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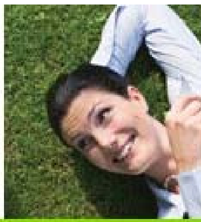

Keeping you informed

A communication to keep you up to date with key developments that affect you

Abolition of contracting out on a defined contribution basis

On 6 April 2012, contracting out on a defined contribution (DC) basis will be abolished. This bulletin looks at the impact this will have on DC schemes and their members, as well as the actions that sponsoring employers and trustees of affected schemes will need to take.

DC contracting out – a re-cap

By contracting out, a pension scheme member no longer builds up entitlement to additional state pension (currently the State Second Pension (S2P), previously the State Earnings Related Pension Scheme (SERPS) and instead receives a contribution from HMRC into their private or company pension scheme.

When contracting out on a DC basis through an occupational pension (also known as a trust-based scheme), the member and employer pay reduced National Insurance Contributions (NICs) and HMRC pay an age-related rebate into the scheme.

If an individual contracts out via a stakeholder or group personal pension scheme (also referred to as contract-based schemes), known as an Appropriate Personal Pension (APP), HMRC again pays a rebate directly into the member's plan every year. However, the member and their employer continue to pay standard rate NICs.

The fund the member builds up with these contributions is known as Protected Rights and must be held separately to the fund built up from ordinary employer and employee contributions. Historically, there have been restrictions on how a member can take benefits from their Protected Rights fund. These restrictions will fall away once DC contracting-out is abolished on 6 April 2012.

What do these changes mean?

From 6 April 2012 individuals will no longer be able to contract out on a DC basis and will automatically be brought back into the additional state pension scheme. HMRC will stop paying NIC rebates into schemes that had previously been contracted out on a DC basis and the fund that a member builds up will therefore be lower than it would otherwise have been had these payments continued. However, the member will begin to build entitlement to additional state pension instead. The only way contracting out will be possible after this date is via an occupational scheme that is contracted out on a salary related basis (a defined benefit scheme).

There are a number of other implications, including:

- The members and sponsoring employers of affected occupational schemes will need to start paying standard rate NICs instead of the reduced contracted-out rate.
- Protected Rights will no longer need to be tracked separately in a member's pension account. In addition, on the death of a member, their spouse or civil partner will no longer be required to receive an income from the member's Protected Rights. Subject to scheme rules, these funds could now be used to provide a lump sum instead, in the form of tax free cash (subject 25% max)

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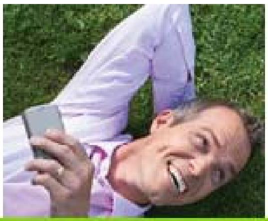

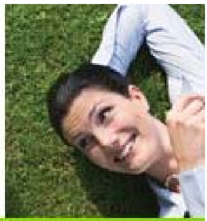

- Transfers between schemes will become simpler, as the previous difficulties with transferring Protected Rights to certain other types of pension scheme will no longer exist.

- If this is an occupational scheme employers will need to amend contracts of employment that refer to contracting out where they offer membership of a DC scheme. As well as changing the contract for new joiners, existing employees will need to be notified of the change in writing.

  Although DC contracting out will end formally on 6 April 2012, a transition period is needed to allow for the payment of rebates for the 2011/12 tax year and to tidy up other rebate 'loose ends' such as the late payment or recovery of recalculated rebates and payments in respect of members who have transferred to a new scheme.

Communicating the changes

Members of affected schemes must be told about the changes and certain information needs to be communicated within specific timescales. They must be told within one month of 6 April 2012 that their scheme has ceased to contract-out, and of the impact of the change on their scheme and state benefits within four months. However, members can be told this information in advance of 6 April 2012.

Although the responsibility for these disclosures falls to the trustees of a trust-based scheme and the provider of a contract-based scheme, employers are likely to want to ensure that any communications provide all the information and explanations members are likely to need.

Other member communications such as employee handbooks, scheme booklets and benefit statements may also need to be updated.

Jelf's view

We welcome the removal of requirements and restrictions relating to Protected Rights. These changes will simplify a whole host of technicalities that have historically added to the complexity of DC pension schemes and made clear communication to members tricky to achieve.

One of the biggest challenges for employers, trustees and providers is ensuring that members understand both the changes and the impact on their retirement planning. Employers may also want to consider making changes to employer and/or employee contribution rates to compensate for the fact that rebates will no longer be paid into the scheme. This will be most relevant to employers who designed their contribution structure to target certain benefit levels.

Fortunately, the timing of this change means employers are able to combine the review of their scheme in light of the abolition of DC contracting out with the review that is needed to ensure they can comply with the new requirement to automatically enrol employees into a qualifying pension scheme that comes into effect from October 2012.

Please contact us to help you understand the impact this topic may have on you

We also look forward to hearing from you on anything employee benefits related

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