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BACK TO BASICS — TAX RELIEF FOR EMPLOYER PENSION CONTRIBUTIONS

Tax relief for employer contributions to a UK registered pension scheme is governed by normal corporation tax deductibility principles subject to two main modifications. First, relief is available only for contributions actually paid. Second, there is no blanket restriction on deductibility for payments of a capital nature. The timing of deductions can, however, be affected by the spreading rules.

Contributions to non-registered schemes (commonly used to provide group life cover to employees) are deductible in accordance with normal (unmodified) corporation tax principles. Depending on the structure of the arrangements, deductions can, however, be deferred (and ultimately denied) if sufficient qualifying benefits are not paid out of the non-registered scheme.

Pension contributions represent a significant cost for many businesses; tax relief associated with those contributions can, therefore, be extremely valuable.

This back to basics article looks first at the general rules governing deductibility of employer contributions to registered pension schemes for corporation tax purposes, with the focus on defined benefit schemes. It then highlights some of the situations in which deductibility might be in doubt and what to do in those circumstances, and ends by considering the position when the scheme in question is unregistered. Funded and unfunded employer-financed retirement benefits schemes are outside its scope, and the asset-backed contribution rules are touched on only very briefly.

Registered pension schemes

The vast majority of UK pension schemes are registered with HMRC under Part 4 of FA 2004 and subject to the registered pension scheme tax regime.

The basic principles

Trading companies and companies with investment business obtain tax relief for employer contributions to a registered pension scheme by way of a deduction in computing taxable profits. The normal corporation tax principles that apply to determine whether a payment is tax deductible apply equally to employer pension contributions, subject to the modifications set out in FA 2004 s196.

For trading companies, this means that, in order to be tax deductible, the contribution in question must be:

- incurred wholly and exclusively for the purposes of the trade of the company making the payment (CTA 2009 s54); and
- actually paid by the company in the relevant period of account (FA 2004 s196(2)(b)).

No deduction will be available for an amount accrued in the company's accounts but not actually paid in that period.

For companies with investment business, in order for an employer contribution to be relievable, it must constitute an expense of management (as defined in CTA 2009 s1219) and actually be paid by the company in the relevant accounting period (FA 2004 s196(3)(b)).

It might seem from the face of FA 2004 s196(3)(a), which says that contributions "are to be treated as being expenses of management to the extent that they otherwise would not be," that all employer pension contributions are deemed to be expenses of management. But this is not how HMRC interprets that provision and is arguably inconsistent with the explanatory notes to Finance Bill 2004. The explanatory notes indicate that the purpose of that provision was narrower — to allow relief for expenses which would otherwise be disallowed solely because they are capital in nature.

The test for whether an employer pension contribution constitutes an expense of management is set out by HMRC in its *Company Taxation Manual* (at CTM08344)

as being whether the contribution is an expense of management made in respect of that company's investment business.

This test, and the wholly and exclusively requirement that applies where the paying company is a trading company, can sometimes present difficulties (see below under "When to worry about deductibility?").

Contributions of a capital nature, which would otherwise be disallowed under CTA 2009 s53 in the case of trading companies or under CTA 2009 s1219(3)(a) in the case of investment companies, are specifically allowed (FA 2004 ss196(2)(a) and 196(3)(a)).

The timing of employer deductions can be affected by the spreading rules considered below.

Recently enacted corporation tax measures are also encouraging employers to investigate whether they can defer pension contributions they might otherwise have made. In some instances, this is to allow employers to use cash resources instead to take advantage of the capital allowances super-deduction available until 31 March 2023. For others, it is driven by the rise in the corporation tax rate to 25% on 1 April 2023. A business making a big contribution now will benefit from some of the rate rise thanks to spreading – but employers paying cash tax and considering a large (and non-urgent) pension contribution, particularly one due to take place next year, may decide to defer this to 2023, so that the whole payment benefits from relief at the higher rate.

When to worry about deductibility?

This section focuses on the wholly and exclusively requirement for trading companies. Investment companies face similar issues around whether a contribution is an expense of management in respect of their investment business. HMRC's guidance for investment companies is set out in its *Company Taxation Manual* at CTM08340 – CTM08355. It largely mirrors the position for trading companies.

The wholly and exclusively test: In the vast majority of cases, the requirement that a pension contribution be incurred wholly and exclusively for trading purposes will be straightforward to satisfy. HMRC recognises this in its *Business Income Manual* at BIM46030, emphasising that "as part of the cost of employing staff, pension contributions are likely to be allowable".

Whilst it will be a question of fact in each case, HMRC states in BIM46005 that "it is likely that you will need to consider the "wholly and exclusively" rule only in the limited circumstances outlined in BIM46030." The "relatively rare" situations where there might be a non-trade purpose include contributions made:

- under s75 of the Pensions Act 1995 ("**s75**");
- as part of the bargain struck to facilitate the sale of shares in a subsidiary; or
- in connection with the pension deficit of another company's trade where the reputation of the payer's trade or the morale of its staff is not the sole purpose behind the contribution.

Section 75 debts: Looking first at s75, when an employer ceases to participate in a defined benefit multi-employer pension scheme, a debt will, unless alternative arrangements are put in place, generally become payable by the departing employer to the scheme trustees under s75, assuming that the scheme is in deficit on a buy-out basis. When schemes are frozen to accrual, the s75 debt is triggered on notice. For completeness, the s75 debt can also be triggered on certain insolvency events in relation to an employer and scheme wind-up.

Section 75 debts often arise in the context of a corporate sale. Upon completion a liability can crystallise in the hands of the target company which is leaving the seller's scheme.

There are various options for dealing with a s75 debt in these circumstances, each having different tax considerations.

Where the s75 debt is relatively small, target might simply make a payment to the pension scheme in satisfaction of the debt. This payment is deemed (as a result of FA 2004 s199) to be a contribution to the pension scheme. Whilst this means that you do not need to worry whether it is income or capital, the wholly and exclusively test still needs to be satisfied. In BIM46045 HMRC states that: "In practice you can accept that payments made to satisfy "debts", which are the liability of the contributor, are made wholly and exclusively for the purposes of the trade." The example in BIM46055 suggests that this remains HMRC's view even where a portion of the s75 debt relates to orphan liabilities (i.e. liabilities relating to members whose employer no longer participates in the scheme) provided that the orphan liabilities arose "by default, for historical reasons arising from group reorganisations, disposals and cessations" and were not created by agreement with the scheme trustee. Payment by target of its own s75 debt is thus likely to be deductible.

It will be important to consider whether the sale documentation appropriately allocates the benefit of any tax deduction between the buyer and the seller. Where the economic cost of target's payment of the s75 debt is borne by the seller rather than the buyer, as will often be the case (through a post-completion indemnity payment to the buyer, for instance), the seller is likely to ask for the tax benefit of the deduction in target to be passed back to it. This brings with it all the usual

challenges with passing reliefs back to the seller. For example, at what point will target be treated as having benefited from the relief? Will target be required to use tax relief associated with the s75 debt in priority to other reliefs it has available? What protection will the buyer have in the event that a payment has been made to the seller and the availability of the relief is challenged by HMRC?

If target doesn't have the cash resources to pay the s75 debt itself following completion, it will often be more straightforward, from a tax perspective, for target to be put in funds so that it can make the payment itself (following an indemnity payment from the seller to the buyer) and then for the economic benefit of the associated tax relief to be passed back to the seller on the basis outlined above. If another company in the seller's group stepped in to pay the s75 debt, assuming it was also an employer under the scheme, it would need, in order to obtain a tax deduction, to be able to demonstrate to HMRC that it did so wholly and exclusively for the purposes of its own trade — to secure the morale of its employees remaining in the scheme or protect its reputation, for example — and not to facilitate the sale.

Flexible apportionment arrangements: A common alternative to target simply paying a s75 debt is a flexible apportionment arrangement (FAA). This allows the liabilities in the scheme attributable to target to be apportioned away from target to another employer under the scheme remaining in the seller's group. No s75 debt is then triggered, so any future payments made as a result of the FAA by the relevant member of the seller's group are simply contributions to the pension scheme.

Whilst an FAA is likely to be attractive to sellers (because it avoids an immediate payment to the pension scheme), at the time of entering into the FAA the tax deductibility of future payments resulting from the FAA should be considered. This will, hopefully, ensure that contemporaneous documentary evidence best supports deductibility.

Future payments are likely to be tax deductible provided that the company taking on the obligations can demonstrate that it took those obligations on wholly and exclusively for the purposes of its *own* trade and *not* to facilitate the sale of target or to obtain a better price for target.

This will be a question of fact in each case. There are, however, some helpful examples included in BIM46045, BIM46060 and BIM46065 indicating how HMRC approaches this area.

It will, unsurprisingly, be more difficult to demonstrate that the wholly and exclusively requirement is satisfied where the target has the resources itself to meet any s75 debt that would have been triggered in the absence of an FAA and the obligations relate to current employees of target (contrast example 3 in BIM46045 with example 2 in BIM46060). Similarly, be prepared for HMRC to investigate any link between the FAA and the sale of target, and whether the FAA was put in place in order to facilitate a sale — in which case future payments resulting from the FAA are unlikely to be tax deductible — or to protect the reputation, as an employer, of the company taking on obligations under the FAA (see example 4 in BIM46065).

A practical checklist of points to investigate, and document appropriately, when putting in place an FAA, or if another company is stepping in to pay a s75 debt, includes:

- What are the pension liabilities comprised in the s75 debt which arises or would have arisen in the absence of an FAA? What proportion of the liabilities are orphan liabilities and what proportion relate to target's current employees?
- Why has the company taking on the s75 debt or obligations under an FAA agreed to do so?
- Does target have the resources to meet any s75 debt itself? If it does, why is it not doing so?
- Are the sale documents, and any communications with potential purchasers, consistent with the answers to the above questions?

Spreading

If the spreading rules apply, relief for the employer pension contribution will be spread over two to four years depending on the size of the contribution.

The purpose of spreading is, according to the explanatory notes to Finance Bill 2004, to 'prevent employers from reducing the tax liability on their profits in a good year by making large special contributions to a registered pension scheme. Its effect is not to deny tax relief but to smooth its flow'.

The detail of how it operates is contained in FA 2004 s197.

It requires you to compare the amount of contributions paid by the company in the current chargeable period (the "**CCCP**") with the amount of contributions paid in the previous chargeable period (the "**CPCP**"). Spreading will generally be required if:

- the CCCP exceeds 210% of the CPCP; and
- the amount by which the CCCP exceeds 110% of the CPCP (the "**excess**") is more than £500,000.

Deductions for the relevant fraction(s) of the excess will be deferred as set out in the table below. The remaining amount of the excess, together with the amount of the CCCP which is not included within the excess, is deductible in the current chargeable period.

Amount of the excess	Fraction and chargeable period(s)
£500,000 or more but less than £1m	One-half of the excess is treated as paid in the chargeable period immediately after the current chargeable period
£1m or more but less than £2m	One-third of the excess is treated as paid in each of the two chargeable periods immediately after the current chargeable period
£2m or more	One-quarter of the excess is treated as paid in each of the three chargeable periods immediately after the current chargeable period

By way of example, where the excess is £2m, £500,000 of the excess would be deductible in the current period of account, with deductions for the remaining £1.5m of the excess spread over the next three chargeable periods, with £500,000 allowed as a deduction in each of those periods.

There are some exceptions to the spreading rule: on a business cessation, for example, or in the case of contributions paid to fund cost of living increases for pensioners.

In specie contributions

Relief under FA 2004 s196 is restricted to "contributions paid". The meaning of this phrase was recently considered by the Upper Tribunal in *HMRC v Sippchoice Ltd [2020] UKUT 149 (TCC)*, albeit in the context of FA 2004 s188 which confers tax relief on individual members for their pension contributions. It was held to be restricted to contributions of money (whether in cash or other forms) — and not to encompass the transfer of shares to a pension scheme made in satisfaction of an obligation to contribute money. HMRC clarified its guidance on *in specie* contributions of assets following this judgment (see *Pension Schemes Newsletter 126*, December 2020).

If an employer wishes to contribute an asset to a pension scheme and obtain tax relief, HMRC's guidance in its *Pensions Tax Manual* at PTM042100 should be followed closely. This says that:

"For a contribution to retain its monetary form, there must be:

- a clear obligation on the contributing party to pay a contribution of a specified monetary sum, say, £10,000. This needs to create a recoverable debt obligation;
- a separate agreement between the scheme trustees and the contributing party to sell an asset to the scheme for market value consideration, and
- a separate agreement whereby the scheme trustees and the contributing party agree that the cash contribution debt may be offset against the consideration payable for the asset."

Contemporaneous documentary evidence of the above three steps should be produced and retained.

Where contributions are structured in this way, the provisions denying upfront tax relief for asset-backed contributions in FA 2004 ss196B—196L should also be worked through. Broadly, in the simple case (with no partnership), upfront relief will not be available (unless the arrangement is an "acceptable structured finance arrangement") if:

- the employer receives money from the pension scheme (the "advance") funded to some extent by the employer's contribution to the scheme;
- the employer (or a connected party) disposes of an income-generating asset to the scheme; and
- it is reasonable to suppose that the amount of one or more payments under the arrangement has been determined to some extent on the basis that the advance represents a loan that is to be repaid.

HMRC notes (at PTM043320) that it "is not intended that outright disposals of property should generally be caught by these rules"; they will often be excluded for failing to meet the condition in the final bullet point above. Nevertheless, given the complexity of these rules, they are worth considering in order to ensure that the arrangement in question isn't inadvertently caught.

Non-registered group life assurance schemes

Non-registered schemes (i.e. schemes which are not registered with HMRC under Part 4 of FA 2004) fall outside of the registered schemes tax regime.

They are often used to provide life cover to employees where that cover (or that level of cover) cannot be provided under a registered scheme without adverse tax consequences for the employee. This might be because, for instance, the employee has a protected lifetime allowance or has benefits close to the lifetime allowance under registered schemes already. They are becoming increasingly common, due in part to the significant reductions in the lifetime allowance over the last ten years. Typically, they hold insurance

policies designed by the insurer to constitute excepted group life policies (as defined in ITTOIA 2005 s480).

Employer contributions under non-registered group life schemes will not be subject to the modifications to the deductibility rules that apply in the case of contributions to registered schemes.

In order to be tax deductible, payments by an employer must, therefore, meet the general corporation tax requirements (i.e. for trading companies, (i) deductible in accordance with generally accepted accounting practice; (ii) of an income nature; and (iii) incurred wholly and exclusively for the purposes of the trade).

Further, contributions to these schemes will often be caught by CTA 2009 s1290, which can defer or disallow tax relief for contributions to an employee benefit scheme, where there is a lag between the contribution and the pay-out. (Section 1290 is automatically disapplied for contributions to registered pension schemes.)

Care needs, therefore, to be taken in structuring the premium payments due to the insurance company to maintain the group life cover policy to achieve the best position on deductibility.

If the employer pays contributions to the scheme trustee and the trustee pays the premium to the insurer, then any deduction for the employer's contribution may (depending on the exact structure of the arrangement) be deferred until a “qualifying benefit” is paid out under the scheme – or denied if no qualifying benefit is paid out within five years. There are several types of qualifying benefits. The relevant one for life cover schemes applies where there is a payment under an employer-financed retirement benefits scheme and that payment is a benefit under an excepted group life policy (CTA 2009 s1292(5) and ITEPA 2003 s393B(3)). The usual exclusion from the definition of an employer-financed retirement benefits scheme where a non-registered scheme provides only pensions or death benefits under excepted group life policies is ignored for these purposes (CTA 2009 s1296(1)). It is fairly common (especially under smaller schemes) for there to be years when no pay-out is made by the scheme and this restriction on deductibility could then bite.

If, instead, the employer pays any premium direct to the insurance company, then there may be scope for claiming the deduction should not be deferred on the basis of the carve-out from CTA 2009 s1290 “for anything given as consideration for goods or services provided in the course of a trade or profession”.

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