

# The State Second Pension and contracting out



This factsheet is from the Financial Services Authority (FSA), the independent watchdog set up by government to regulate financial services in the UK and protect the rights of consumers.

This factsheet is for you if you're an employee and are contracted-out or are thinking of contracting out of the State Second Pension. It's good to review your position before the end of the tax year (5 April 2007) as your decision will affect your pension fund for the current tax year.

This factsheet is not for you if you are:

- self-employed – as you cannot build up a State Second Pension; or
- a member of an employer's occupational pension scheme which is contracted-out, because the decision has been made for you and you cannot change it.

## What is the State Second Pension?

Nearly everyone can expect to get a basic State Pension when they reach State Pension age. You will also qualify for the State Second Pension – or S2P for short – if you're employed and earning above a certain level on which you have paid National Insurance contributions. Until April 2002, the second pension was called the State Earnings Related Pension Scheme (SERPS).

## What is contracting out?

The government allows people to leave S2P and this is known as contracting out. If you contract out through a personal or stakeholder pension, the government will pay some of your National Insurance contributions (called 'rebates') and income tax relief into a personal or stakeholder pension of your choice. The private pension replaces some or all of your S2P.

If you are a member of your employer's contracted-out occupational pension scheme, both you and your employer will pay reduced rate National Insurance contributions. Your occupational pension replaces some or all of your S2P.

## Does contracting out affect me?

If you have a personal or stakeholder pension and are not sure whether you are contracted-out, ask your pension provider to check.

## I am contracted-out, what should I do?

If you are contracted-out through a personal or stakeholder pension, you should review your decision now.

Your decision about whether to stay contracted-out depends on, among other things, your own personal circumstances and attitude to investment risk.

Your decision is about now and the future but you should review it every year. It does not affect past years in which you were contracted-out.

An independent report which we published in August 2005 says that, in purely financial terms, most people who contract out or stay contracted-out this year are likely to get a lower pension than if they were in S2P. The report looks at recent trends and makes assumptions about future investment returns and interest rates. It also assumes that S2P stays in its current form. The government is currently looking at pensions reform and it is difficult to predict what will happen to S2P in the future.

The table overleaf summarises the features of contracting out and the flexibility it offers. It also compares contracting out with being in S2P.

**This table compares the differences between being in and out of the State Second Pension.**

	<b>Contracting out or staying contracted-out of S2P</b>	<b>Contracting in to S2P</b>
<b>How does your pension grow?</b>	The government pays your rebates into a personal or stakeholder pension of your choice. Personal and stakeholder pensions invest in, among other things, the stock market.  Investments can go down as well as up. So you may end up with a smaller pension than with S2P.	You rely on government policy to decide how much you will get from your S2P.  Governments may change pension policy, so you may end up with less S2P than calculations based on current pension policy would suggest.
<b>What happens when you retire?</b>	When you retire you use your pension fund to buy an annuity. An annuity is a special type of investment that converts your pension fund into retirement income. Annuity rates depend on your age, sex, health and personal circumstances.  You can take your personal or stakeholder pension from age 50 but this is going up to 55 by 2010.	The government will pay your S2P at the same time as your basic State Pension. The amount you get depends on National Insurance contributions you have paid during your working life.  You can currently claim your State Pension at 65 for men, and 60 for women. The pension age for women is gradually going up to 65 by 2020.
<b>What happens if you die before you retire?</b>	If you have a spouse or civil partner and die before you retire, your contracted-out fund may be used to provide benefits for them.  If you don't have a spouse or civil partner, your contracted-out fund can be left as a part of your estate.	If you have a spouse or civil partner and die before you start taking your State Pension, they may be eligible for half the S2P you have earned.
<b>What happens if you die after you retire?</b>	If you have a spouse or civil partner when you retire, you will have to buy an annuity that will pay out half the income to your spouse or partner if you die before them.	If you have a spouse or civil partner, they may qualify for a portion of your S2P if you die before them.
<b>Is there a tax-free lump sum option?</b>	You are able to take 25% of your contracted-out fund as a tax-free lump sum when you retire. This will reduce the amount you have left to buy your annuity.	You cannot take a tax-free lump-sum.

**I've made my decision – what now?**

If you've considered all the above points and are happy with your current position, you don't need to do anything now.

But you should review your decision next year because things change. The government is reviewing pensions policy and this may affect the things you need to consider in the future.

If you decide to change your current position, contact your pension provider. They will give you the necessary forms to complete. Make sure you do this before 5 April 2007 if you want to change things for the current year.

**Where can I get help and advice?**

If you need professional advice, AIFA (The Association of Independent Financial Advisers) has a list of advisers who can give advice in this area. See their website at [www.aifa.net/contractingout/home.htm](http://www.aifa.net/contractingout/home.htm).

For more information about pensions, read

- **the FSA guide to pensions 2: reviewing your pensions** – for tips on reviewing your pensions and how you can 'top up'.
- **the FSA guide to pensions 3: annuities and other retirement options** – explains about annuities and other options when you reach retirement age.

You can view or order these guides online on our website or Consumer Helpline (call rates may vary) – see below.

**The FSA's consumer publications aim to give you general information to help you make financial decisions. The information does not constitute financial or other professional advice: for advice about your own circumstances, you should consult a professional adviser.**



May 2006