AF1 2021/2022
The State Pension System

The milestones are to understand:

- How individuals build up their rights to receive a State Pension.
- The differences between the pre and post April 2006 regime
- When it can be useful to make voluntary NIC

What you get for your money.

Entitlement to the State Pension is built up by paying National Insurance Contributions (NIC)

Although individuals and employers make contributions the system is unfunded. NIC are simply used to pay the pensions of those who have retired. This is known as the Pay as You Go system. The Government has made continually made changes to the system ever since it was launched in 1948. The latest and most significant change came into effect on 6th April 2016. Effectively there is a pre and a post April 2016 pension.

Anyone who reached state pension age before that date will continue on the old system and those who attained state pension age on or after that date will be on the new system. The state pension age for everyone in 21/22 is 66.

- The pre April 2016 pension (Old scheme) offered a flat rate pension and possibly an earnings related element. (The additional element)
- The post April 2016 is a flat rate pension with no earnings-related element.
- Both pensions are paid gross but are taxable.

The old scheme.

It is probably unlikely that you will get a question on the details of the different additional state pensions but since everyone who reached State Pension Age on or before 5 April 2016, will continue on the old basis for the rest of their lives, it's important to know the key details if only to compare them to the post April 16 system.

- This was made up of the flat rate Basic State Pension (£137.60 a week for 20/21) and earnings related additional state pension.
- The Basic State Pension (BSP) was paid to anyone, employed or self-employed, who had 30 years Class 1 or Class 2 National Insurance Contributions or credits.
- Only employees were entitled to the Additional State Pension. The self-employed were excluded so someone who had always been self-employed all their working life would only get the BSP.

- It was possible for defined benefit schemes to contract all their members from both SERPS and S2P. Both the employer and employee paid a lower rate of NIC but did not build up any credit for Additional State Pension.
- Between April 1988 and April 2012 it was possible for money purchase schemes and individuals to contract out of the additional state pension.
- There are normally no survivor benefits with BSP. The exception is where a married couple's pension is being paid. If the man dies his wife would then receive a BSP based on her late husband's contributions. The right for a woman on marriage to pay a lower rate of NIC and rely on her husband's contributions was abolished in 1978
- SERPS and S2P will pay at least 50% of the pension to a surviving spouse.
- All parts of the state pension can be deferred, either at SPA or later although only one deferment can be made. The minimum deferment is 5 weeks and the pension will increase by 1% for every 5 weeks it is deferred. This is 10.4% for a 12 month deferment. Alternatively, if it is deferred for 12 months it can be taken as a lump sum with interest at 2% above base rate. This is taxable but the rate will be based on the first £1 of income. In other words, if the payment is £8,000 and before this is added to other non-savings income, the individual is paying basic rate tax, the whole sum will be taxed at 20% even if some of it is in the higher rate band
- The BSP will increase each year by the greater of, CPI, National Average Earnings or 2.5%. This is known as the **Triple Lock.** Additional State Pension will only increase by CPI.

The Single Tier State Pension

On April 6 2016 the whole state pension system changed. Before looking in detail at how this will be calculated it is useful to take an overview of the changes.

- The new system will only apply for men born on or after April 6 1951 and for women born on or after April 6 1953. Everyone born before those dates will carry on under the old system.
- April 6 2016 marked the start of a long process that could take 30 to 40 years to complete.
- For 20/21 the payment is £179.60 a week.
- Contracting out was abolished so members of formerly contracted out schemes now pay higher NIC.
- The number of years' NIC contributions to qualify for the full pension is now 35 years and there is a minimum requirement to have 10 years otherwise nothing will be paid.
- Pension deferment is still possible but deferment must be for 9 weeks to get a 1% increase. The lumps sum option has been abolished.
- The STP will increase each year using the Triple Lock

Transitional Arrangements

The easiest way to understand how the system works is to take the example of someone who starts work for the first time after April 6 2016.

Simon started work on May 1 2016. Every year he has a full NIC record he will build up 1/35th of the current flat rate pension. For 21/22 that would be £5.13 a week.

After 35 years he would be entitled to the full pension at his state pension age. That is likely to be well before SPA and he will continue to pay NIC until then but will not get any further increase in his pension entitlement.

It doesn't matter if he earns just the minimum wage all his whole working life or he is a high flying executive, he will get the same pension. There is no earnings related element.

For at least the next 30 years most people who reach state pension age will have pre April 2016 benefits and these will be taken into account in calculating their pension rights.

Everyone who comes under the new system will get a **starting or foundation amount.** This will calculate the individual's pension based on both the old and the new basis as at 6 April 2016 and the starting amount will be the highest of these two.

Individuals who have been contracted out will have a deduction from the starting amount. This will apply whether the individual was a member of a contracted out scheme or contracted out using a Personal Pension between 1988 and 2010. The rationale behind this is that having been contracted out you will have an additional pension from another source.

The starting amount will either be more or less than the original single tier pension of £155.65 a week.

If it is higher the excess amount is called a **protected payment**.

Antonia is 50 and has a starting amount of £200.65 a week because she has substantial additional state pension rights. Her protected amount is £45 a week.

This will be increased each year in line with CPI and paid on top of the flat rate pension. However, whilst she will continue to pay NIC for the rest of her working life she will not build up any further increases to her pension.

If the starting amount is below £155.65 a week then each year's NIC will build up another 1/35 of the current STP a week until they have built up entitlement to the flat rate pension.

Tristan is five years off his state pension age and his starting amount is £120 a week. For the next five years he builds up 1/35 of that year's STP.

Voluntary NIC Contributions

Anyone reaching state pension age after April 5 2016 needs 35 years "qualifying years" so if someone has less than this their pension will be reduced. Anyone with less than 10 qualifying years will not get a state pension.

Making voluntary contributions enables individuals to ensure the current tax year becomes qualifying or to "buy back" earlier years that aren't qualifying to increase their state pension. Whilst the principle is simple the details are more complicated.

The main restrictions on voluntary contributions are:

- Anyone who reached State Pension Age (SPA) before 6 April 2016 cannot increase their pension above the current level of the Basic State Pension.
- Anyone who reached SPA on or after 6 April 2016 cannot increase their pension above the level of the Single Tier Pension (£179.60 a week in 21/22).
- The number of missing years that can be made up is limited.
- Voluntary contributions cannot be made in the tax year the individual reaches State Pension Age.

Should voluntary NIC be made?

With a state pension age of 66 from 2020 individuals could be working for 46 years. Since only 35 years' contributions or credits are needed it is unlikely anyone younger than 40 need be concerned about paying voluntary NIC even if for whatever reason they have not built up a credit in that year.

Individuals approaching state pension age may realise that they are short of the 35 years or the 10 years to get any pension at all. Before making any decision, a state pension forecast should be obtained.

Individuals who were contributing prior to April 2016 will have a **starting amount** based on the greater of the pension accrued on the old basis or on the new basis. In both cases a deduction will be made for periods when contracted out.

If the Starting amount is less than £155.65 a week it does not mean that they should start paying Class 3 contributions. Every qualifying year from 2016/17 will build up 1/35th of the STP.

Jo is 50 and has a foundation amount of £120 a week. She plans on working another 10 years so will reach the Single Tier Pension and should not make Class 3 NIC (The STP will be higher than £155.65 week by the time she reaches SPA but so will the credit she will get for each qualifying year.)

Individuals who don't intend to work between retirement and state pension age can also boost their state pension by making Class 3 contributions. This can be very useful to anyone who has been contracted out for most of their life.

Helen is a teacher who retired in 2016 aged 60. She had 35 years service but her starting amount is equivalent to the Basic State Pension as she was contracted out throughout her working life. Her state pension age is 66 but as she doesn't intend to work between now and then her starting amount will not increase. She can however pay class 3 NIC as each year's contribution will increase her state pension by £5.13 a week based on 2020/21 rates.

This is excellent value since for a total cost of £800 (52 x £15.40) she will get an additional indexed linked pension of around £250 a year. This means if she survives beyond 69 she will have received more in pension than the initial cost.

That concludes this chapter so you should now understand:

- How individuals build up their rights to a state pension.
- The differences between the pre and post April 2006 regime
- How voluntary NIC can be made.