More certainty on pensions and disguised remuneration

Finance (No. 3) Bill 2011

Finance (No. 3) Bill 2011 (Finance Bill), published on 31 March 2011, means that employers have more certainty on the new pensions and disguised remuneration rules and so can start to take action. In the context of disguised remuneration, there are still certain unresolved issues and so care is required.

Disguised remuneration

The Finance Bill introduces anti-avoidance rules for employment income through third parties. The Chancellor said in Budget 2011 that these are rules are designed to "end the practice of disguised remuneration, which sees highly paid employees offered tax-free, lifetime loans that are never repaid".

In addition, they are designed to:

- create a pay-as-you-earn (PAYE) and National Insurance contributions (NIC) charge when certain benefits are provided by employee benefit trusts (EBTs), and
- prevent planning that allows employees to exceed the £50,000 registered pension scheme annual allowance.

The legislation has more than doubled to cover 60 pages and is complex, so these are our initial comments. HM Revenue & Customs (HMRC) have also published 19 pages of frequently asked questions to help explain the legislation.

The original draft law (published on 9 December 2010) meant that a number of day-to-day arrangements were caught by the legislation but the good news is that this number has been substantially reduced. We are pleased that the Government has listened to the

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numerous representations and has made many changes to limit its scope. But in our view the changes have not gone far enough and may mean that employers and employees are left with unexpected tax bills.

What the new rules say

We have included a more detailed analysis of the new rules as they apply to different arrangements in the Appendix but in summary:

Timing
The new regime applies from 6 April 2011, with anti-forestalling rules applying from 9 December 2010.

Relevant steps
The rules refer to relevant steps. A relevant step is widely defined and includes one where money or assets are transferred, or just earmarked (however informally and even if all the details have not yet been worked out) or where assets are made available.

Tax charge
PAYE and NIC will be due when relevant steps are taken as part of an arrangement that relates to the provision of employment-related rewards or recognition or loans. Measures are included to avoid double tax, for example when an EBT is first funded and then again when the employee receives a bonus. But no relief is available if a loan is subsequently repaid (although relief is available for loans made in the anti-forestalling period that are repaid before 6 April 2012).

Exceptions
These new rules do not apply to tax-favoured share plans or to registered pension schemes. In addition, there are limited exemptions for deferred bonuses, loans from group companies, cashless exercise facilities, benefits provided to substantially all employees and investment income on funds already allocated for employees.

Pre-existing arrangements
The new rules do not apply to pre-existing arrangements, such as money already paid to an EBT or loans already made to employees. But if a relevant step is taken now in relation to those funds, they will apply to that step in exactly the same way, for example if an EBT makes a new loan with existing funds.

When payments are due
The employer will normally need to pay the PAYE and NIC when the step occurs. But none is due until Royal Assent of the Finance Bill, expected to be around July 2011. For payments made between 9 December 2010 and 5 April 2011, the PAYE/NIC date will be 6 April 2012.

These rules mean that most day-to-day arrangements are now not caught. As explained in the Appendix, more care will need to be taken with any arrangement involving:

- EBTs, including unregistered pension plans
- deferred bonuses
- loans, and
- hedging arrangements.

It is possible that further amendments will be made as the Finance Bill passes through Parliament.

Pensions

Reduced annual allowance

As expected, the maximum amount of tax exempt pension savings that can be built up by an individual in one year will be reduced to £50,000 for the tax year beginning on 6 April 2011. The Government will have the power to increase or decrease the annual allowance without the need for further primary legislation, but it is anticipated that this limit will be frozen until at least 2015/16.

Any contributions or build up (see below) under a defined benefit scheme over £50,000 will be taxed at the individual's marginal rate of income tax and paid through their personal tax return.

Rights under defined benefit pensions will be valued by assessing the increase in pension promise over a year after allowing for indexation of the pension at the start of the year. Indexation will be in line with the increase in the consumer price index (CPI) published in September each year. The increase will be valued at £16 for every £1 of extra pension accrued over the indexed start position.

Rights under defined contribution pensions are valued based on the actual amount of the employer and employee contributions in the year.

The Government has provided two ways (carry forward and scheme pays) that may help reduce the burden of exceeding the annual allowance in any one year.

Carry forward
It will be possible to carry forward to 2011/12 and subsequent years any unused annual allowance from the three tax years prior to the year of assessment. For the purposes of carry forward, the annual allowance for the tax years 2008/09, 2009/10, and 2010/11 is deemed to be £50,000.

An individual will only be able to carry forward relief if they were a member of a registered pension scheme at some time in that earlier year. Unused annual allowances are carried forward automatically.

Scheme pays
The Government announced on 3 March 2011 a mechanism that allows an individual to direct their pension scheme to pay their annual allowance tax charge in full provided that the tax bill exceeds £2,000 and the tax is due in relation to that pension scheme. This is known as scheme pays. Pension schemes cannot refuse a request from an employee to use scheme pays other than in exceptional circumstances.

The employee will be able to select this facility from the 2011/12 tax year. Scheme pays will reduce the total value of the individual's pension fund in defined contribution schemes, or pension promise in defined benefit schemes.

Reduced lifetime allowance

The maximum amount of tax exempt pension savings that an individual can build up in all their registered pension arrangements over their lifetime will be reduced to £1.5m, effective from 6 April 2012. This will be frozen until at least 2015/16.

Protection will be available for those individuals who have already exceeded the new lifetime allowance. The deadline to apply for protection is 5 April 2012 and the form will be available from HMRC from July 2011.

Individuals with protection will retain a personal lifetime allowance of £1.8m but cannot have any further contributions to a defined contribution scheme and can only

accumulate defined benefits as if they had left service on 5 April 2012 (e.g. at CPI only with no link to future final salary or further years of service). Future investment growth in the defined contribution scheme and revaluation of accrued defined benefit pensions will count towards the £1.8m lifetime allowance.

Increased flexibility

Individuals will no longer have to convert any remaining pension savings they have into an annuity when they reach age 75. In addition, those with income of at least £20,000 a year from other pension sources (including state pensions) can, from age 55 onwards, take as much of their remaining defined contribution pension savings as they like.

Pension input periods (PIPs)

The Government will introduce legislation to align PIPs (i.e. pension scheme years) with the tax year. This is good news for employees and trustees as it will be easier to work out people's pension tax liabilities for a tax year. If the start date of a scheme year has previously been changed, the default alignment described above will not apply.

Other issues

There are a number of issues with the legislation provided in the Finance Bill including:

- it unrealistically assumes that overseas schemes will facilitate scheme pays, and
- it is not specific on how scheme pays should be implemented, nor does it capture the Government's stated objective of not allowing the cost of scheme pays to be passed onto members.

Actions you can take immediately

1. Work out which employees have been affected by the disguised remuneration or pension rules – find out if they have already triggered a tax charge and if so what steps need to be taken.
2. Identify how your reward arrangements have been impacted by the new rules, both in terms of the arrangements specifically targeted and the broader elements that may unexpectedly be caught, e.g. graduate loans or deferred bonus plans.
3. Ensure that if an employee requests scheme pays you can meet your legal obligation to arrange this.
4. Determine communication strategy and whether to provide access to individual financial advice.
5. Take the lead in implementing scheme pays - additional costs may arise if individuals opt to remain in pension schemes and utilise scheme pays to meet annual allowance tax charges.
6. Review non-registered pension arrangements to avoid unnecessary PAYE and NIC charges from 6 April 2011.

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Appendix: Finance (No. 3) Bill 2011 – disguised remuneration

Employee share plans
The disguised remuneration rules will generally not apply to the grant and exercise of share options and most other share awards. This means that such awards will continue to be taxed under the existing law (e.g. normally income tax and NIC when the shares are received).

However, many companies hedge their obligations under their share plans. This could crystallise a PAYE/NIC charge under the new rules, even if the employees have not received any value. But hedging will not generally create a PAYE/NIC charge if:

- the hedging is carried out on an "aggregate basis" rather than on an individual-by-individual basis, or
- the amount hedged is reasonable and:
  - the shares are in the employer or another group company
  - the awards must vest (or the option must be exercisable) within five years
  - there is a "reasonable chance" that none of the award will vest, and
  - it is not part of a tax avoidance scheme.

Unfortunately, it is not clear what is meant by a "reasonable chance". HMRC's frequently asked questions confirm that they would accept that "bad" leaver provisions would mean that there was a reasonable chance of forfeiture.

In addition, at first glance it appears as if the award must be granted by the employer (rather than the parent or an EBT) for this exemption to apply. We do not believe that HMRC intended to draft the exemption so narrowly. However, if the law is not amended, companies are likely to want to amend their procedures to ensure that they fall squarely with the exemption so that no PAYE or NIC is due when the hedge is made.

This exemption seems to be limited to shares (or securities) in a group company and so would not apply where, for example, a company grants options over funds it manages. Companies that have plans that allow diversification will need to look at these rules carefully.

We welcome the new exemption for cashless exercise facilities where the loan to cover the exercise price is repaid promptly. If it is not repaid promptly, PAYE and NIC will be due.

Deferred bonus plans
The new rules do not apply where the deferred bonus plan is not hedged or is hedged by the employer or another group company. As such, PAYE and NIC will be due at the normal time.

Where a third-party, such as an EBT is involved, there is a limited exemption where the amount hedged is reasonable and:

- the awards are made by the employer and must vest within five years
- the employees pay tax on or before vesting
- there is a "reasonable chance" that none of the award will vest, and
- it is not part of a tax avoidance scheme.

Where the exemption does not apply, PAYE and NIC would be due on the grant of the award.

As noted above, it is not clear what is meant by a "reasonable chance". Similarly, this exemption from the disguised remuneration rules appears only to be available where the employer grants the award and so companies are likely to want to amend their grant procedures if the law does not change.

Unfunded unregistered pension schemes

The new rules will not apply to wholly unfunded unregistered pension schemes. However, if the employer (or a third-party) has earmarked assets to provide a pension then PAYE and NIC will be due when the earmarking occurs.

The draft legislation was unclear as to the position where the employer provided security for the unfunded pension. The new rules make it clear that where security is provided over assets held by the employer or another group company then the earmarking would be a relevant step, meaning that PAYE and NIC would be due when the security is given. This will not be welcomed by many companies. HMRC's frequently asked questions confirm that it may be possible to provide employees with some form of security in certain cases.

The Government's intention is to monitor "changes in patterns of pension savings behaviour" should be noted and it says that it "will be ready to act if necessary to prevent additional fiscal risk in this area".

Existing funded unapproved retirement benefit schemes (FURBS) and employer-financed retirement benefit schemes (EFRBS)

Pensions and lump sums out of FURBS and EFRBS will remain taxable on distribution under the normal income tax rules. This means that, where appropriate, the remittance basis and the 10% abatement for overseas pensions (but not lump sums) will be available. In addition, the new rules will not alter the character of pensions and retirement income under the UK's double tax agreements. But if an employee does not pay income tax when the benefits are drawn, this will no longer crystallise the employer's corporate tax deduction.

Generally, no PAYE or NIC obligation will be due on investment income arising on funds already earmarked for former or present employees at the time this arises. This exemption will also cover any reinvestment suggested by an employee provided that no additional value is passed to the employee because of the arrangements. The investment return will normally be subject to PAYE and NIC when distributed to the employee or dependant.

The new rules mean that PAYE and NIC will apply if any new funds are allocated to employees after 5 April 2011. However, HMRC's frequently asked questions confirm that it may be possible to operate a defined benefit EFRBS in certain circumstances.

Sub-funds and sub-trusts

In the same way as with EFRBS, generally no PAYE or NIC will be due on investment income arising on funds already earmarked for employees. This exemption will also cover any reinvestment suggested by an employee providing that no additional value is passed to the employee because of the arrangements.

If new funds are earmarked for employees after 5 April 2011, PAYE and NIC will be due.

HMRC has also confirmed that it will continue to challenge anything seen as unacceptable tax avoidance under existing legislation.

Loans

The new rules do not apply to loans made before 9 December 2010.

PAYE and NIC will be due when a third party lends money from 9 December unless it falls within one of the very limited exemptions. These include:

- loans provided by other group companies

- loans provided by a licensed lender to buy a car under an employee car ownership plans, and
- short-term loans to allow the cashless exercises of options.

In each case though, the exception does not apply if there is any connection with a tax avoidance arrangement.

Examples of loans caught by the new rules include “graduate” loans where the employer helps to facilitate a loan from a bank to a new employee on favourable terms.

Where a loan is within the scope of the new rules then (other than for loans made before 6 April 2011) there will be no relief if the loan is subsequently repaid.

Private equity

Most management equity plans and carry arrangements are likely to be outside the new rules. However, there is no specific exemption from the earmarking rules where part of the carry is, for example, granted to employees. In addition, care will need to be taken with leveraged co-invest arrangements.

General

The Finance Bill contains limited exemptions for benefits provided as part of day-to-day arrangements. These include:

- benefits that are provided to substantially all employees,
- those that are exempt from tax under Part 4 of ITEPA 2003 (e.g. annual parties, approved mileage allowances, loan of cycles),
- the £8,000 removal benefits exemption, and
- genuine holiday pay schemes.

The Finance Bill does not contain a specific exemption for dividends on shares acquired by reason of employment. In their frequently asked questions, HMRC has confirmed that “a normal dividend payment that simply happens to follow a shares transaction will not be caught by the new rules”.