Discretionary tax approval of UK pension schemes: How will the 'sole purpose' test be replaced?

Received: 27th August, 2004

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Abstract Discretionary tax approval of pension schemes by the Inland Revenue (IR) will come to an end on 5th April, 2006, when the new tax regime for pension schemes replaces the current regime. The 'sole purpose' test upon which tax approval by the IR is based will then pass into history. This paper looks at how it will be replaced and considers whether the IR will leave any loopholes following its demise.

Keywords: *sole purpose test; non-relevant benefits; registration; trust-busting; tax avoidance; disclosure*

Introduction

On 5th April, 2006 discretionary tax approval granted by the IR to both occupational pension schemes¹ and to personal pension schemes² will come to an end and all the legislation relating thereto will be replaced by s 149–284 and Schedules 28–36 of the Finance Act 2004. On 6th April, 2006, discretionary tax approval will be replaced by statutory registration.

Occupational and personal pension schemes will be required to register with the IR and, if the registration is in order, the customary tax reliefs and exemptions will flow from the registration. The 'sole purpose' test for occupational and personal pension schemes contained in s 590(2)(a) and 630 of the Income and Corporation Taxes Act 1988 (ICTA) will be consigned to history. The statutory legislation governing registered pension schemes from 6th April, 2006, contains

no mention at all of a 'sole purpose' test. Why is the IR abandoning this founding principle of tax approval? This paper looks at the reasons in detail and how the succeeding legislation and perhaps developments elsewhere have apparently closed any loopholes.

Sole purpose test

One needs to understand what the current 'sole purpose' test, applied by the IR before it will grant tax approval to a pension scheme, is all about before looking at the legislation that will replace it on 6th April, 2006. For an occupational pension scheme, the IR needs to be satisfied that the scheme is 'bona fide established for the sole purpose of providing relevant benefits.'³

The approval terms for personal pension schemes contained in s 630, ICTA 1988 are broadly identical. This

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wording quite deliberately precludes the approval of any pension scheme which has a duality of purpose, not just in its establishment, but also at any time during its operation. The prime and only motive must be the funding of the scheme by an employer or by individual members to provide benefits at retirement for its employees or for themselves respectively.

The provisions of the current legislation are aimed specifically at three features — assignments, non-relevant benefits and tax avoidance — each of which will be looked at later, especially as to where the new legislation counters these currently unacceptable features. It is also important to make the point that if an occupational or personal pension scheme, which has been granted tax approval by the IR, were currently to permit the assignment of retirement benefits, or provide non-relevant benefits, or engage in tax avoidance, the scheme's tax approved status may be withdrawn by the IR. It was widely expected that the IR would retain the 'sole purpose' test in some form in the legislation covering the new tax regime for pension schemes, but surprisingly it has not. The IR's sanctions for engaging in these unacceptable activities from 6th April, 2006 are somewhat different.

De-registration

The replacement legislation contains no provision allowing the IR to withdraw tax approval from a pension scheme. Instead, because all pension schemes that wish to obtain the various tax reliefs and exemptions available to them, will register with the IR from 6th April, 2006, the IR's ultimate sanction will become the de-registration of the pension scheme concerned.⁴ This sanction will not be imposed for the same reasons as currently provide

grounds for the withdrawal of a scheme's tax approval, although de-registration will have the same effect of withdrawing the various tax reliefs and exemptions a scheme enjoys. The grounds giving rise to the de-registration of a pension scheme from 6th April, 2006, are that:

- the amount of the scheme chargeable payments, ie unauthorised payments, (see s 241, Finance Act 2004) made by the pension scheme during any period of 12 months exceeds the de-registration threshold;
- the scheme administrator fails to pay a substantial amount of tax (or interest on tax) due from the scheme administrator by virtue of Part 4 of the Finance Act 2004;
- the scheme administrator fails to provide information required to be provided to the IR by virtue of Part 4 of the Finance Act 2004 and the failure is significant;
- any information contained in the application to register the pension scheme or otherwise provided to the IR is incorrect in a material particular;
- any declaration accompanying that application or the provision of other information to the IR is false in a material particular; or
- there is no scheme administrator.

Readers will note from these grounds for de-registration of a pension scheme, that the assignment of retirement benefits, or the provision of non-relevant benefits, or engagement in tax avoidance are not included. They are covered elsewhere in the new legislation by various other sanctions as will be seen.

Assignments

The provision of retirement benefits currently through a tax approved pension

scheme and from 6th April, 2006, through a registered pension scheme is intended to be permanent. In other words, they should not be capable of assignment. For instance, they cannot be assigned to a third party to pay off a debt when they come into payment. There cannot be any written commitment by a member of a pension scheme to pay some or all of their cash lump sum entitlement on retirement to a building society to repay a mortgage. Such a feature would fail the 'sole purpose' test at present, but from 6th April, 2006 it will be treated as an unauthorised payment⁵ and subject to a tax charge of 40 per cent on the scheme administrator or the member.⁶ So the IR is keeping this door firmly bolted in future, not by the withdrawal of the tax approval of the pension scheme, but by an equally punitive monetary sanction.

Non-relevant benefits

The benefits paid currently by a tax approved pension scheme and from 6th April, 2006, by a registered pension scheme, must be genuine retirement or death benefits. Examples are a pension paid on retirement to a member or, following the death of a member, to a dependant. Benefits paid due to illness or an accident to a member are non-relevant benefits and cannot currently be paid from a tax approved pension scheme. If such benefits are paid from a registered pension scheme from 6th April, 2006, they will be treated as unauthorised payments⁷ and subject to a tax charge of 40 per cent on the administrator of the scheme.⁸

Under the current tax regime the use or enjoyment by a member of an asset of a pension scheme, whether the member pays a market rent for the usage or not, constitutes a non-relevant benefit. This would offend the 'sole

purpose' test and the tax approval of the pension scheme could be withdrawn. However, from 6th April, 2006, scheme members will be allowed to use or enjoy scheme assets, eg occupy residential property, or display a painting in their home even though the asset concerned is owned by the trustees of their pension scheme. Such use or enjoyment of an asset though, will be classed as an unauthorised payment to the member⁹ and the benefit in kind enjoyed will be taxable on the member via self-assessment to the extent of any open market rent not paid for the use of the asset. So, again, in these instances the provision of a non-relevant benefit will be caught in future by the IR, either by a monetary sanction or self-assessment as opposed to the withdrawal of the scheme's tax approval. This is seen as eminently fairer than the current system as withdrawal of tax approval hits all the members of a pension scheme, whereas the new system of sanctions will affect only the members concerned.

Tax avoidance

The deliberate use of a pension scheme as a vehicle to achieve tax avoidance, whether for the benefit of the scheme itself or a third party, currently offends the 'sole purpose' test and could lead to the withdrawal of the scheme's tax approval by the IR. With the demise of the 'sole purpose' test from 6th April, 2006, and only limited provision within the new legislation to counter tax avoidance by pension schemes from that date, one has to look elsewhere for the counter measures to be applied by the IR to combat such a feature. There are quite a number of means by which tax avoidance can be achieved by a pension scheme.¹⁰ These will be looked at in

turn, together with the counter measures already in place — or which will be put in place from 6th April, 2006 — which the IR will use to prevent this tax evasion.

Dividends

The opportunities for pension schemes to obtain a tax advantage from the payment of special or abnormal dividends and from dividend stripping came to an end with the abolition of repayable tax credits on UK company distributions on 2nd July, 1997, and of the foreign income dividend scheme on 5th April, 1999. Bond washing, however, in respect of interest or dividends paid by foreign companies may still survive. Such manipulation of interest and dividends can be countered by the IR under the transfer of securities legislation¹¹ and presumably the IR will continue to adopt this counter measure from 6th April, 2006.

Contributions

Employers obtain tax relief on the contributions they make on behalf of their employees to a tax approved pension scheme. If an employer fails to make a taxable profit in any trading year, they may decide not to pay a pension scheme contribution in that year, but to pay it in the following year or in a later year when profits are sufficient to obtain tax relief thereon. Playing ducks and drakes with their tax liability by paying irregular contributions in this way may lead to the IR treating all contributions as special contributions and spreading them as deductions over two to four years.¹² Under the new regime spreading contributions by the IR will continue in respect of exceptional contributions (in excess of £500,000). This still leaves some scope, though for employers paying

irregular contributions of less than £500,000 to escape spreading and so lessen their tax liability.

If an employer pays a contribution to its pension scheme shortly before it goes into receivership or liquidation, knowing that the appointment of a receiver or liquidator is imminent, this constitutes tax avoidance or even evasion. Such action reduces the amount of assets available to a receiver or liquidator to satisfy liabilities and make payments to shareholders. It would, therefore, reduce capital gains tax liability in respect of a final distribution. This is a well-known device and fully recognised as one that could currently lead to loss of tax approval by the pension scheme. From 6th April, 2006, however, the payment of such contributions is not a ground for de-registering a pension scheme and there is nothing in the new legislation to counter the situation, for instance disallowing the contribution as a deduction for tax purposes. One wonders if the IR has overlooked this or is it going to rely on receivers and liquidators seeking successful recovery of such contributions under their powers in the Insolvency Act 1986?

Captive companies

The trustees of large self-administered pension schemes sometimes own the total issued share capital of an unquoted company which is used to carry out administrative functions, including investment of scheme funds. It is not unusual for the scale of the company's investment — dealing activities to be such that it would be considered by the IR to be trading and therefore taxable on its profits. Problems are likely to arise though with such a company or any other wholly or majority owned unquoted company if the directors (the trustees) vote themselves excessive

remuneration or the company commences to pay substantial dividends to its shareholders. Any similar arrangement may call into question the 'sole purpose' of the pension scheme and may currently lead to loss of its tax approval. Counter action is also possible under the transfer of securities legislation.¹³

Nonetheless, there are currently restrictions in place limiting the size of a shareholding a pension scheme may have in a connected company and in unquoted shares which reduce the scope for tax avoidance to a considerable extent. Large self-administered pension schemes are limited by Department for Work and Pensions legislation¹⁴ to holding no more than 5 per cent of the value of the fund in a connected company. Small self-administered pension schemes are limited to a holding of 30 per cent in an unquoted company which must not exceed 50 per cent of the value of the fund.¹⁵ Self-invested personal pension schemes are prevented altogether from investing in unquoted companies.¹⁶ From 6th April, 2006, these restrictions will be amalgamated and tightened up so that all pension schemes will be subject to the restriction of investing no more than 5 per cent of the value of the fund in an unquoted company.¹⁷ This should reduce tax avoidance in this area in future and the IR will always be able to rely on the transfer of securities legislation¹⁸ as a counter measure.

Trust busting

Trust busting occurs where either one or more members of a pension scheme realise the scheme's assets and take the proceeds without taking a pension in contravention of the scheme's rules. A bout of small self-administered pension scheme trust busting in the 1990s ended with the IR taking action to prevent it

on various fronts, all involving withdrawal of tax approval, a tax charge of 40 per cent on the value of the fund¹⁹ and tax charges on the scheme income received and benefit payments made consequently. Another bout of illegal pension liberation from large self-administered pension schemes two years ago ended in criminal prosecutions quite apart from tax charges. From 6th April, 2006, the new legislation contains very similar monetary sanctions against those involved in trust busting. Payments released from a pension scheme in this manner are unauthorised²⁰ and will be subject to a tax charge of 40 per cent²¹ and a tax surcharge of 15 per cent may also be imposed.²² As if this was not a sufficient deterrent, it is quite possible that the IR may invoke the provisions regarding the disclosure of tax avoidance schemes generally that came into effect on 1st August, 2004.²³ These are aimed at the promoters of tax avoidance schemes, which would include trust busting, and could also include the advisers to pension schemes if they are involved. The result may be additional tax to pay and penalties. It appears the disclosure provisions will apply to pension schemes involved in trust busting currently and from 6th April, 2006, under the new tax regime.

Leasing

There are various leasing arrangements of capital assets owned by pension schemes that can be used to obtain tax relief for a third party. They all depend on the inability of the trustees of a pension scheme to benefit directly from capital allowances on the ownership of fixed assets such as industrial buildings, fixtures and fittings or plant and machinery, and the ability of third parties to lease such assets from the trustees and benefit from

the tax advantages unavailable to the trustees. For example, substantial tax savings can be claimed by leasing industrial buildings or units in development zones which attract industrial buildings allowances (IBAs). Here, the sponsoring company of a pension scheme can purchase a freehold interest in an industrial unit and grant a long lease thereof to the trustees of its pension scheme. The trustees in turn grant the company a sub-lease for a different period. The leases are on commercial terms. The company, as the freeholder, claims IBAs and consequently avoids corporation tax on any subsequent balancing charge on relinquishing its sub-lease.

Arrangements also exist whereby the trustees of a pension scheme lease plant, machinery and equipment to a totally unconnected third party. The latter claims capital allowances on these assets and pays the trustees less than a full commercial rent to recompense the trustees as they are generally non-taxable and unable to benefit directly from capital allowances in respect of their ownership of assets. Whilst these may be seen as normal commercial arrangements, in each instance the pension scheme is being used as a vehicle to achieve tax avoidance. The 'sole purpose' test has apparently been breached and the IR could well withdraw the tax approval of the pension scheme unless the arrangements are undone.

What will happen here though from 6th April, 2006? There will be no grounds for de-registering the pension scheme concerned. Without a 'sole purpose' test it appeared the IR had left a loophole, unless it was prepared to accept the use of IBAs and capital allowances in this manner were genuinely commercial. Many in the pensions industry had expected the 'sole purpose' test to remain in some form

especially as the IR had intimated at this once its second consultation document²⁴ was published in December 2003. Yet the Finance Bill published in April 2004 and eventually the Finance Act 2004 contained no 'sole purpose' test and the IR did not provide a reason for its demise. It can only be surmised that sometime in early 2004, perhaps when the Budget proposals were being finalised, the IR realised its requirements for disclosure of tax avoidance schemes would also sweep up pension schemes engaging in tax avoidance. So, the new pensions legislation does not appear to contain a loophole on this front. Not just from 6th April, 2006, when the new tax regime for pension schemes commences, but from 1st August, 2004 when the disclosure regime commenced, as mentioned earlier, the promoters of tax avoidance schemes, and the advisers to pension schemes involved in tax avoidance via leasing of fixed assets, will apparently be caught by the disclosure legislation.²⁵ So, there could be further tax to pay and penalties up to and beyond 6th April, 2006, and even withdrawal of tax approval in addition up to 5th April, 2006. The door looks to have been well and truly bolted.

Conclusion

It is clear that with the demise of discretionary tax approval of pension schemes by the IR on 5th April, 2006, the new system of registration replacing it and the tax charges on unauthorised payments will counter most of the measures which would currently lead to withdrawal of a scheme's tax approval. Where tax avoidance is concerned there may be a loophole regarding contributions paid shortly before the liquidation of an employer, but the implications for pension schemes of the provisions for general disclosure of tax

avoidance schemes look to have wrapped up all other tax avoidance devices involving pension schemes, without the IR saying anything and the pensions industry realising it.

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