

what if ?



What's next for unapproved benefits?

by Stephen Green

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What if?

Many employers have legacy unapproved arrangements from the previous tax regime for pension schemes. This review investigates how these arrangements may be varied to reflect the new tax regime.



Introduction

The new tax regime for pension schemes that came into force on 6 April 2006 (A day) has presented us with many challenges, not the least of which is determining how to pronounce the acronym EFRBS – Employer Financed Retirement Benefit Schemes.

‘EFRBS’ is the new umbrella name for pension arrangements providing benefits outside of the registered pension scheme structure. It includes arrangements that were previously termed ‘unapproved’ under the old tax regime, such as Funded Unapproved Retirement Benefit Schemes (FURBSs), Unfunded Unapproved Retirement Benefit Schemes (UURBSs) and Secured Unfunded Unapproved Retirement Benefit Schemes (SUURBSs).

For ease of understanding, the old acronyms will be used here to

differentiate between the different forms of EFRBS.

This review looks at the considerations for the use of EFRBS as part of an ongoing benefits strategy, but primarily concentrates on the issues relating to the many legacy arrangements that were developed to address the impact of the earnings cap under the previous tax regime for pension schemes.

Providing future benefits through EFRBS

Many employers have reviewed their future benefit offerings to senior employees to reflect the new tax regime and, whilst some have chosen to continue to use UURBS within their benefit structure, it is evident that very few have created a new FURBS since A day or continued to contribute to a pre A day FURBS.

Where UURBSs continue to be used as part of the ongoing benefit

strategy, the key issue employers need to consider when establishing the terms of these arrangements is; which corporate entity is supporting the UURBSs? There is a risk that employees will express concerns if they learn that it is a service company which is supporting the benefit obligation rather than the operating company.

The question of whether to provide additional security to back any unfunded benefit obligation is also a difficult one. There is an argument that would question why senior employees should be given additional security above that afforded to registered pension scheme members through the Pension Protection Fund. One approach, to address such concerns, would be to limit any security backing an UURBS promise to the level of funding of the registered scheme on a buy-out basis.



One area not to forget is to specify how the benefits will be delivered on leaving service or retirement. Should the benefit promise be capitalised to a lump sum, how will this lump sum be determined, will this capitalisation be an option or automatic, will there be any option to optimise the use of the registered scheme? It is infinitely more desirable for such issues to be specified in the terms of the benefit promise, when it is being established, than to be negotiated upon as part of a severance package.

What should be done with pre A day arrangements?

Many employers established UURBSs and FURBSs before A day as part of their earnings cap benefits policy. Whilst in many cases these arrangements were made paid up on A day, they still need to be maintained until the members ultimately draw their benefits. Of course, a default strategy may be adopted of letting such arrangements run their course until the members reach their

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respective retirement ages but there are several compelling reasons in favour of an immediate review of these arrangements. In particular, these include:

- the significant overheads in terms of the continued responsibility for maintaining the arrangements, together with the associated demands on management time and support costs
- the potential for a future loss of understanding of how these arrangements operate through staff turnover
- the risk of missing opportunities to reduce the cost of benefits by not taking full advantage of the most tax-efficient options
- the need to adopt a consistent approach for both pre and post A day top-up benefits

- the need to simplify the ongoing disclosure of the benefits applicable to a particular executive in an annual report.

These concerns, which apply to varying degrees for FURBSs and UURBSs, are considered further below.

FURBS

Most pre A day FURBSs became paid up on A day because any further contributions to a FURBS would tarnish the tax status of the existing funds within the FURBS. Employers are now faced with a decision as to how they should deal with these paid-up arrangements. In summary, the main options available to the employer are to:

- continue to run the arrangement as a paid-up fund until the member reaches at least the minimum retirement age specified in the rules

- transfer the trusteeship and the future administration of the arrangement to the member
- pay benefits out to those members who have already reached retirement age
- wind up the FURBS and arrange settlement of the benefits accordingly.

The option that is most appropriate to a particular FURBS is likely to be influenced by:

- whether the member continues to be employed by the sponsoring employer
- the size of the assets contained within the FURBS
- the financial circumstances and objectives of the executive.



Before considering these options further in more detail, it is useful to revisit the current tax status of FURBSs. A series of legislative amendments since FURBSs first became permitted arrangements in 1989 have worsened the tax treatment of a pre A day FURBS, such that the taxation of investment profits within a FURBS is now very similar to that of a higher rate tax payer. Some tax advantages do remain, however, including:

- no inheritance tax on death before retirement if paid to a nominated beneficiary
- an annual capital gains tax exempt amount
- investments already held for some years will be benefiting from the taper relief reduction on capital gains tax applicable to past and future gains in a particular investment.

Working against these tax advantages will be the administration costs of the arrangements, a potential preference for the members to have immediate access to their funds and/or a desire to invest in other investment opportunities such as directly in property, say, or within a more tax-efficient wrapper.

Whilst regular administration costs for many FURBSs may now have diminished as there are no ongoing contributions to invest, the additional tax that now falls due on investment income received does increase the year-end tasks relating to a FURBS. Clearly FURBSs with significant amounts of assets may justify continuing to meet the ongoing administration costs much more than ones with only a small level of funds.

In circumstances where a member does wish to keep a FURBS running, there is a choice as to whether the

sponsoring employer and its nominated trustees should continue to be responsible for the administration of the arrangement or if the trusteeship and administration may be passed on to the member. The latter option may be particularly appropriate if the member wishes to defer immediate receipt of their benefits but would like to invest in a wider range of investments than the existing trustees would permit (owing to the additional governance and administration costs of allowing such flexibility).

If a member has reached the minimum retirement age and is keen to take immediate receipt of their benefits, then the FURBS investments may be encashed and the fund, net of any tax due on investment returns, may be paid to them.

The option, highlighted above, of winding up the FURBS is currently the option with the least clear implications

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for the member. Many of the typical options available on wind up of a registered pension scheme do not apply to a FURBS, as there are no insurance company products to which FURBSs may be transferred and it is unlikely that a new employer for a former member would be prepared to establish a new FURBS to receive a transfer from an existing FURBS. The only choice therefore that remains available under this option is an immediate settlement of the FURBS funds to the member. The tax position for such a payment to a member who has yet to reach retirement age is complex and, based on our experiences in this area, employers should obtain clarification on this point from HM Revenue & Customs (HMRC) before proceeding with any such payments.

Whilst there is a further option to effect a transfer from a FURBS to a registered pension scheme, this is

very much a theoretical option which is not likely to be attractive for many pre A day FURBSs. This is due to there being a large element of double taxation in such a strategy.

UURBS

Turning now to the options for UURBSs, there is scope to consider the transfer of a benefit obligation to a registered pension scheme for these arrangements, since the risk of double taxation does not apply in the same way as it does for FURBSs. The main options employers are considering are therefore:

- to transfer all or part of the unfunded pension obligation to the employer's registered pension scheme
- to continue to provide the benefit as an unfunded obligation until retirement and then settle benefits direct with the member

- to continue to provide the benefit as an unfunded obligation until retirement and consider optimisation, at that time, of the member's registered scheme benefits within their lifetime allowance (LTA), with commensurate reduction of the UURBS obligation
- to provide security for all or part of the promise (a SUURBS).

Whilst the first point may seem at first sight to give the member greater security for their unfunded promise this may not always be the case as, given the level of benefit already provided in the registered scheme, it is likely the member's benefit may exceed the protection threshold of the Pension Protection Fund if the scheme subsequently needs to wind up in deficit. Such an approach may therefore only result in additional lifetime allowance concerns for the member.





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At the point of retirement, however, if some scope remains within the member’s lifetime allowance, it may prove more tax-efficient for at least part of the promised level of benefits to be provided through the registered scheme rather than directly to the member. Although, despite this extra tax efficiency, the member may still prefer for the benefit to be provided in an unapproved form so that it may all be paid in lump sum form, albeit taxable.

If the intention is to supplement registered scheme benefits on retirement, it will be important to communicate this to members on leaving service so that any scope intended for use within the member’s lifetime allowance before retirement is not utilised unknowingly by the member’s new employer.

The annual allowance

The LTA is not the only threshold of concern to the member. Any benefit

promise switched from an UURBS to a registered scheme will count towards the member’s input amount for assessment against their annual allowance (AA). The scope to make such a switch without generating an additional tax charge will therefore be dependent on the level of any other registered benefit accrual during the input period. Strategies such as spreading the switch over a number of tax-years or effecting the switch during the input period falling in the tax year of retirement (when no annual allowance test applies) can, however, be used to minimise the risk of an annual allowance charge being levied.

Death benefits

The options outlined in this review have thus far related to unapproved retirement benefits, but many employers also established unapproved life assurance arrangements to top up approved



benefits before A day. Under the new regime, the level of the lifetime allowance, and the fact that it is only the lump sum death benefit that is tested against it, will allow a much higher level of benefit to be provided through a registered pension scheme before any top-up arrangement may be needed.

However, with registered pension scheme insurers continuing to apply maximum benefit thresholds on schemes for underwriting, members not wishing to join new schemes in order to avoid invalidating their transitional protection and some members being at risk of breaching the lifetime allowance, there continues to be demand for top-up life assurance arrangements.

Typically many employers are now investigating the use of single member excepted life policies as an alternative to the traditional

unapproved life assurance policy, as this new form of policy will avoid the benefit in kind income tax charge to the member that existed on the traditional unapproved life policy. It is worthwhile noting that there remains some uncertainty around the tax position for premiums paid on excepted policies and again, discussion with HMRC is advised here.

Summary

Whilst the new tax regime has provided some opportunities for simplifying pension arrangements it is likely that, with the new arrangements established for members who wish to opt out to avoid the lifetime allowance charge, many employers have currently increased the range of retirement arrangements they operate for their senior employees and the choices that executives must make.

In order to redress this situation, employers should take the opportunity, by means of a review of pre A day unapproved arrangements, to:

- consolidate the forms of arrangements that continue to be provided, where practical
- confirm an agreed approach for the run-off of existing arrangements
- ensure any opportunity to minimise the tax payable is fully considered
- clearly record any benefit obligations undertaken for future reference
- ensure policy stances have been effectively communicated to the relevant members.

Once these steps have been taken the management of these arrangements should follow a smooth rather than a troubled path.

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