The Personal Tax Planning Review

FUNDED UNAPPROVED RETIREMENT BENEFITS SCHEMES - THE TRAPS FOR THE UNWARY

Alexander Pepper[1]

Introduction

1 Prior to 27th July 1989 an employee could not participate in both an approved and an unapproved pension scheme. Finance Act 1989 changed this situation, at the same time as introducing a "cap" or maximum amount which can qualify as pensionable earnings under an approved pension scheme (see FA 1989 Sch 6 para 3(4), which amended TA 1988 s.590). Accordingly, from 27th July 1989 an employee may benefit under an unapproved pension scheme as well as under an approved scheme.

2 One way of providing a pension in respect of earnings above the cap is through a "funded unapproved retirement benefits scheme" (or "FURBS"). Various professional advisers are actively promoting FURBS at present, but these are complex arrangements and it is apparent that the relevant issues are not always understood; hence this article.

3 A FURBS is an arrangement whereby:

(a) an employer sets aside funds for employees in advance of their retirement, typically under a separate trust established for each participating employee, or under one trust with separately constituted sub-funds for each participating employee; the trust may be located onshore (with UK resident trustees), offshore (with non-UK resident trustees) or may be of mixed residence (UK resident for income tax purposes but not capital gains tax purposes);

1 Alexander Pepper BA ACA, Tax Partner, Coopers & Lybrand, 1 Embankment Place, London WC2N 6NN
Tel: (071) 583 3000 Fax: (071) 822 4652

(b) the employer pays single or recurring contributions to the trust; such contributions are deductible for corporate tax purposes but treated as taxable emoluments of the employee; for various reasons employees' contributions will not normally be paid;

(c) the fund is designed to provide a lump sum for an employee on reaching retirement; benefits can, however, be taken on leaving service, but arguably not before age 50 (see paragraph 31 below); double taxation means that a pension will not normally be provided directly, although an employee could elect to use the lump sum to purchase an annuity (see paragraph 14 below);

(d) the arrangement is not an approved scheme within Chapter 1 Part XIV TA 1988.

4 The principal reason for establishing a FURBS is to provide additional retirement benefits (in the form of a lump sum on retirement) to individuals affected by the pension cap. An alternative (but related) reason might be to provide deferred compensation for employees through a tax-efficient savings vehicle, in effect as an alternative to saving out of net pay.

5 Other reasons sometimes given for establishing a FURBS include:

(a) to avoid secondary class 1 ("employer's") national insurance contributions ("NICs");

(b) in the case of closely held private companies, to avoid inheritance tax.

6 The first of these can be largely discounted in that, if a FURBS is being established solely to save employer's NICs, the significant restriction on the employee's access to funds prior to retirement or leaving service (or age 50, if later) and the cost of establishing and operating a FURBS, would appear to make the arrangement uneconomic in most cases.

7 An inheritance tax saving is potentially obtained if a FURBS trust established for the benefit of a director shareholder acquires part of the director shareholder's shareholding. Any future growth in value of the shares is thus removed from the shareholder's estate and, provided that the FURBS qualifies as a "sponsored superannuation scheme" (see paragraph 19(d) below) the trust fund will not itself be liable to inheritance tax. However, there are risks involved in substantial self-investment; see, for example, paragraph 17 below. At worst the Inland Revenue might attempt to argue that trust was not a bona fide "sponsored superannuation scheme" and hence either that it is part of the shareholder director's estate or else that it is subject to the discretionary trust inheritance tax regime.

8 The tax implications of establishing a FURBS depend on whether the trust is located onshore (with UK resident trustees), offshore (with non-UK resident trustees), or is of mixed residence (UK resident for income tax purposes but not capital gains tax purposes). These three options are examined separately below.

9 It is also necessary to determine what sort of trust a FURBS trust will be. This is not a straightforward matter:

(a) the trustees will have the power to accumulate income and gains of the fund during the lifetime of each participant in respect of whom contributions to the fund are made;

(b) participants will have a deferred right to receive a lump sum or pension from the trust fund, contingent upon them reaching retirement age, however defined, or possibly on leaving service, if earlier, or reaching age 50, if later than on leaving service; there may be other conditions upon which payment is contingent (e.g., remaining in employment with the sponsoring company, although this might not be acceptable to the participant);

(c) participants might have the right to take a transfer of contributions relating to them (and possibly accrued income and gains) to another pension fund on ceasing employment with the company before retirement age; alternatively, rights could be frozen until retirement age is reached.

10 The most likely scenario is that:

(a) rights remain contingent until retirement age is reached, at which point a lump sum is paid (and not a pension for reasons explained in paragraph 14 below);

(b) in the event of cessation of employment prior to reaching retirement age, rights under the scheme are frozen until the participant reaches retirement age, and a prior transfer is not permitted;

(c) there are no other contingencies.

If so, the FURBS trust would be treated for all tax purposes as a discretionary trust, subject to special rules because it is providing "relevant benefits".

Onshore Schemes - Tax Position of Employee

11 Employer's contributions will be deemed for all purposes of the Income Tax Acts to be income of the employee assessable to tax under Schedule E (TA 1988 s.595(1)(a); the arrangement is a "retirement benefits scheme" within TA 1988 s.611 because it is designed to provide a "lump sum ... on retirement or on death, or in anticipation of retirement" - see s.612). A minor advantage (but probably only until the introduction of "K" codes on 6th April 1993) is that tax will be collected through the P11D/assessment route rather than through PAYE. This is the position set out in the Inland Revenue's booklet "The Tax Treatment of Top-up Pension Schemes", paragraph 2.2.9. The technical grounds are that pension contributions are not "payment of emoluments to the employee" (Reg 13(1) IT (Employments) Regulations 1973). However, if a grossing-up arrangement is operated the Revenue's view is that tax should be collected on the grossed-up contribution through the PAYE system ("The Tax Treatment of Top-up Pension Schemes" paragraph 2.2.8). In the case of directors, special care should be taken with grossing-up arrangements because of the prohibition (in CA 1985 s.311) on a company paying tax on a director's behalf.

12 Employees' contributions would not be deductible in computing their taxable income. In addition, lump sums referrable to employees' contributions would not necessarily be exempt from tax under TA 1988 s.189 (b) (see paragraph 13 below) and may be taxable. For these and other reasons employees' contributions are not recommended.

13 A lump sum payment to an employee will not be taxable provided it is paid "in pursuance of a retirement benefits scheme ... and the person to whom it is paid was chargeable to tax ... under s.595 in respect of sums paid, or treated as paid, with a view to the provision of the benefit" (TA 1988 s.189(b)). This will certainly be the case if only employer's contributions are made to fund the trust. Arguably, this is true provided that some, but not necessarily all, of the trust's funding is by way of employer's contributions, but this is only one interpretation of TA 1988 s.189(b) and the Inland Revenue might contest it.

14 A pension paid by the trust would be taxable, either under Schedule E (TA 1988 s.19(1)3) or, if not within paragraph 3 of Schedule E and the pension is an overseas possession, under Schedule D. If a pension is required it would be preferable to take a lump sum from the trust and use this to purchase an annuity, part of which (that relating to capital) would not subsequently be liable to income tax (TA 1988 ss.656-658). However, this may not be an effective investment decision except in special cases. A better return can often be obtained in other ways.

Onshore Schemes - Tax Position of Employer

15 The employer will be entitled to a corporation tax deduction for its contributions (under the normal rules of Schedule D, and see FA 1989 s.76, particularly s.76(3)(b)). Set-up costs will not be deductible (*Atherton v British Insulated & Helsby Cables Ltd* 10 TC 155).

16 There is a theoretical possibility that, if the employer has a legal obligation to pay contributions to the trustees, the payments could be treated as annual payments. This would potentially have disastrous consequences; the company would be required to deduct income tax at basic rate from payments and the trustees could not recover such tax. Any formal obligation to pay recurring sums should therefore be avoided.

17 Particular care is required in relation to companies controlled by directors and their associates. In one case (*Samuel Dracup & Sons Ltd v Dakin* 37 TC 377) pension contributions paid to an insurance company for two director shareholders were disallowed as failing the "wholly and exclusively" test. It is considered that this would be a particular risk if substantial self-investment, in shares or by way of loans-back, was made in the contributing company.

18 In the same way that contributions to a pension scheme are not normally "emoluments" for income tax purposes as defined in TA 1988 s.131 (this is why TA 1988 s.595(1) is necessary to tax employer's contributions to a FURBS), so they will not normally be "earnings" for NIC purposes as defined in SSC & BA 1993 s.3. This is the basis for the generally held view that employer's NICs are not due in respect of employer's contributions to a FURBS. However, two points must be made to qualify this, as follows:

(a) If the FURBS comprises separate trusts for each employee established by each employee the first argument (that employer's contributions are not "emoluments" or "earnings") does not necessarily apply; if it did, the tax exemption in TA 1988 s.643 for employer's contributions to an approved personal pension arrangement made by an employee would be unnecessary. In such circumstances one would have to rely upon the "payments in kind" exception in SI 1979 No 591 Reg 19(d) to avoid employer's NICs.

(b) If a FURBS arrangement is entered into as part of a salary sacrifice arrangement care is needed; *Smyth v Stretton* 5 TC 36 is an example of things that can go wrong.

Onshore Schemes - Tax Position of Trustees

19 The tax position of UK resident trustees is, in summary, as follows:

(a) the trustees will be liable to income tax at the basic rate, but not the additional rate, provided that the trust is structured so as to provide only "relevant benefits" (see TA 1988 s.686(2)(c)(i) and s.612);

(b) capital gains will be taxed at the basic rate (TCGA 1992 s.4(1)) but not the higher rate (TCGA 1992 s.4(2) ... the trustees are not "individuals"), and the additional rate will not apply (TCGA 1992 s.5(2)(a));

(c) provided that the trust is funded by employer contributions, an employee should not be deemed to be a settlor for CGT purposes (see TCGA 1982 s.79) so that capital gains cannot be treated as accruing to the employee under TCGA 1992 s.77; this is a further reason for avoiding employee contributions;

(d) provided that the trust constitutes a "sponsored superannuation scheme", the trust fund will not be liable to inheritance tax (see IHTA 1984 s.151); to qualify as a "sponsored superannuation scheme" one of the trust's objects must be to provide retirement, death or disability benefits and some of the costs met by the employer in connection with the arrangement (for example, set-up costs) must not be treated as taxable income of employees; the Inland Revenue have indicated that set-up and administration costs will not be apportioned to participants so that this condition will normally be satisfied.

20 Assuming set-up costs of £1,500, annual administration costs of £750, a return on capital of 10% and 10 years until retirement, a single contribution of some £35,000 or regular contributions of some £5,000 would be needed before a FURBS achieves any savings. This takes into account, by use of discounted cash flows, the restricted access to funds before retirement in assessing the merits of the arrangement.

Offshore Schemes - General

21 The tax position of employees and employers will be the same as for onshore schemes, subject only to the application of anti-avoidance legislation.

Ignoring anti-avoidance legislation for a moment, the trustees of the scheme trust:

(a) will only be liable to UK income tax on UK-source income, and not on non-UK source income;

(b) will not be liable to UK capital gains tax.

Offshore Schemes - Anti-Avoidance Legislation

23 TA 1988 s.739 ("transfer of assets abroad"): provided that an employee does not make direct contributions to the scheme, and provided it could not be argued that he has indirectly made contributions (through a salary or bonus sacrifice arrangement) s.739 cannot cause an income tax charge to arise in the hands of an employee; nor can it cause a tax charge to arise on an employer who is not an individual.

24 TA 1988 s.740 ("transfers of assets abroad - liability of non-transferor"): this section taxes a person receiving "a benefit provided out of assets which are available for the purpose by virtue or in consequence of the transfer or any other associated operations". There is no requirement that the person taxable must have provided funds, so that the defence in paragraph 23 above is not available. Hence, there is a significant risk of a tax charge (under Schedule D Case VI) arising on income which has accrued to the trust, but presumably not until a UK ordinarily resident individual actually receives a benefit in the form of a lump sum (or in any other form).

25 TA 1988 ss.757-764 ("offshore funds"): these sections could apply if there is, to any extent, pooling of funds (see TA 1988 s.759(1)(c)). However, a charge to tax can be avoided if:

(a) funds are held for each participant under separately constituted trusts or under one trust with separately identifiable sub-funds, each with separate investments; or

(b) it is a clear principle of law in the jurisdiction in which the trust is located, and under whose laws the trust is established, that the arrangement does not create rights in the nature of co-ownership; or

(c) the participant's interests cannot be realised (in any manner) for more than seven years (see TA 1988 s.759(2)).

26 TCGA 1992 s.86 ("attribution of gains to settlor with interest in non-resident settlement"): provided that:

(a) the company which contributes to the trust cannot benefit from the trust;

(b) participants (who clearly can benefit from the trust) have not directly or indirectly contributed funds to the trust (see paragraph 23 above on this);

then s.86 cannot apply, even if the arrangement constitutes a "settlement".

27 TCGA 1992 s.87 ("attribution of gains to beneficiaries"): this section imports the definition of "settlement" used in TA 1988 s.681(4). There are a number of cases, notably *CIR v Plummer* 54 TC 1, demonstrating that in order to be a "settlement" for the above purposes there must be an element of "bounty" in the relevant transactions. The Inland Revenue have confirmed in respect of employee benefit trusts that, where such trusts are established for purely commercial reasons, for example, the desire to attract, retain and motivate staff, and such trusts continue to be operated solely for those reasons, it is unlikely for there to be any bounty involved. If it is possible to argue similarly for FURBS, and that will depend entirely on the facts of each case, then the same conclusion (that s.87 does not apply) must follow.

Mixed Residence Trust

28 An alternative to a wholly onshore trust and a wholly offshore trust would be a trust which is:

(a) UK resident for income tax purposes by virtue of having at least one UK resident trustee (FA 1989 s.110); and

(b) non-UK resident for capital gains tax purposes by virtue of the majority of the trustees being not UK resident and the general administration of the trust being carried on outside the UK (TCGA 1992 s.69).

29 The trust would then be subject to UK income tax on income at a rate of 25% (and to a full tax credit for dividends received from UK companies), but the TA 1988 s.740 regime would not apply. Capital gains would continue to be free of tax provided the TCGA 1992 s.86 and s.87 regime is avoided (see paragraphs 26 and 27 above). It would therefore make sense for the trust's investment strategy to take account of this by investing for gains rather than income.

30 The problem here is that if proposals contained in the Inland Revenue's Consultative Document "The Income Tax and Capital Gains Tax Treatment of UK Resident Trusts" are enacted in their current form, the meaning of residence for capital gains tax purposes would be brought into line with the meaning for income tax purposes, bringing an end to mixed residence trusts.[2]

Preservation Rules

31 The "preservation rules" are contained in the Social Security Act 1973 and Statutory Instrument 1991/167. They apply to "occupational pension schemes", broadly defined and likely to include typical FURBS arrangements. One part of the preservation rules prohibits an occupational pension scheme from providing retirement benefits before normal retirement age, except in limited circumstances (physical or mental infirmity or the employee having reached 50 years of age). Thus it would seem that, if the preservation rules are not to be ignored, benefits cannot be obtained from a FURBS before (in normal circumstances) age 50.

32 This begs the question of whether the preservation rules need to be complied with; non-compliance carries no sanctions but the Occupational Pension Board has powers to require trustees or managers to modify particular schemes in such circumstances. However, even if the Occupational Pension Board was to express no interest, there must be a risk that the Inland Revenue would cite non-compliance with the preservation rules as a reason why a FURBS trust was not a "retirement benefits scheme" or "sponsored superannuation scheme", hence frustrating the desired tax consequences.

FURBS as a Means of Providing Retirement Benefits

33 In assessing the merits of a FURBS as a means of providing retirement benefits it must be compared with the alternatives of a cash payment (which the employee invests on his own behalf to produce income on retirement) or an unfunded unapproved retirement benefits schemes (or "UURBS"). An UURBS is, in effect, merely a promise (which may be documented by letter or more formally by deed) that a company will pay a lump sum on retirement and/or a pension thereafter.

34 The problem with a cash payment is that it does not provide a pension or lump sum on retirement. A profligate employee might squander his assets, leaving an employer with a moral obligation, or possibly a legal obligation (for example, resulting from a settlement negotiated following dismissal where absence of

[2] The Inland Revenue proposals on UK trusts have been abandoned - according to *The Financial Times* of 19th March 1993.

pension rights was taken as a point by the former employee's legal advisers) of having to provide actual retirement benefits at a later stage.

35 The principal advantages of a FURBS, in comparison with an UURBS, are as follows:

(a) a FURBS provides more security for the employee; funds are segregated from the assets of the company and governed by the terms of the trust, reducing the risk of losing benefits because the company goes into liquidation or is taken over, or the possible need to litigate to enforce the deed or letter establishing the right;

(b) a FURBS can be used to provide a widow's pension; an UURBS could only provide an enforceable right to a widow's pension if established by deed;

(c) the nature of the arrangement, similar as it is to an occupational pension scheme or personal pension, is arguably more familiar to human resources managers than an UURBS.

Disadvantages of a FURBS, in comparison with an UURBS, are:

(a) the costs of establishing and administering the arrangements;

(b) a lesser investment return if (as is often the case) a company could achieve a better return on funds retained for use within the business than could be obtained by external investment.

Conclusions

And so, in summary, the particular traps to avoid are these:

(a) employee's contributions (paragraphs 12 and 19(c));

(b) paying pensions out of a FURBS (paragraph 14);

(c) a formal obligation on an employer to pay recurring sums (paragraph 16);

(d) self-investment by trusts established by director shareholders of closely held companies, unless the risks are properly assessed (paragraph 17);

(e) ill-conceived salary sacrifice arrangements (paragraphs 18(b), 23 and 26);

(f) assuming that income tax does not apply in the case of offshore trusts (paragraphs 23 and 24);

(g) the offshore funds legislation (paragraph 25);

(h) ignoring the preservation rules (paragraphs 31 and 32);

(i) assuming that FURBS are the only way of providing additional retirement benefits to capped employees (paragraphs 33 to 36).

38 That having been said, FURBS form an important part of the armoury of the human resources manager or consultant designing remuneration packages for employees subject to the earnings cap, an issue that will become of increasing importance as the earnings of certain employees who were not in occupational pension schemes at 26th July 1989 increase beyond the cap, and attempts are made to head-hunt senior executives out of companies (and pension schemes) where they have been since before 27th July 1989.