

UK Pensions Briefing: Dividends, contribution notices and the new “employer resources” test: A trap for the unwary?

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Introduction

Companies which support defined benefit (DB) pension schemes need to be aware that their decisions about dividends are impacted by new rules in the Pension Schemes Act 2021 regarding when the Pensions Regulator can issue “contribution notices”. A “contribution notice” is an order for either an employer of a scheme or someone connected with it – for example, a director or another group company – to pay money into the scheme.

The new rules could produce some surprising results in terms of which dividend payments could be in scope for regulatory action. Companies will need to factor these changes into their decision-making and audit trail.

What is the Pensions Regulator’s view on dividends?

The Pensions Regulator has long been concerned that some companies are not treating their DB schemes fairly compared to shareholders, paying generous dividends which are disproportionate to the level of deficit repair contributions made to the scheme. While the Regulator has stopped short of placing explicit restrictions on dividends, it continues to be concerned about this form of “covenant leakage”.

Can the payment of dividends result in a contribution notice?

Potentially, yes.

Currently, if an employer pays a substantial dividend and this makes it materially less likely that members will receive their scheme benefits, the Regulator could issue a contribution notice against the employer or connected parties.

Under the new rules, the circumstances in which the Regulator can issue a contribution notice are being widened. This makes it more likely that a dividend payment could result in enforcement action.

Why are the contribution notice rules changing?

The Regulator has not been altogether happy with the current contribution notice tests, which focus on the impact on the scheme rather than the employer and can require the Regulator to show what would have happened to benefits in the future. This can make it difficult for the Regulator to prove its case.

The Regulator wanted a simpler snapshot test, focussed on the immediate impact of an action on the employer.

How does the new “employer resources” test work?

A new “employer resources” test will slot in alongside the existing contribution notice provisions. This new test is met where in the Regulator’s opinion:

- An act reduced the value of the employer’s resources; and
- That reduction was material relative to the employer’s “Section 75 debt”.

A “Section 75 debt” is, broadly, an employer’s share of the deficit in the scheme, measured on the conservative “buy-out” basis (the cost of securing benefits with an insurer).

The Department for Work and Pensions is currently consulting on how best to determine and calculate “employer resources”. It proposes that resources will be measured by looking at the employer’s profitability.

This will work as follows:

Step 1	Using the last available accounts, calculate the employer’s normalised annual profits before tax (excluding exceptional items)
Step 2	Calculate the impact of the act on normalised annual profits before tax
Step 3	Compare the amount of the impact to the Section 75 debt – is it material?

How is the new test problematic for dividends?

Applied to dividends, the test looks at the amount of the payment compared to the scheme’s underfunding. It does not look at the company’s remaining resources after the dividend or its ability to support the DB scheme over a period of time.

Arguably so long as the dividend does not damage the company’s ability to support the DB scheme, it should not be a cause for concern and should not trip the test for a contribution notice.

To take an example:

	Company A	Company B
Pre-tax profits (after adjustment for exceptional items, etc.)	£12 million	£200 million
Proposed dividend	£10 million	£10 million
Section 75 debt	£30 million	£30 million

Under the new “employer resources” test, the dividend payment of both Company A and Company B could be problematic as in both cases, the £10 million dividend is probably material compared to the £30 million Section 75 debt. (The new laws do not explain what is “material” for these purposes and the Regulator has yet to clarify this.)

However, Company B’s case is clearly very different from Company A’s, because of its remaining profits after paying the dividend. It would seem an odd result if Company B’s dividend could not be paid.

It is not the case that a contribution notice will automatically be issued where the “employer resources” test is met. The Pensions Regulator will only do so if it considers this reasonable. We would expect the Regulator to take into account factors such as the strength of the employer’s covenant, its balance sheet and remaining assets at that stage. However, having to rely on the Regulator’s assessment of what is reasonable is an uncertain and undesirable position to be in.

Is there any defence available?

Yes. There is a statutory defence if the employer company:

- Considered to what extent the act would reduce its resources;
- Took all reasonable steps to minimise this impact; and
- Reasonably concluded that the act would not materially reduce its resources relative to the Section 75 debt.

When do the new rules on contribution notices come into force?

That's still to be confirmed, but in all likelihood not until October 2021.

That said, there is some uncertainty about whether the Regulator will be able to use the power retrospectively, and even though it is expected that the legislation will not of itself be retrospective, the Regulator has a look back period of six years in assessing whether to issue a contribution notice. So companies with DB schemes should be taking the new rules into account now.

What steps should companies that support DB schemes be taking now if they want to pay a dividend?

Companies need to be thinking about the statutory defence and consider it in relation to the steps they are taking when deciding to pay a dividend.

A good audit trail will be very important, so the steps taken and rationale should be carefully documented.

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