



The Law Society

Employer Asset-backed Pension Contributions

Comments of the Tax Law Committee of the Law Society of England and Wales

Introduction

1. The Law Society is the representative body for over 140,000 solicitors in England and Wales. It negotiates on behalf of the profession and lobbies regulators, the Government and others.
2. This response has been prepared on behalf of the Law Society by the members of the Tax Law Committee. The Committee is made up of senior and specialist tax lawyers from across the country.
3. We are pleased to have the opportunity to the Consultation Document ' Employer Asset-backed Pension Contributions' published on 24 May 2011.

General Comments

3. As a general point we would agree that there has been an increase in the use by employers of asset backed pension contributions (“ABC”) over the last few years. The Consultation Document points out that this is due to the prevalence of funding deficits in these schemes which continue even after significant employer contributions have been paid over the past.
4. In our view an ABC arrangement can result in a “win win” situation for pension scheme trustees and the sponsoring employer as members enjoy increased security without there being an immediate cash cost implication to the employers. These arrangements can also be useful to avoid “trapped surpluses” in pension schemes which are maturing and intend to secure all benefits in full in the short to medium term by means of a buy out with an insurance company.
5. We do not consider that the tax treatment of an ABC is a primary driver for employers when establishing an ABC arrangement. That said we would agree that ABCs should qualify for tax relief but there should be no “double dip” of relief.

Specific comments

Question 1 – Do the examples accurately describe the range of asset backed arrangements?

6. In practice examples 1 and 2 (direct transfer or lease of business property) are very unusual because of the restrictions under the Pensions Act on Employer Related Investments (ERI). In both examples the employer's property would be classed as ERI. A maximum of 5% of the assets of the pension scheme can be invested in ERI (and in practice most schemes do not hold any ERI assets).
7. In your examples 1 and 2 the ERI is valued at £400 million. This would require a pension scheme with existing assets in excess of £7.6 billion in order to hold £400 million of ERI without breaching the ERI limit.
8. The development that has led to an increase in the use of ABCs has been the identification of special purpose vehicle (SPV) structures that can hold assets used by the employer (which would otherwise be ERI) but which themselves are not deemed to be ERI for Pensions Act purposes. The most common structure currently used is a Scottish limited partnership.
9. The flexibility of the SPV structure means that there is significant scope for design and innovation. The first SPVs tended to hold real estate assets – on a sale and leaseback basis. However, recently other forms of assets including intellectual property rights and, in one reported case, maturing whisky have been held by the SPV.
10. The income interest granted to the trustees holding an SPV can also be flexible so that as well as the “bullet” payment referred to in the consultation other arrangements have “income switch off” provisions should the funding level of the pension scheme exceed a specified target during the life of the SPV.

Question 2 – Why these arrangements have emerged

11. The Consultation Document sets out clearly the reasons why employers have developed ABC arrangements. As mentioned above SPVs can also be used to avoid trapped surpluses arising in the scheme and give the employer a greater influence over the investment strategy than if a cash contribution is paid into the pension scheme (pensions law gives trustees full powers of investment).
12. These are valid reasons and employers have not implemented such arrangements purely for tax considerations – rather the availability of a tax deduction on the contribution is a welcome by-product of the SPV.
13. As for how long SPV arrangements are likely to exist, we consider that their use will expand over the next few years as they become more common place (and commoditised). However the regulatory environment could easily change if either:
 - (a) employers resorted to ABCs in place of cash contributions to the schemes (where such cash contributions are readily affordable); or

- (b) a high profile employer fails and the security of the assets of the ABC is found wanting – with a resulting claim on the Pension Protection Fund and reduction in members' benefits.

Questions 3 and 4 – Achieving balance and other situations

- 14. It is clearly right that there should be no double tax benefit for employers that implement an ABC arrangement. Likewise it is right that employers should receive a tax deduction on the provision of the ABC.
- 15. However, with ABC arrangements the challenge will be in drafting the legislation to achieve these aims. By way of example, the following points would need to be taken into account.

Defining an ABC

- 16. The definition of an ABC will need to be flexible. Employers proposing an ABC need to commit to pay a cash contribution to their pension scheme in order to qualify for a tax deduction under Finance Act 2004. Typically that contribution may then either be:
 - (i) physically paid to the scheme and then immediately invested by the trustees in the SPV arrangement – with money being transferred between bank accounts often on the same day; or
 - (ii) “netted off” in return for the trustee being granted an interest in the SPV equal to the value of the committed cash contribution.
- 17. The time lag between commitment to make a cash contribution and investment in the SPV is therefore usually minimal. However, it would be open to employers and trustees to build in a pause between the cash being contributed to the scheme and the trustee applying that cash to purchase an interest in the SPV. For example the employer could contribute £400 million in cash to the scheme (which would qualify for tax relief – subject perhaps to spreading). The trustees could then invest that contribution (in, say, Government bonds) for a period of time (say a month) and then decide to liquidate that investment and apply the proceeds to buy into the SPV.
- 18. Another approach would be for the trustees to liquidate assets already held in the scheme to buy into an SPV with the employer subsequently agreeing to make a cash contribution to the scheme – which is used to invest in more traditional investments.
- 19. Both of these arrangements should logically be treated as ABCs but might fall outside the statutory definition.

Valuing an ABC

20. Trustees participating in an ABC arrangement will invariably obtain professional advice to ensure that the value to the scheme of the asset is at least equal to the value of the committed cash contribution that it is replacing.
21. Where the ABC includes a form of bullet payment or provisions for income switch off based in either case on the future funding position of the scheme, the trustees' advisers will need to make an allowance for the likelihood of that eventuality arising (often erring on the side of prudence). The expected income stream is then discounted to get a net present value.
22. Should the assumptions adopted by the valuer not be met (as is often the case) – for example the income does not switch off when anticipated - then the trustee's interest will be worth more to them than initially calculated. Likewise, in the case of an income switch off earlier than anticipated the value of the trustee's interest will be lower than first anticipated.
23. The legislation would need to have the flexibility to adjust tax reliefs to reflect the actual position (rather than the assumed position at the point of contribution).

Aligning with Accounting Treatment

24. As pointed out in the Consultation Document, it is possible to design an ABC so that it is accounted for as either equity or debt in the accounts of the employer. The proposed Option B would only allow an upfront tax deduction when the SFA rules apply (and this would require the SPV to be accounted for as debt rather than equity in the employer's accounts).
25. It may be that employers would seek to arbitrage between debt and equity treatment during the lifetime of the SPV (by agreeing amendments to the terms of the SPV which have no practical impact but which affect the accounting treatment). The new rules will need to address this issue to prevent abuse.

Questions 5 and 6

We would agree that Option B is the preferred option and has advantages over Option A (where relief is only given when cash funds are received by the scheme out of the SPV). As mentioned though the flexibility of ABCs means that the legislation defining Option B will need to be suitably flexible.

Question 7

We do not think that applying Option B to ABCs would have any significant impact on the use of ABCs.

Indeed, the acceptance by the Government that these structures are a practical means for employers to meet their obligations to underfunded pension schemes coupled with a clearer understanding of the tax treatment, is likely to result in an increase in the use of ABCs in the future.

Questions 8 and 9

We have no comment to make.

Question 10 – likely costs

Implementing an ABC arrangement is a complex process which requires a significant amount of professional advice for both employers and the trustees (legal, tax, actuarial and valuation). It is suggested that the costs associated with complying with Option B would be insignificant compared to these implementation costs and would not deter employers.

Conclusion

As mentioned we consider that Option B is the preferred approach for providing tax relief on Asset-Backed Contributions. HMRC's consultation on the subject and the resulting rules on deductibility is welcome.

We look forward to commenting on the draft legislation in due course.

Contact details:

If you have any questions concerning these representations or would like to discuss anything contained in them, please contact Mr Duncan Buchanan (Tel: 0207 296 2323, E-mail: duncan.buchanan@hoganlovells.com).

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