

EXPLANATORY MEMORANDUM TO
THE OCCUPATIONAL PENSION SCHEMES (PAYMENTS TO EMPLOYER)
REGULATIONS 2006

2006 No. 802

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. **Description**

2.1 The Occupational Pension Schemes (Payments to Employer) Regulations 2006 set out the conditions that must be satisfied before the trustees of a scheme subject to these regulations can authorise a payment to the employer from the funds of a pension scheme.

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

3.1 None.

4. **Legislative Background**

4.1 Under current HM Revenue and Customs' (HMRC) tax legislation, an ongoing defined benefit pension scheme is required to take actions to reduce any actuarial surplus in their funds to a specified limit. Section 37 of the Pensions Act 1995 builds on these requirements by allowing pension scheme trustees to consider making a payment to the employer from the scheme's funds only where HMRC has approved the payment. However, tax simplification in the Finance Act 2004 will repeal HMRC's legislation relating to the requirement for the reduction of pension fund surpluses in prescribed pension schemes from 6 April 2006.

4.2 Section 250 of the Pensions Act 2004 substitutes a new section 37 into the Pensions Act 1995 to allow payments to the employer provided certain conditions are met.

4.3 Transitional powers have also been introduced in section 251 of the Pensions Act 2004 to allow trustees to amend existing scheme rules in order to take into account the new provision in the Pensions Act 2004 and HMRC's tax simplifications.

4.4 The existing Occupational Pension Schemes (Payments to Employers) Regulations 1996 (S.I. 1996/2156) will be revoked and replaced by new

regulations which set out the detailed requirements that must be met before a payment can be made to the employer.

5. **Extent**

5.1 This instrument applies to Great Britain.

6. **European Convention on Human Rights**

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. **Policy background**

7.1 The new regulations set out the requirements that must be followed before trustees can make a payment to the employer.

Defined Benefit Schemes

7.2 The regulations apply to ongoing defined benefit schemes that are subject to Part 3 of the Pensions Act 2004 (the new scheme funding requirements which replaced the minimum funding requirement). The trustees will only be able to authorise a payment to an employer if they have obtained an actuarial valuation to show that the scheme's assets are above the level which should be sufficient to ensure that all the accrued rights of the scheme members could be secured through the purchase of annuities and deferred annuities from an insurance company (known as "full buy-out"). In addition, trustees must be satisfied that any payment to the employer is in the interests of scheme members.

Money Purchase Schemes

7.3 The regulations cover money purchase schemes only where each member's benefits are held in a separate insurance policy or contract, or where the scheme benefits are secured by a 'global' insurance policy or contract, which earmarks specific payments to specific members. A payment may be made where all potential liabilities relating to a specific member have been discharged in full and there remain excess assets.

Consultation Responses

7.4 There was no statutory requirement to consult on these regulations as they are made within six months of the commencement of the powers in sections 250 and 251 of the Pensions Act 2004. However, the Government carried out a short consultation exercise to obtain the views of interested parties. The consultation exercise ran from 5 January 2006 to 1 February 2006. Seventeen responses were received.

7.5 As a result of the consultation, the Government has widened the definition of ear-marked money purchase schemes to cover both insurance policies and

contracts. In addition the Government has removed a number of administrative requirements which, whilst appropriate for defined benefit schemes, would be inappropriate for money purchase schemes, given the relatively small amounts which will be involved in such payments. These include the requirement for trustees to notify members and the Pensions Regulator, and to produce a certificate. Tax provisions will still require trustees to notify HMRC of any payments for tax purposes.

7.6 Six of the seven respondents who commented on the provisions for defined benefit schemes considered that the full buy-out requirement for ongoing schemes was too high and might deter some sponsoring employers from agreeing to stronger funding targets. The intention to require a 'full buy-out' funding level for defined benefit schemes was made clear by Ministers during the passage of the primary legislation through Parliament. The Government does not consider that the relatively low number of consultation responses would justify such a change to the previously announced approach at this stage. However, the Government intends to keep the situation under review.

8. Impact

8.1 An assessment of the impact on business, charities and the voluntary sector of the provisions of these Regulations was included in the Regulatory Impact Assessment that accompanied the Pensions Act 2004. A copy of the relevant extract is attached at Appendix A.

8.2 The impact on the public sector is minimal as the only defined benefit schemes covered by these regulations are those subject to the legislative requirements on scheme funding. Public sector schemes are generally exempt from those requirements.

9. Contact

Yuen Luk at the Department for Work and Pensions (Tel: 0207 962 8500 or e-mail: Yuen.Luk1@dwp.gsi.gov.uk) can answer any queries regarding the instrument.

Extract from the Regulatory Impact Assessment for the Pensions Act 2004

4.9 Payments of Surplus to Employers

- 4.9.1 At present a ‘statutory surplus’ exists where, according to Inland Revenue (IR) definitions designed to determine appropriate tax relief on contributions and investment income, an occupational scheme has assets greater than its liabilities as assessed on a particular set of assumptions. However, a true surplus only strictly emerges when a scheme has wound up, discharged all its liabilities, and there is money left over.
- 4.9.2 Any valuation of the assets and the liabilities of a defined benefit (DB) pension scheme will demonstrate an apparent surplus, or deficit, of assets over liabilities at a particular point in time. Good equity performance in the 1980s and 1990s created investment returns higher than had been assumed by actuaries, which gave rise to valuations showing significant excesses of assets over liabilities - an “actuarial surplus”.
- 4.9.3 Pension scheme rules themselves may define or restrict options on the treatment of an actuarial surplus and the making of payments to an employer in a scheme, and may give powers to the employer, the trustees, or the scheme actuary in relation to the steps to be taken. As noted above, current IR rules define a statutory surplus, which, to retain tax-exempt approved status, must be reduced by benefit enhancements, contribution reductions or holidays, or payments to employers (which are taxed).
- 4.9.4 The Pensions Act 1995 builds on the IR definition to limit payments to employers to those schemes with a statutory surplus, to override scheme rules in order to give to trustees the power to decide on the payment of a surplus to the employer, to require the extension of 5% LPI provision to rights acquired before 1997 before a payment to an employer can be made, and to specify a detailed consultation procedure before a payment to an employer can be made.

Policy description.

- 4.9.5 IR proposals for changes to the tax treatment of pensions remove the current concept of a statutory surplus. In future, their only concern will be to tax any payments from a pension scheme to an employer at 35%. DWP pensions legislation will now define the circumstances in which such payments may be made from pension schemes.
- 4.9.6 The proposals are for legislation that will, first, prevent the making of payments to employers from DB pension schemes, unless these are funded to ‘full buy-out’

level. This means that the scheme has to have funds in excess of what is needed to secure its liabilities through the purchase of annuities and deferred annuities from insurance companies to pay promised benefits in respect of leaving service benefits for active members. Second, payments from DC schemes will only be permitted where assets are clearly not required to meet the scheme's commitments. At the same time we want to simplify the requirements, removing much of the detail of current Pensions Act provisions, giving employers reasonably ready access to funds which really are 'surplus' to the full buy-out level of funding. These simplifications include the removal of the current requirement on DB schemes to extend LPI provision to pre-1997 benefits before a payment to the employer is made, and streamlining the notification procedure.

Practicalities (further details to be prescribed in regulations)

4.9.7 Before a payment to the employer can be made:

- The employer must consent to receiving the payment. The trustees must request the scheme actuary to carry out a valuation of the assets and liabilities of the scheme
- The scheme actuary must carry out that valuation and provide a certificate (of limited duration, period to be prescribed in regulations) to the trustees confirming that the full-buy out test (in the case of DB schemes) or other prescribed requirements (in the case of DC schemes) are met, and specifying the maximum amount of the permissible payment (which will be the difference between the assessed assets and liabilities)
- Trustees must notify the members of the proposed payment before it is made (period to be prescribed) and must satisfy themselves that the payment is in the interests of the members

4.9.8 The trustees will be required to notify the Pensions Regulator and the Inland Revenue when the payment is made.

4.9.9 The Pensions Regulator will have powers to stop payments of surplus, or demand their repayment, where the above procedures have not been properly followed, as well as powers under section 10 of the Pensions Act 1995 to impose penalties.

Costing

4.9.10 These measures replace an existing requirement that a payment of surplus to an employer could only be made from an occupational scheme where the scheme had a surplus when measured against a statutory basis. Indeed, where a scheme had such a surplus, Inland Revenue rules, now to be abolished, required the scheme to take action to reduce the surplus, which could have included taking a refund or

other measures, or to risk losing the tax exempt status generally enjoyed by pension schemes. The statutory basis was defined by the Inland Revenue.

- 4.9.11 Under both the old legislation and the new legislation, there is an option for pension schemes to pay refunds of surplus to sponsoring employers in certain circumstances. Because of the very different way in which the circumstances are defined in this new legislation compared to the Inland Revenue rules it is difficult to say whether the option of paying a refund of surplus will be open to more or fewer schemes under the legislation proposed here or currently.
- 4.9.12 In addition, under the current legislation, taking a refund of surplus is only one option for reducing a surplus, although where a surplus when measured on the statutory basis exists, some steps must be taken to reduce it. Under the proposed measure, taken together with others in the Bill and in concurrent Inland Revenue proposals, schemes will have wide flexibility for pacing their funding, and, indeed, have the option of retaining surplus where they do not have such an option presently, with a refund of surplus possible only where the scheme is funded to the 'full-buy out' level. Therefore it is hard to see how this measure, taken with others in the Bill and in the Inland Revenue proposals, can be said to impose additional funding costs on schemes and their sponsoring employers. In addition, since there is no information to suggest how many schemes would wish to take advantage of the option of making a refund of surplus were they in a position to do so, the administration costs of this restriction of the option are not at all easily quantifiable.