

J05 2021/2022

The State Pension System

This section will cover the State pension system a notoriously weak area for many candidates. There may only be one or two questions but getting these right could be the difference between a pass and a fail.

The milestones are to understand:

- How individuals build up their rights to receive a State Pension.
- The differences between the pre and post April 2016 regime
- To understand how post April 2016 benefits are calculated
- When it can be useful to make voluntary NIC

State Pension Overview

Whilst there has been some form of state pension for over 100 years, the concept of a universal pension covering everyone started in 1948. It went through a number of changes until April 2016 when a new system, the **Single Tier Pension** was introduced. Anyone qualifying for state pension age before 6 April 2016 will remain on the old basis, anyone reaching state pension age after 6 April 2016 will get their pension on the new basis.

There are similarities between the two which can be summarised as follows:

- Both can only be taken once an individual reaches state pension age. This is currently 66 for both men and women. It cannot be taken earlier but both can be deferred in return for a higher pension.
- Individuals qualify by paying National Insurance Contributions (or credits).
- They are funded on a “pay as you go basis”. An individual’s NIC do not go into a fund but are used to pay the pensions of those who have already retired. It also means that if you die before SPA nothing is payable
- Both are paid gross but are taxable

Why the Government changed the system

When the post war pension was set up in 1948 it was a simple flat rate benefit at the princely rate of £1/6s/0d (£1.30) a week. Originally called the Old age Pension, the current term is Basic State Pension. As time went on earnings related benefits were added. These were:

- Graduated Pension Scheme (GPS) from the late 1950’s up until April 1975
- State Earnings Related Pension Scheme (SERPS) April 1978 to April 2002
- State Second Pension (S2P) April 2002 to April 2016

Each had its own rules regarding eligibility and entitlement. Moreover, final salary schemes could contract out all its members from these elements. Then to add further confusion there were welfare benefits that could top up the pension but if individuals had savings these could make the individual worse off.

In short it was very complex system that made it difficult for an individual to forecast what they might get and whether making additional savings would reduce their pension.

The government's response was to set up the **Single Tier Pension**. This goes back to the original concept of a flat rate pension but at a higher level than the BSP.

A summary of the pre April 2016 system.

- This was made up of the flat rate Basic State Pension (£137.60 a week for 21/22) and possible 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 earnings related elements. 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.

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 21/22 it 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.

STP is a quasi DB scheme since each year's contributions builds up 1/35 of that year's STP

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 have built up a full entitlement. Whilst this might be 20 years away, he must continue paying NIC 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.

The benefits of this system are:

- Simon has a much clearer picture what he will get.
- Whilst the UK pension is low compared to other European countries, at around £9,000 it provides a foundation and if Simon makes further additional pension or other savings, these won't reduce what he gets with the STP

Transitional Arrangements

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 the amount they will receive.

Everyone reaching SPA after 6 April 2016 got a **starting or foundation amount**. This is the amount of an individual's state pension on April 5 2016 calculated by using both the old and the new basis and the starting amount will be the highest of these two.

Individuals who had 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 higher or lower than the original single tier pension amount 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 was 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 $\frac{1}{35}$ th of that years STP. A potential additional pension of $\frac{7}{35}$ or $\frac{1}{7}$ th of the STP. However he can never receive more than the STP in the year he reaches SPA. Provided he has 35 years contributions he will always get a pension equivalent to the BSP.

We'll now look at some other common features of pre and post 2016 benefits.

Inflation protection

The Basic State Pension and the Single Tier Pension are increased each year by the “triple lock”. This is the greater of CPI, National Average Earnings or 2.5%. Any earnings related element of the old system together with any protected amount of STP is only increased by CPI.

If an individual leaves the UK they will still receive their pension but may not get any annual increases. This usually applies to those who have moved to a Commonwealth country.

Survivor benefits

Until 1978 a married woman could elect to pay a lower rate of National Insurance. The result was that she would not build up a pension for herself but would rely on her husband's contributions. When he reached the then SPA of 65, he would receive a married couple's pension and if he died first, his widow would usually receive a single person's pension.

Women who married on or after 6 April 1978 didn't get this option and will build up their own pension. Therefore, there is no survivor benefit with either the BSP or STP, the pension ends on the person's death.

However up to 50% of any earnings-related benefits including the Protected Amount of the STP can be inherited by the surviving spouse or Civil Partner

Deferring State Pension

About two months before reaching state pension age individuals will be contacted, told how much they will receive and asked whether they wish to start taking it.

This might seem a no brainer but there can be good reasons why it should be deferred. The most likely reason is that an individual is still working and doesn't need the pension, particularly if it would take them into a higher tax bracket.

By deferring the pension you will receive an increased pension but the terms are different depending whether it's pre or post April 2016.

- A pre-April 2016 pension will be increased at the rate of 1% for every five weeks of deferment which is about 10.4% a year

- A post April 2016 pension is increased at 1% for every nine weeks of deferment which is about 5.4% a year.

Another difference is that someone who defers a pre-April 2016 pension can take a taxable lump sum which is the amount they gave up increased by Base Rate + 2% for every year of deferment. This option isn't available for anyone with a post 2016 pension.

A deferred lump sum is taxed in a unique way.

Thirza deferred her pension and became entitled to a lump sum of £18,000. Her other income was just £500 short of the higher rate threshold. All the lump sum would be taxed at 20% as the first £1 of the lump sum was in the basic rate band.

Deferment can be selected when individuals reach SPA but also at a later date. However, deferment can only be done once.

Jack took his state pension immediately but three years later he was offered a 12 month contract to write some training material so he deferred his state pension until the contract ended.

Two years later he was offered another contract but he could not defer his state pension.

Interaction with welfare benefits

As a percentage of average earnings the UK pension is one of the lowest in the EU there has always been an element of welfare top up. Currently **Pension Credit** guarantees that everyone will receive a minimum income once they reach SPA. For 2021/2022 this is £177.10 a week for a single person and £270.30 for a married couple. If total income is below this figure individuals can claim the **Guarantee Credit** element of Pension Credit. This though is means tested so any savings will be taken into account.

There is a further **Savings Credit** that can only be paid to those who reached State Pension Age before April 6 2016. This mitigates the effects of means testing for those who have made some savings.

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, normally you only make up the last 6 years.
- Voluntary contributions cannot be made in the tax year the individual reaches State Pension Age.
- Women who elected to pay the lower rate of contribution cannot buy back those years when they were paying the lower rate.

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 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 decided to pay class 3 NIC for 5 years and this increased her pension by as each year's contribution will increase her state pension by £25.65 a week (c£1,333 a year) when she gets her state pension.

This is excellent value since for a total cost of around £800 you will get an additional indexed linked pension of around £266 a year. This means if she survives beyond 69 she will have received more in pension than the initial cost.

It is even better for someone who is self employed who doesn't have profits above £6,515 as they can pay class 2 at £3.05 a week.

That concludes this part 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

- To understand how post April 2016 benefits are calculated.
- How voluntary NIC can be made.