… Pensions Tax

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Introduction

Pensions tax is an area with a long history. Tax relief on pensions can be traced back just over a century to the Finance Act 1921[1], a ground-breaking piece of legislation which introduced a framework for the taxation of superannuation funds. For most modern purposes, however, the story starts with the Income and Corporation Tax Acts 1970 and 1988, which until A-Day (6 April 2006) set out a regime of discretionary approval of pension schemes and their taxation. Those Acts were accompanied by Inland Revenue Practice Notes, most notably IR12, which was first published in 1979 (then amended on several occasions) and which still remains relevant to the terms of some older occupational pension schemes. On A-Day, the discretionary approval regime was replaced with a regime of registered pension schemes, as set out principally in the Finance Act 2004, Part 4, subject to transitional provisions[2]. Existing schemes were generally deemed to be registered from that date, albeit with an opportunity to opt-out[3]. This article provides an overview of that Act, with focus on certain topics of particular importance to practitioners.

Before moving on, it is worth mentioning that not all pension schemes are registered[4]. A common example is an EFRBS (or employer-financed retirement benefit scheme, formerly FURBS/UURBS), which are taxed under a different regime[5], and which are often used to top up the pensions of higher-paid employees. Practitioners may also encounter overseas pension schemes, which are often not registered in the UK, despite having a UK-nexus.

[1] See FA21, s32
[2] See in particular FA04, Sch36
[3] FA04, Sch36, para1, 2
[4] See HMRC Manuals PTM021000, EIM15010
[5] See ITEPA03, Part 6, Chapter 2

Types of registered pension scheme

The distinction between occupational pension schemes (established by employers) and personal pension schemes is well-known, although the distinction has been blurred in recent years by the widespread withdrawal of defined benefit schemes, so that now many employers offer group personal pension schemes.

The types of person by whom a registered pension scheme may be established is described in the Finance Act 2004, section 154[6]. In summary:-

(1) The scheme may be established by an employer, i.e. an occupational pension scheme[7];
(2) The scheme may be established by a person permitted under FISMA 2000 to established a personal pension scheme or stakeholder pension scheme in the UK. This is a much broader category than the category in section 154 as originally enacted (which contained a list, which included bodies such as insurance companies and banks), but the Finance Act 2004 was amended by FA07 to broaden the category. The broadening of the category of persons who can set up personal pension schemes has not been uncontroversial, and in some cases which one has seen in practice has facilitated misselling and pensions liberation;
(3) The scheme may be a public service pension scheme, i.e. a scheme established by or under any enactment, approved by a relevant governmental or Parliamentary person or body, or specified in an order made by the Treasury[8].

Tax reliefs on investments held by registered pension schemes

A significant benefit enjoyed by registered pension schemes is tax relief on income[9] and capital gains[10]. Failure to extend these benefits to certain non-UK pension schemes in the EU has been held to contravene EU Treaty free movement obligations[11].

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[6] See generally HMRC Manual, PTM022000
[7] FA04, s150(5)
[8] FA04, s150(3)
[9] FA04, s186
[10] TCGA92, s271, as inserted by FA04, s187
[11] *BAV-TMW-Globaler-Immobilien Spezialfonds v HMRC* [2019] UKFTT 0129 (TC). The loophole identified in that case was reversed by legislation: Finance Act 2004 (Specified Pension Schemes) Order, SI 2019/1425

The benefit of this tax-exempt status is not as generous as it used to be, given the abolition of advance corporation tax and the associated dividend tax credits by the New Labour government in 1997. The effect was to reduce substantially the value of dividends to pension schemes holding UK equities and to wipe billions off the value of the assets of pension schemes[12]. Some argue this was a substantial factor in causing the pension scheme deficits which, in turn, have led to the demise of the defined benefit scheme outside of the public sector. Recently, the Times reported that, at the turn of the Millennium, British pensions had over half of their assets invested in UK-listed equities, but this has reduced to 4% as a result of tax and accounting changes[13].

Annual and lifetime allowances

It is difficult to miss the publicity given to the near-annual tinkering with the rules relating to how much can be put into a scheme and how much can be build up within the scheme in a tax-efficient way.

Typically, contributions to registered pension schemes are eligible for tax-relief, which means the scheme can usually claim back basic rate tax on the contribution, members can enjoy higher rate tax relief and companies can look to seeking corporation tax deductions. Recent caselaw has established that relief is not available for *in specie* contributions (e.g. a transfer of shares), outside certain specific arrangements permitted by the Finance Act 2004 (SAYE schemes/save as you earn plans)[14]. Restrictions on how much could be put into a pension scheme go back to the earnings cap (introduced in 1989), since A-Day replaced by the annual allowance, which is lower for higher earners, but is currently up to £60k pa, together with some ability to carry forward unused relief.

Restrictions on the amount which could be built up within a scheme without tax penalty go back to the old Revenue limits, which readers of occupational pension schemes would encounter as a wodge of extra paper towards the end of an already-long set of Rules. The lifetime allowance, with its list of benefit crystallisation events potentially giving rise to a lifetime allowance charge and

[12] See: Advance corporation tax - Wikipedia

[13] "*Turn pensions lifeboat into £400bn superfund, says Blair think tank*": Times, 29 May 2023

[14] See *HMRC v Sippchoice Ltd* [2020] UKUT 0149 (TCC); *Mattioli Woods plc v HMRC* [2022] UKFTT 00179 (TC). Cf PTM042100, which describes how assets might be transferred to a scheme, and which is difficult to reconcile with the position taken by HMRC in these cases

complex series of transitional reliefs (which proliferated every time the allowance was shrunk by the government), is in the course of abolition, following the 15 March 2023 Budget. The charge itself is being abolished with effect from 6 April 2023, and the surrounding framework is due to be abolished with effect from 6 April 2024. The surprise move has been criticised as permitting potential abuse, and many expect to see the position reversed in the near future.

The payments regime

Introduction

The taxation of payments by registered pensions schemes is governed by Chapters 3 to 5 of Part 4 of the Finance Act 2004, as well as Part 9 of the Income Tax (Earnings and Pensions) Act 2003.

The basic structure of the regime is that a registered pension scheme is only authorised to make payments to, or in respect of, a member or employer of the scheme in a limited set of circumstances prescribed by the Finance Act 2004[15]. Any other payment is an unauthorised payment and attracts charges to income tax in the form of an unauthorised payment charge[16] and an unauthorised payment surcharge[17].

In addition, certain acts which would otherwise not qualify as unauthorised payments by the scheme may be deemed to be unauthorised payments to, or in respect of, a member or employer of the scheme[18].

The rationale behind the regime is to ensure that the tax reliefs and exemptions in respect of contributions to registered pension schemes are available only to the extent that pension schemes genuinely make provision for the benefit of members on retirement, subject to various statutory limits[19].

In summary, the payments which are authorised to be made to or in respect of a member are[6]:

[15] FA04, ss160(1) and 160(3)
[16] FA04, s208(1)
[17] FA04, s209(1)
[18] FA04, s160(2)(b) and 160(4)(b)
[19] *Willey v HMRC* [2013] UKFTT 328 (TC), para [6]; approved in *Danvers v HMRC* [2016] UKUT 0565 (TCC)

a. Pensions permitted by the pension rules or the pension death benefit rules[20];

b. Lump sums permitted by the lump sum rule or the lump sum death benefit rule[21];

c. Recognised transfers[22];

d. Scheme administration member payments[23];

e. Payments pursuant to a pension sharing order or provision; and

f. Payments of a description prescribed by regulations made by the Board of Inland Revenue.

The payments which are authorised to be made to or in respect of an employer are[24]:

a. Public service scheme payments[25];

b. Authorised surplus payments[26];

c. Compensation payments[27];

d. Authorised Employer Loans[28];

e. Scheme administration employer payments[29]; and

f. Payments of a description prescribed by regulations made by the Board of Inland Revenue.

The meaning of "payment"

Central to the regime is the concept of "payment". Payment includes a transfer of assets and any other transfer of money's worth[30].

An issue which has generated a substantial body of caselaw (both in relation to s160 of the Finance Act 2004 and its predecessor legislation, ss600-601 of the Income and Corporation Taxes

[20] FA04, ss165 and 167
[21] FA04, ss166 and 167
[22] FA04, s169
[23] FA04, s171
[24] FA04, s175
[25] FA04, s176
[26] FA04, s177
[27] FA04, s178
[28] FA04, s179
[29] FA04, s180
[30] FA04, s161(2)

Act 1998) is whether the concept of "payment" includes a payment which was not effectively made: for example, where the payment constituted a breach of trust and was therefore invalid, and/or where the sums were subsequently repaid.

In *Hillsdown Holdings plc v Inland Revenue Commissioners* [1999] STC 561 a pension scheme paid surplus assets to the employer, and paid tax on the payment. The payment was subsequently held to be a breach of trust and invalid. Arden J (as she then was) held that no tax had been due on the payment, since there was no reason why Parliament would have intended to tax payments which were not effectively made[18]. In her view, the concept of a "*transfer of assets*" meant a "*real transfer of an asset*" rather than simply a transfer of legal title without beneficial ownership[31].

In *Venables v Hornby* [2002] EWCA Civ 1277, the rules of the scheme (in line with the tax regime) authorised payments to be made to a member who retired early in normal health. Mr Venables retired as an executive director but remained an unpaid non-executive director and received pension. There were three issues (i) whether Mr Venables had "*retired*" (ii) whether Mr Venables was in "*normal health*" and (iii) whether Mr Venables had received a "*payment*" for tax purposes. In relation to the last issue, Mr Venables, who was also one of the trustees of the scheme, argued that if he had not *"retired"* then the payment would not have been authorised by the scheme rules and consequently would have been recoverable by the trustees. Consequently, he argued that in these circumstances there would have been no effective payment giving rise to a charge to tax. The Court of Appeal disagreed, stating that if an unauthorised payment was to be treated as no payment at all, the regime would be self-defeating, which could not have been Parliament's intention[32].

However, in *Thorpe v Revenue and Customs Commissioners* [2009] STC 2109, the Court declined to follow the approach of the Court of Appeal in *Venables v Hornby*, stating that such a construction was not necessary to give effect to the intention of Parliament. Instead, the Court took the view that it was consistent with the legislative intention that where a payee had not disposed of the proceeds

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[31] *Hillsdown Holdings plc v Inland Revenue Commissioners* [1999] STC 561, 571

[32] *Venables v Hornby* [2002] EWCA Civ 1277 [33]; In the House of Lords, the issue was rendered academic as the majority concluded that Mr Venables had "*retired*". Lord Walker (who dissented on the retirement issue) expressed agreement with the analysis of the Court of Appeal

of the unauthorised payments and had returned those payments to the scheme (or expressed a willingness to do so) with interest, he should escape tax. On the other hand, the payee should be taxed on the proceeds of unauthorised payments which he was not able to return[33].

These authorities were considered in *Clark v Revenue and Customs Commissioners* [2020] EWCA Civ 204. The Court of Appeal followed *Venables* rather than *Thorpe* and concluded that the word "*payment*" in Chapter 4 of the Finance Act 2004 could include sums which were subsequently repaid. The Court noted that it would be unsatisfactory if the charge to tax could be varied, or even negated, depending on the happening of events subsequent to those which gave rise to the assessment[22]. The intention of the scheme contained in Chapter 4 of the Finance Act 2004 was to impose tax charges on unauthorised payments, whether or not they also involved a breach of trust[34].

Following *Clark,* it seems likely that future decisions will proceed on the basis that the concept of "*payment*" in Chapter 4 of the Finance Act 2004 includes payments that were invalid and in breach of trust, irrespective of whether the sums are subsequently repaid by the payee. However, the position is not certain given the conflicting authorities to date. The reader is also referred to PTM146100, which ameliorates the position in relation to promptly remedied genuine payment errors.

Deemed unauthorised payments

There are a number of circumstances in which a payment will be deemed to be an unauthorised payment to, or in respect of, a member of the pension scheme:

(1) Assignment: Where the member, or a person with an entitlement in respect of the member, assigns or agrees to assign:

a. any benefit to which they have to an actual or prospective entitlement, or

b. any right in respect of any sums or assets held under the pension scheme,

there is a deemed unauthorised payment to, or in respect of, the member unless the payment is made pursuant to a pension sharing order or provision[35].

[33] *Thorpe v Revenue and Customs Commissioners* [2009] STC 2108, para [34]
[34] *Clark v Revenue and Customs Commissioners* [2020] EWCA Civ 204, para [79]
[35] FA04, s172

(2) Surrender: Where the member, or a person with an entitlement in respect of the member, surrenders or agrees to surrender:

a. any benefit, other than an excluded pension, to which they[36] have a prospective entitlement under the pension scheme, or

b. in the case of a member, any rights to payments under an annuity purchased by the application of sums or assets held for the purposes of the pension scheme, or

c. any right in respect of any sums or assets held for the purposes of any arrangement under the pension scheme.

there is a deemed unauthorised payment to, or in respect of, the member, except in certain excepted circumstances such as surrenders pursuant to a pension sharing order or provision[37].

(3) Increases in benefits on death: Where[38]:

a. at any time after the death of a relevant member[39] of a pension scheme, there is an increase in the pension rights of another member of the pension scheme which is attributable to the death; and

b. the dead member and other member were connected persons[40] immediately before the death.

there is a deemed unauthorised payment to the other member of except insofar as the increase is attributable to the other member becoming entitled to pension death benefits or lump sum death benefits in respect of the dead member[41].

(4) Benefits: A registered pension scheme is to be treated as having made an unauthorised payment to a person who is or has been a member of the pension scheme if an asset held for the purposes of the pension scheme is used to provide a benefit (other than a payment) to:

a. the person; or

b. member of the person's family or household[42].

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[36] Or any dependant, nominee or successor
[37] FA04, s172A
[38] FA04,s172B
[39] Which includes any member with a prospective entitlement to benefits
[40] as defined in s993 of the Income Tax Act 2007
[41] FA04,s172B
[42] FA04, s173(1)

Dalriada v Faulds [2011] EWHC 3391 (Ch) concerned a group of six pension schemes which operated a pensions reciprocation plan (**"PRP"**). The way in which the PRP worked was that one scheme ("**Scheme Y"**) would loan funds to a member of another scheme (**"Scheme Z"**) and, reciprocally, Scheme Z would loan the same amount of funds to a member of Scheme Y (both loans were on highly advantageous terms for the member). The Court concluded that this arrangement resulted in deemed unauthorised payments being made to the members. The 'loan' from Scheme Z to the member of Scheme Y was a benefit. Since that loan would not have been provided by Scheme Z without the reciprocal loan by Scheme Y to the member of Scheme Z, the assets of Scheme Y had been "*used to provide*" the benefit[43].

(5) Acquisition of taxable property by IRPS: Deemed unauthorised payments also form a crucial part of the regime relating to investment-regulated pension schemes (**"IRPS"**). An IRPS is a scheme where the member or a person related to the member is or has been able (directly or indirectly) to direct, influence or advise on the manner of investment of any of the sums and assets held for the purposes of an arrangement under the pension scheme relating to the member[44]. There are restrictions on the investments which an IRPS can make, including in relation to residential property.

An IRPS is to be treated as making an unauthorised payment to a member of the pension scheme if:

a. the IRPS acquires an interest in taxable property[45], and

b. the interest is held by the pension scheme for the purposes of an arrangement under the pension scheme relating to the member[46].

There are also deemed unauthorised payments where taxable property is improved[47] or where property is converted to residential property[48].

[43] *Dalriada v Faulds* [2011] EWHC 3991 (Ch), para [47]
[44] FA04, Schedule 29(A)
[45] As defined in FA04, Schedule 29A(6)-(11)
[46] FA04, s174A
[47] FA04, s174A(2)
[48] FA04, s174A(3)

Payments "by" the scheme

Although Chapter 4 of the Finance Act 2004 refers to payments "*by*" registered pension schemes, it is not necessary for the payment to be made directly from the assets of the scheme. A good example is pension reciprocation cases, such as *Dariada v Faulds* (referred to above) where the payments to the member were made by a different scheme.

Similarly, in *Danvers v HMRC* [2016] UKFTT 3 (TC), a loan to a member from a third party was held to be "*inextricably linked*" with an investment made by the member's SIPP, such that it constituted an unauthorised payment[49]. The approach in *Danvers* has been followed by the First Tier Tribunal in a number of subsequent cases, including *West v Revenue and Customs Commissioners* [2019] UKFTT 602 (TC), *Hughes v Revenue and Customs Commissioners* [2019] UKFTT 641 (TC), *Rowland v Revenue and Customs Commissioners* [2019] UKFTT 741 (TC) and *Curtis v Revenue and Customs Commissioners* [2022] UKFTT 172 (TC).

Consequences of making unauthorised payments

The consequences of making an unauthorised payment to, or in respect of, a member or an employer of a scheme are:

a. A charge to income tax at a rate of 40%, known as the unauthorised payment charge[50]. This is payable by the member in the case of an unauthorised member payment or the person to or in respect of whom the payment was made in the case of an unauthorised employer payment.

b. Where the unauthorised payment exceeds specified limits, an additional surcharge of 15%, known as the unauthorised payment surcharge[51]. Again, this is payable by the member in the case of an unauthorised member payment or the person to or in respect of whom the payment was made in the case of an unauthorised employer payment.

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[49] *Danvers v HMRC* [2016] UKFTT 3 (TC), para [74]
[50] FA04, s208
[51] FA04, s209

In addition, an unauthorised payment will (unless exempt) constitute a scheme chargeable payment[52]. The scheme is subject to a charge to income tax at a rate of 40%[53] of the scheme chargeable payment, for any tax year where one or more scheme chargeable payments are made: this is known as the scheme sanction charge[54].

Court's power to waive unauthorised payment surcharge/scheme sanction charge

A person liable to the unauthorised payment surcharge or a scheme sanction charge may apply to the Inland Revenue on the ground that, in all the circumstances of the case, it would not be just and reasonable for that person to be liable to the unauthorised payment surcharge in respect of the payment[55].

The test is simply whether it is just and reasonable for the person to be subject to the charge or surcharge - no unnecessary gloss should be applied. Finding that it would be just and reasonable for a person to be liable to the surcharge does not require any finding of dishonesty or negligence on their part[56].

In the case of a scheme sanction charge arising out of an unauthorised payment, the scheme administrator may apply for a discharge of its liabilities on the same ground in respect of a scheme chargeable payment which is treated as being an unauthorised member payment by s172, s172A, 172B, 172C or 172D of the FA 2004[57], or in all other cases on the ground that:

(a) the scheme administrator reasonably believed that the unauthorised payment was not a scheme chargeable payment, and

(b) in all the circumstances of the case, it would not be just and reasonable for the scheme administrator to be liable to the scheme sanction charge in respect of the unauthorised payment.

In *HMRC v Bella Figura* [2020] UKUT 0120 (TCC), the Upper Tribunal held that, in determining whether the scheme administrator had a reasonable belief that the unauthorised

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[52] FA04, s241(1)

[53] Although a deduction applies where a tax charge in respect of an unauthorised payment has been made, with the deduction being the lesser of 25% of the scheme chargeable payment and the amount of tax which has been paid: FA04, 240(2)

[54] FA04, ss239-240

[55] FA04, s268(3)

[56] *O'Mara v HMRC* [2017] UKFTT 091 (TC), paras [152]-[153]

[57] FA04, ss268(5)-(6)

payment was not a scheme chargeable payment, a relevant factor was whether the administrator had obtained (implicit or explicit) reassurance from its advisors that the payment was authorised. In practice, however, this is only likely to offer the administrator protection if they have taken steps to ensure that those who they relied on had the relevant expertise and, even if they did so, they had scrutinised the transactions in question to fulfil their role as trustee of the scheme: *Morgan Lloyd Trustees v HMRC* [2023] UKFTT 00355 (TC) [191].

Death and pensions taxes

The question of how registered pension schemes are treated on death is a political hot potato, and the rules have undergone many changes over the years. The purpose of the tax advantages associated with such schemes it to encourage saving to meet needs in retirement, not to facilitate a tax-efficient wrapper for the purpose of intergenerational wealth planning. On the other hand, it is right that schemes can grant a tax-free death benefit for the families of those who die unexpectedly young, so a balance needs to be struck.

Traditionally, that balance was struck by the requirement that a pension or annuity was granted by the age of 75. The possibility of income drawdown (i.e. something more flexible than a pension or an annuity) was introduced in 1995, but this was not permitted after the age of 75 (when a pension or annuity was required), even after A-Day[58]. Following the general election in 2010 and associated change of government, the upper age limit for income drawdown was raised to 77[59]. Then, the Finance Act 2011 removed the upper age limit for income drawdown altogether, and further flexibilities still were introduced by the Taxation of Pensions Act 2014, which made numerous amendments to the Finance Act 2004. The rules were last updated by the Finance (No 2) Act 2015.

The current position in relation to lump sum death benefits, which spans three Acts, may be summarised as follows[60]:-

[58] FA04, Sch28, para7 (as originally enacted). Some may recall alternatively secured pensions, which were a special arrangement for a religious group, but which had wider appeal, and which were accompanied by special inheritance tax rules: see HMRC Manual IHTM17350

[59] F(No 2)A10, Sch3, para3

[60] See generally HMRC Manual PTM073000 *et seq*

(1) Lump sum death benefits are authorised payments: Finance Act 2004, section 168;

(2) Death benefits paid by pension schemes are usually outside of inheritance tax: Inheritance Tax Act 1984, section 151; HMRC Statement E3; HMRC Statement of Practice 10/86. An exception is where the member has a right to direct the death benefit (for most schemes, the member has only a power to set out a non-binding statement of wishes);

(3) A charge to income tax under Finance Act 2004, section 206 (special lump sum death benefits charge), at 45%, is charged on payments made to "non-qualifying persons" (such as a trust):-

    (a) In the case of members dying over the age of 75, in any case; and

    (b) In the case of members dying under the age of 75, if the death benefit is not paid before the end of a 2-year period after the death[61];

(4) A charge to income tax under the Income Tax (Earnings and Pensions) Act 2003, Part 9, Chapter 15A, section 579A, at the individual's marginal rate of income tax, is charged on payments made to individuals: see section 636A(4ZA), section 636AA:-

    (a) In the case of members dying over the age of 75, in any case; and

    (b) In the case of members dying under the age of 75, if the death benefit is not paid before the end of a 2-year period after the death; and

(5) Where a death benefit is paid in the case of a member dying under the age of 75, and is paid before the end of a 2-year period after the death, the payment is exempt. This is the case, whether the payment is made to a non-qualifying person or to an individual, and whether or not the member had accessed the funds (unaccessed funds are known as "uncrystallised funds"). The present position is therefore relatively generous.

Finally, some schemes will, of course, provide income benefits rather than lump sum benefits to surviving dependants, such as a pension to a surviving spouse. The Finance Act 2004 provides the circumstances in which these qualify as authorised payments: see section 167.

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[61] This period commences on the date on which the scheme administrator first knew of the death, or could reasonably have been expected to have known it

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