

Pension planning - Miscellaneous issues (Lecture P1448 – 13.02 minutes)

Pension fund recycling

Pension recycling occurs when you take a tax-free lump sum and reinvest it into another pension plan. If you did that, you would get the tax relief twice as you have got tax relief on the original contribution and then you get it again on the subsequent contribution.

There are anti-avoidance provisions to stop recycling of pension fund lump sums. This applies where all of the following conditions are met:

- The individual receives a pension commencement lump sum;
- Because of the lump sum, the amount of contributions paid into a registered pension scheme in respect of the individual is significantly greater than it would otherwise be;
- Additional contributions are made by the individual or someone else (such as the employer);
- Recycling is pre-planned;
- The amount of the pension commencement lump sum, taken together with any other such lump sums taken in the previous 12-month period, exceeds £7,500 and the cumulative amount of the additional contributions exceeds 30% of the pension commencement lump sum.

If caught, the lump sum becomes an unauthorised payment from the pension fund and will be taxed at a minimum of 40%.

It is important that the conditions are met and there are various issues to consider.

Pre-planning requires an individual to make a conscious decision to use a lump sum as way of paying greater contributions. If they decide to make the payment only after the lump sum has been received, then there is no pre-planning. The onus would be on HMRC to prove this although they could make inferences from the known facts.

It is important to realise that the cumulative period over which the additional contributions are measured is the tax year in which an individual takes the lump sum with the intention of using it to increase contributions, the two years before that and the two years after that.

All arrangements need to be critically examined. The following example comes from PTM133850 and shows why the involvement of an employer can trigger these rules:

An employee intends to receive a pension commencement lump sum of £100,000 with the intention of using it to pay a contribution of the same amount into a registered pension scheme. However, rather than taking the lump sum and then using it to make the contribution, the employee instead arranges a salary sacrifice in respect of a bonus of £100,000 that would otherwise have been paid to the employee. As part of that salary sacrifice arrangement, the employer pays a contribution of £100,000 into a registered pension scheme in respect of the employee. That contribution of £100,000 is a significant increase.

The recycling rule is triggered because:

- *the employee intended to use the pension commencement lump sum as a means to pay a contribution to a registered pension scheme*
- *that objective has been achieved through the salary sacrifice arrangement – taking the lump sum instead of the bonus foregone has allowed the individual to place the same £100,000 into a pension scheme that would have been paid had the employee taken the lump sum and then used it to pay a contribution of the same amount into the scheme*
- *there has been a significant increase in contributions and that increase represents more than 30% of the amount of the lump sum.*

Third party contributions

Third party contributions may be something which have not been encountered before but can give some interesting planning opportunities.

A contribution made by a third party into a pension fund do not count towards the donor's annual allowance. The limits which apply are based on the donee's allowances so they must have sufficient net relevant earnings and annual allowances to allow the payments to be made.

Sometimes, we see pension payments of the minimum value of £3,600 (or £2,880 net) being made for minor children or non-working spouses or civil partners. This is basic planning and can be a useful way for grandparents to pass value on to grandchildren. This would be a gift for IHT purposes although this can often be covered by normal expenditure out of income exemptions. It would also be a way for a parent to pass value to their children although a larger gift might be a PET rather than immediately exempt.

If one spouse's contributions are being limited by (tapered) annual allowance issues, they could make contributions for the other spouse which might be useful to increase retirement income for the couple generally.

As an example, say we have an individual who cannot make further contributions due to tapered annual allowance issues but has a wife who earns £12,000. She has very little pension provision and so he could make a contribution of £9,600 (gross £12,000) to her pension fund. No further tax relief would be obtained but it would enable a pension fund to be established for the wife which might utilise lower tax rate bands in retirement.

If the donee is a higher rate taxpayer, they could reclaim any additional income tax relief in the normal way.

Lifetime ISAs

The lifetime ISA were introduced from 6 April 2017 for adults under 40. The idea was that they could contribute up to £4,000 each year and receive a 25% bonus from HMRC at the end of each year. The savings can be kept in cash or investments and grow tax free within the LISA. The LISA contributions have to be taken into account as part of the overall annual ISA investment limit of (currently) £20,000. Only one LISA can be held in each tax year. Contributions can continue to be made with the bonus paid up to the age of 50.

Funds can be used to buy a first home at any time from 12 months after opening the account and can be withdrawn from age 60 for use in retirement. The limit for property purchases is £450,000.

Whilst these were supposed to be the future of pension planning, there is little evidence that they are being used widely, or indeed at all! The Help to Buy ISA which preceded this was very popular to help saving towards a first home and it is suspected that the LISA is being used for this purpose rather than for pension planning.

In reality, it might be a good IHT planning vehicle for the older generation. A LISA funded by a grandparent for two grandchildren could move £80,000 out of an estate over a ten-year period, hopefully covered by normal expenditure out of income. This would save £32,000 of IHT and bonuses of £20,000 would be received from HMRC to top up the fund. The fund would be worth £50,000 for each grandchild even without investment growth but any growth would be tax free. The downside – can't access it very easily!

Company pension contributions

An employer can make pension contributions for their employees or former employees.

Such contributions are not a benefit in kind and so are exempt from income tax in the hands of the employees. Such contributions are not subject to a NICs charge.

If an employer pays pension contributions into a scheme for a family member, this would be taxable as a benefit for the employee and subject to tax and Class 1A NICs.

The employer would be able to claim a deduction for any contributions assuming that the contributions are made wholly and exclusively for the purposes of their trade or business. Pension contributions are a cost of employing staff and HMRC accept that there is only going to be a limited number of situations where the wholly and exclusively test might not be met. However, they do highlight that contributions made in respect of a controlling director or shareholder of a company might be seen to be excessive.

The guidance at BIM46035 states:

A pension contribution by an employer to a registered pension scheme in respect of any director or employee will be an allowable expense unless there is a non-trade purpose for the payment.

In cases where the contribution is part of a remuneration package paid wholly and exclusively for the purposes of the trade, then the contribution is an allowable expense. General guidance on deductions for remuneration paid to close relatives of directors can be found at BIM47105.

Whether there was a non-trade purpose for the payment will depend upon the facts of the individual case. The case of Samuel Dracup & Sons Ltd v Dakin [1957] 37TC377 (see BIM37745) was decided on its own particular facts. It confirms that, where there is a non-trade purpose for the payment, then the payment is disallowable, but you should not read more into it than that.

One situation where all or part of a contribution may not have been paid wholly and exclusively for the purposes of the trade is where the level of the remuneration package is excessive for the value of the work undertaken by that individual for the employer. In this situation, you should consider whether the amount of the overall remuneration package,

not simply the amount of the pension contribution, was paid wholly and exclusively for the purposes of the employer's trade.

On occasion an employer may make an increased pension contribution on the basis that a scheme is underfunded. It is important when comparing contributions between periods to consider the full facts, including the history of remuneration and contributions, before challenging a deduction based solely on annual comparatives.

You should accept that the contributions are paid wholly and exclusively for the purposes of the trade where the remuneration package paid in respect of a director of a close company, or an employee who is a close relative or friend of the director or proprietor (where the business is unincorporated) is comparable with that paid to unconnected employees performing duties of similar value. When there are no employees with whom duties are genuinely comparable, you should follow the general guidance at BIM47105.

Where the facts show that a definite part or proportion of an expense is not wholly and exclusively incurred for the purposes of the trade, only disallow that part or proportion.

The deduction can be claimed (subject to comments above on wholly and exclusively) in the year that they are paid although there are some provisions for spreading of pension contributions where there is an increase of over 210% from one period to another but the increase has to be more than £500,000 for the spreading to apply. This is only going to be a problem for very large businesses.

The reduction in the annual allowance does make it more difficult to extract significant sums from a company as pension contributions but it is still an efficient way of extracting profits from OMBs.

Practical issues

There are often questions asked about making significant pension contributions – it is one of those areas where there is a high degree of uncertainty about the true position.

There are risks, as highlighted above in situations where the pension contributions are out of line with general levels of remuneration but the figures have to be high before they can be argued to be excessive in the context of the overall package. Clearly there will be a greater vulnerability where losses are generated by excessive contributions.

Another area of risk is in relative to spouses who are on the payroll but are not really making any real work contribution to the business. Arguably the payment of a significant pension contribution would follow general principles but there is a risk that it will attract a general enquiry which would see HMRC scrutinising whether any of their remuneration meets the wholly and exclusively test.

One question that does come up quite often is where a company has ceased trading, perhaps because it has sold its business but sometimes that it has just ceased trading, and the shareholders want contributions to be made from the surplus funds. It is unlikely that there will be any profits for CT purposes against which the payment can be deducted but even if that is the case, there would still be no employment tax issues for the directors. So, it might still be a reasonable idea.

It should be noted that any payment made post-cessation pursuant to an obligation which existed when the trade existed (such as in relation to the wider employee pool) would be capable of being deducted from profits in the final period of trading.

Use of SIPPs or SSASs by OMBs

Is there any difference between using a Small Self-Administered Scheme (SSAS) rather than the more popular Self-Invested Personal Pension (SIPPs)?

SSASs were very popular under previous regimes and were typically used by small companies. The advantage of a SSAS over a SIPP is the ability to make loans back to the sponsoring employer although there is a limit in this now to 50% of the fund assets. There is no limitation on the use of the funds by the employing company.

Example

A company with two brothers aged 55 and 40 has significant reserves. It is likely that the older brother will want to retire earlier than the younger brother and that the latter will not be able to afford to buy out the former.

The company makes profits in excess of £250,000 and is now paying tax at 25% which is annoying the directors. There is no company pension fund.

Money is being accumulated in the company as the brothers are thinking it could be used to buy back the older brother's shares. However, they could make a contribution to a SSAS over the next, say, 5-year period. Corporation tax could be saved on the contributions. The fund would build up and that money could be lent back to the company in due course to fund the buy back of the shares.

In specie pension contributions

The legislation gives tax relief for contributions paid in a tax year and so it is HMRC's view that such contributions must be a monetary amount, for example in cash, cheque, direct debit and bank transfers as other assets cannot be 'paid'. It should be noted that there are specific rules about transfer of certain tax incentivised shares to a registered pension scheme counting as a relievable transaction.

This point was argued in the Courts in 2020 and this highlighted inconsistencies in HMRC's approach. It is clear that HMRC now considers that it is only possible to structure a transaction so that a monetary contribution can be achieved without the need for cash to pass between the contributor and the pension scheme where there is a separate agreement to offset the consideration for the asset sale against the contribution obligation.

HMRC's previous view was that it may be possible for a member to agree to pay a monetary contribution and then to give effect to the cash contribution by way of a transfer of an asset or assets:

“[For this to be acceptable, there had to] be:

- a clear obligation on the member to pay a contribution of a specified monetary sum, say, £10,000. This needs to create a recoverable debt obligation;
- a separate agreement between the scheme trustees and the member to pass an asset to the scheme for consideration.

If the scheme agree[d], the cash contribution debt may be paid by offset against the consideration payable for the asset. This is the scheme effectively agreeing to acquire the asset for its market value.”

Following HMRC's statement in *Pension Schemes Newsletter* No 126 (December 2020), HMRC has now 'clarified' its guidance by adding the further condition mentioned above that an in-specie arrangement must meet for the contribution to be relievable.

The revised guidance now makes it clear that the practice of accepting in specie contributions as relievable is limited to a set-off arrangement where there is a pre-existing obligation to contribute a defined monetary amount and a separate agreement between the contributor and the scheme trustees to sell an asset to the scheme at market value.

The guidance in *Pensions Tax Manual*, para. PTM042100 now reads:

“Where an asset is transferred to a registered pension scheme in satisfaction of an earlier obligation to contribute money, the resulting contribution is not a monetary amount and therefore the requirements for relief under [s. 188(1)] or [s. 196(1)] (as applicable) are not met.

Where a contribution obligation exists and the registered pension scheme has separately agreed to purchase an asset from the member or employer for consideration, the parties may enter into a contractual offset agreement in relation to the payment of the contribution and the asset-sale consideration. HMRC recognises that, in certain circumstances, it is possible for a contribution effected in this way to retain its monetary form for the purposes of sections [s. 188(1)] and [s. 196(1)].

For a contribution to retain its monetary form, there must be:

- *a clear obligation on the contributing party to pay a contribution of a specified monetary sum, say, £10,000. This needs to create a recoverable debt obligation;*
- *a separate agreement between the scheme trustees and the contributing party to sell an asset to the scheme for market-value consideration; and*
- *a separate agreement whereby the scheme trustees and the contributing party agree that the cash-contribution debt may be offset against the consideration payable for the asset.*

HMRC would expect there to be contemporaneous documentary evidence of each of the above.

If the asset's market value is lower than the contribution debt the balance must be paid in cash in order for the entire contribution to qualify for relief.

If the contribution is being made to a registered pension scheme that operates relief at source (RAS) the amount of cash contribution specified would, if applicable, be the net amount after the individual exercises his [or her] right to deduct from the payment the relevant rate of tax (see PTM044220). The relief at the relevant rate [may] be claimed by the scheme administrator in the normal way from HMRC and if appropriate the individual [may] claim higher-rate relief via [the] self-assessment return.”

In a further case in 2022, the First Tier Tribunal ruled that the acceptance of a member's IOU to pay a fixed sum by way of contribution to the scheme was not a monetary payment and therefore did not constitute a relievable contribution.

Contributed by Ros Martin