The Single-Tier Transition and Contracting Out

Introduction

1. The Department published a technical note on 24 January 2013 describing the transition arrangements for the single-tier state pension. The note explains how we will undertake two valuations at the introduction of the single-tier pension. The higher of these amounts becomes the Foundation Amount.

2. Both calculations will take into account periods when people were contracted out of the additional State Pension (since 2002 this has taken the form of the State Second Pension and between 1978 and 2002 it was the State Earnings-Related Pension Scheme or SERPS). This reflects the fact that, whilst people were contracted out, they paid lower National Insurance contributions and received a National Insurance rebate to fund their workplace pension.

3. To ensure these periods are reflected fairly we use slightly different ways of **recording** contracting out in the two valuations. This note is intended to explain why.

4. The following is an overview of the way we have recognised amounts of workplace pension paid for by the contracted-out rebate over the years:

- **1978/79-1996/97 – The Guaranteed Minimum Pension (GMP).** For this period we work out what SERPS a person would have got based on the earnings they had - this amount is called Gross Additional Pension. We then work out how much pension a contracted-out scheme should pay based on the rebate received – the Guaranteed Minimum Pension (GMP). The GMP is then subtracted from the Gross Additional Pension, this is called the Contracted-out Deduction. If there is any net Additional Pension after this calculation the State pays this at State Pension age. The Contracted-out Deduction is calculated in the same way for Defined Benefit and Defined Contribution pension schemes.

- **1997/98-2001/02 – not recorded.** For the 5 tax years between 1997/98 and 2001/02 a contracted-out person had no Additional Pension recorded on their account - there was no need to do any form of offsetting.

- **2002/03-until implementation of the single tier.** From 2002/03 onwards a modified form of the 1978/97 arrangement is used to take account of the new State Second Pension rules.

The Single-tier valuation

5. On the introduction of single tier in 2016 we will undertake two valuations:

- the current scheme valuation – which uses exactly the same rules as if someone has reached State Pension age at that point;
- the single-tier valuation – which calculates what entitlement someone would have if the single tier had been in place at the beginning of their working life.

Both valuations take full account of people's contracted-out record. But the way it is **recorded** is slightly different in the two calculations.

Current Scheme Valuation

6. The calculation comprises basic State Pension (and any graduated pension) plus:

1. Gross Additional Pension minus the Contracted-out Deduction for any contributions until 1997;
2. Any SERPS built up through being contracted in between 1997/98-2001/02;
3. S2P for people who were contracted in (plus any S2P top-up for low to moderate earners who were contracted out) between 2002 and 2016.

7. There is no need to factor anything in for the period 1997/98 to 2001/02 (and from 2002 onwards) if the person had been contracted out.

Single-Tier Valuation

8. We take the qualifying years a person has at 2016 and multiply them by 1/35th of the full amount of single-tier pension up to the maximum of £144 (the illustrative amount of full single tier in 2012/13 earnings terms). This will provide an increase in pension for many people retiring in the early years of the single tier. However, we still need to take account of the National Insurance rebate (otherwise the person would get the benefit of the increase **and** any workplace pension they built up as a result of being contracted out).

9. For the period to 1997 this is straightforward as there will be a Contracted-out Deduction as per paragraph 6 (1) above. However, we also need to reflect that during the periods 1997-2002 and from 2002 onwards if someone had been contracted out they would be building the private pension equivalent of Additional Pension in the contracted-out scheme. So the Rebate Derived Amount is calculated as follows:

1. Contracted-out Deduction from 1978-97;
2. A new notional deduction in respect of being contracted out between 1997 and 2002 - this value will be the amount of SERPS the person would have had if they had been contracted in;
3. The deduction made from gross S2P in respect of being contracted out from 2002 to 2016.

Transition calculation - an example

The example is of a man born in 1957 who will reach State Pension age on 6 April 2023 at age 66. He started to work at age 21 in 1978. For the calculation we have assumed that this person has over 35 qualifying years and their Additional Pension is £2 a week for each year in which they have worked (plus £0.85 a year in S2P top-up). We have also assumed that the man has always been contracted out in a Defined Benefit scheme.

Period	Gross Amount of AP recorded in current	Net AP recorded in current	Rebate-Derived Amount in	Approximate amount paid by private

	scheme valuation	scheme valuation	single-tier valuation	pension
1978-97	£38	£0	£38	£38
1997-02	£0	£0	£10	£10
2002-16	£37	£11[1]	£26	£26
Total	£75	£11	£74	£74

Current Scheme Valuation

Using existing rules as if this person had reached State Pension age at the point of single-tier implementation in 2016 the current scheme valuation would be:

Basic State Pension	£107
Gross SERPS	£ 38
Minus Contracted Out Deduction	-£38
"Gross" S2P[2]	£ 37
Minus S2P "contracted out deduction"	-£26
Total Amount	**£118**

Single-Tier Valuation

Single-tier pension (35 qualifying years)	£144
Minus Rebate-Derived Amount	-£ 74
Total Amount	**£ 70**

Foundation Amount = £118

So in this case the current scheme valuation is the higher of the two valuations and becomes the Foundation Amount - this person receives a pension payable from the State of £118 and a further £74 paid by their workplace pension scheme. They can build a further 6 qualifying years (through contributions or credits) until they reach State Pension age. If they do this they could increase their pension by £24.66 (6x £4.11) and could retire on a single-tier pension of £142.66.

[1] This amount is the S2P "top up" which provides low to medium earners with an uplift

[2] The terms "gross" S2P and S2P "contracted-out deduction" are used to simplify this example (the actual calculation is more complicated and including it here would not aid clarity)