremely helpful to members to read in conjunction with your (likely) material. Given the short time frame to 6 April, we will do this shortly after your RPSM pages are released, so long as those pages are materially similar to (and as short as) the draft pages we saw in February. However, in the awareness that our readings could be wrong, it would clearly be helpful if you could review this letter and let us know whether you think any material here is incorrect. If it would be useful to aid dissemination (noting HMRC's long lead in time for publications), we would be pleased to publish any response from HMRC on the same page.

Yours sincerely

Karen Goldschmidt FIA (Chair) and Mike Richardson
Pensions Taxation Committee

Appendix 1

We have set out below the key aspects of legislation and, where appropriate, what we believe to be the legal basis underpinning HMRC's guidance - very much aware that we may have got this wrong. We would be grateful for confirmation that HMRC agrees with this interpretation or, where appropriate, what its differing interpretation is.

In this letter we refer to "mandatory" Scheme Pays, as being a case where the individual has a right to demand that a scheme pays some or all of a member's AA charge (with consequential reduction in scheme benefit) because the conditions under s237B(1) of Finance Act are met and the member has made a valid election under s237B(3).

Note: In all cases that follows the "tax year of entitlement" means the tax year for which the AA charge triggers the special provisions of section 237B(6); ie it is the tax year in which the individual becomes "actually entitled to all of the individual's benefits under the pension scheme" and for which the member is asking the scheme to meet under the "mandatory" Scheme Pays provisions of the tax law.

As will become clear from Appendix 2, this will not always be the last AA charge arising from the member's accrual up to drawing all entitlement - sometimes it will be the penultimate AA charge.

For simplicity in Appendix 1 we assume that the member has entitlement in the scheme under one arrangement only and we comment further on this aspect in Appendix 2.

1. Some basics

S237B of Finance Act 2004 applies solely to mandatory Scheme Pays and not to voluntary.

2. When does the Scheme Administrator's liability to the AA charge arise for the "tax year of entitlement?

It is important to identify when the Trustees' liability to the charge arises because it is only then that an adjustment to benefits can count as being a "consequential adjustment", the latter being a legislative requirement under s237E

In all mandatory Scheme Pays cases, the Scheme Administrator's liability to AA charge arises at the point at which the AA charge becomes joint and several. This arises when the member makes a valid irrevocable election notice.

In the general case when an AA charge is being met under the mandatory process and the special provisions of s237B(6) do not apply in relation to the charge (ie for the AA charge for any tax year that is not the "tax year of entitlement"), a notice of irrevocable election cannot be made until the AA charge is known. As the AA charge will not be known until the end of the tax year to which the AA charge relates (ie once all events influencing it have happened), this means that the election cannot be made until after the end of the tax year to which the AA charge relates.

In respect of an AA charge for the "tax year of entitlement", s237B(6) applies. This requires the notice – if the Scheme Pays is to qualify as a mandatory one - to be given before the entitlement date. When s237B(6) applies and an election is made before the end of tax year to which the charge relates, the Scheme Administrator becomes liable to the amount set out in the notice on receipt of that notice. The Scheme Administrator has now become liable 'in tax year' for a tax charge relating to that tax year.

3. When is an adjustment "consequential"?

An adjustment cannot be "consequential" to satisfying a liability if the liability has not yet arisen; so an adjustment cannot be made before the date described above.

With that constraint, whether an adjustment to benefits is classified as "consequential" to the Scheme Administrator satisfying a liability within the meaning of section 237E (ie the Scheme Administrator paying the joint and several amount of tax to HMRC) does not depend on the ordering of the adjustment and the satisfying the liability.

So a reduction to benefits can be 'consequential' if it occurs before the Scheme Administrator pays the tax required under the notice –or if it occurs after. The only requirement is that if the liability is satisfied, a reduction must be made some time on or after the joint liability arose.

4. How does Scheme Pays interact with the closing balance adjustments in section 236?

In relation to the adjustments to closing values for pension input amount calculations set out under section 236:

- A consequential reduction of benefits for the purposes of any mandatory Scheme Pays (ie so long as the s237B procedure has been followed (notice being given etc – and, whether the AA charge for the "tax year of entitlement" or otherwise) does not count as a surrender under section 236(8) and so the amount of the reduction is not added back to the PIA under this section. It does not count as a surrender under s236(8) because it is a reduction directly related to the statutory procedure contained in s237B rather than an option under the scheme rules. This remains the case if a pension scheme actually formalises the Scheme Pays arrangement within its Trust Deed and Rules.

  One of section 236(8C) or (8D) closing value adjustments then applies, as appropriate to the tax year involved.

- By contrast, voluntary Scheme Pays does trigger the provisions of section 236(8), because it is a surrender using an option available under the Scheme rules. Section 236(8) applies to a reduction "pursuant to an option under the arrangement", which does not require a specific stand-alone provision in the rules governing the arrangement (and "option" is not formally defined) - it is enough to identify something in the rules that gives the Trustees the power to pay the tax charge, and their making that conditional on a reduction agreed with the member as a "trade-in".

5. What is the classification of the payment when a scheme pays the tax on behalf of a member under voluntary scheme pays? Can all schemes pay voluntary scheme pays?

Where a scheme pays an AA charge under voluntary Scheme Pays, the payment can be considered authorised by virtue of it being a Scheme Administration Member Payment under Finance Act 2004.

Changes to a particular Scheme's rules may be needed to allow such a payment if there are not already provisions that could accommodate this: there is no overriding legislation to allow Trustees actually to pay a tax charge on behalf of a member under voluntary Scheme Pays.

There are overriding regulations that allow Trustees to make a fair and reasonable reduction to benefits if the Trustees pay an AA tax charge under the voluntary process. But the tax charge does no arise until the end of the tax year and hence the overriding regulations enable a reduction, for an AA charge for a tax year, to impact following the end of the tax year. Where entitlement arises in the tax year of the AA charge, this means that the AA charge cannot be met, and reduction cannot happen, until **after** the end of that tax year and **after** the actual entitlement has arisen – with the risk that reducing the pension in payment may in some circumstances lead to the pension becoming unauthorised. For such a charge, it may only be possible to make the reduction from the start of pension payment if the scheme already has a power for trustees to reduce benefits with member consent in appropriate circumstance, or if such a power is introduced into the rules.

Trustees can always pay a mandatory Scheme Pays obligation, whatever their scheme rules say, because it is an obligation under primary legislation. (But see example below regarding interaction with unauthorised payments provisions).

[COMMENT ON SEEING FINAL VERSION RELEASED MARCH 15 2012: HMRCs final guidance seems to think differently. There is what seems to be a key phrase, repeated more than once "This is because a notice can only be given before the end of a tax year if it is for a charge in the tax year that the member takes all their benefits under the pension scheme (or BCE 5, 5A or 5B occurs). Otherwise the member must wait until after the end of the tax year in question to give a notice for the following tax year, irrespective of whether the notice is given on the 'mandatory' or voluntary basis." This seems to imply that - for any scheme - giving notice before the BCE enables making a reduction before the end of the tax year under voluntary Scheme Pays, if the AA charge is for the tax year of entitlement. We understand the case for mandatory but cannot see how this arises automatically for voluntary.]

6. What happens if corrections are required in subsequent tax years?

Under the mandatory Scheme Pays process, "where an individual's liability to the annual allowance charge in relation to the relevant tax year changes after the submission of the notice to the scheme administrator, the individual may amend the notice by sending a further notice to the scheme administrator." (This applies whether or not this is in respect of a charge for "the tax year of entitlement".) Members have the right to make amendments to the amount elected for in their irrevocable election for up to four years later.

We are under the impression that HMRC takes the view that in general any consequential adjustment to benefits does not "retrospectively" change the tax processing done originally. The member's tax charge 'as a matter of fact' for the earlier year might have changed but this would not alter the fact of the actual amount of benefits paid. And whilst the amount of tax due may have changed for whatever reason – including errors in the calculation work for the return – this would not count as a mistake to the effect that the past PIA/BCE were incorrectly reported in some way that requires an adjustment to reflect the position that should have been taken into account at that earlier time.

7. How do “tax year of entitlement” reductions interact with sections 67 and 91 of Pensions Act 1995?

Our understanding is that section 67 and section 91 of the Pensions Act 1995 are not relevant when reducing benefits so long as joint and several liability has already arisen, so that the reduction is classed as being ‘consequential’ to a liability being satisfied and hence is covered by the regulations.

(So in respect of an AA charge for the “tax year of entitlement”, these sections do not constitute a block to reducing benefits before the entitlement arises and hence in time to change the entitlement.)

8. Can consequential reductions be made after retirement?

In certain circumstances the Scheme Administrators may wish to implement a Scheme Pays reduction as a reduction in scheme pension, after that scheme pension has been put in place. This is permitted – or at least not blocked - under the Scheme Pays provisions.

However, if the Trustees do so, this may contravene the requirements set out in Schedule 28 of the Finance Act 2004 that a scheme pension will not reduce except in certain specified circumstances.

Provided the specified circumstances are met, a reduction in benefits after retirement for the purposes of Scheme Pays would not contravene the definition of a scheme pension.

This issue particularly arises where amendments (under the four year provision described above) are made to reductions that have been put in place. The election made for the charge for the tax year of entitlement in particular is likely to be based on estimated figures and so is quite likely to need to be adjusted (including the joint and several liability being increased if, for example, the member forgot to allow for some savings made, in calculating carry forward) after the end of the tax year when the actual charge is known.

Some key specified circumstances set out in Schedule 28 in which a scheme pension already in payment could be reduced yet continue to count as a scheme pension include where:

- the pension was put into payment by virtue of the ill-health condition being satisfied (nb this is the broader definition in Finance Act 2004 Schedule 28(1), not the tighter definition “severe ill health” under Finance Act 2004 s229(4); or

- the member is between ages 60 and 65 and the reduction is less than a certain level.

And if the reduction for Scheme Pays is timed to be simultaneous to an increase in pension such that the net effect is no reduction, there would be issues to consider under this heading.

It is important to be clear that a specified circumstance applies for the purposes of a Scheme Pays reduction. Where no specified circumstance applies:

- As RPSM09101580 notes, if the rate of scheme pension payable to an individual is reduced in any but the specified circumstance, all payments after the reduction will count as unauthorised member payments, and be taxed as such; and in some cases, the tax free cash sum paid in connection with the pension may be subject to tax too.

- But some scheme rules do not permit unauthorised payments to be made at all – preventing a Scheme Pays reduction being implemented in this way at all.

9. What happens if a correction means that "mandatory scheme pays" becomes "voluntary scheme pays"?

As a corollary to the above point, we would be grateful for HMRC's view on what happens when an irrevocable election for mandatory Scheme Pays was made in good faith and a benefit reduction applied, but the election is ultimately found not to have satisfied the criteria for mandatory Scheme Pays, for example, if an adjustment was made to the member's AA charge calculations two years later which meant the total AA charge dropped from just above £2,000 to just below £2,000.

There is also a special case regarding the AA charge for the "tax year of entitlement" where HMRC's view would be very welcome:

- Assume a member – Paul - has an AA charge for his "tax year of retirement" of £2,500.
- Paul is entitled to mandatory Scheme Pays through his scheme, provided he makes an irrevocable election prior to his benefits crystallizing in the scheme.
- Paul makes the appropriate election, within the necessary time frame, and the scheme implements a consequential adjustment prior to the benefits coming into payment.
- In accordance with section 236(8D), the reduction in benefit is NOT added back to the benefit entitlement at the end of the PIP and so, the reduction in benefit serves to reduce the pension input amount and the actual AA charge.
- In particular, for this individual it reduces the AA charge to £1,800.

Does this mean that the adjustment was actually carried out using the voluntary Scheme pays route rather than the mandatory Scheme Pays route? If so, the closing adjustments in section 236(8) confirm that the reduction should be added back in for the purposes of the pension input amount calculation i.e. the AA charge returns to £2,500 in which case the member's mandatory Scheme Pays election was valid and the cycle begins again. We would be grateful for HMRC's confirmation as to how such a member should be treated in practice.

10. When does a reduction count as happening?

In order to calculate PIA correctly for any PIP (in relation to the provisions under s236) it becomes important to know when a Scheme Pays reduction counts as having happened.

In the case of an election being made just before an entitlement to benefit under s237B, and the consequential adjustment reducing that entitlement (eg reducing the start level of a scheme pension) it will usually be clear which PIP the reduction has fallen into.

In the case where benefits impacted by the reduction will not actually be payable for some time, there is not such a clear marker.

- Some schemes will apply the consequential reduction to DB benefits, using a "negative DC' structure (this being one of option that the Treasury paper envisaged). The way this might operate is that this takes the form of a separate 'loan account' within the pension scheme, running alongside the DB arrangement: the member has unadjusted DB rights from time to time but an amount equal to the tax charge is placed in a 'pot' and then uprated each year. In this case an adjustment to the member's DB benefits is not made each year but is actually made when the member takes their benefits, when the uprated amount is off set against those benefits. The uncrystallised DB pension rights from time to time would not count as reduced – and hence an adjustment to the pension input amount under s236(8C) and s232(8C) would not (need to) apply – until the member actually takes their benefits.

(This reading supports one of the main reasons for using negative DC options, which is to limit Scheme Pays calculation work to the minimum until actual retirement). It is our reading that, although the reductions apply in the “tax year of entitlement”, they do not all trigger the special provisions of s237B because at most only one element of the reduction will relate to an AA charge for the “tax year of entitlement”.

- Some schemes will apply the consequential reduction to DB benefits as a deferred pension offset. We are not clear as to what could count as the timing of the reduction: would it be the date that the member gives the irrevocable election notice? Or some other date? Could the trustees decide what the relevant date is (so long as it is not earlier than the irrevocable election notice?

- What if a valid notice has been made and the Scheme Administrator has duly paid the joint and several liability to HMRC, but the reduction is deemed not to have occurred yet (so eg the negative DC case) and the member dies before drawing benefit. It may be that the Scheme Administrator pre-agreed with the member that the reduction would be taken from the spouse pension in those circumstances – or there may be no spouse pension payable. There then would seem no way for the Trustees to make a consequential reduction. What would the Scheme Administrators position be vis-a-vis this mandatory Scheme Pays obligation? Would they be deemed to have made an unauthorised payment: this is what RPSM06109050 seems to suggest.

11. Interaction with calculation of Lifetime Allowance charge and PCLS

We note that the process for reducing pension before entitlement, for an AA charge for the tax year of entitlement, involves an estimate being made by the member/Scheme Administrator; and then an upward adjustment after the tax year.
We would be grateful for guidance on how this is managed for LTA calculations. Can we take the actual BCE2 value in the tax year as the basis for setting the LTA charge, with no adjustment for the later correction? Equally, is the maximum PCLS based on the actual BCE2 value, again with no later correction?

Appendix 2

1. Potential for a member having no access to Scheme Pays for an AA charge

We believe that, under the legislation as drafted, there is a class of people who will not be able to make use of Scheme Pays for AA charge arising in relation to "the tax year of entitlement", even though they satisfy s237B(1). This arises because of the drafting of s237B(6) reproduced below:

> "237B(6) In a case in which the individual becomes actually entitled to all of the individual's benefits under the pension scheme in **the tax year** or benefit crystallisation event 5, 5A or 5B occurs in the tax year in relation to the individual and the pension scheme, the notice must be given before the date on which the individual becomes so entitled or the benefit crystallisation event occurs."

The provisions of sections 237A to 237F set out how Scheme Pays applies for each pension input period. However, as the above legislation refers to the "tax year" in which benefits crystallise rather than to the pension input period in which the benefit crystallises, it is possible that a member may not be able to use s237B(6) in order to make an irrevocable election in advance of the usual timescales. Effectively the member needs to become entitled to their benefits in a pension input period that will be tested against the current tax year, which is not always possible.

It is probably easiest to illustrate this by an example:

> Gareth is a member of the XYZ Scheme, a defined benefit scheme with a single arrangement, where the pension input period is defined as the calendar year.
>
> He plans to retire on 1 February 2012 aged 55 and in normal health. He did not have an AA charge for 2011/12 (ie the 2011 calendar year PIP) but he has no carry forward. His pension input amount for 2012 is large (despite there being only a single month of accrual) because of the pension put in place when he retired (say, the scheme rules include a provision enabling unmarried members to reshape their pension to single-life provision, the normal basis including provision for contingent spouse's benefit; or a variety of other circumstances). Say his pension input amount for 2012 (and hence for the 2012/13 tax year) is determined as being £90,000.
>
> Because he has no carry forward, the excess of his savings over the annual allowance is £40,000. Gareth is a 50% tax payer, which means that the annual allowance charge for the 2012/13 tax year is £20,000.
>
> Gareth would like to use mandatory Scheme Pays in respect of this 2012/13 tax year AA charge. His retirement fell into the 2011/12 tax year, so it would be in respect of that charge that the provisions of s237B(6) apply (but they are irrelevant for that year because no AA charge arose for it). For the AA charge for 2012/13, the provision of s237B(6) do not apply; so he can elect for mandatory Scheme Pays for 2012/13 but such an election will be valid only if and when it is made after 5 April 2013 (and, for completeness, before 31 July 2014).
>
> Gareth having made his irrevocable election on 6 April 2013, the Scheme Administrator of the XYZ Scheme is now required to settle the tax liability and make a consequential adjustment to Gareth's pension. However, as none of the exemptions in Schedule 28 para 2 of the Finance 2004 apply, any reduction to benefits means that the pension would become unauthorised after the reduction. In common with many schemes, the Trust Deed of the XYZ Scheme expressly forbids it from making any unauthorised payments.
>
> How should the Scheme Administrator proceed in this case? How can the member have his right to Scheme Pays satisfied?

2. Other complexities relating to Scheme Pays and Entitlement

The provisions relating to AA charge for the "tax year of entitlement" are clearly complex and include anomalies. Individuals will need to understand these if they are to make informed decisions about how best to draw benefits. Scheme Administrators will need to understand them, firstly so as to correctly calculate and report Pension Input Amounts to the member; and secondly so as to know when they are operating under mandatory Scheme Pays or not – for the different treatment of the two cases and in the light of whether their scheme rules offer voluntary Scheme Pays.

We note two particular points.

- In Gareth's case above, if he had had excess savings in the pension input period calendar year 2011 ie for the tax charge arising for 2011/12, and he had wanted to use Scheme Pays, the provision of s237B(6) **would** have applied. He would have had to make an election before 1 February 2012. If the scheme consequentially put in a reduced level of scheme pension, that would change the pension input amount (and hence the AA charge if there was one) for the tax year 2012/13. (There would be no impact on the pension input amount in respect of the 2011 PIP ie for 2011/12)

- S237B(6) refers to "entitlement under the pension scheme". We can appreciate that this may been with an eye to limiting post-retirement reductions once all benefits have been settled). But we note that if for example Gareth had the DB pension noted above and also a small DC AVC fund in the same scheme, and DC AVCs were used to buy an insured annuity (BCE1) but the scheme processes mean that the purchase price was paid to the insurer after 5 April 2012, then this fact alone would mean that s237B(6) switches to applying not for the AA charge in 2011/12 but for the AA charge in 2012/13.