

REPORT to the Trustees of the LKL Pension 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 and serving directors of the company.

The rules of the pension scheme have created two types of pension accounts, namely a general fund and an individual fund. Contributions paid to date, to the extent permitted by each member's annual allowance are presently held in a general fund.

Contributions allocated to a member from the general fund are only permitted up to a the individuals PAYE from employment with LKL. This creates a long term funding issue insofar as the amount built up within the general fund would only be reduced by virtue of the increase pay which does also increase national insurance liability.

The purpose of this report is to see what steps can be taken to increase pension provision to members with enhanced protection beyond that available with the current rules underpinning the scheme. Also, to consider whether the use of non-allocated funding can assist members without a PAYE reference basis of benefit accrual.

The delay in the production of this report has been due to assessing the interaction of pension funding against the HMRC introduced anti-avoidance provisions, which have only recently been clarified.

## 2. How the Scheme is presently funded

Contributions are presently funded from the Company within the annual allowance of each members. No contributions are paid in respect of Simon and George as these members are registered for enhanced protection. Any contribution paid in favour of the protected members would cause them to lose enhanced protection.

The Company also pays contributions into a general fund to meet future pension promises to the active members.

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. In respect of the 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 registered 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 is the payment must be to the advantage of the Company and cannot be solely to the advantage of the members of the pension scheme.

In cases where the contribution is part of a remuneration package and paid wholly and exclusively for the purposes of the trade, then the contribution is an allowable expense, unless it is excessive i.e. whether the pension contribution being part of remuneration is excessive.

Broadly speaking, where the pension contribution paid is in excess of the member's annual allowance it is caught as an unauthorised member payment. We do not permit contributions to be paid above a member's annual allowance for this reason.

## Surplus

If it transpires, that the 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.

### 3. Annual Allowance and Protection

Each member of the Scheme has an annual allowance, subject also to carry forward provisions that I will not go into here. I have separately addressed protection for George and Simon later in this report.

The annual allowance is currently £40,000 and where any person has earnings above £150,000, the annual allowance reduces on a tapered basis (a 'reduced annual allowance').

The payments of contributions under the current SSAS money purchase arrangement creates what is known as a benefit accrual in the scheme. The relevant benefit accrual test for defined benefits arrangement is an output test. This is because under a defined benefit scheme the amount of benefit being provided is defined at outset. So the payment of contributions to defined benefits schemes for a member with enhanced protection does not trigger its loss. However, the payment out or transfer of benefits may cause loss of enhanced protection. Benefits may continue to accrue under defined benefit arrangements but if the benefits accrue at more than a set rate, enhanced protection is lost.

We assess what benefits at outset can be provided under a defined benefit scheme, by reference to pay and length of employment period and provided that the reference to those benefits is within that person's annual allowance, there is then technically no restriction to the contribution amount needed to fund for that benefit accrual.

As we do not know what benefits at outset can be provided under a money purchase scheme, the only reference we can apply is to restrict the contribution to a monetarised amount, which under current tax regulation is known as the annual allowance.

#### 4. New Approach to Funding

Where benefits have been accrued in the SSAS, these rights could be converted into an equivalent scheme pension amount in the defined benefits scheme. By way of an example, we have calculated based on current actuarial rates that a scheme pension for a male retiring at age 65, with a pension fund of £1.8 million would at this time pay an annual pension of £39,000 p.a. increasing in line with inflation and providing a 50% spouse's pension. A reduction in this rate of pension would arise where a lump sum is taken tax free. For comparative purposes we have included a 10 year guarantee

The guarantee is an important element to this as it represents a type of insurance policy that in the event of a member's death within 10 years of commencement of his pension, the balance of instalments can be paid to a beneficiary.

If we were to assume that the value of the fund were to fall by 10%, because the scheme is a defined benefit arrangement, the Company would be required to pay contributions to make good this shortfall – in this simple case £180,000. The reason for this is that by offering a defined benefit pension guarantee irrespective of the value of the fund, this promised deferred pension must be maintained. The company would obtain tax relief on that payment. Conversely, superior investment growth could create an over funding position meaning that there is no scope to provide revaluation of the deferred pension in the final salary scheme and indeed provides a scheme surplus.

The legislation allows for what is known as a re-valuation factor to be applied. In this case, the deferred pension could be revalued by 5% p.a. until retirement date which would either require investment growth or pension contributions to fund for this promise. The company would, for the reasons explained earlier in this report be entitled to tax relief on the contributions paid.

In summary, by converting from a money purchase to a final salary based scheme, the ability to sustain pension rights through additional contributions is permissible for members with protection provided that a relevant benefit accrual does not arise. In our opinion, if we were to consider that pension liabilities will continue to rise as is forecasted by the Association of British Insurers, then it is likely to be in a member's interest with protection to convert to a final salary scheme to maintain that pension promise, given the

re-valuation option of 5% on deferred rights, which would not be permissible under a money purchase scheme.

### **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; its adoption even where enhanced protection is applied 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. Therefore, this creates a pension liability on the Company in future years in that a shortfall in pension fund liability arises due to the cost of maintaining a given level of pension the Company would be required to make good that liability. Where a funding deficit arises or there is a commitment to pay contributions this must be reflected within the accounts of the company

## **Active Members**

There are presently six deemed active contributing members, namely Ivar and Julie Gordon, Sheila Collier, also members Claire, Huw and Matthew all participate.

Contributions for these members are subject to the annual allowance whether they are in a money purchase or defined benefit scheme.

Under a defined benefit scheme, the members benefits would be targeted over their lifetime earnings and provided that the relevant benefit accrual does not exceed £40,000 per member no excess tax charge arises.



Where the ability to make larger contributions may favour a defined benefit scheme, is that the contributions paid now are used to fund future pension liabilities and the ability to allocate future liabilities, unlike a money purchase scheme is not prohibited by reference to PAYE income as the rules of the scheme would define pensionable earnings.

I would recommend that the trustees consider a scheme pension or annuity equivalent under a defined benefit scheme on a target basis in accordance with the annual allowance. I would further recommend that protected members consider a transfer to a defined benefits scheme, in order that an equivalent scheme pension as their money purchase equivalents are provided; allowing further contributions to be paid to fund a 5% deferred increase in equivalent pension with the rules of the scheme providing a ten year guarantee on the pensions in payment post crystallisation.

There are additional costs that would apply operating a scheme of this nature. In addition, the statutory requirement to disclose scheme funding in the Company accounts and any associated liabilities. There is also a requirement to appoint a scheme actuary.

## 5. Actuarial Test

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 funding rate and benefits that the scheme provides.

It is a requirement that there must be an initial and thereafter a tri-annual valuation report, with a statement of funding principles to ensure that the objective can be met.

Trustees must take advice from the actuary on the assumptions to be used. The actuarial valuation must incorporate the actuary's certification of the technical provisions calculation and the schedule of contributions. The actuary is not responsible for choosing the method and assumptions or certifying that they are appropriate; this will be guided by Carlton James.

Given that the Company can make contributions against future liabilities, it follows therefore that the technical provisions must provide a target reserve using assumptions that have been chosen prudently, taking into account the degree to which the employer covenant can support a range of likely adverse outcomes. One such outcome being a drop in the value of funds below a certain level.

Trustees are responsible for prudently choosing the assumptions to be used for the calculation of technical provisions; this will be given in consideration with advice from Carlton James.

That advice must consider whether, and if so to what extent, account should be taken of a margin for adverse deviation when choosing prudent economic and actuarial assumptions. The actuarial valuation must include the actuary's estimate of the scheme's solvency. The actuary's estimate of the solvency position, and the assumptions underlying the calculations, are useful reference points for trustees and the employer when considering the adequacy of the technical provisions. The trustees should discuss whether the actuary considers there are any material implications for the scheme. In particular they should discuss the relationship between their technical provisions assumptions

(particularly investment return and mortality) and the assumptions which the actuary will use in the 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. This will have an impact on scheme funding and the ability to meet future pension increases for the member's with enhanced protection.

## 6. Company Accounts

If the scheme investment returns exceed that of the assumption rates used, then it would be difficult to justify contributions to the scheme. Similarly, if the investment returns to the scheme underperform, greater contributions would be needed and there will also be a requirement to show a provision in the audited accounts for the Company of the funding liabilities to the pension scheme.

FRS 17 sets out the accounting treatment for retirement benefits during retirement.

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 pensions 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 will 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.

## 7. Summary

Conversion of the scheme to a final salary or targeted benefit basis may not allow additional contributions to be paid for the members who are not protected from the lifetime allowance charge, unless of course the valuation assumptions of those benefits accrued were not matched by the investment returns earned.

This is because that whilst a target benefit basis would not be referenced to PAYE earnings but in respect of overall pay, there would still be a referencing to an annual allowance for each active member.

For George and Simon, the conversion of their rights to a targeted benefit basis could allow additional contributions to be paid. This is because their pension rights are being converted into an equivalent scheme pension; which can attract pension increases and any ancillary death benefits, such as a pension guarantee – that does not cause a loss of enhanced protection. From our calculations, for a male retiring at age 65, with a mortality date of 84 and 5% increase of pension income in retirement with an attaching 10 year guarantee, the additional funding needing over that lifetime per member would be in the order of £250,000 - £300,000. Investment growth.

The Company therefore 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.