

FACT SHEET

THE STATE PENSION – PART VIII

Contracting Out of the Additional State Pension, The Final Chapter

If you are employed with annual earnings above £5,044 in 2010/11, you can choose to leave the State Pension, this is called contracting-out. It is not possible to leave the basic State Pension. You can contract-out with a Stakeholder or Personal Pension. If you do this you will not pay lower National Insurance Contributions. Instead once a year the Inland Revenue will pay directly into your Pension a rebate of your National Insurance Contributions. The rebate is intended to provide benefits broadly the same as the Additional State Pension given up, the Government's words not mine. If you choose to contract-out by joining your employer's Occupational Pension Scheme, both you and your employer will pay lower, reduced National Insurance Contributions. When you retire your second pension will come from your employers scheme and not from the Additional State Pension.

Some people will continue to build up a small entitlement to the Additional State Pension even when contracted-out. A person contributing to a contracted-out personal pension earning less than £14,100 in 2010/11 will also get an additional State Pension top-up for that year.

From 6 April 2012 contracting-out of the Additional State Pension on a Defined Contribution basis will be abolished under the provisions of the 2007 and 2008 Pension Acts. Those contracted-out will be readmitted to the State Scheme and will start to accrue entitlement to the Additional State Pension instead. HMRC will no longer pay the National Insurance, NI, rebate into their Pension Scheme. The last payment will be for the 2011/12 fiscal year. It is expected 'Protected Rights' secured by NI rebate will be converted to ordinary benefit relaxing the rule to secure a Widow/Widowers Pension at retirement.

State Pensions have over time become more and more complex and think it appropriate that in the remainder of this Fact Sheet we explain the Additional State Pension starting with the State Earnings Related Pension Scheme (SERPS) the predecessor to the current State Second Pension, S2P.

State Earnings Related Pension Scheme (SERPS)

SERPS was introduced by the **Social Security Pensions Act 1975** and began on 6 April 1978. It was a State Pension in addition to the basic State Pension for employed individuals (the self-employed were not eligible) and was based on earnings between the lower and upper earnings limited (LEL and UEL) commonly known as 'middle band earnings'.

When it was first introduced the benefit under SERPS was calculated as 1.25% of middle band earnings (which were revalued each year in line with national average earnings (NAE)) for each year of your working life, up to a maximum of 20 years. It is worth noting that you could use the best 20 years. The maximum was therefore 25% (125% x 20) of middle band earnings. This applied to everyone with a state pension age (SPA) before 6 April 1999.

After changes announced in the **Social Security Act 1986**, if your SPA was 6 April 1999 or later you were entitled to a reduced benefit of 20% of average revalued lifetime earnings in respect of accrual from 6 April 1988. So, you were no longer able to use the best 20 years. The 20% restriction would apply in full to those with a SPA on or after 6 April 2009. If your SPA was in the period 6 April 1999 to 5 April 2009 you would get between 20% and 25% for post 6 April 1988 accrual only.

SERPS accrual ended on 5 April 2002 when it was replaced by the State Second Pension.

State Second Pension (S2P)

Introduced by the **Child Support, Pensions and Social Security Act 2000** S2P is the successor to SERPS and was effective from 6 April 2002. As well as providing an Additional State Pension for the employed, S2P for the first time gives an Additional State Pension based on earnings of £14,100 (2010/11) to:

- Those with earnings above £5,044 but below £14,100
- Carers with no earnings or earnings below £5,040 for any year that they:-
 - Receive child benefit for a child under six, or
 - Are looking after an ill or disabled person in circumstances which qualify for Home Responsibilities Protection, or
 - Have an entitlement to Invalid Care Allowance (even if the benefit is not claimed because of entitlement to another greater benefit)

- Those who are entitled to long term incapacity benefit or severe disablement allowance, provided that they have worked for and paid Class 1 NI contributions for at least one tenth of their working life since 6 April 1978.

S2P is not available to those earning less than £5,040, the unemployed, students, those caring for children older than six and the self-employed.

How does S2P actually work?

S2P is based on an earnings-related system similar to SERPS but with different accrual rates.

S2P in detail

As previously mentioned S2P is earnings-related (similar to SERPS). To ensure that the principle aim of Government was met, that is that low and non-earners received a greater benefit from S2P, there were three bands of accrual. To accommodate three bands a Low Earnings Threshold (LET) and a Higher Earnings Threshold (HET) were introduced in addition to the LEL and UEL that were used for SERPS. The bands based on the 2009/10 tax year are set out below:-

- Band 1 – covers earnings from the LEL up to the LET. Benefit accrued at a rate of 40% (twice what SERPS provided). As previously mentioned those earning less than the LET are treated as though they had earned the LET.
- Band 2 – earnings between the LET and the HET. The accrual rate is 10% for earnings within this band (half what SERPS provided).
- Band 3 – covers earnings from the HET to the Upper Accrual Point (UAP). Benefit in this band accrues at 20% (the same as SERPS).

Note:- The LET is announced each year by Government in the same way that the LEL and UEL are. The HET is calculated separately using these figures and is the sum of 3 times the LET less 2 times the LEL rounded to the nearest £100 rounding down any exact sum of £50.

These bands apply to everyone with a SPA on or after 6 April 2009. Individuals reaching SPA before 6 April 2009 had enhanced accrual under SERPS. These transitional arrangements were extended to S2P by increasing the accrual rate in each band. An additional 1%, 0.25% and 0.5% of earnings is added to each band respectively for each year that SPA is earlier than 6 April 2009.

So, if your SPA is before 6 April 2009 you will not receive less under S2P than you would have done under SERPS.

Pensions Act 2007 and National Insurance Contributions Act 2008 changes

The Pensions Act 2007 put in place legislation to reform the State Second Pension so that it would become a flat-rate top-up to the Basic State Pension by 2030. The National Insurance Act brought these reforms forward and a decision was made to start these changes in 2009 when the Upper Accrual Point (UAP) was established. The UAP will be cash fixed from the point it is introduced. This meant that from 6 April 2009 employers and employees with Occupational Pension Schemes contracted-out of S2P receive contracted-out rebates on earnings between the lower earnings limit and the UCP. Employers and employees pay National Insurance Contributions at 12.8% and 11% respectively on earnings between the UCP and UEL. The UEL is £43,875 for the 2010/11 tax year.

From 6 April 2010 bands 2 (10% band) and band 3 (20% band) were merged so that all earnings between the LET and the UAP will accrue additional pension at a rate of 10%. From an unspecified future date, the band 1 (40% band) will be replaced by a weekly flat-rate accrual of £1.50 (£78 p.a.). The 10% accrual component will be withdrawn around 2030, leaving a wholly flat-rate benefit.

Also in 2010 national insurance credits were introduced for those with long-term disabilities and people with caring responsibilities so that they can build up some additional pension entitlement.

S2P – the benefit calculation

The benefit calculation is based on a three-step process which is detailed below:-

- Earnings for each tax year from 2002/03 onwards are split across the bands and revalued broadly in line with the rise in National Average Earnings (NAE) from the tax year in question up to the tax year before the employee reaches SPA (earnings in the tax year before SPA are not revalued).
- The revalued earnings at SPA in each band are then multiplied by the accrual rate applicable to that band.

- These revalued earnings are divided by the total number of years in the individual's working life since 1978 to give the S2P benefit. Working life is defined as being from age 16 to SPA.

The examples below show how this works in practice assuming earnings are revalued to State Pension Age at approximately 2.5% per annum.

John, age 44 and a draughtsman, has earnings of £42,000 and a working life of 49 years.

Calculation of earnings in each band for 2009/10 tax year:-

Band 1 – (£13,900 - £ 4,940) = £ 8,960

Band 2 – (£31,800 - £13,900) = £17,900

Band 3 – (£40,040 - £31,800) = £ 8,240

Assume that the revalued earnings are £15,049, £30,065 and £13,840 respectively.

Band 1 - £15,049 x 40%/49 = £122.85

Band 2 - £30,065 x 10%/49 = £ 61.36

Band 3 - £13,840 x 20%/49 = £ 56.49

Total S2P benefit for 2009/10 tax year is **£240.70**

Julie, age 50 and a nurse, has earnings of £22,000 and a working life of 49 years.

Calculation of earnings in each band for 2009/10 tax year.

Band 1 – (£13,900 - £ 4,940) = £8,960

Band 2 – (£22,000 - £13,900) = £8,100

Assume that the revalued earnings are £12,977 and £11,731 respectively.

Band 1 - £12,977 x 40%/49 = £105.93

Band 2 - £11,731 x 10%/49 = £ 23.94

Total S2P benefit for 2009/10 tax year is **£129.87**

Note – In both examples the S2P benefit would be converted into a weekly amount.

Interaction with SERPS

SERPS and S2P will be calculated separately and individuals will be entitled to both a SERPS and a S2P benefit at SPA, assuming of course that they were in both SERPS and S2P. Finally, remember contracting-out by way of Personal Pension will end April 2012. Our State Pension is one of the most complex and disappointingly is perhaps the least generous in the European Union.

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