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Nugee Memorial Pensions Conference & Dinner 2023

WEDNESDAY 21ST JUNE 2023

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Nugee Memorial Pensions Conference 2023

Talk papers

Wednesday 21st June 2023

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Speakers

Sir Steve Webb (Guest Speaker)
Steve Webb was Minister of State for Pensions between 2010 and 2015. During that time he implemented major reforms to the state pension system, oversaw the successful introduction of automatic enrolment and played a key role in the new pension freedoms implemented in April 2015. He was awarded a knighthood in the New Year's honours in 2017. Following his time in Parliament he worked for Royal London for four years before joining LCP as a partner in 2020, where he has campaigned successfully to secure £1.5 billion in backpayments for over 230,000 people who had been underpaid state pensions. More recently he has been working on supporting trustees to prepare for the implementation of pension dashboards, and is working on how to secure the best possible post-retirement outcomes for DC pension savers.

Paul Newman KC (Chair)
Paul regularly acts for some of the largest UK pension schemes, FTSE 100 companies and regulatory bodies on various pensions issues, often of a highly technical nature. A seasoned advocate, he is consistently ranked in the legal directories as a leading practitioner: Chambers & Partners 2023 says "*Paul stands out from the crowd as a pensions silk*", while The Legal 500 2023 notes that "*Paul's vast knowledge and experience of all forms of pensions litigation make him a top choice to advise on technical matters*". Paul's book, A Practitioner's Guide to Correcting Mistakes in Pension Schemes, was published by Bloomsbury Professional in March 2022. For this, Paul was awarded the prestigious Wallace Medal by the Association of Pension Lawyers.

Robert Ham KC
Robert has a litigation and advisory practice, which covers not only traditional private client work, and associated tax law, but also pension schemes together with professional negligence in those fields. He was one of the first trust practitioners to specialise in occupational pension work. He appeared in the first modern case in the Court of Appeal – *Kerr v British Leyland* – and the first modern case to go to the House of Lords – the *National Grid* case. The Legal 500 2023 describes Robert as "*one of the best-known and respected silks in the area. He easily cuts through complexity, getting to the heart of a matter with minimum fuss, which goes down very well with clients*".

Michael Tennet KC
Michael's practice encompasses litigation and advice in the fields of pensions (including professional negligence), financial services and private trusts. Has appeared in many of the most high profile and complex pensions cases of recent years. He has a particular knowledge of the work of actuaries, both in relation to pension funds and life assurance funds and is co-author of the chapter on actuaries in Professional Negligence Law and Practice (LLP). Chambers & Partners 2023 describes Michael as "*a first-class pensions silk*", while The Legal 500 2023 says he "*has sound judgement and brings to his work an admirable pragmatism, too. Hugely clever, invested in the case, an energetic, fearless and effective advocate*".

David Pollard
David is a leading and highly experienced lawyer in the pensions field and related areas. He switched to practise as a barrister at the end of 2017, after 37 years practice as a solicitor. He was a chair of the Association of Pension Lawyers (APL). His practice has

included advising employers and trustees on relation to pension law matters, including corporate transactions, scheme funding, scheme mergers, scheme changes, employer insolvency and Pensions Regulator issues. David has been involved in many noteworthy cases, including *Merchant Navy Ratings Trustee v Stena* [2022], where he acted for representative beneficiaries in relation to settlement of ill-health early retirement issues. He has published five books in the areas of pensions, insolvency and employment law. His latest book "Employment Law and Pensions" (2nd edition) is due out in July 2023.

Edward Sawyer
Edward has extensive experience of pensions litigation and advisory work, having appeared in a number of high-profile recent cases such as *Mitchells & Butlers*, *Lloyds Bank Pension Scheme* (GMP equalisation), *Pensions Protection Fund v Dalriada*, *IBM*, *Nortel*, *Merchant Navy Ratings* and many others. He has often appeared as advocate against silks on the other side. Edward regularly deals with issues as to scheme funding, s75 debts, equalisation, rectification, trustee and employer duties, interpretation, insolvency, regulatory powers, PPF entry and professional liability, amongst other matters. Chambers & Partners 2023 says "*Edward is hugely experienced and has got amazing technical knowledge – what he doesn't know about pensions isn't worth knowing. He's the safest pair of hands in the Pensions Bar*."

Thomas Robinson
Thomas acts across a wide range of pensions matters, on behalf of scheme trustees, scheme members, employers and bodies such as the PPF and Pensions Regulator. He has advised on matters from the operation of section 67 of the Pensions Act 1995 and section 37 of the Pension Schemes Act 1993 to trustees' duties and the PPF Levy. He has a particular interest in the interplay between pensions and insolvency law, and has written on this topic for pensions and insolvency publications. He is also instructed on rectification matters, both as sole counsel and as part of a team. The Legal 500 2023 says "*Tom is extremely knowledgeable regarding all aspects of pension law*", while Chambers & Partners notes that he "*finds the quickest and most effective route to achieving his client's aims*".

Jennifer Seaman
Jennifer is an established junior in the field of pensions and is recommended in both Chambers & Partners and The Legal 500 for her pensions experience. Her recent cases in this area have included wide-ranging issues such as the professional negligence of actuaries and solicitors; the construction and rectification of pension deeds and rules; the validity of deeds and estoppel and the proper exercise of pension trustee powers. She has also acted for the Pensions Regulator, including in an oral hearing before the Determinations Panel in a Master Trust case. Jennifer is a co-author of Tolley's Pension Law chapter: "Dispute Resolution and Pension Scheme Litigation". The 2023 edition of Chambers & Partners highlights that "*she has a great manner with clients and inspires confidence*".

Michael Ashdown
Michael has an extensive pensions practice , acting for both trustees and employers, as well as the Pensions Regulator and the Pensions Ombudsman. He is regularly instructed as sole counsel, and as part of a larger team, and his practice encompasses both litigation and non-contentious advice and drafting. He has appeared in important cases including *British Airways v Airways Pension Scheme Trustee Ltd* (both at the High Court trial and in the Court of Appeal), and the *Silentnight* regulatory case. Michael is ranked as a leading

junior in both The Legal 500 and Chambers & Partners for Pensions and Trusts, the latter of which describes him as "*an absolutely superb barrister*".

Joseph Steadman
Joseph has been recognised by the Legal 500 since 2022 as a Rising Star at the Pensions Bar. He has experience of acting in contentious and non-contentious pensions matters for trustees, employers, members and the Regulator. For five years between 2017 and 2022, Joseph combined his practice in Chambers with a consultancy role in the pensions, incentives and employment team at a Magic Circle law firm. Through that role, he gained extensive expertise and experience across the spectrum of pensions work, which he brings to bear in his own advice and advocacy. Chambers & Partners 2023 describe Joseph as "*as "an absolute brain on a stick" whose "advocacy is phenomenal"*", while The Legal 500 notes that he "*offers sensible, pragmatic and commercial advice*".

John Grocott-Barrett
John joined Chambers in September 2022 on successful completion of pupillage. Since then, John has appeared both in the County Court and in the Business and Property Courts. Having gained experience across the range of Chambers' work, John is now building a broad commercial chancery practice. He is equally happy to be instructed as sole counsel or as part of a team. His pensions experience includes a dispute concerning the validity, proper construction and rectification of various deeds, and a pensions-related professional negligence claim. John has also written on the alienation and forfeiture of benefits from occupational pension schemes for the website of Paul Newman KC. Before becoming a barrister, John worked for two years at a Big Four firm, EY, in its Corporate Governance team.

Pensions and the Equality Act 2010 (EqA)

Thomas Robinson and Jennifer Seaman

Direct and indirect discrimination in pension schemes

1. The law governing direct and indirect discrimination in employment and other fields in Great Britain[1] is now contained in the Equality Act 2010 ("EqA"). That act came into force on 1 October 2010, and covers the particular field of occupational pension schemes in Chapter 5.

2. The EqA uses what it itself describes as several "key concepts" (see Part 2 of EqA). The first of these are the "protected characteristics". They are listed in s.4 EqA and all are at least potentially relevant to pension schemes:
   age;
   disability;
   gender reassignment;
   marriage and civil partnership;
   pregnancy and maternity;
   race;
   religion or belief;
   sex;
   sexual orientation.

3. Further details of each of these are given in the following sections (s.5-12 of EqA). For example for the protected characteristic of age, s.5(1) provides that "*a reference to a person who has a particular protected characteristic is a reference to a person of a particular age group*", which can include a group defined by a range of ages, as well as one particular age.

4. The next "key concept" to have in mind is that of "prohibited conduct". This is identified in Chapter 2 of EqA and starts with direct discrimination, then covers discrimination because of something arising in consequences of disability, specific forms of discrimination in relation to maternity, and at s.19 defines indirect discrimination.

5. Other prohibited conduct is the failure to comply with the duty that the EqA imposes to make adjustments that will avoid practices, criteria etc from putting

[1] With a few exceptions the EqA 2010 does not form part of the law of Northern Ireland.

disabled people at a substantial disadvantage (s.20), and the prohibited conduct of harassment and victimisation (s.26 and 27 EqA). These different types of "prohibited conduct" are all focussed on the protected characteristics listed in s.4. Harassment in this context is conduct "*related to a relevant protected characteristic*" which has the purpose or effect of violating the victim's dignity or creating a hostile or similar environment for them (s.26(1)).

6. The rest of the EqA then defines the contexts (or "areas of activity" as they are also known) in which prohibited conduct is unlawful, such as premises and "work". Notably for our purposes, "work" includes occupational pension schemes. Different areas of activity are addressed under different parts of the EqA. They include: the provision of public services (which includes goods and facilities); the disposal of premises; education; and associations.

7. Unless "prohibited conduct" in relation to a "protected characteristic" falls within one or more of those areas of activity, it falls outside of the EqA and is not unlawful.

8. The "area of activity" of occupational pension schemes is covered in Chapter 2 of Part 5 of EqA. It contains only three sections, ss.61-63, but others are in fact relevant to pension schemes too, including the sex equality rule under s.67.

9. Section 61 is critical. It provides for a "non-discrimination rule" ("NDR"):

   61 Non-discrimination rule

   (1) An occupational pension scheme must be taken to include a non-discrimination rule.

   (2) A non-discrimination rule is a provision by virtue of which a responsible person (A)—

   (a) must not discriminate against another person (B) in carrying out any of A's functions in relation to the scheme;

   (b) must not, in relation to the scheme, harass B;

   (c) must not, in relation to the scheme, victimise B.

   (3) The provisions of an occupational pension scheme have effect subject to the non-discrimination rule.

   (4) The following are responsible persons—

   (a) the trustees or managers of the scheme;

   (b) an employer whose employees are, or may be, members of the scheme;

   (c) a person exercising an appointing function in relation to an office the holder of which is, or may be, a member of the scheme.

   (5) A non-discrimination rule does not apply in relation to a person who is a pension credit member of a scheme.

   (6) An appointing function is any of the following—

(a) the function of appointing a person;

(b) the function of terminating a person's appointment;

(c) the function of recommending a person for appointment;

(d) the function of approving an appointment.

(7) A breach of a non-discrimination rule is a contravention of this Part for the purposes of Part 9 (enforcement).

(8) It is not a breach of a non-discrimination rule for the employer or the trustees or managers of a scheme to maintain or use in relation to the scheme rules, practices, actions or decisions relating to age which are of a description specified by order by a Minister of the Crown.

(9) An order authorising the use of rules, practices, actions or decisions which are not in use before the order comes into force must not be made unless the Minister consults such persons as the Minister thinks appropriate.

(10) A non-discrimination rule does not have effect in relation to an occupational pension scheme in so far as an equality rule has effect in relation to it (or would have effect in relation to it but for Part 2 of Schedule 7).

(11) A duty to make reasonable adjustments applies to a responsible person.

10. A number of points should be made.

    a. since this section came into force in October 2010, every pension scheme is to be taken to have an NDR. Not only is the NDR treated as being a provision of the scheme's governing documentation, but s.61(3) means that the remainder of the documentation has effect subject to the NDR. In *London Fire Commissioner v Sargeant* [2021] ICR 1057, [2021] Pens LR 12 the EAT held that, in a statutory public service scheme, the NDR overrides discriminatory provisions in the relevant statutory instrument establishing the scheme. The EAT said:

       '113. Thus, if, as here, a provision of an occupational pension scheme, though

       contained in subordinate legislation, would oblige a responsible person to
       discriminate against another person on the ground of age, that provision is subject
       to the non-discrimination rule, which the scheme must be taken to include.
       That rule obliges the responsible person not to discriminate. Accordingly, by
       reason of the hierarchy of obligations provided for, the responsible person, by

discriminating against that person, breaches the rules of the scheme (the non-discrimination rule having precedence) and thereby contravenes the Equality Act (subsection (7)).

......

b. Section 61 uses the concept of a "responsible person". The NDR is a rule under which a "responsible person" must not discriminate against another. The focus is on those in positions of responsibility in relation to the scheme. Hence the definition of "responsible person" includes the trustees and employers of members & those eligible to join.

c. The rule prohibits discrimination by a "responsible person" (see above) in carrying out their functions in relation to the Scheme. It also prohibits harassment and victimisation, also as long as it is "in relation to the scheme". The relevant area of activity here is the operation of an occupational pension scheme, and the NDR is limited in its scope to that area.

d. At the end of the day however the NDR is a prohibition on discrimination, harassment or victimisation by the responsible person. As its name suggests, without discrimination there is nothing for the rule to bite on. The then President of the Employment Appeal Tribunal ("EAT"), Choudhury P, put it as follows in *Parker v MDU Services Ltd* UKEAT/0113/17/DA at [47]:

   "*the essential ingredient of any claim under s.61(1) would be to establish that there was discrimination within the meaning of the 2010 Act*".

11. Section 62 allows trustees and managers of schemes to remove any inconsistencies between the NDR and the rules of their scheme where to do so using the amendment power of the scheme may be impracticable or even impossible. The section uses the concept of a "non-discrimination alteration", which it defines as "such alterations to the scheme as may be required for the provisions of the scheme to have the effect that they have in consequence of section 61(3)". That is the subsection that means scheme provisions have effect "subject to" the NDR. The trustees or managers might be able to make such alterations using the scheme's amendment power, but s.62 recognises they may not have the power to do so. If not, and even if they do but the process would be impracticable, then s.62 allows theym to do so by way of resolution. Hence the Government's Explanatory Notes to the Bill for this Act say as follows:

- *Changes to the scheme rules of a large scheme require consultation with all the members before they may be made. This is impracticable, particularly as some deferred members cannot be traced. Scheme trustees may make the necessary alteration to scheme rules relying on this power."*

12. Note that by s.62(4) a non-discrimination alteration can have retrospective effect. They "*may have effect in relation to a period before the date on which they are made*."

Express exemptions in the Age Exceptions Order 2010

13. This part of the paper is relevant to only one of the "protected characteristics", namely age. Age discrimination was not prohibited in employment relationships until 2006, by the Employment Equality (Age) Regulations 2006 (SI 2006/1031). These Regulations came into force on 1 December 2006 for pension matters.

14. From 1 October 2010 these regulations have been replaced by the EqA but also (for pensions) by the Equality Act (Age Exceptions for Pension Schemes) Order 2010 (SI 2010/2133) ("Age Exceptions Order"). The Age Exceptions Order exempts various practices, actions and decisions relating to age which are described in the Age Exceptions Order. Section 61(8) of EqA provides for certain practices not to breach the NDR, where they are specified by an order of a Minister. The Age Exceptions Order duly lists them, in Schedule 1 thereto. They include:

    a. Admission to schemes: use of minimum or maximum ages as admission criteria is exempted.
    b. the use of age criteria in actuarial calculations.
    c. Contribution rates. It is not age discrimination to have different member or employer contribution rates for different members where this is because of a difference in the pensionable pay or different accrual rates of those members;
    d. A minimum age for enhanced redundancy benefits or ill health benefits; and
    e. The closure of a scheme or a section of a scheme from a particular date to workers who have not already joined it.

The "defence" of justification

15. EqA provides for a "defence" of justification in relation to a number of types of prohibited conduct. They include indirect discrimination and discrimination arising from disability, but most importantly for us they include direct discrimination on the grounds of age.

16. Thus the first and most effective response to a complaint of age discrimination is likely to be to show that the conduct complained of falls in the Age Exceptions Order. However if that is not possible, the next response is likely to be to argue the conduct is justified.

17. Although justification is often called a defence, in fact EqA is drafted on the basis that if the test of justification is met, the conduct was not in fact discrimination at all. The relevant test is that under s.13(2):

"If the protected characteristic is age, A does not discriminate against B if A can show A's treatment of B to be a proportionate means of achieving a legitimate aim".

18. The test is objective. The structure of it is first to identify the aim of the treatment in question and consider whether that aim is legitimate, and then (and only then) to ask whether the treatment was a proportionate means of achieving that aim. Put another way, were the means used appropriate to meet that aim, and reasonably necessary to do so?
19. The approach to be adopted by an employment tribunal was described as follows by the EAT in *McAllister v HMRC* [2023] ICR 483 at [54]:

"(1) The burden of proof is on the respondent to establish justification: see British Airways plc v Starmer [2005] IRLR 863, para 31 .
"(2) The classic test was set out in Bilka-Kaufhaus GmbH v Weber von Hartz (Case 170/84) [1987] ICR 110 , in the context of indirect sex discrimination. The Court of Justice, at para 36, said that the court or tribunal must be satisfied that the measures must 'correspond to a real need ... are appropriate with a view to achieving the objectives pursued and are necessary to that end'. This involves the application of the proportionality principle, which is the language used in regulation 3 [of the Employment Equality (Age) Regulations 2006] itself. It has subsequently been emphasised that the reference to 'necessary' means 'reasonably necessary': see Rainey v Greater Glasgow Health Board [1987] ICR 129, 142–143 , per Lord Keith of Kinkel.
"(3) The principle of proportionality requires an objective balance to be struck between the discriminatory effect of the measure and the needs of the undertaking. The more serious the disparate adverse impact, the more cogent must be the justification for it: Hardy & Hansons plc v Lax [2005] ICR 1565 , per Pill LJ, at paras 19–34, Thomas LJ, at paras 54–55 and Gage LJ, at para 60.
"(4) It is for the employment tribunal to weigh the reasonable needs of the undertaking against the discriminatory effect of the employer's measure and to make its own assessment of whether the former outweigh the latter. There is no 'range of reasonable response' test in this context: Hardy & Hansons plc v Lax."

20. In terms of legitimate aims that will satisfy s.13(2), the guidance from the Equality and Human Rights Commission (below) states that for an aim to be legitimate it must pursue "social policy objectives", e.g. relating to the labour market or employment policy. There are certainly decisions of the ECJ supporting that

approach,[2] although other decisions of the ECJ[3] recognise that there may be other factors in play too, such as cost factors, which do not mean that the aim is not legitimate when taken as a whole.

21. The trustees can rely on the employer's justification for an allegedly discriminatory practice if faced with a claim for age discrimination based on that same practice. The trustees (and other respondents) can also rely on a justification that had not even occurred to the alleged discriminator at the time of the alleged discrimination: an ex post facto justification can be deployed (*Seldon v. Clarkson Wright and Jakes* [2012] I.C.R. 716).

22. Useful sources for the defence of justification include the supplement to the Equality and Human Rights Commission's Statutory Code of Practice on Employment. This identifies acceptable legitimate aims as including "rewarding experience" and "promoting access to employment for younger people", among other aims. Several of these are also recognised in *Seldon*.

Available Remedies for discrimination in pension schemes

23. As set out above, in the EqA there exists different bases on which a discrimination claim could be brought. In this paper, I will focus on remedies for claims based on:
    a. S.61 EqA – the non-discrimination rule (NDR) (above, para 9-10) and
    b. S.66-67 EqA – Sex equality clauses and rules. Under s.67 EqA, occupational pension schemes are treated as including a sex equality rule, which is a provision which modifies terms so they are not less favourable to A than to B. Under s.66 EqA, the terms of A's work is treated as including a sex equality clause which modifies terms so employees' terms are not less favourable to each other.

24. This focuses on the interpretation of s.120, s.124, s.126, s.127-129, s.133-134 EqA.

(1) <u>Jurisdiction of the Employment Tribunal in discrimination claims</u>

25. Discrimination claims are mainly brought in the Employment Tribunal ('**ET**'). The ET has statutory specified jurisdiction for determining matters under the EqA which is found in, s.120:
    a. Under s.120(1)(a) EqA, an ET has jurisdiction to determine a complaint relating to Part 5 of the EqA ("Work")

[2] Heyday [2009] IRLR3 73.

[3] Fuchs & Kohler [2012] All ER (EC) 863.

i. - Chapter 2 of Part 5 relates to Occupational Pension Schemes and contains the non-discrimination rule at s.61.
ii. Chapt 1 of Part 5 of EqA covers "Employment, etc" and covers discrimination in respect of the way in which an employer affords staff access to occupational pension schemes in their terms of employment for example.

b. An ET has jurisdiction to determine an application by a "responsible person" [s.61(4), e.g. trustees or managers, or employer] for a declaration as to the rights of that person and a worker in a dispute about s.61 and the non-discrimination rule. (see s.120(2) and s.120(3) contains similar provisions).
c. An ET has jurisdiction to determine a question that relates to the non-discrimination rule and is referred to the ET by a court under s.122 EqA (s.120(4)).

26. S.127 sets out the jurisdiction of ET in relation to cases involving sex equality rules and equality clauses.

(2) <u>The Civil Courts</u>

27. The civil courts are not prevented from considering a claim that an occupational pension scheme has operated in a discriminatory manner (s.122 EqA and s.128 EqA), but the court can (i) strike out the claim (ss(1)), or (ii) refer the matter to an ET, and stay or sist the proceedings in the meantime (ss(2)), if it would be more convenient for an ET to hear it.

(3) <u>Time limits to bring a claim</u>

28. A claimant needs to act quickly if they are going to bring a discrimination claim in the ET.

29. Generally, proceedings under s.120 cannot be brought after the end of 3 months starting with the date of the act to which the complaint relates (s.123(1)(a)).

30. There is discretion for the ET to extend this, to such other period as they think is just and equitable (s.123(1)(b)).

31. Time limits for bringing a claim for breach of an equality clause or equality rule or to apply for a declaration about the effect of such a clause or rule are generally no later than 6 months after the end of the employment contract under s.129 EqA.

(4) <u>Remedies under EqA in the context of occupational pension schemes.</u>
<u>Remedies for breach of s.120(1)</u>

32. S.126 applies if the ET finds there has been a contravention of a provision referred to in s.120(1) in relation to:
    a. The terms on which persons become members of an occupational pension scheme, or

b. The terms on which members of an occupational pension scheme are treated.

33. S.126 dictates the remedies that the ET can award in these scenarios. S.126 states that the ET can do anything under s.124 EqA (subject to the provisions in s.126) including:
    a. Making a declaration as to the rights of the complainant and the respondent in relation to the matters to which the proceedings relate (s.124(2)(a)).

    b. Making an appropriate recommendation (s.124(2)(c)). This is a recommendation that within a certain period the respondent takes specified steps for the purpose of obviating or reducing the adverse effect on the complainant of any matter to which the proceedings relate (s.124(3)). If a respondent fails, without reasonable excuse to comply with an appropriate recommendation, the tribunal may (a) increase the amount of compensation to be paid; or (b) make an order for compensation (s.124(7)).

    c. Also, if the complaint relates to the terms on which persons become members of a scheme, the ET can order that the complainant has a right to be admitted to the scheme. If the complaint relates to the terms on which members of the scheme are treated, the ET can order that the complainant has a right to membership of the scheme without discrimination (s.126(2) and see s.126(4)).

    d. The ET can also order the respondent to pay compensation to the complainant (s.124(2)(b)). **But importantly, under s.126(3), the ET cannot make this order unless (a) the compensation is for injured feelings or (b) the order is made under s.124(7) – order for compensation if the respondent fails without reasonable excuse to comply with an appropriate recommendation.** The amount of compensation corresponds to the amount which could be awarded by the county court under s.119 EqA (remedies for breach of s.114 EqA – jurisdiction of the county court) (s.124(6)) i.e. assessed in the same way as any other claim in tort.

34. If the ET finds that there is indirect discrimination under s.19 EqA, but is satisfied that the provision, criterion or practice was not applied with the intention of discriminating against the complainant, then the ET cannot make an order for compensation under s.124(2)(b), unless it first considers whether to act under ss.(2)(a) or (c) [making a declaration or recommendation].

Specific provisions for breach of sex equality rule or clause

35. s.133 EqA governs remedies in pension cases for breach of the sex or maternity equality rule or the sex or maternity equality clause regarding membership or rights in an occupational pension scheme. A court or ET can make a declaration

as to the rights of the parties and must not order arrears of benefits or damages or any other amount to be paid to the complainant (s.133(2)), but this does not apply if s.134 applies.

36. s.134 EqA governs remedies in claims for arrears brought by pensioner members relating to breach of an equality clause or rule with respect to a term on which the member is treated. Here the Court or ET may make a declaration as to the rights of the complainant and respondent and order an award by way of arrears of benefits or damages or of any other amount in relation to the complainant.

37. Under s.134, generally (apart from a 'concealment' or 'incapacity' case) a court or ET may not order that arrears of benefit or damages be paid in respect of a time six years before the proceedings were commenced. In *Lloyds Banking Group Pensions Trustees Ltd v. Lloyds Bank PLC & Ors* ("*Lloyds 1*") [2019] Pens LR 5, Morgan J held that s.134 EqA infringed the European principle of equivalenence (the rules laid down by the domestic legal system must not be less favourable than those governing similar domestic actions [440(3)) by imposing a 6 year limitation period, as opposed to claims by beneficiaries seeking to recover arreas of payments where the trustees are in possession of trust assets (no limitation period under LA 1980 s.21(1)(b)) ([447] and [472(11)]), and held that the position should be governed by the rules of the Scheme and the Limitation Act 1980, where Morgan J found that there was no period of limtiation under s.21(1)(b). It is interesting to question the status of *Lloyds 1* after the European Union (Withdrawal) Act 2018 and IP day – does s.134 EqA apply or LA 1980 s.21(1)(b) (see further, paragraph 44(iii) below in the context of *Beattie*, s.126 EqA and the general principle of 'effectiveness')?

(5) Injury to feelings

38. Injury to feelings encompasses "feelings of upset, frustration, worry, anxiety, mental distress, fear, grief, anguish, humiliation, unhappiness, stress, depression and so on" (*Vento v Chief Constable of West Yorkshire Police (No 2)* [2003] IRLR 102, per Mummery LJ at [50]). Such awards are virtually inevitable, to reflect the fact that any act of discrimination is likely to cause hurt to feelings at least to some minor degree.

39. As set out above, the ET can order compensation for injury to feelings under s.126(3), and is given a statutory foundation to do so under s.119(4) EqA. In the leading case of *Vento v Chief Constable of West Yorkshire Police (No 2)* [2003] IRLR 102, the CA set clear guidelines for the amount of compensation to be given for injured feelings, and set out 3 bands of potential awards:

- Lower band ("less serious cases, such as where the act of discrimination is an isolated or one-off occurrence"). The Presidential Guidance on Vento Bands suggests such an award is £1,100-£11,200.
- The middle band ("serious cases, which do not merit an award in the highest band".) Band now is £11,200-£33,700.

- The top band ("the most serious cases, such as where there has been a lengthy campaign of discriminatory harassment on the ground of sex or race".) Band now is £33,700 - £56,200.

40. The ET will focus on the effect the discriminatory act has had on the particular claimant. Factors include the vulnerability of the claimant (e.g. medical conditions, and mental health), the degree of hurt, distress or upset caused, the position of the person who was found to be discriminating and the nature of the claimant's job, and the seriousness of the treatment by the discriminator.

41. An injury to feelings award is not punitive, but is intended to be compensatory. Also a claimant does not necessarily need to show medical evidence of injury to feelings, but it might help.

42. Aggravated and punitive or exemplary damages can also technically be awarded on top. They are not specifically mentioned in the EqA.

(6) <u>Is there jurisdiction for the ET to award damages for breach of s.61 EqA outside of compensation for injury to feelings (the operation of s.126(3))</u>

43. On its face, s.126(3) EqA limits the compensation available to claimants who suffer discrimination in occupational pension cases to compensation for injury to feelings.

44. Is there a way around this?

(i) The ET could make a <u>recommendation</u> for a financial award under s.124(2)(c), i.e. within a certain period the respondent pays £x amount to the complainant for the purpose of obviating or reducing the adverse effect on the complainant of any matter to which the proceedings relate.

But case law suggests that this is problematic. In *Prestcold Ltd v Irvine* [1981] ICR 777, a woman applied to be promoted to the post of service administration manager but her employers appointed a man. A tribunal upheld her complaint that the employers had unlawfully discriminated against her on the ground of sex and awarded her compensation under s.65(1)(b) of the Sex Discrimination Act 1975[4], ordering that she should be paid the net difference between her salary and the higher salary of the service administration manager up to the date of the hearing and for a further 4 months. The Tribunal also made a

[4] An order requiring the respondent to pay to the complainant compensation of an amount corresponding to any damages he could have been ordered by a county court or by a sheriff court to pay to the complainant if the complaint had fallen to be dealt with under section 66.

recommendation under s.65(1)(c) of the Act[5] that she should be considered for the post when it became vacant and that, in the alternative, she should continue to be paid the difference between the two salaries until she was appointed to that or an equivalent post. The CA held that the power conferred on the tribunal by s.65(1)(c) did not extend to ordering the payment of remuneration, since monetary compensation for loss of remuneration was fully provided for under s.65(1)(b), and it was "*not necessary for the protection of the complainant*". Also, the language of sub-section (1)(c) was not apt to cover recommendations as to payment of remuneration: the "*words "within a specified period" are inapt to cover a recommendation as to the payment of a particular remuneration during a period which might well extend over several years…*" and "*the payment of remuneration for employment does not, as a matter of the ordinary use of English, fit the description "take within a specified period action…*" (p.782).

There are various points that can be made from this:

- In contrast, under s.126(3) EqA, compensation is not generally provided for. This is different to the position under the old s.65 of the Sex Discrimination Act 1975, so arguably there might be scope for a recommendation of compensation under s.126 EqA.
- However, the language of s.124(2)(c) (making a recommendation) is similar to s.65(1)(c), where the CA found that it was not apt to cover recommendations as to payment of remuneration.
- Also, if recommendations as to remuneration are allowed under s.124(2)(c), arguably that may subvert the parliamentary intention behind the restrictions in s.126(3).

(ii) The ET could make a <u>declaration</u> under s.126(4) EqA as to the terms on which the claimant is to enjoy admission to or membership of the scheme for a period prior to the date the order is made, which could render <u>the scheme</u> liable to pay arrears to the claimant for past inability to accrue benefits under the scheme, which is an indirect way of awarding compensation (i.e via the scheme, rather than from the discriminating employer). This then raises the issue as to whether the scheme is liable for the payment of arrears without a limit of time under s.21(1)(b) of Limitation Act 1990 and/or dependant on the construction of any forfeiture rules in the scheme (see Morgan J in *Lloyds Bank* [2019] Pens LR 5, [2021] Pens LR 10 and *Axminster* [2022] Pens LR 1 and Leech J in *CMG* [2022] EWC 2130 (Ch)).

[5] A recommendation that the respondent take within a specified period action appearing to the tribunal to be practicable for the purpose of obviating or reducing the adverse effect on the complainant of any act of discrimination to which the complaint relates.

(iii) A further potential alternative argument is that s.126 EqA is contrary to the general principle of 'effectiveness' or 'effective judicial protection' in art 47 of the EU Charter of Fundamental Rights or the requirement to provide an effective remedy for age discrimination under the Equal Treatment Directive 2000/78/EC (the "Framework Directive") (see Article 9(1) and 17[6]). Such an argument is now extremely difficult after *SoS for Work & Pensions v Beattie* [2022] EAT 163 and Schedule 1 para 3 of the EU Withdrawal Act 2018 (the Charter or general principles of EU law cannot after IP completion day (31 Dec 2020) be relied on lead to the disapplication or quashing of any enactment or other rule of law) (due to be amended in the Retained EU Law (Revocation and Reform) Bill 2022-23 (see a useful article on Practical Law Brexit for an overview of the Bill - Clause 4 of the Bill currently amends the 2018 Act to remove from UK law the effects of general principles of EU law from the end of 2023). In *Beattie*, the claimants complained to an ET that the reduced compensation paid by the trustee during the scheme's PPF assessment period amounted to direct age discrimination and breach of s.61 EqA, and that the exemption in art 3 of the Equality Act (Age Exceptions for Pension Schemes) (Amendment) Order 2010 was contrary to general principles of EU law or alternatively with the Equal Treatment Framework Directive. The EAT held the Framework Directive cannot be directly invoked against the trustee and a court obligation to disapply inconsistent domestic legislation (excluding the operation of the Withdrawal Act) can only arise in repsect of directly effective EU law [118]. Further, the EAT highlighted that under Sch 1, para 3 of the Withdrawal Act, it would no longer be open to a court or tribunal to disapply a domestic enactment on the basis that it was incompatible with the general principles of EU law after the IP completion day.

(iv) Perhaps it could be argued that the EU principle of providing an effective remedy for discrimination (existing irrespective of the EU Charter) is a retained

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[6] Article 9: Defence of rights

1. Member States shall ensure that judicial and/or administrative procedures, including where they deem it appropriate conciliation procedures, for the enforcement of obligations under this Directive are available to all persons who consider themselves wronged by failure to apply the principle of equal treatment to them, even after the relationship in which the discrimination is alleged to have occurred has ended.

Article 17: Sanctions

Member States shall lay down the rules on sanctions applicable to infringements of the national provisions adopted pursuant to this Directive and shall take all measures necessary to ensure that they are applied. The sanctions, which may comprise the payment of compensation to the victim, must be effective, proportionate and dissuasive.

fundamental right or principle under s.5(5) of the Withdrawal Act and that the power to grant a recommendation under s.124 EqA should include compensation for financial loss against an employer in relation to an occupational pension scheme and be interpreted in an expansive way (rather than asking the court to disapply s.126(3)), and also that *Prestcold* should be distinguished for the reasons set out above.

Reflections on Firefighters and Police Pensions Litigation

(1) Background

45. In 2015, changes were introduced to police officers and firefighters (and judges) pension entitlements, whereby younger employees were excluded from earlier established statutory occupational pension schemes and moved into new pension schemes which they argue are less generous. This was part of a widescale amendment to public sector schemes.

46. In claims brought by judges and firefighters, those changes were found by the CA to be unlawful direct age discrimination (see *Secretary of State for the Home Department & Ors v. Sargeant & Ors* and *McCloud v Lord Chancellor & Ministry of Justice* [2018] EWCA Civ 2844), and an application for permission to appeal was refused by the SC.

47. Initial estimates suggest that the cost of remedying the discrimination will add around £4bn p/a to scheme liabilities from 2015. There have been recent hearings on which scheme is to bear the liability for the costs of the remedy.

48. Further, in "*Sargeant II*" [2021] UKEAT 0137, the EAT held that the effect of s.61 EqA was to insert a non-discrimination rule into the firefighters pension scheme in question which automatically overrides any provisions in the scheme which would otherwise constitute unlawful discrimination.

49. Thousands of ET claims have now been brought by police officers alleging that the move of younger police officers into the new 2015 pension schemes whilst their older colleagues remained in legacy schemes was unlawful direct age discrimination in breach of the non-discrimination rule in s.61 EqA.

50. On 15 July 2019, the Government accepted that it was required to implement a remedy across all public sector pension schemes affected. The Police Pension Managers admit that the police claimants are entitled to the same full protection as the fully protected members of the legacy schemes, and are now entitled to be provided with benefits under the legacy schemes for the period that they were excluded from such schemes.

51. Statutory remedies are in the process of being introduced by Parliament. The Public Service Pensions and Judicial Offices Act 2022 has been enacted on 10 March 2022, which is intended to provide a framework for a remedy for all members of the public service pension schemes who have suffered discrimination by reason for the 2015 reforms. All eligible members will be offered a choice, at retirement or death, to receive benefits for the affected period based on the legacy scheme benefits or the new 2015 scheme benefits. The difficulty is in introducing a <u>retrospective</u> remedy to adjust the position for past service when the affected members were moved out of the legacy schemes. This retrospective remedy raises various, complicated tax consequences which need to be thought through. Retrospective, remedial legislation is due to be in place from October 2023, and the pension managers will then have to implement the process.

52. Certain retired members of the police and firefighters pension schemes are claiming that they are suffering an immediate detriment in not receiving benefits under the legacy schemes for the period they were not members of those schemes and want to seek immediate redress now before the remedial legislation is in place. The police have issued at two pronged attack:
    - In so-called "*Slade/Roderick*" claims - Thousands have brought claims in the ET seeking:
        - Declarations as to their rights in relation to their pension benefits under the schemes without discrimination; and
        - Orders that the SoS for the Home Department and the relevant chief officer in whose force they served and/or the relevant police pension authority pay compensation, arreas of benefits and/or consequential losses to the claimants, including compensation for injury to feelings.

    - 3 police officers have also brought a 'test case' claim in the KBD (*Dean & ors v. Chief Constable of Merseyside Police & Ors*) seeking declarations, damages (including exemplary damages) and other remedies against the chief officer of their police force, on the grounds that they have breached their statutory duty to pay the claimants their proper pension entitlement under the legacy schemes.

53. The Fire Brigades Union ("**FBU**") issued similar legal proceedings in the High Court on behalf of 3 test claimants who had retired. The FBU then entered into a Memorandum of Understanding to provide for a remedy, and required authorities to process immediate detriment cases before remedial legislation in place. Tax complications were then raised, and the FBU are currently working on an alternative MoU (see the Circular dated 27 March 2023 on the FBU website).

54. In the police litigation (*Dean etc*), the police forces are currently taking a neutral position, and will await the directions of the court as to whether remedies can be awarded before the remedial legislation in place. The Home Office has recently

been added as a defendant and it remains to be seen what position they will take. The claimants have applied for summary judgment, which is due to be heard on 20 July 2023.

55. The litigation could *possibly* raise some interesting points such as:

- Can the police officers seek compensation in the ET, given s.126(3) EqA?
- Will the KBD allow the claims to proceed in that jurisdiction, notwithstanding the existing litigation in the ET. Would the KBD consider exercising its power to strike out the proceedings under s.122 EqA on the basis that the claims could be more conveniently be determined by an ET.
- Will the police pension managers be ordered to pay before the remedial legislation in place?
- Can the police offers claim exemplary damages against the police forces?
- If the claimants are treated as being members of the legacy schemes during the relevant remedy period, and they would have paid higher contributions to those legacy schemes, how should these unpaid contributions be taken in account in the provision of any remedy to the claimants in advance of any legislation coming into force?

How much worse can things get? Pensions and tax when things go wrong

Edward Sawyer and Michael Ashdown

1. Pensions are complicated and sometimes things go wrong. Happily for pensions litigators at least, the things that can go wrong are almost infinitely varied. But the focus of this lecture is on one particular sort of "going wrong", namely the unexpected charge to tax. For all that pensions tax has been modernised and codified, it is still replete with dangers which may catch out the unwary trustee or administrator – or their professional advisers. In this paper we will consider first, mistakes in relation to pensions tax, the possible uses of the mistake jurisdiction, and the impediments to using it as a panacea for pensions tax problems, and second a variety of issues arising in connection with unauthorised payments under the Finance Act 2004 ("FA 2004"), pension liberation, surcharges, and applications to HMRC to discharge liability.

MISTAKES ABOUT PENSIONS TAX

2. Pensions law can sometimes seem like an island entire of itself: although its foundations are rooted in the ordinary English law concepts of trusts and contract, the reality can seem a long way from anything that would be taught in a law school class on these subjects. The vast array of statutory and regulatory provisions, together with the development over recent decades of a sizeable but essentially separate body of pensions case-law, leads readily to thinking of pension law in a silo of its own. But the law of equitable mistake is one area where non-pensions law principles break through. What may be thought to be surprising is that it does not do so more often.

Principles of equitable mistake

3. In the world of private and family trusts, equitable mistake has become the "go to" remedy for fixing tax mistakes, since the Supreme Court in *Pitt v Holt* [2013] UKSC 26 refashioned the *Hastings-Bass* principle in terms which drastically curtailed its use.[7] The idea is a straightforward one: where a voluntary disposition has been

[7] In particular, by requiring that the trustees' failure to take relevant considerations into account (or to leave irrelevant considerations out of account) must be sufficiently serious as to amount to a breach of fiduciary

made – such as a gift, a transfer into trust, or the exercise of a power of appointment – in circumstances which incur an unanticipated tax liability, the disponor may apply to the Court to set aside the disposition on the basis that they would not have made it if they had not been mistaken about the tax position. Many such applications have been, and continue to be, made, often (though not always) successfully.

4. The legal test is also derived from *Pitt v Holt*, but is somewhat broader and arguably more fact-sensitive than the *Hastings-Bass* rule. A mistaken disposition may be set aside (i.e. is voidable, though not void) in circumstances where the disponor has acted under a mistake which is of the relevant type, and which is sufficiently serious to render it unjust or unconscionable on the part of the donee to retain the property transferred.[8] As far as the type of mistake it concerned, a conscious mistake or tacit assumption will suffice, but mere causative ignorance will not,[9] and neither will a misprediction[10] (i.e. as to a future event, rather than a present state of fact of law). There is no longer a strict rule[11] that only mistakes as to the effect, but not the consequences, of a transaction will suffice: Lord Walker held that any causative mistake of sufficient gravity can suffice, albeit that normally this test will be satisfied only by a mistake as to the legal character or nature of the transaction, or as to some matter of fact or law which is "basic" to the transaction.[12] The effect of a successful mistake claim is to render the transaction voidable, and, usually, to set it aside. It is generally assumed that this means that any adverse tax consequences will also be wiped away, though recent case law casts doubt on that as a proposition of general application in pensions cases.

5. Applying the principles of equitable mistake to the pensions context, it is notable that there are relatively few cases of mistake applications being made to undo unforeseen pensions tax liabilities. This paper will therefore consider first both the circumstances in which such applications can usefully be made, as well as some of the barriers to making a successful mistake application in the pensions tax context. Second, it will go on to consider the tax consequences of setting aside a disposition

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duty: *Pitt v Holt* [2013] UKSC 26 at [73], and by making it impossible to establish such a breach in many cases where the trustees have relied on "apparently competent" professional advice (at [80]).

[8] At [101], [103]

[9] At [104], [108].

[10] At [104].

[11] As had previously been understand to be the effect of the judgment of Millett J in *Gibbon v Mitchell* [1990] 1 WLR 1304.

[12] At [121]-[123].

in relation to a pension, and third will look at whether mistake claims can be brought when the pensions context is not merely tax, but tax avoidance.

Availability of equitable mistake claims in the pensions context

6. The starting point, therefore, is to consider where mistake claims could be available in relation to pension schemes. It is sometimes suggested that they are not available at all, because pension schemes are fundamentally contractual, or at least bilateral, in nature. That is to say, in the context of an occupational pension scheme, there is likely to be a bilateral arrangement between employer and trustees, the very existence of the scheme may be pursuant to a contractual obligation, and the benefits conferred on members are not gratuitous, but are rather deferred remuneration, paid in consideration of their work, their own contributions to the scheme, or both.[13] It has rightly been suggested that this has given rise to doubt about the availability of equitable mistake.[14] However, properly understood, these considerations do not rule out the use of equitable mistake to correct pensions tax mistakes.

7. In *Smithson v Hamilton* [2008] 1 WLR 1453, Sir Andrew Park explained[15] that equitable mistake could not be used to set aside a scheme rule said to have a different effect from that which was intended, because the adoption of the scheme's definitive deed and rules (where the errant rule was to be found) was not a voluntary transaction, for the reasons already explained (and a contractual provision could not be set aside for equitable mistake following the Court of Appeal's decision in *Great Peace Shipping Ltd v Tsavliris Salvage (International) Ltd* [2003] QB 679[16]). It was also noted that equitable mistake is normally relied upon to set aside an entire transaction: that would mean setting aside the whole definite deed and rules, and not merely the rule said to be erroneous.[17] There is much to be said for the force of Sir Andrew Park's rejection of the invocation of equitable mistake to set aside, in part, a pension scheme rule. But there will nevertheless be

[13] See e.g. *Smithson v Hamilton* [2008] 1 WLR 1453 at [111]; *Stevens v Bell* [2002] EWCA Civ 672 at [27]; *Sterling Insurance Trustees Ltd v Sterling Insurance Group Ltd* [2015] EWHC 2665 (Ch) at [26].

[14] J Seaman and V Brown "Dispute Resolution and Pension Scheme Litigation" in Tolley's Pension Law at [J1.10A].

[15] *Smithson v Hamilton* [2008] 1 WLR 1453 at [106]-[123].

[16] This provided the basis for Sir Andrew Park to decline to follow the earlier decisions of Lawrence Collins J in *AMP (UK) plc v Barker* [2001] Pens LR 77, and of Etherton J following that decision in *Gallaher Ltd v Gallaher Pensions Ltd* [2005] Pens LR 103. It appeared that Lawrence Collins J had relied on *Solle v Butcher* [1950] 1 KB 671 in relation to mistake in bilateral transactions, but this had been subsequently disapproved in *Great Peace Shipping Ltd*.

[17] *Smithson v Hamilton* [2008] 1 WLR 1453 at [109].

numerous scenarios where these objections do not apply, and equitable mistake is available and useful.

Transfer into a pension scheme

8. The first situation, and perhaps the most obvious analogy with the use of mistake claims in the private trust context, is where the problem arises from the transfer of assets into a pension scheme. In the relatively recent Jersey case of *In the matter of the Representation of P* [2021] JRC 157, the representor had established new Jersey trusts which had been intended to be Qualifying Non-UK Pension Schemes pursuant to s 271A of the Inheritance Tax Act 1984 and the Inheritance Tax (Qualifying Non-UK Pension Schemes) Regulations 2010. Unfortunately it did not comply with "Primary Condition 1" in regulation 5, namely that the scheme be "*open to persons resident in the country or territory in which it is established*". In fact the scheme was only capable of having a single member, the first representor, and there was no mechanism for adding further beneficiaries.[18] The result was that the first representor's transfers of interests in real property in London into the Jersey scheme were immediately chargeable transfers for UK inheritance tax purposes, with a liability of more than £5 million, together with subsequent periodic or exit charges under the "relevant property" regime.[19]

9. The Royal Court set aside both the Jersey trusts and the transfers into them,[20] holding that (i) the representors were mistaken, and the mistake was causative of what was done, because they would never have made the arrangements they did if they had been aware of the tax consequences,[21] (ii) the mistake was a serious one, which resulted in a substantial UK IHT liability,[22] and (iii) the other circumstances pointed to it being unjust to direct the transfers and the Jersey trusts to stand, namely that the representors were dependent on their advisers, and had been advised both by reputable tax accountants and by leading tax counsel in London

[18] At [6].

[19] See Inheritance Tax Act 1984, pt 3, ch 3. The general exemptions from UK IHT for pension schemes is found in s151 of the Act, but applies only to registered pension schemes, Qualifying Non-UK Pension Schemes, and schemes qualifying under the Income and Corporation Taxes Act 1988, s 615(3).

[20] At [23]. There was no suggestion in this case that the Jersey schemes were in any sense bilateral or contractual.

[21] At [13]-[14].

[22] At [15].

that the arrangements would be effective for tax purposes.[23] The effect of the Royal Court's order was to undo the adverse tax consequences.[24]

10. A similar case has been heard in Guernsey, in *M v St Anne's Trustees Ltd* (2018) 23 ITELR 857, albeit as a *Hastings-Bass* rather than mistake case. In that case the Guernsey Court of Appeal set aside the acquisition by a Guernsey pension scheme (which HMRC accepted was a Qualifying Recognised Overseas Pension Scheme) of the shares in two companies which held residential property, which had triggered an unauthorised payment charge by reason of ss 174A and 208 of the FA 2004. However, it is far from clear that the effect of the Royal Court's order would necessarily be to wipe out the unintended tax liability: this point is returned to below.

Unauthorised payments

11. The second situation is the making of unauthorised member payments out of a pension scheme. In *Gresh v RBC Trust Company (Guernsey) Ltd* (2016) 18 ITELR 753, Mr Gresh was a member of the Bankers Trust Company International Pension Plan and the respondent was the trustee. Mr Gresh took professional tax advice in relation to obtaining a distribution from the Plan at the age of 50, and was duly advised that a lump sum paid to him would be tax-free as long as not remitted to the UK.[25] The advice was wrong: payment of a lump sum in these circumstances was an unauthorised member payment which attracted a 40% charge to income tax. It was not disputed that the trustee made a causative mistake in reliance on the tax advice obtained: it would not have made the distribution to Mr Gresh if it had understood the true tax consequences.[26]

12. However, the Royal Court declined to set aside the distribution,[27] accepting HMRC's submission[28] that it had to look closely at the "*injustice (or unfairness or unconscionableness) of leaving a mistaken disposition uncorrected*",[29] and that in this case, viewed objectively, it would not be unconscionable, unjust or unfair to

[23] At [16]-[22].

[24] At [2]. See also: Inheritance Tax Act 1984, s150(1).

[25] At [6].

[26] At [7].

[27] At [58].

[28] Unusually, HMRC had played an active role in these proceedings, having obtained leave from the Guernsey Court of Appeal to intervene: *Gresh v HMRC* [2010] WTLR 1303.

[29] *Pitt v Holt* [2013] UKSC 26 at [126].

leave the distribution in place and for Mr Gresh to have to pay the tax.[30] This is a salutary warning not to assume that proof of a mistake will necessarily lead to the setting aside of a disposition. The Royal Court accepted that this was not a case of artificial tax avoidance where public policy might be relevant[31] (as to which see further below), but it also noted that (i) unlike in some other cases, there was no one apart from Mr Gresh whose interests were affected (e.g. other beneficiaries), and (ii) Mr Gresh had obtained the tax advice himself, and therefore would be the proper claimant if that advice had been negligently given.

13. That said, this remains above all a fact-sensitive evaluation in each case. In *JTC Employer Solutions Trustees Ltd v Khadem* [2021] EWHC 2929 (Ch), HHJ Jarman QC was willing to set aside an escrow arrangement entered into between trustee and member on the basis of a mistake as to the tax law and practice of the UAE Ministry of Finance, and found the requisite unconscionability in (i) the size of the tax charge (45% on a £6 million fund), (ii) the lost opportunity for the trustee to pay the member in tranches in future, some of which might have been paid when Mr Khadem was not UK resident, and (iii) the possibility of the uncorrected mistake exposing the trustee to an action for breach of trust.[32]

Loss of fixed protection

14. The third situation concerns loss of fixed protection. In *Hymanson v HMRC* [2018] UKFTT 667 (TC) Mr Hymanson had obtained a certificate of fixed protection from HMRC pursuant to regulation 3 of the Registered Pension Schemes (Lifetime Allowance Transitional Protection) Regulations 2011, but it was revoked by HMRC after he continued to make contributions to two pension schemes by means of a standing order to his bank.[33] The First-tier Tribunal found that Mr Hymanson did not cancel the standing orders, despite having been advised that he must cease to make contributions, because "*he genuinely did not believe that there was a problem with continuing to make the existing payments*" and "*had a genuine belief that continuing to make the standing order payments would not prejudice his Fixed Protection*".[34] It was not disputed that the ongoing contributions made by standing order resulted in "*benefit accruals*" within the meaning of paragraph 14(4) of schedule 18 to the Finance Act 2011, and that fixed protection was therefore *prima facie* lost. The Tribunal accepted that Mr Hymanson had made a causative mistake:

[30] At [55]-[57].

[31] At [45].

[32] At [50]-[53].

[33] At [2], [13], [26].

[34] At [24].

he consciously believed that it was acceptable, in terms of the fixed protection regime, to continue making the standing order payments to the pension schemes. The result was that he made payments of around £7,000, but suffered a tax loss of around £50,000. This was therefore sufficiently serious to warrant the setting aside of the payments of the impermissible contributions.[35]

15. The First-tier Tribunal followed the decision of Proudman J in *Lobler v HMRC* [2015] UKUT 152 (TCC) that although the Tribunal did not have jurisdiction itself to make an order for rescission, it could ascertain Mr Hymanson's tax position on the footing that the High Court would make such an order if sought.[36] However, in relation to fixed protection, the question was whether HMRC had acted lawfully in revoking Mr Hymanson's fixed protection, which it was entitled to do if it had "*reason to believe*" that there had been benefit accruals.[37] The Tribunal found that HMRC had exercised this power without taking into account that the impermissible contributions were liable to be set aside for mistake, that HMRC's decision was therefore unreasonable, and that Mr Hymanson's appeal against the setting aside of his fixed protection succeeded.[38]

16. More recently, in *Gough v HMRC* [2021] UKFTT 273 (TC), Mr Gough's appeal in similar circumstances failed. However, in that case HMRC successfully argued that, following correspondence, the fixed protection certificate had been returned voluntarily: it had not been formally revoked by HMRC, and so there was no decision against which Mr Gough could appeal.[39] However, Mr Gough's appeal would have failed in any event, because unlike Mr Hymanson, his impermissible contributions were not the result of any mistake of fact or law. In fact Mr Gough had appreciated contributions needed to cease, and had given instructions to that effect. Unfortunately these had not been complied with by the company which dealt with payroll matters for Mr Gough's company, acting as his agent.[40] *Gough v HMRC* does not, therefore, cast doubt on the correctness of *Hymanson v HMRC* in relation to cases where the impermissible contributions do follow from a mistake of the relevant type.

[35] At [69]-[75].

[36] At [79], [92].

[37] Registered Pension Schemes (Lifetime Allowance Transitional Protection) Regulations 2011, reg 11.

[38] At [93]-[95].

[39] At [46].

[40] At [53]-[55].

Tax consequences of set aside

17. These cases all tend to suggest that, notwithstanding the likely unavailability of equitable mistake claims in relation to the contractual and bilateral core of pension schemes, there will be many instances of tax liabilities arising from transfers of assets or the exercise of discretionary powers where it can be an invaluable remedy, and one which might be thought to be under-utilised in the pensions context, by comparison with the plethora of mistake claims brought in relation to private trusts.

18. However, this analysis has all proceeded on the assumption that the utility of such a claim is that when a disposition, or the exercise of a power or discretion, is set aside, the adverse tax consequences are undone automatically. In the case of inheritance tax, there is statutory authority for this proposition, in s 150(1) of the Inheritance Tax Act 1984, which provides that where "*it is shown that the whole or any part of a chargeable transfer ("the relevant transfer") has by virtue of any enactment or rule of law been set aside as voidable or otherwise defeasible – (a) tax paid or payable by the claimant (in respect of the relevant transfer or any other chargeable transfer made before the claim) that would not have been payable if the relevant transfer had been void ab initio shall be repaid to him by the Board, or as the case may be shall not be payable*".

19. In other tax contexts the treatment has been assumed to be essentially the same. In *Pitt v Holt* [2013] UKSC 26, Lord Walker noted, in relation to the consequences of a mistake about tax, that "*if a transaction is set aside the Court is in effect deciding that a transaction of the specified description is not to be treated as having occurred*".[41]

20. In *AC v DC* [2012] EWHC 2032 (Fam), the Court had previously set aside a transaction made by the husband under s 37(2) of the Matrimonial Causes Act 1973.[42] In relation to the tax consequences of having done so, Mostyn J held that: "*The law of tax is not an island entire of itself. Unless a taxing statute says to the contrary the right of the state to charge tax in relation to a given transaction is subject to the effect of that transaction as defined by the general law. In the specific context with which I am concerned there is long-standing authority from the Court of Session (First Division) in Scotland, IRC v Spence (1941) 24 TC 312, never doubted in subsequent tax cases in the English Courts, which says that the tax effects of a transaction will be*

[41] At [130].

[42] This provision permits the Court, in defined circumstances, to set aside a transaction made by a party to financial relief proceedings where it is made with the intention of defeating the claim for financial relief.

annulled retrospectively if it is subsequently found to be voidable, and is declared void."[43]

21. In *Bainbridge v Bainbridge* [2016] EWHC 898 (Ch), this was followed by Master Matthews, who held that whilst Parliament could legislate to tax a purported disposition or transaction – and it would be a matter of construction of the taxing statute in each case to determine whether it had done so – the default assumption would be "*that the tax (whatever it was) should be exigible only where the act or event is ultimately held to be valid and effective under the general law*".[44]

22. However, in 2020 the Court of Appeal decided *Clark v HMRC* [2020] EWCA Civ 204, a decision which has been little remarked upon in this context[45] but which, on one view, effects a drastic change, despite not being a mistake case. The facts were relatively straightforward: Mr Clark procured the transfer of the assets from his SIPP to a new scheme, the Laversham Marketing Ltd pension scheme (the "LML Pension"). The LML scheme had been sold to Mr Clark as a means of freeing the assets from the investment and other constraints applicable to his SIPP.[46] However, the trust deed of the LML scheme did not sufficiently define the benefits to which Mr Clark would be entitled, and following Rose J's decision in *Re LPA Umbrella Trust* [2014] Pens LR 319, they were void for uncertainty.[47] The tax issue that arose was that it was agreed that, if there was a payment at all from the SIPP to the LML Pension, it was an unauthorised member payment, and so liable to 55% income tax (40% unauthorised payments charge, plus 15% unauthorised payments surcharge[48]). The principal issue was whether there was a payment at all: it was accepted that the assets transferred from the SIPP were held not on the terms of the LML Pension, but on resulting trust for the SIPP by reason of the voidness of the LML Pension trusts.[49] It might be thought that, following the cases already referred to, the consequences would be straightforward: there was no valid transfer to the LML scheme, and therefore nothing to be taxed. The Court of Appeal thought differently, holding that it would be "*deeply unrealistic to approach the question whether the Suffolk Life Transfer* [i.e. the transfer from the SIPP] *was a "payment"*

[43] At [31].

[44] At [38].

[45] An honourable exception being its thorough treatment by the late Rodney Stewart Smith: "Tax consequences of setting aside a voidable transaction on the ground of mistake" (2020) 26 Trusts & Trustees 728.

[46] At [1]-[3].

[47] At [4].

[48] FA 2004, ss 208, 209.

[49] At [37].

for the purposes of section 160(2) on the basis that the failure of the trusts of the LML Pension should, without more, prevent the subsection from applying" [50] Applying a "*practical and common-sense perspective*", Henderson LJ considered that it was obvious that there had in fact been a payment – £2.115 million had passed from the SIPP to the LML Pension – and that it did not make a difference that the transfer was defective and gave rise to a resulting trust.[51] Mr Clark was said to be "*responsible for bringing about a situation where an ostensible recognised transfer between registered pension schemes was in fact nothing of the sort*", and the charge to tax would be "*self-defeating*" if it could be disapplied by reason of the fact that the transfer was not effective in law.[52] The Court also considered the language of the FA 2004 did not point away from this approach.[53] Finally, Henderson LJ concluded that "[t]*he concept of a charge to tax which can vary in amount, or even be negated, depending on the happening of events subsequent to those which gave rise to the assessment, seems to me a very strange one which Parliament is most unlikely to have contemplated*".[54]

23. It might be said that *Clark v HMRC* is quite different from the mistake cases already considered, simply because it does not involve the Court exercising its jurisdiction to set aside a transaction. The problem with that line of argument is that one would normally expect the case of a void transfer to be *a fortiori*: if no tax is due on a presumptively valid disposition because it is subsequently found to be voidable and is set aside, still less should tax be due on the same disposition if it is void *ab initio*. It is therefore hard to avoid the conclusion that when Henderson LJ stated that it would be "*very strange*" if a charge to tax could be negated by subsequent events, that would squarely include the subsequent setting aside of the transaction which gave rise to the charge to tax. At least as far as the FA 2004 is concerned, it cannot now safely be assumed that setting aside a transaction for mistake will eliminate any adverse tax consequences. However, three further points are worth drawing out.

24. First, even if this is correct, this will not apply to all mistake claims. *Clark v HMRC* is only authority in relation to unauthorised payments and the FA 2004. This analysis would not have any application to *Hymanson v HMRC*, for example, where entirely different questions arose. It would not apply to *In the matter of the Representation*

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[50] At [39].

[51] At [40].

[52] At [41].

[53] At [53].

[54] At [79].

of P [2021] JRC 157, since the tax there was inheritance tax and section 150(1) of the Inheritance Tax Act 1984 would apply.

25. Second, it is notable that *Clark v HMRC* was not a very attractive case. The money had been transferred from the SIPP to the LML Pension some years before the claim was brought, with the result that Mr Clark had had "*unfettered use of it for over ten years*".[55] This may therefore be the sort of case where, if it had depended on the Court ordering that the transfer be set aside, it would have declined to do so.

26. Third, it cannot now be assumed that HMRC will not take this point. It has not always done so in the past: it would have been open to HMRC in *Gresh v RBC Trust Company (Guernsey) Ltd* (2016) 18 ITELR 753 to assert that, even if Mr Gresh's distribution could be set aside for mistake, the unauthorised member payment income tax charge would remain. However, it did advert to this point in *M v St Anne's Trustees Ltd* (2018) 23 ITELR 857. There a scheme had been established in Guernsey, approved under the Income Tax (Guernsey) Law 1975, and also accepted by HMRC as a Qualifying Recognised Overseas Pension Scheme.[56] The member, having borrowed £2.6 million from the Guernsey scheme, sought to repay it by transferring to the scheme his shares in Bermudian and BVI companies which owned real property in London and Florida.[57] This triggered an unauthorised member payment charge under ss 174A and 208 of the FA 2004, as well as an additional possible charge on rent received or deemed rental income under s 185A.[58] The Guernsey Court of Appeal set aside the trustee's acceptance of the shares on the basis that its failure to consider the tax position was a sufficiently serious breach of fiduciary duty in accordance with Lord Walker's judgment in *Pitt v Holt* [2013] UKSC 26, and followed Mostyn J in *AC v DC* [2012] EWHC 2032 (Fam) in relation to the tax consequences. However, HMRC was not a party to these proceedings, and so was not bound by the Guernsey Court of Appeal's decision. HMRC had twice been invited to take part in these proceedings, but had declined to do so, and had made representations by letter. HMRC appeared content to proceed in this way because it "*takes the view that the restoration of the status quo ante by the court would not affect the applicability of the charge to tax caused by the triggering event of the original transfer*".[59] That rather suggests that, even back in 2017 when *M v St Anne's Trustees Ltd* was first heard in the Guernsey Royal Court, HMRC were foreshadowing the argument on which they ultimately succeeded in *Clark v HMRC*.

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[55] *Clark v HMRC* [2020] EWCA Civ 204.

[56] At [3]-[4].

[57] At [5]-[12].

[58] At [13].

[59] *M v St Anne's Trustees Ltd* (2018) 21 ITELR 222 at [12].

Tax avoidance

27. Finally, it is also important to note that there have been recent tax mistake cases (albeit not in the pensions context) where the Court has declined to set aside an otherwise mistaken disposition because of the strong element of tax avoidance in what has been done. This was envisaged by Lord Walker in *Pitt v Holt* at [135], holding that "[i]*n some cases of artificial tax avoidance the court might think it right to refuse relief, either on the ground that such claimants, acting on supposedly expert advice, must be taken to have accepted the risk that the scheme would prove ineffective, or on the ground that discretionary relief should be refused on grounds of public policy.*" This has come to fruition in two recent decisions.

28. In *Dukeries Healthcare Ltd v Bay Trust International Ltd* [2021] EWHC 2086 (Ch), Deputy Master Marsh,[60] HMRC did not argue the "public policy" limb of Lord Walker's observation, but successfully asserted that the arrangements in that case amounted to "*artificial tax avoidance*".[61] The mistake claims failed for want of sufficient evidence that the claimants were actually mistaken,[62] but if they had not, the Deputy Master would also have rejected them on the basis that the claimants knowingly ran the risk that the arrangements would fail i.e. would not be effective for tax purposes, either as a matter of fact, or, more controversially,[63] because in circumstances amounting to artificial tax avoidance, it can properly be concluded that they "*must be taken to have accepted the risks of the schemes failing*".[64]

29. Very recently, the Court of Appeal in *Bhaur v Equity First Trustees (Nevis) Ltd* [2023] EWCA Civ 534 has adopted a very similar approach, holding that a person who makes a disposition under a mistake of fact or law can be denied relief "*f they deliberately decide to go ahead and run the risk of being wrong*".[65] Snowden LJ found that even if Mr Bhaur was operating under a relevant mistake, and was innocent of any involvement in tax evasion,[66] this was nevertheless a case "*a case in which Mr. and Mrs. Bhaur deliberately chose to implement what they knew to be a tax avoidance scheme which, to their knowledge, carried a risk of failure and*

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[60] As the former Chief Master had by then become.

[61] At [90]-[91].

[62] At [135].

[63] See: Fenner Moeran KC "An artificial solution to an artificial problem – Tax avoidance and the Dukeries case" (April 2022) https://www.wilberforce.co.uk/article/an-artificial-solution-to-an-artificial-problem-tax-avoidance-and-the-dukeries-case-by-f-moeran/.

[64] At [136]-[139].

[65] At [69].

[66] At [98].

possible adverse consequences … in implementing the Scheme Mr. and Mrs. Bhaur knew there was a risk and decided to take it anyway."[67] Furthermore, Snowden LJ accepted that whilst tax avoidance is not unlawful, "*artificial tax avoidance is a social evil that puts an unfair burden on the shoulders of those who do not adopt such measures*" and that "*this is a very weighty factor against the grant of any relief*".[68]

30. There is no reason why these considerations, although so far not raised explicitly in pensions tax mistake cases, should not apply equally where a pension scheme has been used as an element of a tax avoidance scheme. The boundaries of this principle are necessarily unclear. It is notable that it was not raised in *In the matter of the Representation of P* [2021] JRC 157 which might be thought to have been a case of artificial tax avoidance. However, in that case the representor had very clear advice (from reputable tax advisers, and leading tax counsel) that the scheme did work, so it would have been more difficult to establish as a matter of fact that the representor was a risk taker. It is also notable that it was a Jersey decision. HMRC necessarily has a different status in courts where it is not the local tax authority: in *Re the S Trust* (2011) 14 ITELR 663 the Jersey Royal Court observed that "*The preference accorded to the interests of the tax authority in the UK is not one, however, with which we are sympathetic. In our view, Leviathan can look after itself*".[69] Arguments which depend on UK public policy, such as deeming a tax-avoiding party to be a risk taker even if this is not factually established, or treating artificial tax avoidance as a distinct reason for refusing relief as a matter of discretion, may therefore be less likely to succeed. But it would be wrong to assume that if such a case – involving a pensions tax mistake with a flavour of tax avoidance – came before the English court now, that HMRC would not seek to press this line of argument, or that it would not find favour with the Court.

Conclusions on pensions and equitable mistake

31. Notwithstanding the reservations which have been expressed about the scope for equitable mistake claims in relation to pensions, it appears now that there will be a wide variety of situations where an equitable mistake claim will provide the best route to seeking to undo an unanticipated pensions tax liability. There is no limit to the type of situation to which this may apply, save for the basic limits expressed in *Smithson v Hamilton* [2008] 1 WLR 1453: where there is a mistake in relation to a unilateral, voluntary transaction, an equitable mistake claim will be worth

[67] At [101].

[68] At [105].

[69] At [39].

considering. However, it must also be borne in mind that whether setting aside the transaction will also dispose of the inconvenient tax liability is a question which will have to be answered case by case, as a matter of construction of the taxing statute, and assuming a degree of judicial scepticism that a tax charge which has arisen can simply be wiped away retrospectively. This judicial scepticism, and reluctance to intervene, is likely now to be all the more powerful in cases where the transaction forms part of an artificial (albeit legal) tax avoidance scheme.

UNAUTHORISED PAYMENTS AND DISCHARGE OF LIABILITY

32. This part of the paper turns to the different topic of unauthorised payments, pension liberation and HMRC's approach to the ensuing tax liabilities. The paper considers when HMRC will be willing to discharge tax liabilities following the making of unauthorised payments, especially in the context of attempts at pension liberation and sale/lending agreements with the pension scheme.

Introduction – authorised payments

33. This section of the paper begins with a reminder of the basic principles.

34. Pension schemes registered with HMRC under the FA 2004 enjoy important tax advantages, including tax relief on member and employer contributions and freedom from income tax and capital gains tax on returns made by the scheme's assets while invested in the scheme. Income tax is chargeable to the member on the pensions and lump sums that are eventually paid upon retirement (subject to various reliefs, usually including a 25% tax-free lump sum and at the lower marginal rate likely to apply to a retired person). There are limits on how much can be contributed to or saved within a tax-advantaged pension scheme (see e.g. the Annual Allowance and the Lifetime Allowance provisions of the FA 2004 which are beyond the scope of this paper).

35. As a quid pro quo for this favourable tax treatment, there are stringent restrictions for tax purposes on members or employers receiving payments out of the scheme, so that the tax advantages are only enjoyed if the payments fall within permitted categories. The general purpose of the permitted categories is to ensure that the pension scheme is only used to provide benefits to members for old age or ill-health retirement, and not as a tax shelter for the general savings of a member or the cash reserves of an employer. The most obvious permitted category is payment of a scheme pension to a member upon reaching normal minimum pension age.

36. The corollary is that very unfavourable tax treatment is accorded to any payments from a registered pension scheme falling outside the permitted categories. This brings us to the concept of "authorised payments" and "unauthorised payments".

37. The basic tax rule is set out in s 160(1) and (3) FA 2004, which provide that the only payments which a registered pension scheme is authorised to make to or in respect

of a person who is or has been a member of the pension scheme are those specified in s 164 FA 2004, and, in the case of payments to or in respect of a person who is or had been a sponsoring employer of an occupational pension scheme, those specified in s 175 FA 2004. Section 160 provides that an "unauthorised member payment" is a payment to or in respect of a member or former member which is not authorised by s 164 or which is treated as such under Part 4 FA 2004. For sponsoring employers, an "unauthorised employer payment" is similarly defined for payments not authorised by s 175. An "unauthorised payment" means either an unauthorised member payment or an unauthorised employer payment: s 160(5).

38. A pension scheme will not be registered by HMRC (and may be de-registered) if it has not been established or maintained wholly or mainly for the purpose of making authorised payments (ss 153(5)(f) and 158(1)(za) FA 2004). HMRC can require a declaration upon registration of the scheme that its governing documents do not entitle any person to unauthorised payments (s 153(3)).

39. The list of authorised member payments in s 164 FA 2004 includes the standard retirement or ill-health benefits for members and "recognised transfers" to another registered or qualifying pension scheme. The list of authorised employer payments in s 175 FA 2004 includes matters like authorised surplus payments and authorised employer loans.

40. In simple summary, the potential tax consequences of an unauthorised payment by a registered pension scheme are:

40.1. An "unauthorised payments charge" under s 208 FA 2004: a charge to income tax of 40% of the value of the payment. The charge is payable by the member or employer to or in respect of whom the payment was made (or, in the case of an unauthorised member payment made after the member's death, the recipient).

40.2. An "unauthorised payments surcharge" under s 209 FA 2004: a charge to income tax of 15% where (in summary) unauthorised payments in any 12 month period exceed 25% of the value of the member's rights under the scheme or (in the case of unauthorised employer payments) of the value of the pension fund. The charge is payable by the same persons as the unauthorised payments charge.

40.3. A "scheme sanction charge" under s 239 FA 2004: a charge to income tax of 40% in respect of unauthorised payments qualifying as "scheme chargeable payments". "Scheme chargeable payments" include most unauthorised payments (subject to some exemptions) and certain other types of payments which are treated as scheme chargeable payments: s 241 FA 2004. The scheme administrator is liable to pay the scheme sanction charge (though typically would seek to indemnify itself from the scheme assets). In broad summary, the 40% scheme sanction charge may be reduced to 15% if the member pays the unauthorised payments charge.

40.4. In very extreme cases, the "de-registration charge" under s 242 FA 2004, if the registration of the pension scheme is withdrawn. This is a charge to income tax of 40% of the value of the entire pension fund, payable by the scheme administrator.

41. Putting to one side the ultimate sanction of de-registration, it can be seen that the tax consequences of an unauthorised payment are severe: potentially 95% of the payment if it triggers the unauthorised payments charge (and it is not paid), plus the surcharge plus the scheme sanction charge; or 70% if the unauthorised payments charge is paid and the scheme sanction charge is fully reduced.[70]

Discretion to relieve from the tax charges – s 268 FA 2004

42. There is no discretion to relieve from the unauthorised payments charge. It is not an excuse under the legislation that, for example, the unauthorised payment was made in the belief that it was authorised or by a mistaken view of the member's entitlements or through a simple administrative oversight (though there are concessions and exceptions to deal with some types of genuine mistake: see the final section of this paper). Nor is there any general judicial discretion to prevent HMRC enforcing the unauthorised payments regime just because a Judge thinks it is unfair to do so: see *McCormack v HMRC* [2018] UKFTT 200 (TC) at [41]-[43].

43. However, s 268 FA 2004 provides for a taxpayer to apply to HMRC for the discharge of a person's liability to the unauthorised payments <u>surcharge</u> and the scheme administrator's liability to the scheme sanction charge. On receiving the application, HMRC must decide whether to discharge the liability on the ground specified in the legislation:

43.1. The ground for discharging the unauthorised payments surcharge liability is:

"*that in all the circumstances of the case, it would be not be just and reasonable for the person to be liable to the unauthorised payments surcharge in respect of the payment*" (s 268(3)).

43.2. The ground for discharging the scheme sanction charge liability is:

[70] As explained in *Curtis v HMRC* [2022] UKFTT 172 (TC) at [11]-[14], s 255 FA 2004 makes provision for HMRC to make regulations for assessing the unauthorised payments charge and the unauthorised payments surcharge. These are the Registered Pension Schemes (Accounting and Assessment) Regulations 2005, SI 2005/3454. Reg 9 provides that s 29(1)(a) Taxes Management Act 1970 applies with modifications – broadly, an officer of HMRC must discover that tax which ought to have been assessed has not been assessed. The scheme administrator ought to report an unauthorised payment to HMRC as part of the annual "event report" pursuant to the Registered Pension Schemes (Provision of Information) Regulations 2006, SI 2006/567, reg 3.

"*(a) the scheme administrator reasonably believed that the unauthorised payment was not a scheme chargeable payment, and (b) in all the circumstances of the case, it would not be just and reasonable for the scheme administrator to be liable to the scheme sanction charge in respect of the unauthorised payment*" (s 268(7)).[71]

44. Applications for discharge are governed by the Registered Pension Schemes (Discharge of Liabilities under Sections 267 and 268 of the Finance Act 2004) Regulations 2005, SI 2005/3452 (and HMRC provides further guidance on the procedure in PTM 134000). Reg 3 requires applications to be made in writing, in the case of a company, no later than six years after the end of the accounting period to which it relates, or, in the case of any other applicant, no later than five years after the 31 January next following the year of assessment to which it relates (subject to stated exceptions where a shorter period applies). In *Morgan Lloyd Trustees v HMRC* [2023] UKFTT 355 (TC), it was held at [131] that the six year time limit applies from the end of the accounting period in respect of which the assessments were made, not from the date when the assessments were made. It was held at [132]-[133] that there is no basis on which Tribunal can extend time for making the applications, and the burden is on the taxpayer to prove the application was made in time.

45. If HMRC refuses to discharge the liability, there is a right of appeal to the First-tier Tribunal: s 269 FA 2004. The Tribunal decides the case afresh; it does not simply review HMRC's decision. This is reflected in s 269(7)-(8) which provide:

"*(7) If the tribunal considers that the applicant's liability ought not to have been discharged, the tribunal must dismiss the appeal.*
(8) If the tribunal considers that the applicant's liability ought to have been discharged, the tribunal must grant the application."

46. Later on, this paper will look at how ss 268-269 have been applied by the Tribunal in the context of pension liberation and unauthorised employer payments. Although the side-heading of this group of sections within the FA 2004 is "*Discharge of tax liability: good faith*", it will be seen below that "good faith" is not of itself sufficient to obtain a discharge.

[71] For some types of scheme chargeable payment, the requirement in (a) does not need to be satisfied: see s 268(6) and (7A).

The aim of the unauthorised payments legislation

47. The aim of the legislation was explained in the following way by Henderson LJ in *Clark v HMRC* [2020] EWCA Civ 204 at [25]:

"*In very general terms, the underlying policy of the legislation, in common with much predecessor legislation in the same field, was to provide fiscal incentives for the establishment and investment of occupational pension schemes, so as to provide retirement pensions and associated benefits for employees and their dependants, but coupled with strict provisions designed to ensure that the schemes would be properly administered, and that payments made out of them to beneficiaries or sponsoring employers would be confined to certain authorised categories of payment. If unauthorised payments were made, they would be taxed at high rates intended to have a deterrent effect and to compensate the State, in a rough and ready way, for the fiscal benefits previously enjoyed by the relevant funds.*"

48. A more detailed explanation of the rationale of the legislation was provided by Nugee J sitting with Judge Richards in the Upper Tribunal in *HMRC v Bella Figura* [2020] UKUT 120 (TCC). They explained that the statutory scheme governing pensions tax:

"*[72] … provides: (i) for contributions made by employers and employees to benefit from tax relief at the point of payment; (ii) for the funds contributed to be held securely to provide pension benefits that can, at least in usual cases, only be taken once an individual reaches the age of 55; (iii) for most income and gains received by the registered pension scheme in connection with the investments of contributions not to be subject to tax; but (iv) for amounts payable to an individual taking benefits to be subject, in most cases, to income tax (with the most important exception of the ability to take a tax-free lump sum equal to 25% of the accumulated fund).*
[73] While conceptually it might be said that tax relief granted to individuals and employers at stage (i) is counteracted by the taxability of pension benefits at stage (iv), the overall scheme clearly involves a material cost to the Exchequer. First, the Exchequer suffers an obvious timing disbenefit as it gives relief at stage (i) a long time before it obtains tax at stage (iv). That timing benefit is not counteracted by a charge on income and gains of the pension scheme– see stage (iii). Second, a person's income in retirement will tend to be lower than income when working, so even in absolute terms the tax charged at stage (iv) will tend to be lower than the tax relief given at stage (i).
[74] Parliament is content for the Exchequer to suffer these costs given the social utility of individuals saving for their retirement, but only where the entire bargain set out at [72] is respected. It is for this reason that different aspects of the unauthorised payments regime apply to different potential breaches of the bargain. For example, if a registered scheme impermissibly pays benefits to a member before he or she reaches 55, there is an unauthorised payment because the Exchequer has suffered the costs we have outlined, but since the funds have been drawn before

retirement age, the social utility of funding retirement is not present. In a similar vein, if pension funds are lent by way of risky loans to an employer, the Exchequer is exposed to the risk that, even though it has given tax relief, and exempted income and gains of the scheme from tax, the funds are not ultimately available to pay pension benefits.

[75] These observations also explain how the making of unauthorised payments can be more, or less, serious. For example, an extreme form of "pensions liberation" might involve a co-ordinated attempt by an individual to access a pension fund held in a registered scheme before he or she reaches the age of 55 in a manner that escapes tax altogether. Such a scheme seeks to impose on the Exchequer the cost of deductions at stage (i) and exemptions at stage (iii) even though no retirement benefits are ultimately provided. In addition, were such a scheme successful the Exchequer would not even obtain tax at stage (iv) when the funds leave the scheme. Considerably less serious would be the making of a loan to an employer which, while it fails the requirements necessary to be an "authorised employer loan" (so exposing the Exchequer to a risk of loss) is ultimately repaid in full with a market rate of interest so that the Exchequer suffers no actual cost and the social utility of the provision of retirement benefits is preserved."[72]

49. While [75] of *Bella Figura* suggests that some unauthorised payments might be less serious, it will become apparent from the case-law considered below that taxpayers have met with limited success before HMRC and the Tribunal in escaping tax charges consequent upon the making of unauthorised payments. Inherent in any unauthorised payment is a breach of the legislative "*bargain*" described in *Bella Figura*, which is not a promising starting point for any attempt to escape the rigours of the unauthorised payments regime.

Pension liberation and unauthorised payments

Overview

50. "Pension liberation" generally involves members attempting to access the value of their pension benefits in situations not permitted by the authorised payment rules in s 164 FA 2004, most commonly prior to their normal minimum pension age.

[72] This analysis is to an extent supported by the background notes to clauses 197 and 255 of the Finance Bill 2004, which explain at para 12-13 that the tax charges "*are intended to prevent abuse by the scheme administrator, any member or any employer sponsoring the scheme of the benefits obtained from the tax relief provided to such schemes. Registered pension schemes will benefit from tax relief on contributions made into the scheme and on income or gains made on investments held within the scheme. Where a registered pension scheme does not comply with the requirements of this part of the Act a charge will be imposed on any scheme funds that cease being held by a registered pension scheme. The effect of that charge is to remove the tax benefits received on that fund or that part of it that is removed from the scheme.*"

Pension liberation arrangements will almost certainly involve some kind of unauthorised payment whereby value is sought to be shifted from the registered pension scheme and to the member.

51. Pension liberation often takes place as part of "pension scams" whereby members are induced to transfer from their bona fide scheme to a registered pension scheme under the control of wrongdoers who then proceed to misappropriate the scheme's assets for their own benefit, while also procuring some form of pension liberation payment to the member. In many cases, the scam has been brought to an end when an independent trustee is appointed to the scheme by the Pensions Regulator.

52. The fact that the member is partly defrauded by the scam does not prevent there also being an unauthorised payment, with all the adverse tax consequences that that entails, insofar as the member benefited from the liberation payment. Thus one often finds that pension liberation arrangements visit a double misfortune on the member: they are defrauded of part of their pension savings, and are then made subject to severe tax charges insofar as unauthorised liberation payments have been made to them – and any remaining scheme assets might also be absorbed by the incoming independent trustee (who becomes "scheme administrator" for FA 2004 purposes) recouping a scheme sanction charge from the scheme assets.

53. The fact that the member who has received the unauthorised payment (or other unauthorised benefit) is also a victim of fraud provides the background to applications under s 268 FA 2004 to discharge the unauthorised payments surcharge. Similarly the background fraud is also the context for an application by the incoming independent trustee, in its capacity as scheme administrator, to seek the discharge of the scheme sanction charge under s 268.

The approach of HMRC and the Tribunal to unauthorised payments in pension liberation cases

54. Unsurprisingly, the case-law shows that the reach of the unauthorised payments legislation is long and it is likely to catch pension liberation in whatever form it takes. HMRC takes a strict approach and the Tribunal has upheld that approach, as illustrated in the following paragraphs.

Pension liberation: indirect benefits

55. In particular, the legislation catches indirect benefits, reciprocal transactions and loans whereby value is sought to be transferred from the scheme to the member. To take a simple example, a loan indirectly funded by a registered pension scheme to a company controlled by a scheme member is caught as a "payment" in respect of the member: see e.g. *O'Mara v HMRC* [2017] UKFTT 91 (TC) at [91] and s 161(5) FA 2004 (which treats a payment to or in respect of someone who is connected with a scheme member or employer as made in respect of that member or employer).

56. Similarly, in *Danvers v HMRC* [2016] UKUT 569 (TCC), Mr Danvers transferred his pension fund to a SIPP with a view to obtaining a loan of those funds. A lending company made a loan to him, conditionally upon the SIPP investing in preference shares of a finance company which substantially funded the lending company. The question for the Upper Tribunal was whether the loan fell within s 161 FA 2004, which provides:

"*(3) Subsection (4) applies to a payment made or benefit provided under or in connection with an investment (including an insurance contract or annuity) acquired using sums or assets held for the purposes of a registered pension scheme.*
(4) The payment or benefit is to be treated as made or provided from sums or assets held for the purposes of the pension scheme, even if the pension scheme has been wound up since the investment was acquired."

57. The Upper Tribunal held that Mr Danvers' loan fell within s 161(3) as a payment made in connection with an investment, namely the investment by the SIPP in the finance company's preference shares. Therefore the loan was treated as a payment from the registered pension scheme to its member and was therefore an unauthorised payment. The Upper Tribunal said:

"*[51] In our judgment, it is clear from the language of the relevant provisions of Pt 4 FA 2004 that it is intended that their scope goes wider than merely catching payments made "from" investments acquired for the scheme.*
[52] … It is therefore clear that the legislation does envisage that payments made to a member of a pension scheme by a third party in circumstances where there is a connection between that payment and an investment in the scheme can fall within the scope of the legislation. …
[64] … As we have said above, the question is whether there is a link between a specific investment made by the scheme and a payment received by a member of the scheme. In our view the wording is consistent with it being necessary that there is a causal link between the investment and the payment.
[65] An obvious situation where the necessary link would exist would be if a third party lender was funded entirely by a company in which a pension scheme was invested, loans being made by the investee company to the third party lender only in circumstances where the scheme member was to take up a loan from the third party lender, the amount being lent by the investee company being identical to the amount on-lent to the scheme member. In such a case, the investee company would be a mere conduit for the making of loans from the scheme to the member and would in our view quite clearly come within the anti-avoidance provisions of s 161(3) and (4) FA 2004."

Pension liberation: member's state of mind irrelevant to authorisation

58. The question whether a payment is unauthorised does not depend on the member's state of mind or intention. For example, in *Curtis v HMRC* [2022] UKFTT

172 (TC), a financial adviser advised Mrs Curtis to take out a loan of £20,000 from a finance company and separately advised her to transfer her pension fund to the "Fast Pensions" scheme; Mrs Curtis had no reason to think that the transfer of her pension and the loan were connected; in fact it was a pension liberation arrangement and a scam, with Mrs Curtis's loan being funded (unbeknown to Mrs Curtis) by the pension fund lending money to the finance company. Mrs Curtis lost her pension and repaid the majority of the loan. Her misfortune was compounded by HMRC imposing an unauthorised payments charge and surcharge. Despite Mrs Curtis's innocence, the First-tier Tribunal confirmed that she was liable for the unauthorised payment:

"*[55] In the present appeal, we are satisfied that there was an investment by way of loan by the [the scheme] to [the finance company]. The loan from [the finance company] to Mrs Curtis was a payment made in connection with that investment. Section 161(4)* [quoted above] *is therefore engaged so as to treat the payment to Mrs Curtis as having been made from the assets of the [the scheme]. [The finance company] was a mere conduit for the purpose of making a loan from [the scheme] to Mrs Curtis. The loan to Mrs Curtis was inextricably linked to the pension transfer and the fund was the source of the loan. It is therefore an unauthorised member payment. It is not relevant that Mrs Curtis was unaware of the connection between her fund and the loan which she received from [the finance company].*"

Pension liberation: ineffective transfers

59. As explained earlier in this paper, *Clark v HMRC* [2020] EWCA Civ 204 illustrates that even an ineffective transfer payment made as part of an attempted pension liberation arrangement still counts as a "payment" for the purposes of the unauthorised payments regime. Thus the adverse tax consequences are triggered by the transfer payment, even if the beneficial interest in fact never leaves the bona fide transferor pension scheme.

Pension liberation: potential for double charge – the Dalriada litigation

60. The drastic consequences of the unauthorised payments regime for attempted pension liberation are amply demonstrated by the recent decision of the First-tier Tribunal in *Dalriada Trustees v HMRC* [2023] UKFTT 314 (TC). This is the latest chapter in the history of the "Ark Schemes" that were the subject of Bean J's decision over a decade ago in *Dalriada v Faulds* [2011] EWHC 3391 (Ch). The Ark Schemes sought to achieve pension liberation without triggering the unauthorised payments charge through a "pensions reciprocation plan". This involved one Ark Scheme (referred to as Scheme Y) lending funds to a member (Member B) of another Ark Scheme, Scheme Z; and Scheme Z would lend funds to a member of Scheme Y (Member A). The idea was that this meant Scheme Y was not making a payment to or in respect of its member, Member A, and likewise Scheme Z was not

making a payment to or in respect of Member B, thus avoiding any unauthorised payment from a registered pension scheme to its member.

61. Unfortunately for the members, the plan failed, because Bean J held in *Dalriada v Faulds* that it fell foul of s 173(1) FA 2004, which provides:

"*(1) A registered pension scheme is to be treated as having made an unauthorised payment to a person who is or has been a member of the pension scheme if an asset held for the purposes of the pension scheme is used to provide a benefit (other than a payment) to —*
(a) the person, or
(b) a member of the person's family or household …".

62. Bean J held that the pension reciprocation plan involved the assets of Scheme Y being used to provide a benefit to Member A within the meaning of s 173 (through making a loan to Member B of Scheme Z in the sure and certain hope that a corresponding payment was going to be made by Scheme Z to Member A): *Dalriada v Faulds* at [47]. Thus even an indirect benefit of this nature was caught by the unauthorised payments regime. Bean J held that the reference in s 173(1) to "*other than a payment*" meant "*other than a payment from the scheme*" – thus s 173(1) caught the loan payment from Scheme Z even though it was a "payment".

63. The *Dalriada v Faulds* case was brought by the newly-appointed independent trustee of the Ark Schemes to establish the validity of the "pension reciprocation" loans. HMRC was not a party to the case and was not bound by the result. The members and the independent trustee sought to re-argue aspects of the case when HMRC subsequently imposed the unauthorised payments change, surcharge and scheme sanction charge, as well as applying for discharge from the surcharge and scheme sanction charge.

64. This led to the recent First-tier Tribunal decision in *Dalriada v HMRC* [2023] UKFTT 314 (TC). Things went even worse for the members and trustee before the Tribunal, because the Tribunal accepted new evidence that the reciprocal loans between Schemes Y and Z were "matched" between Members A and B. Thus the loan payment by Scheme Y to Member B of Scheme Z could be said to be made "in respect of" Member A. It followed that Scheme Y had made a direct unauthorised payment "in respect of" its own member, Member A, within the standard definition of an unauthorised payment in s 160(2)(a) FA 2004, so the unauthorised payments tax charges applied.

65. HMRC had conceded before the Tribunal that, if a payment by Scheme Y was a direct unauthorised payment in respect of Member A within s 160(2)(a), it could not *also* be a deemed unauthorised payment under s 173 as found by Bean J. However, the Tribunal did not accept that concession. The Tribunal considered that both provisions could apply to the same payment: see [2023] UKFTT 314 (TC) at [278]-[279]. It reached this conclusion "*with considerable regret because of the dire financial consequences to which our conclusion inexorably leads*" [285], namely a double tax charge for the unfortunate member.

66. Although the Tribunal accepted that the "*other than a payment*" exception in s 173(1) was intended to prevent an overlap between a deemed unauthorised payment under s 173 and an actual unauthorised payment under s 160(2)(a), it held that there was an overlap on the unusual facts of the case. The Tribunal said at [286] "*it is not entirely surprising to us that a scheme which sought to avoid falling within Section 160(2)(a) by ensuring that there was no direct payment by an Ark Scheme to a member of that Ark Scheme but which then failed to achieve that objective because the payment was held to be in respect of the member in question might then fall outside the scope of the language in Section 173 which was designed to avoid an overlap between the two different regimes.*"

67. This is a very adverse outcome for the members (and not one that HMRC was urging). The Tribunal could easily have avoided the outcome by concluding that it is implicit in the statutory regime that something which is an *actual* unauthorised payment under s 160(2)(a) cannot *also* be *deemed* to be an unauthorised payment under s 173; alternatively that the exception in s 173 ("*other than a payment [from the scheme]*") means any payment from the scheme *to or in respect of the member* – thus ensuring no double charge between s 160 and s 173. It remains to be seen whether an appeal will be pursued.

68. As matters stand, the case-law is a salutary warning that the unauthorised payments regime can be applied remorselessly with extremely harsh consequences for members who get involved with pension liberation.

Other examples of unauthorised payments not involving pension liberation

69. Putting to one side cases of mistaken overpayments (as to which, see the end of this paper), two other areas which are fraught with the risk of making unauthorised payments are (i) loans by a registered pension scheme to an employer and (ii) sale of assets to a registered pension scheme. Once again, the case-law in these two areas shows that a firm approach will be taken with taxpayers.

Loans to employer

70. The list of authorised employer payments in s 175 FA 2004 includes "authorised employer loans". The detailed requirements for an authorised employer loan by a registered pension scheme to a sponsoring employer are set out in s 179 FA 2004.[73] They include limits on amount (50% of the value of the scheme assets), a

[73] These are the requirements for the loan to be authorised for tax purposes. Further requirements apply under general pensions law and trusts law as to whether a loan can be made to an employer.

requirement that “the loan is secured by a charge which is of adequate value”, and requirements as to repayment terms and interest rate.

71. These requirements are strictly enforced. For example, in *Nilebond v HMRC* [2023] UKFTT 14 (TC), a loan from the scheme to a corporate employer was held to be unauthorised for lack of a “charge which is of adequate value” (s 179(1)(b) and Sch 30 para 1 FA 2004). The employer had given a charge, but it had not been registered under s 859H Companies Act 2006, making it void against other creditors. Even though registration was not an express requirement of the FA 2004, the Tribunal held that the lack of registration meant the charge was not of adequate value – even though the charge had been belatedly registered with partial retrospective effect and the loan had been repaid. Applying *Bella Figura* (cited earlier in this paper – itself a case about unauthorised employer loans), the Tribunal considered that the purpose of the legislation was to ensure that tax-relieved pension scheme funds were not loaned in circumstances where there was a risk they might not be repaid. The lack of registration had put the pension scheme funds at risk and accordingly the employer loan was unauthorised. Thus the Tribunal took a strict approach – indeed arguably stricter than was apparent from the face of the FA 2004 which contains no loan registration requirement.

72. In the recent case of *Morgan Lloyds Trustees v HMRC* [2023] UKFTT 355 (TC), a similarly strict approach was taken, holding that employer loans had not been secured by charges of adequate value. Notably, as the “value” tests in s 179 and Sch 30 involve questions of market value, the Tribunal applied the approach to market valuation in the capital transfer tax case of *IRC v Gray* [1994] STC 360, CA, i.e. a retrospective exercise in probabilities derived from the real world.

Sale of assets to a registered pension scheme

73. The list of authorised member payments and employer payments include “scheme administration” payments, which include payments by a registered pension scheme to a member or employer “*for the purchase of assets to be held for the purposes of the pension scheme*” (ss 171 and 180 FA 2004). However, these provisions state that if the payment “*exceeds the amount which might be expected to be paid to a person who was at arm's length, the excess is not a scheme administration … payment.*”

74. In *Boardman v HMRC* [2022] UKFTT 238 (TC), Mr Boardman sold shares in a Montenegro property development business to his SIPP. The Tribunal concluded that the SIPP’s payment of the purchase price was an unauthorised payment. Mr Boardman argued that he and the SIPP trustee were at “arm’s length” within the meaning of s 171 FA 2004 because they had no relationship other than as pension holder and pension trustee. However, it was held on the facts that Mr Boardman had instructed the SIPP trustee to make the purchase [96]; therefore they could not be regarded as being at “arm’s length” [97]. The Tribunal noted at [107] that there was no statutory definition or case-law on the meaning of “*the amount which might*

be expected to be paid to a person who was at arm's length", but it applied the valuation approach in *Gray v IRC* (see above) and concluded that a hypothetical purchaser would not have paid anything for the shares, so the price paid by the SIPP exceeded the arm's length price.

75. A similarly firm approach was taken in *Morgan Lloyd Trustees v HMRC* [2023] UKFTT 355 (TC), discussed under the previous heading on employer loans. The *Morgan Lloyd* transactions included various sale and leaseback arrangements, involving sales of assets by the employer to the pension scheme. Applying the *Gray v IRC* valuation approach, the Tribunal upheld HMRC's assessment that the purchases involved unauthorised payments. More positively for the taxpayer, the Tribunal held that the unauthorised payments did not include any recoverable input VAT. Insofar as VAT was not a cost to the fund, no value had left the fund. In the Tribunal's view, the purpose of the legislation was to minimise the risk of loss of funds from a pension scheme, citing *Bella Figura v HMRC* (quoted earlier in this paper). Accordingly, the Tribunal concluded at [50]-[51] that the legislation was directed at payments which result in an actual economic loss to the pension fund, and that, as a payment of VAT which can be reclaimed by the pension fund does not result in an economic loss to the pension fund, "payment" in the context of s 179 FA 2004 should not include any recoverable input tax.

Are the tax charges penal?

76. Given the taxpayer-unfriendly approach apparent in the case-law discussed above, it might be said that the unauthorised payments legislation is in substance penal, ensuring that such payments are "*taxed at high rates intended to have a deterrent effect*" (per Henderson LJ in *Clark v HMRC* [2020] EWCA Civ 204 at [25], as quoted earlier in this paper).

77. The penal or otherwise nature of the legislation has been debated in a number of the judgments in this area. In one of the earlier cases, *Stephen Willey v HMRC* [2013] UKFTT 328 (TC) at [57], the First-tier Tribunal said it was unnecessary to decide whether the scheme sanction charge should be regarded as a penalty, as on any view it was a proportionate measure and therefore compliant with Article 1 Protocol 1 of the European Convention on Human Rights.

78. In *Peter Browne v HMRC* [2016] UKFTT 595 (TC) at [71], the First-tier Tribunal said that the purpose of the unauthorised payments surcharge was "*to penalise unauthorised payments where they are made in order to frustrate the purposes of the pension scheme tax regime and abuse its tax reliefs and exemptions.*" The Tribunal held that since the taxpayer in that case had acted in good faith with no such intention, the surcharge should be discharged. This approach has not subsequently prevailed, as will be seen below.

79. In *O'Mara v HMRC* [2017] UKFTT 91 (TC), the First-tier Tribunal took a harder line and said at [154] that it would be wrong to characterise the surcharge as penal; it was "*a tax charge designed to recoup tax relief on contributions and tax free growth*",

albeit there was no need to enter into a detailed attempt to calculate whether the 55% combined charge and surcharge exactly represented the value of the tax relief and tax-free growth on the taxpayer's pension fund.

80. In *HMRC v Bella Figura* [2020] UKUT 120 (TCC), Nugee J and Judge Richards sitting in the Upper Tribunal said they did not find the description as "penal" (or not) helpful in deciding whether or not to discharge the surcharge. As already explained, they spoke in terms of whether the legislative "bargain" had been breached in a more or less serious way.

81. However, the "bargain" rationale rather lends itself to HMRC and the First-tier Tribunal taking a firm approach with taxpayers, since, as already noted, any unauthorised payments will involve a breach of the bargain and will probably have caused loss to the Exchequer. Therefore a fairly unforgiving and "deterrent" approach can be justified without needing to describe it as "penal".

82. The current state of play is that the First-tier Tribunal does not regard the charges as having a penal objective but as recovering tax reliefs previously granted, so good faith and honesty are not sufficient grounds for escaping the charges: see *Boardman v HMRC* [2022] UKFTT 238 (TC) at [165]-[167] and the s 268 discharge case-law discussed below.

Discharge under s 268 FA 2004

83. As explained earlier in this paper, s 268 FA 2004 allows HMRC (in summary) to discharge the unauthorised payments surcharge if it would not be just and reasonable for the taxpayer to be liable to it, and to discharge the scheme sanction charge if the scheme administrator reasonably believed the payment was not a scheme chargeable payment and it would not be just and reasonable for the scheme administrator to be liable to the charge.

84. The burden is on the taxpayer to establish that it would not just and reasonable to be liable: e.g. *Curtis v HMRC* [2022] UKFTT 172 (TC) at [95].

The "just and reasonable" test

85. The leading authority on the grant of the discharge is *HMRC v Bella Figura* [2020] UKUT 120 (TCC). The "just and reasonable" test falls to be applied adopting the "bargain" rationale and the seriousness or otherwise of the breach of the bargain, as explained above. As already suggested, this does not allow for a very forgiving approach.

86. Thus in *Boardman v HMRC* [2022] UKFTT 238 (TC) (discussed earlier – sale of the Montenegro shares to the scheme), HMRC's argument was that the purpose of the surcharge was to prevent abuse of the tax system by broadly reclaiming tax relief given on pension contributions and on tax-free growth in pension funds; it argued that an unauthorised member payment is an abuse of the tax system regardless of

the intention of the taxpayer in receiving that payment. Thus one sees that HMRC takes a fairly hard-line approach, with no concessions to an innocent state of mind.

87. In *Boardman*, the First-tier Tribunal accepted that Mr Boardman had acted in good faith and believed the arrangements entered into were permitted, but it did not discharge the surcharge on just and reasonable grounds. The surcharge does not depend on proof of negligence or dishonesty. The Tribunal applied the earlier decision of the Tribunal in *O'Mara v HMRC* [2017] UKFTT 91 (TC) at [169]-[170]:

"*Of itself, an honest but mistaken belief of a taxpayer, based on the advice of a scheme provider or otherwise, that that the arrangement is authorised and compliant is not sufficient to render liability to a surcharge as unjust or unreasonable. Otherwise it would encourage the promoters of unauthorised schemes, whatever the promoter's beliefs. Unscrupulous advisers and promoters, in recommending such schemes, would be able to advise clients that the worst that would happen if a scheme turned out to be unauthorised is that HMRC would impose an unauthorised payment charge to recover the tax relief.*
... the fact that a taxpayer has taken legal, accounting or tax advice that the scheme was legitimate or authorised should not be sufficient, of itself, to make it unjust or unreasonable to impose a surcharge. The taxpayer cannot rely on such advice as conclusive. Of course, it may be a relevant circumstance but it would not be determinative. The nature and extent of the advice and other circumstances of the case would have to be taken into account."

88. Taking the view that the surcharge was not penal but designed to recover tax relief granted by the Exchequer, the Tribunal in *Boardman* considered that Mr Boardman's good faith did not justify a discharge. It concluded at [166]: "*It is clear that Mr Boardman did little research and asked very few questions about the structure and particularly did not ask how he was able to access a very substantial proportion of his pension fund across the two investments at the age of 50 without a tax charge. We consider that it is more likely than not that he was swept along by what appeared to him to be a fabulous opportunity.*"

89. Thus it seems that it will often cut little ice for taxpayers to argue that they believed the payments were authorised or (certainly in the context of pension liberation or other dubious dealings with pension scheme assets) that the promoter of the arrangements advised them that there was no problem. Probably for policy reasons, such excuses may not wash with HMRC and the Tribunal, otherwise the unauthorised payments regime would be undermined in the liberation context, since promoters routinely assure members that the arrangements are proper. Hence in *O'Mara v HMRC* [2017] UKFTT 91 (TC) at [163], the Tribunal looked at the matter objectively, holding that the scheme members "*knowingly took part in <u>a scheme whose intention was unauthorised</u> even if they did not share the intention*" (emphasis added): in other words, it was relevant to look at the objective intention *of the arrangement* (as devised by the wrongdoers behind it) rather than the

subjective position of the taxpayers.[74] Further, reasonable care is expected of the taxpayer.[75]

90. This approach significantly limits any scope for a successful application to discharge liability under s 268 FA 2004, at least where the member has received outright payments (rather than a loan).

91. Turning to loans (as opposed to outright payments), the leading case of *Bella Figura* seemed to suggest that unauthorised payments that did not in fact pose a risk to the legislative "bargain" (e.g. a loan which is repaid) might be less serious and could result in a s 268 discharge. However, the suggestion appears to have had limited impact. In *Morgan Lloyd Trustees v HMRC* [2023] UKFTT 355 (TC) (the case on employer loans and sale/leaseback discussed above), the fact that the relevant deals had all been repaid with no loss to the pension scheme counted for little. The First-tier Tribunal considered that the risk to the scheme was diminished as the deals were repaid, "*but the legislation is drafted on the basis that the relevant time for measuring the risk is the time when the transactions are entered into*" (see [221]), so it was just and reasonable for Morgan Lloyd to be liable to the scheme sanction charge. Similarly, the fact that advice was obtained on the transactions was no excuse, as Morgan Lloyd failed to provide any critical analysis to that advice (see [224]).[76]

92. On the other hand, in *Dalriada Trustees v HMRC* [2023] UKFTT 314 (TC) (the reciprocal loans case discussed earlier), the Tribunal was willing to accept that the repayability of the reciprocal loans would have made it just and reasonable to discharge the scheme sanction charge (see [438]), albeit that the "reasonable belief" pre-condition was not satisfied: see below. The Tribunal would also have been willing to discharge the unauthorised payments surcharge for a member on just and reasonable grounds, although this was "*very finely-balanced*" (see [461]). The Tribunal again relied on the repayability of the loans as diminishing the seriousness of the unauthorised payments, and considered that – given the other ruinous consequences for the member of having got involved in the attempted liberation arrangements – the member had suffered enough: see [471]-[474]. This seems to be a more generous decision than a number of the earlier cases discussed above, reflecting the Tribunal's "*sympathy for the predicament of the members*" ([485]). In fact, no discharge was granted as the member's application was out of time: see [455].

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[74] For similar decisions on pension liberation arrangements, see *Franklin v HMRC* [2019] UKFTT 232 (TC) and *Rowland v HMRC* [2019] UKFTT 741 (TC).

[75] See *Franklin* cited in the previous footnote: "*The standard of care which is expected to be exercised by the appellant is that of a prudent and reasonable taxpayer in the position of the taxpayer in question*" [53].

[76] For a similar decisions on an employer loan, see *AIM (Perth) v HMRC* [2017] UKFTT 533 (TC).

93. A rare example of the taxpayer's good faith leading to a discharge is *Curtis v HMRC* [2022] UKFTT 172 (TC), where Mrs Curtis was wholly innocent and had no idea that the loan she received was connected to pension liberation, and moreover she was a victim of fraud and had repaid the majority of the loan. This was a markedly deserving case.

94. It would seem from the above case-law that, in any less deserving case, there is a strong chance that a discharge would be refused if the member has received an outright payment (as opposed simply to a loan as in *Curtis* or *Dalriada*).

Reasonably believed the payment was not a scheme chargeable payment

95. In relation to the scheme sanction charge, the other requirement to be satisfied in order to obtain a discharge under s 268 is that the scheme administrator "*reasonably believed the payment was not a scheme chargeable payment*".

96. Again, HMRC and the Tribunal apply a high threshold to satisfy this requirement. In *Morgan Lloyd Trustees v HMRC* [2023] UKFTT 355 (TC), it was held that the burden was on the taxpayer to prove reasonable belief (see [149]), and while Morgan Lloyd as scheme administrator had relied on expert valuers for the purpose of the deals at issue, the Tribunal held that it was incumbent on the scheme administrator to take steps to ensure that the advisers had the relevant expertise and to scrutinise the relevant transactions and at least apply basic commercial acumen to test the advice provided (see [191]). Morgan Lloyd failed to show this: the Tribunal concluded that in order for a belief to be reasonable it has to be based on reasonable grounds and tested by reference to critical thinking, but Morgan Lloyd had relied unquestioningly on the advice of others (see [200]-[204]). Therefore there was no reasonable basis for Morgan Lloyd to believe the payments were not scheme chargeable payments.

97. Arguably this approach places a higher burden on a trustee in terms of scrutinising its own professional advice than is the case under general trusts law, where a trustee is not in breach of duty for following apparently competent professional advice which turns out to be wrong (*Pitt v Holt* [2013] UKSC 26 at [80]).

98. Another trap for scheme administrators was exposed in *Dalriada Trustees v HMRC* [2023] UKFTT 314 (TC). The incoming independent trustee, Dalriada, had been appointed by the Pensions Regulator after the pension liberation activity and had become "scheme administrator" for FA 2004 purposes. Under the then legislation,[77]

[77] As the Tribunal explained at [16], the position has been modified in respect of independent trustees so that they do not assume liability for the scheme sanction charge, which instead remains with the previous scheme administrator, but this change took effect only in respect of independent trustee appointments made on or after 1 September 2014 and so did not apply in the *Dalriada* case: see s 272A-272C FA 2004.

it was therefore subject to the scheme sanction charge (s 271 FA 2004) and applied under s 268 to discharge it. However, the reasonable belief referred to in s 268 is that of the scheme administrator at the time of the unauthorised payments: see [382]. The pension schemes had not in fact had a duly appointed "scheme administrator" at the time of the unauthorised payments: see [386]. Therefore it could not be shown that any relevant person had the reasonable belief required for the s 268 discharge: see [394]. This forced the Tribunal into the "*highly unfortunate, to say the least*" conclusion that Dalriada could not be discharged from liability for the scheme sanction charge: see [450].

Overall conclusion on discharge under s 268 FA 2004

99. In very broad terms, the trend of the case-law is that it is difficult to obtain a discharge unless the taxpayer's conduct is beyond reproach and/or the unauthorised payment took the less serious form of a loan rather than an outright payment. The consequences of applying the unauthorised payments regime to pension scams involving pension liberation can be disastrous for the taxpayers – though possibly in cases of fraud there might be some scope for an occupational pension scheme to recover scheme sanction charges from the Fraud Compensation Fund (as to which, see *PPF v Dalriada* [2020] EWHC 2960 (Ch) at [147], [172]).

Relief under ss 266A-266B FA 2004

100. In passing, it should be noted that there is separate provision for relief from the unauthorised payments charge, surcharge and scheme sanction charge in ss 266A-266B FA 2004 where property has been recovered by the scheme pursuant to specified restitution orders under the Pensions Act 2004. This could be relevant in pension liberation cases where liberated scheme assets are recovered under these statutory powers. This is in contrast to the general position where there is no relief from the unauthorised payments regime just because the unauthorised payment is returned to the scheme (or is even ineffective, as in *Clark v HMRC* discussed above).

A word on accidental overpayments

101. There is clearly scope for a mistaken overpayment from a registered pension scheme to fall foul of the unauthorised payments regime. This is topic in itself which is not addressed in any detail in this paper. Suffice it to note that HMRC has accepted in PTM 146100 that:

"*An inadvertent payment made in the following circumstances will not be an unauthorised payment:*

- *the payment is made in genuine error, such that there was no intention to make a payment to that extent or at all, and*

- *the erroneous payment is spotted by someone involved with the management of the scheme (or the recipient of the payment or the recipient's adviser might have brought the matter to the attention of the scheme managers), and*
- *the error is rectified as soon as reasonably possible.*"

102. This concession is elaborated at PTM 146200 onwards, including a general policy not to enforce the charges where the overpayment does not exceed £250. There are also specific exceptions in Regulations covering certain types of mistaken overpayments, treating them as authorised payments: see Parts 3 and 4 of the Registered Pension Schemes (Authorised Payments) Regulations 2009, SI 2009/1171. These cover, for example, routine overpayments of instalments of pension where the scheme administrator believed the recipient was entitled to a payment of that amount (reg 13).

Aspects of DB surpluses – refunds and benefit improvements

Robert Ham KC and Michael Tennet KC

Introduction

New trust textbooks say surpluses don't ever arise, and that corresponds with the experience of many practitioners the focus of whose practice has been deficits as opposed to surplus. Lately, however, surpluses are back largely because of the change in monetary policy and interest rates. Suddenly, there are substantial surpluses in schemes where until very recently employers were having to make large deficit repair contributions. And in cases where there is an appetite to buy out or buy in benefits these are – or are likely soon to be –actual surpluses as opposed to the purely notional actuarial surpluses which had to be dealt with to avoid fiscal disadvantages under the 1986 FA found in the 1980s and 1990s.

This paper will frame the questions that arise and examine some of the constraints on answering them.

Aspects of DB Surpluses 1 – refunds and benefit improvements

Where there is a surplus in a scheme that is closed to further accrual, the employers ability to achieve a refund of surplus or an application of surplus for its own benefit and the members' ability to secure an augmentation of benefits out of the same surplus, is critically dependent on the balance of powers under the pension scheme.

The key questions are:

- Who has the power to augment /amend benefits while scheme is ongoing?
- Who has the power to trigger a winding up?
- What happens to a surplus on a winding up?
- Can the winding up provisions be amended?

Position while the scheme is ongoing

- Generally it is difficult to return surplus to the employer while a scheme is ongoing. Few schemes have powers that allow this and s. 37(3) of the Pensions Act 1995 provides that while the scheme is ongoing the trustee would need to be satisfied that it is "*in the interests of the members that[any] power [to transfer surplus] is exercised in the manner proposed*". There are also consultation requirements under the section.

- This test is unlikely to be satisfied, unless perhaps there were some quid pro quo for members to secure augmentations which were not otherwise possible while the scheme is ongoing. Even then it is unclear whether this would mean that the payment of part of the surplus to the employer was "in the interests of members". The ongoing nature of the scheme may also complicate a return of surplus because of the need to maintain a security buffer against future adverse experience.

- S.37(3) would not prevent surpluses being used to fund future accrual, but if the scheme is closed and the employer wants to remove funds from the scheme, the best course may be to trigger a winding up.

- Although it is difficult for the employer to benefit from surplus while the scheme is ongoing, many scheme have provisions allowing the trustee to augment benefits (esp. from surplus) while the scheme is ongoing.

- Such provisions may affect the trustee's willingness to put the scheme into winding up unless the ability to improve members benefits from surplus is maintained in a winding up situation.

Who has power to wind up?

- In most case the power to wind up will be vested in the employer or be bilateral:

    - Trustees sometimes do have unilateral powers to wind up a scheme but generally only where there is a solvency issue (which will not be the case in the situation we are considering).

    - Even where the employer appears to have a unilateral right to compel a winding up, the trustees will often have a discretion run the scheme as a frozen scheme, so that in practice the power is really bilateral.

- So need to consider both the Employers and Trustees motivations for triggering a winding up.

- The Employer is likely to wish to trigger winding up if:

    - There is no express prohibition on return of surplus to employer on winding up (saying more about this in a moment).

    - The Trustee has a power to augment benefits on winding up but is sympathetic to employer claims of "over funding".

    - The trustee is prepared to agree a mutually satisfactory division of surplus as "price" for the agreement of whoever has the power to wind up, to exercise that power.

- <u>Trustee</u> may support winding p to return surplus to the employer for various reasons:

    - In the simplest case, the trustee may be sympathetic to the employer's wish to have surplus returned to them on the basis that, in light of the history of the scheme, they regard the surplus as the product of employer overfunding. In such cases the trustee may be willing to agree to a winding up on the basis that it will allow surplus to be returned to the employer.

    - If the trustee is not so disposed, whether the trustee is willing to co-operate with attempts to put the scheme into winding up may depend on whether there is any advantage to members in keeping the scheme going.

- Whether there is any advantage to members in keeping the scheme going will depend upon:
    - Whether the trustee has power to augment or amend to increase benefits while the scheme is ongoing.

    - Whether there is a power or duty to augment benefits from surplus in winding up.

    - If not whether the Trustee and employer can negotiate a division of surplus on winding up as a quid pro quo for agreeing to exercise the power to winding up.

- The trustee is likely to be more willing to wind the scheme up if the power to augment, increase or amend to increase benefits while the scheme ongoing is vested in the <u>employer</u> either unilaterally or jointly with the trustee:

    - This is likely to give the employer the ability to block the use of surplus for benefit improvements while the scheme is ongoing. Over time this may result in members leaving the scheme or dying without benefitting at all from surplus. In the long term it could result in more of the surplus being paid to the employer on a wind up.

    - In this situation the trustee may perceive that winding up offers a better prospect of surplus being used to augment benefits. However this will also depend on the balance of powers over surplus in a winding up and/or whether the Trustee can negotiate a division of surplus on winding up as a quid pro quo for agreeing to exercise the power to winding up.

- Although the employer may be in a position to use its powers to “block” the use of surplus while the scheme is ongoing, it is nevertheless important for the employer not to rule out or threaten to rule out the exercise of these discretion “for ever” to put pressure on the trustees to provide a quid pro quo for the exercise of such powers . This could be a breach of the employers Imperial duties: *Hillsdown Holdings v PO* [1997] 1 All ER 862

Position if the scheme is wound up

- In all cases, whether the employer is willing to put the scheme into winding up, and whether the Trustee is likely to support that decision will depend on what the winding up provisions say about the use of surplus on a winding up:

- There are basically 5 potential situations which might govern the use of surplus on a winding up (alone or in combination) :

  1. All surplus is payable to the employer
  2. There is a trustee discretion to augment benefits following which the residual surplus is payable to the employer.
  3. There is a duty to augment benefits up to Revenue limits, and only then is any residual surplus payable to the employer.
  4. There is an express prohibition on the return of any surplus to the employer. This is likely to be accompanied by a similar restriction on using the POA to bring about a return of surplus to the employer
  5. There is no explicit provision dealing with any surplus or residual surplus.

- In situation 1 (all surplus to employer) it is clearly in the employer interests to wind up, and the issue will be:

  - Whether there is a unilateral power to put the scheme into winding up; if not
  - Whether the trustee can be persuaded to exercise a bilateral power to wind up;
  - If the trustee is not otherwise willing to wind up, whether a deal can be reached as to the division of surplus on a wind up as the price the trustee seeks for agreeing to wind up. The greater the Trustees powers to use surplus to benefit members while the scheme is ongoing, the higher the price may be .

- In situation 2 (trustee discretion to augment) whether it is in the employer interests to wind up, will depend on the position of the Trustees:

- if the trustees are otherwise minded to use the surplus to augment benefits up to Revenue limits (if they apply), this is likely to exhaust any surplus and the employer may itself have to negotiate limits on the exercise of any discretion by the trustee as the price of putting the scheme into winding up. Again the employer will need to be aware of its Imperial duties

- If the trustees are more sympathetic to the idea that the surplus is the product on employer overfunding, the employer may be content to rely on expressions of intent as to the likely exercise of any discretion if the scheme were to be put into winding up, although the trustees could not bind itself, absent a quid pro quo for doing so.

- In situation 3 (duty to augment from surplus) it will (prima facie) not be in the employer interests to wind up, unless there are very few remaining members as the surplus may not be large enough to exhaust Revenue Limits (assuming they are still applicable to the Scheme post 2006). The only way forward would be to explore a deal whereby the scheme was amended so as to divide the surplus up between the employer and the members on a winding up. This is only likely to be achievable if:

    - the employer has an effective veto on the use of surplus while the scheme is ongoing;

    - the employer has an effective veto on putting the scheme into winding up;

    - there is no express prohibition in the POA on using the POA to amend to return surplus to the employer. Sometimes there is.

- In situation 4 (prohibition on return of surplus to the employer) a return of surplus is unlikely to be achievable. Generally in such cases the POA contains a similar restriction on its use. The employer would need to reach an agreement with the trustee to reopen the scheme and use surplus to fund ongoing accrual: *Barclays Bank v Holmes*

- In situation 5 (no provision dealing with surplus or residual surplus) according to *Air Jamaica v Charlton* any surplus (or residual surplus if there is a prior discretion to augment benefits) would be returnable to contributors on a resulting trust.

- Although the Privy Council in *Air Jamaica* contemplated that surplus would be returned pro rata to employer and employee contributions this was in the context of a <u>shared cost scheme</u> where employer and members paid the same % of salary.

- The issues are more complex in a balance of cost scheme. If an employer has been making deficit repair contributions the calculation it may not be easy to work out who has paid what.

- Even if one adopted the same approach in relation to a balance of cost scheme the resulting trust is likely to be in favour of the employer given:

    - the longer period over which it usually will have made contributions compared to the average period of service of members
    - the amount of the employer contributions, especially deficit repair contributions.

- Some tricky issues also arise, e.g if you repay the estates of deceased members what happens where employers have ceased to participate (perhaps having substantial paid s.75 debts)?

- There is an argument for excluding former members and employers on the basis that they have ceased to participate having received everything to which they were entitled in return for their contributions. That argument was rejected on the facts in Air Jamaica, but has some appeal given it would be very difficult in most schemes to track down those entitled on the deaths or insolvencies of former contributors.

- Can an argument now be made that the whole of the surplus should be treated as bellowing to the employer ?

- The Courts have been traditionally sceptical of the argument that the employer is the owner of surplus as a result of complying with its balance of cost covenant: see e.g. *National Grid* However in such cases:

    - There was no resulting trust issue, the issue was how discretions over surpluses should be exercised and the Courts not unreasonably considered that to be a matter of construction of the powers themselves, without any philosophical predisposition as to who the "owner" of surplus was.

    - Historically the surpluses which featured in the case law (in the 1980s and 1990s) has arisen from benign investment conditions, inflating the future value of both member and employer contributions. The emergence of the surpluses had not been preceded (as in most current cases) by an extended period of deficit during which members ceased to accrue benefits (and make contributions) but during which the employer was required to make substantial deficit repair contributions.

  There therefore does now seem to be an argument that the whole of the surplus should result to the employer as the proximate cause of it arising.

The constraints

From a legal perspective, one is concerned with the exercise of powers and discretions vested in the trustees and/or the employer. The starting point is of course that the decision whether to exercise a power or discretion is one for the power holder or holders rather than the court or any regulatory body. But there are limits.

At a very high level of generality, the :

- the putative exercise of discretion must be within the scope of the relevant power
- it must be made for a proper purpose
- in the case of trustees and other fiduciaries:
  - the trustees must make the decision themselves
  - the decision must be rational, that is based on considerations with a logical connection with the decision i.e. based on all relevant and no irrelevant considerations,
  - the ultimate decision must not be totally unreasonable
- in the case of an employer, the decision must comply with the *Imperial Tobacco* duty of good faith

I propose to illustrate the operation of each of these principles in the context of some well-known cases relating to surplus. But before doing so, there are two preliminary points to be made:

- the courts are in general concerned to prevent the abuse of powers, not to compel their exercise: there is a dearth of cases where the court has done so, probably limited to cases of bad faith or where there is only one reasonable and proper conclusion
- failure to comply with the principles does not necessarily mean the decision is void *ab initio*: the decision in Pitt v Holt establishes that in cases with the scope of a fiduciary power an imperfect decision-making process may make the exercise of the power merely voidable as opposed to void: cf current version of section 67.

Key cases

Courage illustrates the first constraint – purely a matter of interpretation

And Millett J sanctions bargaining between employer and trustees. Bargaining power will depend on division of powers and extraneous circumstances.

Hillsdown:

- illustrates improper purpose principle in operation
- show not enough that t'ees think it deal is in the interest of their beneficiaries
- Imperial duty – but as CA pointed out in IBM misnomer to refer to duty.

Edge

Barclays v Holmes

Aspects of DB surpluses (part 2) – transfers out and cross-funding DC sections

David Pollard, Joseph Steadman and John Grocott-Barrett

1. This second session aims to look at some of the further specific aspects of dealing with surpluses in a defined benefit (DB) occupational pension scheme[78], following on from the discussion of refunds and surplus allocations dealt with in the previous session of these 2023 Nugee Lectures.

2. This session will look in more details at some specific issues:

   (a) using surplus by adding in a new defined contribution (DC) section;
   (b) using surplus round a group – some corporate issues on transfers to another scheme in relation to disguised dividends and returns of capital; and
   (c) tripwires for trustees and employers seeking to reduce or return a surplus.

3. A "surplus" within an on-going scheme can be said to be purely notional, representing no more than the fact that an estimated current value of the scheme assets[79] exceeds an estimated current value of the DB liabilities.

4. For an on-going scheme, the asset value will tend to represent the current market value of the assets, based on the market value (for listed assets) and an estimate of disposal value for assets with no ready market (eg land). This asset value will inevitably tend to fluctuate as markets and asset values move (unless the benefits have been matched by a buy-in policy with an insurer). The estimate of the current value of the DB benefits will depend on what actuarial bases and assumptions have been used to reach the current value (in particular, investment return/discount rate, longevity and inflation).

5. The position usually differs where a scheme is at (or nearing) winding-up. In that scenario, the trustees will be looking to secure the benefits by buy-outs with an insurance company. If any funds are left after this process (and payment of any expenses or insurance), this can be said to be a true – rather than a notional – surplus.

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[78] This paper deals with such an occupational pension scheme in the private sector, established under trust and registered for tax purposes with HMRC under the Finance Act 2004.

[79] Ignoring the DC assets.

6. Unlike the position (some decades ago) when potential surpluses were last more common, many more DB schemes are now both closed to new DB entrants and frozen to new DB accrual. This means that the prospect (from an employer perspective) of a “trapped” surplus is greater than it was previously.

7. Previously, if a surplus emerged in an open or non-frozen scheme it was possible for adjustments to be made to on-going contributions to reflect the surplus – ie a “contribution holiday” or reduction. In effect, the on-going employer contributions for future accrual could be reduced from what would otherwise have been required. This reduction would reflect – and over time seek to reduce – the notional surplus. The trustee and the employer would monitor the on-going funding position to reflect this (in particular by the formal triennial actuarial valuations).

8. Whether such contribution reductions were allowed under the DB scheme depended on the terms of the contribution rule and the terms of the employment relation with the active members. Some schemes were not pure balance of cost (the employee pays a fixed contribution – as a percentage of relevant pay – and the employer pays the balance of cost as required), but instead included provisions requiring employers to pay at least a multiple of the employee contributions. These are more complex[80] and not discussed in detail in this paper.

9. Where a DB scheme has been closed to all (or most) future service accrual (with onward pension provision[81] in a separate DC arrangement), this flexibility to absorb surplus by contribution reductions is less easy or effective.

10. The prospect therefore arises, from the employer’s perspective, of a “trapped surplus”. It has paid more in contributions that turned out to be required, and it has problems in getting value back from the scheme. This can be an issue for the trustee too. The employer may become more reluctant to fund at a very full level, instead looking to defer contributions, perhaps supporting them with contingent assets (eg a mortgage).

11. This paper looks at two of the ways of utilising a surplus in these circumstances (other than envisaging a cash return to the employer or providing DB benefit improvements for members):

    A. using surplus by adding in a new DC section; and

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[80] See for example the Railways Pension Scheme discussed in *Railways Pension Trustee Co Ltd v Atos IT Services UK Ltd* [2022] EWHC 3236 (Ch) 16, [2023] Pen LR 6 (Flaux C).

[81] For example to comply with the employer duties under the auto-enrolment legislation in and under the Pensions Act 2008.

B. using surplus round a group – some corporate issues on transfers to another scheme in relation to disguised dividends and returns of capital.

12. It then goes on in Section C to explore some potential legislative tripwires for trustees and employers seeking to reduce or return a surplus.

A. Using surplus by adding in a new DC section

13. It is possible for there to be an on-going surplus, calculated on a "technical provisions" (or company accounts) basis, even where the value of the assets is less than the funding estimated to be required on a buy-out basis or on the new "low dependency" basis envisaged by the new funding code of the Pensions Regulator (if it ever comes into force).

14. In those circumstances, using that surplus to fund future employer contribution reductions (whether DB or DC) will in practice require agreement with the trustee as part of the triennial funding documentation, in particular the schedule of contributions.

15. The trustee's willingness to agree to such a reduction may well depend on what would happen to the surplus (and employer contribution rate) absent such agreement.

16. Depending on the rules of the scheme, it may be that sometimes the trustee has a unilateral right to increase benefits out of a surplus. But the trustee would need to exercise this power consistently with its trustee duties (bearing in mind that the employer may be characterised as a beneficiary under the scheme, to whom the trustee also owes duties along with the members and other beneficiaries) and for a proper purpose (which is far from straightforward[82]).

17. In the absence of a unilateral power to increase benefits, or where there is doubt about the propriety of using it, the provision of additional benefits will have to be by consent.

18. Many of the cases in this area pre-date the changes made by the Pensions Act 2004 and later legislation. These need to be considered in detail before proceeding with a DC section approach.

[82] See eg the decision of the Court of Appeal in *British Airways plc v Airways Pension Scheme Trustee Ltd* [2018] EWCA Civ 1533, [2018] Pens LR 19 that unilaterally increasing benefits (pension indexation) was outside the purpose of the trustee's amendment power.

19. **Structure of DC section cross payments**: In practice it is safest for the scheme rules to be amended to set up the relevant DC benefit section and to confirm that it is not intended to be a separate ring-fenced section of the scheme for statutory purposes[83]. If the DC section was considered to be a separate sub-trust, in effect a form of separate scheme, one consequence of that might be a prohibition on cross subsidy between the separate schemes.

20. Much (but not all) of the pensions legislation expressly provides for segregated sections of a single scheme to be treated as separate schemes for various purposes. These include scheme funding. In practice a linked DC section in an otherwise DB scheme would not work if such a segregation applied.

21. Accordingly it is prudent to ensure that the rules of the scheme are amended to deal with the terms of the DC section and to deal with its (and the scheme's) funding and expenses. An express provision allowing for funds notionally in the DB section to be used to credit the employer (and perhaps employee) contributions to the DC section is prudent.

22. Absent such express wording there is a risk that the courts would later construe the DC section as needing separate funding and not allowing cross funding[84].

23. It is vital that the rules of the DC section provide for members' benefits to be calculated to match the value of the assets notionally held within their DC "pots". Otherwise, the benefit arrangement will not comply with the "money purchase benefits" definition now in s181 and s181B of the Pension Schemes Act 1993 (as amended, in particular by PA 2011).

> Section 181 includes the definition:
>
> > *"money purchase benefits" , in relation to a member of a personal or occupational pension scheme or the widow, widower or surviving civil partner of a member of such a scheme, means—*

[83] See eg OPS (Employer Debt) Regulations (SI 2005/678, as amended), reg 8; OPS (Scheme Funding) Regs 2005 (SI 2005/3377), reg 19; OPS (Investment) Regulations (SI 2005/3378), reg 16; OPS (Winding-up etc.) Regulations 2005 (SI 2005/706), reg 13; OPS (Winding-up) Regulations 1996 (SI 1996/3126), reg 12; OPS (Payments to Employer) Regulations 2006 (SI 2006/802), reg 18; Pension Protection Fund (Entry Rules) 2005 (SI 2005/590), reg 1(3).

[84] See for example *Kemble v Hicks: Re Scientific Investment Pension Plan (No.3)* [1999] OPLR 1, [1999] Pens LR 287 (Rimer J).

(a) *benefits the rate or amount of which is calculated by reference to a payment or payments made by the member or by any other person in respect of the member and which fall within section 181B, and*
(b) *collective money purchase benefits;*

Section 181B provides:

181B Money purchase benefits: supplementary
(1) This section applies for the purposes of paragraph (a) of the definition of "money purchase benefits" in section 181(1).
(2) A benefit other than a pension in payment falls within this section if its rate or amount is calculated solely by reference to assets which (because of the nature of the calculation) must necessarily suffice for the purposes of its provision to or in respect of the member.
(3) A benefit which is a pension in payment falls within this section if—
(a) its provision to or in respect of the member is secured by an annuity contract or insurance policy made or taken out with an insurer, and
(b) at all times before coming into payment the pension was a benefit falling within this section by virtue of subsection (2).
(4) For the purposes of subsection (2) it is immaterial if the calculation of the rate or amount of the benefit includes deductions for administrative expenses or commission.
(5) In this section references to a pension do not include income withdrawal or dependants' income withdrawal (within the meaning of paragraphs 7 and 21 of Schedule 28 to the Finance Act 2004).

In practice the crediting of amounts or contributions from the DB assets to the DC section will probably need to involve a notional transfer of specific "surplus" funds held within the scheme.

Barclays Bank v Holmes

24. The establishment of a DC section, with cross subsidy from the other funds of the scheme was clearly sanctioned by Neuberger J (as he then was) in 2000 in *Barclays Bank plc v Holmes*[85]. He distinguished *Kemble v Hicks* as being concerned with the wording of the particular scheme.

[85] *Barclays Bank PLC v Holmes* [2001] OPLR 37, [2000] Pens LR 339 (Neuberger J).

25. Neuberger J approved the amending deed for the Barclays Bank scheme dealing in particular with the following points:

a. There was a single trust fund for the whole scheme, covering both DB and DC benefits (at [54]: *"There is no intrinsic reason, as a matter of general law, why an employer or any other person could not set up a Pension Scheme expressly on that basis, in the way that the Bank has purported to do in the present case…"*. This is perhaps unsurprising as it was common for DB pension schemes to include a DC section[86] dealing with AVCs alongside the DB benefits. As Neuberger J pointed out, the creation of separate beneficial interests within one trust structure is also common in private trusts.

b. The Barclays rules provided for employer contributions to be "credited", but for member contributions to be "paid" (at [72] to [74]).

c. The notional "member's account" in the DC section does not give rise to a separate trust fund – following Inland Revenue practice[87] (at [78] and [81]).

d. The decision of Rimer J in *Kemble v Hicks* could be distinguished as dealing with an amending deed that expressly provided for the payment of contributions into the new section (at [95] and [96]).

e. There were no wider considerations that prevented surplus being used in this way – in effect to provide retirement benefits (albeit not on a DB basis). The surplus could not be said to be beneficially owned by the employees or pensioners (at [100] and [101]).

f. The relevant amendments allowing for cross subsidy did not infringe the restriction in the scheme on amendments "which purported to result in the return of any portion of the Fund to the employers" (at [104] to [111]). This part of the decision is supported by the later decision of the House of Lords in *National Grid v Laws*[88], which was given after Neuberger J's decision. Neuberger J distinguished

[86] An AVC facility was required under the Social Security Act 1986 and PSA 1993 and the Pension Schemes (Voluntary Contributions Requirements and Voluntary and Compulsory Membership) Regulations 1987 (SI 1987/1108, as amended).and most employers dealt with this by a money purchase/DC facility within the DB scheme.

[87] Citing para 2.9 of the Inland Revenue Practice Notes, IR12.

[88] [2001] UKHL 20, [2001] 1 WLR 864.

the earlier decision of Vinelott J in *British Coal*[89] on a similar point (Vinelott J's decision was later overruled by the House of Lords).

g. Similarly the amendments did not infringe the other limitation in the Barclays scheme's amendment power, that a rule change should not "cause the main purpose of the Fund to cease to be that of provision of pensions on retirement". Neuberger J held[90] that the DC section did not infringe this, the only difference being the basis on which the pensions are calculated (at [113] to [118]).

h. The amendments did not adversely affect accrued rights and so did not trigger the limitations under Pensions Act 1995, s67.

26. Although *Barclays Bank v Holmes* is now a decision from over 20 years ago, there is no reason to think that it would not be followed today. The changes in legislation since 2000 do not seem to materially affect the position[91].

27. Care would however be needed if:
    a. the crediting cross subsidy were sought to be extended to employee contributions as well as employer contributions (the crediting approach in Barclays Bank only extended to employer contributions); or
    b. the employer wished to use the DC section for the purpose of complying with its auto-enrolment duties (this is considered in more detail below).

28. Barclays Bank has been applied in later cases – see eg *Alexander Forbes*[92] and *Leadenhall Independent*[93]. Similarly the lengthy decision of the Pensions Ombudsman in the *IBM determination*[94] in 2004. Overseas cases[95] have reached different results in different cases and are perhaps more dependent on the local legislation.

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[89] *British Coal Corporation v British Coal Staff Superannuation Trustees Ltd* [1995} 1 All ER 192 (Vinelott J)

[90] Referring to *Courage* [1987] 1 WLR 495 (Millett J) at 505 and *Edge* [2000] 3 WLR 79, CA Chadwick LJ at 96F.

[91] At least, it does not seem that the amendments to s67 of the Pensions Act 2004 alter the position.

[92] *Alexander Forbes Trustee Services Ltd v Halliwell* [2003] EWHC 1685 (Ch), [2003] Pens LR 269 (Hart J).

[93] *Leadenhall Independent Trustees Ltd v Welham* [2004] EWHC 740 (Ch), [2004] OPLR 115 (Park J).

[94] IBM Pension Plan (K00516) Laverick PO (22 October 2004).

[95] See eg *Tek Corpn Provident Fund v Lorentz* [1999] OPLR 137 (South Africa); *Hughes Aircraft Company v Jacobson* 105 F3d 1288 (US Supreme Court, mentioned in *Barclays Bank* at [88]); and *Nolan v Kerry (Canada) Inc* 2009 SCC 39, [2009] 2 SCR 678 (Supreme Court of Canada).

Credits within the scheme instead of payments by the employer

29. The aim is to use the surplus within a DB section to credit the employer contributions that would otherwise be envisaged as payment by the employer[96] to the scheme. This raises the question of whether such credits count as:

> *"a payment or payments made by the member or by any other person in respect of the member"*

within the definition of "money purchase benefits" within PSA 1993, s181 (quoted above). A similar issue can arise under the auto-enrolment legislation (see below).

30. This obligation for there to be a payment in respect of the member could be argued not to an amount to be "paid" does not to fit neatly with the crediting concept for DC contributions within a scheme.

31. But it seems to have the same monetary effect as the usual situation of the employer making a payment to the scheme by (say) arranging a credit from one bank account (of the employer) to another bank account (of the scheme)—the best argument is that it is analogous to a credit within a bank. In modern times the likelihood of physical cash payments being made is slim. The only difference in a DC section credit is that the credit is within the scheme's notional accounts rather than coming from outside.

32. The issue on payment as against credits as regards the statutory definitions did not expressly arise in the *Barclays Bank* case, although the statutory definition at that time (2000) of "money purchase benefits" in PSA 1993 s181 (as originally enacted[97]) included the same wording on *"a payment or payments made by the member or by any other person in respect of the member"*. This element of the definition was not altered as part of the later statutory changes.

Checklist for a DC section

33. A checklist of issues to be considered for a DC section is below:

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[96] As to crediting against employee contributions, see below.

[97] As originally enacted in PSA 1993, s181:

"money purchase benefits", in relation to a member of a personal or occupational pension scheme or the widow or widower of a member of such a scheme, means benefits the rate or amount of which is calculated by reference to a payment or payments made by the member or by any other person in respect of the member and which are not average salary benefits;

1) Check/amend scheme rules to clarify that (i) not a separate scheme; (ii) nor sectionalised; (iii) cross-subsidy allowed; and (iv) DC section bases benefits on both contributions paid and credits made.

2) Check agreements with members on employer contributions – do they allow for credits as well as cash payments?

3) Use the crediting approach for employer contributions only.

4) Consider impact on auto-enrolment.

5) Consider impact on schedule of contributions.

6) Consider whether to re-open scheme to new members/employers in the DC section.

7) Consider winding-up position.

8) Consider impact on s75 debts (eg cessation of active membership and employment cessation events).

34. **Trustee approval:** In practice it is likely that the trustee will need to approve the new arrangements, both any rule amendments (depending on the amendment power) and changes to the schedule of contributions etc. The trustee would also need to consider the potential impact of such arrangements on the DB funding position.

35. There ought to be limited adverse effect of introducing a new DC arrangement (and the use of surplus to credit contributions to it) on the existing DB members, whose position is already well secured by the surplus (provided the assumptions underlying the valuation are sufficiently prudent). It is likely that the surplus will, over time, be reduced by the crediting approach. But this is a matter for the trustee to monitor, and to deal with by the regular schedule of contributions and perhaps by seeking additional security as mitigation in case a deficit emerges in the future.[98]

36. **Scheme amendment:** The terms of the amendment power, and any applicable fetters, will need to be considered, as will the question whether the amendment is made for a proper purpose (as mentioned above). The *Barclays Bank* decision is helpful in relation to s67 and two common forms of restriction.

37. **Schedule of contributions:** As a DB scheme, there will be a schedule of contributions covering the DC contributions as well as the DB—a payment schedule (PA 1995, ss87

[98] Implementing a new DC section could, however, have an impact on the scheme reaching its "low dependency" funding level.

and 88) only applies to a "pure" DC scheme (or DC and death benefits) and so would not apply to a hybrid scheme.

38. **Crediting against member contributions?** The DC section may involve:

- both member contributions and employer contributions (or credits); or
- only employer contributions (or credits).

39. It would be usual for the employer to deduct member contributions from the member's pay and then pay an amount equal to the amount deducted to the scheme. The pensions legislation includes a requirement for the employer to pay such an amount to the scheme before the 19th (or 22nd)[99] of the month following the month on which they were deducted from pay – PA 1995, s48(8)[100]. The statutory obligation requires that "the amount deducted is to be paid within the prescribed period to the trustees ... of the scheme" (emphasis added).

40. As mentioned above in relation to the definition of "money purchase benefits" in s181, this obligation for an amount to be "paid" does not fit neatly with the crediting concept for DC contributions within a scheme (the best argument is that it is analogous to a credit within a bank).

41. In relation to employee contributions, failure to comply with the s49(8) obligation:

- can result in a civil penalty on the employer – s49(9)(a);
- may require the trustee to notify the Pensions Regulator (if they have reasonable cause to believe that the failure is likely to be of material significance) – s49(9)(b)—a trustee who fails to take all reasonable steps to secure compliance with the notification obligation can be the subject of a civil penalty (under s10) - s49(10)(b); and
- can result in a criminal offence on any person knowingly concerned in the fraudulent evasion of the obligation – s49(11) and (12).

42. The s49(8) obligation only applies to member contributions and is not an issue for the crediting of employer contributions (or credits). This can be another reason why a salary sacrifice arrangement (in which all contributions are by the employer) could be helpful.

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[99] The 22nd of the month if paid by means of electronic communication – SI 1996/1715, reg 16(1)(a) as amended by SI 2012/215.

[100] Pensions Act 1995, s49(8) and the OPS (Scheme Administration) Regulations 1996 (SI 1996/1715), reg 16 as amended.

43. **AE issues:** If the DC section is to be used by the employer to meet its auto-enrolment employer duties (under the Pensions Act 2008), then the DC section will need to meet the qualifying requirements of an automatic enrolment ("AE") scheme.

44. The test scheme standard for this is in Pensions Act 2008, s22, with s24 dealing with a hybrid scheme (as would be the case here). This allows the scheme to be a qualifying scheme if it satisfies the appropriate test either for a money purchase scheme (under PA 2008, s20) or for DB scheme (under PA 2008, ss21 to 23A), in both cases subject to prescribed modifications. The DWP can also make rules as to which test is appropriate (s24(2)). The Hybrid Schemes Quality Requirements Rules 2016[101] would need to be considered as to whether they applied to the scheme (this can depend on whether there are still active members accruing benefits in the DB section as well).

45. The 2016 Hybrid Schemes Rules envisage that the two benefit sections may need to be treated as if they provided for benefits under separate schemes "in the application of section 24(1) of the Act". This seems to relate to the benefits only rather than the contributions.

46. But the standard test for a member to be within AE on a DC basis envisages that:

- the employer must make minimum contributions of at least 3% of the jobholder's qualifying earnings over the relevant pay reference period; and
- the total amount of contributions paid by the jobholder and the employer must be at least 8% of the jobholder's qualifying earnings over the pay reference period (PA 2008, s20(1) and regulation 5, Automatic Enrolment Regulations[102]).

47. The legislation requires that the employer "must pay contributions" in respect of the jobholder. It is at least questionable whether a crediting approach would meet this requirement. The term "contribution" is not generally defined in PA 2008[103] or the relevant regulations, so that provides no assistance.

[101] http://data.parliament.uk/DepositedPapers/Files/DEP2016-0339/Hybrid_Schemes_Quality_Requirements_Rules_2016.pdf

[102] Occupational and Personal Pension Schemes (Automatic Enrolment) Regulations 2010 (SI 2010/772, as amended).

[103] In s23A (Alternative quality requirements for UK defined benefits schemes) note the definition in s23A(2) of "contributions" as meaning "contributions to the scheme by, or on behalf or in respect of, a relevant member".

48. There are alternative quality tests under regulations made under s23A[104] (as inserted by PA 2014, s39), but these also do not fit well with a crediting approach (note the definition of "contributions" as meaning "contributions to the scheme by, or on behalf or in respect of, a relevant member").

> **23A Alternative quality requirements for UK defined benefits schemes**
> (1) The Secretary of State may by regulations provide that a defined benefits scheme that has its main administration in the United Kingdom satisfies the quality requirement in relation to a jobholder if any one or more of the following is satisfied—
>
> (a) the scheme is of a prescribed description and satisfies the quality requirement under section 20 in relation to that jobholder;
> (b) the cost of providing the benefits accruing for or in respect of the relevant members over a relevant period would require contributions to be made of a total amount equal to at least a prescribed percentage of the members' total relevant earnings over that period;
> (c) in the case of each of at least 90% of the relevant members, the cost of providing the benefits accruing for or in respect of the member over a relevant period would require contributions to be made of a total amount equal to at least a prescribed percentage of the member's total relevant earnings over that period.
>
> (2) For this purpose:
>
> "contributions" means contributions to the scheme by, or on behalf or in respect of, a relevant member;
> "relevant earnings" means earnings of a prescribed description;
> "relevant members" means members of the scheme of a prescribed description;
> "relevant period" means a period specified in or determined in accordance with the regulations.
>
> (3) A percentage prescribed under subsection (1)(b) or (c) must be at least 8%.
> (4) Regulations under subsection (1)(b) or (c) may make provision—
>
> (a) about how to calculate whether the requirement is satisfied, including provision requiring the calculation to be made in accordance with prescribed methods or assumptions;
> (b) requiring benefits of a prescribed description to be disregarded in determining whether the requirement is satisfied;

[104] See Regulations 32L and 32M, Automatic Enrolment Regulations. There is DWP guidance from April 2016, but this does not deal expressly with a DC credit issue: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/511119/automatic-enrolment-quality-requirements-guidance.pdf

> (c) that a scheme only satisfies the requirement if the scheme actuary certifies that it does; and for this purpose "scheme actuary" has the prescribed meaning.
>
> (5) Section 13(3) (meaning of "earnings") applies for the purposes of this section as it applies for the purposes of that section.

Ultimately this means that it is not clear that a crediting approach would allow an employer to meet the AE minimum amounts (although it could be used for any amounts envisaged above the minimum required by AE).

B. Using surplus round a group – some corporate issues on transfers to another scheme in relation to disguised dividends and returns of capital

49. Surplus in a scheme can lead to restructuring of pension arrangements (such as the addition of a DC section discussed above). Another way of making more effective use of funding might be to refund surplus to the employer or to merge two occupational schemes together.

50. In practice such arrangements may well involve more than one company within a group. When such intra-group arrangements are involved, it is important to consider the potential company law issues that could arise, in particular the implications for the arrangement to result in:

- a transfer of assets (at an undervalue) from one company to another;
- a disguised dividend; or
- a disguised return of capital.

51. This may also be relevant if one or more of the participating companies is not wholly-owned (for example if one of the participating companies is a joint venture or has minority shareholders). A minority shareholder is likely to be concerned at any restructuring that takes assets away from being utilisable by the company itself.

52. If this occurred, it could result in the transaction being reversed (or stopped in advance) or a breach of duty action against relevant directors (eg by a later liquidator). Remedies available could include: an unfair prejudice petition; derivative action; or a petition to wind up on just and equitable grounds.

53. These issues may well be less relevant if:

1) there are no minority shareholders;
2) there are no cross-border issues;

3) the companies are all solvent so there is less risk of future action by or on behalf of creditors; and
4) the companies have sufficient distributable reserves (supported by accounts) so could make the payments anyway[105].

54. When reorganising pension arrangements, the corporate implications for the employers need to be considered. Does the reorganisation result in a transfer of value from one company to another, so that this could later be invalidated either as:
   - a transaction defrauding creditors – Insolvency Act 1986, s423; or
   - a transfer at an undervalue or a preference (usually needing to be within two years of a formal insolvency) – Insolvency Act 1986, ss238 and 239; or
   - a disguised dividend or capital return?

55. In practice this is very fact and structure dependent. How does any restructure affect the corporate position? What are the intentions or purpose of the relevant employers or other parties?

   - In relation to s423, the core ingredients were pithily expressed by Flaux J in *Fortress Value Recovery Fund I LLC v Blue Skye Special Opportunities Fund LP* [2013] EWHC 14 (Comm), [104] as follows:

     "There are thus four requirements for relief to be granted:
     (1) a debtor;
     (2) who enters into a transaction;
     (3) at an undervalue;
     (4) with the purpose of putting assets beyond the reach of or prejudicing the interests of a person with an actual or potential claim."

   - In relation to transactions at an undervalue, the test in s238(4) is that:

     "a company enters into a transaction with a person at undervalue if–

     (a) the company makes a gift to that person or otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration, or
     (b) the company enters into a transaction with that person for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company."

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105 Note however that the disguised distribution rule is applicable, even if the company is solvent, so this is not a complete answer: *Aveling Barford v Perion* (1989) 5 BCC 677 at 683F and *Add2 research and Development* [2021] EWHC 1630 (Pat) at [223](iv), [230](ii), and [225].

- In relation to a preference, the test in s239(4) is that:

  "a company gives a preference to a person if—
  > *(a) that person is one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities, and*
  > *(b) the company does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done."*

- In relation to disguised dividends or capital returns, the legal issue that a transaction that otherwise looks to have been properly approved is found to be in reality a capital return or disguised dividend. Capital returns and dividends are protected by the legislation and the common law, with particular conditions applicable before they can take place.

Progress Property v Moore

56. The leading case on invalidating a transaction because it should in reality be categorised as a distribution is *Progress Property v Moore* [2010] UKSC 55, [2011] 1 WLR 1. In that case, the Supreme Court confirmed that:
    - "whether a transaction infringed the common law rule that a distribution of a company's assets to a shareholder, except in accordance with specific statutory procedures, was unlawful and ultra vires the company, was a matter of substance and not form";
    - the essential issue was how the transaction was characterised as a matter of law, and the label attached to the transaction by the parties was not decisive;
    - where a transaction which had been negotiated at arm's length and in good faith between a company and a shareholder proved with hindsight to have been detrimental to the company, the company's real task was to inquire into the true purpose and substance of the impugned transaction by investigating all the relevant facts, which might include the states of mind of those orchestrating the corporate activity; and
    - sometimes the states of mind of the directors were irrelevant and their conduct alone was enough to establish the unlawful character of the transaction.

57. The case involved an allegation of a sale by a company to a connected company at an undervalue. This benefited a company under the control of the same company as the vendor. The issue was whether such a sale at an undervalue was really a distribution of capital - either a reduction of capital or a form of distribution: [1].

58. It was assumed for appeal purposes that there was a sale at an undervalue, but that the relevant director agreeing the sale (Mr Moore) had a genuine belief that it was an arm's length sale: [14]. It was also assumed for appeal purposes that Mr Moore was in

breach of duty in in failing to realise that the transaction was in fact a transaction at an undervalue: [4].

59. Lord Walker confirmed that the issue was a matter of substance not form: [16]. Some previous cases had re-categorised transactions, for example: -

- "grotesque" amounts of interest (*Ridge Securities v IRC* [1964] 1 WLR 479): see [16] to [17]; and
- payment of too large remuneration to non-executive director which was held to be a "gift out of capital" as in *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016 (described by Lord Walker as "hardly apt on the facts of the case" at [19]).

60. Here the assumed facts were that Mr Moore had no "knowledge or intention" that the sale would be an undervalue: [25] to [27]. Lord Walker discussed whether the test was objective or subjective depending on the knowledge or intention of the parties. But it will sometimes be an objective test: see [28] and [29].

61. Lord Walker noted cases where there could be a "margin of appreciation" for the parties[106].

62. Lord Mance (agreeing) confirmed that the test could be objective or subjective. See [42] where he explained it was not just a subjective motive test:

> *"But there may come a point at which, looking at all the relevant factors, an agreement cannot be regarded as involving in substance anything other than a return or distribution of capital, whatever the label put on it by the parties."*

63. Lord Mance gave three reasons why the transaction in this case was not prohibited as being categorised as really being a return of capital or distribution ([45] to [47]):

    1. it may not be an undervalue in fact;
    2. the directors may have been ill advised or unwise—this does not mean axiomatically that the transaction is a distribution of capital
    3. the court should not make the assumption that an indemnity agreement would fail, thereby reducing the value of the transaction, when that had not yet happened.

[106] See *Chalcot Training Ltd v Ralph* [2020] EWHC 1054 (Ch).

64. Most of the cases in this area[107] have not to date involved pension restructures. But from a related area, note *Tone v Ross* [2019] EWHC 2855 (Ch) (Chief ICC Judge Briggs), where the use of an EBT trust was treated as return of capital to shareholders.

Blackwood Hodge

65. An example of the corporate issues in a pension context is given by the facts in a case in 1996, *Re Blackwood Hodge Plc* [1997] 2 BCLC 650.

66. Blackwood Hodge ("BH") had been taken over by another company, BM. But the preference shares in BH remained outstanding. On the takeover BH had two final salary pension schemes with, it seemed, a surplus (argued to be £5.6m). Only one of the BH subsidiary employers was paying contributions.

67. It seemed that after the takeover, BM had treated the two BH schemes as merging into the BM scheme, but the legal documentation for this was deficient and the Judge later held that the scheme mergers did not work. BH later sold its subsidiaries, so they ceased participating in or contributing to the scheme.

68. Some of the preference shareholders later complained that the BH directors had committed a breach of duty by agreeing to the merger (if it had actually taken place) and that this amounted to unfair prejudice against them. In effect they argued that the surplus that was in the two BH schemes had been transferred to the BM scheme at a nil value. BM should have paid BH for the surplus – hence the unfair prejudice petition under the Companies Act 1985, s459 (now CA 2006, s994).
69. The evidence was rather confused, but ultimately Jonathan Parker J held that:
    - there seemed to be various breaches of duty by the BH directors in relation to the merger (p675a);
    - but there was no evidence of loss to BH—it would have lost the value of the surplus in the schemes, but it seemed that no surplus would return to BH on a winding up because there was a provision for augmentation up to revenue limits: pp668g and 677g) and no evidence that BH could get any value from the surplus on the sale by BH of the participating employers (p679a); and
    - there was no evidence that BM would have paid anything for the surplus (p680c).

70. Accordingly Jonathan Parker J held that there had been no unfair prejudice to the preference shareholders in BH.

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[107] For example *Madoff Securities International Ltd v Raven* [2013] EWHC 3147 (Ch) (Popplewell J), *SSF Realisations v Loch Fyne Oysters Ltd* [2020] EWHC 3521 (Ch) (Zacaroli J); *-ILiffe News and Media Ltd v HMRC* [2012] UKFTT 696.

71. This seems a fortuitous victory for BM (and the relevant directors). A breach of duty and a very messy situation as regards the BH pension schemes seems not to have resulted in unfair prejudice. We must wonder what happened later to the BH pension schemes given that there had not (apparently) been a merger.

72. This set of facts would be a warning to get the pension steps right while also considering the corporate law implications.

Checklist of corporate issues

73. A checklist of some corporate issues to consider is below. This is in addition to the specific requirements of pensions legislation, which are considered in more detail in Section C:

    1) **Separate approval:** Have all relevant companies separately approved the transaction - ie with the directors complying with their own duties to that company (in the context of the group)? It can be helpful to approve the transaction by a shareholder vote (or unanimous written resolution[108]), although this may not be effective if the company is approaching insolvency[109].

    2) **PE duties:** Does the Principal Employer owe any duties to the other participating companies in the scheme?

    3) **Transfer of assets:** Does the restructure result in a transfer of assets away from one company to another for less than full value? This will not necessarily result in an issue, but could be a concern on a later insolvency - eg a transaction at an undervalue or s423 (transaction defrauding creditors) claim[110]. Depending on the circumstances it may also allow a claim based on minority oppression[111]. For an example of such a claim in a pension merger context, see *Re Blackwood Hodge plc*[112]

    4) **Disguised dividend/ return of capital:** In many cases the transaction will not cause any of the employers to become insolvent, but may still have the commercial effect

[108] *Re Duomatic Ltd* [1969] 2 Ch 365.

[109] *BTI 2014 LLC v Sequana SA* [2022] UKSC 25, [2022] 3 WLR 709, [2023] 2 All ER 303.

[110] The potential ambit of s423 claims has been widened by the recent decision of the Court of Appeal in *Invest Bank PSC v El-Husseini* [2023] EWCA Civ 555 to cover transactions involving companies (and presumably other entities) owned or controlled by the debtor.

[111] Companies Act 2006, s994 (formerly CA 1985, s459).

[112] *Re Blackwood Hodge plc* [1997] 2 BCLC 650 (Jonathan Parker J).

of moving access to assets to other members of the group. Consideration should be given as to whether this could later be challenged as being in effect a disguised dividend or a disguised return of capital, with the result that the transaction may be challengeable and/or the directors found in breach of duty. The leading case is *Progress Property Co Ltd v Moore* [2010] UKSC 55.

5) **Agreement compliance:** Does the transaction comply with any agreements binding the company – eg restrictions in banking or other finance documents?

C. Legislative tripwires

74. This final section draws to a close our consideration of aspects of DB surpluses in these 2023 Nugee Memorial Lectures, by considering the tripwires which the legislature has placed in the path of trustees and employers who are seeking to reduce or return a surplus.

75. **Pre-conditions for a return of surplus from an ongoing scheme** are set out in:

(a) s37 of the Pensions Act 1995 (PA95); and

(b) the Occupational Pension Schemes (Payments to Employers) Regs 2006 (SI 2006/802).

76. Section 37(1) provides that the pre-conditions apply to an occupational scheme established under trust, the terms of which confer a power on the employer or any other person to make payments to the employer out of funds held for the purposes of the scheme (save authorised employer payments of the types set out in paragraphs (c) to (f) of section 175 of the Finance Act 2004), at a time when the scheme is not being wound up.

77. Section 37(2) provides:

(a) that any such power which is conferred by the scheme on a person other than the trustees cannot be exercised by that person, but may instead be exercised by the trustees, and

(b) that any restriction imposed by the scheme on the exercise of the power shall, so far as capable of doing so, apply to its exercise by the trustees.

78. Section 37(3) sets out additional pre-conditions to a repayment of surplus.

79. Those preconditions are:

(a) that the trustees have obtained a written actuarial valuation of the scheme's assets and liabilities;

(b) that there is an actuarial certificate in force which complies with prescribed requirements and specifies the maximum payment to the employer (which is, broadly, the surplus on a buyout/solvency basis rather than any less prudent basis);

(c) that the payment does not exceed the maximum amount specified in the certificate;

(d) that the trustees are satisfied that it is in the interests of the members that the power is exercised in the manner proposed;

(e) where the power is conferred by the scheme on the employer, that the employer has asked for the power to be exercised, or consented to its being exercised, in the manner proposed;

(f) that there is no freezing order in force in relation to the scheme under section 23 of the Pensions Act 2004; and

(g) that notice of the proposal to exercise the power has been given, in accordance with prescribed requirements, to the members of the scheme.

80. The notification requirements are prescribed by regulation 10 of the Occupational Pension Schemes (Payments to Employers) Regs 2006 (SI 2006/802).

81. The members (and beneficiaries who are within the definition of "survivors") must be notified:

(a) that the trustees of the scheme have decided to make such a payment;

(b) of the amount of the proposed payment;

(c) of the date that the payment is to be made (which must be at least three months after the day the information is sent to the members or survivors, and not later than the last day on which the valuation certificate is valid

(d) that the member may, within one month of the date of the notice, request a copy of the relevant valuation certificate.

82. Failure to comply with section 37 may give rise to civil penalties. So:

(a) by section 37(6), a trustee who has failed to take all reasonable steps to secure compliance with the legislative pre-conditions is liable to a civil penalty under section 10 of PA95; and

(b) a purported exercise of a power to return surplus by someone other than the trustees, for instance the employer, also gives rise (by section 37(7)) to a civil penalty under section 10 of PA95.

83. In both cases the penalties may be imposed a notice in writing given by the Regulator. The maximum amount is £5,000 in the case of an individual and £50,000 in any other case (such as a corporate entity).

84. It is worth noting in the latter case that individuals connected with a body corporate (such as the directors) or Scottish partnership may themselves be the subject of civil penalties if they the relevant act or omission was done with their consent or connivance, or is attributable to any neglect on their part.

An **additional pre-condition for ongoing schemes established before 6 April 2006** applies by virtue of section 251 of the Pensions Act 2004.

85. Section 251(1) provides that the additional pre-condition applies to a scheme to which section 37 of PA95 applies <u>and</u> to which the previous iteration of section 37 applied immediately prior to 6 April 2006.

86. Section 251(2) provides that no payment to the employer may be made out of funds held for the purposes of the scheme (save authorised employer payments of the types set out in paragraphs (c) to (f) of section 175 of the Finance Act 2004) except by virtue of a resolution of the trustees made under that section, resolving that the power shall become (and continue to be) exercisable.

87. The resolution may either:

(a) by section 251(3), specify that the power shall become exercisable according to its terms or shall become exercisable only in specified circumstances and/or subject to specified conditions; or

(b) by section 251(4), replace a power which is expressed to confer power to make payments to the employer only in pursuance of proposals approved by the Revenue with one which is instead exercisable only in specified circumstances and/or subject to specified conditions.

88. Importantly, by section 251(6)(c), the resolution must <u>already</u> have been made because no such resolution can be passed on or after 6 April 2016.

89. Before passing such a resolution:

(a) the trustees must have been satisfied that it is in the interests of the members of the scheme that the power be exercised in the manner proposed; and

(b) notice of the proposal to do so must have been given to the employer and to the members of the scheme in accordance with section 251(5) of PA04 and regulation 13 of the Occupational Pension Schemes (Payments to Employers) Regs 2006.

90. The notice must:

(a) be in writing;

(b) state that the trustees have decided to exercise their power to pass a resolution under the relevant limb of section s251 of PA04; and

(c) state the date, which must be at least three months after the date of the notice, when the trustees propose to pass that resolution (so note that any such notice must have been given before 6 January 2016).

91. If the power to pay a return of surplus has not been preserved by giving a section 251 notice and passing a section 251 resolution, then it cannot be exercised while the scheme is ongoing.

92. **Pre-conditions for a return of surplus on a winding up** are set out in section 76 of PA05 and regulation 15 of the Occupational Pension Schemes (Payments to Employers) Regs 2006.

93. Section 76(1) provides that the pre-conditions apply to an occupational scheme established under trust, where the scheme is being wound up and in those circumstances a power on the employer or the trustees to distribute assets to the employer.

94. Section 76(2) provides that such a power cannot be exercised unless the pre-conditions are satisfied.

95. There are two sets of pre-conditions.

96. Section 76(3) sets out the first set of pre-conditions, which are:

(a) that the liabilities of the scheme have been fully discharged;

(b) that any power under the scheme to distribute assets to any person other than the employer has either been exercised or a decision has been made not to exercise it; and

(c) that notice has been given to the members of the scheme of the proposal to exercise the power.

97. Regulation 15 of the Occupational Pension Schemes (Payments to Employers) Regs 2006 sets out the notification requirements. The notice must be divided into two parts.

98. The first part of the notice must:

(a) inform the member as to the trustees' estimate of the value of the assets remaining after the liabilities of the scheme have been fully discharged and the persons or class of persons to whom, and in what proportions, it is proposed that they should be distributed, and whether the requirements of section 76(3) are satisfied;

(b) invite the member, if he wishes, to make written representations in relation to the proposal to the trustees or, as the case may be, to the employer, before a specified date (which is not earlier than two months after the date on which the first part is given);

(c) advise the member that the second part of the notice will be sent to him if the trustees or, as the case may be, the employer intend to proceed with the proposal to exercise the power to distribute assets to the employer; and

(d) advise the member that no excess assets may be distributed to the employer in accordance with the proposal until at least three months after the date on which the second part is sent to him.

99. The second part of the notice must be given after the date specified in the first notice and at least three months before the power is exercised. It must:

(a) repeat the information in sub-paragraph (a) above, with any modifications to the proposal; and

(b) advise the member that he may make written representations to the Regulator before a specified date (which is not earlier than three months after the date on which the second part of the notice is sent to him) if he considers that any of the requirements of section 76(3) of the 1995 Act are not satisfied.

100. Where:

(a) a member has made written representations to the Regulator that the requirements of section 76(3) of the 1995 Act have not been met, or information from any source sufficient to raise a doubt as to whether all the requirements are satisfied; and

(b) the Regulator has notified the trustees/employer not to exercise the power until the Regulator confirms that those requirements are met, section 76(4) applies.

101. Section 76(4) sets out the second set of pre-conditions.

102. Those pre-conditions are that the Regulator is of the opinion:

(a) that any requirements prescribed under subsection (2) are satisfied; and

(b) that the requirements prescribed by subsection (3) are satisfied.

103. If the Regulator has <u>not</u> notified the trustees/employer not to exercise the power, the trustees/employer must (by regulation 17 of the Occupational Pension Schemes (Payments to Employers) Regs 2006) obtain written confirmation from the Regulator that the second set of pre-conditions does not apply.

104. Any person who purports to exercise a power to distribute assets to the employer on a winding up without complying with section 76 is liable, under section 76(6) and (7) to a civil penalty under section 10 of PA95.

105. **Requirements following a return of surplus from an ongoing scheme** are imposed by regulation 11 of the Occupational Pension Schemes (Payments to Employers) Regulations 2006. The trustees of an ongoing scheme which has made a return of surplus must notify the Regulator that the payment has been made by no later than one week after the day on which the payment was made.

106. By section 37(6), a trustee who has failed to take all reasonable steps to secure compliance with the requirement to notify the Regulator is liable to a civil penalty under section 10 of PA95.

107. **Risks arising from a surplus reallocation exercise** such as those canvassed in sections A and B of this paper may arise from the new offences and penalties recently introduced by the Pension Schemes Act 2021.

108. The new sections 58B and 58D of PA04 create a new criminal offence (to be tried in Court, applying the criminal standard of proof) and impose a new financial penalty (to be imposed by the Regulator's Determinations Panel, presumably applying the civil standard of proof).

109. Sections 58B and 58D apply where a person (note, any person, not just a trustee, employer, or connected person or individual):

(a) does an act or engages in a course of conduct – or, in relation to the financial penalty but not the criminal offence, is party to a deliberate failure to act – that "detrimentally affects in a material way the likelihood of accrued scheme benefits being received";

(b) knew or ought to have known that the act or course of conduct (or deliberate failure to act) would have that effect; and

(c) did not have a reasonable excuse / it was not reasonable to act (or fail to act) in that way.

110. The conduct to which sections 58B and 58D apply may also found a material detriment Contribution Notice against a "connected or associated" person (PA 2004, section 38).

111. A surplus reallocation exercise which involves using a notional surplus – calculated on a technical provisions basis – in a way which prevents it from then being used to provide the DB benefits already accrued under the scheme, <u>might</u> engage sections 58B and 58D. If the assumptions underlying the valuation which gave rise to the notional surplus do not hold good, then a deficit may well subsequently emerge and – depending on the strength of the employer covenant – that might materially affect the likelihood of accrued scheme benefits being received.

112. A lot therefore hangs on (i) whether the relevant person knew or ought to have known that their actions or inactions would have that effect (noting that the word is "would" rather than "might") (ii) the reasonableness or otherwise of the trustee/employer's conduct. The criminal penalty is imprisonment for a term not exceeding seven years, or a fine, or both. The financial penalty is up to £1 million. And a contribution notice may be the whole of the section 75 debt in relation to the scheme.

113. Depending on the nature of the surplus reallocation exercise – for instance if it involves a large transfer payment being made from one scheme to another – it may also engage the notifiable event regime in section 69 of PA04. That regime now has more teeth as a result of PSA21: where the trustees or managers of a scheme fail to comply with an obligation to notify the Regulator, section 88A (financial penalties) of up to £1million applies in relation to any trustee or manager who has failed to take all reasonable steps to secure compliance with that subsection; and that is also the case in relation to any other person who, without reasonable excuse, fails to comply with such an obligation.

D. Conclusion

114. Surpluses are perhaps a better outcome, compared with deficits. But with large amounts at stake, it is unsurprising that the interested parties – whether employers, trustees or members – will be concerned to ensure it is they who benefit from those sums. With pension schemes existing in such a highly regulated space, this will inevitably lead to legal complications and in some cases legal disputes.

115. It is likely, then, that the re-emergence of surpluses will lead to a new round of court litigation and ombudsman determinations, with plenty of interesting issues for pensions practitioners to get their teeth into.

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Michael Tennet KC	KC 2006	Call 1985
Thomas Lowe KC	KC 2008	Call 1985
James Ayliffe KC	KC 2008	Call 1987
Lexa Hilliard KC	KC 2009	Call 1987
Paul Newman KC	KC 2009	Call 1991
Joanne Wicks KC	KC 2010	Call 1990
Martin Hutchings KC	KC 2011	Call 1986
Mark Wonnacott KC	KC 2013	Call 1989
Thomas Grant KC	KC 2013	Call 1993
Fenner Moeran KC	KC 2014	Call 1996
Marcia Shekerdemian KC	KC 2015	Call 1987
Clare Stanley KC	KC 2015	Call 1994
Tim Penny KC	KC 2016	Call 1998
Jonathan Davey KC	KC 2016	Call 2003
Jonathan Hilliard KC	KC 2016	Call 2003
Max Mallin KC	KC 2017	Call 1993
Julian Greenhill KC	KC 2018	Call 1997
Tiffany Scott KC	KC 2018	Call 1998
Nikki Singla KC	KC 2018	Call 2000
James Bailey KC	KC 2019	Call 1999
Zoë Barton KC	KC 2020	Call 2003
Andrew Mold KC	KC 2020	Call 2003

Full-time arbitrators:

Jules Sher KC	KC 1981	Call 1968
Sir Paul Morgan	KC 1992	Call 1975

John Child		Call 1966
Thomas Seymour		Call 1975
David Pollard	Solicitor 1980	Call 2017
Gabriel Fadipe		Call 1991
Graeme Halkerston		Call 1994
Andrew Child		Call 1997
Edward Sawyer		Call 2001
Stephen Brown	Solicitor 1991	Call 2013
Thomas Robinson		Call 2003
Daniel Lewis		Call 2003
Emily McKechnie		Call 2005
Sebastian Allen		Call 2006
James Walmsley		Call 2007
Jennifer Seaman		Call 2007
Benjamin Faulkner		Call 2008
Anna Littler		Call 2008
James McCreath		Call 2009
Emer Murphy		Call 2009
Tom Roscoe		Call 2010
Jonathan Chew		Call 2010
Harriet Holmes		Call 2011
Alice Hawker		Call 2011
Bobby Friedman		Call 2011
Simon Atkinson		Call 2011
Sri Carmichael		Call 2012
Jack Watson		Call 2012
Jessica Brooke		Call 2012
Michael Ashdown		Call 2013
James Goodwin		Call 2013
Rachael Earle		Call 2013
Elizabeth Houghton		Call 2014
Tim Matthewson		Call 2014
Jamie Holmes		Call 2014
Joseph Steadman		Call 2015
Tara Taylor		Call 2016
Daniel Scott		Call 2016
Jia Wei Lee		Call 2017
Francesca Mitchell		Call 2017
Daniel Petrides		Call 2018
Lemuel Lucan-Wilson		Call 2018
Caspar Bartscherer		Call 2019
Ram Lakshman		Call 2020
Benjamin Slingo		Call 2020
John Grocott-Barrett		Call 2021
Samuel Cathro		Call 2021

Caroline Furze (unregistered barrister) Call 1992
Door Tenant

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