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To HM Revenue & Customs Pensions Policy

Dear Sir/Madam

Draft statutory instrument - The Annual Allowance Charge (Amendment) Order
Closing adjustments for transfers-in to DB and CB arrangements

I refer to the draft statutory instrument HM Revenue & Customs (HMRC) has published for external comment making a number of changes to the annual allowance legislation following the changes in Finance Act 2011. This letter is part of our response and should be read in conjunction with our separate letter of today's date.

This letter focusses on one area, the provisions relating to closing adjustments for transfers-in to DB and CB arrangements. In the Appendix, we focus on DB, as set out in s236(5) and proposed (5A); and at the end of our letter comment on an appropriate extension for CB arrangements.

I have discussed several points in this letter with Jonathan Moody of the Association of Pension Lawyers to aid our understanding of the current legislation, and in places I have adopted wording Jonathan suggested. We understand that time constraints prevented HMRC from putting out explanation of its reading of the current legislation and the reason for the proposed changes. Oral explanation was given at the PISF meeting of 18 December 2012. We have here detailed our understanding of the situation, this being the basis for our comments.

The lack of explanation may mean that responses to the consultation that HMRC receive in relation to the draft clause may be limited and/or provided on a basis of misunderstanding. This may be a good reason for giving a period for discussion and development of the legislation beyond 31 December, as noted in our other letter. While there is an urgency for a solution to what emerges under the current HMRC reading, a delay may be acceptable so long as there is the prospect of a retrospective solution and knowledge of the broad direction of travel.

As per our other letter, retrospection is important, back to the notional PIA calculations for tax year 2008/9. It is unthinkable that, for a transfer between schemes of mirror image benefits because of a corporate transaction, members use up AA and potentially trigger an AA charge; or that trustees have to create the corresponding notional allocations of transfer value and actuarial calculations with no other meaning and potentially insufficient data now.

We hope our comments are of assistance and would be happy to discuss them further if helpful. You can contact me on 020 7432 6622 (karen.goldschmidt@lcp.uk.com) or Mike Richardson on 0118 977 2277 (mike.richardson@puntersouthall.com).

Yours sincerely

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APPENDIX

This letter relates to the interpretation of s236(5) Finance Act 2004 as it currently stands and the proposed change and addition of a new (5A). We comment from the perspective of what happens in typical schemes with typical trustee considerations – we appreciate that there may be eg small schemes where manipulation might be a higher risk.

1 Introduction

The legislation under discussion covers transfers from DC to DB and transfers from DB to DB. (Transfers into DC arrangements are covered by other legislation so do not raise the specific issues discussed here.) Individual transfers resulting in a DB transfer credit have become rare in the private sector, though they do still happen; "transactional" transfers resulting in a DB transfer credit are much more common; and internal transfers (ie transfers between different sections of a single scheme) may be relevant here too.

Where a transfer is brought into a scheme and a credit is therefore granted during a PIP, s236(5) provides for an offset to pension right at the close of the PIP, in calculating pension input amount for AA purposes, as follows *"If, during the PIP, the annual rate of the pension … to which the individual would be entitled under the arrangement has been increased* ***by reason of a*** *transfer relating to the individual of any sums or assets held for the purposes of, or representing accrued rights under, any pension scheme so as to become held for the purposes of, or to represent rights under, the arrangement, the amount of the increase is to be subtracted from PE or LSE."*

We understand from discussions with you and from your explanation at the PISF meeting of 18 December that HMRC's interpretation of s236(5) as it currently stands is that the adjustment must be based solely on the benefits that the sums transferred would "purchase" in the receiving scheme; and there is a direct link between the actual amount transferred and the increase in benefits.

As we would summarise it, HMRC's position is that s236(5) should be read on the basis that a DB transfer credit is "by reason of" a transfer payment only if the transfer credit is actuarially equivalent to (or actuarially justifiable by reference to) the payment received, disregarding all considerations other than the amount of the transfer payment. If the transfer credit is more than this, we think HMRC's position is that the excess (if any) over what is actuarially justified is effectively an augmentation which the AA legislation will (depending on the form of the augmentation) count as a PIA in the PIP of receipt.

We can see that HMRC would be concerned at the loophole that would be opened up on a broader reading of s236(5), ie that any DB transfer credit awarded in connection with a transfer is disregarded for AA purposes, and we agree that that is a factor favouring HMRC's interpretation.

2 Structure of this letter

Despite our sympathy with HMRC's concern to rule out abuse, we have several real concerns about HMRC's reading of s236(5):

(a) First, whether the reading is actually correct in law.

Our impression from discussion with Treasury as to the policy intent of Finance Act 2011 has been that "*increased* ***by reason of a*** *transfer"* was deliberately written widely to accommodate the many forms of individual and bulk transfers that exist without over-focus on the sums received. The sort of issues that otherwise can arise had already been identified and been "solved" by way of guidance to the original Finance Act 2004 in force in 2006. Our understanding is that many lawyers currently read Finance Act 2011 to encompass credits granted because of a transfer but not having specific definition relating to the amount of the transfer.

If there were the possibility that HMRC could revert their reading to the above, then the matters in this letter and the drafts could all be dealt with by guidance together with some broad anti-avoidance provisions.

(b) Second, how one determines whether the transfer credit has gone beyond actuarial equivalence (the key point here being that there is no single answer to how a bundle of pension rights should be valued actuarially) and the treatment of excess if it arises; and

(c) Third, assuming that the reading holds, how well 236(5A) deals with what would otherwise be unfortunate and unintended results.

Part 3 of this letter gives more background about the situations where transfers happen within the private sector.

Part 4 expands on issue (b) above, while part 5 expands on issue (c) and some practical issues. Part 6 comments on the changes needed in parallel for CB to CB arrangements.

3 Transfer activity in the private sector

The circumstances in which DB transfer credits are granted in a receiving scheme from a DC scheme are narrow (and narrowing) but might include:

- "individual request" – on the whole employers aim to limit how much their DB liability increases, so even in a predominantly DB scheme the transfer in option might be for DC benefits – but a few DB schemes still do offer this option
- employer-incepted requests - we have come across some special arrangements
- employer promises that in particular circumstances members would be able to transfer between sister schemes on special terms – these are rare but do exist and each such case could involve a material number of individuals, many of whom would not be high earners

The circumstances in which DB transfer credits are granted in the receiving scheme from a DB scheme are narrowing but might include:

- individual requests outside transfer club arrangements, where the transfer grant solely reflects the TV paid. As above, on the whole, employers aim to limit how much their DB liability increases, so even in a predominantly DB scheme the transfer-in option might be for DC benefits – but a few DB schemes still do offer this option
- individual requests between schemes within a transfer club arrangement – both public sector schemes and those private sector schemes with connections to public – where the grant reflects (though not necessarily mirrors exactly) the benefit expectations as an active member in the preceding (transferor) scheme

- “bulk transfers” in connection with scheme restructures or corporate transactions – which may be with the members consent or without. Most commonly though not invariably, the grant mirrors the benefits in the previous scheme. Indeed in most cases, particularly where schemes are being merged or the transfer relates to a large number of members, there will be no calculated “individual transfer value” as such, more an overall amount. The amount transferred may not reflect the full value of the scheme benefits granted in the receiving scheme if the assets in the ceding scheme are inadequate or would disadvantage members not being transferred

- transfers from a public service scheme to a private sector scheme in connection with an outsourcing, and vice versa

- "internal transfers” between two arrangements within the same scheme, for example as per the ACA question about how to deal with split NPAs[1].

  (We think there may be other implied internal transfers to take into account when considering the meaning of and changes to s236(5). There is an analogous point for schemes where, upon re-joining, a member has the option but not the obligation to link a previous service period to their new salary. This is a feature of the LGPS and PCSPS, but also of some industry-wide multi-employer schemes which are based on a public sector template. At day 1 of the second period of employment, the benefits must be in two arrangements (because if the member opts not to link, the scheme will continue to apply the deferred member carve-out to the first period). Down the line, if the member does opt to link they must be in a single arrangement (because the scheme won’t be worrying about zeroing negative PIA for the benefit built up in the first service period). So at some point the benefits must have been “transferred” from the first arrangement to the second.)

4 Where s236(5) continues to be appropriate: what transfer credits would count as actuarially equivalent to a transfer payment, for AA purposes ?

We agree that something along the lines of HMRC's reading of s236(5) continues to be a reasonable approach for dealing with most **individual** transfers for DB credit (whether from DB or DC arrangements).

There are important issues when the concept of “actuarially equivalent” is used, which we assume HMRC is aware of but which seem to us to create the fundamental difficulties that need to be sorted out as soon as possible in guidance.

Firstly there is the point that different schemes’ trustees/different actuaries can quite properly apply different values to the same benefits - and hence grant quite different benefit credits for identical transfer payments received - because of scheme-specific circumstances. For example, in considering the appropriate grant, the trustees will consider among other things the likely investment returns on the funds. In one scheme, where the expectation is that all benefits will be bought out in the near future, the valuation factors used might approach buy-out level. Another scheme which is not intending to buy-out but which has concerns about the employer covenant might use gilts-

[1] http://www.aca.org.uk/files/C._ACA_letter_to_HMRC_dated_15_June_2012_re_split_NPAs-24_July_2012-20120724114301.pdf

based transfer factors. A third with a strong employer covenant might link them to equity returns. Many other and / or intermediate approaches are possible. A different transfer credit would emerge in each case.

And even where all surrounding circumstances are the same, different actuaries may take different reasonable views: in terms of investment return, different or intermediate investment benchmarks might be taken to those outlined above, as well as different views on future returns on the asset benchmark chosen; views could differ about future inflation, future longevity, future salary growth to assume (if relevant), likelihood of exercising options such as commutation (if relevant) and so on, leading to quite different assessments of actuarial equivalence – none objectively more valid than the others and all within the reasonable range.

We also note that there may be situations where a scheme has no need to set a specific “transfer in basis” for normal benefit setting purposes because, firstly, there are no transfers-in in the normal course of events; and secondly the logic for the benefit they propose to grant is not actuarial. Application 3 below gives you an example of this. This may result in the position that an appropriate basis has to be determined solely for identifying what constitutes a “transfer in credit for the purpose of operating HMRC’s reading of s236(5)”. It is still appropriate that this should be scheme-specific. The actuary might take into account assumptions used by the scheme for other purposes and modify them appropriately to the purpose: perhaps a starting point would be the cash equivalent basis, or the commutation basis, or the funding benchmark, or the buy-out basis, if they exist, modified appropriately for the purpose. One particular modification might be that, if the credit is granted with future salary linkage, an assumption will have to be set to value this. Essentially, there is no "right" way of assessing actuarial equivalence.

Even if HMRC's reading of s236(5) is right in principle, given the above, we do not think it can be read as saying that there is a single "right" amount of transfer credit that a scheme can properly award in exchange for a given transfer payment received, and that any excess over that counts as a (precisely-defined) pension input amount.

We assume therefore that HMRC's position is that there is no PIA on a transfer into a DB arrangement so long as the factors used to calculate the credit “use normal actuarial practice” – with that common phrase interpreted with the same flexibility as in other areas of pensions’ tax legislation. We would take here to mean broadly “within a reasonable range and are not being specially manipulated”. In principle we agree that this would be reasonable, at least to deal with one-off individual transfers made in response to one-off individual requests.

The following examples for consideration reflect positions which raise important connected points (such cases and considerations do arise).

Application (1):

It is proposed that a DB scheme receives a sum £100K from a DC scheme. The employer requests, and the receiving Trustees agree to the scheme providing, a DB transfer credit pension of P. The Trustees note that this is the correct pension for them to grant if using a “best estimate of cost to the scheme” basis i.e. applying their scheme-specific formal cash equivalent basis, appropriately adjusted to allow for the revaluation that will operate for P. However, the Trustees do not normally accept new DB risk, and are doing so in this case on the basis of the employer request. In recognition of this, to protect against loss to the scheme (and thus maintain the security of other members' benefits) they wish to use a more prudent basis and ask the employer for a top up funding contribution of £10K.

P is clearly "by reason of a transfer" and, on a 'normal actuarial practice' for the scheme is equal in value to the transfer value. But the trustees want an additional funding sum before they will grant the credit. We believe P is acceptable - without any change to the legislation - as the transfer credit pension to offset within the calculation in s236(5).

There are all sorts of variations to this: the Trustees have the same issue in mind but the scheme is very well funded so they do not demand an explicit funding top up from the Employer; or defer considering more prudent (additional) funding on the basis that it will be consolidated within the overall conclusion of a future valuation and be dealt with as part of the holistic funding agreement, at that time.

Application (2):

A DB scheme receives a sum of £100K from a DC scheme as an individual transfer in. The rules allow the trustees to determine the benefit to be granted and to decide the quantum, having considered actuarial advice. The member has no other benefits due from the scheme. Based on the actuarial advice, the Trustees decide to grant a pension Q payable to the member, that is fixed once in payment (ie with no increases), calculated using "normal actuarial practice" to be equivalent to the transfer payment received. The employer subsequently decides to grant an augmentation to those benefits, by way of making provision for increases to the pension once in payment. The trustees, in accordance with the scheme's augmentation rules, consider what is the appropriate funding contribution (if any) to agree to such an augmentation given the funding level of the scheme, and duly request and receive (say) £10K from the employer.

It is a feature of the AA legislation for DB benefits that it ignores the "quality" of benefits (such as increases to pensions once in payment, contingent dependants pension, due payment age) and focusses solely on quantity (assessed using the valuation assumptions). An augmentation such as the above to an uncrystallised benefit, in any normal course of events, would not cause PIA ie is "AA invisible". Our reading is that this same invisibility would feature in this example. Overall no PIA would arise in consequence of these two steps.

We read the situations above as being reasonably clear in how they should operate within the spirit of AA law, and how they would operate within your reading of s236(5); but they highlight various issues in its operation.

Application (3):

A DB scheme receives a sum of £100K from a DC scheme as an individual transfer in. The rules allow the trustees to determine the benefit to be granted, and to decide the quantum, having considered actuarial advice. The employer asks them to grant a pension Q, with full attaching quality; the trustees take actuarial advice, note that the actuary advises that in his view the proposed benefit is more than actuarial value for the transfer in; but the trustees (having considered the funding of the scheme and the reason for the request) exercise their broad power under their transfer in rule and agree to the proposals. This is a case where the first part of the actual transfer credit granted would fall to be treated as the credit for the purpose of s236(5) adjustment, and the balance would count as excess and result in PIA.

The Trustees would need to decide which elements of the benefit fall in the former. Could they take the same structural line as in Application 2 (eg say the “value for transfer payment” part of the credit was the pension without increase, and the excess value was the provision of increases? Or, given that the benefit is all arising from one rule, might HMRC take the view that the spirit of the legislation would be to assume that the credit granted for s236(c) purposes was “(TV paid) / (Actuarial value of whole package actually granted by virtue of the scheme transfer in rule) x member initial pension”.

5 When is something different to s236(5) needed and does the proposed 236(5A) deliver this appropriately?

As mentioned above, we believe that something along the lines of HMRC's reading of s236(5) would be a reasonable approach for dealing with most individual transfers for DB credit (whether from DB or DC): for these we can see no objection in principle to the idea that a "fair value" transfer credit should always be invisible for AA purposes. We also think it would be deeply unfortunate if HMRC proposed to replace that legislation with something that worked on a completely different basis – such as saying that (for DB to DB, differently from the case of DC to DB) there was always a PIA if a transfer resulted in the member having a higher pension in the receiving scheme than in the paying scheme, as measured on the valuation assumptions. If the receiving scheme has for example a higher normal pension age, providing fair value may well force it to offer a credit of pension level/pensionable service which – on the valuation assumptions – would appear bigger than the member had before: we think it would be clearly wrong if the member incurred a PIA as a result of an individual transfer when there was no real increase in the actuarial value of his pension.

However, there are other special circumstances where the current s236(5) – as HMRC reads it – gives a perverse result unless some variation on s236(5) (as HMRC reads it) is introduced. In such circumstances - typically employer transactions involving scheme reorganisation – we agree that the focus should be on the benefits in the old and new schemes.

The draft regulations aim to solve this by a mechanism such that for “block transfer” DB into DB, a replacement to the current s236(5) adjustment will apply involving solely looking to reducing the receiving scheme initial pension by an amount equal to the paying scheme’s exit pension (ignoring attaching quality matters such as NRA, increases due before and after NRA, and funding, all of which might be built into how an individual TV out and TV credit were worked out).

Where the receiving scheme pension is equal, the result would be that the grant is adjusted out completely; where it is less than the transferring scheme, it would eliminate extra PIA in the receiving arrangement.

We agree that such an approach would be helpful in the context of scheme mergers and reconstructions, and bulk transfers following a corporate sale, where the intention is simply to mirror transferring members' existing benefits, for perfectly sensible commercial reasons, in circumstances where the mirroring would have to occur in a scheme other than the one where they originally built up.

Our initial thoughts are that it would best be appropriate to draw a range of special circumstances from the Enhanced Protection permitted transfers - recognising that they may need to be more widely drawn given that AA is relevant much more widely than EP. (If offered too widely it offers abuse opportunities: the initial pension may be no higher, but the receiving scheme quality could be significantly more valuable – but you may be satisfied that this is dealt with a range of checks and balances that already exist).

The draft legislation instead defines the special circumstances using the concept of "block transfer". This seems potentially too wide, unless modified. We note that the definition of "block transfer" in the draft legislation refers solely the "singleness" of the transfer out of the transferring scheme. We would expect there also to be a condition that there is a single receiving scheme. As well as being appropriate to the issue being addressed, it would also give the receiving scheme trustees appropriate control as to whether (5) or (5A) applies (whereas as drafted it is in the hands of the transferring scheme and/or member).

We do note in the next section examples of where "mirror" or "pension no higher than" might not aid some real life relevant cases.

We are not sure of the implications of how this will apply in another situation – in the context of individual transfers rather than bulk transfers – that of individual DB to DB transfers in relation to the public sector schemes. Where the transfer comes from a funded scheme (such as the NHS), our understanding is that the nature of "transfer club" arrangements is that the credit granted reflects an overall agreement about benefits, rather than the sums transferred which may be too little for a particular case. Where the transferring schemes involved are wholly unfunded, it is not entirely clear to us how those transfers are protected on HMRC's reading of s236(5) or (5A) as there is not "a transfer relating to the individual of any sums or assets held for the purposes of…". However, that is not an area where the contributors to this letter have special expertise.

There is a broader area to be considered where there is a transfer of liability but where there is no recognisable transfer of assets. The most common situation would seem to be when there is internal transfer of liability from one arrangement to another within the same scheme (examples are given in an earlier section of this letter). At a scheme level there is no concept of assets being allocated to a particular arrangement; and so no concept of a transfer of assets between different arrangements. (The exception may be when one of the two arrangements is DC, in which case it is easy to see a direct correlation between assets and benefits, but even that is not always the case). Given the difficultly in seeing allocated assets, it is not clear how either of s236(5) or s236(5A) are called. However, it seems that the intention is that legislation works for intra-scheme transfers in the same way as inter-scheme transfers. At a minimum it may be that the legislation needs appropriate modification (or guidance needs to confirm) that the appropriate amount of assets are to be assumed to have transferred.

Where will (5A) produce PIA in inappropriate circumstances?

The transfer credit pension can be higher in the receiving scheme than the exit pension in the transferring scheme. Focussing on the transactional cases, a transfer that involved a receiving scheme with lower quality benefits (eg NRA 65 compared to the paying scheme of NRA 60) might reasonably grant the individual a higher pension figure, to maintain overall fair value compared to the transferring scheme benefits.

Such cases of differing quality are unusual in private sector "transactional" transfers. Many aim for mirror image provision (even though this might mean that the receiving scheme ends up with a miscellany of historical inherited benefit scales) because it eases bulk transfer without member consent. (Obtaining member consent within a transactional transfer is an expensive, time-consuming and often insufficiently effective option.) However, such cases can exist.

There may be an important case connected with public sector to private sector transfers under the Fair Deal (as it has operated to date) where the benefits have to be broadly comparable but not necessarily identical. If the member chooses to transfer, any worsening in quality would need to be balanced, and this might be achieved by granting a service credit that is higher than from the transferring scheme so a higher deemed accrued starting pension in the PIP of grant. (A common case might be because the private sector scheme wants to provide increases in payment of CPI capped at 2.5/5%, where the public sector scheme from which the transfer is made provides full CPI.) Equivalently, the private sector scheme may elect to provide a pension of N/60ths, rather than the public sector's N/80ths plus 3/80ths lump sum.

It is also worth noting that the right to a transfer of past service benefits under Fair Deal is maintained for subsequent transfers on, if for example the contract is subsequently retendered. This can mean that a transfer as described as above is actually between two private sector schemes, rather than a public sector and a private sector scheme.

Transfers under Fair Deal are not ones where the existing s236(5) would seem appropriate, and are ones where the proposed provisions under s236(5A) usually should and will be triggered: the receiving scheme has to provide a target benefit without regard to its view as to whether the transfer received is enough to pay for the benefit. Indeed the public sector scheme is likely to pay a transfer based on equities which the receiving trustees might not think adequate – and it will expect the employer to make good the 'shortfall' albeit perhaps through future on-going funding contributions, rather than an upfront payment.

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There is the question of whether the receiving scheme would know about the pension in the paying scheme. This will be the case by definition in a "transactional situation", where the new benefits are being based on the old. To the extent that individual transfers effectively get brought into "block transfer" provisions, usually the pension in the transferring scheme would be unknown by the recipient scheme – you would need to be put a disclosure requirement on the paying trustees (which would not be welcomed as this might well involve them in extra calculations that they would not otherwise undertake e.g. working out a deferred pension with some allocation of its accrued statutory deferment increases). This then leads on to the issue of where sanctions would lie if errors emerge, timescales are not met etc.

Transfers of deferred pensioners

Our separate letter on the draft legislation notes the proposed change to the definition of "deferred pensioner" which highlights that, on DB to DB transfer, tax law treats the individual as having had "accrual". That letter questions whether the predecessor scheme "specified rate" carries through, including in the PIP of transfer-in. If not and some other mechanism is to be looked through, the following is relevant:

We would then assume that 236(5A) is to be used to ensure that, in the PIP of transfer, the accrual is effectively neutral for PIA so long as the benefit granted in the receiving scheme matches the “lost” benefit in the transferring scheme. If so, there may be an issue in relation to timing depending on PIPs. The receiving scheme benefit at the close of its PIP will depend on the period from exit to the PIP end date; the benefit “lost” in the transferring scheme (which is the offset made under (5A)) may have a different number of revaluations (typically lower) and potentially a different amount (see our June letter about determining leaver revaluation for PIA) depending on the date of transfer out and the PIP involved.

6 Transfers into cash balance schemes

To the extent that the above applies for defined benefit arrangements, there are directly comparable issues for cash balance arrangements. So a mirror of 236(5A) needs to be added into the draft instrument as a modification to 232(6).

(The following explains why cash equivalents can be lower than the value of the benefits granted, so that given HMRC’s reading of 236(5A), a transfer-in PIA adjustment that is solely based on cash equivalent is not adequate. Suppose a member has an “accrued cash balance right” of £10,000 for AA purposes. The cash equivalent paid will not be £10,000. That would be the benefit due had he reached NRD – which may be e.g. 20 years hence, and the opportunity for investment growth in the meantime means a lesser amount would be paid. Conversely, the £10,000 “right” for AA purposes might have attaching to it future revaluations – say inflation proofing or a link to national average earnings, also to be anticipated in a cash equivalent. Similarly there will not be 100% funding: reserves held would typically be less than £10,000 taking into account the investment returns that the trustees hope to make on the funds until their payment, but higher to the extent that there is a revaluation commitment to fund for; both aspects involving assumptions for the future. Under and overfunding in such a scheme are, therefore, quite possible. Conversely, a CB benefit granted in respect of a transfer amount will not simply be the transfer amount because the benefit promised in the receiving scheme will have an NRA attached to it and again may involve the promise of salary linking or other types of projected revaluation.)

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