Pensions Legal Update

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Pension benefits on insolvency

Summary. The European Court of Justice has ruled that UK pensions law is not compatible with the Insolvency Directive.

The European Court of Justice has ruled that UK pensions law is not compatible with the Insolvency Directive.

Background. Article 8 of EU Directive 80/987/EEC (the **"Insolvency Directive"**) requires that European member states ensure protection for pension rights if an employer becomes insolvent. It provides:

"Member States shall ensure that the necessary measures are taken to protect the interests of employees and of persons having already left the employer's undertaking or business at the date of the onset of the employer's insolvency in respect of rights conferring on them immediate or prospective entitlement to old-age benefits, including survivors' benefits, under supplementary company or inter-company pension schemes outside the national statutory social security schemes."

Facts. R and B were former employees of ASW Limited (**"ASW"**) and members of its defined benefit pension schemes. On ASW's insolvency, R and B's benefits from the pension schemes were substantially reduced to 20% and 49% respectively of R and B's original entitlements. R and B bought a claim for damages against the UK government in the English High Court. They argued that UK legislation did not provide them with the level of protection required by Article 8 of the Insolvency Directive. The High Court referred three preliminary questions to the European Court of Justice.

Decision. The European Court of Justice's decision on the preliminary questions was as follows:

In order for the High Court to determine that the UK government is liable to pay damages to R and B, it will be necessary to find that there has been "manifest and grave disregard" of its obligations under the Insolvency Directive.

- Article 8 of the Insolvency Directive does not necessarily require that member states must fund accrued pension rights themselves or that accrued pension rights should be funded in full.
- However, UK law did not adequately implement the Insolvency Directive. The Insolvency Directive does not specify the level of protection which is required but a system which guarantees only between 20% and 49% of accrued benefits was not adequate. This conclusion applied despite the introduction of the Financial Assistance Scheme under s286 Pensions Act 2004 which provides compensation for certain employees where an employer became insolvent between 1997 and 2005.
- In order for the High Court to determine that the UK government is liable to pay damages to R and B, it will be necessary to find that there has been "manifest and grave disregard" of its obligations under the Insolvency Directive.

Case: Carol Marilyn Robbins and Others v Secretary of State for Work and Pensions, case C-278/05, available at www.curia.europa.eu.

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Pension benefits on insolvency

The court has also directed the Secretary of State to reconsider the Ombudsman's recommendation to compensate the people who have lost pension rights.

Summary. The High Court has required the government to reconsider the Parliamentary Ombudsman's recommendation to compensate people who have lost pension rights as a result of winding up of their pension schemes following insolvency of the sponsoring employer.

Background. On 15 March 2006, the Parliamentary Ombudsman determined that the government was guilty of maladministration when it provided misleading information to the members of final salary pension schemes about the security of their pension entitlements.

The Ombudsman concluded that the finding of maladministration was one of a number of factors that caused injustice to over 75,000 people. Among her recommendations was that the government should consider arrangements for the restoration of the benefits of those affected.

In a written statement to Parliament of 15 March 2006, the government rejected most of the Ombudsman's findings and recommendations.

Facts. Four individuals who lost pension entitlements on winding up of their employers' pension scheme following the insolvency of their employer applied for judicial review of the government's decision. They argued the government was wrong to reject them.

...the government plans to provide better compensation for these members via the Financial Assistance Scheme but precise details of the compensation which will now be available, have yet to be published.

Decision. The High Court has held that the government's rejection of the Ombudsman's finding of maladministration (consisting of the provision of misleading official information) was unlawful.

However, the court upheld the government's rejection of the Ombudsman's conclusion that the maladministration had caused injustice to all individuals who had suffered losses on the winding up of their pension schemes between 1995 and 2005. In order to prove injustice, the individuals would have to show that they had read the offending leaflets, or relied on advice from others who did.

The court has also directed the Secretary of State to reconsider the Ombudsman's recommendation to compensate the people who have lost pension rights.

Case: R (on the application of Henry Bradley, Robin Duncan, Andrew Parr and Thomas Waigh) v. Secretary of State for Work and Pensions [2007] EWHC 242 (Admin).

Comment. These two decisions put pressure on the UK government to provide better compensation for members of company pension schemes who have lost out because their employer became insolvent between 1997 and 2005. In his Budget Speech, the Chancellor of Exchequer announced an increase in the budget for the Financial Assistance Scheme from £2 billion to £8 billion. It is thus clear that the government plans to provide better compensation for these members via the Financial Assistance Scheme but precise details of the compensation which will now be available, have yet to be published.

Pension rights during maternity and adoption leave

Summary. Employees will have new rights to pension benefits during maternity and adoption leave from April 2007.

Background.

Paid maternity leave is being extended from 26 to 39 weeks...

- Paid maternity leave is being extended from 26 to 39 weeks for women whose expected week of childbirth starts on or after 1 April 2007 (The Statutory Maternity Pay, Social Security (Maternity Allowance) and Social Security (Overlapping Benefits) (Amendment) Regulations 2006 (SI 2006/2379)).
- An employee on maternity or adoption leave can do up to 10 days' work ("keeping in touch days") without bringing their maternity or adoption leave to an end (The Maternity and Parental Leave etc. and the Paternity and Adoption Leave (Amendment) Regulations 2006 (SI 2006/2014)).
- Paid adoption leave is being extended from 26 to 39 weeks for adopters where the placement of the child is expected to occur on or after 1 April 2007 (The Statutory Paternity Pay and Statutory Adoption Pay (General) and the Statutory Paternity Pay and Statutory Adoption Pay (Weekly Rates) (Amendment) Regulations 2006 (SI 2006/2236)).

Pension implications. An employee must be provided with pension benefits during paid maternity and adoption leave as if they were working normally and receiving the remuneration likely to be paid for doing so. However, they can only be required to pay contributions to a pension scheme on the amount of any contractual remuneration or statutory maternity or adoption pay which they actually receive. (Schedule 5, paragraph 5 and 5B, Social Security Act 1989).

This means:

- In a defined benefit scheme, an employee on paid maternity or adoption leave will receive the same pension benefits as if they were working normally during the whole 39 weeks of paid maternity or adoption leave.
- In a defined contribution scheme, an employer must pay contributions in respect of the employee during the whole 39 weeks of paid maternity or adoption leave, as if the employee were working normally.
- If keeping in touch days are paid, pension benefits must be provided in respect of the employee as if they were working normally.

Payment of lump sum death benefits

With effect from 22 March 2006, the inheritance tax legislation has been changed so that inheritance tax can now be payable in relation to such trusts even if the specified age is only 18.

Beneficiary under 18

Where a lump sum benefit was payable on the death of a member and the trustees decided to use their powers under the pension scheme's discretionary trusts to pay the lump sum to a beneficiary who was under 18, it was the practice to pay the lump sum into an "accumulation and maintenance trust" under which the beneficiary would not be entitled to the capital until reaching an age between 18 and 25. This meant that, under the inheritance tax legislation applicable up to 22 March 2006, no inheritance tax was payable on the payment from the pension scheme into the trust, whilst the money was in the trust or when the capital was paid from the trust to the beneficiary on attainment of the specified age.

With effect from 22 March 2006, the inheritance tax legislation has been changed so that inheritance tax can now be payable in relation to such trusts even if the specified age is only 18. The inheritance tax position is now:

- There will be no inheritance tax on the payment from the pension scheme to the trust where that payment is made by the trustees in exercise of their discretionary powers under the pension scheme.
- While the trust subsists, it may be subject to an inheritance tax charge on every tenth anniversary of the date the member joined the pension scheme (although there can be no such ten year charge before the date of the member's death).
- The trust may also be subject to an inheritance tax charge when the trust comes to an end because the capital is being paid to the beneficiary.

There will be no inheritance tax charge at a tenth anniversary or at the termination of the trust, if the value of the trust assets plus any gifts made by the member in the seven years before his death does not exceed the nil rate band for inheritance tax (currently £285,000). Otherwise, there may be a 6% inheritance tax charge on the excess. For example:

Value of trust assets on ten year anniversary	=	£250,000
Plus value of Member's lifetime gifts in last seven years	=	£150,000
Total	=	£400,000
Nil rate band at 10 year anniversary, say,		£325,000
Excess	=	£75,000
Inheritance tax charge = 6% x £75,000	=	£4,500

Only a proportion of that £4,500 will be actually payable if the first ten year anniversary falls less than ten years after the member's death. Equally, only a proportion of the £4,500 would be payable on the termination of the trust if that termination was less than ten years after the previous ten year anniversary (or the member's death, if there is no ten year anniversary between the member's death and the termination of the trust).

Comment. The possibility of such inheritance tax charges has led some trustees to reduce the period for which such trusts must exist to a minimum by specifying that the capital should be paid to the beneficiary as soon as the beneficiary reaches age 18.

Late notification of death

Most pension schemes provide that, to be paid under the scheme's discretionary trusts rule, the trustees must decide to whom the money is to be paid within two years of the member's death. There are cases, however, where this is not possible because the scheme administrator does not learn that the member has died until more than two years after the date of death. Since A Day, HM Revenue & Customs have been saying that, if in these circumstances a lump sum was paid out more than two years after the date of death, this was an "unauthorised payment" under the Finance Act 2004 which could have led to adverse tax consequences for the recipient and for the pension scheme. The legislation is now being changed to remove the risk that such payments will be "unauthorised payments".

Where the member dies before 6 April 2006, the Regulations have already been amended so that, if the payment is made within two years of the date upon which the scheme administrator could reasonably have known of the member's death, the payment will not be an "unauthorised payment".

Where the death occurs on or after 6 April 2006, the Finance Bill currently before Parliament will contain a provision with a similar effect and the application of the provision will be backdated to 6 April 2006.

Sources: Article 40 of the Taxation of Pension Schemes (Transitional Provisions) Order 2006 No. 572 (as amended); paragraph 11 of Schedule 20 to the Finance Bill 2007.

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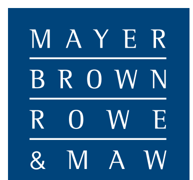

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