Current issues

May 2022

Articles this month:

DB Annual Funding Statement 2022

In its *Annual Funding Statement 2022*, the Pensions Regulator encourages trustees of private sector defined benefit pension schemes to engage in open dialogue with their sponsors about immediate challenges and longer-term risks.[1] There is recognition of the current difficult economic conditions—including high fuel and energy prices and the war in Ukraine—as well as the lingering effects of COVID-19 and Brexit, and the implications for schemes and their sponsors. Robust risk management and long-term planning remain vital.

The AFS is primarily of interest to 'Tranche 17' schemes—those with valuations dates in the period from 22 September 2021 to 21 September 2022—with indications that their average funding level has improved since the last valuation round. It is also relevant to other schemes with circumstances meriting reassessment of the trustees' funding and risk strategies. This Summary highlights the key expectations and advice contained in the AFS.

Covenant considerations

Trustees should consider the aggregate effect of recent events on the employer's business, assessing the seriousness and the short- and medium-term prospects for recovery, obtaining expert advice if necessary. If the conclusion is that there has been little effect on the business, the trustees should, if anything, seek to reduce the recovery plan length. Where there are short-term affordability constraints, any requests for temporary contribution easements should be carefully considered, higher contributions should be paid upon resumption to limit extension of recovery plans, and employers should ideally make up any deferred deficit recovery contributions (DRCs) before resuming shareholder distributions. If the employer requests revision of a recovery plan to defer or reduce DRCs, the trustees should obtain suitable mitigations.

The Regulator stresses the importance of regular information sharing between trustees and their sponsor's management. The trustees should understand the crucial variables and assumptions underlying the employer's financial projections and business plans (avoiding over-reliance on a single set of forecasts). Stress testing or scenario planning will help them understand how possible developments (such as persistent high inflation and interest rates) could affect the covenant. They should compare projected versus actual performance and, if possible, agree contingency plans for detrimental covenant events.

[1] <www.thepensionsregulator.gov.uk/en/document-library/statements/annual-funding-statement-2022>.

Trustees should be alert for distributions to shareholders and ensure that the scheme is treated fairly, and dividend sharing agreements or negative pledges could be sought during valuation discussions. As a minimum, if distributions exceed DRCs, the Regulator expects the scheme to have a robust funding target and a '*relatively short*' recovery plan (hinting at less than five years). For a weak or tending-to-weak employer, DRCs should top shareholder distributions unless the recovery plan is short and the funding target strong. The Regulator does not expect to see any distributions made by weak employers that are unable to support the scheme.

Levels of corporate activity remain high. Trustees should assess the impact rigorously, keep records of the deliberations, and seek mitigation for any detriment prior to and separately from valuation discussions.

Actuarial & investment considerations

High inflation should prompt trustees to ensure that benefit increases are being correctly modelled, and that any salary increase assumptions remain appropriate. They should also understand how any inflation hedges are working in light of the current environment and any application of caps or collars on pension increases. Pending the expected High Court review of plans to align of the Retail Prices Index with the Consumer Prices Index including owner-occupier housing costs, pre- and post-2030 assumptions should reflect the current position. Any adjustment to market-implied inflation measures should be consistent with inflation exposure within the investment strategy.

Whilst of the opinion that the long-term implications of COVID-19 remain unclear, in a shift from last year, the Regulator indicates willingness to countenance appropriate changes to mortality assumptions. However, that is subject to the proviso that any consequential reduction to liabilities is no more than two per cent, in the absence of strong justifying evidence.

Managing risks

The Regulator again encourages trustees and sponsors to agree long-term funding targets and journey plans, in anticipation of the commencement of the *Pension Schemes Act 2021* requirements. In doing so they should engage with the employer to understand longer-term covenant risks, and factor that into their funding and investment strategies, monitoring arrangements and contingency plans. Scenario planning is once again highlighted as a useful tool for risk management.

Funding positions should be regularly monitored against asset and liability risks, and employer performance against forecasts and other thresholds. Contingency plans should set out the actions that employers and trustees should take when the threshold limits for funding, investment and covenant metrics are breached. Downside protection could be requested, where appropriate, to help manage the risks. Recognizing the increasing number of schemes that have attained or will soon reach full funding of their technical provisions, the Regulator stresses that regular monitoring and contingency plans remain just as important. Contingent contributions linked to funding and risk triggers can help manage ongoing risks whilst addressing concerns from employers about trapped surplus.

Trustees should consider updating valuations of any existing contingent assets or asset-backed contribution arrangements to ensure that they remain sufficient to underwrite any additional risk taken.

They should also consider their short-term liquidity requirements, including collateral calls on hedging portfolios. Trustees at or approaching full funding should consider how the absence of employer contributions will affect their liquidity needs, and make appropriate changes to their investments.

The Regulator has once again set out its risk-management expectations in the form of tables that categorize schemes according to funding strength, covenant and maturity. The only change from the tables in the AFS for 2021 is that the pivotal recovery plan length has been shortened from seven years to six, in recognition of a decrease in the average plan length.

New Funding Code

The Regulator remains on track to publish a consultation draft of a revised funding Code of Practice '*later in 2022*' (assuming that the Department for Work and Pensions' consultation on draft legislation takes place as expected). Details of proposed changes to the guidance on *Assessing and Monitoring the Employer Covenant* (published in 2015) will be released at the same time. They are expected to provide more information on the treatment of employer-group guarantees and environmental, social and governance considerations.

This year's AFS contains few surprises, echoing themes that the Regulator has been promoting for some time. Although investment performance has kept many schemes on track, perhaps even bringing them (close) to full funding, recent events are a reminder that things can, and do, change quickly; so we support the emphasis on development of robust long-term plans and integrated risk management.

GMP equalisation: tax effects of transfer top-ups & conversion

Her Majesty's Revenue and Customs (HMRC) has published a new *Guaranteed Minimum Pension (GMP) Equalisation Newsletter*, covering issues that arise when scheme administrators take corrective action in connection with historical transfers, and providing an update and guidance for those who convert GMPs into ordinary scheme benefits after equalisation.[2]

Historical transfers

Transfer top-ups

Most top-up transfer payments will be ‘recognised transfers’ and therefore authorised member payments for tax purposes. It is notable, however, that the receiving scheme must be a registered pension scheme or a qualifying recognised overseas pension scheme (QROPS) *when the top-up is paid*.

Lump-sum payments

A lump-sum payment made to the member in lieu of a transfer top-up may also be an authorised member payment, if the necessary conditions are met. The *Newsletter* discusses several of the small lump sums, and winding up lump sums.

A commutation payment not exceeding £10,000 could be paid after a ‘*relevant accretion*’ (the calculation of the GMP-equalisation uplift), provided that the historical transfer was to a registered pension scheme or QROPS. Unfortunately, this means that pre-A-day (6 April 2006) transfers are excluded, as there were no RPSs or QROPSs then. The scheme administrator must not have been aware (or reasonably expected to have been aware) of the member’s entitlement to an additional benefit at the time of the original transfer. The *Newsletter* indicates that this condition will be satisfied if the administrator did not then know the specifics of the transferring member’s GMP-equalisation uplift entitlement. Whilst the lump sum must be paid within six months of the ‘relevant accretion’, HMRC does not regard that period to have begun until the lump-sum amount, member’s whereabouts, and other details such as banking information have been established.

Occupational pension schemes can pay other small lump sums of up to £10,000. Notably, though, it is a condition of such payments that there cannot have been a recognised transfer from the scheme (or, in some cases, any other scheme related to the same employment) in respect of the member during the three years preceding the date of the lump-sum payment.

Taxation

If lump sum payments are made directly to members, or to their estates after their deaths, to extinguish their rights to top-up transfer payments, they will be considered to be payments in respect of uncrystallised rights, so that 25 per cent of the lump sum will be tax-free. Where an authorised lump sum is payable to another individual following the member’s death (rather than being owed to the member and payable to the estate), the lump sum will be wholly taxable. Tax is due in the tax year in which the lump sum is paid, and PAYE should be operated on the lump sum.

There should be no additional annual allowance consequences of making a top-up transfer payment or paying a lump sum in lieu.[3] Nor should a top-up or lump sum endanger the 'block transfer' status of the original transfer, for transitional-protection purposes. However, an additional transfer payment could result in a loss of fixed or enhanced protection if it is not a '*permitted transfer*': transfers to money-purchase schemes will be safe in most cases, but there are limited circumstances in which transfers to DB schemes are *'permitted*'.

GMP Conversion

Pre-retirement

When conversion occurs pre-retirement, the *Newsletter* says that there can be annual-allowance effects both in the tax year of conversion and in all subsequent years up to and including the year of retirement. In particular, there is a risk that early leavers will lose the benefit of the ‘deferred member carve out’ that usually means that they are treated as though their

[2] *Guaranteed Minimum Pension Equalisation Newsletter—April 2022* <www.gov.uk/government/publications/guaranteed-minimum-pension-gmp-equalisation-newsletter-april-2022/guaranteed-minimum-pension-equalisation-newsletter-april-2022>.

[3] The annual allowance implications of GMP equalisation benefit adjustments were discussed in *Guaranteed Minimum Pension (GMP) Equalisation Newsletter—February 2020* <www.gov.uk/government/publications/guaranteed-minimum-pension-gmp-equalisation-newsletter-february-2020/guaranteed-minimum-pension-gmp-equalisation-newsletter-february-2020>.

pension rights did not increase in value during the tax year. Members may also lose fixed protection from the lifetime allowance. Further work—and possibly legislative change—is required.

Pensioners

There are no annual-allowance consequences if conversion occurs after the tax year of retirement. Fixed protection is not endangered by conversion of a pension in payment provided the member's rights in the arrangement have been fully crystallised. The lifetime allowance test for benefit crystallisation event (BCE) 3—which applies when pensions in payment increase beyond certain levels—should be done as though the member was always entitled to the equalised benefits.

Recent retirees

Conversion after, but in the same tax year as retirement does not constitute benefit accrual for AA purposes, and does not affect the deferred member carve-out determination, even if the resulting increase in pension triggers a BCE3 tax charge. Again, the BCE3 test should be done as though the member was always entitled to the equalised benefits.

Pre-A-day leavers

Members who left service before 6 April 2006 should remain outside of the scope of the annual allowance so long as conversion does not increase the actuarial value of their benefits.

The court judgment on the implications for historical transfers has created new tangles that have to be carefully teased out, especially when a top-up transfer payment cannot be made. The ability to pay lump sums (and have part of it tax-free) in suitable circumstances will be helpful.

There was doubt until very recently that guidance on the tax implications of GMP conversion would be forthcoming, so we are pleased to see the *Newsletter* and to learn that additional guidance can be expected. The message is, unsurprisingly, that the issues involved are complex. It seems likely that legislation will be needed to resolve some of the complications, such as the potential for loss of valuable protections. The indications are that HMRC wants to work with industry bodies to achieve appropriate outcomes, and for that it should be applauded.

GMP conversion addenda

Tax treatment of interest on arrears

Following publication of the *Newsletter*, the Pension and Lifetime Saving Association clarified with HMRC the tax treatment of interest paid on arrears of pension.[4] The note confirms, for example, that the interest should be treated for pension tax purposes as interest paid in respect of a late payment of pension instalments. Whilst it is likely to count as '*yearly interest*' for tax purposes, an obligation to withhold income tax from the payment is unlikely to arise if the payee is in the UK. It is hoped that HMRC will discuss these issues in a future newsletter.

Pension Schemes (Conversion of Guaranteed Minimum Pensions) Act 2022

The *Pension Schemes (Conversion of Guaranteed Minimum Pensions) Act 2022* received Royal Assent on 28 April 2022. Once brought into force and the necessary secondary legislation passed it will clarify the application of GMP conversion to survivors, and remove from primary legislation the requirements for employer consent and notification of HMRC.

[4] <www.plsa.co.uk/Policy-and-Research/Document-library/Additional-clarity-on-HMRCs-GMP-equalisation-guidance-on-tax-treatment>.

Tax relief for low earners in ‘net pay’ arrangements

Her Majesty’s Treasury (HMT) expects that the first top-ups for scheme members affected by the ‘net pay anomaly’ will be ‘*paid by 2026-27*’.[5] This seems like evidence of slippage in the timetable announced at the time of the Autumn Budget 2021.

Disparate routes to contributions tax relief

There are two principal methods of obtaining income tax relief on contributions to pension schemes. Scheme members who contribute using ‘relief at source’ (RAS) are deemed to have made their contributions net of basic-rate tax. They obtain a corresponding top-up to their retirement savings via the tax system, regardless of whether they pay tax. To achieve a gross contribution of £100, they need only pay £80.

By contrast, members of schemes that operate under ‘net pay arrangements’ (NPA) automatically receive contributions tax relief at their marginal rates. If that marginal rate is 0 per cent, because a member earns less than the income tax personal allowance, he or she must pay £100 to achieve a £100 contribution. Low-earning members of NPA schemes are therefore at a disadvantage relative to those in RAS schemes, as they will have lower take-home pay, all else being equal (*ceteris paribus*, if you want to be fancy about it).

Confronting the anomaly

The Government made an election manifesto commitment to consider ways of eliminating the disparity. Then, in conjunction with the 2021 Autumn Budget, it announced that Her Majesty’s Revenue and Customs (HMRC) would identify affected NPA-scheme members and invite them to claim top-ups equivalent to the missing twenty-per-cent tax relief, to be paid into their bank accounts, starting from contributions paid in the 2024-25 tax year. At that time, it referred to ‘*the first payments being made in 2025 – 26*’, and ‘*after the end of the 2024-25 tax year, in 2025-26*’.

The latest position

Now, in written evidence recently submitted by the Department for Work and Pensions (DWP) and HMT to the House of Commons Work and Pensions Committee, the Government indicates that the first top-ups will be ‘*paid by 2026-27*’. As in 2021, it mentions the complexity of the IT changes necessary to process the claims, and the ‘*other ongoing HMRC delivery programmes*’ that are being worked on. It still says that the changes to HMRC’s systems will be in place by April 2025.

Primary legislation is needed to establish the top-up mechanism for low-earning NPA-scheme members. The Government intends to publish draft clauses on ‘L-Day’ (the ‘L’ stands for ‘legislation’) in 2022 (L-Day 2021 was in July of that year). They would thereafter be incorporated into a Finance Bill.

[5] *Written evidence from the Department for Work and Pensions & HM Treasury (PSL0047)* (published 30 March 2022) <committees.parliament.uk/writtenevidence/107378/html/#_Toc98338193>.

Regulator pursues overseas parent over MBO

The Pensions Regulator has imposed a contribution notice on a German company that (in its assessment) disposed of a UK business with a '*complete disregard*' for the interests of the business's defined benefit (DB) pension scheme.[6] For the first time, the contribution notice included amounts in respect of lost investment returns and interest.

The Dosco group comprised two employers that participated in the DB scheme, plus a holding company. The scheme had a substantial deficit (£39m on the buy-out basis, compared to assets of £53m, at the time of the sale). The group was owned by a parent company registered in Germany, which concluded that it was '*unacceptable*' for it to continue to support the group, financially and operationally, when the pension scheme was '*skimming off all profit*'. It decided to search for a buyer.

The Regulator's Determinations Panel notes that different accounting assumptions were chosen so as to maximize the deficit disclosed in the parent company's accounts, thereby flattering the effect of the eventual disposal, whilst minimizing the employers' deficits to make them as attractive as possible to potential buyers. The group's chief executive entered into a consultancy arrangement with the parent company that promised him a cut of the sale proceeds, to incentivize him to find a buyer.

Two external buyers showed interest, but one was put off by the pension scheme deficit, and the other offered only a relatively low upfront payment combined with a share of future profits. The parties instead decided to pursue a management buy-out (MBO), via an acquisition vehicle that was a shell company with no assets or investors. The sale took place in May 2013. Of the €2m purchase price, €1.5m was lent to the buyer by the scheme employers (on onerous terms, and using up the employers' free cash), and the remaining €500k took the form of an interest-bearing loan from the parent company.

There was no clearance application in connection with the MBO, though the parent company was presumably familiar with the process, having obtained clearance at the time of its purchase of the group. Neither was there prior notification of the MBO to or consultation with the scheme trustees, despite legal advice that the transaction would probably have a materially detrimental effect on the scheme. That advice said that mitigation should be considered, but none was offered.

Insolvency proceedings were commenced in connection with the employers only eight months after the MBO. A buy-in of less-than-full benefits kept the scheme out of the Pension Protection Fund.

The Regulator concluded that there was '*no reasonable doubt*' that the sale and the employer loans had been materially detrimental to the likelihood of members receiving their accrued benefits. It imposed a contribution notice on the parent company for £2,082,382.86, which is the sum of the amounts received by the company, plus an additional £670,269.09 representing interest on those amounts and lost investment returns. Additional interest of £114.10 will be added, daily, until payment.

The Regulator had initially also pursued the Dosco group's chief executive, on the grounds that he had personally benefited from the sale, under the consultancy arrangement. It withdrew its case having agreed to settle for around £130,000, reflecting the benefit that he received.

The Regulator notes that this is the first time in which it has added lost returns and interest to the amount specified in a contribution notice. Its case team had argued for returns from the date of the MBO, but the Determinations Panel decided on a lower sum, by estimating the date by which the scheme would have received the funds of which it had been deprived, based on the deficit recovery contributions in force prior to the annuity buy-in.

[6] *TPR Flexes Powers to Safeguard Savers in Small DB Scheme* (PN22-07) <www.thepensionsregulator.gov.uk/en/media-hub/press-releases/2022-press-releases/tpr-flexes-powers-to-safeguard-savers-in-small-db-scheme>. *Dosco Overseas Engineering Limited—Regulatory Intervention Report* <www.thepensionsregulator.gov.uk/en/document-library/enforcement-activity/regulatory-intervention-reports/dosco-overseas-engineering-limited-regulatory-intervention-report>. *The Dosco Overseas Engineering Limited (1973) Pension and Assurance Scheme—Determination Notice* <www.thepensionsregulator.gov.uk/en/document-library/enforcement-activity/determination-notices/dosco-overseas-engineering-limited-determination-notice>.

Regulator's guidance on conflict in Ukraine

In March, the Pensions Regulator has published a brief note on its expectations of pension scheme trustees in light of the conflict in Ukraine.[7] The note mainly covers investment issues, but also touches on cyber security and member communications.

The Regulator notes that the conflict in Ukraine and the associated Russian sanctions have resulted in volatility in investment markets. The guidance states that trustees should consider whether they need to take any action, including in relation to investments, to align with sanctions announced by the Government. Trustees are expected to be vigilant and speak to their advisers about any steps that may need to be taken, depending on the scheme's investment, risk management or employer covenant exposures.

The guidance also warns trustees to consider whether their cyber security procedures are still adequate given the increased risks of cyber-attacks and financial crime.

HMRC newsletter April 2022

Pension Schemes Newsletter 138, from Her Majesty's Revenue and Customs, includes the following:

- a brief summary of the changes to annual-allowance-related reporting deadlines following changes made by *Finance Act 2022* to the *'scheme pays'* rules (primarily to facilitate the *McCloud* remedy in the public sector);
- repetition of earlier advice that charity lump sum death benefit payments do not need to be reported via Real Time Information (RTI), and that the Revenue still intends to fix the legislation that inadvertently implied that they should be; and
- a prompt to scheme administrators to migrate their schemes to HMRC's 'Managing Pensions Schemes' online service (they will need to do so soon if they are to submit a first-quarter 2022 Accounting for Tax return by the 15 May 2022 deadline).

[7] <www.thepensionsregulator.gov.uk/en/trustees/russia-ukraine-conflict>.

And Finally…

A question from a colleague, about examples of overpayment of pension after the death of a member, briefly sent *AF* down an internet rabbit hole a couple of weeks ago. Before he stepped back from the abyss, the following headlines about the same case in the Republic of Ireland caught his eye, as much due to the differences in headline-writing style as from morbid fascination:

> *Son claiming dead parents' pensions for over three decades caught when dad turned 100*[8]

> *Scrutiny of the bounty brings end to Corkman's 33-year gamble on parents' pensions*[9]

The latter gem alludes of course to ~~Clark Gable~~ Fletcher Christian and ~~Charles Laughton~~ Lt William Bligh's famous 18th century contretemps, known as 'the Mutiny on the *Bounty*', as portrayed oft-times on the silver screen. The synopsis of that tale is that ~~Marlon Brando~~ Christian and his fellow mutineers preferred the lure of Polynesian island living to Royal Navy ship-board discipline, and set ~~Trevor Howard~~ ~~Anthony Hopkins~~ Bligh (and the sailors who remained loyal to him) adrift in an open launch, probably not suspecting for a moment that he would doggedly navigate thousands of miles to safety and grass them up to the Admiralty. This cultural touchstone found its way into the newspaper headline because the son's eccentric interpretation of filial devotion capsized when he attempted to claim a €2,540 'President's bounty' paid to Irish citizens who survive to age 100.

Another example:

> *Man who took uncle into post office to collect his pension 'didn't know he was dead'*[10]

We don't know how these things are in the Emerald Isle, but *AF* recalls some lunchtime queues at the main Post Office in Glasgow's city centre that led him to question whether he had unwittingly expired and gone to Hell…

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[8] <www.dailyrecord.co.uk/news/uk-world-news/son-claiming-dead-parents-pension-26243367>.
[9] <www.irishexaminer.com/news/spotlight/arid-40811289.html>.
[10] <www.walesonline.co.uk/news/world-news/dead-man-post-office-pension-22850318>.