Abolition of contracting out on a defined contribution basis

Published: March 2011

To help simplify the pensions system and decisions about retirement savings, the Government has decided to abolish contracting out on a defined contribution basis.

At the moment, some pension schemes are set up to provide a pension which replaces all, or part, of the additional State Pension (also called the State Second Pension). This includes some company, stakeholder and personal pension schemes. When you join one of these pension schemes, you are said to be ‘contracted out’ of the additional State Pension.

There are two ways of contracting out, based on how the benefits are to be calculated. Some company schemes, generally money purchase or defined contribution schemes, along with personal and stakeholder pensions, contract out on a **defined contribution basis**. Other company schemes, normally defined benefit schemes, are contracted out on a **salary-related basis**. Currently individuals who are members of a contracted out scheme pay lower National Insurance contributions and/or receive some National Insurance rebates into their pension scheme.

What is happening?

The Government is planning to end contracting out of the additional State Pension on a **defined contribution** basis from 6 April 2012.

What do I need to do?

If you are in a personal, stakeholder or company pension scheme which contracts out on a defined contribution basis, it is important for you to read this factsheet to understand how abolition will affect you. If you are in a contracted-out personal or stakeholder pension scheme you should also read section A. If you are in a contracted-out company pension scheme you should also read section B.

If you are not sure whether your pension scheme is contracted out, or on which basis, you should look at your pension documents or contact your pension provider.

Which contracted out schemes will be affected by abolition?

- Personal pensions
- Stakeholder pensions
- Company pensions contracted out on a defined contribution basis

Company schemes which contract out on a salary-related basis can continue to do so.

What are the changes to defined contribution contracted-out pension schemes?

From 6 April 2012, the planned changes mean that you will no longer be able to use a pension contracted out on a defined contribution (money purchase) basis in place of the additional State Pension.

Instead you will automatically be brought back into the additional State Pension and, depending on your earnings, you may begin to build up entitlement to the additional State Pension from this time. In most cases you will earn entitlement to the additional State Pension. There may be some cases in which you won’t, for example if you stop working or earn less than the Lower Earnings Limit.

HM Revenue & Customs

DWP Department for Work and Pensions

Why is contracting out on a defined contribution basis being abolished?

The National Insurance rebates an individual and, where applicable, their employer currently get if they are contracted out are intended, when invested in the contracted-out scheme, to provide benefits broadly the same as those given up in the additional State Pension. However, benefits from defined contribution schemes can vary depending on investment returns and annuity rates. This means it is difficult for individuals to predict with any degree of certainty whether they would be better off in the additional State Pension or contracted out. To help simplify the pensions system and decisions about retirement savings, the Government has, therefore, decided to abolish contracting out on a defined contribution basis.

How much additional State Pension will I get once I am back in the State system?

From 6 April 2012, instead of receiving rebates of your National Insurance contributions you may begin to build up entitlement to the additional State Pension. For every year that you pay National Insurance on earnings over £5,044 a year (based on 2010/11 earnings) you will get around an extra £1.60 a week on your State Pension when you come to claim it.

People earning above £14,100 a year (based on 2010/11 earnings) will also be entitled to an extra earnings-related payment but the earnings-related payment will be gradually withdrawn so that by about 2030, additional State Pension will be made up of the flat-rate amount only.

However, you should also be aware that on 4 April the Government published a consultation on proposals for simplifying the State Pension system. It includes two options:

- to speed up the transition to a two tier flat rate pension; or
- to create a single tier flat rate pension above the Pension Credit standard minimum guarantee.

The consultation, *A state pension for the 21st century*, can be found at www.dwp.gov.uk/state-pension-21st-century. The consultation ends on 24 June 2011.

These proposals will only affect pensioners who reach State Pension age on or after any changes are introduced.

I thought the Government was encouraging people to save in private pensions – why are you stopping me doing so?

All this change will do is remove the option for people to use this type of pension arrangement in place of the additional State Pension. You will still be able to save in a defined contribution company, personal or stakeholder pension scheme.

What do I need to do?

- This factsheet will help you to understand how the abolition of contracting out on a defined contribution basis will affect you. If you are in a contracted-out personal or stakeholder pension scheme you should also read **section A**. If you are in a contracted-out occupational pension scheme you should also read **section B**.

- Your pension scheme administrator or employer should contact you before the date of abolition in order to explain how your scheme will operate in future.

- You should continue to review your pension position as you may wish to consider opting back into the State system prior to the abolition date.

HM Revenue & Customs

DWP Department for Work and Pensions

Section A

Q&A for employees in a contracted-out personal pension scheme or a contracted-out stakeholder pension scheme

What does it mean for me?

- From 6 April 2012, the planned changes mean that you will no longer be able to use a personal or stakeholder pension in place of the additional State Pension.
- The Government will no longer make National Insurance rebate payments into your pension scheme in respect of earnings paid in tax years from the 6 April 2012.
- You can continue to pay your personal contributions into your scheme as usual.
- You may, depending on your level of earnings, start to build up entitlement to the additional State Pension instead.
- The changes will not affect any past or future entitlement you have to the Basic State Pension.

Will my rate of National Insurance contributions change as a result of abolition?

No. However, the Government will no longer pay a rebate of National Insurance contributions into your personal or stakeholder pension.

What will happen to the National Insurance rebates that have already been paid into contracted-out personal and stakeholder pension schemes?

The money already in the scheme will remain invested to provide benefits in place of the additional State Pension for the time that you were contracted out.

At the moment the rebates together with any investment return are known as "protected rights". There are currently restrictions on how protected rights can be used, over and above the restrictions which apply generally to pension scheme benefits.

This is because they are intended to be used to provide benefits in place of the additional State Pension. However, from 6 April 2012 these restrictions will no longer have to apply and benefits can be paid according to the pension scheme's rules. Your pension provider will be able to give you more details.

I have a rebate only pension scheme, what will happen to it in the future?

A 'Rebate-only Pension' is one where the only contributions paid into it are the end-of-year rebates of National Insurance contributions paid by the Government direct to the pension scheme. Following abolition, these rebates will no longer be made in respect of any earnings paid in tax years from the 6 April 2012. However, rebates paid for tax years before 6 April 2012 will remain in the scheme to provide benefits in place of the additional State Pension for the time you were contracted out. If you wish you can transfer these rights to another pension scheme if the new scheme is prepared to accept them.

Can I make payments into my personal or stakeholder pension scheme after the abolition date? Will I still get tax relief?

You will still be able to continue to make payments into your personal or stakeholder pension, but you will no longer receive a rebate of your National Insurance contributions. Tax relief will still be available on any of your own payments that you continue to make.

How do I know if I have used my stakeholder/personal pension to contract out?

If you have used your stakeholder/personal pension to contract out, details should be in the paperwork sent by your pension provider.

For example, the annual statement you receive about your pension will give information about National Insurance rebates received from HMRC or details of protected rights. Otherwise contact your pension provider.

Where can I go to find out more about my contracted-out personal/stakeholder scheme and the changes to contracting out?

Your pension provider

Your pension provider will be able to answer questions about your particular pension scheme and how it will be affected by the changes to contracting out.

Her Majesty's Revenue and Customs (HMRC website)
Find out more information about National Insurance and contracting out.

The Pensions Advisory Service (TPAS website)
TPAS is an independent non-profit organisation that provides free information, advice and guidance on the whole spectrum of pensions, including State, company, personal and stakeholder schemes.
Telephone Helpline: 0845 601 2923

Directgov (website)
Find out further information about State Pensions.

HM Revenue & Customs

DWP Department for Work and Pensions

Section B

Q&A for employees in a contracted-out defined contribution company pension scheme

What does this mean for me?

- As you are contracted out, you and your employer currently pay lower National Insurance contributions. Following abolition, you will both pay standard rate National Insurance. The higher National Insurance contributions will go towards building up entitlement to the additional State Pension.
- Your employer currently has to pay the difference between the two rates of National Insurance into your pension scheme. This amount is known as the 'minimum payment'. However, following abolition, this will no longer happen as you and your employer will be paying the standard rate of National Insurance contributions.
- You and your employer may currently pay more than the minimum payment into the pension scheme. Any further contributions paid into the scheme will continue to be invested on your behalf and used to provide benefits when you retire.
- The changes will not affect any past or future entitlement you have to the Basic State Pension.

What will happen to the National Insurance rebates and minimum payments that have already been paid into my employer's scheme?

The money already in the scheme will remain to provide benefits in place of the additional State Pension for the time that you were contracted out. At the moment the rebates together with any investment return are known as "protected rights". There are currently restrictions on how protected rights can be used. This is because they are intended to be used to provide benefits **in place of the additional State Pension.**

However, from 6 April 2012 these restrictions will no longer have to apply and benefits can be paid according to the pension scheme's rules. Your pension scheme will be able to give you more details.

Can I still pay into my employer's pension scheme?

The end of contracting out will not stop you or your employer from paying into your employer's pension scheme. However, employers and schemes may implement the changes in different ways so you should contact your employer if you have any questions about how the scheme will be run after April 2012.

Does my employer still have to run a company pension scheme?

Employers do not have to run a pension scheme - they do this on a voluntary basis for the benefit of employees as part of an overall pay and reward package. The changes will not mean your employer has to stop running a pension scheme. You should contact your employer if you have any questions about how the scheme will be run after April 2012.

Where can I go to find out more about my contracted-out company scheme and the changes to contracting out?

Your employer or the scheme trustees

Your employer or the scheme trustees will be able to answer your questions about how the pension scheme will be run after April 2012, or what contributions you will pay towards your pension.

Her Majesty's Revenue and Customs (HMRC website)
Find out more information about National Insurance and contracting out.

The Pensions Advisory Service (TPAS)
TPAS is an independent non-profit organisation that provides free information, advice and guidance on the whole spectrum of pensions, including State, company, personal and stakeholder schemes.

Telephone Helpline: 0845 601 2923

Directgov (website)
Find out further information about State Pensions.

.

HM Revenue & Customs

DWP Department for Work and Pensions