



# Pensions: legal issues on additional voluntary contributions



## **Summary**

This guide looks at the legal obligations on pension trustees in relation to additional voluntary contributions payable by members. It considers both the current legal issues and the likely changes from April 2006 under the Finance Act 2004 and the Pensions Bill.

## Contents

Introduction	1
Current statutory AVC requirements	4
Proposed changes to statutory AVC requirements	7

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## **Introduction**

Currently, occupational pension schemes are generally required to provide a facility for members to be able to make additional voluntary contributions (AVCs) to the scheme. These are contributions on top of the regular contributions payable for the main scheme benefits. The AVC facility allows members to top up their pension under the scheme (eg to fund early retirement).

Strictly, of course, if the scheme is non-contributory (ie does not require any basic contributions from members), any AVC facility relates just to voluntary contributions by members, but the practice is to call these facilities AVCs.

This requirement was introduced from April 1988 because current Inland Revenue rules do not generally allow concurrency: members may not normally contribute to a personal pension at the same time as being members of an occupational pension scheme. Members are now allowed to contribute to a free-standing AVC scheme (FSAVC), a form of personal pension outside the main occupational scheme.

### **Future changes**

The Revenue prohibition on concurrency was partially relaxed in 2001. Broadly, those earning less than £30,000 pa are allowed to contribute up to £3,600 pa to a personal pension (see section 632B, Income and Corporation Taxes Act 1988 (ICTA)).

The tax simplification provisions in the Finance Act 2004 envisage allowing concurrency for all members from 6 April 2006.

In the light of this the government proposes to remove the statutory requirement for schemes to have an AVC facility, as concurrency will render them redundant. The relevant legislation is part of the Pensions Bill, currently before parliament. It is envisaged that this change will also take effect in April 2006.

### **When are contributions voluntary?**

In many schemes it will be easy to tell whether or not member contributions are basic or voluntary (additional).

The position becomes less clear if there is provision in the scheme for the rate of member contributions to vary – eg as the member gets older, or at the member's option. Such variation can often occur in money purchase (defined contribution) schemes, particularly those with matching employer contributions.

Slightly oddly, there is no definition in the existing pensions legislation of what voluntary contributions are, and the Pensions Bill does not currently propose to add a definition.

Current Revenue practice does define the position. Generally, the rate of basic or contractual member contributions should be required to continue for at least one year (or until earlier death, retirement or leaving service). Therefore, if the member has the right to change the rate of contribution, the Revenue looks for the scheme to treat the contributions as AVCs instead of basic or contractual contributions. The test is set out in the Inland Revenue Practice Notes (IR12).

#### **Salary sacrifices are not AVCs**

If extra contributions are paid by way of a salary sacrifice arrangement, these will *not* count as AVCs. This is because the effect of the sacrifice is to treat the extra contributions as made by the employer (see our briefing no. 103 *Salary and bonus sacrifices*, December 2003).

#### **Legal implications of AVCs**

If member contributions are classified as being AVCs, the implications are as follows.

- Lump sum commutation is not possible for those who began making AVC contributions after 7 April 1987 (see PN 8.3 of IR12). In practice it is often possible to mitigate the effect of this by providing for commutation of other benefits (within Inland Revenue limits) to achieve the same result. The tax simplification changes from April 2006 will remove this restriction.
- Priority is currently given on a winding-up to benefits derived from AVCs (section 73, Pensions Act 1995) (see further below).
- If the member has paid too much and hit Inland Revenue limits on benefits, surplus AVCs can now be refunded to the member, less a tax charge – see part III, schedule 6, Finance Act 1989, section 599A ICTA and paragraph 17.35 of IR12). The tax charge is currently 32 per cent – see the Income Tax (Charge to Tax) (Payments out of Surplus Funds) (Relevant Rate) Order 2000 (SI 2000/600). The member is credited as having paid basic rate tax on this surplus refund. Schemes are required to liaise with other occupational schemes and FSAVC schemes about this – see the 1993 AVC regulations and paragraph 16.28 of IR12.
- Benefits from AVCs do not count as contracted-out rights after April 1997 (section 9(2B) rights). Thus they do not become protected rights on a transfer to a scheme contracted out on a money purchase basis.
- Schemes do not have to give a minimum level of increases to pensions in payment (currently price inflation up to 5 per cent pa)

to benefits derived from voluntary contributions (section 51(6), Pensions Act 1995).

- Investments derived from AVCs do not count as employer-related investments (within section 40, Pensions Act 1995) if the investment is agreed in writing by the member – regulation 6(5) of the 1996 Investment Regulations. Members can therefore agree to invest AVCs in (say) employer shares without infringing the current limits. It may be that this exemption does not survive the application in the UK of the European Directive on Institutions for Occupational Retirement Provision (the IORP Directive). The IORP Directive limits employer-related investment but does not have any specific exception for member-directed AVCs.
- Payments to the scheme which are voluntary contributions do not have to be recorded in the statutory schedule of contributions (or a payments schedule for a money purchase scheme) – regulation 17 of the 1996 MFR Regulations.
- If AVC benefits are given on a money purchase basis, this will trigger an obligation on the scheme to send out statutory money purchase illustrations (SMPIs) in relation to those benefits (even if the rest of the scheme benefits are defined benefit (DB) – see our briefing no. 86 *Statutory money purchase illustrations*, March 2003).

## Current statutory AVC requirements

### Which schemes do these apply to?

Generally, occupational pension schemes are required to provide an AVC facility (section 111, Pension Schemes Act 1993).

Limitations on the statutory right of a member to pay AVCs are contained in regulations 2 and 2A of the Pension Schemes (Voluntary Contributions Requirements and Voluntary and Compulsory Membership) Regulations 1987, as amended.

Broadly, these limitations on the statutory right are as follows.

- The AVCs must qualify for tax relief. Therefore the requirements apply only to tax-approved schemes (eg not a Funded Unapproved Retirement Benefit Scheme). The tax limit on total member contributions also applies – 15 per cent of taxable earnings (or the earnings cap, if less, for members who joined after May 1989).
- Scheme rules can require the member to give notice of up to 12 months of the intention to pay AVCs or to change the rate.
- Members who are entitled only to death benefits or who are not in pensionable service or who are within one year of normal pension age have no statutory right.
- Members who are in another occupational scheme to which AVCs can be paid have no statutory right.
- Scheme rules can require a minimum level of AVCs in any tax year (but no more than the greater of 0.5 per cent of the member's earnings or three times the lower earnings limit<sup>1</sup> for national insurance purposes).
- Scheme rules can impose a maximum level of AVC contributions in any tax year based on the 15 per cent limit imposed by the Revenue, but ignoring benefits in kind.

Schemes can (subject to Revenue requirements) take AVCs even if the statutory right is not present.

### What Revenue restrictions apply to the benefits?

Benefits derived from AVCs must fall within the usual Revenue limits on amount and timing. Currently, if the AVC arrangement started after 7 April 1987, it cannot be taken as a lump sum (see above).

- Contributions (regular *and* voluntary) must not exceed 15 per cent of remuneration (subject to the earnings cap for post-1989 joiners).

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<sup>1</sup> Currently (tax year 2004/05) about three times £4,100 – ie about £12,300.

- AVCs can usually be paid only if the contribution is tax deductible (PN 4.4 of IR12), but there are exceptions (eg payment of a lump sum to make up a deficit or if the employee is overseas).
- Benefits cannot be paid before age 50 (usually).
- AVC benefits must be added to the other scheme benefits for the purpose of checking Revenue benefit limits. If these limits are exceeded, a surplus refund can now be made to the member (less tax) – see above.
- Since June 1999, the Revenue has allowed schemes to allow AVC pensions to start earlier or later than the main scheme benefits (see IR Updates 54 and 66), but it is up to the scheme whether or not it allows this flexibility (or instead insists on AVC benefits starting at the same time as the other benefits).
- AVCs must currently be included in any transfer to another arrangement at the same time as main scheme benefits; they cannot currently be transferred on their own or left behind. Generally, the Revenue does not allow such partial transfers (save for leaving contracted-out rights behind if the receiving arrangement is not contracted-out).

#### **What benefits must be provided?**

Subject to Revenue restrictions, it is a matter for the scheme how AVC benefits are calculated. Most provide money purchase benefits, but some have a DB provision (commonly called ‘added years’). This obviously creates a funding concern for an employer, so many schemes prohibit such DB AVC benefits unless the employer consents.

The AVCs must be used by the trustees to provide additional benefits for or in respect of the member (section 111(1)(c) of the 1993 Act). The benefits to be provided from AVCs must be reasonable in value having regard to the amount of AVCs paid (section 111(1)(d)(i) of the 1993 Act).

Money purchase AVCs will comply with this by basing benefits on the assets in which the AVCs are invested. This also requires in effect that the value of AVCs is included in any refund of member contributions if a member leaves with less than two years’ pensionable service and in any lump sum paid on death.

In addition, if the AVC benefits are not money purchase (ie DB), the value of the AVC benefits must be reasonable having regard to the value of the other benefits under the scheme (section 111(1)(d)(i) of the Pension Schemes Act 1993). This does not apply to money purchase AVCs (regulation 2(12) of the 1987 AVC Regulations).

### **Payment mechanics**

AVCs are usually deducted from pay by the employer. A written authority for this is needed from the member (part II, Employment Rights Act 1996, formerly the Wages Act).

The employer must then pass the contributions to the scheme by no later than the 19th of the following month. The Occupational Pensions Regulatory Authority (Opra) can fine employers who default in this (section 49(8), Pensions Act 1995 – and see our briefing no. 106 *Late payment of pension contributions by employers*, February 2004). Fraudulent failure may be a criminal offence.

The trustees should invest the AVCs, once received, reasonably promptly. The Pensions Ombudsman held in 2003 that an eight-day delay (from the receipt of cleared funds) was maladministration (determination in the case of *Mr Hall* [L00363], April 2003).

### **Impact on share options**

Members should note that the payment of AVCs will reduce their taxable remuneration and so may reduce the maximum available in other areas (this used to be an issue for Revenue-approved share options).

### **What is the limit on contributions?**

The Revenue requires that total member contributions (ie AVCs and any ordinary contributions) must not exceed 15 per cent of remuneration in any tax year. Remuneration is limited to the earnings cap for post-June 1989 joiners (subject to transitional provisions). Unused relief cannot be carried forward to subsequent tax years (this contrasts with the position for personal pensions until recently).

AVCs must be restricted if total benefits would exceed Revenue limits (PN4.4 of IR12). However, employees are able to pay AVCs to fund early retirement benefits (PN13.2 of IR12).

## **Proposed changes to statutory AVC requirements**

### **Finance Act 2004 provisions**

These limits will cease to apply from 6 April 2006 when the Finance Act 2004 comes into force. Instead, member contributions will be unrestricted. Tax relief will, however, apply only on contributions paid before age 75 (section 188(3), FA 2004) and up to 100 per cent of the member's taxable income (section 190, FA 2004).

The removal of the contribution limits may have an impact on employers, in particular, if the pension scheme currently provides for:

- payment of matching contributions by the employer; or
- AVCs to be able to secure benefits on a DB basis – eg an added years facility.

Employers should check to see if the removal of the Revenue limits on contributions could mean a further exposure to them (eg if the matching contribution obligation currently does not have any specific scheme limit). If it does and employers are concerned about the potential exposure, a scheme amendment may be necessary.

### **Pensions Bill changes**

The Pensions Bill currently passing through parliament envisages making various changes that will affect AVCs.

#### **No compulsion**

The Bill proposes the repeal of the requirement to offer an AVC facility (ie the repeal of section 111, Pension Schemes Act 1993). This is likely to come into effect only in April 2006 (at the same time as the pensions tax simplification changes).

#### **Existing deeds**

The removal of the statutory requirement will leave it open to schemes to terminate their existing AVC facilities. Depending on the wording of the relevant scheme, this may require a deed of amendment (which will often also require trustee consent).

#### **Existing AVCs**

Trustees and employers may be inclined to leave in place existing facilities (at least for existing members). Alternatively, they may decide that it should be for the member to choose his or her own top-up arrangements outside the scheme. This is more likely to be the case if the existing AVCs are money purchase.

#### **Transfer out?**

If the decision is made to terminate the facility for future AVC contributions, this will still leave existing AVCs in place. It may be

possible for the scheme to arrange for these to be transferred to a suitable personal pension or buyout policy. The Revenue's current prohibition on partial transfers will apparently cease to apply from April 2006.

Scheme rules will need to be checked to see if they will allow a partial transfer and, potentially, a transfer without consent. The trustees will also be concerned to obtain suitable investment advice on the appropriate recipient policy for any transfers without consent (the issues here are similar to those applicable to the buyout of pension credit members following a pension sharing order on divorce).

**Priority order**

The current overriding statutory priority order on the winding-up of a DB scheme gives priority to benefits attributable to AVCs (section 73, Pensions Act 1995). This was commonly reflected in scheme rules before April 1997 (when the Pensions Act 1995 came into force) anyway – at least in relation to money purchase AVCs where the relevant assets were segregated from the other assets of the scheme (such a priority was permitted by the contracting out rules applicable before that date).

The latest proposed amendments to the Pensions Bill envisage a change in the statutory priority order. AVC benefits will lose their existing priority. Instead benefits covered by the new Pension Protection Fund (PPF) (ie 100 per cent of pensions in payment over normal retirement age, but only 90 per cent for deferred members with a cap) will be given priority. AVC benefits will be treated in the same way as other benefits for this purpose. Any balance of AVC benefits not covered by the PPF cap will take the next level of priority. This change is likely to affect only DB AVCs – money purchase benefits (including AVCs) are likely to be outside the PPF and outside the statutory priority order.

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