

# State Second Pension – The Facts and Figures

These notes are geared to contracting out using personal / stakeholder pensions. The position for employer-sponsored schemes can be different and you should seek further guidance from your scheme administrators.

Only employees can contract out. Those who are self employed receive no earnings related state pensions.

When people refer to contracting out they usually mean the decision that an individual has made to give up the right to receive an earnings related pension from the state for a particular tax year. In essence, in exchange for giving up a “guaranteed” state benefit at retirement, the employee opts to receive a cash payment into his/her own pension plan.

When employees who have contracted out reach the state retirement age (now 65 for all men and for women under the age of 50) they will receive a pension from a pension provider for the tax years for which they have opted to contract out. They will also receive a State Earnings Related Pension (the current version of which is S2P) pension for those years when they were in the state scheme.

If an employee decides to contract out of S2P the government provides a lump sum rebate of part of their National Insurance contribution into a pension plan in the employee’s name. The amount of rebate provided alters according to age and salary. The government actuary alters the rates of rebate periodically. The lump sum rebate is paid directly by the DWP to the employee’s chosen pension provider, usually in the October following the tax year to which the rebate applies.

## 1. STATE EARNINGS RELATED PENSION (SERPS) AND S2P JARGON

In order to understand state benefits, it may be helpful to explain some of the common expressions used:

### 1.1 “A” Day

“A” Day took effect on the 6<sup>th</sup> of April 2006 and is the term used for the pensions simplification tax regime change.

### 1.2 Appropriate Personal Pension Plan

An Appropriate Personal Pension Plan is one designated to receive SERPS and S2P benefits. You cannot mix rebate contributions with additional pension savings.

### 1.3 Higher Earnings Limit (HEL)

Also known as the Upper Earnings Limit (UEL). The highest level of income used to create Qualifying Earnings (QE). Above the HEL, National Insurance taxation generates no benefits to the individual.

#### **1.4 Lower Earnings Limit (LEL)**

The limit below which National Insurance tax is not charged and hence no credits are given towards S2P.

#### **1.5 Lower Earnings Threshold (LET)**

A level of income currently set at twice the Minimum Income Guarantee (MIG), which the government consider is the minimum income for everyone to base their state pensions and QE for S2P benefits.

#### **1.6 Minimum Income Guarantee (MIG)**

Also known as the Pension Credit Guarantee this is the minimum income the government believe all pensioners should receive. It currently (2008/09) stands at £6450.60 pa for a single person, £9846.20 pa if you are married.

#### **1.7 National Insurance Tax (NI)**

A tax levied on all employees and employers. It was originally conceived as a National Insurance premium to protect employees "from the cradle to the grave" (Winston Churchill 1943), however, this concept has long since been abandoned and it should be treated as a second income tax.

#### **1.8 Non Protected Rights Fund**

The pension fund built up from additional pension savings.

#### **1.9 Protected Rights Pension**

The pension provided by rebated payments.

#### **1.10 Protected Rights Fund**

The pension fund built up from rebates.

#### **1.11 Qualifying Earnings (QE)**

Are the earnings between the LEL and the employee's salary subject to a minimum of the LET for carers and those on low pay and a maximum of the HEL for those on high earnings.

### **2. WILL THE GOVERNMENT BE ABLE TO PAY STATE EARNINGS RELATED BENEFITS?**

All state pensions were originally conceived as being funded arrangements. In other words, National Insurance contribution payments would be invested on behalf of the employees to produce the benefits when claims arose. Unfortunately, governments of the day have used the National Insurance received to pay for more pressing immediate liabilities, meaning that National Insurance paid now, provides the pensions being paid now.

This lack of funding means that the effect of the so called "demographic time bomb" becomes much worse. The demographic time bomb refers to the fact that the birth rate is falling and people are living longer. This will result in less people paying taxes whilst there are more people claiming pensions as well as other benefits such as NHS treatment and nursing home care.

Looking forward for perhaps the next 15 to 20 years it seems likely that the state will still be able to pay pensions from taxation receipts. Further out, however, one does begin to wonder how the state can afford to pay substantial pensions.

Put simply, will the children of today be prepared to see 40% or 50% of even modest incomes going in taxes to fund retirement and welfare benefits? If the answer is no then there is every likelihood that current promises will be “watered down” to being means tested or cancelled out all together.

### **3. IS IT FINANCIALLY WORTH CONTRACTING OUT?**

With S2P came a review of the amount of cash the government will swap for the individual deciding to contract out. Anyone wishing to contract out after 6<sup>th</sup> April 2002 should be dealt with on an individual basis and on its own merits, we would therefore advise if you are considering contracting out them please consult us for Financial Advice. One can, however, draw some generalised conclusions:

- For many contracting out it doesn't matter as their total pensions including the S2P pension will be close to, or below, the MIG and hence will form part of MIG.
- For anyone with benefits above the MIG the level of S2P does matter as a lower S2P pension will mean (even after pensions credit / MIG deductions) a lower income in retirement.

Assuming that the current system is not changed again (highly unlikely!) if:

- You are happy that the state will have the funds to pay pensions from income receipts then you are probably best off to remain in S2P and/ or contract back into the state scheme.
- If you are a high earner who is now under the age of 40 you are probably better off to remain contracted out, or at least to commence contracting out when stage 2 of S2P becomes live.

For the rest of the working population the decision is really based on individual preference for state benefits or private provision bearing in mind our comments that mathematically the private provision is most unlikely to generate better benefits on a like for like basis for the next few years at least.

### **4. ARE THERE OTHER CONSIDERATIONS?**

The new “A” Day legislation means that those who contract out can claim their contracted out private pensions from age 55 instead of having to wait until age 65.

In addition the new legislation allows people with protected rights pensions to receive 25% of their savings as a tax free lump sum which could be a big incentive to some to contract out.

### **5. WHAT ACTION IS REQUIRED TO CONTRACT OUT?**

Having made a decision to contract out, the relevant form is completed and a formal notice is sent to the DWP confirming your decision. You will then remain contracted out until you notify the DWP of your decision to go back into the state scheme.

The pension provider will issue the initial policy documentation and then continue to inform you of the value of your plan after each rebate has been received.

Please note! the DWP have no systems for rejecting claims if the computer doesn't recognise any data and some insurance companies have no systems for chasing up payments which don't arrive. You must remember to keep an eye on whether cash is received into your contracted out plan (usually around October / November following the tax year-end in question).

## **6. IS CONTRACTING OUT A GAMBLE?**

YES! There is no guarantee whatsoever that by contracting out you will receive a bigger pension. However, bearing in mind the demographic time bomb and the changes already mentioned above neither is there any guarantee that the state will provide for you in your old age!

You have to choose between taking a risk that the pension provider will look after your money well and provide a reasonable pension, or whether to trust the state to fulfill its promise in many years time.

## **7. ONCE CONTRACTED OUT, CAN I CONTRACT BACK IN?**

Yes, you can contract back in at anytime, however, you cannot retrospectively change your mind (ie, say you want to contract back in for previous tax years) so it is essential to keep the issue under regular review.

## **8. HOW DOES ONE CHOOSE AN APPROPRIATE PENSION PROVIDER?**

With the introduction of stakeholder pensions, the charges made from different providers are all pretty similar. There is a case for choosing a mutual life office if you like the secure with profits pension fund approach. In view of the rapid contraction of those companies prepared to offer stakeholder plans it is probably a good idea to choose a relatively large insurer who has sufficient financial strength to safeguard your investment.

There is an argument for not "putting all your eggs in one basket" and it is possible to change your pension provider from one year to the next.

If you wish to discuss the above in more detail please contact us to arrange a confidential no obligation meeting, at which time we will be able to furnish you with the information to make an informed decision, however we will not make an individual recommendation on contracting out.