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New Protection for Early Leavers

1 BACKGROUND

From 6 April 2006 members who leave occupational pension schemes with at least three months' pensionable service, but without having reached the scheme's threshold for providing accrued (or vested) benefits, will have new rights. Trustees will need to give such members the option of either a contribution refund or a cash transfer sum.

Like a lot of the new requirements, the Pensions Act 2004 (PA 2004) contains the bones of the new provisions but we have been waiting for regulations and a code of practice to flesh out the detail. The draft code of practice (which deals with "reasonable periods" - see paragraph 7 below) was published for consultation by the Pensions Regulator in May, followed by the draft regulations on 29 June 2005. Consultation closes on:

- 29 July 2005 for the draft code of practice; and
- 26 August 2005 for the regulations.

A copy of the draft regulations can be found at:
http://www.dwp.gov.uk/publications/dwp/2005/occ_pen_schemes/consultation29-06-05.pdf

The draft code of practice on reasonable periods can be found at:
http://www.thepensionsregulator.gov.uk/pdf/COPEarlyLeavers.pdf

2 THE CHANGES IN BRIEF

Essentially, the Pension Schemes Act 1993 (PSA 1993) currently gives early leavers with at least two years' pensionable service[1] a right to a deferred pension in the scheme ("vesting") or to take a cash equivalent transfer value (CETV). Those with less than

[1] And also someone who has transferred benefits from a personal pension scheme

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Continued
New Protection for Early Leavers

two years' pensionable service are generally only entitled to a contribution refund (although it is always open to scheme rules to provide for earlier vesting).

The new protections being introduced by PA 2004 build on the existing protections in PSA 1993. However, it is important to note that they do not affect the statutory vesting period, so the magic two years' pensionable service remains intact. Members who are protected by the new provisions (namely, those who leave their scheme after three months' pensionable service but before two years) will be entitled to either:

- a "cash transfer sum" (see paragraph 5); or
- a "contribution refund" (see paragraph 6).

3 AT THE MEMBER'S OPTION

The member can choose whether to take a cash transfer sum or a refund of contributions. The trustees must write to the member within a "reasonable period" after termination of pensionable service to give him details of "the nature of the right acquired by him" and how he can exercise that right. The member has to be given a "reasonable period" within which to exercise his right (the deadline given by the trustees for doing so is known as "the reply date").

The trustees should then follow the member's election or, if the member fails to respond by the reply date and the trustees do not extend this period, the trustees may pay a contribution refund to the member.

4 INFORMATION TO BE PROVIDED

Trustees need to provide sufficient information for the member to make an "informed choice". The draft regulations specify certain information to be provided which includes:

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Continued
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- whether the cash transfer sum has been reduced because the scheme is underfunded;
- any tax liability in respect of the contribution refund;
- how the exercise of the right will affect the member's other rights (if any) under the scheme; and
- a statement that, if the member does not exercise his right by the reply date (or such later date as the trustees allow), the trustees can pay a contribution refund. (This is important because, by including this information, trustees will be afforded the protection of a statutory discharge on payment of the contribution refund.)

5 CASH TRANSFER SUM

The draft regulations make it clear that the "cash transfer sum" should be calculated in the same way as a CETV. For defined benefit schemes, calculation of the member's CETV is currently based on the minimum funding requirement but the basis will move to the new statutory funding objective set out in PA 2004 once a scheme has conducted its first valuation on this basis[2].

Cash transfer sums could be reduced in the same way as a CETV if, for instance, a scheme is underfunded or begins to wind-up. There is also provision for the cash transfer sum to be increased if trustees fail to make payment within the "reasonable [time] period"[3]. The cash transfer sum can be used by the individual to:

- acquire rights under another occupational or personal pension scheme – provided that the scheme nominated by the member is "able and willing" to accept the transfer; or

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[2] See Sackers Extra Alert "Scheme Funding – consultation published" dated 23 March 2005

[3] Contribution refunds may also be subject to reduction / increase in certain circumstances

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Continued

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- purchase one or more "appropriate" annuities (broadly, this means an annuity chosen by the member through an insurance company which meets prescribed requirements).

6 CONTRIBUTION REFUND

By contrast, the regulations do not currently prescribe the calculation basis for the "contribution refund"; this is left to scheme rules. But trustees should be aware that there appears to be no provision for the payment of interest. Also, any refund will be taxed from April 2006 at the rate of 20% on the first £10,800 and 40% on any excess.

7 AND FINALLY, THE MEANING OF "REASONABLE PERIOD"

Trustees will have to take certain steps "within a reasonable period". Rather than set out prescriptive time periods in the legislation, trustees are encouraged to consider the timescales in the context of the scheme and the individual member. However, the draft code of practice indicates that:

- The notice setting out his options should be sent to the member "as soon as possible and that this should normally be within two months of the member leaving pensionable service".
- The member should be given "at least three months" to reply but that a longer period may be necessary in certain circumstances (for example, if the member has changed address, left the country to travel or asked for the timescale "to be extended for personal reasons").
- The trustees should give effect to members' rights "without unjustifiable delay … and in any event this should normally be within three months of the members making their elections".
- Crucially, where the member fails to exercise his right, the Pensions Regulator also expects trustees to wait at least three months after the reply date before resorting to the default option of paying a contribution refund.

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