Facilitating adviser fees directly from personal pensions

When paying an adviser fee, the client often has two choices: pay the adviser firm direct (e.g. by cheque or bank transfer) or instruct a provider to facilitate the payment of the adviser fee. Facilitation is payment of the fee, on behalf of the client, through the provider and can take various forms:

- selling all or part of the client's investment product to pay the fee
- disposing of or reducing all or part of the client's rights under the investment product to pay the fee
- separating out an amount received from the client for fee payment from the amount to be invested
- paying the fee from a client's cash account

For the purposes of this paper, we'll use the term facilitation to mean a situation where the client's fee is paid by selling or disposing of their underlying investment product, as opposed to simple payment from a cash account or payment before an investment is made. Sometimes, selling or disposing the investment to meet a fee can bring tax disadvantage compared to paying direct. It might create a tax bill or use up part of a valuable tax allowance that the client might otherwise wish to utilise. In the past, advisers were generally remunerated by commission which had the advantage of normally keeping things outside the client's own tax affairs. Nowadays, cashing-in the investment to meet an adviser fee is often no different to cashing-in for any other purpose and the same tax consequences flow. There may also be tax disadvantage in taking fees from a particular product. Take an ISA... an exceptionally tax-efficient vehicle but with a limited allowance. We might question whether it makes sense to deplete the client's ISA pot with fees where other options exist. However, sometimes facilitation can offer an advantage over direct payment and this may often be the case with registered pension schemes.

Why facilitate pension-related advice fees direct from the pension scheme?

As ever, there will always be exceptions, but as a general proposition taking advisers fees direct from the pension is likely to convey advantage to the client. Firstly, taking fees from the pension scheme is normally more efficient since tax relief on contributions effectively reduces the net cost of fees. Secondly, in the post-crystallisation/retirement phase, fee payments from the pension are normally more tax efficient than paying the fee from income taken. However, strict rules apply and it is critical to remain within them or serious consequences will unfold for the client.

Background legislation – scheme administration member payments

The underlying tenet of pension legislation is to restrict the types and amounts of payments that can be made by the scheme from the member's pension fund. The legislation prescribes a definitive list of permitted or 'authorised payments' and provides that any other payment is ipso facto an 'unauthorised payment'. In addition to the things you would expect to see as authorised, such as a tax-free cash lump sum and a pension, the list of authorised payments includes what are termed 'scheme administration member payments'. In essence, these are payments by the pension scheme, in respect of the member, made for the purposes of administration or management of the pension scheme. This includes paying fees to professional advisers but the amount must be reasonable and paid at a rate commensurate with an 'arm's length' rate. Any excess amount paid over this rate is an 'unauthorised member payment'.

Adviser charging – a permitted scheme administration member payment

Payment by a registered pension scheme to a financial adviser to meet pension advice costs is an authorised member payment provided the payment is made as a result of:

- a genuine commercial remuneration agreement between member and adviser; and
- is made for the pension advice given by the adviser in relation to that pension scheme; and
- the amount of the fee is appropriate to the service provided in respect of the advice given

If the fee costs are not genuinely commercial this will create an unauthorised member payment. The amount of the unauthorised member payment would be the excess amount over the genuinely commercial cost for the pension advice concerned. If the fees do not relate to pensions advice on that pension scheme, then the whole payment will be an unauthorised member payment.

What does the term 'pension advice' mean in this context?

Pension advice means advice concerning or connected with the particular pension involved and that advice can be in relation to:

- asset allocation and fund choice
- pension provider
- pension taxation
- checking against the various statutory limits

It can also cover advice on:

- income optimisation from that pension fund at/in retirement
- investment return optimisation on that pension fund
- more general advice on the payment outcomes/risks of choosing the type of pension to be taken (e.g. scheme pension, lifetime annuity or drawdown pension)

Advice costs also include any associated costs for implementation and administration covered within and arising from the advice given. For example, as part of giving pension advice, an adviser recommends a client to switch from one fund to another within a pension scheme. The adviser then implements the recommendation on behalf of the member by arranging for the funds to be switched and the adviser charges the client for undertaking that implementation work.

What does not constitute 'allowable' pension advice?

The advice must relate to pension advice on that particular registered pension scheme and unrelated advice is not allowable. Firstly, it is not allowable to charge fees to one pension scheme where the fee relates to advice given on another pension scheme. The payment must relate to costs for advice related to the pension scheme in question. Secondly, the fee cannot cover amounts related to wider matters not associated with the pension, albeit they may be relevant in the overall context of planning for retirement or planning at retirement. For example, costs for advice in relation to ISAs or other investments are not allowed. The amount of any unauthorised payment would be the amount of the costs that did not relate to pensions advice connected with the registered pension scheme in point.

What happens if adviser fees exceed what is allowable?

It will constitute an unauthorised member payment by the scheme and will be liable to an income tax charge known as the 'unauthorised payments charge'. The person liable to the charge is the individual scheme member for whom the payment was made and the tax charge is at a rate of 40% on the amount of the unauthorised payment. A person is liable to the unauthorised payments charge even if they are not resident or domiciled in the United Kingdom and it is a free-standing tax charge, which means, for example, any losses a taxpayer may have cannot be set against the tax charge.

The individual liable to the tax charge has the obligation to report and declare the unauthorised payment on their Self-Assessment return. Where someone does not receive a Self-Assessment return they must report their chargeability to tax in respect of the unauthorised payment to HMRC.

In certain circumstances, albeit perhaps unlikely in the context of fees, the individual may become liable to an additional 'unauthorised payments surcharge' of 15%. The rules are complex but in brief this is triggered where total unauthorised payments to a member in a given 12-month reference period exceed 25% of the fund values.

In addition to the individual tax charge, the pension scheme will generally be liable to an additional 'scheme sanction charge'. This is set at a rate of 40% of the unauthorised payment, although it will reduce to 15% provided the individual member has fully paid the tax due.

It is critical to understand that fee payments from a pension scheme must not exceed the permitted authorised amounts. Considerable tax penalties can apply and such unauthorised payments will likely contravene the scheme rules. Most schemes rules provide for the administrator to demand repayment of unauthorised payments previously believed to have been authorised, and for any unauthorised payment tax charges to be paid from the member's fund.

Specific items

Within the general treatment there are particular circumstances worthy of closer examination, as follows.

Adviser fees and purchasing a pension lifetime annuity

An adviser charge for pension advice can be a scheme administration member payment where the member is purchasing a lifetime annuity (either open market option or in-house option). This applies whether the charge is deducted from the member's funds before they are passed from the pension scheme to the chosen annuity provider or is deducted by the annuity provider after the member's funds have been passed from the pension scheme.

Provided the fee is for advice relating solely to the annuity purchase, it will be an authorised payment and will not have any bearing on the maximum amount of Pension Commencement Lump Sum (PCLS) (a.k.a. 'tax-free cash'). Broadly, the maximum PCLS is one-third of the amount applied to purchase the annuity, and fees for the annuity advice are considered to be part of the overall funds applied in connection with the annuity purchase. This would cover payment of fees in relation to any of the following:

- advice in relation to exercising the in-house lifetime annuity option/open market option
- advice about the type of lifetime annuity
- advice concerning from whom the lifetime annuity should be bought
- advice on how to maximise income from the pension fund at retirement
- advice on choosing the type of pension taken

For the purposes of establishing the amount that is being used or applied in connection with the annuity purchase, fees for wider pension advice cannot be included simply because that happens to be given at the same time as the advice leading to the annuity purchase. For example, advice about the investment of other pension funds that are being left in force and not being considered as part of the member's pensions options. The annuity-related advice must relate directly to the pensions options of the member and the member's retirement fund being used to purchase the annuity. It follows from this that an annuity provider will probably only facilitate a fee that relates solely to annuity advice, so as to ensure it is an authorised payment.

That is not to say a fee cannot be facilitated regarding the wider advice on other funds that are being left in force, but that fee relates to those funds and not the annuity purchase pot. For example, assume £100,000 of a total pot of £200,000 is being used to purchase an annuity. A total fee of £2,000 is raised to cover work of £1,000 on the pension options and the annuity purchase and £1,000 for investment advice on the uncrystallised funds being left in force. Both aspects taken separately may well be authorised payments but only £1,000 relates to annuity purchase. If the total amount being charged of £2,000 is deducted from the member's funds before being passed from the scheme to the annuity provider, the amount being applied in connection with annuity purchase is £99,000 not £100,000 and the PCLS is based on this amount.

Adviser fees deducted when designating funds for a drawdown pension

As with the purchase of a lifetime annuity, an adviser charge for pension advice when a member designates funds available for a drawdown pension can be considered as a scheme administration member payment.

However, how and when the adviser charge is deducted at the time of designating funds for a drawdown pension can have a bearing on the maximum PCLS. The amount of tax-free lump sum is based on the amount of the designated funds. Broadly, the maximum sum is one-third of the funds designated. Provided the fees are deducted after the member has designated funds for the drawdown pension, there should be no bearing on the maximum PCLS. If the charge is taken before designation it follows that the PCLS will be lower as the amount being designated is lower. Similarly, the maximum 'GAD' income withdrawal under a capped arrangement will be slightly lower too. When fees are taken shortly after a basis amount has been established at a review point, the amount deducted can nevertheless be included as part of the member's drawdown pension funds at the review point. Put another way, a fee taken shortly before a review date will reduce the maximum income available, whereas one taken shortly after will not.

Adviser fees deducted when taking a trivial commutation lump sum

When a trivial commutation lump sum is paid in respect of uncrystallised rights, 75% of the lump sum is treated as taxable pension income and the remaining 25% is tax-free. When an adviser charge for pension advice is deducted from the member's funds at the time of the trivial commutation, the 75% taxable and 25% tax-free elements are based on the amount actually paid to the member after deduction of the adviser charges.

When it might not make sense to facilitate fees directly from the pension

There will always be individual circumstances where it may not be advantageous or may be less advantageous to facilitate fees from the pension scheme. In particular, this will need to be considered where the client is effectively unable to replenish the tax-efficient pension pot. Examples include:

- where a client has enhanced or fixed protection
- where the client is aged over 75
- in certain circumstances, where the client wishes to maximise use of their annual allowances and ensure the maximum amount remains invested in the pension

In summary

It is often likely to be beneficial to your client to have an adviser fee facilitated direct from their personal pension scheme but it is vital to stay within the prescribed limits and guidance. The adviser will know the type of advice being provided, the fees being charged and the interaction with the client's pensions. The golden rules are:

- keep pension fee facilitation within the prescribed limits
- do not facilitate fees for non-pension advice from pensions
- facilitate fees for advice on a particular pension scheme from that pension and do not facilitate fees for advice given on one pension scheme from another pension scheme
- take care where fees may influence entitlement to tax-free cash or other limits

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