

Repaying surplus - why you should act now!

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Pensions Briefing

HIGHLIGHTS

- Repayment of surplus funds to the sponsoring employer will not be possible from most mainstream pension schemes unless the trustees put in place a resolution on such repayments.
- Trustees have power under statute to resolve about the repayment of surpluses to employers - but the power may only be exercised once and will fall away if not used by 6 April 2011.
- Decisions to repay surplus may be made after 6 April 2011 - provided the trustees have passed an appropriate resolution before that date.
- There are accounting reasons why the ability to repay surplus can be important to sponsoring employees, even if surplus is not actually repaid.
- Employers should raise the issue with trustees now.
- UPDATE: members of Hogan Lovells' pension team have taken part in discussions on section 251 with the Pensions Minister and officials on behalf of the Association of Pension Lawyers and the Society of Pension Consultants. Following these meetings, we are not optimistic that the section 251 restrictions will be removed or postponed in sufficient time for clients to avoid the need to pass a resolution. Accordingly, our advice continues to be that employers and trustees should plan to put in place a section 251 resolution by 5 April 2011 and should notify members of this intention at least three months before the resolution is passed.



WHAT'S THE ISSUE?

A little known provision of the 2004 Pensions Act (section 251) means that repayments of surpluses in pension schemes to employers are only allowed if the trustees have made a resolution under that section. The provision was added as the Pensions Bill 2004 was passing through Parliament. The record of Parliamentary proceedings at the time suggests that the addition was rushed and that inadequate time was available for proper scrutiny of the drafting.

Since section 251 came into force in 6 April 2006, economic conditions have meant that dealing with surplus funds has not been top of the agenda for most pension managers and trustees. However, the power to resolve under section 251 may only be exercised before 6 April 2011 - meaning that, if the deadline is missed, the scheme may then be prevented from paying surplus before or after that date.

Note: the urgency is to put in place a resolution before 6 April 2011. Decisions to repay surplus, and the repayment itself, may be made after that date.

WHICH SCHEMES ARE AFFECTED?

Broadly, section 251 applies to any scheme that, as at 5 April 2006:

- contained a power to make payments from scheme funds to the employer
- was subject to the Inland Revenue limits on the amount of surplus that could be held in the scheme (in general, the limits applied to all tax exempt approved schemes with

more than 12 members other than certain defined contribution schemes) - see box on Schedule 22 below

- at that date was not in winding up.

This means that almost all of our clients' mainstream defined benefit schemes established before 6 April 2006 will be affected.

WHY DOES IT MATTER?

Having a power to repay surplus is important for two main reasons:

- Even though in current economic conditions pension scheme surpluses can seem an unlikely dream, it was not so long ago that surpluses were common and the proper division of them between members and sponsoring employers the subject of regular debate. It is not far-fetched to imagine that circumstances may change in future such that surpluses arise again - accompanied by rigorous discussions as to their use.
- Under International Accounting Standards (IAS19), a power to repay surplus (even where repayment is not envisaged) may have a significant effect on the reporting of pension assets in the sponsoring employer's balance sheet. If no repayment is allowed, the asset that can be shown on the balance sheet may be limited, even where the scheme is over 100% funded on the IAS19 basis.

WHAT MAY THE TRUSTEES RESOLVE?

What the trustees may resolve depends on the terms of the scheme's existing power to repay surplus:

- If the current power only allows payments of surplus in order to comply with Schedule 22 (see box), the trustees

may resolve that the repayment power may be exercised instead in such circumstances and subject to such conditions as the trustees specify in the resolution (and subject to the requirements of sections 37 or 76 of the Pensions Act 1995 - see below)

- If the current power is wider than is necessary to comply with Schedule 22 (see box), the trustees may resolve that the power:
 - may be exercised as it already stands, or
 - may be exercised as it stands, but only in such circumstances and subject to such conditions as the trustees specify in the resolution.

(Subject to the requirements of sections 37 or 76 of the Pensions Act 1995 - see below)

The trustees must be satisfied that it is in the members' interests for them to make the resolution proposed.

NOTICE REQUIREMENTS

Before trustees exercise their power to make a resolution under section 251, they must give three months' written notice to the employer and the members. Note that the requirement is merely to notify members, not to ask for their views as part of a consultation exercise.

WHY WOULD TRUSTEES AGREE TO EXERCISE POWER UNDER SECTION 251?

Arguments about the division of surplus, and the proper role of trustees in making such decisions, have been heated. Trustees may have concerns about exercising a power under section 251 that seemingly would help pay scheme funds to a sponsoring employer. Trustees facing such a decision should bear in mind that:

- A resolution under section 251 is not a decision to repay surplus - it merely enables a decision to refund surplus to be made at a later date.
- The trustees may specify circumstances and conditions which must be met before a power to refund surplus may be exercised.
- Where a scheme is not in winding up, any decision to refund surplus must be made by the trustees - regardless of what is said in the scheme rules. A refund may only be made if the scheme is fully funded on the buy-out basis.
- Without a resolution made before 6 April 2011 no repayments of surplus may be made, no matter how generously funded the scheme. Arguably, this prohibition may also apply to repayment of excess funds following the buy-out of benefits on winding up.
- In a balance of costs scheme, the employer bears the downside risk of economic or demographic factors reducing the level of scheme funding. It is in members' interests for trustees to encourage employers to fund schemes as fully as they are able. The inability to reclaim excess funds should economic and other conditions improve (and once benefits are fully funded on the buy-out basis) would discourage employers from funding their scheme as generously as they might otherwise do.

BACKGROUND - OTHER RESTRICTIONS ON RETURNING SURPLUS

Except where a scheme is winding up, surplus may only be repaid to an employer if the requirements of section 37 of the 1995 Pensions Act are complied with. In particular, section 37 provides that the power to pay surplus may only be exercised by the trustees - even where the scheme rules give the power to another person, such as the employer.

Surplus may only be repaid if several conditions are met, including:

- A valuation of the scheme's assets and liabilities has been obtained, meeting prescribed requirements and assuming benefits are to be bought out with annuities.
- The payment is no greater than the excess of the value of the assets over the liabilities on the buy-out basis.
- The trustees are satisfied the repayment is in the members' interests.
- Where under the scheme rules the power to repay surplus rests with the employer, the employer has consented to the repayment.
- Members have been given at least three months' notice of the proposed repayment, in accordance with prescribed requirements.
- The Pensions Regulator is notified within one week of the payment.

HOW DOES SECTION 251 INTERACT WITH SCHEME RULES?

The power under section 251 to amend the scheme's refund of surplus rule is independent of the scheme's amendment power and is not subject to any restrictions in the scheme's power. The position for schemes in several common situations is set out in the table below.

Position under scheme rules	Application of section 251
No power to refund surplus, not even to comply with Schedule 22 (see box)	Section 251 does not apply. The power for the trustees to make a resolution under section 251 is not available. A power to refund surplus may be added to the scheme rules, subject to any restrictions in the scheme's amendment power. (Surplus may only be refunded from an ongoing scheme if the requirements of section 37 of the 1995 Pensions Act are complied with - see below)
Power to refund surplus only allowed to secure compliance with Schedule 22 (see box) **	Section 251 applies. Trustees may resolve to extend the circumstances and conditions in which the power may be exercised. No repayments of surplus may

	<p>be made unless a resolution is in place before 6 April 2011.</p> <p>(Surplus may only be refunded from an ongoing scheme if the requirements of section 37 of the 1995 Pensions Act are complied with - see below)</p>
Power to refund surplus, not restricted to compliance with Schedule 22	<p>Section 251 applies. Trustees may resolve that the refund power may be exercised as it is already set out in the scheme rules, or may specify additional circumstances and conditions which must apply.</p> <p>No repayments of surplus may be made unless a resolution is in place before 6 April 2011.</p> <p>(Surplus may only be refunded from an ongoing scheme if the requirements of section 37 of the 1995 Pensions Act are complied with - below)</p>

**Note that a power to refund surplus may have been properly introduced, even if the scheme's amendment power prohibits changes that would allow payments to the employer. The Occupational Pensions Board (replaced by the Occupational Pensions Regulatory Authority and subsequently the Pensions Regulator) had power to authorise the modification of scheme rules to allow repayment of surplus to secure compliance with Schedule 22. Individual investigation may be needed to ascertain the position of any particular scheme.

DOES THIS APPLY TO THE POWER TO REFUND SURPLUS ON A WINDING-UP?

On the face of it, the prohibition on paying surplus to employers except by virtue of a resolution under section 251 also applies to refunds on winding up, except where the

winding up had started before 6 April 2006. Again, this may be an unintentional consequence of rushed drafting.

The safer course is to include reference to refunds on winding up in the trustees' resolution. Any refund made on a wind up must also comply with the notice and other requirements of section 76 of the 1995 Pensions Act.

PRACTICAL STEPS

- Discuss the need for a resolution with the trustees
- Trustees take legal advice as necessary
- Trustees decide on the form of the resolution
- Notify members at least three months before trustees exercise power to resolve
- Trustees pass the resolution before 6 April 2011

BACKGROUND - SCHEDULE 22

Schedule 22 of the Income and Corporation Taxes Act 1988 (ICTA) was intended to prevent excessive funds benefitting from the tax advantages of being invested through pension arrangements. It was revoked as part of the changes to the pension tax regime on 6 April 2006 ("A-Day").

The Schedule gave power to the Inland Revenue (as HMRC was then called) to require tax privileged schemes to produce a valuation of their assets and liabilities on a prescribed basis. Where the scheme was more than 105% funded on this basis, the funding level had to be reduced in one or more ways, including allowing employer or member contribution "holidays" or repaying surplus to the employer.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

KEY HOGAN LOVELLS CONTACTS

Jane Samsworth	(Partner)	+44 20 7296 2974	jane.samsworth@hoganlovells.com
Stephen Ito	(Partner)	+44 20 7296 2330	stephen.ito@hoganlovells.com
Katie Banks	(Partner)	+44 20 7296 2545	katie.banks@hoganlovells.com
Duncan Buchanan	(Partner)	+44 20 7296 2323	duncan.buchanan@hoganlovells.com
Claire Southern	(Partner)	+44 20 7296 5316	claire.southern@hoganlovells.com

www.hoganlovells.com

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