

What is the future for unapproved pension schemes?

At present, many employers provide unapproved pension schemes to 'top up' pension benefits for their high earners. From A-Day, 6 April 2006, unapproved schemes will be replaced with Employer-Financed Retirement Benefit Schemes (EFRBS). This survival guide looks at what this will mean for employers and for the members of unapproved schemes.

What are the existing rules on unapproved schemes?

Unapproved schemes were introduced to allow employers to compensate employees who were subject to the earnings cap in their approved occupational pension scheme. There are two types of unapproved schemes - Funded Unapproved Retirement Benefit Schemes (FURBS) and Unfunded Unapproved Retirement Benefit Schemes (UURBS).

FURBS

Under a FURBS, employer contributions are allowable against corporation tax as soon as they are made. The employee is taxed on the employer contributions as a benefit-in-kind. There is no tax relief on employee contributions, so these are rarely made. National Insurance Contributions (NICs) are also paid on contributions. Investment returns are taxed at the basic rate on income (22%) and capital gains are subject to CGT with taper relief available.

Where benefits are paid as cash, there is no liability to tax, but benefits paid as pension are taxed as income. Normally, therefore, benefits from a FURBS are taken as cash. Where death benefits are provided under a discretionary trust, there is no liability to inheritance tax.

UURBS

UURBS are not established under trust. Tax relief on employer contributions is allowed when the benefits are paid (i.e. at retirement) and the employee is not taxed on contributions as a benefit-in-kind. There is no liability to NICs so long as the employment has ceased before the benefit commences. There are no funds invested, so there is no taxation of investment returns to worry about.

Whether the benefits are paid out as pension or cash, they are taxed as income. Inheritance tax is payable on death benefits unless they are provided under a discretionary trust.

Important note

It should be noted that this guide is provided for general information only and should not be relied upon to take action nor should it be seen as attempting to provide you with any advice. The issues covered are most likely to be of interest to employers who currently provide unapproved schemes or who are considering providing an EFRBS after A-Day or to members of such schemes. A-Day will present a large number of complicated opportunities and you will need to seek advice specific to your individual circumstances, needs and objectives.

It is important to note that the provisions of the 2004 Finance Act have not yet come into force, and may be amended before A-Day.

The views and opinions expressed here are those of PSFM Ltd and Punter Southall & Co Ltd given our understanding of the issues at the time of publication.

What are the new rules for EFRBS?

From A-Day, the distinction between approved and unapproved pension schemes will be replaced with a distinction between registered and unregistered schemes. As unregistered schemes, EFRBS will not be subject to the new pensions taxation regime set out in the Finance Act 2004. This means that contributions to an EFRBS will not be subject to the Annual Allowance Charge and benefits from an EFRBS will not be tested against the Lifetime Allowance.

The new rules on EFRBS apply equally to funded and unfunded arrangements. The rules for EFRBS are closer to the existing rules for UURBS than to those for FURBS.

As with an UURBS, no tax relief will be available on employer contributions to an EFRBS until the benefits are actually paid to the member. This is irrespective of whether the benefits are funded or not.

Recent draft regulations confirm that NICs will not be payable on benefits from an EFRBS so long as the pension broadly meets the rules for a pension from a registered scheme, any cash lump sum is no greater than 25% of the fund and the member has ceased to work for the employer.

There will not be a benefit-in-kind charge on the member. Instead, the member will be taxed on both cash and pension as income (although any amount in respect of the member's own contributions can be taken as tax-free cash). There will be no inheritance tax relief. Any investment returns, whether income or capital gains, will be taxed at 40% with dividends taxed at 32.5% and with taper relief still available on CGT.

Are there transitional protections available?

There are some transitional protections for FURBS benefits built up before A-Day. So long as the employee has already been taxed on employer contributions, cash arising from pre A-Day service will remain tax-free (where there are post A-Day contributions, the protection will apply to pre A-Day cash increased in line with price inflation).

In addition, protection from inheritance tax will remain on pre A-Day funds (again if there are post A-Day contributions, the protection will apply to the fund as at A-Day increased in line with retail price inflation, less any expenses).

What may happen to existing UURBS?

The regime for EFRBS is very similar to that for UURBS and so there is no reason why existing UURBS should not continue to operate. However, historically, UURBS have often been poorly documented and so A-Day presents an opportunity for employers to review their unfunded benefit promises and ensure they are in line with their expectations.

There may be cases where a member is currently entitled to an UURBS because he was subject to the earnings cap, but the value of his occupational pension scheme benefits is well below the Lifetime Allowance. If the UURBS is consolidated into the main scheme within 3 months of A-Day, there will be no liability to the Annual Allowance Charge arising from the one-off contribution. This would bring the previously unfunded benefit within the scope of the new pensions taxation regime and therefore this benefit would be included when testing against the Lifetime Allowance.

Whether this is an attractive course of action will depend on whether the member is likely to exceed the Lifetime Allowance by retirement, the view the member takes of the security of benefits in the occupational scheme and whether the employer is prepared to fund the immediate cost.

Unfunded EFRBS may also be used as a way of maximising the tax efficiency of the pension promise. In the year before retirement (when there is no liability to the Annual Allowance Charge), a top-up can be paid from the unfunded EFRBS into the registered scheme so that the member takes full advantage of the Lifetime Allowance, with the rest of the benefit promise being made via the unfunded EFRBS.

What may happen to existing FURBS?

The future for funded EFRBS after A-Day looks much less rosy. Although there are transitional protections in place that will effectively preserve the advantages of the old FURBS regime for benefits that have already been built up, any employer contributions after A-Day would not be eligible for tax relief until the member came to retire. This makes the FURBS a rather unattractive vehicle for future contributions unless there are other reasons for continuing with a funded unregistered scheme, such as retaining a key employee.

Extra contributions might be more appropriately directed to the member's occupational pension scheme (where the employer could benefit immediately from tax relief and lower taxation on investment returns), although the member would be subject to the recovery charge if benefits exceeded the Lifetime Allowance. Alternatively, employers could provide a salary supplement to members in place of the contributions previously directed to the FURBS.

At present, FURBS are often used to provide death-in-service benefits in excess of approved scheme limits. After A-Day, registered pension schemes will be able to offer tax-free death lump sums up to the member's Lifetime Allowance. Given this and the change in inheritance tax treatment for unregistered death benefits accruing in future, it may well be more appropriate for death benefits to be provided through the registered scheme.

It is likely that some FURBS will be replaced for post A-Day service with unfunded EFRBS. In some cases, employers may be able to reassure members that their benefits will continue to be secure even though they will be unfunded, by providing insurance or some other form of security for the unfunded pension promise. Where insurance is obtained, members will have to pay a benefit-in-kind tax charge on the insurance premiums.

Where can I get further information?

For independent financial advice, please contact **Richard Meek on 0121 213 1800 or your usual PSFM Consultant. For a review of your unapproved arrangements, please talk to Clare James on 020 7839 8600 or your usual Punter Southall contact.**