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Overpayments – a taxing problem?

In recent years, another layer of complexity has been added to the already complicated (and sometimes emotionally fraught) area of mistaken overpayments by pension schemes. The culprit is the Finance Act 2004 and its treatment of overpayments as unauthorised payments. Here we recap the key historical considerations relating to overpayments, before looking at the latest developments under the Finance Bill 2008.

The basic problem

- By their very nature, overpayments represent an error made somewhere along the line. Once picked up, trustees face a dilemma.
- On the one hand, it can seem unjust to require a member to repay overpaid sums received in good faith.
- On the other hand, trustees (who must act in accordance with their scheme rules and fairly towards all members) are entitled to require repayment.

Pensions Act 1995

The historic position

- In the past, there were concerns that section 91 of the 1995 Act[1] prevented the deduction of overpayments from a member's ongoing pension entitlement.
- However, the Pensions Ombudsman's determinations in *Noble* (2002) and *Cook* (2003) identified a basic principle that payments made by mistake were recoverable in this way.

Pensions Act 2004

A helping hand for trustees

- The 2004 Act amended section 91 with effect from 6 April 2005.
- The amendments made put trustees' ability to recover (or "set-off") overpayments against future pension instalments beyond doubt.
- Nonetheless, care needs to be taken in how requests for repayment are handled, as an insensitive attempt at recovery could of itself amount to maladministration.

[1] This section generally prevents pension being paid to anyone other than the intended recipient

The overpaid member

Possible defences

- A member might be able to resist repaying an overpayment, and even establish an entitlement to the greater amount going forward, by showing a "change of position".
- The member would have to show that they irrevocably changed their position in reliance on their higher income, and did so in good faith.
- In some cases, a member may even be able to argue that a separate contractual entitlement has been created.

Tax implications

Finance Act 2004

- To protect the "integrity of tax reliefs and exemptions", the tax rules for registered schemes distinguish between authorised and unauthorised payments.
- Unrecovered overpayments will generally (although not always) be unauthorised, resulting in significant tax charges of up to 70%.
- HM Revenue & Customs (HMRC) provides further guidance in its Registered Pension Schemes Manual ("RPSM").

HMRC guidance

Some key points

- If a payment made in genuine error is identified and rectified "as soon as reasonably possible", it will not be treated as an unauthorised payment[2].
- For cost reasons, HMRC will not seek to collect tax on overpayments of pension instalments made to a member after 5 April 2006 which do not exceed £250 in total[3].

Finance Bill 2008

Good news?

- The Bill will give HMRC greater flexibility to reclassify certain unauthorised payments as authorised (and allow them to be taxed accordingly).
- Helpfully, the circumstances on HMRC's radar are:
  - overpayments of ongoing pension (recognising that recouping these can be "difficult, disproportionately costly and sometimes undesirable"[4]);
  - pensions which continue for a short period after a member's death (because of a delay in reporting it);
  - payments made after a member's death where payment beforehand was not possible.

[2] And will not need to be reported to HMRC
[3] Overpaid instalments before 6 April 2006 (A Day) do not count for this purpose
[4] HMRC's impact assessment on widening the scope of authorised payments

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