Linklaters

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UK Tax Alert: Employer Asset-Backed Pension Contributions.

Highlights

> Proposals have been published by HMRC to prevent unintended tax relief for pension contributions to pension schemes where asset-backed pensions structures are used.

> These proposals are designed to restrict tax relief for contributions to pension schemes for asset-backed structures accounted for as equity.

Background

In recent years, a number of groups have made asset-backed contributions to their pension schemes. These contributions have often been structured through partnerships between the employer and the pension scheme. The employer has contributed income producing assets to the partnership, often in the form of commercial property which is leased back to the employer. Income earned by the partnership from the assets (e.g. the rental paid by the employer where commercial property is leased back) is paid to the pension scheme. The employer may be required to make a final bullet payment when the arrangements expire depending on the level of the pension fund deficit at that time.

Asset-backed contributions have often been structured so that a tax deduction is obtained for the value of the asset contributed to the pension scheme when the arrangements are set up (subject to a spreading limitation). As and when further payments are made by the employer in respect of the asset to the partnership, further tax deductions may be obtained by the employer. The size of these further tax deductions depends on the nature of the asset and on the accounting treatment. If the arrangements are accounted for as a financial liability the further payments will typically be limited to the financing element. In contrast, if the arrangements are accounted for as an equity interest and the further payments are of a deductible nature (e.g. rent), a tax deduction may be obtained for the whole of the payments.

In 2006, the “structured finance arrangements” rules were introduced to deal with structures that alienated income in return for a lump sum. It is these rules that will typically limit the employer’s deductions as mentioned above where the arrangements are accounted for as giving rise to a

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Comment

Two general observations are of particular interest.

First, many (if not all) of the asset-backed pensions structures which have been implemented have benefited from non-statutory “clearances” from HMRC. So the implication contained in the Consultative Document that the Government has recently “become aware” that some asset-backed pension structures may give rise to extra and unintended tax deductions might cause some eyebrows to be raised.

Secondly, the KPMG report referred to in the Consultative Document seems to have been prepared as a marketing brochure and is not a report commissioned by HMRC. It would appear that HMRC take a keen interest in marketing brochures prepared by advisers.

financial liability. However, they do not apply where, instead, the arrangements are accounted for as an equity interest.

On 24 May 2011, HMRC published a Consultative Document on Employer Asset-Backed Pension Contributions setting out proposals for reform.

HMRC's Concerns

HMRC's main concern relates to structures accounted for as an equity interest. Here, HMRC are looking to restrict the availability of tax relief for asset-backed contributions. This is because where equity interest accounting treatment is obtained, tax relief may effectively be claimed twice. First, it may be claimed when the arrangements are established on the value of the asset which is transferred to the partnership. Secondly, it may be claimed on the payments which the employer makes in respect of the asset held by the partnership.

Another of HMRC's concerns is that where the arrangements are structured so that the payments made to the partnership are conditional on the future funding position of the pension scheme (or dependent on some other contingency), tax relief may be claimed on an amount in excess of the actual contributions made by the employer. This can happen where the pension scheme's deficit falls faster than expected or the arrangements are unwound before they expire.

HMRC's Proposals

HMRC have floated two options for reforming the tax treatment of asset-backed contributions to a pension scheme. In either case, employers are likely to find their tax deductions restricted under some of the structures in use today.

Option A

The first option on which HMRC are consulting is to change the legislation which gives tax relief on employer contributions. The proposal is to give tax relief only when cash or another readily convertible asset (such as a marketable security) is received by the pension scheme. The result of this will be that tax relief will only be available when the pension scheme acquires an unfettered right to use the assets contributed to meet its obligations to pay pensions. So, for example, where an income stream is transferred to a pension scheme, a tax deduction for the value of the income stream transferred would not be available to an employer unless the pension scheme could transfer that income stream and convert it into cash. Under this proposal, HMRC are seeking to prevent employers getting a tax deduction for an upfront payment to a pension scheme where that payment is immediately returned in exchange for a right to future payments. Instead a deduction will be available when the payments under the income stream are made.

Option B

HMRC's preferred option is broadly to adopt the approach set out in the structured finance arrangements rules. Under this option, where the arrangements are accounted for as a financial liability, employers would be entitled to a tax deduction for the accounting value of the financial liability. Tax relief would also be available only for the financing element of the future payments made under the arrangements, and not for the element which represents a repayment of the financial liability. A tax charge would be imposed on employers on the outstanding amount of the financial liability where:

(i) the arrangements are unwound;

(ii) there is a change in the amount of contributions paid by the employer (e.g. because a contingency is not met); or

(iii) the arrangements cease to be a financial liability.

The purpose of this tax charge would be to claw-back any excess tax relief on amounts in excess of the economic cost suffered by the employer in making contributions.

Where the arrangements are accounted for as an equity interest, the proposal is that no tax relief should be available for any upfront contribution when the structure is established and tax relief should only be available for actual payments as and when made. This is a version of Option A.

What is the Practical Effect of the Proposals?

HMRC intends that where cash is contributed to a pension scheme, the current rules will continue to apply. Tax relief will continue to be available subject to the existing limitations. Where an asset is to be contributed to a pension scheme this is currently structured as a cash contribution followed by an acquisition of the asset by the pension scheme from the employer with the payment obligations of the parties being set off. Where after the transfer the pension scheme bears all the risks and rewards of ownership of the asset and also makes its own investment decisions in respect of the asset (i.e. the asset is transferred on an unfettered basis), again, there should be no change to the current tax treatment. Providing that the arrangements are appropriately structured, a tax deduction would, in effect, be available for the market value of the property transferred to the pension scheme.

Where arrangements which involve asset transfers which do not give the pension scheme unfettered ownership of the asset are used, HMRC intend to change the law. The practical effect of the proposals will depend upon whether Option A or B is adopted and, in the case of Option B, upon the accounting treatment.

Impact on Existing Structures

It is intended that the new rules would not be retrospective. They would not therefore disturb the current tax treatment of arrangements before the new rules come into force (likely to be Finance Act 2012). However, they would apply to amounts that arise under existing arrangements after the new rules come into force.

One area where the proposals are unclear and could have potentially unexpected consequences relate to existing structures involving contingent payments. In this case, where the contingency occurs so that no further payments are made, or lower payments are made, a tax charge is to be imposed on the employer to reflect the reduction in payments to the pension scheme. However, as a commercial matter, the effect of the contingency will already have been reflected in the value of the upfront payment (and in the level of tax relief for this payment claimed when the structure was implemented). The operation of the contingency ought not to give rise to a tax charge under the new proposals to the extent that the tax relief for the upfront payment already recognised the contingency. This aspect of the proposals needs further refinement.

Likely Impact of the Changes

It is unlikely that the proposed changes would cause employers who have commercial reasons for making asset-backed contributions to pension funds not to do so. For pension schemes, the arrangements have the advantage of providing security for the employer's covenant to contribute to the scheme. They may also allow cash payments to be spread over a longer period than a normal recovery plan. However, HMRC's intention is that the arrangements will no longer achieve a double deduction, or a deduction in excess of the overall commercial cost for contributions to a pension fund.

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