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Dear Peter/Angela

Annual Allowance: "Scheme Pays" in practice

Our letter of 23 June 2011 to HMRC set out a range of comments and questions we had on the operation of the legislation on Scheme Pays (then in draft). On 9 August 2011 HMRC published new guidance on Scheme Pays for both members and scheme administrators. The guidance clarified some issues but left key queries unanswered, as well as raising some additional questions.

We would appreciate an opportunity to go through the guidance and points in our June letter with HMRC. However, in the meantime, the Appendix to this letter highlights some of the most important areas where clarification is needed urgently from HMRC. The ACA pensions taxation committee is making this letter available to our members so that they are aware of our views.

The key area of concern is how calculations involving a Scheme Pays case should be carried out as a member retires, including what different options trustees and scheme administrators have for dealing with the charge, and the extent to which different approaches may have different consequences.

We would be grateful for confirmation as to how Scheme Pays works in the year of retirement, covering for example, details of any interactions with the calculation of how much Lifetime Allowance is used up, the permitted level of Pension Commencement Lump Sum, and possibly with the calculation of the Pension Input Amount itself. No examples of this complicated area appear in the guidance.

This is a matter of urgency as

- Retirements now (and retirements in the last five months) are potentially triggering an AA charge under the new AA regime, and members retiring since 11 August may have the right to demand Scheme Pays to meet the charge.
- For some of these cases, the right to claim Scheme Pays under the "mandatory access" route disappears unless the member makes an irrecoverable election before the entitlement is crystallised.
- Most members would want proper information before such an election as to what reduction would be applied by the scheme administrator to recoup the charge, and what the overall tax consequences will be.
- Correspondingly, some scheme administrators will wish to offer Scheme Pays on a voluntary basis after that deadline (and this may be even more likely where this deadline is missed in the present circumstances of uncertainty about how the legislation works).

Along with considering the questions and providing clarifications in principle, we think that this is such a complex area that detailed examples are likely to be the most effective way of explaining the position. As a minimum, we would be grateful for examples showing, for each of the mandatory and voluntary Scheme Pays processes:

- Scheme Pays in relation to a PIP or tax year some time before the member is actually drawing benefits;
- Scheme Pays in relation to a PIP or tax year when an individual crystallises some benefits; and
- Scheme Pays in relation to a PIP or tax year when an individual crystallises benefits such that there is no remaining uncrystallised entitlement from a scheme

bearing in mind that the deduction might count as taking place in a later PIP/tax year; and in particular separating the analysis for the second and third bullets into the case where a Scheme Pays reduction is “made” prior to the benefit being crystallised; and where the reduction is being made after the benefit has been crystallised.

In each case we would be grateful for confirmation of the details of the pension input amount calculation, including references to the appropriate pieces of the legislation, as the interaction of sections 8, 8A, 8C and 8D of Section 236 of FA2004 are not obvious.

We hope that this letter is useful and would be pleased to discuss it further, and to help HMRC develop the examples referred to above. However, we would reiterate the urgency with which these clarifications are required. There are real cases happening today where large annual allowance charges are being incurred and members and schemes simply lack the information to be able to process them, or to understand the consequences if the cases proceed without special action.

Yours sincerely

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APPENDIX

See main letter regarding year of drawing retirement benefits

Type of reduction

The August guidance suggests that the reduction (if of a DB form) in respect of meeting the AA charge

- o must be in the form of a “whole of life pension”
- o can be only to the member’s pension and not to any contingent dependant’s pension (or at least, if a contingent dependant pension is reduced, the value of any consequential reduction in such pension does not count when comparing to the AA charge paid by the scheme).

We cannot see these requirements in the legislation. They seem to take away the intended flexibility that was described in policy statements from the government (eg a scheme administrator may wish to offer a reduction operating only over the first 5 years of pension payment, for speedy recovery of the charge) and be inconsistent between DB and DC. We would be grateful for confirmation as to how these requirements arise from the legislation.

The August guidance appears to have a presumption that, when scheme administrators apply a Scheme Pays reduction where the AA charge has arisen in respect of accrual of a DB benefit, that the reduction would be from DB benefits; and, similarly, there would be a DC reduction for DC accrual leading to the AA charge. However, where a member has both DB and DC benefits within a scheme but the accrual that caused the charge was of DB benefits, there seems to be no legislative block - and indeed there may be good reasons why scheme administrators may want - to apply a DC reduction. This could include when the member has AVC money purchase funds as well as their main DB benefits. Similarly a member may have only DB benefits but the scheme may wish to apply a “Scheme Pays” by way of a notional negative DC fund that would crystallise at retirement. We would be grateful for your confirmation, and for clarification to appear in updated guidance.

Withholding benefit until tax is paid

The guidance suggests that, in almost all cases of Scheme Pays, scheme administrators will want to delay the start of the benefits (in particular scheme pension) until the AA charge tax has been paid, to avoid a reduction that changes the scheme pension into an unauthorised benefit. However, under many scheme rules that may not be possible; furthermore this may have other consequences (an entitlement may move into a later PIP and so result in a different AA position – or indeed have wider tax consequences). We would welcome your comment on this and more information as to what are the consequences of either approach.

Scheme administrators would also welcome confirmation on whether there is any block under tax law to the benefits being reduced before the tax is actually paid.

As we noted in our June letter, applying the Scheme Pays reduction to the scheme pension after it starts does not necessarily lead to unauthorised payment. If an actual overall reduction arises it may be that it falls within some of the exemptions of Section 2(4) of Schedule 28 of Finance Act 2004 (for example, if the pension was put into payment by reason of “ill health” as defined in that Schedule, or the member is aged between ages 60 and 65 and is no more than certain levels) albeit that these exemptions were not originally written with Scheme Pays in mind. Alternatively it may be that the Scheme Pays reduction is coincident with when the pension would otherwise be increased so there is no net fall. Please could you confirm our reading on each of these situations.

Timing of reduction

We are trying to follow through the technicalities of the legislation. We would be grateful for confirmation as to when the members’ benefits are deemed to have been “consequently reduced” under Finance Act 2011 - we believe that this may impact on pension input amount calculations. Is it the point at which the member gives their irrevocable consent (for mandatory Scheme Pays only), the point at which the scheme actually pays HMRC the/any charge, or some other point, if so when?

Charges

The March 2011 Treasury paper indicated a policy intent that Scheme Administrators would not be permitted to charge a member for the administration costs arising in quoting for and onward-managing a reduction for Scheme

Pays. However, there appear to be no explicit restrictions in either the legislation or guidance to prevent this, whether for Scheme Pays on a voluntary or a mandatory basis. Unless this is specifically addressed, scheme administrators may, in setting the terms of reduction, consider that allowing for such a charge “delivers a just and reasonable outcome to that individual *and to other scheme members*” as per the Treasury paper. Your comments are welcome.

Power for any particular scheme to offer voluntary Scheme Pays

The Modification of Scheme Rules regulations insert provisions into all registered schemes allowing benefit reductions where the scheme has paid AA charge for a member (mandatory or voluntary), but there seems to us to be nothing in the regulations that explicitly allows all schemes to pay an AA charge in the first place, if on a voluntary basis. (If paying the charge is triggered under the mandatory process, then Finance Act 2004 as amended requires the payment.) We would be grateful for your confirmation as to whether, through some other mechanism, all schemes are able to offer Scheme Pays on a voluntary basis; or whether each scheme considering this will need to look for some pre-existing provision in their rules that effectively might allow this, or indeed may have to change their rules.

(If schemes do have to consider their own rules, it may be relevant for them to understand what the payment of the AA charge under the voluntary Scheme Pays process counts as for the purposes of Finance Act 2004. Is it a payment in respect of the member falling under S160? If so, we wonder whether the only possible provision of 164(1) that could apply (in the absence of explicit regulations under 164(1)(f)) is (d) ie that it is treated as a scheme administration member payment. We would be grateful for your confirmation.)