TAX-EFFICIENT NON-APPROVED PENSION SCHEMES

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1. The New Climate

While the Chancellor of the Exchequer may have announced (on 19th March 2014) the biggest changes to approved (registered) pension schemes in almost a century, non-approved pension schemes still offer substantial advantages over registered schemes for persons of above average income.

2. Basic United Kingdom Taxation of Non-Approved Pension Schemes

2.1 Taxation of Employee and Persons Connected with Employee

2.1.1 A non-approved scheme is often referred to as "employer-financed retirement benefits scheme".[2] Typically, it takes the form of a trust.[3] For increased United Kingdom tax efficiency, the trustees are often resident outside the United Kingdom, usually in a low-tax jurisdiction.

2.2 Tax Charge on Contributions to employer-financed retirement benefits scheme or Appropriation to Sub-Fund

2.2.1 April 6th 2006 - April 5th 2011

The charge to tax formerly imposed on an employee when contributions to an employer-financed retirement benefits scheme were made by the employer was abolished as from April 6th 2006.

2.2.2 After April 5th 2011

Finance Act 2011 added to Income Tax (Earnings and Pensions) Act 2003 a new Part 7A (Employment Income Provided Through Third Parties),

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formerly known as the "disguised Remuneration" legislation. That can impose a charge to tax on an employee when money or assets are "earmarked" within the meaning of section 554B.[4] Further, Chapter 3 of Part 7A can apply to impose an earmarking charge in certain circumstances where the employer undertakes to make a future contribution to an employer-financed retirement benefits scheme and itself earmarks money or assets.

In brief, Part 7A will be problematic if the employee obtains any current vested rights to future benefits. Provided the employer-financed retirement benefits scheme is made discretionary and care is taken to ensure that Chapter 3 does not apply, an earmarking charge can be avoided.

Contributions to non-approved discretionary schemes will thus be particularly appropriate where

(a) the employer is a close company and the employees who hope to benefit from the employer-financed retirement benefits scheme are participators in it or

(b) the contribution is made by way of bonus and the employee has no contractual or other right to have it made.

2.3 Charge to Tax on Benefits from an Employer-Financed Retirement Benefits Scheme

2.3.1 Relevant Benefit Charges

Income Tax (Earnings and Pensions) Act 2003 Part 6 Chapter 2 (Employer-financed retirement benefits) imposes a charge to income tax on certain benefits ("relevant benefits") received from an employer-financed retirement benefits scheme. There is some uncertainty as to whether certain benefits constitute "relevant benefits".

2.3.2 Other Charges

A benefit conferred by an employer-financed retirement benefits scheme may be taxable under some other part of the tax code. As a general rule, a benefit conferred on an employee or former employee will result in an income tax charge (unless double taxation relief can be claimed). A benefit conferred on someone who is not an employee or former employee is more likely to be subject to no charge to income tax.

2.3.3 Planning - Conventional and Current

Long-term planning previously often took the form of an employee taking

4 Part 7A does not apply to a registered pension scheme or certain other privileged schemes: section 554E.

a loan rather than a taxable benefit from an employer-financed retirement benefits scheme. He would have been taxable, it at all, only to the extent to which he did not pay interest at the "official rate" on the loan. The debt would have been deductible for Inheritance Tax purposes on his death while the funds comprised in the employer-financed retirement benefits scheme would have escaped Inheritance Tax relevant property charges. Benefits, often tax-free, could be conferred on his family at some stage after his death.

Income Tax (Earnings and Pensions) Act 2003 Part 7A taxes simple loans made by employer-financed retirement benefits scheme as if they were out-and-out payments. However, it is often possible for an employee to receive a "synthetic loan", which places him in the same position as if had been made such a loan.

Part 7A has increased the number of situation in which benefits conferred on family of an employee from an employer-financed retirement benefits scheme can be liable to income tax. Yet there is still some scope for planning.

Finance Act 2013 has made the deductibility of debts on death more complex. See in particular the new Inheritance Tax Act 1984 section 175A. While these changes put competent professional advice at a great premium, the situation is not intractable.

2.3.4 Use of Double Taxation Arrangements

Where an employee emigrates after retirement to become resident in a jurisdiction which has a Double Taxation Arrangement with the United Kingdom, it may be possible to ensure that benefits are conferred in such a way as to qualify for relief from United Kingdom tax. Double Taxation Arrangements are often particularly generous when it comes to pensions and similar benefits. Relief from United Kingdom tax is sometime available even where there is no charge to tax in the other Contracting State!

2.4 Deductibility of Contributions to Employer-Financed Retirement Benefits Scheme

2.4.1 The Basic Rule

Provided contributions are made which are deductible in computing the profits of a trade carried on by the employer which are calculated in accordance with generally accepted accounting practice, then prima face they are deductible for corporation tax purposes too: Corporation Tax Act 2009 section 46.[5]

5 In the case of an employer within the charge to income tax, the rules are contained elsewhere but very similar. Special rules apply to investment companies.

2.4.2 The Unpaid Remuneration Rules (Corporation Tax Act 2009 sections 1288-89) may prevent (immediate) deductibility of contributions. In practice, they will be problematic only if a contribution is made after the end of the Accounting Period for which the deduction would otherwise be made.

2.4.3 The Employee Benefit Contribution Rules (Corporation Tax Act 2009 sections 1290 - 1296) may also prevent (immediate) deductibility of contributions. Before 2011, they clearly did not apply at all to contributions made under an employer-financed retirement benefits scheme. Since the changes made by Finance Act 2011, further conditions need to be satisfied in order to ensure that they do not apply for this reason. Specialist advice will be required.

2.4.4 The GAAR must obviously be kept in mind. However, where a contribution is being made for bona fide commercial reasons, it is far less likely to be a problem.

2.5 Taxation of the Trustees

2.5.1 Inheritance Tax

It should normally be relatively easy to ensure that the property is not exposed to ten-year and exit charges on relevant property trusts by ensuring that the settled property falls within Inheritance Tax Act 1984 section 86 and not within section 58. Inheritance Tax Act 1984 section 72 (special exit charge in certain cases) must be borne in mind.

2.5.2 Income Tax

If the trustees of the employer-financed retirement benefits scheme are United Kingdom resident, they will be liable to income tax at the top rate on their worldwide income. This may not be a problem if the trust has no income. If the trust does have income, the trustees themselves will not be liable to income tax on non-UK source income if they are not United Kingdom resident. However, the Transfer of Assets Abroad Provisions must be borne in mind.

2.5.3 If the trustees of the employer-financed retirement benefits scheme are United Kingdom resident, they will be liable to capital gains tax at the top rate on their worldwide capital gains. This may not be a problem if the trust has no capital gains. If the trust does have capital gains, the trustees themselves will not normally be liable to capital gains tax[6] if they are not United Kingdom resident. Moreover, provided the contributions to the employer-financed retirement benefits scheme are made for bona fide commercial reasons, beneficiaries who receive capital payments from the

6 But changes are proposed as from Apr 6th 2015 in respect of gains realised from certain United Kingdom situate real property.

employer-financed retirement benefits scheme will not be liable to capital gains tax under Taxation of Chargeable Gains Act section 87.[7]

3. Advantages of Non-approved As Compared with Registered and Other Approved Schemes

3.1 No Limits on Contributions BUT always best to ensure that commercially justifiable.

3.2 No Limits on the time at which or the form in which benefits can be taken or by whom.

3.3 Some benefits can be taken in a tax-free form (but not one conferred on an employee or former employee).

3.4 No restrictions on range of investments.

3.5 No restrictions on loans or synthetic loans being made to employees / former employees or persons connected with them. BUT ensure Income Tax (Earnings and Pensions) Act 2003 Part 7A is not in point.

4. Disadvantages of Non-approved As Compared with Registered and Other Approved Schemes

4.1 No tax-free lump sum on retirement.

4.2. No exemption from capital gains tax on gains of the employer-financed retirement benefits scheme BUT probably not a problem if the trustees are non-UK resident.

4.3 No exemption from income tax gains tax on income of the employer-financed retirement benefits scheme BUT not a problem (at least in the short to medium term) if the trustees are non-UK resident and the income does not have a United Kingdom source.

4.4 May be more difficult to ensure that contributions to employer-financed retirement benefits scheme by the employer are not prevented from being immediately deductible for corporation tax purposes by the Unpaid Remuneration Rules or Employee Benefit Contribution Rules.

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7 If the contributions are not made for bona fide commercial reasons, Taxation of Chargeable Gains Act section 87 may apply or, even worse, section 86 might apply to tax United Kingdom resident and domiciled deemed "settlors" on the gains as they arise to the trustees.

5. Some Commonly Encountered Problems or Supposed Problems

5.1 Employer Lacks Liquidity to Make Contribution

This problem can easily be overcome. There simply needs to be a diminution in the net asset value of the Employer. Where the employer is a close company, the inheritance tax position (especially Inheritance Tax Act 1984 Part 4) needs to be very carefully considered.

5.2 Avoidance of Immediate Income Tax Charges on Pensioners and Other Beneficiaries

Ensure that there is no earmarking charge under Income Tax (Earnings and Pensions) Act 2003 Part 7A. See 2.2.2 above.

5.3 Tax-efficient Investment of Pension Fund

Where the funds in the employer-financed retirement benefits scheme will produce income, then, provided the trustees are not resident in the United Kingdom, they can so invest as to avoid charges on them to United Kingdom income tax.

Provided the trustees are not resident in the United Kingdom and the arrangements are bond fide commercial, neither they nor any beneficiary will normally be liable to pay any United Kingdom capital gains tax.

5.3 Tax-efficient Loans to Beneficiaries

A direct loan from an employer-financed retirement benefits scheme to a beneficiary should normally be avoided, on account of Income Tax (Earnings and Pensions) Act 2003 Part 7A. Synthetic loans will normally be more appropriate.

6. Problems Arising from Proposals for Accelerated Payment of Tax In Dispute

6.1 HMRC "Accelerated payments of tax associated with schemes covered by the DOTAS rules or counteracted under the GAAR" of 19th March 2014:

> "General description of the measure
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> "This measure extends requirement for taxpayers to pay disputed tax upfront to any disputed tax associated with schemes covered by the DOTAS rules or counteracted under the GAAR."

It appears that hyper-scrupulous persons who in the past have made what was in effect a voluntary disclosure may have unwittingly put themselves and their clients in a worse position!

The proposal is "Guilty until Proved Innocent". Further, in defiance of all accepted standards which have prevailed in this country since the Glorious Revolution of 1688, HMRC is to be prosecutor, judge and jury in its own cause, without any appeal to the courts!

6.2 The Need for new Non-DOTAS Disclosable and GAAR-proof Strategies

There will thus now be a premium on the invention of new strategies, which have not already been disclosed under DOTAS and which are not disclosable, which ensure that taxpayers pay no more than their share of tax.