



## Contracting out: Abolition of protected rights

Protected rights are being abolished on 6 April. Scheme members currently contracted-out on a DC footing will rejoin the state second pension (S2P) automatically. The members and their employer will start to pay full NICs.

Statutory restrictions on the use of protected rights already accrued are also being removed. These can be used in the same way as any non-protected rights if a scheme's own rules say so.

Today, in a contracted-out money purchase (or COMP) scheme, the amounts members and the employer save through reduced NICs are paid to the scheme and give rise to protected rights. Because these are a substitute for a state pension, there are restrictions on the way they can be used.

Many schemes have rules that are hard-wired to these restrictions and are likely to want to make rule changes to remove them in order to give members full flexibility.

Questions for trustees and employers include:

- what must they tell members?
- do they need to take any steps in relation to contracting-out certificates?
- what rule amendments should they make?

Employers will want to bear auto-enrolment in mind as they respond to abolition.

Contracting-out through personal pension schemes is also being abolished.

### Communication

The legislation on abolition requires trustees to give affected members certain information but this is very limited and, on its own, might lead to lots of questions. Many trustees will want to offer a fuller explanation to all members. Part of this is likely to be to set out changes in the "basic information" about the scheme that trustees are required to provide and to update within three months of any material alteration.

Trustees should not forget that, whatever the statutory communication requirements, general trust law requires them to keep members reasonably well informed about significant changes to their pension.

The specific statutory requirement in relation to abolition is for trustees to inform members:

- by 5 May at the latest, that the scheme is no longer contracted-out,
- by 5 August at the latest, that:

- it was 6 April when the scheme ceased to be contracted-out,
- as a result, the member was re-instated in S2P and began to build up an entitlement there,
- their protected rights became ordinary scheme rights from 6 April,
- the scheme is no longer required to provide a pension to a surviving spouse or civil partner.

In the unlikely event the scheme has insufficient assets to cover a member's accrued rights, the trustees must say how much they are reduced. They must also say what they are doing to try to restore the value of the benefits and what steps the member can take.

Trustees can provide the above information before 6 April if they wish.

Clearly there will also need to be changes in the information supplied in future to individuals e.g. in benefit illustrations.

Employers do not need to carry out the 60 days consultation required for some scheme changes. But if employees' contracts of employment say they will be contracted-out if they join the scheme and this will not be the case in future, the employer is likely to need to take steps to communicate the change in contractual terms.

Employers may want to join in with the trustees' communication about abolition for good employee relations too.

Where an employer runs a group personal pension scheme, the main burden of communicating abolition will be on the scheme provider.

### Contracting-out certificates

No action is needed to cancel or surrender a COMP scheme's contracting-out certificate. It will cease to have effect automatically on 6 April.

This applies also to a hybrid scheme with DC and DB sections that is contracted-out on the protected rights and salary-related bases. This is sometimes called a "contracted-out mixed benefit (or COMB) scheme". The part of the certificate that relates to the DC section will cease to have effect automatically on 6 April.

If a DB scheme is contracted-out on the protected rights basis and wants to continue to contract out, it must do so on the salary-related footing. To contract out in future, a COMP scheme must do the same.

The normal election process applies in either case. Broadly the employer has to consult affected employees and make an election to HMRC after the end of the consultation period. This is three months unless there is no trade union or, if there is a union, it agrees to a shorter period (of at least a month). The election should reach HMRC before contracting-out is due to begin.

In relation to a COMB scheme, the DWP has confirmed that there is no need to carry out a consultation and election exercise if the intention is for members of the DC section to be contracted-out in future by joining the DB section.

## Rule amendments

Some of the main restrictions on protected rights funds today are that they must:

- be recorded separately,
- be treated differently in benefit illustrations,
- lead to an annuity that provides a pension to a surviving spouse or civil partner,
- normally provide an annuity for any surviving spouse or civil partner on death in service,
- be used to buy an annuity at a unisex rate,
- satisfy extra conditions on transfers and
- not be paid as a short service refund.

The legislation that first allowed contracting out on a DC basis encouraged schemes to write these restrictions into their own rules. But now the government has chosen not to make abolition override scheme rules. As a result, in many schemes, members will be unable to take advantage of abolition in relation to rights earned up to 6 April until the scheme rules are amended to remove the restrictions. Most schemes are likely to want to make these changes.

To help with this, the government is proposing to create a special amendment power for schemes to remove protected rights restrictions. This gets around any fetters on the scheme's own alteration power that might hinder removal and also avoids the statutory protection for accrued benefits in section 67 of the Pensions Act 1995.

The government issued a consultation draft last August but, as we go to press, has yet to publish the final version. We wait to see what it will say.

The draft helped schemes remove only those restrictions that derive directly from the protected rights legislation. This would largely fit the bill for most COMP schemes. But for a DB scheme contracted out on a protected rights basis, for

example, it would allow the removal of the restrictions but a general DC underpin would remain in place. Whether or not that could be removed would depend on the scheme amendment power and any application of section 67.

The special power would be available only until 5 April 2015. It could be used retrospectively.

Trustees should review their rules more generally too. For example:

- if the contribution rate for members or employers is expressed as "X% less any NIC rebate", the rule may now lead to a contribution increase unless it is amended. Depending on the changes, the employer might need to hold 60 days' consultation,
- nomination arrangements over death benefits may need adjustment now they cover all scheme benefits,
- similarly, the scheme's general administrative rules may need to be given wider application.

## Transitional issues

The abolition legislation creates a three year transitional period when HMRC procedures for administering rebates will continue so that payments and records for the pre abolition period can be resolved.

Schemes themselves need to be alert to the watershed on 6 April. For example:

- where the event triggering a benefit happens before 6 April (e.g. a death) but payment is made afterwards, the general principle is that the pre abolition rules apply and
- members scheduled to retire just before 6 April might have more flexibility if they delay until later.

There are likely to be a lot of transitional issues at the administrative level.

## DWP and HMRC publications

The DWP and HMRC have issued some helpful literature.

For HMRC's bulletin counting down to abolition, see: <http://www.hmrc.gov.uk/nic/countdown-bulletins.htm>

A DWP factsheet for employers: <http://www.dwp.gov.uk/docs/emp-contracting-out-factsheet.pdf>. And for trustees: <http://www.dwp.gov.uk/docs/trustee-contracting-out-factsheet.pdf>

## More information

For more information, please contact the person in our pensions team with whom you normally deal or Marcus Hellyer at [marcus.hellyer@burges-salmon.com](mailto:marcus.hellyer@burges-salmon.com) or on 01 17 902 7789.

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Burges Salmon LLP, One Glass Wharf, Bristol BS2 0ZX Tel: +44 (0) 117 939 2000 Fax: +44 (0) 117 902 4400  
Chancery Exchange, 10 Furnival Street, London EC4A 1AB Tel: +44 (0) 20 7685 1200 Fax: +44 (0) 20 7685 1266

[www.burges-salmon.com](http://www.burges-salmon.com)

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