The Personal Tax Planning Review

"FUNDED UNAPPROVED RETIREMENT BENEFITS SCHEMES" - A RE-EXAMINATION POST BUDGET NOVEMBER 1993

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Introduction

This article is, in a sense, a sequel to *Funded Unapproved Retirement Benefits Schemes - The Traps For The Unwary* (which appeared in Volume 2, 1992/93, of this *Review*); in a sense a sequel, because it was not envisaged when the earlier article was written. That earlier article highlighted the pitfalls of Funded Unapproved Retirement Benefits Schemes (or "FURBS"), particularly offshore FURBS, but at the same time identified a number of tax planning opportunities.

Among the Press Releases issued after the Budget on 30th November 1993, under the heading "Measures To Protect Revenue" was a Press Release entitled "Funded Unapproved Retirement Benefits Schemes". This announced new provisions, effectively bringing to an end many of the benefits of using an offshore FURBS, by taxing any lump sum paid from funds which have not otherwise suffered tax in respect of income and gains. At the time, this announcement came as something as a surprise. With hindsight, however, perhaps it was not so surprising that the potential tax planning opportunities afforded by offshore FURBS had not passed the Inland Revenue's attention, given the number of FURBS products launched by pension providers during the early part of 1993 (most notably by Eagle Star and Sun Life).

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Background

Before examining the new provisions, a brief resumé of the position prior to 30th November 1993: the Finance Act 1989 introduced a limit to the maximum amount that could qualify as pensionable earnings under an approved pension scheme. For 1992/93 and 1993/94 this limit was fixed at £75,000. One of the ways of providing retirement benefits above the "cap" was through a FURBS, this being an arrangement whereby:

(a) an employer sets aside funds for employees in advance of their retirement under a separate trust for each participating employee, or under one trust with separately constituted sub-funds for each participant;

(b) the employer pays single or recurring contributions to the trust, which are deductible for tax purposes but treated as taxable emoluments of the employee; for various reasons employees' contributions are not normally paid;

(c) the fund is designed to provide a lump sum for an employee on reaching retirement; however, benefits can be taken on leaving service, if over the age of 50, or in cases of physical or mental infirmity;

(d) the arrangement is not an approved pension scheme.

While originally envisaged as a means of providing retirement benefits, FURBS have in practice been used to shelter capital gains and in other forms of tax planning.

One example of the use of an offshore FURBS as a capital gains tax shelter was where the managers in a management buy-out in effect acquired an interest in shares through an offshore FURBS. When the shares were later sold, no capital gains tax was payable and the lump sums received on retirement, or on ceasing employment after the age of 50, would be tax free.

In addition, it was widely held that offshore FURBS investing in "pooled investments" (unit trusts and equivalent vehicles) would not be attacked by the Inland Revenue under s.740 TA 1988 ("transfer of assets abroad - liability of non-transferors"), so that both income and capital gains could accrue to an offshore FURBS with an appropriate investment policy entirely tax free (except for withholding taxes). The technical basis for this was not, however, entirely certain; indeed it was recently questioned by the Special Commissioner's in a case relating to offshore income bonds (see "Mr Hart Strikes Again", Taxation, 3rd June 1993).

The November 1993 Budget

The 30th November 1993 Press Release stated that the Chancellor's intention was to stop offshore FURBS, whose income and capital gains were wholly or partly tax- free, from providing employees with a larger tax-free lump sum on retirement than would be provided by an offshore fund whose income and gains were taxable. The new rules apply equally to FURBS products marketed by insurance companies.

The new rules are contained in s.108 of the 1994 Finance Act. This amends s.596A TA 1988, which deals with the taxation of benefits under non-approved schemes. As a matter of clarification, the amendment first of all exempts a lump sum arising from a FURBS from tax under s.19(1), s.148 and s.596A TA 1988, provided that:

(a) the employer has paid sums to the FURBS with a view to the provision of any relevant benefits under a retirement benefit scheme;

(b) the employee has been taxed on these sums under s.595(1); and

(c) the fund from which the lump sum was paid from was subject to UK tax; pensions received from a FURBS trust will continue to be taxed under Schedule E, or Schedule D Case V in the case of offshore pensions.

The main charging provision is now in s.596A(9) TA 1988. This states that, where any of the income or gains accruing to a scheme have not been brought into charge to tax, income tax shall be charged on any lump sum received from a FURBS trust. The amount chargeable is the lump sum, less:

(a) employer's contributions which have been assessed to tax on the employee under s.595(1) TA 1988;

(b) any employee's contributions.

Where more than one lump sum is expected to be payable, the deduction allowed in respect of taxed employer's contributions and employee's contributions is allocated across the various lump sum payments, by reference to a formula (s.596A(11) TA 1988).

The new rules apply to retirement benefit schemes entered into on or after 1st December 1993, or schemes entered into before that day if subsequently varied.

All of this raises a number of issues. Firstly, the new rules more than achieve the Chancellor's intended objective as articulated in the Press Release. Income and capital gains arising to an onshore FURBS are chargeable to tax at the basic rate but not the additional rate or higher rate. Lump sums received from an offshore FURBS will be charged to tax at the recipient's marginal rate, which will typically be the higher rate. Hence, any cash flow benefit arising as a result of the tax deferral under an offshore FURBS (tax being payable by the recipient on the lump sum when received rather than by the trustees as income and gains arise) is normally more than compensated for by the higher rate of tax which may eventually apply.

Secondly, there is some inexactness in the way that s.596A(9) TA 1988 is worded. The trustees of an onshore FURBS will be entitled to an annual exempt amount in respect of capital gains tax calculated in accordance with TCGA 1992 Schedule 1 paragraph 2, being one half of the annual exempt amount available to an individual. To the extent that such an annual exempt amount is available, capital gains are not brought into charge to tax. Hence, as drafted, an onshore FURBS which takes advantage of the annual exemption will not satisfy s.596A(9) TA 1988. Clearly this is not the legislator's intention.

Thirdly, it is not entirely clear that a pre-1st December 1993 offshore FURBS to which contributions are made on or after 1st December 1993 has or has not been "varied" within the terms of s.108(8) FA 1994. Arguably, if the trust deed allows for such contributions, and they are made to existing participants, then there is no variation.

Leaving aside these rather detailed points it is clear that the balance of advantage between funded and unfunded arrangements as a solution to the problem of uncapping (how to provide additional retirement benefits to employees who are subject to the earnings cap) has been pushed firmly towards unfunded arrangements (Unfunded Unapproved Retirement Benefits Schemes or "UURBS") as a consequence of the new rules.

We have done some calculations to illustrate this, but also to demonstrate that, when thought of as an alternative to deferred bonuses, a FURBS may still have advantages.

Example 1 - pension planning

A company wishes to pay an employee a lump sum when he retires in 10 year's time. The net present value of the payments to be made by the company, after tax, will be £100,000. The company has the choice of making payments into an onshore FURBS or an offshore FURBS. Both of the FURBS would invest in assets which give a gross return of 5%. Alternatively, the company could retain funds for self-investment, providing retirement benefits via an UURBS. In this example we assume firstly an internal rate of return of 5% (all passed on to the participant) and a rate of 8.5%. In this second scenario, the company would provide the employee with a return of 5% and retain the difference.

We have assumed that an appropriate discount rate is 5% and that the following tax rates apply:

Corporation tax	33%
Employee's marginal rate of tax	40%
Onshore FURBS	25%
Offshore FURBS	0%

Table 1 shows that a net present value cost of £100,000 results in payments to the employee (before tax) of:

Onshore FURBS	£145,800
Offshore FURBS	£145,800
UURBS - 5% return	£175,700
UURBS - 8.5% return	£241,000

Table 1: cost to employer

			Year	**Onshore FURBS £000**	**Offshore FURBS £000**	**5% UURBS £000**	**8.5% UURBS £000**
			0	(145.8)	(145.8)	(126.4)	(173.3)
Contributions			1	48.1	48.1		
Corporation tax on FURBS			10			175.7	301.6
Capital & growth returned			10			(175.7)	(241.0)
Payment on retirement			10			(17.9)	(24.6)
Employer's NIC			11			63.9	87.6
Corporation tax on payment				(97.7)	(97.7)	(80.4)	(49.7)
Total cost							
Net present value factors							
Year	0	1.000		(145.8)	(145.8)	(126.4)	(173.3)
	1	0.952		48.1	48.1	0.0	0.0
	10	0.614		0.0	0.0	(17.9)	36.0
	11	0.585		0.0	0.0	63.9	87.6
Net Present Value				(100.0)	(100.0)	(100.0)	(100.0)

Table 2 shows the contributions paid into the FURBS, the participant's Schedule E tax liability on the initial contribution, and the growth in value of the fund. We have assumed that the company grosses-up the tax on the payment into the FURBS and accounts for employer's national insurance contributions on the grossed-up amount. In the offshore FURBS, tax on the growth in value of the fund (via the new exit charge) is also shown. The comparative figures for UURBS show the gross and net figures, after deducting the Schedule E tax on payments made.

Table 2: lump sum to employee

	Onshore FURBS £000	Offshore FURBS £000	5% UURBS £000	8.5% UURBS £000
Contributions	145.8	145.8	175.7	241.0
Employer's NIC	(5.7)	(5.7)	0.0	0.0
Tax on entry to FURBS	(56.0)	(56.0)	0.0	0.0
Growth in FURBS	37.4	52.9	0.0	0.0
Tax on growth in FURBS	0.0	(21.2)	0.0	0.0
Tax on UURBS	0.0	0.0	(70.3)	(96.4)
Net lump sum	121.5	115.8	105.4	144.6

Again, for simplicity, the relative set-up costs of FURBS and UURBS have been ignored. In practice a UURBS will typically be cheaper to establish and administer than a FURBS.

Analysis of results

It is immediately obvious that, based on these assumptions, the lump sum will be largest when an UURBS is used and funds are invested within the business at a higher rate of return than is paid over to the participant.

Rates of return

A company will often obtain a higher rate of return by retaining funds for investment within its own business, hence in effect obtaining a better return through an UURBS than could be obtained by a FURBS investing externally. Indeed, for many companies the 8.5% rate of return used above is very modest. This is not true, however, of a cash-rich company which is already investing its funds externally. For companies in this position a FURBS may continue to offer advantages because of the favourable tax rates applicable to income and gains.

Tax assumptions

It has been assumed in these calculations that the onshore FURBS will pay tax at 25%. However, there are many ways in which this rate can be reduced; for example, by investing in:

(a) assets which will give rise to capital gains, so utilising the trustee's annual exemption and indexation allowance;

(b) assets which are exempt from capital gains tax (gilts and qualifying corporate bonds);

(c) UK equities, so as to produce dividend income, taxable at 20%, this being covered by the available tax credit.

Example 2 - FURBS as an alternative to discretionary bonuses

If the company in the above example had decided that it was going to pay either £100,000 as a contribution into a FURBS or a discretionary bonus of £90,744 (which, with the addition of employer's national insurance contributions at 10.2%, gives a cost of £100,000) then after 10 years the employee would eventually realise the net lump sums shown in Table 3, assuming the bonus is invested by him in assets giving a gross return of 5%.

Table 3: discretionary bonus/FURBS contributions

	FURBS £	**Bonus** £
Contribution to FURBS	100,000	-
Discretionary bonus	-	90,744
Income tax	(40,000)	(36,298)
Net growth over 10 years	26,703	18,725
Net lump sum	86,703	73,171

Since there are no employer's national insurance contributions on payments into the FURBS and since the FURBS benefits from a lower rate of tax, the employee will inevitably be better off, in 10 year's time, with a FURBS rather than with a bonus. Against this, with a FURBS the employee is accepting that his funds are locked up until retirement, or at least until cessation of employment post-aged 50.

Conclusion

No doubt there will be further developments in using onshore FURBS as an alternative to cash bonuses. Some interesting ideas are already starting to emerge, but that is another story ....