



## Contracting Out of the State Second Pension (S2P)

### Tax Year 2006/2007

The Government introduced the State Second Pension (S2P) during 2002/03 which basically does the same job as the previous arrangement called SERPS (State Earnings Related Pension Scheme) i.e. provides an additional income for all employed individuals based on their earnings levels during the relevant tax year, but it is slightly more complicated to work out.

The Government's intention has been to make the State pension benefits simpler all round, with a change in two stages, the second change being made with effect from this tax year.

They have also wanted to ensure that the additional State benefit becomes more targeted, and they have had to keep an eye on the Minimum Income Guarantee (MIG) and Pension Credits that they introduced.

Because of all these issues, the Government reviewed the level of S2P rebates being offered to those who wish to Contract Out of the additional State benefit, and they are now offering rebates that are 'actuarially' equivalent to the S2P benefits being given up. This is meant to mean that the fiscal decision on whether to Contract Out or not has now been taken away as, all things being equal, everyone will end up with the equivalent benefits either way.

There is a wide degree of advice being given over who should or shouldn't now Contract Out. The general opinion for the last few years has been that the S2P rebates were too low, and therefore no one should be Contracted Out. For the current year, 2006/2007, the general opinion is even stronger on the side of no one being Contracted Out.

We agree with the general opinions being expressed and would advise that the rebates provided are unlikely to be sufficient to provide a greater benefit than could be received under S2P.

It is important to understand the differences in the benefits available and following is a summary that may be of assistance.

### Why would you Contract Out?

The reasons why someone would Contract Out of S2P are really the same as to why they may have Contracted Out of SERPS previously, and these are listed below.

**Fiscal** – The potential benefits available from the monies invested in a Personal Pension Plan or Money Purchase Occupational Pension Scheme being greater than the potential benefits being given up under S2P.

**Emotive** – The belief that future Governments might not provide the potential benefits from S2P in the future, and therefore there is a desire to bring any monies available now under personal control. In addition, it is possible to take the benefits from the Contracted Out plan from age 50, 55 from the 2010/11 tax year, rather than 65 from the State.

The Fiscal comparison is obviously not an exact science as a number of assumptions have to be made on such things as underlying plan charges, future investment returns, future increases in National Average Earnings, and future annuity rates.

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As mentioned earlier, the rebates have now been calculated in such a way by the Government Actuary so that there should be no difference in the ultimate benefits. Having said that, the Government Actuary has had to make his own assumptions on the same issues and these assumptions were drawn up some time ago. Since then there has been a marked reduction in the actual returns achieved. Of course, this does not mean that in the future returns on investments will achieve the assumed returns.

## Current advice for the 2006/2007 tax year

Comments in the press, and also from some of the major insurance companies in the UK, suggest that everyone should contract back into S2P, as has been the case for the last few tax years. One of the major reasons being that net returns on monies invested are not what they were previously, and therefore will not be at the levels previously projected and, as such, the S2P rebates available are no longer likely to be sufficient to provide greater benefits at retirement.

Whilst this is generally the position we agree with, the blanket approach might not necessarily be appropriate for everyone.

Fiscal considerations:

- Obviously, the longer the length of time to go to retirement, the longer the time the funds have to grow. Therefore, there is still a fiscal argument for the younger element of the population to remain Contracted Out for the current tax year as they will hopefully be able to regain any short term losses.
- Linked with the above, one of the problems currently being faced by all pension arrangements which come to provide income for the owners/ beneficiaries, is that annuity rates are at a low and have been depressed for a number of years. Whilst there is no indication of an upturn just yet, there is a reasonable chance that over the longer term, say 10 years plus, annuity rates may creep back up. If this happens, then the projected fund values will be able to purchase greater incomes.
- Obviously, on the reverse side to this is that, even if the investment conditions are suitable to allow annuity rates to rise, the fact that life expectancy is increasing might keep annuity rates depressed, furthermore under the Pension Simplification legislation introduced this year it is now possible never to purchase an annuity which might have an impact on annuity rates over the longer term.
- Single people will not have any benefits from the spouse's benefit provided by S2P, therefore the additional monies can be used to provide additional benefits for them on retirement, or their chosen beneficiaries on their earlier death.
- Emotive considerations:
  - The emotive reasons are still strong, relevant, personal and valid and are:
  - You might not believe the Government will provide you with the benefits that are being promised now, in the future;
  - You might wish to have control over your own monies;
  - You might want to be able to take your benefits when you want to take them, rather than having to wait until the State Pension Age.

## Summary Recommendations

- During 2006/2007, everyone should be in S2P.
- Anyone already Contracted Out should therefore Contract Back In.

However, Contracting Out may be appropriate for you on a personal level if

You believe that the benefits being promised by the current Government under S2P will be reduced by the time you retire;

or

You feel that it is almost certain that you will not be married when you come to take your benefits;

or

You wish to have as much money in your direct control as possible;

or

You wish to take your benefits before the State Pension Age.



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## Contracting Back In during 2006/2007 Tax Year

- Personal Pension Policy Holders Only

Once a decision has been made to **Contract Back In** to the State Second Pension (S2P), you will need to complete a form and send this to the Insurance Company through whom you are currently Contracted Out.

The appropriate form has the reference **CA1543**, and is called '**Cancellation Notice to stop payment of Minimum Contributions**'.

Each Insurance Company will have a supply of their own forms you can use and you should therefore make contact with them in the first instance.

Once you have completed the form, it will need to be sent back to the Insurance Company, who will then sign it and forward it onto the relevant section of the Department for Work and Pensions.

- Everyone else

Once you have made the decision to **Contract Back In** to S2P, you will need to advise your Scheme administrator who will then arrange for the completion of any appropriate forms. In some instances it might not be possible for you to **Contract Back In** and remain a member of the Scheme. Your Scheme administrator will advise you if this is the case.

You should realise that there may be an alteration in your take home pay, as under some Schemes the cost of Contracting Out have been absorbed by the Scheme, or are allowed for in your normal Pension Scheme contributions. Again, your Scheme administrator will be able to advise you further on this aspect.

**We would strongly advise that you seek independent financial advice to ensure that any decision you do make is in line with your own requirements.**



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