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Pensions: Fixed protection and life cover

Linklaters has recently seen correspondence from HMRC setting out its view as to how the continued provision of life cover under a registered pension scheme will affect members who have registered for fixed protection. Employers should consider urgently whether they need to take any action in advance of 6 April 2012 to change their existing life cover arrangements.

Background – the reduced lifetime allowance and fixed protection

From 6 April 2012, the "lifetime allowance" will reduce from £1.8m to £1.5m. Members of registered schemes who are or may be affected can choose to register for "fixed protection" which will allow them to retain a lifetime allowance of £1.8m.

To maintain fixed protection, the member must not have any "benefit accrual" after 5 April 2012. Paying a contribution to provide money purchase benefits for the member would be "benefit accrual" for this purpose.

If there is benefit accrual – or if a new arrangement is created for the member under a registered pension scheme after 5 April 2012 – fixed protection will be invalidated.

In practice, this means that, in most cases, a member with fixed protection must opt out of any registered pension scheme. However, Guidance issued by HMRC earlier this year suggested that providing continued life cover based on a multiple of salary would not invalidate protection.

Now, in correspondence, HMRC has said that providing continued life cover could invalidate fixed protection. The position may depend on the scheme rules and on whether benefits are insured.

What does this mean in practice?

Employers will need to review their Rules urgently to identify whether continued provision of lump sum death benefits and/or survivors' pensions will invalidate fixed protection. Based on HMRC's views, the following will apply and is explored in further detail in this newsletter.

Contents

Restrictions in Scheme Rules?	Is the benefit insured or self insured?	Action required?
None.	Insured or self-insured.	No action required.
Benefits are restricted to the amount payable by an insurer.	Insured.	Payment of premium could invalidate fixed protection. Action required.
Benefits are restricted to the amount payable by an insurer.	Self-insured.	No action required at this time. However, if a decision is taken to insure in future, the position of members with fixed protection will need to be considered.
Benefits can be restricted at the discretion of the Trustee or Employer.	Insured or self-insured.	Depends on exact wording of Rules. If employer wishes to be 100% safe from risk of invalidating fixed protection, action should be taken.

The life cover problem

Many employers wish to continue to provide lump sum death in service cover – and in some cases survivors' pensions – to employees who register for fixed protection.

HMRC's Guidance earlier this year said that, if the benefit is a simple multiple of salary, this will not prejudice fixed protection (although paying the benefit could result in a lifetime allowance charge – see below). However, HMRC has recently commented on the position where a scheme provides for a lump sum death benefit calculated as a multiple of salary but *also provides that it will be restricted to the amount paid out by any insurance policy.* This is a very common provision, particularly in defined contribution schemes. HMRC takes the view that, if the restriction applies, the benefit would be "money purchase" (because the amount would be dictated by the available funds).

If the potential benefit is "money purchase", paying a contribution to provide it could invalidate fixed protection. There may also be implications for other circumstances.

In particular:

- we can see no reason why HMRC would treat insured survivors' pensions differently; and
- many schemes include a discretion for Trustees or Employer to reduce benefits in defined circumstances (e.g. if there is a catastrophic event). Depending on the exact wording, this could also cause the benefit to be restricted and amount to a "money purchase benefit" – which would again invalidate fixed protection.

How immediate is the issue?

Even if the potential benefit is money purchase, the problem arises only when a contribution is paid after 5 April 2012 to provide it for the member. Until then, continuing to provide the benefit will not invalidate fixed protection. In practice, however, we expect most employers will wish to put in place a long term solution as soon as possible.

If benefits are self-insured, the problem could arise as soon as a contribution is paid after 5 April 2012, which could be deemed to include an amount towards these benefits.

What action could be taken?

We expect that employers will not wish to take the risk that fixed protection will be invalidated.

If the Scheme Rules fall into one of the categories above which cause a difficulty, there are a number of actions which could be considered:

Cease providing continued death benefits?

Employers will need to check this is consistent with contracts of employment and in some cases employee consent may be needed.

Continue to provide life cover through the registered scheme?

- Consider whether it is possible to amend the Rules to remove any relevant restrictions for members with fixed protection.
- Consider whether it is possible to exercise Employer discretion so that relevant restrictions do not apply to members with fixed protection.

Either would need to be implemented by 5 April 2012 at the latest but should result in the removal of the issues described above.

Set up a separate arrangement:

Otherwise, the Employer will need to cease to provide benefits from the registered scheme and either self insure or establish a separate, non-registered, arrangement. It is possible to establish an arrangement via an "excepted life policy", which can be managed so that the tax treatment for members and beneficiaries is essentially the same as under a registered scheme.

New arrangements

If a member has fixed protection, establishing a "new arrangement" under a registered scheme after 5 April 2012 will invalidate this. A "new arrangement" is (broadly) one which did not exist prior to 6 April 2012.

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This means, for example, that if an employee is hired on or after 6 April 2012 and has registered for fixed protection, any provision of life cover under the new employer’s registered scheme – however the benefit is calculated or funded – will invalidate fixed protection.

Employers will need to put procedures in place to ensure employees with fixed protection are identified and excluded from their registered schemes.

In addition, changing life cover arrangements on or after 6 April 2012 for members with fixed protection (e.g. to increase the multiple of salary) could amount to a “new arrangement” and so invalidate fixed protection.

Lifetime allowance charge

Even where continued provision of lump sum death benefits does not invalidate fixed protection, it is worth remembering that, if the member dies and the amount actually paid out exceeds the protected amount, this will give rise to a lifetime allowance charge.

Members with enhanced protection

HMRC has not specifically extended its comments to enhanced protection. However, the technical analysis is the same.

Many employers have continued to provide death benefits for members with enhanced protection, based on HMRC’s previous guidance.

We do not recommend revisiting past actions, but suggest that, going forward, employers should assume that the same concerns apply to members with enhanced protection as are set out above in relation to fixed protection. This may mean that changes are required to the existing arrangements for death benefits for these members as well.

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