

With the abolition of contracting-out imminent, trustees and employers of occupational contracted-out pension plans will need to be aware of how these changes may affect them after 5 April 2016 (the “**Abolition Date**”).

We discuss below some of the tricky issues which need to be considered in respect of pension plans providing reference scheme test (**RST**) benefits and/or guaranteed minimum pensions (**GMPs**). Some or all of these issues will affect all pension plans providing GMPs and/or RST benefits – including money purchase and hybrid plans that have been contracted-out on a salary-related basis.

We recommend that trustees and employers take the time to understand what the implications of the abolition of contracting-out will be for their pension plan, and what action may be required.

Future Service Benefits for Contracted-out Pension Plans With Ongoing Accrual After the Abolition Date

Calculation of RST benefits

Pension plans that are currently contracted-out on the RST basis will not be required to provide RST benefits for pensionable service after the Abolition Date. Trustees will need to ensure they understand how accrued RST benefits in their pension plan will need to be calculated after the Abolition Date. This is likely to depend on the wording of their pension plan’s rules, and rule amendments may be required to clarify the position. Advice is likely to be required to ensure that the RST requirements continue to be met after the Abolition Date.

Changes to National Insurance Contributions

Both employers and members will see an increase (of 3.4% and 1.4% respectively) in their National Insurance Contributions (**NICs**) after the Abolition Date. Employers have a statutory power to offset the increase in employer NICs by unilaterally modifying their pension plan’s rules to increase member contributions and/or adjust future benefit accrual. Trustee consent is not required to exercise the statutory power, but a 60-day consultation with the affected members will usually be needed, as well as a certificate from the scheme actuary as to the impact of the amendment. The new statutory power is available until 5 April 2021.

Automatic enrolment

At present, defined benefit and hybrid pension plans meet the automatic enrolment qualifying criteria as a result of being contracted out. After the Abolition Date, employers will need to certify their pension plan as a qualifying scheme for auto-enrolment purposes by confirming that it meets one of several statutory tests. Employers should take advice to confirm that current members of their pension plan will continue to be enrolled in a qualifying scheme from the Abolition Date.

Benefit structure issues

Pension Plan rules will need to be reviewed to check whether there are any other consequences resulting from the cessation of contracting-out. For example, elements of the benefit structure that are defined by reference to defined terms such as “Basic State Pension” or other terms relating to the State Pension or contracting-out should be reviewed to ensure that the relevant provisions work as intended after the Abolition Date. Rule amendments may be required to address these issues.

Guaranteed Minimum Pensions

GMP revaluation between the Abolition Date and State Pension Age

GMPs are currently revalued by reference to changes in average earnings (in accordance with “section 148 orders”) for the period from 6 April 1997 (the date GMPs ceased to accrue) until the member ceases to be in *contracted-out service*. After that date, most pension plan rules give trustees and/or the sponsoring employer the option to either continue to revalue GMPs on the section 148 basis up until the State Pension Age that applies for GMP purposes, or to switch to “fixed rate” revaluation (set at 4.75% p.a.) up to State Pension Age.

After the Abolition Date, new legislation requires GMPs to be revalued on the section 148 basis until the member leaves *pensionable service* in the pension plan. Trustees/employers can then switch to fixed rate revaluation up to State Pension Age.

The new legislation may create an issue for the period between the Abolition Date and the date on which members leave pensionable service, as it may result in an underpin arising. Depending on the rules of the pension plan (and administrative practice), members may need to be given the better of section 148 and fixed rate revaluation for this period.

The good news is that this issue can be resolved. After the Abolition Date, trustees will have a new statutory power to amend their pension plan’s GMP rules with retrospective effect to prevent this underpin from arising. The new power may be exercised at any time between the Abolition Date and 6 April 2017. We recommend that trustees take advice on whether action is required in respect of their pension plan.

Increases to GMPs in payment

At present, occupational pension plans are only required to pay inflation increases to post-1988 GMPs in payment, capped at 3% p.a. Increases on pre-1988 GMPs, and any increases on post-1988 GMPs in excess of 3%, are paid by the State.

The State will cease to pay these increases after the Abolition Date. This will not usually result in any additional liability on the pension plan, although trustees should check their plan rules to confirm whether they contain express provisions requiring certain increases to GMPs to be paid from the pension plan if they are not paid by the State, in which case an amendment may be desired.

Disclosure Obligations

Trustees of contracted-out plans that will be open to accrual after the Abolition Date will need to notify all affected members that the pension plan is no longer contracted-out by no later than 6 July 2016, as this is a change to "basic scheme information" for disclosure purposes.

Pension plans that are already closed to defined benefit accrual do not need to make any specific member notifications, although trustees and/or employers may wish to send a general communication to members to notify them of the changes to the State Pension.

Watch This Space...

Further announcements are awaited in respect of the following areas which are yet to be resolved:

Trivial commutation

The law currently prevents the payment of trivial commutation lump sums before State Pension Age unless GMP revaluation is calculated on the fixed rate basis for the period after the member leaves contracted-out service. This is not a new issue, but the changes to GMP revaluation after the Abolition Date (see above) create further disparity between the tax requirements and contracting-out laws in relation to commutation. The Government is aware of this issue, but it is not yet known if the contracting-out requirements will be relaxed to make it easier for members with defined benefits worth up to £30,000 to receive a trivial commutation lump sum before State Pension Age.

Transfers without consent to non-contracted-out arrangements

At present, bulk transfers of GMPs and RST benefits can be made without members' consent where the receiving plan is also contracted-out. It is not possible to make a without-consent transfer to a pension plan that has never been contracted-out. This restriction will also apply to pension plans established after the Abolition Date (even though such pension plans could never have been contracted-out). The Government has confirmed it is aware of this issue, and new legislation is expected during 2017.

In the meantime, this issue will affect pension plan mergers and other restructuring projects if they require new pension plans to be established for the purpose of receiving bulk transfers (as it is now too late to establish a new contracted-out pension plan). This issue will not directly affect bulk transfers between existing contracted-out plans after the Abolition Date, although advice will be required on the impact of recent legislative changes.

GMP equalisation

The DWP has announced that now is not the time to resolve the long-running saga of GMP equalisation. It is not yet known when (if at all) this issue will be resolved. Meanwhile, the Pensions Ombudsman has confirmed in a recent determination that, in his view, it is reasonable for trustees not to take any action to equalise their GMPs whilst their pension plan is ongoing until such time that the Government decides what approach to take. The Ombudsman's decision related to a pension plan that was ongoing; action is likely to be required to equalise GMPs for pension plans in winding-up.

Money purchase pension plans with RST underpins

The Government acknowledges that the abolition of contracting-out poses additional complexities for money purchase pension plans that are contracted-out on a reference scheme test basis. Further details are awaited on how these plans should administer their RST underpin benefits.

Further Information

For further information please contact any of the partners listed or your usual contact in the Squire Patton Boggs Pensions Team.

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