



From 6 April 2012, contracting-out on a protected rights basis will be abolished. Contracting-out certificates will be cancelled and members will be contracted back in to the State Second Pension.

The abolition of protected rights changes the foundation on which affected pension plans operate and will impact upon members whose benefits are not yet in payment. It is the Government's stated intention that protected rights that are in payment before the abolition date will retain their current status.

Employers and trustees should establish the effect of this change on their pension plan and should assess options where benefits are no longer restricted by protected rights regulations. Decisions need to be taken promptly so that members approaching retirement understand the effects of taking benefits before and after 6 April 2012.

This article highlights some of the key considerations affecting trust based Defined Contribution pension plans and hybrid pension plans with a DC element.¹

What are protected rights?

Where a pension plan is contracted-out on a protected rights basis, employers and members pay reduced rate National Insurance contributions. The amount of National Insurance saved (the National Insurance 'rebate') forms the basis of the protected rights fund, together with:

- age related rebates
- 'incentive payments' for contracted-out service before April 1993
- any further contributions designated as protected rights by individual pension plans
- some or all of the benefits transferred in from other contracted-out pension plans
- investment returns on the above contributions.

Protected rights restrictions

Protected rights were heavily regulated in the past. Many of the old restrictions have eroded over the years but some still remain. The remaining restrictions will cease to apply from 6 April 2012 unless they are documented in the rules as a feature of the pension plan.

Where the member is married or in a civil partnership the following restrictions currently apply:

- annuities deriving from protected rights must provide for a survivor's pension
- the protected rights must be used to provide a survivor's pension if the member dies before the protected rights come into payment
- 50% of the protected rights fund must provide a survivor's pension if the member retires on serious ill-health grounds.

Additionally, protected rights:

- must be separately identifiable from non-protected rights
- cannot be refunded to a member who leaves the pension plan with short service
- can only be transferred to pension plans that meet specified conditions.

Annuities deriving from protected rights must also be based on unisex rates.

Rule amendments

It is possible that the abolition of protected rights will require amendments to pension plan documents but this depends on the rules of the pension plan in question. In some cases rules are drafted so that the forthcoming legislative changes will take effect automatically – in other cases protected rights requirements are written into the rules and an amendment will be required to remove them. Legislation which is still in draft form but is intended to apply for a 3 year period from 6 April 2012, will allow protected rights rules to be removed by trustee resolution and it is expected that many affected pension plans will want to use this option.

Naming conventions

Protected rights will not exist after April 2012 but circumstances will arise when trustees need to refer to the historic position. Terminology such as "former protected rights" could be adopted.

¹ This article does not consider the specific effects on Defined Benefit plans that are contracted-out on a protected rights basis.

Scheme design considerations

Employer contributions

In a minority of pension plans, National Insurance rebates will have been taken into account when setting the employer contribution rate. In this circumstance contributions may remain at the current level but National Insurance rebates will cease. In response, employers may decide to reduce their contribution rate, increase employees' contributions or put in place salary sacrifice arrangements. Where employers are considering altering contribution rates, contracts of employment need to be checked, employee consultation will be required and legal advice should be sought. Any change should be considered in the light of the need to pay minimum contributions under the forthcoming automatic-enrolment requirements.

Death before retirement

If a member dies before his protected rights come into payment and before 6 April 2012, the protected rights must be used to provide an annual income to the surviving spouse or civil partner (if the member has such a relationship), otherwise it is paid to the estate or in accordance with written directions given by the member. Non-protected rights are normally paid as a lump sum under discretionary trust, with the trustees taking account of the member's expression of wish form. Where a member dies on or after 6 April 2012, it will be possible for 'former protected rights' to also be paid as a lump sum under discretionary trust, if the rules allow this. Some members will have made financial decisions based on the different treatment of protected rights and non-protected rights. Trustees need to consider very carefully their pension plan rules and the options open to them and should ensure that they encourage members to review their death benefit arrangements in the light of any changes.

Death after retirement

Currently, where a member is married or in a civil partnership at his retirement date, his protected rights must be used to provide a continuing survivor's benefit of 50% of the member's pension. From 6 April 2012, this will no longer be required, which will give additional options to members. Administration systems should be equipped to provide members with options based on retirement before and after 6 April 2012. Those approaching retirement are likely to need additional help and information.

Transfers

Protected rights restrictions on transfers from contracted-out DC pension plans will no longer apply for transfers from 6 April 2012. It will still be possible to transfer benefits from a pension plan that is contracted-out on a salary related basis (including GMP benefits) to a pension plan that was formerly contracted-out on a protected rights basis but specific safeguards have to be met, including a requirement to obtain member consent.

Serious ill-health benefits

When a member elects to take his protected rights fund as a lump sum due to serious ill-health before 6 April 2012, 50% of the fund must be retained to provide a pension for his spouse/civil partner. This will no longer be required from 6 April 2012.

Where a member receives a serious ill-health lump sum before 6 April 2012 and is still alive after that date, the DWP has confirmed that the remainder of the former protected rights fund could be paid to the member if the pension plan rules allow this. Tax considerations will also be relevant in these circumstances. Trustees might wish to inform members who claim a serious ill-health lump sum shortly before 6 April 2012 of the effect of delaying the claim until after that date but this is a hugely sensitive issue due to the short life expectancy associated with such claims.

Short-service refund

From 6 April 2012 it will be possible to refund protected rights as part of the short service lump sum payment that can be paid to early leavers where the rules allow this.

Illustrations and statements

Currently, protected and non-protected rights funds must be identified separately on money purchase illustrations. From 6 April 2012, unless the pension plan rules require a distinction to be maintained, the figures could be combined and common assumptions used which should make illustrations easier for members to understand.

It will no longer be necessary to provide unisex annuity rates for protected rights funds, however, it is likely that annuities provided under insured arrangements outside the plan will only be offered on a unisex basis from December 2012². Also, it will not be necessary to quote a contingent spouse's pension on the assumption that members will be married at retirement.

Member notice and communications

Trustees need to notify affected members that the pension plan will cease to be contracted-out with effect from 6 April 2012. This notice can be given in advance or within one month of the change.

Trustees must also explain to members the effect of the abolition of protected rights on their benefits and inform them that they will start to build entitlement to the State Second Pension. This more detailed notice must contain specific information covering changes to rules and benefits and can be issued in advance or within 4 months of contracting-out ceasing. On a practical level, trustees will probably wish to combine both notice requirements.

Employers also have notice obligations and may wish to combine their communication with the notices issued by the trustees. Employees' contracts of employment will state whether there is a contracting-out certificate in force and notice of the contractual change should be given to employees. Out of date references to contracting-out should be removed from employment contracts issued to new employees. Employers may also wish to forewarn employees of the changes that they will see to their payslips.

We recommend that notices are issued before April 2012.

Record keeping

From 6 April 2012, there will no longer be a legal requirement for protected rights to be separately identifiable from non-protected rights but pension plan rules may still require this. HMRC will make automated adjustments for the payment or recovery of rebates until 5



² This is in line with a recent ECJ ruling (commonly called the 'Test-Achats' case).

April 2015 and there will be a continuing requirement during this period for pension plans to identify to members the source of the previous year's contributions. Administration systems will need to be able to process adjustments and a clear audit trail should be maintained.

Reconciliation of problem data

Before 6 April 2012, Trustees can request HMRC to reconcile pension plan contracting-out data with its own records where there is a risk to members' benefits (ie because the records have not been well maintained). HMRC will consider any requests on a risk basis. Trustees are under a duty to maintain accurate member records and HMRC will report record keeping failures to the Pensions Regulator. However, a reconciliation request can be considered if trustees have serious concerns about member data and wish to correct the problems.

Summary of action

- Take legal advice to assess whether rule amendments are necessary.
- Assess the impact of the abolition of protected rights on 'scheme design' issues.
- Plan your notifications to members.
- Review contracts of employment and amend where necessary.
- Consider whether training would be helpful for trustees and employer personnel who are involved in making key decisions.
- Speak to your administrator regarding the level and quality of information that is being provided to members now and after 6 April 2012 and implement an action plan for dealing with communications.
- Consider asking HMRC for assistance to reconcile member data if there are problems in this area.
- Gauge the risks stemming from the abolition of protected rights and update the pension plan's risk register.
- Reconsider the information that is provided to members on money purchase illustrations.
- Assess whether general member communications need to be updated, for example, member booklets and new employee information.

Further Information

We strongly advise that action is taken promptly to ensure that you are operating your pension plan in line with the trust documentation and to avoid member complaints and administration problems. Please contact any of the partners listed below or your usual contact in the pensions team for help or information.

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