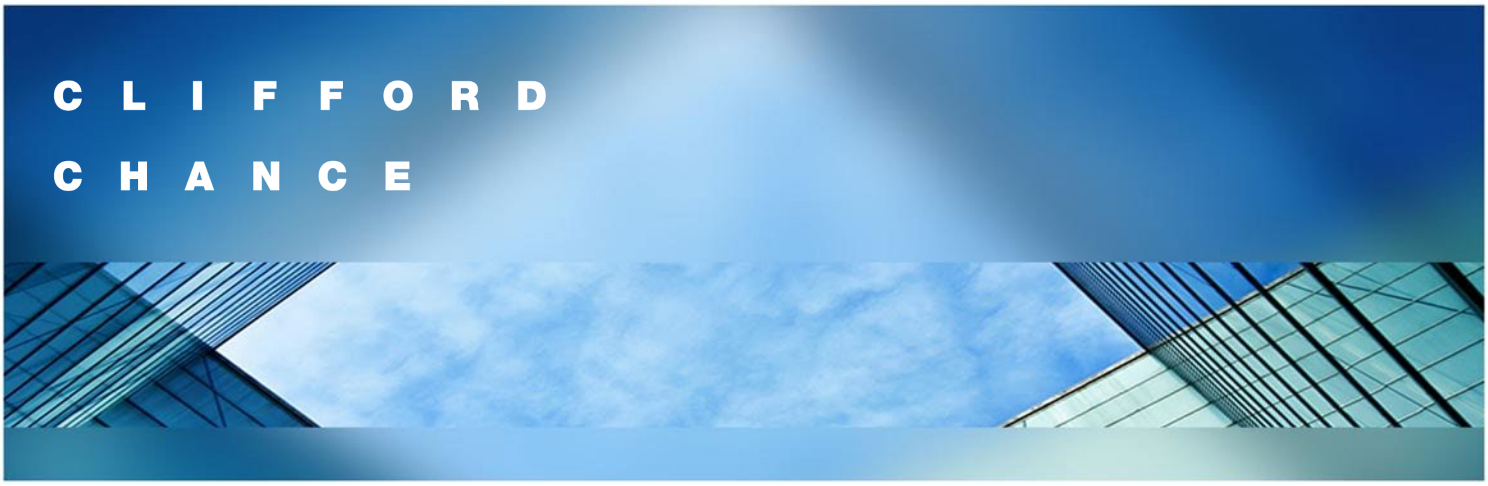

UK PENSIONS UPDATE – SEPTEMBER 2023

In this edition, we take a look at a variety of recent pensions court decisions. We also cover the Pensions Regulator's updated guidance on superfunds and new draft legislation to abolish the Lifetime Allowance, as well as providing an update on pension dashboards.

Content

1. UPPER TRIBUNAL UPHOLDS TPR'S DECISION TO ISSUE CONTRIBUTION NOTICE

The Upper Tribunal has made a determination in a Contribution Notice ("**CN**") case, directing the Pensions Regulator ("**tPR**") to issue a CN for c£1.8m against an individual target in relation to the Meghraj Group Pension Scheme.

The target had been a director of the scheme's sponsor, which went into liquidation. The sponsor's subsidiary owned shares in a Joint Venture ("**JV**") and over time, the shares were sold and proceeds paid to the scheme's sponsor before being paid to offshore entities. In 2014, the remaining shares in the JV were sold and the proceeds (c£3.7m) were paid directly to a Jersey-registered company that was a nominee company for the target's nephew. The payment was made pursuant to a 2012 agreement between the employer (acting by the target) and the parent company (acting by the target's nephew).

TPR had originally pursued both the target and his nephew but settled with the nephew prior to the hearing. The Upper Tribunal ultimately decided that the material detriment test had been met and it would be reasonable to issue a CN against the target for £1,875,403 – 50% of the sum tPR had been seeking against the joint targets, plus an uplift to take account of the passage of time since the acts in question.

To date, there have only been a few cases where a CN has been issued (more often they are either only threatened, or issued before being withdrawn in light of a settlement) and there are some interesting points coming out of this latest case:

- **Meaning of "series of acts"** – tPR relied on the act of entering into the 2012 agreement and the subsequent act of the 2014 payment together as a "series" of acts. The Upper Tribunal agreed that the 2012 agreement had cleared the path for the extraction of value from the JV and that the 2014 payment then constituted the extraction of value – this was sufficient to amount to a series of acts for the purposes of the legislation.

- **The reasonableness test –** tPR argued that it was reasonable to impose a CN for a number of reasons, including that the target had misled the trustee in relation to the employer's financial position, his role as a director of the employer and his sole responsibility for negotiating the scheme's 2010 valuation, and the high degree of his involvement in the acts. The target argued it was not reasonable, largely on the basis that he had limited financial resources and he did not directly benefit from the 2014 payment.

In considering the target's financial position, the Upper Tribunal found that for a long time during his career he had been a wealthy man. While that may no longer be the case, he had not put forward cogent evidence to clearly demonstrate his financial position and he had accepted that the religious principle of Aparigraha which he and his family follow would suggest that further financial support would be provided to help to pay the CN. Applying the principles in ***Carrington Wire***[1], it was right for tPR to consider not just a target's current financial position but how they ended up there. Also, whilst the target was relying heavily on the financial hardship argument, this was only one factor to be considered and there was nothing to suggest this should be given stronger weight over any of the other factors which pointed strongly in favour of issuing a CN.

- **Quantum of the CN** – in considering the sum to be specified in the CN, the Upper Tribunal confirmed that the sum did **not** need to be limited to the amount of loss suffered by the scheme as a result of the act/failure to act (at least in the context of the material detriment test). The Upper Tribunal concluded that there is nothing in the language of the legislation which suggests a need to base the quantum of a CN on any kind of compensatory analysis. The effect of the act/failure on the scheme's liabilities may be one relevant factor in appropriate circumstances, but ultimately the only cap under the legislation is the amount of the total section 75 debt.

2. HIGH COURT APPROVES TRUSTEE DECISION TO WIND-UP SPONSORING EMPLOYERS

The High Court recently handed down its decision in relation to a Part 8 claim[2] brought by the trustee of the Biwater scheme, seeking the court's approval of its decision to issue petitions to wind-up the scheme's two sponsoring employers.

Under the scheme rules, the trustee could only unilaterally wind-up the scheme on the principal employer's insolvency. Evidence provided by the trustee sought to demonstrate that the employers were in extreme financial difficulties (and had been for a number of years), with little current or future business prospects. The application to court was ultimately made because of the momentous consequence of the decision.

The court considered that the evidence provided by the trustee likely understated the full extent of the employers' financial problems given how unforthcoming the employers had been to provide information and it was clear the employers had no prospect of meeting their financial obligations to the scheme. Ultimately, the court approved the trustee's decision to wind-up the employers, being satisfied that the test for approval in ***Public Trustee v Cooper***[3] had been met. Namely, the trustee's opinion was one which a reasonable trustee could properly have arrived at, taking into account relevant and disregarding irrelevant considerations and the opinion was not vitiated by any conflict of interest. The court's view was also reinforced by the representative beneficiary's investigations and conclusion that there were no credible grounds to oppose the decision, together with analysis conducted by the Pension Protection Fund ("**PPF**").

It is interesting to note that, in the judgment, the court made some comments on the extent to which the trustee could take into account the existence of the PPF (e.g. due to the benefit to members of PPF Drift[4], and thus potential benefit in delaying the winding-up) and the PPF's interests in deciding to issue winding-up petitions for the scheme's sponsors.

In agreement with the trustee's conclusions and following the reasoning in ***ITS Ltd v Hope***[5], the judge concluded that the prospective availability of PPF compensation is **not** a relevant factor for the trustee to take into account in the exercise of this power/powers of a similar nature, because to do so would be contrary to the legislative intent of the Pensions Act 2004 and public policy. However, he did comment that there is not a single all-purpose answer to

[1] Paragraph 146 of the Determination Notice issued in respect of the Carrington Wire Defined Benefit Pension Scheme.
[2] *BRASS Trustees Ltd v Goldstone & Another [2023] EWHC 1978 (Ch).*
[3] *Public Trustee v Cooper [2001] W.T.L.R. 901.*
[4] PPF drift is the increase in compensation available for members under the PPF which occurs the longer it takes for an employer to suffer a qualifying insolvency event. This is because more members will reach their normal pension age before the scheme goes into the PPF (and hence enjoy a higher percentage of PPF compensation), scheme benefits will increase to a higher level than they would have done and more members may have died, triggering full survivors' benefits rather than the reduced level in the PPF had the member died after the assessment date.
[5] *Independent Trustee Services Ltd v Hope & Ors [2009] EWHC 2810 (Ch).*

the question of whether the PPF is a relevant consideration – it all depends on the context and purpose of the particular power and so he did not feel it necessary to make general observations as to the relevance of the PPF other than to say *obiter* that he would expect a similar approach to be adopted in any instance where trustees seek to take advantage of the existence of the PPF as a justification for acting in a way which would otherwise be improper. Following previous case law, trustees should not seek to 'game' the PPF. *Obiter*, the judge also commented that the PPF's interest (such as in *preventing* PPF Drift) was also **not** a relevant factor for the trustee to take into account.

It is worth contrasting this case with the longstanding authority of ***Edge v Pensions Ombudsman***[6], in which the Court commented that it is not generally the function of trustees to put their employers into insolvency. This recent case indicates that there are exceptions to that principle, although the circumstances may need to be extreme.

3. HIGH COURT HANDS DOWN JUDGMENT IN *BBC* CASE

The High Court has given judgment[7] in another case concerning questions of interpretation around a scheme's amendment power. This was a Part 8 Claim brought by the BBC in the context of proposed changes to future accrual within the BBC Pension Scheme with a view to reducing ongoing costs.

The amendment power was subject to certain fetters, including that no alteration or modification shall take effect as regards active members "***<u>whose interests</u> are certified by the Actuary to be <u>affected thereby</u>***" unless certain criteria are fulfilled (which, broadly, were designed to ensure that the relevant "interests" are not substantially prejudiced).

The case focused on two key questions:

1. What is meant by the term "interests" in the fetter? Does this include future service benefits?
The judge held that "*interests*" was to be interpreted broadly and meant members' interests in both past **and** future service benefits (including final salary linkage). He distinguished between "*interests*" and "*rights*" – saying the former should offer a broader scope of protection than "rights" as "interests" more naturally includes a reference to the effects of an intended change to the terms on which benefits can be earned in the future. His view was that the natural focus of the question should be on the position the active members had under the rules as they stood prior to any proposed amendments, compared to their intended position after the proposed amendment had effect. He said that if their position is going to be different pre and post amendment, then it seems inescapable that their "*interests*" are "*affected*". This broad interpretation was supported by reference to the original wording of the amendment power.
2. If the trustees used the amendment power to terminate future accrual, or otherwise re-design future service benefits, would this be an exercise of the power for an improper purpose if either the BBC and active members had not agreed to the changes?
The judge held that if a proposed amendment was consented to by the employer (as required by the amendment power) and complied with one of more of the proviso safeguards contained in the amendment power, then the use of the amendment power, in principle, to terminate future accrual/redesign future benefits would not be an exercise for an improper purpose because its very purpose was to allow amendments which fulfilled those criteria. (Although, in practice, this then leads back to question 1.)

The BBC has not yet announced an intention to appeal the case and has only publicly noted that it is considering its next steps. If it does decide to appeal, it will initially seek permission to do so at the consequential hearing for the case on <u>15 September</u> – permission will either be granted by the judge at this hearing or else the BBC will have another 21 days from the date of the hearing to seek permission to appeal directly from the Court of Appeal.

[6] *Edge & Ors v Pensions Ombudsman & Anor [1999] EWCA Civ 2013.*
[7] *BBC v BBC Pension Trust Ltd [2023] EWHC 1965 (Ch).*

4. COURT OF SESSION HANDS DOWN JUDGMENT IN USE OF SURPLUS CASE

A Scots law judgment[8] was recently published concerning an application by a pension scheme trustee for directions as to whether they were entitled to buy-out the scheme and hold any surplus on resulting trust for the participating employers.

The questions arose due to the particular wording of the scheme rules which seemingly made no provision for what should be done with any surplus.

The scheme was in surplus and the trustee and employer were looking to buy-out and wind up. As part of this, it had been agreed that part of the surplus would be used to augment member benefits and to transform certain discretionary increases into fixed increases on buy-out. The scheme rules made no provision for what should be done with any remaining surplus and essentially prohibited any rule amendment which would permit payment to the employer (although the specific wording was not set out in the judgment and it appears to have been argued that the prohibition did not apply to distribution of surplus specifically).

The trustee's application to the court asked for directions on various questions:

1. Is the trustee entitled to enter into the buy-in/out agreement (including securing fixed increases)? i.e. is this in accordance with the scheme rules and the trustee's fiduciary duties?

2. Are the remaining assets the subject of a resulting trust arising as a matter of law?

3. If so: (A) in favour of whom does the resulting trust operate? Those participating employers who were employers at the time accrual ceased? (B) does the resulting trust only operate following buy-out and sufficient provision having been made for wind-up expenses?

In short, the court ruled "yes" to all questions:

- On (1), the court was not asked (and would not be able to opine) on whether the trustee's discretion *should* be exercised in a particular way. This is a matter for the trustee and not capable of delegation to the court. However, the court can answer the question of whether the trustee was *entitled* to enter into the buy-in/out and agreed that the decision was one the trustee is entitled to make. The trustee had sought appropriate professional advice and taken into account all material considerations and the court was satisfied that entering into the buy-in/out is a decision that a pension trustee acting reasonably could make.

- On (2), the court agreed that a resulting trust had arisen as a matter of law. The law recognises the arising of a resulting trust in favour of the original contributor of funds where there has been a failure or completion of the trust purposes.

- On (3A), in principle, any surplus is held on resulting trust for those who provided it (applying ***Air Jamaica***[9]). The court was satisfied that this was to be held for those who were participating employers at the time accrual ceased. The court was satisfied that no other former employers retained any entitlement to surplus (although this was not addressed in detail in the judgment).

- On (3B), the surplus only emerges once all the members' benefits have been secured on buy-out and all other liabilities and winding-up costs have been met/provided for. Until that time a surplus has not "emerged".

[8] *Petition of abrdn (SLSPS) Pension Trustee Company Ltd for Directions [2023] CSIH 31.*
[9] *Air Jamaica Ltd. & Ors v Joy Charlton & Ors [1999] 1 W.L.R. 1399.*

5. TPR UPDATES SUPERFUNDS GUIDANCE

TPR has published a blog on superfunds, confirming it has conducted a general review of its 2020 guidance to ensure the interim regime remains fit for purpose (given the permanent legislative regime will take some time to develop). At the same time, tPR published a response to the engagement exercise it conducted earlier this year, updated superfunds guidance and accompanying superfund guidance for transferring trustees/employers.

The rationale is to boost the superfund market given that since 2020, only one superfund has been authorised by tPR and it has yet to transact.

Key points

Gateway tests for accessing superfunds	Some changes have been made to the tests to be satisfied in order for a transfer to a superfund to occur: • One of the gateway principles has been changed so that a transfer to a superfund should only be considered if the scheme cannot <u>access</u> buy-out (rather than <u>afford to</u> buy out). Access to buy-out will be determined on whether buy-out is affordable <u>and</u> if so, whether the scheme can in practice actually access the insurance market. In assessing whether the scheme can actually access a buy-out, this should now be based on the response by an "appropriate insurer". If the insurer declines the scheme or says buy-out could not be completed within a "reasonable period", then it is reasonable to conclude that the scheme cannot access buy-out (and therefore can pursue a superfund). "Reasonable period" is not and will not be defined because this will depend on the individual scheme's circumstances and market conditions at the relevant time. • The expectation is still that a superfund should not accept a transfer from a scheme that can access buy-out/is on course to do so within the foreseeable future e.g. "in the next five years". • Timing – the time between the date when the gateway principles are met and the transfer takes place should not exceed nine months. Throughout the intervening period, the transferring trustees should continue to consider whether they remain comfortable with the transaction. The transaction should normally take place within three months of clearance being obtained.
Profit extraction	In tPR's original consultation on superfunds, the intention seemed to be to cater for two types of superfund: **"bridge to buy-out"** models (where profit extraction occurs at the point when liabilities are bought out) vs. **"run-off models"** (where surplus value can be extracted once funding levels exceed certain thresholds). However, the 2020 guidance subsequently published was written on the premise that the superfund would ultimately be targeting buy-out i.e. only based on the bridge to buy-out model, providing that no surplus value should be extracted from the superfund (or the capital buffer) unless scheme benefits are bought out in full with an insurer. In the 2020 guidance, tPR committed to review the position on profit extraction with a view to updating it within three years. In this updated guidance, tPR acknowledges there needs to be a distinction between the extraction method for the different models and agrees that allowing a proportion of surplus profits to be extracted in some circumstances could help the market to start transacting. However, it is a complex area and so tPR needs to engage further with industry to establish the appropriate profit trigger mechanism for the interim regime.
Funding expectations	TPR has amended its minimum expectations for the approach superfunds should take to the key elements of setting their Technical Provisions. This includes moving to a discount

	rate of Gilts+0.75% rather than Gilts+0.5% - it thinks this will help superfunds price appropriately, whilst still ensuring security of member benefits. It says that following analysis by Mercer, without this change the superfund market is unlikely to be able to price at a level below buy-out.
Assessment and supervision	Additional information on the superfund assessment process and ongoing supervision has been included, including an expectation for superfunds to report regularly on key aspects of the requirements.
Alternative models	Superfunds are just part of the innovative developments in the defined benefit ("**DB**") marketplace and later this year tPR will publish guidance focussed on other arrangements as well. (The guidance indicates these may be options such as entering a DB master trust and "other" capital-backed arrangements and options that provide access to economies of scale and improved governance/support without severing the employer support, but does not specify further.)

6. DRAFT LEGISLATION TO ABOLISH LIFETIME ALLOWANCE PUBLISHED

Following the removal of the Lifetime Allowance ("**LTA**") charge from 6 April 2023, draft legislation has been published to abolish the LTA completely from 6 April 2024. The draft legislation is currently subject to consultation. As part of the regime to remove the LTA completely, the legislation would also make several other significant tax changes:

- The draft Bill introduces the concept of a **lump sum allowance** and a **lump sum and death benefit allowance**.
- An individual's **lump sum allowance** will be set at **£268,275** (25% of the current LTA) (unless the person has a higher protected tax-free lump sum) and caps the amount of certain lump sums which can be taken tax free in respect of an individual from all registered pension schemes. Any lump sum paid in excess of this amount is taxed at the individual's marginal rate of income tax.
- An individual's **lump sum and death benefit allowance** is set at **£1,073,100** (the current LTA) (or any higher protected LTA that an individual may have). This caps the total amount of tax-free lump sums together with, broadly, any tax-free death benefit lump sums and tax-free serious ill-health lump sums which can be paid in respect of an individual from all registered pension schemes. Any lump sum paid above this level will be taxed at the individual's/beneficiary's marginal rate.

The effect of the legislation as currently drafted is that the maximum **tax-free** pension commencement lump sum that could be paid is capped at the lowest of (i) 25% of the benefits being crystallised at the relevant time; (ii) the individual's remaining lump sum allowance; and (iii) the individual's remaining lump sum and death benefit allowance. However, the way the drafting works seems to mean that a lump sum larger than any of these limbs could be paid, with any amount in excess of the tax-free limit being taxed as pension income i.e. there would be no limit on the size of the lump sum that can be taken (only on the amount that can be taken tax-free).

However, it is not clear that this was the policy intent behind the legislation, which is still in draft at this stage and this is something that has been raised with HMRC by the pensions industry. HMRC has said in response that it is **not** the government's intention to significantly expand the pension freedoms and it is therefore likely that the drafting will be clarified on this point.

Timing: the consultation closed on <u>12 September</u>. The intention is for the legislation to be finalised ready for the changes to take effect from April 2024, but it seems there is still a lot of detail to work through before then.

7. PROGRESS ON DASHBOARDS

Following the announcement of the new connection deadline (as discussed in the UK Pensions Update: June 2023), there has been some further progress on pensions dashboards over the Summer, namely:

- The *Pensions Dashboards (Amendment) Regulations 2023* have now been made and came into force on 9 August 2023. They operate to remove the staging profile and staging deadlines and replace it with the single connection deadline of 31 October 2026 for all relevant schemes. They also remove the concept of early connection.

- TPR has updated its initial guidance on dashboards; specifically, it has updated the section on failure to comply with dashboard duties which sets out how trustees can demonstrate compliance.

- The Pensions Administration Standards Association has updated its guidance on dashboard accuracy data; the updated guidance provides further information on the example data sources which can be used by pension schemes to validate member information (as will be required under the new regime).

- The Department for Work and Pensions has updated its guidance on deferred connection to reflect the fact that the 2023 regulations referred to above have come into force and refer to the new connection deadline of 31 October 2026. The guidance still contemplates the possibility of applying to defer connection by up to a year (i.e. no later than 31 October 2027) but only in very limited circumstances (and the latest date for making an application would be 8 August 2024).

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