

## Recycling of tax-free cash - the anti-avoidance rules considered

In a technical note issued in December 2005 alongside the Pre-Budget Report, the Government announced that there would be legislation in the Finance Bill 2006 to prevent a scheme member “withdrawing a tax-free lump sum which is reinvested back into a registered pension scheme, automatically generating further tax relief on the amount reinvested”. This approach, which has been used for many years by members of personal pension and s.226 arrangements, would have become even more attractive under the simplified regime because of:

- » the much higher contribution limits;
- » the end of partial concurrency restrictions;
- » the ability to take a Pension Commencement Lump Sum (PCLS) and a nil unsecured pension (e.g. 25% cash alongside zero drawdown).

It is for these reasons, highlighted by some inflammatory press articles, that HMRC have felt it necessary to ban this practice under the new regime.

Although HMRC accept that recycling will only apply in a relatively few number of cases, the barely one page of draft legislation to ban the practice has been accompanied by no less than 10 pages of guidance. This bulletin considers the new anti-avoidance rule.

### The basic rules

The new anti-avoidance rule will treat all of a member’s PCLS as an unauthorised payment if any part of it is recycled. For this to apply:

- » the individual must have received a PCLS which, when added to any other PCLS received in the previous 12 month period, exceeds £15,000;

- » because of the payment of the PCLS the amount of the contribution paid to a registered scheme by or on behalf of the individual is significantly greater than would otherwise be the case. This is defined as where the amount of the additional contributions are more than 20% of the contributions that might have been expected;

- » the cumulative amount of the additional contributions to the registered scheme must exceed 20% of the PCLS;
- » the recycling must be pre-planned.



## The new rules considered

Although the guidance concerning the new rules stretches to 10 pages and includes 19 examples, there are many aspects which are still unclear. These include:

What is pre-planned? And how can it be proved or disproved? In the first instance the member has to make the decision, as it is their responsibility to blow the whistle to the scheme administrator. In the event of a dispute, will the onus of proof be on HMRC, or will the individual be required to show their action was not pre-planned?

With the ability to pay substantial contributions to a registered scheme, and no annual allowance charge applying to contributions paid in the tax year in which a member draws all benefits from an arrangement, it has been suggested that a number of individuals may well pay a very large single contribution just before they draw their retirement benefits. As the recycling rules apply to contributions paid before, as well as after, a PCLS has been paid, could HMRC argue that such contributions were pre-planned and seek to tax the PCLS under the anti-avoidance rules?

Although many examples are given in the guidance on the contribution that might have been expected, these are virtually all in straightforward situations

(e.g. where the contribution is of a fixed amount or a fixed percentage of earnings). There is no guidance on what would have been the expected contribution where contributions have varied over the years depending upon what an individual felt willing or able to pay at the time.

Examples are given in the guidance of circumstances where the recycling rule will not apply. These include situations where an individual is in receipt of a windfall (e.g. from an inheritance, divorce settlement or a substantial lottery win) but do not cover an individual who had substantial free assets which they decided to apply as a pension scheme contribution.

While the guidance refers to measuring additional contributions on a cumulative basis it is unclear how long a cumulative period will apply for the calculation. Is it 5 years before and after the payment of PCLS? Or some other period?

The new rules are also likely to create problems for a scheme administrator where a member's PCLS is deemed to be part of a recycling exercise and hence subject to an unauthorised payments charge. This will mean the scheme administrator will be subject to a scheme sanction charge of between 15% and 40%

of the amount of the PCLS subject to the unauthorised payments charge. From where will the scheme administrator be able to recover that charge? Would schemes need, or be allowed, to include a specific rule permitting them to recover any scheme sanction payment from any remaining benefits of the member, where the member has taken a PCLS which is deemed subject to the recycling rule? Although a scheme administrator is able to apply to HMRC for the discharge of a scheme sanction liability, no indication is given in the guidance of the circumstances in which HMRC might accede to such a request. For example, suppose a scheme administrator required a declaration to be signed by the member before paying any PCLS indicating it was not to be used for recycling of pension contributions, but it was subsequently found that the member had recycled part of the PCLS. Would the signed declaration be sufficient grounds for any scheme sanction charge to be set aside by HMRC? Consider, in particular, the contribution could have preceded the PCLS – i.e. taken place *before* the member signed the declaration!

## Acting before A-Day

A word of warning is required to anyone thinking of recycling before A-Day. While, the new rules will only apply to a PCLS, which in turn can only arise from benefits crystallised on or after 6 April 2006, the recycling rules

will still take account of any contributions paid pre A-Day.

It is a shame that HMRC has felt it necessary to impose such overly complicated and potentially onerous restrictions when by its own admission relatively few

people will be involved in recycling. It is even more disappointing that despite copious guidance notes, and examples, the legislation is still unclear in many cases.

*This bulletin is based on our current interpretation of the changes under Pensions Simplification.*