# EXPLANATORY MEMORANDUM TO

# THE PENSIONS ACT 2008 (ABOLITION OF PROTECTED RIGHTS) (CONSEQUENTIAL AMENDMENTS) ORDER 2011

**2011 No. 1246**

# THE PENSIONS ACT 2008 (ABOLITION OF PROTECTED RIGHTS) (CONSEQUENTIAL AMENDMENTS) (NO.2) ORDER 2011

**2011 No. 1730**

# THE PENSIONS ACT 2007 (ABOLITION OF CONTRACTING-OUT FOR DEFINED CONTRIBUTION PENSION SCHEMES) (CONSEQUENTIAL AMENDMENTS) REGULATIONS 2011

**2011 No. 1245**

**AND**

# THE PENSIONS ACT 2007 (ABOLITION OF CONTRACTING-OUT FOR DEFINED CONTRIBUTION PENSIONS SCHEMES) (CONSEQUENTIAL AMENDMENTS) (NO. 2) REGULATIONS 2011

**2011 No. 1724**

**1.** This explanatory memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.

## 2. Purpose of the instruments

**2.1.** These instruments make consequential changes to primary and secondary legislation as a result of provisions in the Pensions Acts 2007 and 2008. Those acts provide for the abolition of contracting-out for occupational, personal and stakeholder pension schemes which contract out of the state additional pension on a defined contributions (or money purchase) basis, and the abolition of the rules governing contracted-out rights in such schemes known as “protected rights”. Together with the primary legislation, they remove the rules and references that relate to contracting-out on a defined contributions basis and protected rights and make some transitional provisions. Most rules and references will be removed from 6th April 2012. Some provisions will remain in place for a transitional period until $5^{th}$ April 2015.

## 3. Matters of special interest to the Joint Committee on Statutory Instruments

**3.1.** None.

## 4. Legislative Context

**4.1.** An independent Pensions Commission set up by the Government in 2005 recommended abolishing contracting-out for occupational, personal and stakeholder pension schemes which contract out on a defined contribution basis. Government accepted the Commission’s recommendations that contracting-out rules on defined contributions are too complex and poorly understood. It had become increasingly difficult for individuals to determine whether it was better to contract out or remain in the state additional pension system. The abolition of contracting-out of the state additional pension on a defined contributions basis was provided in the Pensions Acts 2007 and 2008. The provisions in these Acts are to be brought into force on 6th April 2012 (“the abolition date”).

## 5. Territorial Extent and Application

**5.1.** These instruments apply to Great Britain.

## 6. European Convention on Human Rights

The Minister for Pensions has made the following statements regarding Human Rights:

- In my view the provisions of the Pensions Act 2008 (Abolition of Protected Rights) (Consequential Amendments) (No.2) Order 2011 and the Pensions Act 2007 (Abolition of Contracting-out for Defined Contribution Pensions Schemes) (Consequential Amendments) (No. 2) Regulation 2011 are compatible with the Convention rights.

- As the Pensions Act 2008 (Abolition of Protected Rights) (Consequential Amendments) Order 2011 and the Pensions Act 2007 (Abolition of Contracting-out for Defined Contribution Pension Schemes) (Consequential Amendments) Regulations 2011 are subject to negative resolution procedure and do not amend primary legislation, no statement is required.

## 7. Policy background

- **What is being done and why**

**Contracting-out**

**7.1** Contracting-out provides a private sector alternative to the state additional pension. People with occupational and personal pensions can contract out of the state additional pension provided certain conditions are met.

**7.2** Contracting-out is currently permitted for occupational pension schemes on a money purchase (also known as defined contribution (DC)) basis or on a salary-related (also known as defined benefit) basis. Personal pension schemes may also contract out (referred to as ‘appropriate schemes’).

**7.3** In a contracted-out DC occupational pension scheme, the employer and employees pay reduced rate of National Insurance contributions (NICs) and Her Majesty’s Revenue and Customs (HMRC) makes an annual age-related payment into the scheme. In a contracted-out personal pension scheme, the full rates of NICs are paid by the employer and employee and the rebate is provided by HMRC through an annual payment into the scheme at the end of the tax year. These reductions and payments are collectively known as the contracted-out rebate.

**7.4** In contracted-out DC schemes, the amount of an individual’s pension fund derived from the rebate, its investment return and any tax relief on the rebate are known as protected rights. There are certain restrictions that apply to the protected rights e.g. how and where they can be invested; which the resulting annuity or pension must be purchased on a unisex basis; and that it must provide survivor benefits where the member is married or has a civil partner.

**7.5** As well as protected rights, a scheme member may build up additional pension rights in the scheme from their own and/or employer’s contributions. Legislation does not extend the above restrictions to these additional accruals, but scheme rules may. If the scheme does not extend the protected rights rules to the entire scheme accruals then the protected rights have to be tracked separately from the scheme’s non-protected rights.

**Abolition in 2012**

**7.6** Section 15 of the Pensions Act 2007 implements the recommendations of the Pensions Commission (reported in 2005) to abolish contracting-out on a DC basis. All schemes currently contracting-out on such a basis will no longer be able to do so after the abolition date. Section 106 of the Pensions Act 2008 removes the rules on protected rights which accrued during the time when the scheme was contracted-out, from the abolition date. On 12th March 2010 the Government announced that the DC contracting-out abolition date would be 6th April 2012.

**What the instruments achieve**

**7.7** These instruments amend or repeal (where appropriate) all references to "contracted-out money purchase schemes", "appropriate personal pension schemes" and "protected rights" in existing legislation. They also amend some consequential amendments contained in Schedule 4 to the Pensions Act 2007.

**7.8** As such schemes will no longer be contracted-out on a DC basis, the related legislation will be redundant or retained for a transitional period only following the abolition date. Protected rights will cease to exist as from 6th April 2012 and they will become ordinary money purchase scheme benefits under pensions legislation. At the same time all contracted-out money purchase rebates will cease and members of money purchase contracted-out schemes will be brought back into the state system and begin to accrue state additional pension.

**Specific issues**

**Late rebate payments due after the abolition date**

**7.9** These instruments also introduce a transitional period to deal with "late" rebates. Rebate payments are made by HMRC to contracted-out DC schemes at the end of each tax year through an automated payment system. These instruments allow for a three-year transitional period following abolition whereby the current automated process of rebate payments and recoveries between HMRC and (formerly contracted-out) money purchase schemes can be maintained in most cases. This transitional period will ease administrative burdens on schemes and HMRC and will allow sufficient time for:

- the payment of the final year's rebate (due for the 2011/12 tax year) after 6th April 2012;
- the payment or recovery of rebates which are recalculated by HMRC as a result of adjustments to individuals' National Insurance records in the three years following abolition;

During the transitional period where automated payments to schemes are not possible because, for example, the member has left the scheme, payments will be made direct to individuals. Upon the expiry of the transitional period on 5th April 2015, all rebate adjustments after this date will be paid direct to individuals and will be handled clerically by HMRC.

**Introduction of a minimum amount of rebate payable by HMRC**

**7.10** In some instances HMRC may need to amend an individual's National Insurance record because of the changes notified to them after the end of a tax year. These adjustments can sometimes result in an additional rebate payment becoming due. These instruments set out a limit below which HMRC will not be required to make a rebate payment. This limit will correspond to the cost of paying the rebate clerically by HMRC (that is, the rebate will not be paid where it costs more to administer the rebate payment than it is worth). HMRC will review this limit on a regular basis.

**Introduction of provisions allowing transfer of DB contracted-out rights to schemes which are not contracted-out**

**7.11** Currently an individual can only transfer from one contracted-out scheme into another. With the abolition of contracting-out on a defined contribution (DC) schemes in April 2012, scheme members of contracted-out defined benefit (DB) schemes would only be able to transfer to another contracted out DB scheme. The pension industry asked for this policy to be reconsidered to allow members to transfer to any pension scheme post April 2012 to provide more choice. The government agreed with industry's proposal and amended legislation to allow such transfers, whilst introducing safeguards to ensure that members are aware of the implications of these transfers.

**Amendments to contracted-out deductions for survivors**

**7.12** People who were contracted-out pre-1997 are treated as having a notional entitlement to the State Earnings Related Pension Scheme (SERPS), now known as state additional pension, for the years in which they were contracted-out up to 1997. A deduction is made from the notional SERPS entitlement to avoid double provision – the member would otherwise benefit from paying lower rate National Insurance – this is known as the contracted-out deduction. When the scheme member dies, his or her surviving spouse or civil partner is entitled to a maximum of 50% of the deceased member's SERPS. The member's contracted-out deduction is similarly inherited and applied to the survivor benefit. Currently the level of the contracted-out deduction depends on whether the member dies before or after annuitising his protected rights:

- If a member dies before annuitising his protected rights, any surviving spouse or civil partner will inherit the member's entire protected rights fund. In this case there would be a corresponding 100% contracted-out deduction applied to the survivor's SERPS (which includes the survivor's inherited 'notional' SERPS as well as any SERPS accrued in their own right).

- If a member dies after annuitising his protected rights, the widow or widower or surviving civil partner will be entitled to a survivor's pension from the scheme of half the member's pension, derived from the protected rights. Subsequently a 50% contracted-out deduction will be made from the survivor's SERPS.

**7.13** As a result of abolition, schemes will no longer be required to record former protected rights and, therefore, will not need to notify HMRC whether a member has died before or after retirement. HMRC will therefore not know how to calculate any survivor contracted-out deduction. Therefore a 50% contracted-out deduction will be made from the survivor's SERPS, in all cases. This will simplify the HMRC processes and reduce administrative costs for the schemes.

**Amendments to the Disclosure of Information Regulations**

**7.14** Amendments made to the Disclosure of Information Regulations have primarily focused upon removing regulations which refer to DC contracting-out. However a one-off requirement for the tax year 2012/13 under each of these sets of regulations has been made which identifies what the affected members of the scheme need to be aware of as a result of abolition. This mirrors the current requirements that schemes have to notify affected members when their scheme ceases to be contracted-out for whatever reason.

**7.15** The draft information requirements were amended following the consultation exercise. The pensions industry sought more flexibility in providing the information through the regular communications issued to members to reduce costs e.g. at the same time as an annual statement or scheme report. The government agreed this was a reasonable proposal and published its response to consultation in November 2010 which confirmed that a scheme would not have to comply with the information requirements set out in these instruments if the relevant information had already been provided to members during the twelve months prior to the abolition date. Although the instruments have not been laid until May 2011, the consultation document response published in November 2010

***Consolidation:***

**7.16** These Regulations amend/repeal/revoke sections of primary legislation and several sets of secondary legislation. Consolidation is not, therefore, considered appropriate. Informal consolidation will be included in due course in the Department's "The Law Relating to Social Security" (the Blue Volumes) which is available on the internet at no extra cost: http://www.dwp.gov.uk/advisers/docs/lawvols/blue/vol/.

## 8 Consultation outcome

**8.1** The Department undertook a 12-week consultation on the draft legislation from 28th July 2010 to 19th October 2010[1]. The consultation sought views on whether the draft consequential legislation would achieve the objective of abolishing contracting-out on a DC basis by amending or repealing, where appropriate, all references to DC contracting-out, and protected rights.

**8.2** DWP received 47 formal responses. While most of the respondents agreed that the draft instruments would achieve the abolition of contracting-out on a DC basis, there were concerns about operational and technical aspects of these regulations – for example, whether HMRC would issue a notice to contracted-out mixed benefit schemes to confirm their new status and; whether legislation would provide standard terminology for schemes to use in communications to members.

**8.3** A large proportion of the respondents (38) expressed concern about the proposed restriction on transfers from contracted-out defined benefits schemes to non contracted-out DC schemes. In summary stakeholders considered that such a restriction would limit pension portability and flexibility. The Government have amended these instruments accordingly to allow transfers from defined benefit contracted-out schemes to non-contracted-out schemes post abolition. There are legislative safeguards to protect members against making inappropriate transfers.

**8.4** Some respondents (14) said that the timescales set out in Disclosure of Information Regulations for communicating the abolition messages to the scheme members were prescriptive and suggested that costs could be reduced if the requirements were more flexible. The Government have amended the provisions accordingly to provide greater flexibility for schemes in providing information whilst protecting the interests of members (see paragraph 7.15 above).

## 9 Guidance

**9.1** DWP and HMRC are working with industry representatives on a communication strategy which aims to ensure that information is targeted at those who need to know. A communication working group, which includes various stakeholders, has been meeting bi-monthly since July 2010. DWP and HMRC have been looking at ways of ensuring employers and schemes get the information they need. A number of fact sheets have been developed and are available online for schemes, employers, trustees and individuals.

## 10 Impact

**10.1** This legislation reduces costs of administrative burdens on the private sector and civil society organisations.

**10.2** This legislation reduces costs on the public sector which will no longer have to administer the DC contracting-out rebate.

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[1] **Consultation response document** http://www.dwp.gov.uk/consultations/2010/abolition-contracting-out-dc.shtml

**10.3** A full impact assessment is attached to this memorandum and will be published alongside the Explanatory Memorandum on www.legislation.gov.uk.

## 11 Regulating small business

**11.1** This legislation applies to all small businesses that have DC contracting-out pension schemes; it reduces costs of administrative burden on such businesses.

## 12 Monitoring & review

**12.1** The Department for Work and Pensions will monitor the effect of these changes in October 2013 from information provided by HMRC with regard to rebate payments. The Department may decide it is necessary to review these instruments following advice from HMRC.

## 13 Contact

**Uzair Farooq, Department for Work and Pensions – Tel: 020 7449 7374,**
**Uzair.Farooq@dwp.gsi.gov.uk**