

# Contracting out of the State Second Pension (S2P)

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## Introduction

The State Second Pension (S2P) and its predecessor SERPS (State Earnings Related Pension Scheme) that it replaced in 2002, is **an integral part of any eligible person's retirement planning**, ie where money will come from in old age to pay for things.

It works as **a top up to the Basic State Pension**. For further details, please refer to our Guide: *Pension Benefits You Can Expect from the State*

## How it works

S2P is available for **anyone who is employed** (so the self employed do not qualify) and pays National Insurance (NI) contributions. Thus **it is available for anyone who earns more than £105 per week** (2008/2009 figures). This figure is known as the Lower Earnings Limit or LEL: there is also an Upper Earnings level (UEL), currently £770 per week.

Although NI is levied and paid on earnings above this figure, no S2P benefits apply.

The actual provision for S2P **comes from the NI that you and your employer pay**.

How much you actually get in retirement is complex and can only be accurately known by **getting a forecast of anticipated payments in retirement** from the Department for Work and Pensions (or DWP) by filling in a form BR19

Whilst SERPS is not available for those who didn't work, certain categories of people do qualify for S2P, notably **carers and women who receive child benefit**, ie they have a child aged under 16.

If you are employed, **you have a legal right to 'contract out'**. This right will not apply in practice though if you are a member of your employer's Occupational Pension Scheme, if the whole scheme is 'Contracted Out'. Some schemes are not though and **it is well to check**.

This means that **instead of you building up rights to this 'top up' pension** payable at your State Retirement Age (currently 65 for males and females born after 1955, but soon to be revised upwards), you can elect to 'contract out'. What this means in practice is that **an equivalent amount of money**, calculated from NI payments, **is sent to your chosen private pension provider**. How that money is invested is then your decision.

The decision to contract out or not **is taken annually**. Whatever is the position decided on the 5<sup>th</sup> April of any year (ie the tax year), **that decision applies for the whole of that tax year** ie back to the previous 6<sup>th</sup> April.

In any subsequent year, unless you change your election, **the previous year's election will apply**. Clearly any past years' decisions **are then set in stone for the rest of your working life** until you actually take any benefits.

You should be clear that contracting out (or not) **doesn't affect your obligation to continue to pay NI contributions**, nor does it impact on your right to receive the Basic State pension

## Should you 'contract out' or not?

This is **a decision not to be taken lightly**, in that the amounts in question could add to tens of thousands of pounds. The decision involves the following factors:

- Your relative **age** in the year in question
- Your level of **earnings**
- Your **marital status**
- Your **attitude to risk**
- Your **philosophy** towards politicians and/or the City

In general terms, 'contracting out' **takes you away from a 'guarantee' in retirement** provided by the State, towards one where **you can exercise more investment control**.

However, the general wisdom is that it is only probably worth contracting out **if you are prepared to take on a relative amount of risk** that comes with investing into share based areas.

From there, if these holdings remain untouched until you actually come to take benefits, there will be fluctuations in values, which you must accept.

## Factors for consideration

- Once the election has been applied for any one year, that decision applies for life and **is irreversible**.
- For people earning under a certain figure (known as the Lower Earnings Threshold and is an earnings figure of at least £13,500 in 2008/2009), **that person's earnings are 'uplifted' to this amount** and is used to calculate the S2P benefit for that year.
- It is now possible to extract **a lump sum of 25%** of the total private fund applicable if you do contract out.
- There is no longer a requirement to buy an annuity that is 'index linked', i.e. the annuity **can be on a level basis**, which will improve its early payments
- The definition and calculation of potential benefits payable in the 17 years that SERPS was around **changed FIVE TIMES**, and every one being an erosion of payment.
- The present Government has already indicated that future S2P benefits will move to a flat rate, **further eroding benefits** in retirement for many.
- The recent Pensions Act has had two significant implications for S2P

(a) The State Pension Age **will be rising to 66 from 2024** and eventually to 68

(b) It will not be possible to 'contract out' **via a private pension beyond 2012**.

## Why did the Government allow contracting out?

It has become clear for quite some time that provision for retirement purely from State Pension provision **will be inadequate for most** because:

- We are all **living longer** so need money for longer in retirement.
- Today's workers pay today's pensioners - this balance is forever putting **extra strain on the workers** as people live longer.
- Successive Governments wish to **encourage more private provision** and this is seen as one way of encouraging us to start up a plan of our own.
- Once you take money out of their hands, they may feel that they have a moral argument (questionable) that **you are on your own**.

## Pros and cons

Giving advice in this area is difficult for us as advisers, given **the mix of personal circumstances and ever changing rules that apply**.

However, the following could be described as guidelines:

You **should NOT contract out if:**

- You are **beyond a certain age** - commentators differ about this and ages range from early 40s to people in their 50s - the key issue is where money is invested into shares you need to allow time for growth or recovery if market volatility occurs early (certainly at least 5 years but more likely to be 10).
- You **earn less than £18,000** - below this figure, you will either be getting the benefit of uplifted S2P benefits (see previous), or the payments you would otherwise receive from contracting out aren't sufficient to warrant the risk.
- You have what is described as a **'cautious' approach to investment** - unless you are prepared to invest a significant amount of your money received from being contracted out into share based areas, the shortfall from returns from other safer forms of investment would not make the exercise worthwhile.
- You **distrust the 'City'** - there will be costs associated with share based investments and the best fund managers do not come cheap - also fund managers take their cut irrespective of performance.

You **should consider contracting out if:**

- You **distrust politicians and their promises** - it could be argued that 80% of something is better than 100% of nothing. However, there is no suggestion at this time that 'means testing' could be introduced but the tinkering with SERPS definitions in the past does not exactly inspire confidence.
- You **think that you can do better** - S2P benefits are based on assumptions that go with more guaranteed types of investment - if you can invest more astutely, you could outperform in the long run.
- You **like the idea of control and flexibility** - accessing your benefits via your private pension is possible in whole or in part at any time from aged 50 at present (55 from 2010 onwards) up to age 75, as opposed to the rigid 'one off' State Pension Age.

The extra ability to take a quarter of your accumulated fund as an immediate lump sum as opposed to only being able to receive income is also appealing.

This guide should give you some idea as to the issues involved but should not be construed as providing you with advice that is specific to your circumstances.

If you do require more detailed advice, you should contact us at Arch Financial Planning Limited for an illustration and further help. You should be aware that **there may be a fee involved** in the provision of such advice to you.

## Further Information

The **Financial Services Authority (FSA)** has published a Factsheet entitled "The State Second Pension - should you be contracted out?" You can obtain a copy by telephoning the **FSA Consumer Helpline on 0845 606 1234**.

The **Pension Service**, part of the Department for Work and Pensions, has published a comprehensive booklet entitled "Contracted-out pensions" that you can download in pdf version from their website **www.thepensionservice.gov.uk**

## Risk Factors

An investment into a Stakeholder Pension or other Personal Pension Plan is intended as a long-term investment. Where past performance is mentioned please note that the past is not necessarily a guide to future performance. If you contract out with a Stakeholder Pension or other Personal Pension Plan, you may not receive as big a pension as you would have received from the state. The future value of a Stakeholder Pension or other Personal Pension Plan is subject to the amount of National Insurance contribution rebates received by the plan, charges extracted by the plan provider, investment returns achieved and annuity rates at the time that benefits are provided.

On their own state benefits or state replacement pension benefits from a Stakeholder Pension or other Personal Pension Plan will not be sufficient for your retirement needs.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. These notes are simply designed as an introduction for you to contracting out of the State Second Pension. It cannot cover every possible aspect of contracting out and is not meant to be exhaustive.

Information given relating to tax legislation is based on our understanding of legislation and practice currently in force. Whilst we believe our interpretation of current law and practice to be correct in these areas, we cannot be responsible for the effects of any future legislation or any change in interpretation or treatment.

In particular you are warned that levels of tax and tax reliefs are subject to alteration and, in any case, the value of such reliefs and benefits may depend on an individual's circumstances.

If you are in any doubt as to whether you should contract out of S2P or not, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

## For personal advice

If you would like to discuss whether you should contract out of S2P or whether you should end your contracting out if you arranged to contract out in the past, please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**  
Email: **enquiries@arch-fp.co.uk**  
Online: **www.arch-fp.co.uk**

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