

REPORT on the
WOODS BUILDING SUPPLIES PENSION SCHEME
("Scheme")
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1. Background

The Scheme is tax registered as an employer's occupational pension scheme, adopting small self administered scheme rules. It operates as money purchase, meaning that the benefits paid are determined by the available money held in the scheme for each member.

As an occupational pension scheme, membership is open to include employees, spouses and serving directors of the company.

The rules of the pension scheme created two types of pension accounts, namely a general fund and an individual fund. The Trustees maintain a notional share of assets within the scheme account as an individual fund, which is monitored by the scheme pension practitioner who undertakes reporting and tax duties to the Regulator.

The purpose of this report is to assess whether additional benefits could be provided to Janice in respect of the conversion of her "pot" to a defined benefit scheme pension. It also considers what are the implications to the Company for providing scheme pension through defined benefit as this can create a liability on the balance sheet of the firm.

The delay in the production of this report has been due to assessing the interaction of benefit allocation against HMRC introduced anti-avoidance provisions, which have only recently been clarified. This assessment was important as there would be a tax benefit to Janice for converting to a defined benefit scheme pension.

2. How the Scheme is presently funded

Contributions were funded from the Company and are held in a general account. This is permitted within the rules of the scheme, which states that " *the Trustees may at any time apply all or any part of the General Fund to create or augment any individual fund or otherwise provide new or increased benefits, either immediate or prospective, for any person or in any other way which in the opinion of the Trustees is consistent with the status of the Scheme as a registered pension scheme*".

All contributions paid must conform to the Wholly and Exclusively to Trade test. In respect of controlling directors and connected persons, this is broadly covered by S34 Income Tax (Trading and Other Income) Act 2005, S54 Corporation Tax Act 2009.

A pension contribution by an employer to a pension scheme in respect of any director or employee will generally be an allowable expense unless there is a non-trade purpose for the payment. Where there is a non-trade purpose for the payment, then the payment is disallowable. The overall theme being the payment must be to the advantage of the Company and cannot be solely to the advantage of the members of the pension scheme.

If it transpires, that money held in the general account should be refunded back to the Company where pension liabilities have been met, then that refund is paid in accordance with the regulations that apply under Occupational pension schemes (Payments to Employer) Regulations 2006 - SI 2006/802 and the Scheme would adopt such provisions, even though it is generally exempt for the most part of these associated regulations. This would mean that the refund back to the Company would give rise to a tax assessment of 35% on the excess. It would not be treated as investment income from the Company, as it is a refund of monies paid.

The circumstances where a refund is applied would be if any sum in the general fund was not allocated to the scheme members for the period that they were members of the Scheme.

3. New Approach to Benefit Provision.

On the basis that contributions paid meet the tax tests in part 2 of this report, they will accrue in a general account within the Scheme and are allocated to the members when benefits become payable up to their respective lifetime limits. This benefit accrual in the scheme as it is constructed is an input test.

The benefit accrual test for defined benefits arrangement is an output test. This is because under a defined scheme pension the amount of benefit being provided is defined at outset. So whilst the payment of contributions (and allocation of general funds) under defined benefit for a member with protection does not trigger it's loss, the payment out of benefits may cause loss of protection. Certain benefits out may not trigger a loss of protection, for example a pension guarantee or pension increases. Nor are they applied against the lifetime allowance in certain circumstances.

The legislation allows for what is known as a re-valuation factor to be applied. In this case, Janice's pension if paid as a defined benefit scheme pension, could be revalued by 5% p.a. until retirement date which would require funds held in the general account to support this pension increase.

I would add a caveat to this in that the NHS pension which Janice is entitled to restricts her lifetime allowance in this scheme and this would also apply in respect of any conversion to a defined benefit arrangement. I would further add that the rate of pension increase of 5% p.a. over her lifetime would utilise some of her surplus, but this would be marginal and would need to be balanced with the costs of conversion and how this interacts on the employer.

Interaction with death benefits

In the event of death before benefits are drawn, funds accumulated are not subject to any tax assessment provided that they are within the protected or lifetime allowance. This applies to both final salary and money purchase.

As a rule of thumb, most defined benefit arrangements pay out a lump sum of a multiple of their salary following their death, e.g. 4 times salary. When a pension becomes payable, it can also guarantee to be paid for a given period which is known as a guarantee and can be for a period of up to 10 years. If the member dies before the guaranteed amount of pension has been paid, the balance can be paid as a pension protection lump sum death benefit. The tax rules do not set any conditions on who can be paid this type of lump sum.

A pension protection lump sum death benefit is not a benefit crystallisation event so its payment does not trigger a lifetime allowance test nor does it use up any of either the deceased member's or the recipient's lifetime allowance. You should therefore consider that this provision to be a form of life assurance funded by the employer but without the constraints of the lifetime allowance test; it's adoption even where protection does not arise.

Where the member was under age 75 when they died, the lump sum is payable tax free. Where the member was aged 75 or over when they died, the lump sum is taxable as income on the beneficiary.

Presently, under a money purchase arrangement if the member was aged under 75 when they died, and payment is made within the two year period, the amount of the lump sum payment is tested against the lifetime allowance. If the total benefits taken in respect of the member are more than their lifetime allowance, the excess is liable to the lifetime allowance charge. Where the excess is paid as a lump sum, the tax rate of the lifetime allowance charge is 55 per cent.

If the member was aged 75 or over when they died, or payment is not within the two year period, the defined benefits lump sum death benefit is not tested against the lifetime allowance as there would have been a lifetime allowance test when the member reached the age of 75.

Scheme pensions are intended to provide a stable and predictable source of pension income for the life of the recipient. Once a member becomes entitled to a scheme pension under an arrangement, that pension must be paid for the lifetime of that individual and at least annually. This creates a pension liability on the Company in future years – any shortfall in pension provisions requires the Company to make good that

liability. Where a funding deficit arises this must be reflected within the accounts of the company.

4. Actuarial Valuation Report

Every scheme that provides defined benefits is subject to the statutory funding objective which is to have sufficient and appropriate assets to cover its technical provisions – which in summary is the methodology adopted for the benefits that the scheme provides.

It is a requirement that there must be an initial and thereafter a tri-annual valuation report, to ensure that the objectives can be met. There would be a requirement to disclose this within the accounts of the Company and in particular the liability to maintain Janice's pension in payment. Any shortfall in funding her pension must be met by the Company in future where there are insufficient funds in the SSAS. It is highly unlikely that this would arise, but it is important that I state this.

Trustees must take advice from an actuary on the assumptions to be used in assessing the liabilities of the scheme pension. The actuarial valuation must incorporate the actuary's certification of the technical provisions calculation. The actuary is not responsible for choosing the method and assumptions or certifying that they are appropriate; this will be guided by your financial advisor and us.

The actuarial valuation must include the actuary's estimate of the scheme's solvency. It is essential for the trustees to understand from the actuary how sensitive the technical provisions are to changes in the value of each financially material assumption. The greater the sensitivity, the greater the importance of choosing an appropriately prudent value for that assumption. This does not mean that detailed calculations are needed in each case, rather that the trustees should ask the actuary to identify the assumptions to which the technical provisions are particularly sensitive. We can provide specific guidance in this area if needed.

5. Company Accounts

FRS 17 sets out the accounting treatment for retirement benefits for Janice, where a defined benefit scheme pension is paid.

The main requirements of FRS 17 are:

1. pension scheme assets are measured using market values
2. pension scheme liabilities are measured using a projected unit method and discounted at an AA corporate bond rate
3. the pension scheme surplus (to the extent it can be recovered) or deficit is recognised in full on the balance sheet
4. the movement in the scheme surplus/deficit is analysed into:
 - a. the current service cost and any past service costs; these are recognised in operating profit
 - b. the interest cost and expected return on assets; these are recognised as other finance costs
 - c. actuarial gains and losses; these are recognised in the statement of total recognised gains and losses

The FRS 17 requires a liability to be recognised as the benefits are earned, not when they are due to be paid. Therefore the scheme pension secured will be a deferred pension, however the provision of pension increases to those pensions in deferment, or retirement and also the 10 year guarantee may continue to represent an ongoing liability, until such time as the trustees, with the consent of the Company change the benefit basis of the scheme.

6. Closing Summary

Conversion of part of the Scheme to a final salary or targeted benefit basis may allow for pension increases to be provided from funds held in the scheme general account for Janice.

It does place additional complexities, in particular Company account disclosures and additional statutory reporting, such as an actuarial valuation report. We would need to advise how the actuarial valuation should be constructed and the assumptions to be used.

The benefit to Janice for the conversion of her rights to a defined benefit basis could allow for additional pension to be provided. This is because pension rights are converted into an equivalent scheme pension; which can attract pension increases and any ancillary death benefits, such as a pension guarantee.

The Company needs to consider whether the costs of conversion and the additional reporting responsibilities would outweigh the relative cost of additional pension provision that a defined benefit scheme provides.

We are awaiting final property valuations for the Scheme and as soon as these are received I will calculate the additional pension provision for Janice over her expected lifetime under the defined benefit option. I will measure this against the cost to the Company given the need for additional reporting requirements as I have outlined in this report.