SLAUGHTER AND MAY/

CLIENT BRIEFING

APRIL 2022

GMP EQUALISATION: TRANSFERS, CONVERSION AND TAX: AN UPDATE

Summary

On 6 April 2022, HMRC issued their third newsletter on GMP equalisation, giving helpful guidance on how transfer top-ups fit with the tax regime, and a welcome update and some limited guidance on conversion.

The transfers guidance should help schemes to progress transfer equalisation exercises. However, for the conversion method of equalisation, a number of tax issues remain unresolved.

Transfers - the background

The third *Lloyds* judgment made clear that GMP equalisation obligations apply to **statutory "cash equivalent" transfers** paid from 17 May 1990 onwards. Mr Justice Morgan found that, where such a transfer has been underpaid because it did not take into account GMP-related inequalities, the affected member can require the trustees to make a transfer top-up payment to the original receiving scheme. But there is no right to a residual benefit in the transferring scheme. He also noted that it would be open to trustees and members to agree an alternative approach, but did not give any further guidance on this. (See our November 2020 briefing for further discussion of the *Lloyds 3* decision).

Practical problems and tax issues with transfer top-up payments

There are practical problems with making a transfer top-up payment to the original receiving scheme in relation to statutory transfers, particularly as affected transfers go right back to May 1990. For example:

- the original receiving scheme may no longer exist.
- the affected individual may no longer be a member of that scheme.
- the scheme may be unwilling to accept a top-up payment.
- the administrative time and cost in facilitating a transfer to the scheme may be significant.

There are also tax issues to consider: is a top-up payment a "*recognised transfer*" and so an authorised payment for tax purposes? This requires the affected individual to be a "*member*" of the scheme, and the sums transferred to represent "*accrued rights*" under the scheme. However, it was unclear how those HMRC requirements would fit with the *Lloyds 3* decision that the individual is entitled to a top-up transfer payment, and not a residual benefit.

Trustees were therefore keen to explore alternatives, particularly whether it was possible to make a payment direct to the individual, instead of to a pension scheme. This is likely to be administratively simpler than arranging a payment to another pension scheme. However, this approach also raises tax issues, as the authorised lump sum payments under consideration all require that the affected individual is, for tax purposes, a "*member*" of the scheme making the payment, and that the payment extinguishes their entitlement to "*benefits*" under the scheme. Again it was unclear how these requirements could fit with the *Lloyds 3* decision.

The April 2022 GMP equalisation newsletter gives HMRC's helpful views on these and other tax questions.

Top-up transfer payments to another scheme

The newsletter notes that, in order to be an authorised payment, a top-up transfer payment to another pension scheme must satisfy the conditions for a "recognised transfer" at the time it is made. In a helpfully broad reading, HMRC confirm that an individual's right to a top-up transfer payment is an "*accrued right*" for tax purposes and that an individual who holds only this

right in the transferring scheme is a "*deferred member*" of the scheme - a person with an accrued right to a benefit (in this case, the top-up transfer payment). So HMRC see these key requirements of the recognised transfer definition as being met.

A further requirement is that the receiving scheme must be either a registered pension scheme or a qualifying recognised pension scheme (QROPS) at the time of the top-up payment. HMRC confirm that from a tax perspective this might be either the same scheme to which the original transfer payment was made or a different scheme.

This means that there should not be any tax obstacle to making top-up transfer payments to a pension scheme, provided it is a registered scheme or QROPS. However it does not of course address the practical difficulties that might arise, which might mean schemes consider payments direct to individuals instead.

Lump sum payments to an individual

When considering making lump sum payments direct to individuals, the confirmations given by HMRC in the recognised transfer context assist with meeting the authorised payment requirements: the individual will be a "*member*" of the scheme with a "*benefit*" that can be extinguished. The newsletter looks at three lump sum types: "*relevant accretion*" lump sums, small lump sums and winding-up lump sums, noting that all the payment conditions will need to be met at the time the payment is made, and giving some detailed guidance on this for the relevant accretion lump sum.

Relevant accretion lump sum

For ongoing schemes, the "*relevant accretion*" lump sum (maximum £10,000) may be the optimum lump sum to consider, as it has no age restrictions[1]. It is available where, following a transfer out, the trustee becomes aware that the member is entitled to a further benefit under the scheme, **provided** the trustee was not aware of the benefit entitlement before the original transfer and could not reasonably have been expected to be aware of it. The payment to the member has to be made within 6 months of the trustee becoming aware of the further benefit entitlement.

In the GMPe context, it was uncertain when a trustee might be said to have become aware of a particular individual's entitlement to an equalised transfer payment. HMRC have, however, given very helpful guidance on this point to the effect that:

- the trustee isn't regarded as being aware of (or reasonably expected to be aware of) a member's further benefit entitlement before the original transfer if, at that point, the trustee was not in a position to know (i) that particular member was entitled to an equalisation benefit and (ii) the amount of the top-up required. So transfers made before work has been done to settle on an equalisation process and calculate top-up amounts should be in scope for this type of authorised lump sum payment in most instances.

- the 6 month period starts when the trustee has established that the member has an actual entitlement to a top-up payment and the amount of that payment, having traced the member and obtained the information (such as bank details) and any consents required to make the payment. This should give adequate time to effect payment in the vast majority of cases.

Less helpfully, HMRC's view is that the relevant accretion route can't be used where the original transfer was before 6 April 2006. This is because there must have been a recognised transfer from one registered pension scheme to another. Pre 6 April 2006 transfers were made between tax approved (rather than registered) pension schemes, and so were not recognised transfers. However, the small lump sum route may assist with these older transfers.

Small lump sums

An alternative lump sum type to consider is the small lump sums (maximum £10,000) payable under Regulations 11 and 12 of the 2009 Authorised Payments Regulations. There are a number of payment conditions including that the individual must have reached normal minimum pension age (currently age 55, unless there is a protected pension age), and that there must not have been a transfer out from the scheme (or for Regulation 11, any related scheme) during the preceding 3 years.

This lump sum type may be particularly helpful for pre 6 April 2006 transfers, where the relevant accretion

[1] Provided for in Regulations 6 and 7 of the Registered Pension Schemes (Authorised Payments) Regulations 2009.

route is not available, but will not be available for the most recent transfers.

Winding-up lump sums

Where a scheme is winding-up, for example, following a buy-out, the winding up lump sum (WULS) is an attractive option where making payment direct to the member as it has a higher cap of £18,000. For a WULS the payment conditions include that the member must have lifetime allowance available. This is a due diligence point that would need to be built into communications.

Other tax matters relating to transfers

Income tax

HMRC confirms that a right to a top-up transfer payment is an uncrystallised right for tax purposes. So, where an authorised lump sum is paid direct to the member (or the member's estate) to extinguish the top-up right, it is taxed as an uncrystallised right, and 25% can be paid tax free, with the remainder chargeable to income tax at the member's marginal rate.

If an authorised lump sum is paid to another person (as is theoretically possible after death for the relevant accretion lump sum and the small lump sums, so long as the payment extinguishes the deceased member's entitlement to a top-up transfer payment), the lump sum is wholly chargeable to income tax at the recipient's marginal rate.

Tax is due for the year of payment of the lump sum and PAYE should be operated.

Where a member has died, deciding on the appropriate approach is not straightforward and this is an area where scheme specific advice is needed.

Annual allowance

HMRC confirms there are no annual allowance implications of paying a top-up transfer payment or a lump sum to extinguish the right to the top-up.

Tax protections

Paying a top-up transfer payment can result in loss of enhanced or fixed protection in limited circumstances, for example where the paying scheme is not winding-up, and makes the payment to a defined benefit arrangement in the receiving pension scheme. This is another due diligence point that will need to be built into member communications. Payment of one of the lump sum types covered in the newsletter to an individual should not affect enhanced or fixed protection.

In relation to protected lump sums and protected pension age HMRC has given a helpful confirmation. Where a transfer formed part of a previous "block transfer" to retain protection (eg "buddy transfers"), requiring all assets and sums of the transferring members to transfer in a single transaction, the "block transfer" status is not disturbed by the later identification of a right to a top-up transfer payment, whether settled by a further transfer or payment of a lump sum.

Where we are now on transfers

The HMRC guidance on transfers is very helpful in addressing the technical tax questions when settling transfer top-up obligations. Schemes will have an array of options depending on their circumstances, including a menu of possible lump sum payments direct to individuals, subject to scheme rules permitting.

However, there are a number of other tricky areas relating to transfers, where advice will be needed. These include:

- how to deal with deceased members.

- whether non-statutory (rules based) individual transfers can be dealt with in the same way as statutory transfers, noting that it may be difficult in practice to distinguish transfer type for historic transfers. In the *Lloyds 3* decision, non-statutory transfers were treated differently. It was decided that the member would have to have the transfer decision set aside to have rights under the original transferring scheme. The guidance relates to cases where there is a right to a top-up transfer payment, and this is a challenge in managing non-statutory transfers in the same way as statutory transfers.

Conversion – the background

Conversion involves using statutory provisions to remove the GMP requirements for some or all scheme members, and provide them with actuarially at least equivalent benefits. Where conversion is used to achieve equalisation, a new equalised benefit is provided which at the date of conversion is actuarially at least equivalent to the greater of the pre-conversion benefit payable to the member and a comparator.

A number of issues have been identified with the conversion method. Some of these are being addressed in the Private Members' Bill that is going through Parliament with Government support, and which is currently at committee stage in the House of Lords. The Bill includes:

- clarification that conversion applies to survivors as well as members,
- regulation making powers to clarify employer consent requirements and simplify minimum survivor pension requirements, and
- removal of the requirement to notify HMRC of a conversion.

Conversion – the tax issues

As conversion involves re-shaping benefits, it raises some difficult tax questions, whether used for GMP equalisation or otherwise. These are particularly acute for deferred and active members, where there is a risk of annual allowance inputs and loss of tax protections. These issues can only be resolved with legislative change, and in the meanwhile, workarounds are required when designing conversion projects.

For pensioners, the position is generally more straightforward from a tax perspective, but questions have arisen as to whether conversion counts as accrual with tax consequences.

The April 2022 HMRC newsletter takes some steps forward in addressing these issues, based on the assumption that:

- post conversion benefits have the same or virtually the same actuarial value as the pre conversion benefits, and
- where conversion is being used for equalisation, the conversion is on the basis of seeking to achieve both equality of present value on the conversion date and equality of subsequent benefit payments between men and women for benefits earned from 17 May 1990.

Deferred and active members - future legislative change?

There is some potential for legislative change for annual allowance issues. HMRC acknowledge in the newsletter that conversion is likely to impact on the annual allowance treatment for members who have not yet retired, both in the tax year of conversion and subsequent tax years. For example, in the tax year of conversion, the change of GMP to another benefit type triggers loss of the "deferred member carve out" (DMCO) - a useful provision, that means a member's benefits don't use up annual allowance. HMRC say they need to undertake further work in this area to "*determine the appropriate outcome and treatment, and the potential for legislative change*".

For deferred members with fixed protection, legislative change looks less likely. The newsletter just includes a warning that the protection will be lost if the member's benefits increase more than is permitted. So, nothing about potential for legislative change here - schemes are advised to "*consider the tax implications that may arise for these members in accordance with the existing legislation*". A bespoke approach is needed for such members, as explored in the PASA conversion guidance, issued in July 2021.

Pensioners

The newsletter includes some helpful guidance for conversion of pensioner benefits. HMRC confirms the expected tax position on some technical points:

- ***annual allowance***: conversion of a pensioner's benefit would not constitute accrual, and so there is no pension input – this is so where conversion happens in the tax year of retirement (but after retirement) even if the conversion triggers a BCE3 (see below).
- ***fixed protection***: conversion would not trigger loss of fixed protection, where all benefits have been crystallised in the arrangement.
- ***further benefit crystallisation events (BCE)***: conversion could result in a BCE3 if the re-shaped pension increases beyond a permitted margin - this is tested against the pension previously in payment, but after allowing for the dual records equalisation method used for

arrears and any adjustments to past lifetime allowance used up.

- *DMCO if conversion happens in tax year of retirement (but after retirement)*: a conversion after retirement does not affect the assessment of whether the DMCO applies for the tax year (even if the conversion triggers a BCE3).

Pre 6 April 2006 deferred members

There is also helpful guidance in relation to members who became deferred before 6 April 2006, where their arrangement has subsequently remained outside the annual allowance provisions. Provided the new benefit has the same actuarial value following conversion (so the post-conversion benefit is actuarially equivalent to the pre-conversion benefit), the member should remain outside the annual allowance provisions.

There is no "virtual equivalence" wording expressly included here, and it is not clear whether this is an intentional distinction.

Where we are now on conversion

The confirmations given by HMRC in relation to conversion are helpful in so far as they go, and the tax position is now much clearer for pensioners, including where conversion happens in the tax year of retirement (but after retirement).

However, when designing conversion solutions for pre-retirement members, the annual allowance and fixed protection issues will have to be considered and will influence conversion design. It may be that a legislative solution is forthcoming at some point for the annual allowance issues, but there is no mention of legislative change to deal with the fixed protection issues.

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