

Countdown to abolition of DB contracting-out: Tricky issues

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Introduction

As a consequence of the introduction of the new single-tier state pension, DB contracting-out will be abolished with effect from 6 April 2016 (“the Abolition Date”). In this Alert we set out some of the trickier issues which must be addressed.

Key points

- Schemes which operate fixed rate revaluation of GMPs are likely to need a rule amendment, prior to the Abolition Date, to allow such revaluation to be triggered when a member leaves pensionable service (in line with changes to the legislation) rather than, as is currently the case, cessation of contracted-out employment.
- Trustees and employers should ensure that any information on the State pension in the scheme’s member communications is updated to take account of the introduction of the single tier on and from the Abolition Date. In particular, changes may be needed to the information on GMP increases for those who retire on and after that date.
- As soon as possible and, at the latest, by 6 July 2016 trustees must inform affected members that the scheme will cease / ceased to be contracted-out on and from the Abolition Date.
- The deadline for registering with HMRC’s scheme reconciliation service is 5 April 2016.

What is a GMP?

The Social Security Act 1975 (which came into effect on 6 April 1978) provided for the State scheme retirement pension to be related to earnings on which NI contributions are paid. It consists of:

- the basic state pension (“BSP”) and
- an additional (earnings-related) state pension (“ASP”).

Where a person is “contracted-in” the additional pension is paid by the State. Where the person is

contracted-out both they and their employer pay reduced NI and, instead of an additional pension from the State, the occupational pension scheme is required to pay a prescribed minimum pension, broadly equivalent to the additional pension which would have been received from the State. Those who were contracted-out between 6 April 1978 and 6 April 1997 accrued an entitlement to a GMP.

Scheme members are entitled to their GMP from age 60 (women) and age 65 (men). These dates are not affected by the [increases being made to SPA](#).

GMP revaluation

To provide protection against inflation, a member's GMP must be increased using one of two methods:

- Section 148 orders – revaluation is calculated using a percentage prescribed under the relevant s148 order by reference to earnings in the final tax year of the earner's working life
- Fixed-rate revaluation – the GMP is increased each year by a fixed rate which is determined by the date the member leaves contracted-out employment

The “default” under the contracting-out legislation is to use section 148 orders. A key difference between the two methods is that, currently, fixed rate revaluation is triggered by a member ceasing to be in contracted-out employment.

Change on and from the Abolition Date

As the abolition of contracting-out is a result of Government policy rather than an employer decision, on and from 6 April 2016, schemes may provide for fixed rate revaluation to be triggered by a member ceasing to be in pensionable service. To make use of this change to the legislation, most schemes will require a rule amendment. At the moment, such a change must be made before the Abolition Date, otherwise any active member on that date will automatically become subject to fixed rate revaluation when contracting-out ceases.

However, [the DWP is planning to introduce a statutory modification power](#) to allow schemes which have a restrictive amendment power to make this change. Where this power applies, it can have retrospective effect to allow amendments to take effect from 6 April 2016.

State pension and GMP increases

The way in which increases are applied to GMPs in payment often causes confusion. This is because a quirk of the State pension calculation makes it appear that the State applies an increase to an individual's GMP.

When a member's state pension comes into payment it comprises both the BSP and the ASP. To calculate an individual's ASP, when a person reaches pensionable age, the State assesses:

- the individual's GMP entitlement; and
- how much ASP he or she would have received from the State had he or she been contracted-in between 1978 and 1997 (their “notional ASP”).

The GMP is then deducted from the notional ASP (known as “the contracted-out deduction” or “COD”) and the balance, if any, is paid to the individual by the State. The COD reflects the fact that reduced NI was paid during that period.

Occupational pension schemes are required to increase a member's GMP each tax year to protect it from inflation. For these purposes, it is divided into pre-and post-1988 accrual. Once the GMP is in payment, the occupational pension scheme is responsible for increasing post-1988 GMPs (up to a maximum of 3%).

There is no statutory obligation on occupational pension schemes to pay increases on GMPs accrued between 1978 and 1988. However, ASP built up during that period is subject to increases. When the COD is subtracted from the ASP (see above), the remaining ASP (if any) which is paid to the individual with their BSP includes an increase linked to prices. In this way, an amount which is broadly equivalent to the member's GMP, but which is in fact ASP, is subject to an increase at an individual's SPA.

Changes on and from the Abolition Date

Individuals with GMP entitlements who retire on and from the Abolition Date will not receive any balancing payment in respect of the difference between their COD and their ASP, as ASP will no longer exist. However, arrangements for people reaching SPA before the single tier model is introduced will not be affected.

Occupational pension schemes will still be required to apply increases to GMPs in the usual way. But trustees and employers should check their member booklets / communications to ensure that the change to the State increases is captured sufficiently in advance of its coming into effect and be prepared to deal with member queries.

Reference scheme test ("RST") underpins

Regulations now make clear that where a DC scheme has an RST underpin, the requirement to provide the underpin in relation to contracted-out employment (i.e. up to 6 April 2016 or the member's earlier date of leaving) will continue after the Abolition Date. What is less clear is whether the value of the underpin should be linked to any salary increases applied on or after that date. Our preferred view is that any final salary link will be broken on 6 April 2016. However, depending on how they are framed, employers should consider amending their schemes' rules to put the matter beyond doubt.

DB schemes should check their rules to ascertain whether any RST benefits (for example a specific level of spouse's pension) have been hardwired into their benefit structure. If not removed, such benefits could act as an underpin to the scheme benefit going forward.

Disclosure

A scheme's contracted-out status forms part of its "basic information" for the purposes of the disclosure requirements. Trustees will therefore need to inform affected members of the change in status that will occur on the Abolition Date. Schemes may communicate the change now, but have until 6 July 2016 to do so.

Transfers

Under the current legislation, on and from the Abolition Date it will only be possible to transfer members from a formerly contracted-out scheme to a scheme which was never contracted-out with their consent (and further limitations on being able to transfer pensions in payment may apply even if consent is given). The DWP has been informed that this will be very restrictive for schemes and has agreed to consider the issue. However, we understand it is unlikely to take any action before the Abolition Date.

Action

With less than two months to go to the Abolition Date, please ensure you speak to your usual Sackers' contact as soon as possible if you are affected by any of the above.

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