

**RECTIFYING DISCREPANCIES IN CONTRACTED-OUT BENEFITS:
NEXT STEPS FOLLOWING DATA RECONCILIATION**

This guidance forms part of a series of notes offering guidance to UK pension schemes on principles for approaching reconciliation of contracted-out benefits in a pragmatic and proportionate way.

This note is not a definitive guide to the issues involved, nor is it a substitute for legal advice on which any particular pension arrangement may rely. It is intended to assist those in the industry to establish appropriate approaches to dealing with the complexity of addressing reconciliation and rectification issues in relation to contracted-out benefits.

This note is based on current understanding and awareness of HMRC processes as at February 2016 and will be revised and updated as information about further developments becomes available.

This note assumes that trustees and administrators have already undertaken a data reconciliation exercise in relation to scheme members who have one or more periods of contracted-out service (see Guidance Note 1, ‘Reconciling contracted-out benefits: a framework for action’ for more information). As a result of that exercise, the administrator will normally provide a closure report to the trustees (see box below). This report will include information on discrepancies identified and will inform trustee discussions and decision-making about corrective action.

In principle, schemes should pay members the correct benefits to which they are entitled under the rules. However, in relation to GMPs, in many cases it is likely to be extremely difficult, if not impossible, to ensure that all data can be reconciled and all payments corrected so that members’ GMP benefits are 100% accurate. This note looks at what trustees should do next in terms of correcting any underpayments and dealing with overpayments in a pragmatic and proportionate way.

End of first stage reconciliation: the closure report

The closure report will indicate the extent to which the administrators have been able to reconcile scheme data with that provided by HMRC. It will identify members in relation to whom data discrepancies remain outstanding (for example, unresolved differences, or members for whom no scheme record exists). It will also indicate what actions are possible to further correct scheme records – for example, which cases would require a manual recalculation to identify the level of underpayment or overpayment, and the impact of setting particular tolerances. For more information, see Guidance Note 4, ‘From reconciliation to rectification’.

In relation to members for whom benefits are not yet in payment (or for pensioners who have not yet reached GMP age), corrective action may simply involve recalculating/resplitting benefits and adjusting scheme records.

Where benefits are already in payment, the issues are more complex. Trustees may require further information in order to inform their decision-making process, but should be aware that there may be additional costs involved in obtaining this information (for example, precise calculations as to the extent to which members have been underpaid or overpaid).

Use of tolerances in rectification

The reconciliation process is likely to reveal that some benefits have been overpaid and some have been underpaid; different approaches to correction may be required depending on which type of error is identified.

The key responsibility for trustees of a trust-based arrangement is to administer the trust in accordance with its terms, including ensuring that members receive the correct benefits payable to them under the scheme rules. They must also safeguard the assets of the scheme for the benefit of all members. These two duties may conflict with each other (particularly where multiple claims for relatively modest individual amounts are involved), but this will vary from scheme to scheme and between groups of members within a single scheme. Trustees should take account of the wider impact of their decisions on the funding of the scheme and, if additional funding may be required, consider whether this is likely to be available. For contract-based schemes, the obligation to pay the correct benefit rests on the contract, and considerations of fairness as regards other members are likely to be easier to resolve. Statutory (public service) pension schemes have to be administered in accordance with the legislation governing the scheme.

As with the first stage data reconciliation exercise, schemes may wish to consider applying thresholds at the rectification stage to determine whether it is appropriate to make corrective payments – i.e. a policy that within certain limits (in value or percentage terms), it may not be cost-effective to make a corrective payment to rectify errors in current or certain types of historic payment (but see below and later sections of this note for factors to take into account). For more information, please see Guidance Note 2, ‘The role of tolerances in reconciliation and rectification exercises’.

Approaches to establishing tolerances, and the level of any tolerance set, may differ depending on factors including:

- whether the arrangement is in the public or private sector;
- whether the difference represents an underpayment or an overpayment;
- proportionality (including the relative value of the GMP to the overall benefit); and
- types of member and types of payment (for example, current members compared to former members who have transferred out or commuted their benefits).

Schemes should seek advice from their legal advisers and administrators to determine the most appropriate approach, and should maintain an audit trail recording their decision-making process and its outcomes.

Corrective tolerances do not provide a legal defence to member complaints about trustees failing to rectify underpayments; schemes would remain potentially liable for any underpayments in the event that the member or a relevant beneficiary makes a complaint. Schemes may therefore consider adopting an asymmetric approach, for example:

- where the agreed data shows that a member has been overpaid, the payment would be corrected going forward but recovery of past overpayments would not be pursued (or would be pursued only if the aggregate overpayment exceeded the lower of x% of the correct benefit or £y); but
- where the agreed data indicates that the member has been underpaid, this would be corrected in full.

Trustees should consider the impact on scheme liabilities of alternative courses of action, and should discuss potential outcomes with the employer as appropriate. Trustees should also be aware of the possibility that their decisions in this context could set a precedent for other data-cleansing/corrective activity; equally, a scheme may already have a correction policy in place based on previous data reconciliation exercises (for example, following bulk transfers), and may wish to maintain a consistent approach.

Setting tolerances – practical issues

Corrective tolerances have a precedent in the context of winding-up, in the Pensions Regulator's suggested £2 a week tolerance for GMP reconciliation. However, schemes may wish to consider whether it is more appropriate to establish tolerances (or a greater level of tolerance) in relation to overpayments than underpayments.

Some trustees have considered applying a *de minimis* threshold to correcting underpayments, for example where the corrective amount is minimal and the costs of tracing the member or making payment would be disproportionate. Whether or not it is appropriate to establish such a tolerance for correcting underpayments is likely to be very context-specific and schemes should seek legal advice before reaching their decision. Note that if a benefit is being underpaid, there is no statutory basis for deciding to underpay benefits, so schemes which take this course of action would remain at risk of potential challenges and/or member complaints.

One of the challenges in correcting benefits is that it may be difficult to identify the history of increases which have been applied to the pension, so that the correct figure can be recreated. Payroll records may not go back as far as the commencement of the pension, particularly if there has been a change of administrator during that period.

Data correction and pensions in payment

Where scheme records do not match with HMRC's figures for a member who is already in receipt of their GMP and it is decided to use the HMRC data, schemes will need to decide how far back the data correction process should be taken – for example, whether to correct data back to GMP age only, or to fully correct data back to the member's date of leaving. This may depend on factors such as the extent of reconciliation carried out when the member reached GMP age; proportionality; the availability of historic records, and the level of increases provided to pensions in payment.

Failure to carry out full rectification now could create problems when any pre-SPA members receive letters detailing their state pension entitlements (note that it is not currently clear what information will be included in these letters), and if the trustees decide to convert and/or equalise GMPs at a later date. It could also make future derisking activity such as a buyout more complicated and/or expensive. Schemes may need to confirm through sample testing whether or not a more restrictive approach would be reasonable in the context of their historic practices. It may be possible to identify members for whom full correction should clearly be undertaken and members for whom it is less relevant, and then consider the relative impact on costs of full correction in relation to remaining cases.

The following sections outline the legal and tax implications of underpayments and overpayments. Guidance Note 6 considers specific situations which may present more complex issues, including deceased members, members who have commuted their benefits or transferred out, and benefits under pension sharing orders.

Underpayments

If a scheme beneficiary has been paid less than the correct amount to which he or she is entitled under the rules, then the starting point is that the scheme should remedy the underpayment (but see Guidance Note 6 in respect of exceptions for special cases). In relation to ongoing pension payments, there is a continuing breach in failing to pay the benefits to which the member is entitled.

There is no general *de minimis* rule that would absolve schemes of the obligation to make small corrections to payments (though note the tolerance level of £2 per week accepted by the Pensions Regulator in relation to GMP reconciliations on winding-up). Successful claims may be made for small underpayments, even within that tolerance. However, in some circumstances there may be no legal mechanism for schemes to make up the shortfall as an authorised payment. Examples of the type of case where this might occur are contained in Guidance Note 6 which covers dealing with special cases such as trivial commutation payments.

Type of underpayment	Available corrective action
Pension	<p>Payments of pension arrears are treated as authorised payments provided that they do not exceed the amount that the member was entitled to under the scheme rules – see regulation 2 of the Registered Pension Schemes (Authorised Payments – Arrears of Pensions) Regulations 2006</p> <p>May be paid as a lump sum (subject to PAYE); member may need to contact HMRC to recalculate tax liability for previous years (see HMRC guidance)</p>
Pension commencement lump sum	<p>The permitted maximum for the member’s tax-free lump sum may have been miscalculated on the basis of the undervalued pension, but corrective action would be complex and there is currently no provision allowing an authorised payment to be made in these circumstances, unless the additional payment can be classed as a new arrangement to which a new election could apply, or unless HMRC accepts, on an individual case by case basis, that the original decision can be re-opened. Schemes should take legal advice if this issue arises</p>

There is no overriding statutory requirement to pay interest on underpayments, but schemes may have power to do so or be required to do so under the scheme rules. Where a member complains to the Pensions Ombudsman in respect of an underpayment case, the Ombudsman does usually require interest to be paid, so schemes may wish to offer this in order to mitigate the risk of member complaints. To qualify as a scheme administration member payment under section 171 of the Finance Act 2004, any interest paid should be calculated at an arm's length rate (for example, a rate comparable to what the member might have obtained if he or she had received the money and deposited it in the bank).

Practical issues relating to underpayments

Discrepancies are often picked up when annual pension increases are being calculated. Trustees may need to decide on corrective action in advance of this and agree with their administrator any impact on increases to be provided.

Where trustees are paying multiple years of underpaid pension arrears as a lump sum, it is common to inform (but not advise) members of the potential tax implications and provide them with a schedule showing what amount is attributable to each tax year. Members can then liaise with HMRC to rectify tax issues as appropriate.

Overpayments

In principle, where a mistake has been made about the amount of a benefit, then:

- members are only entitled to be put in a position as if they had been given the correct information, not as if the incorrect information was correct; and
- schemes have a legal right to recover overpayments made under a mistake of fact or law, subject to the recipient having a defence to such an action.

Where trustees have established that a pension is being overpaid, they have two decisions to make:

1. if, when and how to reduce the pension to the correct level so it reflects the member's correct entitlement under the arrangement; and
2. what, if any, action to take in respect of past overpayments.

Easements set out in the Registered Pension Schemes (Authorised Payments) Regulations 2009 (the **2009 regulations**) mean that, where overpayments are written off, they may in appropriate circumstances be treated as authorised payments. A decision to write off the overpayment may therefore be the most cost-effective option in cases where the cost in time and expense of chasing repayment outweighs the benefit of recovery. However, schemes (and sponsors) may still want to recover overpayments in order to protect the scheme's funding position, or because they are required to do so under their trust deed and rules.

Possible options in relation to correcting past overpayments are:

1. **To amend the scheme rules with retrospective effect to allow the payment, or to exercise discretion to augment benefits in respect of the particular member concerned** – either of these options would resolve the problem of the past overpayment, but could formalise an increase in the benefits of some members beyond those formally intended under the scheme rules. Employer consent may be required.

If schemes decide to continue to pay a pension at the higher rate as outlined above they may wish to consider imposing special terms in relation to the amount which exceeds the member's strict entitlement under the rules – for example:

- not providing a contingent spouse's benefit on the additional amount, and/or
- removing or restricting non-statutory increases on that portion of the benefit until such time as the member's lower 'official' benefit reaches or exceeds the current pension in payment.

This removes the need for reduction of pensions in payment (see below), but trustees should consider the impact on liabilities and obtain employer consent if required. Trustees should also consider the potential administrative complexity involved in imposing special terms on a particular segment of benefit. Member communication issues are also relevant – for example, would the removal of the contingent spouse's benefit be perceived as more detrimental than a

restriction on increases in relation to the same segment of the benefit?

2. **To seek repayment of past overpayments from the member.** If successful, this would rectify any breach by restoring the position as if the breach had not occurred. Schemes may also wish to explore the possibility of setting off past overpayments against future pension instalments (known as recoupment). Members may in some cases have a defence to recovery (for example, based on change of position or estoppel), and schemes should consider what resources they have available to deal with member complaints about attempts to secure recovery.
3. **To write off past overpayments.** Again, employer consent may be required as this would involve giving up potential savings to the scheme. In some cases, historic error payments may be authorised under the 2009 regulations. For more details, see the table below. Where error payments are written off which do not fall within these provisions, schemes will have to comply with breach reporting and other requirements.

Type of overpayment	Available options to allow past overpayments
Pension	Where a pension is overpaid in error, the excess payment may be an authorised payment under regulation 13 of the 2009 regulations. Payments made within a reasonable period after the discovery of an error, but which would otherwise be authorised under regulation 13, may also be authorised in some circumstances under regulation 14 of the 2009 regulations
Pension commencement lump sum	Where a pension commencement lump sum has been paid which exceeds the permitted maximum only because it has been calculated by reference to the amount of an overpaid pension which would fall within the description above, the whole of the lump sum is an authorised payment under regulation 17 of the 2009 regulations

Practical issues relating to overpayments

1. Reducing a pension in payment

Schemes which opt to reduce future pension payments to the correct level must consider how to ascertain the ‘correct’ level of payment. This can be complex and may depend on the data available to the scheme administrators in relation to past practices, historic scheme factors, etc. It may be difficult to provide a complete recalculation for members who have had a period of deferment, taken early retirement, or had a normal pension age earlier than state pension age. Schemes may have to make reasonable working assumptions and use their best endeavours to achieve an appropriate result.

Where a decision is taken to reduce a member’s pension to the correct level, trustees should consider their preferred approach and timescale for any changes, bearing in mind the position outlined above in relation to authorised and unauthorised payments and that the following steps are typically required:

- the effective date for the change will normally be preceded by a ‘notice period’ for the pensioners so that they can make any appropriate changes to their financial arrangements to accommodate the reduction in income;
- the revised values, including any adjustments to tranches of benefit, need to be finalised;

- the trustees should agree the content of an explanatory letter providing details of the revised pension and arrangements for correction, which is then sent to affected pensioners at the start of the notice period;
- the pension payroll team should be provided with the changes to pension amounts before the payroll cut-off preceding the effective date; and
- the administration team should be able to view the revised values and should be briefed so that they can respond to any member enquiries.

A notice period of two monthly pension payments is normally regarded as a minimum in practice, as this allows pensioners time to change standing orders etc. Depending on the timing of the letters in relation to the payment date, this can result in an actual notice period of between approximately five and eight weeks. Some trustee bodies allow a further month.

2. *Action in relation to past overpayments*

In practice, seeking recovery of past overpayments is costly and potentially time consuming, and there is a risk of reputational damage. Where a pension has been overpaid for a significant period, it is common to allow repayment by instalments over the same period (and the Pensions Ombudsman often uses this as a rule of thumb in overpayment cases). Successful recovery is not guaranteed, so schemes commonly undertake a cost-benefit analysis in order to decide on their approach. Typically trustees will need to review:

- the number of pensioners affected;
- the total amount of the overpaid pensions;
- the highest/lowest amount for an individual pensioner or, if the number of pensioners affected is high, how numbers are spread across specified bands, for example by age; and
- in some cases, the value of the overpayment in relation to the monthly pension, to assess the potential impact of seeking recovery at an individual level.

If the trustees request it, this information could be included in the administrator's closure report at the end of the first-stage reconciliation exercise; however, it should be noted that calculating the relevant amounts is likely to incur additional costs. Trustees may wish to discuss with their administrator whether a cost-effective solution can be found by using an informed sampling process and/or making relevant assumptions.

If the amount of the overpayment is relatively significant, it is likely to be appropriate for trustee boards to liaise with the employer and/or seek employer consent before making their decision (or this may be required under the scheme rules).

Failure to recover overpayments: unauthorised payments and breach reporting

Trustees should consider both the position under the scheme rules (has a payment been made in breach of the rules, and how should that issue be rectified?) and the tax rules on unauthorised payments.

The trustees' approach to overpayments will affect the tax implications – for example, if the trustees decide to augment a member's benefits up to the (incorrect, higher) level actually in payment, then an overpayment no longer exists (but scheme liabilities will have been increased). However, if the amount remains an overpayment compared to the level of benefits payable under the scheme rules, HMRC's policy (see [PTM146300](#)) is that where schemes decide not to pursue recovery, or recovery is unsuccessful and an overpayment is written off (even on grounds of sensitivity or administration costs), this will constitute an unauthorised member payment.

There are two exceptions to this rule: the easements provided in the 2009 regulations (referred to above) and a *de minimis* easement provided by HMRC for overpaid pension or lump sum payments not exceeding £250 in respect of an individual. Payments within this threshold will remain unauthorised but HMRC will not seek to collect tax charges and the unauthorised payment does not have to be reported. If the aggregate unauthorised overpayment to a member exceeds £250, the whole overpayment is chargeable.

In addition to navigating a way through the legal and practical complexities, schemes also need to be aware of the broader governance implications of any underpayments or overpayments. If they have discovered a systemic problem, they may need to report it to the Pensions Regulator; HMRC event reports will also be required in relation to any unauthorised payments, and tax charges may apply.

Member defences to recovery of overpayments

Limitation periods

The general rule is that the limitation period on a claim (for example, for recovery of an overpayment) runs from the date when the cause of action occurs, or the earliest date on when it is known or could with reasonable diligence be discovered (section 32(1) of the Limitation Act 1980). Overpayment of a pension is regarded as a continuing breach, so in practice the period starts when the overpayment is discovered. Note that reasonable diligence does not require exceptional or excessive measures, but trustees should be conscious of acting promptly once an overpayment is identifiable from HMRC data or later calculations.

Where trustees bring a claim within six years of discovery of the error, they can pursue recovery of all past overpayments, without limitation of time. If trustees delay seeking recovery and bring a claim more than six years from discovery of the error, recovery will be restricted to overpayments made within the previous six-year period.

Change of position

A member may have a defence to a trustee claim for restitution where he or she has changed his position such that it would be inequitable to require repayment of money paid in error. The defence applies to the extent that restitution would be unjust – i.e. if the member has given away part of an overpayment, it might still be possible to obtain a court order for partial restitution in relation to the remainder.

Estoppel

In some circumstances, the equitable defence of estoppel may prevent trustees from either or both of (a) recovering past overpayments and/or (b) reducing future pension payments to the correct level. The availability of this defence will depend on the member being able to show that:

- the trustees made a clear representation (for example, as to the amount of the member's benefit) on which it was reasonably foreseeable that the member would rely;
- the member acted in reliance on that representation, and
- the member would suffer detriment if the trustees are not held to the original representation.

Whether each of these elements can be established would depend on the circumstances of the individual case – trustees may wish to take legal advice in specific cases.

A member need not show that he or she would not have taken a particular action 'but for' the effect of the error – it need only be a significant factor which he or she took into account. Particularly where the overpayment is relatively low, it may be unlikely that a member can establish that they have taken a specific act in reliance on those additional funds; however, where the overpayment has been sustained over a lengthy period, they may be taken to have relied on it for their general standard of living. The member must also be able to prove that he or she has relied on the error to his detriment, and that detriment must be more than merely hypothetical or speculative.

Dealing with non-standard cases

Corrective payments may be more complex (and costly) to achieve in relation to some classes of member – for example, those who have died or transferred out. Schemes (and sponsors underwriting reconciliation costs) may also be less willing to incur the costs of correcting payments for some categories of member, for example those who have commuted their benefits. However, the principles outlined in this note still apply in relation to individual members, and schemes should be alert to the wider risk of appearing to treat some categories of member or beneficiary unfairly (or more favourably than others).

Trustees should aim to establish a strategy for payments which is fair to members overall and consistent with their duty to administer the trust in accordance with its terms, ensuring that members receive the correct benefits, while balancing this with the interests of the scheme as a whole – this can include taking cost/benefit issues into account. For more information on dealing with particular types of non-standard case, see Guidance Note 6 'Dealing with non-standard cases'.

Are schemes protected by discharge provisions?

Where a member has exercised a statutory right to transfer a cash equivalent under sections 94 or 101AB of the Pension Schemes Act 1993, a statutory discharge applies. However, it is not clear that a scheme can rely on this discharge as against a member who claims that he or she was underpaid, if the value shown in the statement of entitlement is incorrect. Schemes should take legal advice on this issue.

Similar considerations apply where members have provided a specific discharge, for example where benefits have been transferred out or commuted, or in relation to general discharge provisions under scheme rules. Schemes should take advice as to whether any such discharge can be relied on to relieve them from liability where a benefit has been calculated incorrectly.