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NEW RIGHTS FOR EARLY LEAVERS

1 BACKGROUND

From 6 April 2006, members who leave their occupational pension scheme "early" (but with at least 3 months' service) will gain new rights. Following consultation documents published in July 2005[1], the regulations which encapsulate these new rights were laid before Parliament in January. But the accompanying code of practice from the Regulator has only recently followed suit.

2 KEY CHANGES

- 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 be entitled to either a:
  - "contribution refund" (see section 5); or
  - "cash transfer sum" (see section 6).
- Trustees will need to provide members with specific information within "reasonable periods" so as to help them make their choice (see section 8).
- If the member does not exercise the option to take a cash transfer sum, the trustees can after a reasonable period choose to pay a contribution refund.

[1] See our Sackers Extra Alert "New protection for early leavers" dated 4 July 2005 which is available from the client pages of our website at: http://www.sackers.com

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3 THE CURRENT POSITION

Under current legislation[2], early leavers with at least two years' pensionable service[3] have a right to a deferred pension in the scheme ("vesting") or to take a cash equivalent transfer value (CETV). Those with less than two years' pensionable service are generally only entitled to a contribution refund (although it is always open to schemes to provide for earlier vesting).

4 NEW PROTECTIONS FROM 6 APRIL 2006

The new early leaver requirements under the Pensions Act 2004 build on these existing protections. So they *do not* disturb the magic two-year statutory threshold for members to be entitled to a deferred pension.

A copy of the final regulations can be found at:
http://www.opsi.gov.uk/si/si2006/20060033.htm

A copy of the code of practice on reasonable periods can be found at:
http://www.thepensionsregulator.gov.uk/pdf/codeEarlyLeaversAgreed.pdf

5 CONTRIBUTION REFUNDS

The basic element of the contribution refund will be taxed from April 2006 at the rate of 20% on the first £10,800 and 40% on any excess.

Unlike the original draft (which was silent on the point), the regulations now make it clear that, depending upon what scheme rules say, contribution refunds can also take account of interest and investment return. There has also been a corresponding shift in how the two should be treated for tax simplification purposes. Originally

[2] Pension Schemes Act 1993

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

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they were in danger of constituting an unauthorised member payment (and therefore liable to a penal rate of tax), but it is now clear that interest and investment return can be applied to short service refunds. But the amount paid must not exceed "the amount which might be expected to be paid to a person who was at arm's length" (namely, consistent with a reasonable commercial basis). Interest and investment return will, however, be taxed separately as income.

6 CASH TRANSFER SUM

A cash transfer sum can be used by the individual to either acquire rights under another occupational or personal pension scheme (specified by the member), or purchase one or more "appropriate" annuities[4].

The "cash transfer sum" should be calculated in the same way as a cash equivalent transfer value (CETV). This brings into play the newly revised actuarial guidance note GN 11 (Retirement Benefit Schemes – Transfer Values).

The original draft regulations proposed retaining a minimum funding requirement (MFR) underpin when calculating CETVs in defined benefit (DB) schemes for a transitional period. But even for DB schemes which have not as yet carried out their first valuation in the brave new scheme funding world, this proposal has now been dropped by the Government. The revised actuarial guidance GN11 has likewise abolished the use of the MFR underpin when calculating transfer values.

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"[5].

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[4] Broadly, this means an annuity chosen by the member through an insurance company which meets prescribed requirements

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

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7 MEMBER INFORMATION

The member can choose whether to take a cash transfer sum or a refund of contributions. The time limits are set out in section 8 below. 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.

Importantly, provided that the trustees follow the correct procedures they will receive a statutory discharge.

8 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 code indicates that:

- The notice setting out his options should be sent to the member "as soon as reasonably possible and that this should normally be within three months of the member leaving pensionable service". This has been extended from the two months originally allowed in the draft code.
- The member should "normally be given at least three months" to reply but note that a member can request a longer period (the trustees are not obliged to grant this).
- The trustees should give effect to members' rights "without unjustifiable delay … and in any event this should normally be within three months of the member making the elections".
- Crucially, where the member fails to exercise his right, the trustees should wait at least one month after the reply date before resorting to the default option of paying a contribution refund. (This period has been reduced from the original three month period provided for.)

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