Employer Asset-backed Pension Contributions: a consultation response by the NAPF

August 2011

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Employer Asset-backed Pension Contributions (Employer ABCs)

Executive Summary

- The NAPF welcomes the opportunity to respond to the review of the tax framework for Employer Asset Backed Pension Contribution arrangements (hereafter employer ABCs).
- Recent years have seen significant changes in the pensions landscape with employers increasingly withdrawing from defined benefit pension provision. The increasing costs of running a DB scheme have meant that many DB schemes have been in deficit for the last two actuarial valuations.
- The NAPF welcomes the Government's commitment to reinvigorate occupational pension provision as set out in the coalition agreement. And it is against this commitment that proposals for amending the employer ABC regime should be evaluated. Given the financial pressures on employers and schemes, the Government needs to be careful not to stifle innovation regarding how employers use different approaches to fund pension scheme deficits.
- The NAPF proposes that any updated tax regime for employer ABCs should be sufficiently robust to prevent abuse of excessive tax relief by plan sponsors, but not so prescriptive to prevent the use of employer ABCs as part of a pension scheme's funding strategy, particularly deficit repair. The flexibility provided by employer ABCs allows scheme sponsors to better manage the cost of deficit contribution payments by spreading additional contributions across a period of time while receiving tax relief within limits set by HMRC. The Government must not undermine this efficient process by introducing unnecessarily burdensome regulation.
- From the options proposed in the consultation, the NAPF believes that option B – a closer alignment between the accounting and tax arrangements for employer pension deficit contributions – is the best fit with the accounting treatment of existing employer ABC arrangements already in place. A one size fits all approach to the use of employer employer ABCs could stifle design innovation and reduce the use of these arrangements by scheme sponsors. Option B permits greater flexibility and recognises the diversity of current arrangements for pension scheme deficit funding. Option B is considered the best choice in policy terms and on practical grounds and should form the core of any new regulatory framework for employer ABC arrangements.

NAPF concerns regarding the Government's proposals

- The NAPF agrees that any new regulations regarding employer ABC arrangements should not be open to tax arbitrage, but equally must not be based on a single prescribed set of key criteria. Any such 'wishlist' from the UK tax authorities could be overly restrictive and stifle new thinking and innovation on options for future scheme funding;
- The Government should proceed with care regarding introducing new regulation. Given the

complexity of the regulatory framework for these arrangements, change could produce major unintended consequences, including, for example, potential debt restrictions for scheme sponsors and unauthorised payment issues for scheme trustees;

- Employer Related Investment (ERI) regulations – greater clarity is required from Government regarding the correct treatment of employer ABCs from a scheme self-investment perspective in order to give reassurance that the 5% self-investment limit for pension schemes has not been breached;
- Asset valuation – provided trustees have obtained independent advice on the audited value of the underlying asset HMRC should not interfere unduly and cause further unnecessary complexity to the valuation process;
- Accounting treatment – any new approach to the tax treatment of employer ABCs should incorporate a practical and commercially viable approach which fits with present employer ABC arrangements and provides a closer alignment of tax and accounting treatment
- Legal implications – any change in the law governing employer ABC arrangements should only be effective from a future date ie no earlier than after Finance Bill 2012 becomes law and not be retrospective eg back to the commencement of the consultation period (excluding exceptional circumstances).

Recommendations

- The NAPF advocates a proportionate and non-prescriptive approach to any new regime for employer ABC arrangements.
- The new regime for employer ABC's must be properly considered, practical, and established so as to be durable and not require significant revision in a relatively short time. The tax authorities should provide greater clarity regarding the definition of underlying (or other suitable assets) to be used for employer ABC arrangements. This clarification should reduce the possibility of schemes using employer ABCs from inadvertently breaching the self-investment regulations.
- In order to better understand the employer ABC arrangement trustees should obtain an auditable independent professional valuation of the underlying asset (ie to demonstrate 'fair value').
- The new regime should be forward looking and assuming regulation under Finance Bill 2012 relate only to employer ABC arrangements introduced after the Bill has become law (excluding obvious and deliberate tax avoidance arrangements).

1. Introduction

1. The NAPF welcomes the opportunity to respond to the joint HMRC HMT consultation document "*Employer Asset-backed Pension Contributions*" (May 2011).

2. Recent years have seen significant changes in the pension's landscape with employers increasingly withdrawing from defined benefit pension provision. According to the latest NAPF Annual Survey, in 2000, 88% of schemes were open to new members, whereas in 2010 this had fallen to just 21%. While there are a number of reasons for this decline, a key driver has been the financial pressure that employers have been under to fund pension deficits and a reduction in employers' appetite to manage the investment and longevity risk associated with running a defined benefit pension.

3. Falling asset values alongside increased liabilities due partly to greater longevity risk has meant that many DB schemes have been in deficit for the last two actuarial valuations and under Pensions Act 2004 must have a recovery plan in place to meet deficit repair. So, scheme funding and, in particular, the requirement to make good a significant scheme deficit in a relatively short timeframe (eg 10 years or less) is the key issue for scheme sponsors and trustees charged with managing the scheme.

4. In carrying out their duties, trustees must consider the willingness and ability of the sponsor to provide ongoing support for a company pension scheme. For employers, flexibility is a particularly useful tool within their future funding strategy. For example, some employers might prefer to choose to provide staged deficit contributions via employer ABC arrangements over a number of years rather than have to meet those contributions by means of large cash payments into the scheme over 1-2 years as this could impact significantly on short- term company cashflow.

5. On the back of this, the NAPF welcomes the Government's commitment to reinvigorate occupational pension provision as set out in the coalition agreement. And it is against this commitment that proposals for amending the employer ABC regime should be evaluated. Given the financial pressures on employers and schemes, the Government needs to be careful not to stifle innovation regarding how employers use different approaches to fund pension scheme deficits, whilst ensuring employers receive the correct amount of tax relief commensurate with the contribution made.

6. If the new regime is too restrictive employers may have to reconsider their commitment to future deficit funding. This may ultimately lead them to decide to provide alternative pension arrangements which are more cost efficient to the company over the long term which could lead to a further decline in DB pension provision.

About The NAPF

7. The NAPF is the leading voice of workplace pension provision in the UK. We represent some 1,200 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. Ten million working people currently belong to NAPF member schemes, while around 5 million pensioners are receiving valuable retirement income from those schemes. NAPF member schemes hold assets of some £800 billion, and account for over one sixth of investment in the UK stock market. Our main objective is to ensure the security and sustainability of UK pensions.

2. The NAPF View

8. ABCs can form an important and legitimate part of a scheme's funding strategy. This is particularly important in the current economic environment where scheme sponsors are under increasing financial pressure.

9. Although the 2010 NAPF Annual Survey indicates that 28% of respondent schemes have utilised contingent or other assets for deficit funding, the specific use of employer ABCs is a relatively new approach and evidence on them is limited with only 9 large pension schemes having established such arrangements by 2010.

10. The NAPF believes that the Government needs to be careful to create an environment where employers have flexibility to fund their schemes using ABCs while ensuring the appropriate amount of tax relief. The Government needs to be careful not to stifle innovation in scheme funding and we have some concerns that in attempting to eradicate specific but limited abuse the tax authorities may overreach themselves and unduly restrict future scheme funding options.

11. Our specific areas of concern are outlined below along with a set of recommendations to address or help rectify some of those issues:

    - **Appropriate regulations**

      The NAPF has concerns that any new regulation could be overly prescriptive i.e. employer ABCs arrangements will become standardised in order to comply with a HMRC 'checklist'. This would not recognise the diversity in arrangements for pension scheme deficit funding and would impose a one size fits all approach to the use of ABCs that could stifle innovation.

Recommendation 1: The new regime must be sufficiently robust to achieve the policy intent of reducing tax arbitrage, but not so prescriptive as to stifle innovation and potentially put the use of future employer ABCs arrangements in doubt.

- **Unintended consequences**

  If new complex regulation is introduced this framework could ultimately lead to unintended consequences such as:

  - Employer ABC income streams becoming categorised as unauthorised payments with the inevitable compliance and tax implications associated with such payments for pension schemes; and
  - A possible impact on the sponsors existing debt arrangements (eg breach of agreed debt limits or the need to revise banking covenants)

Either of the above could have major practical and cost implications for UK pension schemes and company sponsors as they would have to undertake more compliance reporting , meet tax charges of 55% on unauthorised payments and commit resource to renegotiate new debt arrangements with banks at a time when banks are under increased scrutiny not to increase default risk. Given such concerns the Government must undertake to consult fully regarding the detail of any new regulations.

Recommendation 2: HMRC/HMT should exercise due care that revised regulations on the cash flows from employer ABC arrangements do not distort the intended scope of those outputs and produce unintended consequences.

- **Contravene Employer Related Investment (ERI) regulations**

  This is a particularly important issue given the confusion surrounding the incorporation of the EU directive on ERI into UK regulation in September 2010 and the ongoing implications for UK pension schemes. If the use of employer ABC arrangements means that additional employer contributions are regarded as a loan arrangement between the scheme and the employer there could be concerns that the 5% self-investment regulations (by the scheme in the sponsor's business) will be breached.

Recommendation 3: To minimise the likelihood of breaching the ERI regulations regarding self-investment HMRC/HMT should provide greater clarity regarding the definition of underlying (or other suitable) assets to be utilised for employer ABC arrangements.

- **Asset valuation**

  Trustees will be reliant on independent professional advice to establish an audited 'fair value' for an asset-backed arrangement and auditors and valuers need to work together to achieve this. Also a single asset may have contingent and non-contingent elements ie a non-contingent annual income stream plus a final bullet payment contingent on the level of scheme deficit (if any) at a specified future time. Given that the trustee's have a duty to act in the best interest of the member, the NAPF believes that it would be inappropriate for HMRC to challenge the trustees unduly regarding the audited value of the assets which underpin an employer ABC arrangement.

Recommendation 4: In order to better understand the employer ABC arrangement trustees should obtain an auditable independent professional valuation of the underlying asset (ie to demonstrate 'fair value').

- **Accounting treatment -** In delivering a closer policy alignment between tax relief and accounting treatment HMRC will need to recognise that not all prospective employer ABC arrangements being discussed are structured in exactly the same way. Consequently a one size fits all approach to meet existing accounting standards (eg Financial Reporting Statement 25) is inappropriate as it would not reflect current practice in employer ABC arrangements.

- **Legal implications** – In considering the legal framework necessary for the future of employer ABC's the Government must not legislate retrospectively.

Recommendation 5: – The new regime should be forward looking and assuming regulation under Finance Bill 2012 relate only to employer ABC arrangements introduced after the Bill has become law (excluding obvious and deliberate tax avoidance arrangements).

3. Conclusion

12. A proportionate and non-prescriptive approach to new regulation should help go some way toward the provision of an environment which can help to deliver a sure and sustainable system for UK pension saving. The NAPF supports a new regulatory approach which meets the Government's policy aims but does not impede or impose unnecessary compliance burdens and additional costs on scheme sponsors.

13. Employer ABC arrangements are a relatively new approach within scheme deficit funding options and are clearly a matter for a full dialogue between trustees and sponsors on the suitability of such arrangements going forward. The trustees would need to be satisfied that the proposals are both appropriate in their design, intent and most importantly that they will deliver the expected funding outcome(s).

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Consultation Questions

Employer Asset-backed Pension Contributions

1. **Do the examples above accurately describe the range of asset-backed arrangements currently in use? Are there any other forms of similar arrangements we have not considered?**

   The KPMG report *Asset-backed Funding for Pensions* (2010) collated details of those employer ABC arrangements which were already public knowledge. There are likely to be future partnership arrangements (eg concerning intellectual property rights) which could be potentially more difficult for trustees to assess the 'fair value' of the relevant assets underpinning the funding arrangements. Expert professional advice for Trustees would be a minimum requirement in this scenario.

2. **Are there further views on why these arrangements have emerged, and whether they will continue to be used in the long-term (including any tax or regulatory issues not considered above in relation to these arrangements)?**

   A more efficient use of employer cash resources has been main driver behind employer ABC arrangements and during a difficult economic cycle they have also been useful in helping facilitate better employer cash flow. Tax incentives for employer pension contributions are particularly important and sponsors should consider all options with regard to future scheme funding particularly deficit repair.

3. **Does this capture the right balance between not disturbing the tax treatment of transactions that have already been reflected in taxable profits and preventing undue reliefs?**

   The 'high level' proposals from HMT/HMRC are designed to strike an acceptable policy balance. However, the problems associated with the implementation of new tax arrangements for employer ABCs will demonstrate whether, or not, those new arrangements are unduly excessive i.e. the devil is in the detail.

4. **Should the new rules apply to any other situations in relation to existing arrangements?**

   No. All existing arrangements have already been agreed with the UK tax authorities on the basis of previous discussions and the law or regulation at the time the arrangement was ratified. The Government should not retrospectively amend the rules around transactions that have already been completed.

5. **Are there any significant advantages of Option A over Option B that have not been identified above? Are there any significant disadvantages of Option B over Option A not identified above?**

A one size fits all approach to the use of employer employer ABCs could stifle design innovation and reduce the use of these arrangements by scheme sponsors. Option B permits greater flexibility and recognises the diversity of current arrangements for pension scheme deficit funding. Moreover, as it is most closely aligned to current practice being undertaken by sponsors in relation to employer ABC arrangements Option B is considered a more efficient mechanism through which to provide sponsor payments, is more efficient as relief is granted up front, and should give trustees greater comfort that a regular stream of funding is available.

6. **Would the options give rise to any commercial issues for employers, for example in the recognition of an asset-backed arrangement in their accounts? If so please also suggest how these issues could be resolved?**

If, in order to obtain up front tax relief - under option B - the new tax regime for employer ABC arrangements was predicated on the basis that the additional employer contributions were categorised as debt not equity (and presented in the company accounts as such) then a key advantage of the current structured finance regime rules would be lost. Moreover, as stated in paragraph 11 above the treatment of this additional employer funding as debt could create financing difficulties for sponsor companies where debt limits may be breached and commercial activity unnecessarily restricted or stopped altogether.

7. **Would the options create a significant impact on the viability of the use of asset-backed structures? Would such impact extend to the funding of pension schemes? If so, what would these likely affects be?**

The ongoing viability of asset-backed structures will largely be driven by the extent that scheme sponsors still regard them as efficient. If the trend continues toward greater use of employer ABCs, trustees, as scheme fiduciaries, must determine whether such arrangements provide 'fair value' and greater security for beneficiaries.

8. **Would either option have any other effects that the Government should take into account?**

We have no further comment to make.

9. **The Government has identified two options and has set out its current preference for Option B, based on an initial assessment. However, if interested parties feel that other options should be considered which can fully meet the Government's principles for reform as set out in paragraph 4.2, please can full details be provided?**

   We have not identified an alternative proposal. We would, however, reiterate that Option B must be delivered in a way that does not present any additional difficulties for pension schemes and sponsors which already have employer ABC arrangements in place or those that maybe in discussions regarding their introduction.

10. **Can interested parties offer views on any other likely costs that employers and pension schemes may incur under either option?**

   The main cost considerations would be the range of professional adviser fees necessary to establish the employer ABC arrangement plus the time commitment of senior company management and the trustee body. One pension scheme has indicated that the establishment of their original Limited Partnership arrangement cost c.£1m in professional fees with subsequent additional work having cost c.£500,000 plus between £60-100,000 required for ongoing annual valuation costs. Additional communication costs in explaining the employer ABC arrangement to all scheme members may also be incurred.

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