Pensions Policy Institute

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The Pensions Primer: A guide to the UK pensions system

Updated as at June 2014

The Pensions Primer: a guide to the UK pensions system

A reference manual by the Pensions Policy Institute

This version of *a guide to the UK pensions system* reflects the current position of, and legislated future changes to, the UK pension system as at June 2014. Any change in Government policy that may have occurred after that date is not included in this version.

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An introduction to the UK pension system

The foundations of the UK pension system were laid in the 1940s. Since the 1960s, successive governments have made many changes to both state and private pensions resulting in today's pension system which is complex and multi-layered.

This document is intended to provide a description of the UK pensions system for the purposes of considering pensions policy. It should not be used to make individual pension decisions.

This guide primarily reflects the current position of the UK pension system as at 30 June 2014. Any changes in Government policy that may have occurred after that day are not included in this version. The Pensions Act 2014, which received Royal Assent in May 2014 will have a major impact on the future pension system in the UK as it includes far-reaching changes, such as the introduction of a single-tier state pension. This paper sets out these changes in boxes.

This guide uses a box format to explain changes that have been legislated in Acts of Parliament but that are not yet applicable. Boxes are also used for areas in which the current Coalition Government has announced a change in policy that has yet to be enacted by Parliament, or areas in which it is consulting on future policy changes.

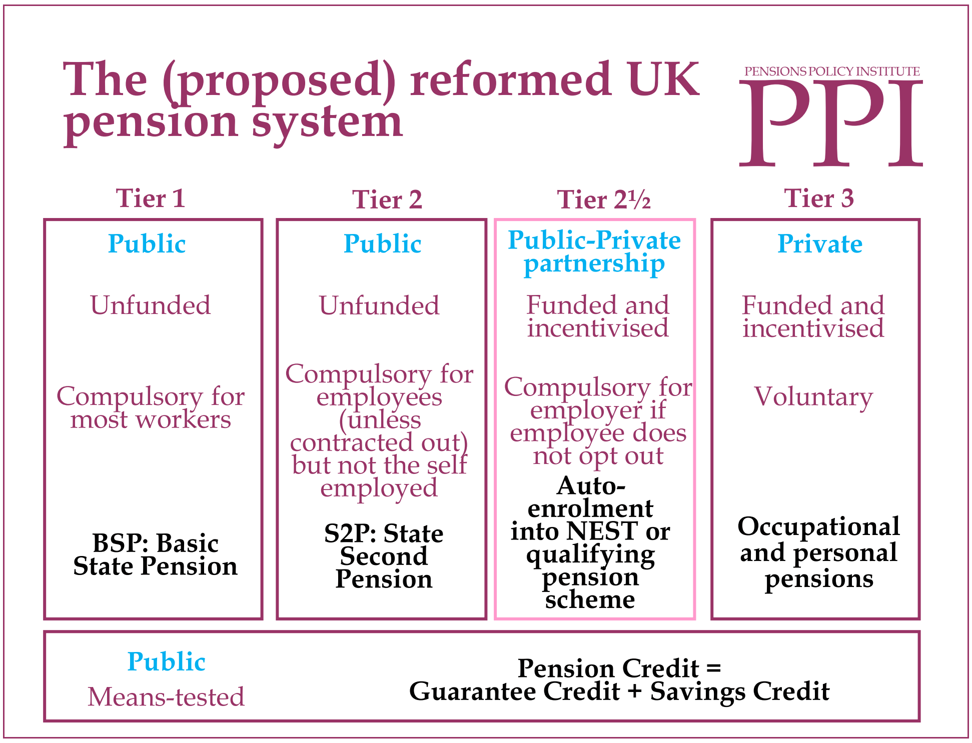
To explain the UK pensions system, this report uses a multi-tier framework. Until recently, this had three tiers; however, as it stands today, the UK pensions system has three and a half tiers:

- **Tier 1** is provided by the state and consists of a basic level of pension provision to which everyone either contributes or has access, providing a minimum level of retirement income.
- **Tier 2** is also provided by the state and aims to provide further pension income that is more closely related to employees' earnings levels. Tier 2 is less redistributive (from rich to poor) than Tier 1. Tier 1 and Tier 2 operate on an unfunded 'pay-as-you-go' contributory basis, through the National Insurance (NI) system.
- **Tier 2½** is a public-private partnership of individualised pension provision. This operates similarly to Tier 3, private provision, but will be funded through employee and employer contributions and Government tax relief. This was legislated following recommendations in the 2005 Pensions Commission Report. Auto-enrolment was introduced for the largest employers from October 2012 and will be in place for all employers by February 2018.
- **Tier 3** is private pension provision, namely all those voluntary pension arrangements that are not directly funded by the state. Private pension contributions, from the employer and/or the individual, fund designated pensions for the individual. The primary

aim of private pensions is to redistribute income across an individual's lifetime, and not to redistribute income from higher-income to lower-income people.

Chart 1 illustrates the three-and-a-half tier UK pensions system as it stands today. Although means-tested benefits span across the three tiers, they are covered in the *First tier provision* section of *a guide to the UK pensions system*.

Chart 1



The next section of this guide describes each of the tiers of the UK pension system. Subsequent Reference Notes (RN) provide details on many of the points covered.

First tier provision

The first tier of pension provision is provided by the state and consists of a basic level of pension provision to which everyone either contributes or has access, providing a minimum level of retirement income. Included are:
- The Basic State Pension
- Pension Credit

The first tier operates on a 'pay-as-you-go' basis, through National Insurance (NI) and general taxation. NI contributions levied on workers' earnings are used to pay the Basic State Pension. Pension Credit is funded through general taxation.

Pensioners receive other benefits, mainly funded through general taxation that could be considered as part of the first tier provision:
- Housing Benefit
- Council Tax Support
- Other (near) universal benefits

The **Basic State Pension (BSP)** is a contributory pension in the sense that the final amount of BSP paid to an individual depends on the number of National Insurance contributions made before reaching State Pension Age (SPA).

SPA depends on an individual's birth date. It is currently 65 years of age for men. Women's SPA is currently 62 and is rising to equalise with men's at age 65 by November 2018 (Pensions Act 2011). Men and women's SPA will increase to 66 between December 2018 and October 2020 (Pensions Act 2011).

Under previous legislation, SPA will increase to 67 between 2034 and 2036 and to 68 between 2044 and 2046. However, the Government announced that SPA will now increase to 67 between 2026 and 2028.[1] This change was included in the Pension Act 2014 which received Royal Assent on 14 May 2014. The Government has also announced an intention to review the timescale for the rise to age 68.[2]

The Pensions Act 2014 sets out the Government's plans for the SPA in the future.[3] This includes legislation for a framework which provides for a review of the SPA every 5 years, the review to be based around the principle that people should expect to spend a certain proportion of their adult life in retirement (based on analysis provided by the Government

[1] Announced in the Chancellor's Autumn Statement: https://www.gov.uk/government/topical-events/autumn-statement-2013
[2] https://www.gov.uk/government/policies/reviewing-the-state-pension-age
[3] *Pensions Act 2014* http://www.legislation.gov.uk/ukpga/2014/19/contents/enacted

Actuary's Department and an independently-led body). For this purpose, adult life is defined as starting at age 20.[4]

Introduction of the Single-Tier pension
Pensions Act 2014, which achieved Royal Assent in May 2014 made provisions for the introduction of the single-tier pension, which will replace the current Basic State Pension and Pension Credit. The single-tier pension will be set at a level above Guarantee Credit, which is currently £148.35 a week (from April 2014) and the Government has promised to recognise all previous state pension entitlements.

The single-tier pension will only be available to pensioners retiring after the date of implementation, this was initially planned to be 2017 at the earliest; however, the Chancellor announced in the Budget 2013 that this will take place from 2016.[5]

There are important differences from the current system; 35 years of National Insurance Contributions or credits will be required for an individual to receive the full pension, and there will be a minimum qualifying period which is yet to be set but will be not more than 10 qualifying years.

The transition process will translate people's pre-implementation National Insurance records into a simple single-tier starting amount, known as the 'Foundation amount' – those people with a foundation amount that is less than the full level of the single-tier will be able to take it up to the full level.

The National Insurance contribution rules for BSP are complex, and there are a number of ways in which contributions can be made or credited. There are further rules for married couples, people with incomplete contribution records, and older pensioners. For people retiring after 6 April 2010 until April 2016, 30 years of National Insurance contributions will be considered to be a full contribution record, and a proportionate amount of pension is paid to those people who have paid fewer than 30 years of National Insurance contributions.

BSP is a redistributive, flat-rate state pension payable once an individual reaches State Pension Age. Subject to having made the same number of contributions, individuals will receive the same level of benefit, irrespective of the size of the contributions. An individual with a complete National Insurance contribution record will receive a full BSP of £113.10 a week from April 2014.[6]

[4] DWP (2013) *The core principle underpinning future State Pension age rises: DWP background note*
[5] HMT (2013) *Budget 2013,* p. 5. www.hm-treasury.gov.uk/budget2013_documents.htm
[6] DWP (2014) Proposed benefit and pension rates 2014 to 2015
https://www.gov.uk/government/publications/proposed-benefit-and-pension-rates-2014-to-2015

Claiming the BSP can be deferred until after State Pension Age in return for an increase in the level of state pension payments. Those who defer claiming their state pension for less than twelve months receive an enhanced state pension. Those who defer claiming their state pension for at least twelve months can choose to receive an enhanced state pension or a taxable lump sum and a non-enhanced state pension.[7]

Between 1974 and 1979, BSP was increased annually by the greater of the increase in National Average Earnings (NAE) or the increase in the Retail Prices Index (RPI). Since 1979, annual increases have generally been linked to RPI.[8] The net effect of past uprating has been that, although the value of the full BSP has increased in price terms since the 1970s, it has reduced relatively to average earnings from 24% of NAE in 1974 to an estimated 16% of NAE in 2009.[9]

From April 2011 the BSP is uprated by the higher of the increase in earnings, the Consumer Prices Index (CPI) or 2.5%. The Government has named this mechanism the "triple lock"[10] and have pledged to keep it in place at least until the end of the current Parliament. However, legislation only provides that the increase in the basic state pension must be at least at the rate of the increase in average earnings.

In addition to the Basic State Pension, there are a number of means-tested benefits that pensioners may be eligible for depending on their circumstances.

Pension Credit (PC) has two components: Guarantee Credit (GC), currently payable from age 62, and Savings Credit (SC), payable from age 65. From 2010, the minimum age for receiving GC is increasing in line with increases in women's SPA, (as introduced by the Pensions Act 1995).[11]

Guarantee Credit is the main means-tested benefit currently paid to those aged 62 and above. As the name suggests, it is a benefit paid if other means (sources of income) do not reach a certain level. If claimed, it provides a safety-net of a minimum level of income. GC is paid on a 'benefit unit' basis; meaning that it is paid to a single person or a couple, on the conditions that income from other sources is below the level of full

[7] *Deferring your State Pension: leaflet* http://www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/@over50/documents/digitalasset/dg_200597.pdf
[8] Since 2004 BSP has been increased by the higher of 2.5% or the RPI
[9] PPI estimate; Department for Work and Pensions (DWP) (2009) Abstract of Statistics 2008 Section 5 - Rates of Benefit http://research.dwp.gov.uk/asd/asd1/abstract/abstract2011.pdf and Office for National Statistics (ONS) (2009) Annual Survey of Hours and Earnings 2009 http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings/2009-revised/index.html
[10] See: http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/fin_consumer_finprovision.htm
[11] The State Pension Credit Act 2002 sets the qualifying age for the Guarantee Credit to be the same as the State Pension Age for women.

GC, and provided any hours worked and savings held are below specified limits.

GC is redistributive. It is paid for from current taxes, which increase with an individual's income, while GC payments are only made to those on low incomes.

Currently, GC provides a minimum income of £148.35 a week for single people and £226.50 a week for couples. GC entitlement can be higher for disabled people, people with caring responsibilities or people with a mortgage.

The Pensions Act 2007 requires the GC to be increased by a percentage at least equal to the increase in national average earnings. For 2013/14 the Government increased the GC by a higher percentage than the rise in national average earnings; resulting in a rise in the benefit similar to the cash rise in the Basic State Pension.[12]

Savings Credit aims to ensure that those who have made some private provision for retirement, or have made provision in excess of the Basic State Pension, including SERPS and S2P, will be better off than those who have made no provision.

The maximum amount payable under Savings Credit is £16.80 a week for a single person and £20.70 a week for a couple from April 2013. For every £1 of income received[13] above the level of the Savings Credit threshold (£120.35 for single pensioners and £192.00 for couples, in 2014/15), but below the level of Guarantee Credit, Savings Credit pays an additional benefit of 60p. The credit is then 'tapered down' for additional income above the Guarantee Credit level.

Housing Benefit and Council Tax Support are means-tested benefits available to both pensioners and people under State Pension Age. Although they are not part of the first tier of pension provision in the UK, they are included here because they are nevertheless important benefits for many older people.

Housing Benefit (HB) is paid to people on low incomes who rent their home. It is designed to help with housing costs, including rent and some accommodation-related service charges. It is paid to renters who claim the benefit once they have been assessed as being eligible.

[12] House of Commons (2012) "2013 Benefit uprating", available: www.parliament.uk/briefing-papers/SN06512
[13] From ongoing employment, SERPS, Graduated Retirement Benefit, occupational schemes, personal pensions and assumed income from capital savings

Not everybody that is eligible claims Housing Benefit. Official estimates show that, in 2009/10, between 16% and 22% of the between 1.7 and 1.9m pensioner households who were eligible did not take up their benefit. [14]

Council Tax Support (CTS) is a rebate scheme to provide help with up to 100% of an individual's council tax. Until April around half of pensioner households are entitled to CTS. From April 2013 this has been replaced by a new scheme named Council Tax Support (CTS) where local councils design their own scheme. However, the Government has stated that pensioners will not be worse off as a result of the introduction of the new scheme[15]

According to official estimates, take-up of Council Tax Benefit (the precursor to Council Tax Support) was relatively low; in 2009/10 between 31% and 38% of pensioner households who were eligible did not take up their benefit.[16]

Pensioners receive other benefits that could be considered as part of the first tier of provision:

- Benefits individually assessed for specific purposes (for example, Attendance Allowance)
- (Near) Universal benefits for all or most people at a certain age (for example, free TV licenses, Winter Fuel Payments)
- Enhanced tax allowances compared to working-age people (however, age-related tax allowances are being phased out from April 2013)[17]

[14] Department for Work and Pensions (DWP) (2012) *Income Related Benefits Estimates of Take-up in 2009-10,* https://www.gov.uk/government/organisations/department-for-work-pensions/series/income-related-benefits-estimates-of-take-up--2
[15] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/14787/LCTS_Q_A.pdf
[16] Department for Work and Pensions (DWP) (2012) *Income Related Benefits Estimates of Take-up in 2009-10,* https://www.gov.uk/government/organisations/department-for-work-pensions/series/income-related-benefits-estimates-of-take-up--2
[17] Chancellor of the Exchequer's Budget, March 2012

Second tier provision

Introduction of the Single-Tier pension
Under the single-tier state pension S2P would be abolished and there would be no contracting-out. Currently, DB schemes can be contracted out of the State Second Pension (S2P), and employers receive a rebate on their National Insurance Contributions.

The UK's second tier of state pension provision operates on an unfunded 'pay-as-you-go' contributory basis, through the National Insurance (NI) system. Benefits are payable from State Pension Age, but can be deferred. The self-employed are currently excluded from second tier provision.

The original aim of the second tier was to provide further pension income to employees more closely related to their earnings level than the flat rate people receive from the first tier. Contributions are made in proportion to earnings (in a band between minimum and maximum limits). Benefits reflect these contributions, so there is less redistribution (from rich to poor) than in the first tier.

Second tier provision in the UK has existed in three different schemes since 1961:

- Graduated Retirement Benefit (GRB: 1961 to 1975)
- State Earnings Related Pension Scheme (SERPS: 1978 to 2002)
- State Second Pension (S2P: from April 2002)

Some of today's pensioners still receive small amounts of benefit from accrued rights to the **Graduated Retirement Benefit (GRB).**

The **State Earnings-Related Pension Scheme (SERPS)** is more significant for current pensioners. The original aim of SERPS was to provide a pension of 25% of band earnings. Subsequent changes to SERPS have reduced the value of SERPS benefits.

State Second Pension (S2P) started in 2002 as a replacement for SERPS. Significant pensions under S2P have yet to start payment. The main aim of S2P is to target greater resources at the lower paid and some individuals who cannot work due to disability or caring responsibilities. It is therefore more redistributive than SERPS, and people working on low pay benefit more than they did under SERPS.

The pattern of accruing benefits under S2P is currently based on two earnings bands and two accrual rates.[18] For low earners, a flat-rate of S2P

[18] Earnings between the Lower Earnings Limit and the Upper Accrual Point. Before 6 April 2010, there were three bands accruing benefits at 40% 10% and 20%. Following provisions in the Pensions Act 2007, the former second and third bands have been merged into a single band accruing benefits at 10%. For more details, see page 43

pension is guaranteed. Higher earners accrue an additional earnings-related benefit. Disabled people, and some individuals with caring responsibilities, are credited into the flat-rate part of S2P.

It is currently possible for members of Defined Benefit schemes to replace some state second tier provision with private pension provision. This is known as **contracting-out**.

Prior to April 2012, members of Defined Contribution pension schemes were able to contract out of S2P, however this option is now only available to Defined Benefit schemes.

Defined Benefit pension schemes can choose to forego some of their members' S2P benefits, provided that they expect to pay benefits that are at least as valuable as the S2P benefits foregone. Individuals who contract out effectively pay lower NI contributions, and so do their employers, since they are considered to be saving the equivalent amount in the private pension scheme.[19] The reduction in the level of NI contributions is called the 'contracting-out' rebate.

The size of the rebate is set every 5 years with advice from the Government Actuary Department, and can act as an incentive or disincentive to contract-out depending on whether the invested rebate is perceived to give more or less than the benefit payable under S2P.

[19] The exception to this is with money purchase or Defined Contribution schemes, where the level of NI contribution remains unchanged, but the Government later pays a rebate into the scheme

Third tier provision

The third tier of pension provision is **private pensions**, including workplace pensions and those that are not directly funded by the state. As with state provision, private pension provision is complicated.

Private pension contributions, from the employer and/or the individual, fund designated pensions for the individual. The primary aim of private pensions is to redistribute income across an individual's lifetime.

Many private pension arrangements are **employer-sponsored**. The employer link may be very strong; for example, the employer funds and administers an occupational scheme. The link may be loose; for example, the employer may only give access to the products of a pension provider. Most schemes are arranged through single employers, although there are a few industry-wide arrangements.

Individuals can make their own private pension arrangements by buying **personal pensions**. There are several types of these, including stakeholder pensions and a distinct product called a personal pension. Each underlying product works on the money-purchase principle: that is, it takes money in through contributions, this money is invested in a fund, and the accumulated value is then used to provide income for the remainder of an individual's life. Subject to limits, part of the fund may also be paid out as a tax-free lump-sum.

Individual contributions to private pension schemes obtain tax relief at least at an individual's highest marginal rate (within limits). The pension fund is accumulated in a tax-favoured environment. On receipt, the pension is taxed as earned income. Any contributions the employer makes to private pensions are tax deductible and so reduce its corporation tax liability. The company also benefits from National Insurance relief.

Most employer-sponsored provision is through **occupational pension schemes**, set up and administered on behalf of an employer. Occupational pension schemes can be Defined Benefit (DB) or Defined Contribution (DC). There are also some hybrid schemes which have features of both DB and DC schemes.

In **Defined Benefit** schemes, the benefit received upon retirement is determined by a formula that sets the levels of benefits to be offered, which are usually linked to final or career average salary levels.

Contributions are varied in order to ensure that this level is reached. This works on a pooled fund basis – all contributions are paid into a common fund, which is invested to provide all retirement benefits. In the normal course of events the investment performance of the scheme assets has no or minimal impact on the benefits an individual receives. The better the investment performance the lower the contributions needed.

The benefit from DB schemes will usually be based on an individual's length of service and his or her earnings at, or close to, retirement. A scheme might typically promise a pension of 1/60th of final salary for each year of service or a 1/80th pension plus a tax-free lump-sum cash amount of 3/80ths for each year of service.

Such schemes usually have a normal pension age of 60 or 65, but a member can usually retire early with a reduction in benefits. People leaving the scheme on changing employer can preserve their rights in the scheme until pension age, or transfer the accrued rights to another arrangement.

Because of the different nature of operation of DB and DC schemes, they carry different risks and benefits to the employer and employee, and there is much debate on the best arrangement for different types of employee.[20]

To increase the security of Defined Benefit occupational pension schemes, the government has introduced a 'Pension Protection Fund', which became operational in April 2005. This will pay a minimum level of pension even if an employer becomes insolvent and the pension fund is underfunded.[21]

Contracting-out of Second State Pension
Currently, DB schemes can contract-out of S2P. The Pensions Act 2007 abolished contracting-out in DC schemes from April 2012.

Defined Contribution occupational schemes operate under similar legislation to a Defined Benefit scheme. The difference is that, while a DB scheme promises a specific level of benefit, a DC scheme operates on the money-purchase basis with a specified rate of contributions being paid into the scheme but with no guarantee as to the level of the benefit that will be paid out.

Contributions are usually expressed as a percentage of salary or total earnings. The rate of contribution could be flat-rate or could be tiered by age and/or length of service and/or seniority and/or level of earnings. Employers may make a base level of contribution for all employees and may also match any employee's additional contribution.

[20] PPI Briefing Note Number 2 *The shift from Defined Benefit to Defined Contribution*
[21] Pension Protection Fund www.pensionprotectionfund.org.uk/ and HM Government (2004) Pensions Act 2004 http://www.legislation.gov.uk/ukpga/2004/35/pdfs/ukpga_20040035_en.pdf

Withdrawing Retirement Income

People are allowed to withdraw pension savings after the age of 55. However, in the Budget 2014 it was announced that this will rise to 57 in 2028. Before age 55 they can only withdraw pension savings if they pay a penalty tax of 55%. After the age of 55, people choose one or a combination of the following options:

- Taking a cash lump sum. Up to 25% of a pension fund can be taken as a tax-free lump sum (provided the scheme rules allow it). If an individual's entire pension fund is less than the trivial commutation limit (set at £30,000 from 27 March 2014),[22] it is possible to 'trivially commute' and take the whole fund as a lump sum, with 25% being tax-free.
- Investing some or all of their fund for some part or all of their retirement in an income drawdown account (while taking an income from it, capped at 150% of an equivalent annuity);
- Purchasing an annuity. An insurance product that pays an income from the date of purchase until the date of death.[23]
- Withdrawing their fund in unlimited amounts provided that individuals can demonstrate a secured guaranteed lifetime pension income of at least £20,000 per year.[24]

Budget 2014

The Government announced in the 2014 Budget that, from April 2015, individuals will be able to withdraw the whole of their pension pot. The 25% tax-free lump sum will remain in place while any withdrawals over this amount will be taxed at the individual's marginal rate.

Additional Voluntary Contributions

If only the employer contributes to the pension scheme, a scheme is known as non-contributory. Both employer and employee make contributions to contributory schemes. Until April 2006, all occupational pension schemes offered the facility for employees to make **additional voluntary contributions (AVCs),** either to accrue further benefits in the scheme or separately in free-standing arrangements. Some companies may no longer offer AVCs following changes to pension rules in April 2006, as there are now more options for people to top up their company pension through other means.[25]

[22] The trivial commutation has previously been set at 1% of the Lifetime Allowance (currently £1.8m) however it has been decoupled from the lifetime allowance from 2012 HMT (2010) *Restricting pensions tax relief through existing allowances: a summary of the discussion document responses*, p. 26.

[23] An annuity insures against an individual's money running out because he or she lives longer than expected

[24] HMT (2011). *Removing the Effective Requirement to Annuitise by Age 75,* p.2. http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/pensions_annuitisation.pdf

[25] Between April 2001 and April 2006 members of an occupational pension scheme earning less than £30,000 per annum had an alternative 'concurrency' option. This allowed them to contribute up to £3,600 per annum into a stakeholder or personal pension. The £30,000 limit applied to each employment. So for example, it was possible for someone with more than one employment to have a concurrent pension even if his or her total earnings were above £30,000.

Defined Ambition
The Department for Work and Pensions is has considered proposals for a new model of occupational pensions whereby the risk is shared between the employee and the employer. This would have some elements of Defined Benefits schemes, where the employer bears the risk and some elements of Defined Contribution schemes, where the employee bears the risk; this programme of work is known as 'Defined Ambition'.

A consultation by the Department for Work and Pensions on this subject found support for the development of pension schemes that would provide more certainty to individuals around their level of retirement income than Defined Contribution schemes currently offer. Further to this, the Government published the Pension Schemes Bill in June 2014.[26] The Bill sets out a framework that aims to encourage the provision of types of pension scheme that may take a variety of approaches to sharing or pooling risk between the stakeholders.

Personal Pensions
Employers can make arrangements for their employees without providing a formal pension scheme. These usually involve giving access to group DC individual personal pensions.

Until April 2001, individual personal pensions were only available to individuals while they were self-employed, or were not members of an occupational pension scheme. Legislation introducing stakeholder pensions widened access further, and from April 2006, individual pension arrangements became open to everyone under age 75.

Stakeholder pensions are a form of DC personal pension that must meet a number of Government standards. The main difference between these and other types of personal pension are that management charges in each year are limited by a maximum charge cap and providers are not permitted to charge exit penalties.[27]

For people who join a stakeholder pension after 6 April 2005, the maximum fund management charge is 1.5% for the first 10 years, thereafter reducing to 1%. For stakeholder plans that were opened before this date, the previous maximum charge of 1% will continue to apply.

Personal pensions and stakeholder pensions can also accept transfer values from occupational pensions or other individual arrangements and contracted-out rebates.

[26] http://services.parliament.uk/bills/2014-15/pensionschemes/documents.html
[27] RN Third tier: Individual pension arrangements

Auto-enrolment into pension schemes from 2012

The previous Labour Government acted on the recommendations of the Pensions Commission (who reported in 2005)[28] and legislated in the Pensions Act 2008 for the introduction of automatic enrolment into private pensions. Auto-enrolment was staged from October 2012. Employees between age 22 and State Pension Age are eligible for automatic enrolment into a scheme chosen by the employer, with employees having the right to opt-out. The earnings threshold above which every employee should be auto-enrolled is £10,000 from April 2014. Contributions become payable on band earnings over £5,772 and up to a limit of £41,865.[29]

- Large employers with 250 or more employees were required to auto-enrol their eligible employees from October 1 2012 to February 2014.
- Medium sized employers with 50 to 249 employees have automatic enrolment dates between 1 April 2014 and 1 April 2015.
- Small employers with fewer than 50 employees will have automatic enrolment dates from 1 August 2015 to 1 April 2017.
- New employers setting up business from 1 April 2012 and up to and including 30 September 2017 will have automatic enrolment dates between 1 May 2017 and up to 1 February 2018.

The required level of contributions that employers and employees must make into a pension scheme (if employees remain opted in) is being phased in between 2012 and 2018 to reach 8% minimum total contributions on band earnings by 2018.[30] This 8% will be made up of a minimum 3% from the employer and the remainder from the employee and the Government (through tax relief).[31] If the employer decides to contribute the legal minimum of 3% of band earnings, then the employee will have to contribute 4% and the Government will contribute 1% through tax relief.[32] However, it will be up to employers to decide whether they want to contribute the legal minimum or more.

National Employment Savings Trust (NEST)

The Pensions Act 2008 also legislated for the introduction of a new national pension saving scheme of low-cost, individualised savings accounts. This scheme is now active and is called NEST (National Employment Savings Trust). Employers who do not offer an occupational pension or a stakeholder or other qualifying pension scheme are able to auto-enrol their employees into NEST, provided that the employee's earnings are above the current proposed auto-enrolment threshold of £10,000 in 2014/15. Employees with earnings below this level will be permitted to opt in to the scheme on a voluntary basis. There will be a

[28] Pensions Commission (2005) *A New Pension Settlement for the Twenty-First Century.*
[29] SI 2014 No.623 *The Automatic Enrolment (Earnings Trigger and Qualifying Earnings Band) Order 2014*
[30] DWP (2012) *Revised implementation proposals for workplace pension reform* July 2012, para 7
[31] The tax relief may be higher for those people who pay higher-rate tax
[32] The tax relief may be higher for those people who pay higher-rate tax

total contributions limit, by or on behalf of a member of £4,600 a year (2014/15).

NEST has a low-charging structure. Members will pay an Annual Management Charge of 0.3% of the fund per year and a 1.8% charge on contributions. Once NESTs start-up costs have been recovered it is intended that the contribution charge will be dropped.[33]

There are currently restrictions on the amount of contributions that can be made into NEST and on individuals transferring pension funds into and out of NEST, except for annuity purchase, where a pension is shared through a divorce settlement or where an individual has been in an occupational pension scheme for less than two years. Following a call for evidence on these restrictions,[34] the Government has announced that the annual contributions limit will be lifted from April 2017, and that the restrictions on individual transfers will be removed in line with the introduction of automatic transfers. There is no intention to lift any restrictions on bulk transfers.[35]

NEST is not the only option for employers without their own pension. Other pension scheme master trusts have been set up in the private sector which aim to provide a pension scheme eligible for auto enrolment. These include Now Pensions and The People's Pension.

Tax Changes

The Finance Act 2004, which took effect from 6 April 2006, included a number of amendments designed to simplify the taxation of the UK private pension regime, effectively capturing all pensions under a single set of rules.[36] The amount by which an individual can benefit from tax advantages is controlled by two 'allowances': annual and lifetime. These allowances apply to each individual, and across all registered pension schemes that the individual uses for providing benefits, regardless of the time of joining.[37]

An individual can make contributions to any number of private pension schemes and receive tax relief on the amount saved in that year up to the

[33] See NEST (2012) *Low charges for future members of NEST.* Available: www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/low-charges-for-future-members-of-NEST,PDF.pdf
[34] DWP (2012) *Supporting automatic enrolment*
[35] DWP (2013) Supporting automatic enrolment The Government response to the call for evidence on the impact of the annual contribution limit and the transfer restrictions on NEST: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211063/nest-automatic-enrolment-call-for-evidence-response.pdf
[36] Inland Revenue (IR) (2003) *Simplifying the taxation of pension: the Government's Proposals* and Her Majesty's Treasury (HMT) (2004) *Prudence for a purpose: A Britain of stability and strength*, Budget report http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/budget/budget_04/budget_report/bud_bud04_repindex.cfm
[37] Although exemptions to the lifetime allowance are available to protect existing rights

annual allowance (AA). The AA for 2014/15 is £40,000.[38] Contributions above this level are taxed at an individual's tax rate.

The Lifetime Allowance is applied when the individual begins to receive a benefit from his or her pension saving. If the value of the pension saving at this time is above the Lifetime Allowance (£1.25 million for 2014/15),[39] an additional tax charge is applied.

38 http://www.hmrc.gov.uk/pensionschemes/understanding-aa.htm
39 http://www.hmrc.gov.uk/pensionschemes/understanding-la.htm

Reference note index

First tier: Eligibility for Basic State Pension

The Basic State Pension (BSP) is based on an individual's National Insurance (NI) contribution record (Chart 3). Any tax year in which an individual makes, or is credited with making, sufficient NI contributions is known as a qualifying year.

Employees make Class 1 contributions when their weekly earnings exceed the 'Primary Threshold' (PT) of £153 a week.[40] If they earn less than the PT but more than the 'Lower Earnings Limit' (LEL) of £111 a week, then they do not make Class 1 contributions but are credited for the BSP.[41] The self-employed make flat–rate Class 2 contributions of £2.75 a week.[42] Class 3 voluntary contributions, of £13.90 a week, are paid by those who wish to protect their entitlement and have not paid enough Class 1 or Class 2 contributions. Class 3 payments must generally be made within 6 years from the end of the tax year for which payment is being made.[43]

Chart 3

How National Insurance Contributions work

PENSIONS POLICY INSTITUTE
PPI

Main Classes of National Insurance Contributions (NICs)	Who pays this class	What this entitles people to
Class 1	Paid by employers at a rate of 13.8% and employees aged between 16 and SPA who earn over the Primary Earnings Threshold (PET) at a rate of 12% and at a rate of 2% for earnings over the Upper Earnings Limit (UEL). People who earn at or above the Lower Earnings Limit (LEL) (£111 per week) but below the PT (£153 per week) are not required to pay but are treated as having paid NICs.	Each qualifying year counts towards an individual's pension entitlement and is used to calculate how much Basic State Pension (and Second State Pension) they will receive. People who earn below the LEL do not accrue entitlement to Basic State Pension
Class 2	Paid by people who are self employed at a fixed rate, people on low earnings can apply for exemption	Each Class 2 contribution is treated as one week of earnings at the LEL.
Class 3	Voluntary contributions people can pay in order to fill gaps in their contribution record.	Can fill in gaps of full or partial years in order to make those years qualifying years for State Pension entitlement
Class 4	Additional contributions paid by self-employed people (as well as Class 2 NICs) at a rate of 9% on profits between the Lower Profits Limit and Upper Profits Limit (UPL) and 2% on profits above the UPL	Does not count towards qualifying years

40 www.hmrc.gov.uk/rates/nic.htm
41 From April 2011
42 Special Class 2 rates apply for fishermen and volunteer development workers. The self-employed also make class 4 contributions, which are earnings-related but do not affect BSP entitlement.
43 People were permitted to make back payments for more than 6 years if the payments were for the tax years 1996/1997 through to 2001/2002, and these payments were made by April 2009 or April 2010 depending on when people reach SPA. For detailed explanation see: http://www.hmrc.gov.uk/ni/volcontr/whentop-up.htm

There are 19 activities that can credit someone into the Basic State Pension without their having to pay contributions. Credit will be given if, for instance, an individual is entitled to Statutory Sick Pay or Statutory Maternity Pay, Jobseekers Allowance, Incapacity Benefit/Employment and Support Allowance, Carer's Allowance, Severe Disablement Allowance, or if an individual is aged 16, 17 or 18, or for men aged 60 to 64.[44]

No qualifying years are earned and no credit is earned if a married woman or widow is paying reduced-rate NI contributions.[45]

Introduction of the Single-Tier pension

The Pensions Act 2014, which received Royal Assent in May 2014, contains the primary legislation setting out the single-tier pension. The single-tier pension will be set at a level above Guarantee Credit, which is currently £148.35 a week and the Government has promised to recognise all previous state pension entitlements[46]. The single-tier pension will only be available to pensioners retiring after the date of implementation, this was initially planned to be 2017 at the earliest; however, the Chancellor recently announced that this will take place from 2016.

There are important differences from the current system; 35 years of National Insurance Contributions or credits will be required for an individual to receive the full pension, and there will be a minimum qualifying period which is yet to be set but can be not more than 10 qualifying years.

Currently, DB schemes can be contracted out of the State Second Pension (S2P), and employers receive a rebate on their National Insurance Contributions. Under the single-tier state pension S2P would be abolished and there would be no contracting-out.

In practice, closure of S2P will mean that employers are required to pay higher national insurance contributions on behalf of their employees; an increase for each employee who is currently contracted-out of 3.4 per cent of relevant earnings. The Government proposes to give employers powers to change scheme rules to implement this without trustee consent. Similarly, contracted-out employees will be brought back fully

[44] House of Commons Hansard, 26 June 2006 Col 63W www.publications.parliament.uk/pa/cm200506/cmhansrd/vo060626/text/60626w0013.htm#06062622000050

[45] Between 1948 and 1978 married women could elect to pay a reduced rate of NI contributions, known as the 'Married Women's Reduced Rate Election'. By electing to pay the reduced rate, women forfeited the right to a pension based on their own contributions and instead relied on their husband's contribution record. The wife would then receive a pension once the husband reached 65 at the rate of 60% of the husband's pension. The option to elect to pay the reduced rate ceased to be available in 1977. Entitlement to the option is lost if an individual is not working for more than 2 complete tax years. Alternatively, individuals can elect to recommence paying the full rate. PPI calculations based on data provided by DWP estimate that in 2003 around 60,000 women were still paying at the reduced rate (Briefing Note 11, July 2004). This figure is likely to have reduced since 2003.

[46] *Pensions Act 2014* http://www.legislation.gov.uk/ukpga/2014/19/contents/enacted

into the state system and start to pay full NI contributions in line with other employees. This means an increase in the contributions that they pay equivalent to 1.4 per cent of relevant earnings (between the Lower Earnings Limit and the Upper Accrual Point).

The transition process will translate people's pre-implementation National Insurance records into a simple single-tier starting amount, known as the 'Foundation amount' – those people with a foundation amount that is less than the full level of single-tier will be able to take it up to the full level. Where an individual has previously been contracted out, a deduction will be applied to the 'Foundation amount'.

Currently a person who has been married or in a civil partnership may be able to qualify for a basic state pension or an increase to their own basic State pension based on the NI record of their spouse or civil partner. However, the single-tier pension will be based on individual qualification.

The Pensions Act 2014 also provides for the abolition of the savings credit element of Pension Credit for those people who reach pensionable age on or after the introduction of the new state pension.

Means-tested support will continue to be available through housing benefit and Council Tax Support. In addition, for a transitional period of 5 years from implementation, support will be retained for those people who may have received more help through availability of the savings credit.

People who retire under the current system are able to use these provisions even if their spouse or partner is in the single-tier system – however, the government will only use the NI records of an individual's spouse or civil partner up to and including the tax year before the implementation of the single tier to calculate any derived entitlement.

Transitional arrangements between the current system and the single-tier pension have been clarified as the Pensions Act 2014 progressed through parliament. Under the current system, some people receive a state pension based on their partner's National Insurance contributions. These include individuals who are expecting to receive a pension based on their spouse's National Insurance contributions and employed married women who, between 1948 and 1977, paid reduced rates of National Insurance on the assumption that they would receive a derived pension based on their husband's contributions. However, the single-tier pension does not make this provision.

Under the measures set out in the Pensions Act 2014 those in the first group reaching SPA under the single-tier provision will not be able to claim on their partner's contributions. In contrast, the Pensions Act 2014 outlines provisions for the transition for the second group: This will include an amount equivalent to the full rate of the 'married woman's' basic pension rate, ensuring that they are not worse off under the new rules.

Home Responsibilities Protection (HRP) was introduced in 1978 and, for people reaching SPA before April 2010, reduced the number of years of contributions required to secure a full BSP. Protection was given for those complete tax years where an individual was caring for children or an older or a disabled person.

There were some changes in the Pensions Act 2007 which affected people who reach SPA between 6 April 2010 and April 2016. These people:

- will be able to earn positive credits towards BSP rather than HRP reductions. The outcome for individuals under a credit system is more generous and simplifies the way entitlement is calculated.
- only need 30 qualifying years to be eligible for the full Basic State Pension, while people who reached State Pension Age before 6 April 2010 still need to have contributed for 39 years (for women) or 44 years (for men) to qualify for a full Basic State Pension.
- will receive a proportion of the full BSP for every contributing year, as the 25% minimum contribution limit is abolished.

Carers now receive *weekly* contribution credits for any week in which they:

- are awarded child benefit; or
- are a foster parent for a child under the age of 12; or
- are engaged in caring within the meaning given in regulations (people caring for one sick or severely disabled person for 20 hours or more per week will qualify for credit, subject to an appropriate validation process).

This change means that in any year, individuals can combine *caring credits* with *NI contributions* to build up a qualifying year. Credits for people who are caring for children are awarded until the youngest child reaches 12 years (down from 16 years), aligning the rules for Basic State Pension and State Second Pension (discussed in the next section).

Grandparents of working age who care for grandchildren for 20 hours or more per week are also eligible to receive caring credits which count towards their BSP entitlement.

People reaching SPA before 2010

For men who reached State Pension Age before 6 April 2010, the full BSP of £113.10 a week is payable with at least 44 qualifying years of National Insurance contributions. For women born prior to 6 April 1950 the full BSP is payable with at least 39 qualifying years.

A proportionate benefit is payable if the number of qualifying years is less than that needed for the maximum. For example, a woman who retired before 6 April 2010 with a 30 year contribution record currently receives a BSP of £87.00 a week ((30/39) * £113.10).[47] However, if the number of qualifying years at retirement was less than 25% of the amount required for a maximum BSP then no BSP benefit is payable, for a person who reached SPA before 6 April 2010.

If a person[48] cared for a child until the child reached age 16 the requirement for a maximum BSP would reduce from 39 qualifying years to 24. HRP did not give complete protection as it did not reduce the number of qualifying years required for a full BSP below 20 years.

[47] Assuming no Home Responsibilities Protection is awarded
[48] Although most recipients are women, HRP is unisex - it is available to the person to whom child benefit is payable

First tier: Categories of Basic State Pension

There are five categories of Basic State Pension (BSP) provided by the state:

- Category A is based on the individual's contributions
- Category B is based on a spouse's or civil partner's qualifying years
- Category C is non-contributory, and is payable to widows of men who were over 65 on 5 July 1948
- Category D is non-contributory and is payable to people over age 80 who satisfy certain residency conditions and fail to qualify for a category A or B pension, or receive less than the non-contributory rate
- Age Addition is non-contributory and is payable to all recipients of state pensions aged 80 or above

Category A pension

This is contributory and is based on the individual's contribution history. Where an individual has an incomplete contribution record then the qualifying years of a spouse or former spouse (separated through either bereavement or divorce) can be substituted to provide a higher BSP.

Changes in eligibility criteria for Category A pension[49]

For people reaching State Pension Age before 6 April 2010 and for those claiming bereavement benefits, past contribution conditions will continue to apply.

For those reaching State Pension Age from 6 April 2010, the number of years needed to qualify for a full category A pension is reduced from 44 years for a man and 39 years for a woman to 30 qualifying years for men and women alike. A person who has less than 30 qualifying years will be entitled to a proportion of the full BSP for each qualifying year they have built up.

Parents and carers are also allowed to build up entitlement to a category A pension through credits. Parents or guardians (awarded child benefit for a child aged under 12), a registered foster parent or a carer providing care (for one or more severely disabled persons or caring for a child under 12) reaching SPA from 6 April 2010 will be able to build up credits towards a category A pension.

For those reaching SPA from 6 April 2010, each complete year (subject to a limit) of home responsibilities protection awarded under the existing rules of the scheme will be converted into a qualifying year for BSP.

[49] The changes described in this section result from legislation in the Pensions Act 2007 and announcements in Budget 2009.

From 2011, grandparents of working age who care for grandchildren for 20 hours or more per week are also be eligible to build up entitlement to a category A pension through credits.[50]

Category B pension
This is contributory and is based solely on a spouse's or civil partner's qualifying years and earnings. Previously it was only payable to married women, widows and widowers but from 6 April 2010 both men and women are able to claim BSP based on their spouse's or partner's NI record if this is better than their own.

Changes to eligibility for Category B pension[51]
From 6 April 2010 people can claim category B pension even if their spouse has deferred their own category A claim. Changes also allow the spouse or partner of a carer to build up entitlement to an associated category B pension.

As a result of these changes, the extent to which people will be reliant on category B pensions derived from their spouse's or partner's contributions will be significantly reduced.

Married couples
If both husband and wife have a satisfactory NI contribution record then they will each receive a full BSP when they reach SPA. However, if the wife is entitled to less than 60% of the full BSP and she is over state pension age, she may be able to claim a composite category A and category B pension based on her husband's contribution record, which could increase her pension to 60% of the full rate.

Abolishment of Adult Dependency Increases
Adult dependency increases for dependants under State Pension Age were abolished from 6 April 2010.[52] Provisions will be made to protect entitlements up to 5 April 2020.

Example (under the rules currently in place)
George and Elizabeth are a married couple who are both over state pension age. George has a full NI contribution record and receives the full BSP of £113.10 a week (category A). In comparison Elizabeth has an incomplete record and based on her contributions would only receive £30.00 a week (category A). However she can claim an additional £37.80 a week (category B) based on George's record giving a total weekly income of £180.90 for the couple.

[50] Budget 2009 speech, http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/bud_bud09_speech.htm
[51] Legislated in the Pensions Act 2007
[52] Legislated in the Pensions Act 2007

Once Elizabeth reached SPA the full £180.9 is payable to the couple even if she continues to work. From that date £113.10 would be payable to George and £67.80 would be payable to Elizabeth (£180.90 - £113.10 = £67.80).

Category C pension
Category C pensions are now obsolete and are being gradually phased out. These are payable at the rate of 60% of the full BSP to people over SPA on 5 July 1948 or to the widows of men who were over 65 in July 1948.

Category D pension
A non-contributory pension, equivalent to the dependent adult's addition, is awarded to those who:

- are aged 80 or above, and
- have been resident in the UK for at least 10 years in the previous 20 and
- receive either no BSP or less than the dependent adult's addition.

This is sometimes called the 'Over 80 Pension' and it amounts to £67.80 a week in 2014/15. If the person is on a reduced pension, he/she will receive the difference between £67.80 and the reduced BSP.

Age addition
An age addition of 25p a week is payable to all recipients of BSP aged 80 or over. When it was introduced in 1971 the full BSP was £6.00 – effectively a 4.2% enhancement. Subsequently, the age addition has not been increased, and so is now only a 0.2% enhancement.

First tier: State Pension Age

The State Pension Age (SPA) is the minimum legal age at which a basic state pension can be claimed. The SPA depends on an individual's birth date. It is currently 65 years for men. Until 5 April 2010 SPA for women was 60 years. Under the provisions of the Pensions Act 1995 and the Pensions Act 2011, SPA for women is increasing from April 2010 in a series of steps to age 65 by November 2018 where it will be equal for both men and women.

The Pensions Act 2007 legislated for the increase in SPA for both men and women to 66 between April 2024 and April 2026. However, the Pensions Act 2011 brought forward the increase in SPA from 65 to 66 to occur by October 2020. Thus, by October 2020 the SPA for both men and women will be 66 years; this is five and a half years earlier than under previous legislation.[53]

For individuals born after 5 November 1954, their SPA will be at least 66 years. The Pensions Act 2007 also legislated for further increases in SPA to 67 between 2034 and 2036 and to 68 between 2044 and 2046. However, the Pensions Act 2014 included provisions that the SPA rise to age 67 will now occur between 2026 and 2028.

Bringing forward the SPA rise to 68 and the mechanism for determining future rises

SPA is currently scheduled to rise from age 67 to age 68 between 2044 and 2046 for both men and women, however the Government intends to review the timescale for the rise to age 68.[54] The Pensions Act 2014, which received Royal Assent in May 2014, sets out the Government's plans for the SPA in the future.[55] This includes legislation for a structure framework which provides for a review of the SPA every 5 years, the review to be based around the principle that people should expect to spend a certain proportion of their adult life in retirement (based on analysis provided by the Government Actuary's Department and an independently-led body). For this purpose adult life is defined as starting at age 20.[56] In the Autumn Statement 2013, the Chancellor illustrated this principle as implying that the SPA would increase to 68 by the mid 2030s and to 69 by the late 2040s.[57]

[53] For specific information on the SPA under the new rules depending on the date of birth, check the State Pension Age calculator: https://www.gov.uk/calculate-state-pension
[54] DWP (2010) *A sustainable State Pension: when the State Pension age will increase to 66* http://www.official-documents.gov.uk/document/cm79/7956/7956.pdf
[55] *Pensions Act 2014* http://www.legislation.gov.uk/ukpga/2014/19/contents/enacted
[56] DWP (2013) *The core principle underpinning future State Pension age rises: DWP background note*
[57] HM Treasury (2013) *Autumn Statement*

Table 1 compares the effects of increases in SPA for women under the Pensions Act 2011 provisions, compared to previous legislation, according to birth date.

Table 1: Comparing the effects of Pensions Act 1995 and Pensions Act 2011 provisions on womens' SPA

	Pensions Act 1995		Pensions Act 2011	
Date of Birth	**State Pension Date**	**State Pension Age**	**State Pension Date**	**State Pension Age**
6 March 1950 – 5 April 1950	6 April 2010	60 yrs 1 mth – 60 yrs	6 April 2010	60 yrs 1 mth – 60 yrs
6 April 1950 – 5 May 1950	6 June 2010	60 yrs 2 mths – 60 yrs 1 mth	6 June 2010	60 yrs 2 mths – 60 yrs 1 mth
6 May 1950 – 5 June 1950	6 Aug 2010	60 yrs – 3 mths – 60 yrs 2 mths	6 Aug 2010	60 yrs – 3 mths – 60 yrs 2 mths
6 March 1953 – 5 April 1953	6 April 2016	63 yrs 1 mth – 63 yrs 0 mths	6 April 2016	63 yrs 1 mth– 63 yrs 0 mths
6 April 1953 – 5 May 1953	6 June 2016	63 yrs 2 mths – 63 yrs 1 mth	6 July 2016	63 yrs 3 mths – 63 yrs 2 mths
6 October 1953 – 5 Nov 1953	6 Jun 2017	63 yrs 8 mths – 63 yrs 7 mths	6 July 2018	64 yrs 9 mths – 64 yrs 8 mths
6 Nov 1953 - 5 Dec. 1953	6 Aug 2017	63 yrs 9 mths – 63 yrs 8 mths	6 Nov 2018	65 yrs – 64 yrs 11 mths
6 Dec 1953 – 5 Jan 1954	6 Sept 2017	63 yrs 10 mths – 63 yrs 9 mths	6 March 2019	65 yrs 3 mths – 65 yrs 2 mths
6 Jan 1954 – 5 Feb 1954	6 Nov 2017	63 yrs 11 mths – 63 yrs 10 mths	6 May 2019	65 yrs 4 mths – 65 yrs 3 mths
6 April 1954 – 5 May 1954	6 May 2018	64 yrs 1 mths – 64 yrs	6 Nov 2020	65 yrs 7 mths – 65 yrs 6 mths
6 May 1954 to 5 June 1954	6 July 2018	64 yrs 2 mths – 64 yrs 1 mth	6 Jan 2020	65 yrs 8 mths – 65 yrs 7 mths
6 Aug 1954 to 5 Sept 1954	6 Jan 2019	64 yrs 5 mths – 64 yrs 4 mth	6 July 2020	65 yrs 11 mths – 65 yrs 10 mths
6 Sept 1954 to 5 Oct 1954	6 Mar 2019	64 yrs 6 mths – 64 yrs 5 mth	6 Sept 2020	66yrs – 65 yrs 11 mths
6 Oct 1954 to 5 Nov 1954	6 May 2019	64 yrs 7 mths – 64 yrs 6 mth	66th birthday	66yrs

First tier: Deferral of state pensions

Individuals can choose to defer the commencement of their BSP in return for an enhanced pension,[58] through the award of increments, or as a one-off lump sum.[59]

For each 5 weeks of deferral, people can receive an increase of 1% in their pension. This is equivalent to an increase of around 10.4% for each year people defer.

Increments can be earned after payments have started if recipients request that the Department for Work and Pensions cease payments. Increments will be earned at the same rate.

Similar rules are in place for other state pensions including the Graduated Retirement Benefit, SERPS and S2P (discussed in later sections). However, individuals must defer all state pension benefits – they cannot elect for instance to defer BSP but start receiving SERPS.

While benefit is being deferred, the amount not claimed is still counted as income for Pension Credit and other means-tested benefits.

Benefit that has been deferred for 12 consecutive months from April 2005 can be taken as a one-off lump sum payment, rather than as an increase in future pension payments. The deferred benefit will accrue interest at 2% above the Bank of England Base Interest Rate, and the whole of the resulting lump sum will be taxable at the marginal rate of tax paid by the pensioner on his or her other income.[60] Because of the interest rate available, there can be a financial gain from deferring and taking a lump sum. The actual gain is not the full value of the lump sum (as it can be claimed and invested instead) but the value of any extra interest over and above what could be gained from claiming the pension and investing it. If the pension could be taken and invested at a higher rate than the 2% above the Bank of England base rate, it would suggest that deferring may not be cost effective.

[58]Deferring your State Pension: leaflet. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/299286/dwp024-apr-14.pdf

[59] Increments can also be awarded if payment is delayed for other reasons, such as a delay in returning the forms, or the Department for Work and Pensions not being aware of a change of address. Whatever the reason for the delay, individuals can only receive a 'back-payment' of up to 3 months of the missed payments.

[60] Even if some of the lump sum would normally have fallen in a higher tax band

First tier: Impact of indexation of BSP

The rules for increasing BSP have undergone many changes over the last four decades.

- Before 1974 BSP was increased on an ad-hoc basis. For instance in November 1969 it was increased from £4.50 to £5.00 a week and then not increased until September 1971 when it was increased to £6.00 a week.
- From 1974 to 1979 it was increased each year by the greater of the increase in National Average Earnings (NAE) and the Retail Prices Index (RPI).
- From 1979 to 2000 it was increased by the rise in RPI – from 1979 to 1983 on a forecasted basis and from 1983 on a historic basis.

The Social Security Administration Act of 1992 first introduced statutory uprating. This means that since 1992, BSP was increased each April by the increase in the RPI for the 12 months to the previous September.

Although the purpose of the statutory uprating is to increase BSP annually in line with the RPI, prior to April 2011, and after 2001, the BSP was increased by the greater of 2.5% or the RPI. The net effect is that although the value of the BSP increased in real terms, when compared to NAE its value has gradually eroded since 1979 (Table 2). Under previous policy BSP would have continued to erode relative to NAE until at least 2012.[61]

Changes to BSP uprating

From April 2011 the BSP is uprated by the higher of 2.5%, earnings or prices (a mechanism known as the "triple lock"). The Consumer Prices Index (CPI), rather than the Retail Price Index (RPI) is used to consider price inflation. Table 2 shows the impact of the new mechanism by comparing the possible uprating under the triple lock with the projected growth in average earnings.

Sources

Office for National Statistics (ONS) (2009 and previous editions) *Annual survey of hours and earnings (ASHE) - 2009 Results*
www.statistics.gov.uk/StatBase/Product.asp?vlnk=15313
Office for National Statistics (ONS) (2010) *Retail Prices Index: monthly index numbers of retail prices 1948-2010*
www.statistics.gov.uk/STATBASE/Product.asp?vlnk=2176

[61] Assumptions – RPI increases each year by 2.87%. NAE increases each year by 2% above the RPI.

Table 2: Historical uprating of BSP in relation to National Average Earnings

	BSP – Weekly Amount	Adjusted to April 2014 prices	Weekly National Average Earnings	BSP as a percentage of NAE
October 1972	6.75	77.41	32.00	21.1%
July 1974	10.00	91.95	41.70	24.0%
November 1977	17.50	94.20	70.20	24.9%
November 1979	23.30	98.88	89.60	26.0%
November 1982	32.85	101.62	136.50	24.1%
April 1987	39.50	99.22	198.90	19.9%
April 1992	54.15	99.76	304.60	17.8%
April 2000	67.50	101.47	425.10	15.9%
April 2001	72.50	107.10	449.70	16.1%
April 2002	75.50	109.88	472.10	16.0%
April 2003	77.45	109.29	487.10	15.9%
April 2004	79.60	109.61	498.20	16.0%
April 2005	82.05	109.50	516.40	15.9%
April 2006	84.25	109.63	534.90	15.8%
April 2007	87.30	108.68	549.80	15.9%
April 2008	90.70	108.37	574.30	15.8%
April 2009	95.25	115.16	587.30	16.2%
April 2010	97.65	112.07	598.30	16.3%
April 2011	102.15	111.38	602.60	17.0%
April 2012	107.45	113.30	607.10	17.7%
April 2013	110.15	112.89	620.30	17.8%
April 2014	113.10	113.10	631.47	17.9%

Table 3: Projected uprating of BSP under the reformed (triple locked) system

Tax Year	BSP - Weekly Amount (Projected)	Weekly National Average Earnings (Projected)	Projected BSP as a percentage of NAE
2014	£113.10	£631	17.9%
2016	£120.80	£674	17.9%
2021	£147.82	£825	17.9%
2026	£185.99	£1,024	18.2%
2031	£234.00	£1,270	18.4%
2036	£294.40	£1,574	18.7%
2041	£370.41	£1,953	19.0%

First tier: Pension Credit

Pension Credit replaced the Minimum Income Guarantee (MIG) in October 2003. Pension Credit (PC) consists of two parts – Guarantee Credit (GC) which is similar to the MIG, and Savings Credit (SC).

Guarantee Credit
Guarantee Credit replaced the Minimum Income Guarantee (MIG) in October 2003. Guarantee Credit (GC) is the name used for income support for people over the women's SPA. It is payable from around age 62 in 2014 as a tax-free means-tested benefit – it is only paid to those with low incomes and with low savings.[62]

Its effect is redistributive – the benefit is paid for from taxes that are related to income and only paid to those on low income. From April 2014 GC 'guarantees' a minimum of £148.35 a week for single pensioners and a minimum of £226.50 a week for couples.

An individual or couple[63] is eligible for GC if they:
- Have an age equal to women's SPA (currently around 62) or higher. This age is progressively increasing in line with the increase in women's SPA.
- are on a weekly income below the GC level of £148.35 a week for single pensioners and a minimum of £226.50 a week for couples, and
- are working less than 16 hours a week (and any partner working less than 24 hours a week).

Changes around eligibility for Pension Credit
The Welfare Reform Act 2012 stipulates that an individual over the SPA will not be entitled to Pension Credit if they have a spouse under the SPA. This rule came into force when Universal Credit was introduced in 2013.[64] Universal Credit is being rolled out gradually with plans to move most existing claimants to Universal Credit by the end of 2017. Once Universal Credit is fully rolled out, the younger partner will be able to claim Universal Credit for both people in the couple until they also reach the qualifying age for Guarantee Credit (currently 62). However, this may be paid at a lower rate than Pension Credit.

GC can be higher where:
- an individual (or an individual within a couple) is disabled and living either on their own or with another disabled person, or

[62] Savings consist of liquid assets, such as cash, building society and bank accounts, national savings, unit trusts and shares. It does not include the value of the home.
[63] Married, Civil Partners, or living together as husband and wife or as civil partners
[64] See UK Parliament (2012) *Welfare Reform Act*,Sch 2, 64 (1A) p. 124. Available at: http://www.legislation.gov.uk/ukpga/2012/5/pdfs/ukpga_20120005_en.pdf

- an individual (or an individual within a couple) is a carer getting Carer's Allowance, or
- where there are housing costs not fully covered by Housing Benefit.

Lower levels of benefit are paid if pensioners have savings of more than £10,000.[65] The assessed savings include savings and investments, and property that is not the beneficiary's main home.[66] GC is currently reduced by £1.00 a week for each £500 (or part thereof) in excess of £10,000. This is more generous than under the MIG.[67]

Savings Credit
Savings Credit (SC) attempts to encourage saving and ensure that anyone who has made some private saving for retirement will be better off than those who have not saved. However, those who do not have a full BSP will not receive credit for all of their savings. While GC is payable from women's SPA (currently around 62), SC is only payable to pensioners from age 65.

SC pays a tax-free allowance of 60p per £1 for any income between the SC threshold and the GC threshold. This includes some income from ongoing employment, SERPS, Graduated Retirement Benefit, employer-sponsored pension schemes, personal pensions and notional income from savings. The maximum SC that can be received in 2014/15 is £16.80 for single pensioners and £20.70 for couples.

In 2014/15 the income above which people are no longer eligible to receive SC is around £190 for single pensioners and around £278 for couples.[68]

For 2014/2015 the SC threshold for single pensioners is set at £120.35 a week and the SC threshold for couples is £192.00 a week.

Example
Dolly is currently aged 65. She is entitled to a BSP of £103.10 a week - £10 below the maximum entitlement for a single person. She also receives an occupational pension of £30.00 a week giving her a total weekly income of £133.10. She is entitled to a guaranteed element of £15.25 from age 61 (to increase her income to the Guarantee Credit level of £148.35 a week). She also receives a savings credit of £7.65 a week i.e. 60% of the excess above £120.35, giving her a total weekly income of £156.00.

[65] The amount of savings pensioners could have before their GC entitlement was reduced was £6,000 until November 2009 when it was raised to £10,000 - Budget 2009 speech, http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/bud_bud09_index.htm
[66] www.direct.gov.uk/en/Pensionsandretirementplanning/PensionCredit/DG_180168
[67] Under the previous legislation the MIG was reduced by £1.00 a week for each £250 in excess of £6,000.
[68] Income limits for single and pensioner couples could be higher if they qualify for a higher level of GC through severe disability, caring or housing costs.

Example

Table 4 below shows the impact of various levels of accrued savings for a single person receiving only the 2014/15 BSP of £113.10. In this table savings above £10,000 are considered when calculating assumed savings income.

Table 4: Interaction of accrued savings with Pension Credit

Savings	Assumed Savings Income	GC Benefit	Total Weekly BSP + GC
£0	£0.00	£35.25	£148.35
£10,000	£0.00	£35.25	£148.35
£12,000	£4.00	£31.25	£144.35
£14,000	£8.00	£27.25	£140.35
£16,000	£12.00	£23.25	£136.35
£18,000	£16.00	£19.25	£132.35
£20,000	£20.00	£15.25	£128.35
£22,000	£24.00	£11.25	£124.35
£24,000	£28.00	£7.25	£120.35

Table 5 shows the interaction of Guarantee Credit with Savings Credit for various levels of assessed income for single pensioners and pensioner couples. The incomes given represent the total income considered for Pension Credit purposes. It may include, for example, basic state pension, additional state pension, private pension income, savings converted into notional income calculated for the pension credit calculation. Savings Credit can increase up to £16.80 a week (for a single pensioner), when income is £148.35 a week, and then begins to tail off for higher levels of income. Table 5 shows in bold the weekly income value at which GC and SC become zero because of hitting the assessed income limit.

Table 5: Interaction of income with GC and SC in the 2014/15 Tax Year

Single Pensioner							
Weekly Income	Guarantee Credit	Savings Credit	Total Income	Weekly Income	Guarantee Credit	Savings Credit	Total Income
£70.00	£78.35	£0.00	£148.35	£150.00	£76.50	£0.00	£226.50
£80.00	£68.35	£0.00	£148.35	£160.00	£66.50	£0.00	£226.50
£90.00	£58.35	£0.00	£148.35	£170.00	£56.50	£0.00	£226.50
£100.00	£48.35	£0.00	£148.35	£180.00	£46.50	£0.00	£226.50
£110.00	£38.35	£0.00	£148.35	£190.00	£36.50	£0.00	£226.50
£120.00	£28.35	£0.00	£148.35	£200.00	£26.50	£4.80	£231.30
£130.00	£18.35	£5.79	£154.14	£210.00	£16.50	£10.80	£237.30
£140.00	£8.35	£11.79	£160.14	£220.00	£6.50	£16.80	£243.30
£148.35	£0.00	£16.80	£165.15	£226.50	£0.00	£20.70	£247.20
£150.00	£0.00	£16.14	£166.14	£230.00	£0.00	£19.30	£249.30
£160.00	£0.00	£12.14	£172.14	£240.00	£0.00	£15.30	£255.30
£170.00	£0.00	£8.14	£178.14	£250.00	£0.00	£11.30	£261.30
£180.00	£0.00	£4.14	£184.14	£260.00	£0.00	£7.30	£267.30
£190.00	£0.00	£0.14	£190.14	£270.00	£0.00	£3.30	£273.30
£190.35	£0.00	£0.00	£190.35	£278.25	£0.00	£0.00	£278.25
£200.00	£0.00	£0.00	£200.00	£279.00	£0.00	£0.00	£279.00

First Tier: Housing Benefit

Housing Benefit (HB) is a means-tested benefit that is designed to help individuals in rented accommodation to pay for their rent. It is paid to single people or couples based on their income. This includes some income from employment, state and private pensions, notional income from capital and Savings Credit.

The maximum amount of benefit available is an amount equal to a person's (or couple's) share of the household's rent and is paid if claimants are also eligible for Guarantee Credit. In practice, the amount of rent that can be taken into account in the calculation of HB will be restricted if the amount of rent paid by the household is considered to be excessive.[69]

The amount of rent that is actually taken into account in the calculation of HB, after these restrictions have been applied, is called 'eligible rent'.

Housing Benefit is reduced once income reaches a personal allowance of £165.15 a week for singles and £247.20 for couples where one or both partners are aged over 65 from April 2014. This is intentionally set to broadly equal the Guarantee Credit level (currently £148.35 a week from April 2014) plus the maximum amount of Savings Credit (£16.80 a week). As Savings Credit is taken into account for HB, this means that HB is withdrawn once an individual is no longer eligible for the Guarantee Credit.

If the claimant's income is above the personal allowance level, then the amount of Housing Benefit is reduced at the rate of 65p for every £1 of additional income. No benefit is payable if claimants have capital of more than £16,000, unless they are also eligible for Guarantee Credit. Higher personal allowances can apply for individuals who are eligible for premiums for Pension Credit.

The Welfare Reform Act 2007 legislated for the roll-out of Local Housing Allowance (LHA) across the private rented sector from 7 April 2008. LHA is similar to Housing Benefit in that it is a means-tested benefit that aims to help people on modest incomes pay for their rent. However, it differs in how the amount of benefit is determined and in the mechanisms by which the benefit is delivered.

The maximum amount of Housing Benefit payable is the amount of rent that a particular person (or couple) pays, subject to a series of restrictions. LHA gives a claimant an allowance, based on market rents in the

[69] For example, if the contractual rent is significantly above the market level. The size of the accommodation relative to the needs of the tenant may also be considered and rents will also be compared to 'local reference rates', which are calculated as the midpoint of a range of rents for properties of the same size in the locality.

particular locality and on housing needs. The highest rents across the country, including the most expensive 8 per cent of properties in London, are excluded from the calculation of the Local Housing Allowance in each area. Individuals can decide to live in more expensive accommodation than the allowance covers, if they can cover the difference, or live in cheaper accommodation.

The Coalition Government made changes to housing benefit from April 2011.[70] As a result:

- The Local Housing Allowance (LHA) is restricted to a maximum of four bedrooms for new and existing claimants.
- Weekly LHA rates are capped at £250 for a one bedroom property, £290 for two, £340 for three and £400 for a four bedroom property. The maximum rate of Housing Benefit is limited to the rate for a four bedroom property.
- LHA rates are based on the thirtieth percentile of rents of the local area rather than the median.
- From April 2013 LHA will be uprated by CPI.

The Welfare Reform Act 2012 introduced a restriction to housing benefit to allow for one bedroom for each person or couple living as part of the household, with some exceptions. Pensioners are currently exempt from this; however, as the state pension age increases those people affected by the increase may also face this restriction. Claimants will forego a fixed percentage of the Housing Benefit eligible rent; the Department for Work and Pensions has indicated that this will be set at 14% for bedroom and 25% for two or more extra bedrooms.[71]

Other changes related to Housing Benefit have been introduced in phased stages. These are include deductions to be made if there is another adult living in the claimant's home and the rate for room share.

LHA aims to pay the benefit more often to the individuals involved, rather than straight to the landlord as can be the case for some Housing Benefit claims, as a way of fostering greater personal responsibility and money management skills.

Example

Susan is a 65 year old single woman who does not own her own home. She rents a flat which costs her £85 a week. Her income from state and private pensions is £140 a week, which would entitle her to £20.14 a week from Pension Credit (made up of £8.35 from the Guarantee Credit and £11.79 from Savings Credit). If Susan had no additional savings she would be entitled to have her whole rent paid by Housing Benefit.

[70] See UK Parliament (2012) *Welfare Reform Act,* p. 124.: www.legislation.gov.uk/ukpga/2012/5/pdfs/ukpga_20120005_en.pdf

[71] http://www.dwp.gov.uk/adviser/updates/size-criteria-social-rented/

On the other hand, if Susan had savings of £15,000 the first £10,000 of savings is disregarded, leaving Susan £5,000 to be considered. This is converted into a "tariff income" for calculation purposes at £1 for every £500 of savings, giving Susan £10 of tariff income. This makes her income for Pension Credit calculations £150 (=£140 + £10). She would not receive income from the Guarantee Credit but her income from Savings Credit would be £16.14 a week.

Her deemed income in the calculation for her Housing Benefit entitlement would be £166.14 a week.

£166.14 = £16.14 (income from Savings Credit) + £140.00 (income from state and private pensions) + £10.00 (deemed income from savings. This is the same as the deemed income for pension credit because the calculation of tariff income from savings for housing benefit has the same savings disregard of £10,000[72]*)*

*This is £0.99 above the personal allowance for Housing Benefit (£165.15 a week in 2014/15), which would reduce her income from Housing Benefit by £0.64 a week (£0.99 * 0.65). So Susan would receive Housing Benefit worth £84.36 a week towards the cost of her rent.*

If her savings were £16,000 or above, Susan would not be eligible to receive any Housing Benefit (since her savings would be above the £16,000 limit).

[72] DWP (2010) *Social Security Benefit Uprating,* p.1.

First Tier: Council Tax Support

Until April 2013, pensioners were able to access Council Tax Benefit, a means-tested benefit designed to help individuals pay their council tax. Like Housing Benefit, it was paid to singles or couples based on their income. This includes some income from employment, state and private pensions, notional income from capital and Savings Credit.

From April 2013, The Local Government Finance Account allows councils in England to design their own Council Tax Support Schemes (also known as Council Tax Reduction); in this way Council Tax Support is no longer a national entitlement. However, the Government has stated that pensioners should not be worse off under this arrangement. For the purpose of Council Tax Support a pensioner is someone who has reached the qualifying age for Pension Credit, currently 62. Therefore, the thresholds and maximums described below continue to apply.

The maximum amount of Council Tax Support payable is an amount equal to the person's (or couple's) liability to pay council tax, subject to certain restrictions. This amount is paid if the individual is eligible for Guarantee Credit.

Council Tax Support is reduced once income reaches a personal allowance of £165.15 a week for a single pensioner, £247.20 a week for a couple aged 65 and over, for 2014/15. If the claimant's income is above the personal allowance level, then the amount of Council Tax Support was reduced at the rate of 20p for every £1 of additional income. No benefit is payable if claimants had capital of more than £16,000, unless they were also eligible for Guarantee Credit.

There is a 'band E restriction' for Council Tax Support. The effect of this restriction is that claimants whose property fell into Bands F, G or H were awarded Council Tax Support as if their property was in Band E.

Second Adult Rebate (SAR) is a means-tested benefit but it is not assessed on the income and capital of the person liable to claim it. It aims to compensate people who pay council tax but who were not able to claim a single person discount because there was a second adult present in their household.

A single person discount can reduce a person's liability to council tax by 25%, if they are the only adult living in the property. If a second adult is present, SAR can rebate up to 25% of the council tax paid by the claimant. A 25% rebate is paid if the second adult is in receipt of Income Support, Income-based Jobseeker's Allowance or Pension Credit, however this amount is reduced if the second adult has higher levels of income. If the second adult's gross weekly income is less than £185.00, the rebate is 15% and if it is between £185.00 and £241.00 the rebate is 7.5%.

Whenever someone claims main Council Tax Support, SAR is also calculated. The claimant is then awarded whichever benefit (main CTS or SAR) is most advantageous to them. In practice, there are very few awards of SAR.[73]

Example

Tim and Kate are a married couple and are both above age 65. Their Council Tax liability is £12.25 a week. Their combined income from state pensions is £230 a week, which would entitle them to £19.30 a week from Pension Credit (made up entirely of Savings Credit).

Even if they had no additional savings Tim and Kate would still not be entitled to a Council Tax rebate of 100% of their liability because their deemed income of £249.30 a week (£230 + £19.30) is above the personal allowance for couples of £247.20 a week in 2014/15.

*Their deemed income is therefore £2.10 above the personal allowance, which would reduce their income from Council Tax Support by £0.42 a week (£2.10 * 0.2). So Tim and Kate would receive a Council Tax rebate worth £11.83 a week.*

If Tim and Kate did have savings above the £16,000 limit, they would not be eligible to receive any Council Tax Support.

Source

Department for Work and Pensions (2014) *Proposed benefit and pension rates 2014 to 2015*
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/275291/Benefit_and_Pension_rates_2014-15.pdf

[73] The DWP is unable to confirm exact figures of how many people claim SAR, and has removed estimates from their publications

First tier: Other first tier benefits

Individually Assessed Benefits
Disability-related benefits such as Attendance Allowance are payable if individuals satisfy the qualifying criteria – for instance:

- Attendance Allowance - lower rate of £54.45 from April 2014 – payable if the individual needs personal care during either the day or the night. Attendance Allowance can only be claimed after age 65.
- Attendance Allowance - higher rate of £81.30 from April 2014 – payable if the individual needs personal care during both the day and the night.
- Disability Living Allowance – consists of two elements - a care component of between £21.55 and £81.30 a week from April 2014 for personal care, and a mobility component of between £21.55 and £56.75 a week from April 2014. This can only be claimed before age 65, although payment can continue after 65.
- Carer's Allowance of £61.35 a week from April 2014 is payable to those spending at least 35 hours a week looking after someone receiving certain disability benefits including Attendance Allowance and Disability Living Allowance.[74]

Attendance Allowance and Disability Living Allowance are tax free, are not means-tested and do not count as income for the purposes of assessing eligibility for other benefits (such as Pension Credit, Housing Benefit and Council Tax Support).

Personal Independence Payment (PIP) will replace Disability Living Allowance for those people aged 16 to 64. There is a staged timetable for this development; in 2013 PIP will be introduced for new claimants. From October 2013, those individuals who report a change in how a health condition or disability affects them will be invited to apply for PIP. From 2015, DWP will start to contact everyone else receiving DLA.[75]

Carer's Allowance is not payable to those who earn more than £102 a week or to those who receive benefits of £61.35 or more. The amount received can also be reduced if individuals receive other state benefits. Carer's Allowance is taken into account as income for the purposes of assessing eligibility for means-tested benefits, although an individual in receipt of Carer's Allowance may qualify for a carer premium in Pension Credit.

[74] Carer's Allowance is a maximum of £61.35 a week from April 2014, but is reduced by any other income the individual receives. Effectively this only benefits those carers with no retirement pension (mostly women) or a reduced rate of retirement pension.
[75] https://www.gov.uk/government/policies/simplifying-the-welfare-system-and-making-sure-work-pays/supporting-pages/introducing-personal-independence-payment

Near Universal Benefits
Paid irrespective of income or assets, including:
- Christmas Bonus - £10 per recipient of BSP - paid annually before Christmas.
- Winter Fuel Payment - £200 per household where at least one person is age 60 or over, and £300 per household where at least one person is aged 80 or over - paid annually in December.[76] The qualifying age for this benefit increases in line with women's SPA.
- Free NHS prescriptions and eye tests for those over 60.
- Free TV Licences for those over 75.
- Free central heating installed for people receiving Pensions Credit and a £300 discount for other pensioners.
- Free off-peak nationwide bus travel for those aged over 60.

Tax Allowances
- The personal allowance (amount of income receivable before income tax becomes payable) is £10,500 for people born between 6 April 1938 and 5 April 1948, and £10,660 for people born before 6 April 1938.[77] This compares to an allowance for the under 65s of £10,000 in 2014/15.[78]
- The Government is removing the increased personal allowance for people aged over 65. The personal allowance for people already aged over 65 will be frozen at current levels of £10,500 and £10,660 until they meet the personal allowance level of under-65s. For people reaching age 65 after April 2013, their personal allowance will be the same as for those under age 65.[79]
- The married couple's allowance is £8,165 for those born before 6 April 1935. Tax relief of 10% is given on income in this band. Where income exceeds £27,000 any married couple's allowance is reduced at the rate of £1 for every £2 of 'excess' income, to a minimum of £3.140.[80] There is no married couples allowance for those born after 6 April 1935.

[76] https://www.gov.uk/winter-fuel-payment
[77] For people with incomes over £27,000 their personal allowance is reduced by £1 for every £2 over the £27,000 limit until it reaches the personal allowance for those born after 6 April 1948.
[78] From the 2010-11 tax year the Personal Allowance reduces where the income is above £100,000 - by £1 for every £2 of income above the £100,000 limit. This reduction applies irrespective of age.
[79] As announced in Budget 2012
[80] This is the notional value of the married couple's allowance to those aged under 65, which was abolished with effect from the 2000/1 tax year

Second tier: Overview

The UK's second tier of state pension provision operates on an unfunded 'pay-as-you-go' contributory basis, through the National Insurance (NI) system. Benefits are payable from SPA, and can be deferred in the same way as Basic State Pension. The self-employed are currently excluded from second tier provision.

Introduction of the Single-Tier pension
Under the single-tier state pension S2P would be abolished and there would be no contracting-out. Currently, DB schemes can be contracted out of the State Second Pension (S2P), and employers receive a rebate on their National Insurance Contributions.

The original aim of the second tier was to provide further pension income to employees in a way that is more closely related to their earnings level than the first tier. Contributions are made in proportion to earnings (in a band between minimum and maximum limits). Benefits reflect these contributions, so there is less redistribution (from rich to poor) than in the first tier.

Second tier provision in the UK has existed in three different schemes since 1961:

- Graduated Retirement Benefit (GRB: 1961 to 1975)
- State Earnings Related Pension Scheme (SERPS: 1978 to 2002)
- State Second Pension (S2P: from April 2002)

Some of today's pensioners still receive small amounts of benefit from accrued rights to the **Graduated Retirement Benefit (GRB).** Further information on GRB is available in the Historical Annex that accompanies this document.[81]

The **State Earnings-Related Pension Scheme (SERPS)** is much more significant for current pensioners.

The original aim of SERPS was to provide a pension of 25% of band earnings.[82] Subsequent changes to SERPS have reduced the value of SERPS benefits. A detailed discussion of the changes SERPS has undergone is available in the Historical Annex.[83]

State Second Pension (S2P) started in 2002 as a replacement for SERPS. Significant pensions under S2P have yet to start payment. The main aim of S2P is to target greater resources at the lower paid and some individuals

[81] www.pensionspolicyinstitute.org.uk
[82] Earnings between the Lower Earnings Limit and Upper Accrual Point
[83] www.pensionspolicyinstitute.org.uk

who cannot work due to disability or caring responsibilities. It is therefore more redistributive than SERPS, and people working on low pay benefit more than they did under SERPS.

The pattern of accruing benefits under S2P is more complicated than in SERPS, being based on three earnings bands and three accrual rates, rather than one band and one accrual rate. As a result of provisions in the Pensions Act 2007, the earnings bands have been reduced from three to two since April 2010. The purpose is to progressively transform S2P into a flat rate benefit.

For low earners, a flat-rate of S2P pension is guaranteed. Higher earners accrue an additional earnings-related benefit. Disabled people, and some individuals with caring responsibilities, are credited into the flat-rate part of S2P.

Current working age employees can only accrue S2P as the SERPs scheme is closed to future accrual, however SERPs remains an important component of the income paid out to today's pensioners and will continue to do so for many years.

This guide focusses mainly on S2P and its predecessor SERPS. An historical annex provides further background on the changes made to SERPs by successive Governments and on Graduated Retirement Benefit – the predecessor benefit to SERPs.

Second tier: State Second Pension (S2P)

State Second Pension (S2P) is an additional state pension scheme introduced by the Government in 2002 under the Child Support, Pensions and Social Security Act 2000, as the successor benefit to SERPS. The aim of S2P is to target greater resources at the lower-paid than SERPS did, and to provide pension benefits for some carers and individuals with a long-term disability.

Transition towards a single tier pension
After the single-tier pension is introduced, people will no longer be able to accrue entitlement to S2P. However, people who have already accrued entitlement will have their entitlements 'recognised' under the new system.

S2P is funded through National Insurance contributions on a pay-as-you-go basis. The pension is payable from SPA and is taxable. All employees are members of S2P, and earn S2P pension for any periods of employment, unless they:

- earn below the Lower Earnings Limit, or
- are aged over SPA, or
- are a married woman or widow paying reduced rate NI contributions, or
- are members of a contracted-out occupational pension scheme.

No S2P is earned for periods of self-employment or unemployment.

S2P pension at SPA is based on band earnings. Before 6 April 2010, there were three bands. Following provisions in the 2007 Pensions Act, the former second and third bands have been merged.[84] The band earnings and accrual rates are the following:

- Those earning between the Lower Earnings Limit (LEL) £5,772 a year (2014/15) and the Low Earnings Threshold (LET) of £15,100 a year (2014/15) are treated as if they earned £15,100. Benefit accrues at a flat rate of £92 indexed to National Average Earnings.
- Those earning between £15,100 per year and the Upper Accrual Point (UAP) of £40,040 per year (2014/15) also accrue benefit but a rate of 10% of earnings within this band.
- Some carers[85] (caring for children under 12-years old or disabled relatives) and people with a long-term illness or disability will be treated as if they are employees earning at the LET.

Changes in the Pensions Act 2007 increased the number of people accruing State Second Pension. Starting in April 2010, the changes have

[84]. For the current earnings limits - http://www.hmrc.gov.uk/rates/nic.htm
[85] Before April 2010 not all carers could accrue benefits, as they had to have cared for the entire financial year. Shorter spells of caring or those that straddle two financial years did not qualify.

allowed people to be deemed to be earning at the LET by combining earnings below the LET with a more generous system of weekly credits.

The new earnings credits, of 1/52 of the qualifying earnings factor for the year, are available in respect of each week in which the person was:
- awarded child benefit for a child under 12, or
- a foster parent, or
- caring for someone with a qualifying disability benefit for at least 20 hours a week, or
- entitled to Carer's Allowance, or
- entitled to Severe Disablement Allowance or long-term Incapacity Benefit. The labour market attachment test will no longer apply to disabled people from April 2010.

Class 3A voluntary National Insurance contributions

The Department for Work and Pensions has outlined plans to introduce Class 3A National Insurance contributions, which will be called the State Pension top-up.[86] These are designed to help those people who have not been able to build up much additional State Pension but have reached SPA before the introduction of the single-tier pension.

The Government has indicated that individuals will be able to make Class 3A contributions from October 2015 and the offer will be open for 18 months.

Each Class 3A contribution will be used to acquire a unit of extra pension which will increase the individual's additional State Pension by £1 a week up to a cap of £25 per week.

The price has been set at an 'actuarially fair' rate and will therefore be lower for older pensioners than younger pensioners.

[86] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/265390/v2_mw__20131211_policy_brief_formatted_FINAL.pdf

Second tier: S2P accrual

Following provisions in the Pensions Act 2007, from April 2010, S2P band-earnings have been reduced to only two. The goal of these changes is to progressively move the S2P towards a flat-rate benefit, though all S2P accrual will end after the introduction of the single-tier pension, however, people who have already accrued entitlement will have their entitlements 'recognised' under the new system.

The two band-earnings are the following:

- The first band is between the Lower Earnings Limit (LEL) and the Low Earnings Threshold (LET) (£5,772 and £15,100 from April 2014).
- The second band is between the LET and the Upper Accrual Point (UAP) (£15,100 and £40,040).

The accrual rate varies for each band. Until 5 April 2012, the accrual rate was 40% of earnings for the first band and 10% of earnings for the second band. From 6 April 2012, the accrual for earnings in the first band was switched to a flat rate.[87] From April 2012, the accrual rates for S2P are the following:

- A flat rate of £92.00 per year for earnings within the first band. This flat rate will be indexed to National Average Earnings.
- A rate of 10% of earnings per year for earnings within the second band.

At retirement the State Second Pension is calculated by dividing the total of the revalued accrual by the individual's potential working life from age 16 to SPA, or from 1978 to SPA, whichever is shorter.

Whereas the upper limit of the first band (LET = £15,100)[88] will increase each year in line with national average earnings, the upper limit of the second band (UAP = £40,040) is fixed.

Where earnings are below the LET, then the individuals are treated as if they earned at that threshold. Qualifying carers or disabled people are also treated as if they earned at that threshold. If individuals have earnings below the LEL (£5,772 in 2014/15), then they do not accrue rights to S2P. Table 6 below shows the annual accrual to S2P for 2014/15 for different levels of earnings.

[87] These changes were introduced by Order 189: The Social Security Pensions (Flat Rate Accrual Amount), following the provisions of the Pensions Act 2007 of moving the S2P progressively towards a flat rate benefit. The order is available: www.legislation.gov.uk/uksi/2012/189/pdfs/uksi_20120189_en.pdf

[88] http://www.legislation.gov.uk/uksi/2013/528/made

Table 6: S2P accrual – 2013/14[89]

Earnings from employment	Band earnings	S2P accrual (p.a.)
Carer - £0	-	£92
£3,000	-	£0
At LEL - £5,772	-	£92
£5,972	£200	£92
£10,000	£4,228	£92
At LET - £15,100	£9,328	£92
£19,000	£13,228	£100
£25,000	£19,228	£112
£33,800	£28,028	£130
£35,000	£29,228	£133
At UAP - £40,040	£34,268	£143
£50,000	£34,268	£143

[89] Assumes potentially 49 years of service

Second tier: State Earnings Related Pension Scheme (SERPS)

SERPS, the precursor to State Second Pension, was introduced in 1978. It was established under the Social Security Pensions Act 1975 and was funded through National Insurance contributions on a pay-as-you-go basis. Subsequent changes have reduced the amount individuals can accrue through SERPS contributions, and from 2002/3 SERPS was replaced with State Second Pension.

SERPS was originally scheduled to provide a pension of 25% of band earnings – annual earnings up to a maximum of 53 times the weekly Upper Earnings Limit (UEL), and less a deduction of 52 times the weekly Lower Earnings Limit (LEL)[90] - linking the pension payable to earnings while in employment. The pension would be higher for higher earners, but capped.

SERPS is payable from SPA and is taxable. Once in payment, it increases in line with prices using the Retail Prices Index (RPI). However, unlike the previous policies for BSP, SERPS is not subject to a guaranteed minimum increase of 2.5% in times of low inflation. From April 2011 SERPS payments are uprated by the yearly rise in the Consumer Prices Index (CPI) instead of the Retail Price Index (RPI).[91]

All employees were members of SERPS, and will have earned SERPS entitlement for any periods of employment, unless they:

- earned below the Lower Earnings Limit, or
- were aged over the SPA, or
- were a married woman or widow paying reduced rate NI contributions, or
- were a member of a contracted-out occupational pension scheme.

No SERPS pension was earned for periods of self-employment or unemployment.

In the Social Security Act of 1986 measures were introduced to reduce the value of future SERPS accruals:

- The best 20 years rule was removed and replaced by lifetime revalued band earnings. This was most disadvantageous to those with fluctuating earnings or with an incomplete employment record.

[90] Originally the LEL was not deducted until the year before reaching SPA. Subsequent calculation changes led to the LEL being deducted in the year of accrual. 53 times the weekly UEL is used where an individual has more than one job and is paid by more than one employer at the same time. For someone remaining in the same employment throughout the tax year, the maximum is 52 times the weekly UEL.
[91] Announced in the June 2010 Emergency Budget. See: http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/junebudget_documents.htm

- The accrual rate was reduced for those reaching SPA after 1998/9 – the long-term target for accrual after 1987/8 was reduced from 25% to 20% of revalued band earnings.

From 1978, members could contract-out of SERPS and into an employer's pension scheme. In addition, from 1988, instead of accruing a SERPS pension, members could contract-out and receive a rebate into a personal pension instead.

The Pensions Act 1995 introduced a further change to the calculation method – the overall effect of which was to reduce entitlement further.

In 2002/3 SERPS was replaced with State Second Pension (S2P). However, people are still eligible to receive SERPS benefits already earned. A more detailed discussion about SERPS is available in the Historical Annex.[92]

[92] www.pensionspolicyinstitute.org.uk

Second tier: Contracting-out

Since the introduction of SERPS in 1978 and S2P in 2002 it has been possible for employers to set-up a private pension scheme that is contracted-out of SERPS/S2P.[93] All employees who were members of a private pension scheme could be contracted-out, as long as certain conditions were met. Both the employer and employee would pay lower National Insurance contributions. Each year, instead of accruing a pension within SERPS/S2P the individual would earn benefits within the private pension scheme.

Between 1988 and 2012, individuals who were members of a stakeholder or personal pension were able to contract-out of SERPS/S2P, receiving a rebate into their stakeholder or personal pension plan. The decision was not irrevocable – they could contract-in and out as many times as they wished, for complete tax years. The accumulated fund arising from such rebates is required to be used to provide pension benefits. From April 2006, it was possible to take some of this fund as a tax-free lump-sum.[94]

From April 2012, it is no longer possible to contract-out from S2P for members of Defined Contribution (DC) schemes, stakeholder and personal pensions.[95] People who were previously contracted out into these schemes are now building up rights to the State Second Pension instead. It is still be possible for Defined Benefit (DB) schemes to be contracted-out.

The Pensions Act 2004 removed the minimum age (60) from which benefits can be paid, enabling them to be paid at the same age as all other rights (55, though the age was 50 until April 2010). Legislation also removed the requirement that the pension bought must include indexation. Members will still be able to opt for an index-linked pension if they wish. However, pensions that are in payment before the changes came into force in April 2005 will not be affected.

If the individual is married, benefits must now also provide a 50% widow(er)'s pension. The overall aim is for the pension arising from contracting-out to be greater than the SERPS/S2P pension given up.

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[93] RN Second tier: Contracting-out of S2P
[94] RN Third Tier: Options for pension withdrawal
[95] Provisions for this were legislated for in the Pensions Act 2007, following the recommendations of the Pensions Commission 2005.

Government Actuary's Department (GAD) (1998) *Occupational and Personal Pension Scheme – Review of Certain Contracting-Out terms*

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Second tier: Contracting-out – additional elements associated with S2P

The replacement of SERPS with S2P created some additional complications for contracting-out.

Contracting–out into a DB pension scheme
If a Defined Benefit pension scheme is contracted-out then the benefits it provides must meet or exceed a minimum standard. For instance benefits should be structured in such a way that at least 90% of the membership is better off than they would have been if they had remained in SERPS/S2P. The enhancements to S2P would have forced schemes to revise their benefit structures.

At the time of the replacement of SERPS by S2P in 2002, it was decided that contracting-out would continue for both Defined Benefit and Defined Contribution pension schemes on terms similar to those which applied when SERPS was in operation:

- The rebates received by the scheme would be based on the accrual rate under SERPS.
- The individual would also accrue a residual S2P benefit which is calculated as the difference between the S2P accrual and the SERPS accrual.
- So anyone earning below the Upper Earnings Threshold £32,600 (2010/11) would accrue benefits in both their occupational scheme and in S2P. The Upper Earnings Threshold was abolished after 2011 when S2P accrual was reduced to two bands.

Contracting-out into a personal pension
For individuals who were contracted-out into a personal pension, the rebate was based on the individual's actual earnings from employment and the actual S2P accrual rates for the different bands of earnings.

Those earning below the Low Earnings Threshold (LET) accrued S2P benefits within S2P, as the flat-rate part of S2P assumed earnings at the LET. The S2P benefit will be based on the difference between their actual earnings and the LET.

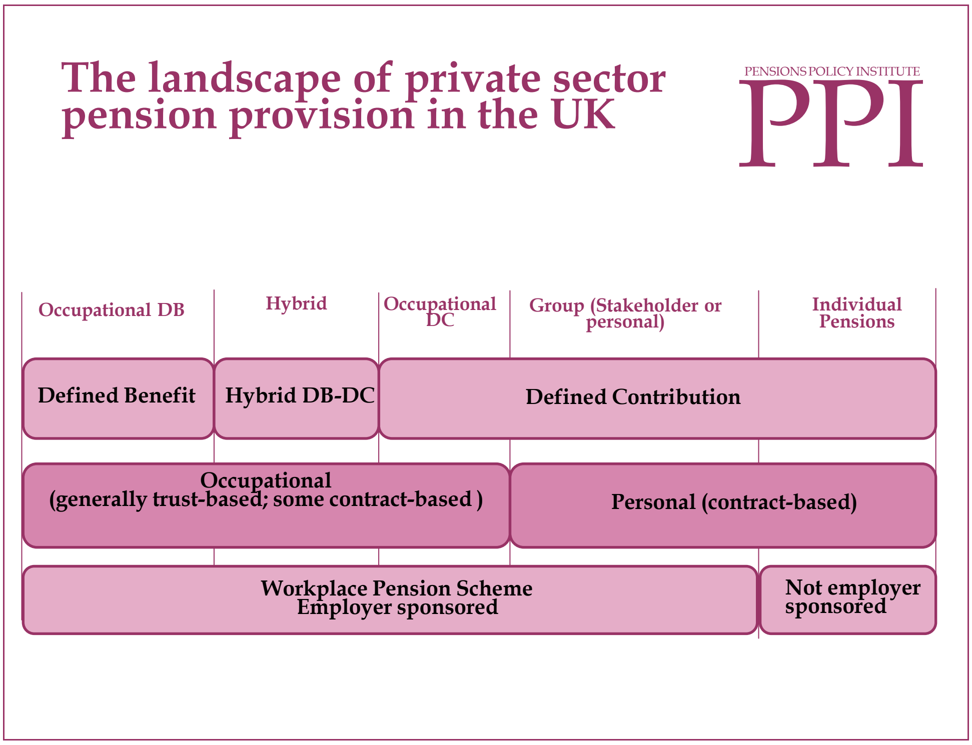
From April 2012 it is no longer possible to contract-out of S2P using a DC occupational, stakeholder or personal pension.

Third tier: Overview of private pension provision

As with state provision, private provision is complicated. The legislative framework has been altered over time, adding layers of new arrangements to those already in place. In addition, because individuals have varied employment histories, many will retire with a number of pensions arising from both employer-sponsored schemes and individual arrangements.

Private pension provision can be made through:
- **Employer-sponsored pension schemes** (including Occupational Pension schemes, group personal pensions and NEST)
- **Individual arrangements**, such as personal pensions (including stakeholder pensions) and before 1988, retirement annuities.[96]

Chart 5[97]



Employer sponsored provision

Some employers run **occupational pension schemes**. Such schemes are arranged under their own trust deeds and rules. The employer usually contributes to these schemes, and more often than not an employee

[96] Access to new retirement annuities contracts ceased in 1988, however those with existing contracts may still contribute.
[97] Adapted from Pensions Commission (2004) *Pensions: Challenges and Choices. The First Report of the Pensions Commission*, Table 3.3, p.80

contribution is required. Most schemes are arranged through a single employer, although there are a few industry-wide arrangements.

Occupational schemes can either be **Defined Benefit (DB)** or **Defined Contribution (DC).**

In **Defined Benefit (DB)** schemes, the benefit received upon retirement is determined by a formula which sets the levels of benefits to be offered, and is usually linked to final salary (or an average of salary over the length of an individual's period of employment). Contributions are paid into a common fund, which is invested to provide all retirement benefits.

The Pensions Act 2004 established the Pension Protection Fund to provide some guarantee of benefits to members of under-funded DB schemes when the sponsoring employer has become insolvent.[98] The Act also introduced a number of changes to the regulatory framework governing Occupational Pensions, including the replacement of the Occupational Pensions Regulatory Authority with a new body, the Pensions Regulator.

In some cases DB occupational schemes will be contracted-out, which means the scheme is providing benefits in place of the State Second Pension (S2P).[99] In this case, the employer and employee's National Insurance contributions are reduced or 'rebated' by the government, and this amount is known as the contracted-out rebate. The rebate helps to fund the benefits. Where the scheme is not contracted-out, the individual has the option of contracting-out on an individual basis.

Additional Voluntary Contributions

If individuals in an occupational scheme wish to increase their pension provision further, then they have the option of paying ***additional voluntary contributions*** (AVCs). These AVCs could either be used to purchase extra years of service – at retirement the total pension will be based on earnings and actual service plus any added years purchased – or could be invested and the resultant pension would depend on the accumulated fund and annuity rates applicable at retirement. Since 1987 there has also been the option of a ***free-standing AVC*** (FSAVC) – this is similar to an AVC except it is a standalone arrangement usually provided by a life assurance company. A FSAVC will only offer money-purchase benefits – it cannot offer added-years. The charges on an AVC are often lower than in other individual arrangements and in some cases the employer will match an AVC contribution.

[98] The PPF does not provide support to schemes that belong to employers who became insolvent prior to the establishment of the PPF. To help groups close to retirement who do not fall under the support of the PPF, the Government established the Financial Assistance Scheme (FAS).
[99] RN Second tier: Contracting-out

Defined Contribution (DC) schemes operate on a money-purchase basis. Contributions are paid into individual accounts and the total benefit upon retirement depends on the value of the accumulated fund. An individual has to translate their pension fund in to an income through income drawdown or the purchase of an annuity.

Hybrid pension schemes are a relatively recent development. These combine DC and DB features within the same pension. For example, a 'nursery scheme' works like a DC for younger staff, but becomes related to final salary as the member gets older.

Personal Pensions

A further option, available since 1988, has been for the employer to make contributions to an employee's **personal pension**. Contributions could be solely from the employer or from both the employee and the employer. The employer can also arrange a **group personal pension**. Each individual member will have their own plan but charges will typically be lower, at least while the member remains in that employment, reflecting the group nature of the contract. In addition the sponsoring employer will usually make some contribution.

Since 2001 there has been the option of employee and employer contributions into a **stakeholder pension**, or a **group stakeholder pension.** Stakeholder pensions are a form of personal pension with limits on the charges that providers can impose. All employers with 5 or more employees, who do not already have comprehensive pension provision,[100] have been required to designate a stakeholder provider but employers are not currently required to make any contribution.

Since April 2012, it is no longer possible to contract-out from S2P for members of Defined Contribution (DC) schemes, stakeholder and personal pensions.[101] People who were previously contracted-out in DC schemes are now building up rights to the State Second Pension. It is still be possible to contract-out from S2P for members of occupational DB schemes. Although the majority of active members of Defined Benefit schemes are contracted-out of the State Second Pension, only a small proportion of members in DC schemes are currently contracted-out of S2P.

Options for pension withdrawal

In April 2010 the minimum age at which private pensions could be taken was increased from age 50 to 55. However, in the Budget 2014 it was announced that this will rise to 57 in 2028. It is possible to begin

[100] An occupational pension scheme or a GPP with a minimum 3% contribution, or some combination, open to all employees

[101] Provisions for this were legislated for in the Pensions Act 2007, following the recommendations of the Pensions Commission 2005.

withdrawing a pension, once over the minimum retirement age, whilst still working.

Prior to April 2006, upon reaching retirement age individuals could take a 25% tax free lump sum leaving the rest invested in an income drawdown account, within limits. By age 75, any remaining pension pot balance had to be annuitised. Individuals with a pension pot below the trivial commutation limit were allowed to take the whole fund as a lump-sum.

Between 2006 and 2010, if a person had private pension savings above the trivial commutation limit and had not opted for an annuity by the time they reached age 75 they were required to begin withdrawing their pension benefits, either by purchasing an annuity or by the additional option of an alternatively secured pension (ASP), primarily for those who had a principled religious objection to buying an annuity.

From April 2011, the requirement to purchase an annuity by age 75 was removed. When individuals opt to withdraw some of their pension saving, they can choose one or a combination of four options:

- **Cash lump sum.** 25% of a pension fund can be taken as a one-off tax-free lump sum, though for members of occupational pension schemes, the exact amount people can take may depend on the rules. If an individual's entire pensions savings (including the value of pensions already in payment) are less than £30,000 from 27 March 2014, it may be possible to 'trivially commute' and take the whole fund as a lump sum, with up to 25% being tax-free and the remainder being taxed as income under PAYE. The Trivial Commutation limit used to be set as 1% of the Lifetime Allowance, however, these were decoupled from 2012.
- **Annuity.** An insurance product that pays an income from the date of purchase until the date of death.[102] Annuity payments are usually taxed as income.
- **Income withdrawal or 'drawdown'.** Also known as an Unsecured Pension Arrangement (USP). This allows an individual to draw an income from their pension fund whilst leaving the remaining fund invested. The minimum and maximum amounts available for withdrawal are set by Government. From 27 March 2014 the maximum amount is 150% of an equivalent annuity there is no age limit to leave fund in a drawdown account.
- **Flexible Drawdown:** Individuals demonstrating that they can satisfy a Minimum Income Requirement (MIR) by demonstrating that they have a secure, lifetime income of at least £20,000 per year, are able to draw down unlimited amounts from their income drawdown product, subject to income tax at their marginal rate. The purpose of the MIR is to ensure that an individual entering Flexible Drawdown has sufficient income to avoid subsequently falling back on the state.

[102] An annuity insures against an individual's money running out because he or she lives longer than expected

People are allowed to withdraw pension savings after the age of 55. Before age 55 they can only withdraw pension savings if they pay a penalty tax of 55%. After the age of 55, people choose one or a combination of the following options:

Budget 2014
The Government announced in the 2014 Budget that, from April 2015, individuals will be able to withdraw the whole of their pension pot. The 25% tax-free lump sum will remain in place while any withdrawals over this amount will be taxed at the individual's marginal rate.

National Employment Savings Trust (NEST)
The Pensions Act 2008 legislated for the introduction of a new pension saving scheme of low-cost, individualised pension savings accounts from 2012 called NEST (National Employment Savings Trust). NEST is now active and accepting members. Once auto-enrolment begins, employers who do not offer an occupational pension or a stakeholder or other qualifying pension scheme will be able to auto-enrol their employees into NEST, provided that the employee's earnings are above the current auto-enrolment threshold for 2014/15 of £10,000. Employees with earnings below this level will be permitted to opt in to the scheme. There is a limit on contributions by or on behalf of an individual of £4,600 a year (2014/15) into NEST.[103]

NEST has a low-charging structure. Members are charged an Annual Management Charge of 0.3% of the fund per year. However, until the start-up costs of the scheme are recovered, NEST members will also pay a 1.8% charge on contributions.[104]

NEST is not the only option for employers without their own pension. Other pension scheme master trusts have been set up in the private sector which aim to provide a pension scheme eligible for auto enrolment. These include Now Pensions and The People's Pension.

Auto-enrolment into pension schemes from 2012
The previous Labour Government acted on the recommendations of the Pensions Commission (who reported in 2005)[105] and legislated in the Pensions Act 2008 for the introduction of automatic enrolment into private pensions. Auto-enrolment was staged from October 2012. Employees between age 22 and State Pension Age are eligible for

[103] Equivalent to £3,600 in 2005/2006 earnings terms. Johnson, P. Yeandle, D. Boulding, A. (2010) *Making automatic enrolment work: A review for the Department for Work and Pensions*, p.19
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214585/cp-oct10-full-document.pdf
[104] See NEST (2012) *Low charges for future members of NEST.* Available:
www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/low-charges-for-future-members-of-NEST,PDF.pdf
[105] Pensions Commission (2005) *A New Pension Settlement for the Twenty-First Century*, p.

automatic enrolment into a scheme chosen by the employer, with employees having the right to opt-out. The earnings threshold above which every employee should be auto-enrolled is £10,000 from April 2014. Contributions become payable on band earnings over £5,772 and up to a limit of £41,865.[106]

After a phasing-in process of 6 years, minimum total contributions of 8% of earnings within designated bands will be paid to a qualifying pension scheme, with a minimum of 3% from the employer. Employees can also contribute and the Government will contribute through tax relief. The specific employee contribution rate will depend on the employer contribution. The Government contribution will be proportional to the employee contribution, as it is calculated as tax relief on employee contribution. If the employer decides to contribute the legal minimum of 3% of band earnings, then the employee will have to contribute 4% and the Government will contribute 1% through tax relief.[107] However, employers will decide whether they want to contribute the legal minimum or more.

National Employment Savings Trust

There are currently restrictions on the amount of contributions that can be made into NEST and on individuals transferring pension funds into and out of NEST, except for annuity purchase, where a pension is shared through a divorce settlement or where an individual has been in an occupational pension scheme for less than two years. Following a call for evidence on these restrictions,[108] the Government has announced that the annual contributions limit will be lifted from April 2017, and that the restrictions on individual transfers will be removed in line with the introduction of automatic transfers. There is no intention to lift any restrictions on bulk transfers.[109]

Tax Simplification

The Finance Act 2004, which took effect from 6 April 2006, included a number of amendments designed to simplify the taxation of the UK private pension regime, effectively capturing all pensions under a single set of rules.[110] Compared to the pre-April 2006 system, there is no limit on the amount of pension saving that an individual can build up in a

[106] SI 2014 No.623 *The Automatic Enrolment (Earnings Trigger and Qualifying Earnings Band) Order 2014*
[107] The tax relief may be higher for those people who pay higher-rate tax
[108] DWP (2012) *Supporting automatic enrolment* *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220474/nest-automatic-enrolment-call-for-evidence.pdf*
[109] DWP (2013) Supporting automatic enrolment The Government response to the call for evidence on the impact of the annual contribution limit and the transfer restrictions on NEST: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211063/nest-automatic-enrolment-call-for-evidence-response.pdf
[110] Inland Revenue (IR) (2003) *Simplifying the taxation of pension: the Government's Proposals* and Her Majesty's Treasury (HMT) (2004) *Prudence for a purpose: A Britain of stability and strength*, Budget report http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/budget/budget_04/bud_bud04_index.cfm

registered pension scheme.[111] Instead, the amount by which an individual can benefit from tax advantages is controlled by two 'allowances': annual and lifetime. These allowances apply to each individual, and across all registered pension schemes that the individual uses for providing benefits, regardless of the time of joining.[112]

An individual can make contributions to any number of private pension schemes and receive tax relief on the amount saved in that year up to the greater of £3,600 or 100% of an individual's annual UK taxable earnings. If in any year the contributions paid by and for the member to money purchase type arrangements, plus the increase in value of benefits under Defined Benefit type arrangements, are more than the annual allowance (AA) (for the tax year 2014/15 this is £40,000), the excess will be taxed at the rate of 40%. The tax charge is payable by the individual.

Individuals who do not pay tax receive tax relief at the basic rate (20%) on all contributions to a private pension in one year up to a limit of £3,600.

The lifetime allowance (LTA) regulates the amount of tax relief an individual is entitled to on their pension savings over a lifetime. Any pension savings in excess of the LTA, set at £1.25 million in 2014/15, will be taxed at the LTA charge of 25% if the benefits are taken as a pension, or 55% if taken as a lump sum.

From April 2013 the new top rate of tax to be paid on earnings above £150,000 will be reduced from 50% to 45%.[113]

[111] All pension schemes must be registered with the HM Revenue and Customs in order to qualify for tax relief and exemption from various taxes
[112] Although exemptions to the lifetime allowance are available to protect existing rights
[113] rates at HMRC website: www.hmrc.gov.uk/rates/it.htm

Third tier: Employer-sponsored pension provision

There are a number of different options available to employers who wish to provide pension arrangements for their employees.

Defined Benefit (DB) occupational pension schemes
There are two main types of DB schemes: 'final salary' and career average.

The benefit arising from a final salary pension scheme is based on an individual's earnings at, or close to, leaving the scheme and their length of service. Career average schemes offer a benefit based on average salary over the course of scheme membership, revalued to take account of inflation throughout the individual's time within the scheme.

Benefits are usually expressed in terms of pension – but the individual has the option of taking a reduced pension and receiving a tax-free lump sum instead. A scheme might typically promise a pension of 1/60th or 1/80th of final salary for each year of service, or alternatively a combined benefit of 1/80th pension plus 3/80^{ths} lump sum for each year of service (although the amount of lump sum may be capped to be within the Revenue's limit for tax-free cash payments).

The scheme will have a specified retirement age – usually 60 or 65. A member can usually take benefits early but is likely to incur a reduction in the accrued benefits to compensate for the longer time that benefits are payable.

Defined Contribution (DC) occupational pension schemes
With a DC or 'money purchase' scheme the employer will specify a rate of contribution, usually expressed as a percentage of salary or total earnings that they will contribute on behalf of a member. The rate of contribution could be flat-rate or could increase with age and/or length of service and/or seniority and/or level of earnings. In addition there might be an element of matching - the employer makes a base level of contribution on behalf of all employees and will increase this where the employee also makes a contribution.

The contributions are invested. Often there is a choice of investment funds – managed, equity, property, gilts, and overseas – and with some schemes a choice of investment manager.

At retirement the pension will depend on the accumulated fund, the amount deducted from the fund as a tax-free lump sum (which is usually up to 25% of the total fund) and the annuity rates available at that time if an annuity is purchased (which depend on age, sex, health, profile of benefits selected plus the long-term underlying gilt yield). The employer makes no guarantees regarding the level of benefits that the accumulated fund will provide – if investment returns or annuity rates are worse, then the resultant pension will be lower, whereas conversely if they are better, then the pension will be higher.

Hybrid pension schemes
Hybrid pension schemes are a catch-all term for schemes that combine elements of DB and DC schemes. This can be done in a number of ways, and is often used as a means for employers to share investment and mortality risk with employees and to increase scheme flexibility.

Such schemes provide a mix of benefits. For example, a 'nursery scheme' works like a DC scheme for younger staff, but becomes related to final salary as the member gets older. Alternatives include DC schemes which guarantee that pension benefits will not fall below the level of a final salary scheme and DB schemes which cap the salary used when calculating the final benefit, incorporating a DC top-up for members who earn more than this.

Defined Ambition
The Department for Work and Pensions is currently looking into proposals for a new model of occupational pensions whereby the risk is shared between the employee and the employer. This would have some elements of Defined Benefits schemes, where the employer bears the risk and some elements of Defined Contribution schemes, where the employee bears the risk. This programme of work is known as 'Defined Ambition'.

A consultation by the Department for Work and Pensions on this subject found support for the development of pension schemes that would provide more certainty to individuals around their level of retirement income than Defined Contribution schemes currently offer. Further to this, the Government published the Pension Schemes Bill in June 2014.[114] The Bill sets out a framework that aims to encourage the provision of types of pension scheme that may take a variety of approaches to sharing or pooling risk between the stakeholders.

Group personal pensions (GPP) and group stakeholder pensions
Some employers have introduced a GPP scheme, or more recently a group stakeholder pension. This is in effect a series of individual personal pensions. These schemes are handled by a pension provider at the request of an employer. The main advantage of a GPP compared to an individual arrangement is that charges are likely to be lower. In addition the employer will usually be making an employer contribution.

Since April 2001 all employers with 5 or more employees have been required to designate a stakeholder provider to which they will make

[114] http://services.parliament.uk/bills/2014-15/pensionschemes/documents.html

payments deducted from an employees pay if they request. Employers are not currently required to make any contributions, although this will change once the requirement to auto-enrol all eligible employees comes into place from 2012 onwards.

Stakeholder pensions are a form of personal pension that must meet a number of Government standards. The main difference between these and other types of personal pension are that management charges in each year are limited by a maximum charge cap.[115]

National Employment Savings Trust (NEST)
The Pensions Act 2008 legislated for the introduction of a new pension saving scheme of low-cost, individualised pension savings accounts from 2012 called NEST (National Employment Savings Trust). NEST is now active and accepting members. Once auto-enrolment begins, employers who do not offer an occupational pension or a stakeholder or other qualifying pension scheme will be able to auto-enrol their employees into NEST, provided that the employee's earnings are above the current auto-enrolment threshold of £10,000. Employees with earnings below this level will be permitted to opt in to the scheme. There is a contributions limit of £4,600 a year (2014/15) into NEST.[116]

NEST has a low-charging structure. Members are charged an Annual Management Charge of 0.3% of the fund per year. However, until the start-up costs of the scheme are recovered, NEST members will also pay a 1.8% charge on contributions.[117]

Automatic Enrolment into private pensions from 2012
The previous Labour Government acted on the recommendations of the Pensions Commission[118] and legislated in the Pensions Act 2008 for the introduction of automatic enrolment into private pensions for all employees between age 22 and State Pension Age to be staged in from October 2012. Employees have the right to opt-out. The Pensions Act 2011 sets the earnings threshold above which every worker should be auto-enrolled at the same level as the income tax threshold, £10,000 in 2014/15. Contributions become payable on band earnings over £5,772 and up to a limit of £41,865 in 2014/15.[119]

[115] RN Third tier: Individual pension arrangements
[116] Equivalent to £3,600 in 2005/2006 earnings terms. Johnson, P. Yeandle, D. Boulding, A. (2010) *Making automatic enrolment work: A review for the Department for Work and Pensions*, p.19 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214585/cp-oct10-full-document.pdf
[117] See NEST (2012) *Low charges for future members of NEST.* Available: www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/low-charges-for-future-members-of-NEST,PDF.pdf
[118] Pensions Commission (2005) *A New Pension Settlement for the Twenty-First Century*
[119] SI 2014 No.623 *The Automatic Enrolment (Earnings Trigger and Qualifying Earnings Band) Order 2014*

Upon auto-enrolment, after a phasing-in process of 6 years, minimum total contributions of 8% of earnings within the designated band will be paid to a qualifying pension scheme, with a minimum of 3% from the employer. Employees can also contribute and the Government contributes through tax relief. The specific employee contribution rate will depend on the employer contribution. The Government contribution will be proportional to the employee contribution, as it is calculated as tax relief on employee contribution. If the employer decides to contribute the legal minimum of 3% of band earnings, then the employee will have to contribute 4% and the Government will contribute 1% through tax relief.[120] However, employers will decide whether they want to contribute the legal minimum or more.

Staging and phasing of auto-enrolment
Automatic enrolment started in October 2012 with large employers enrolling their eligible employees in a staged process.

Large employers with 250 or more employees will not face any change in the date they are due to enrol their eligible employees and they will begin to do so from 1 October 2012 to 1 February 2014.

Medium sized employers with 50 to 249 employees will have automatic enrolment dates between 1 April 2014 and 1 April 2015. This means that the implementation dates of some of these employers will be up to nine months later than originally planned.

Small employers with less than 50 employees will have automatic enrolment dates from 1 June 2015 to 1 April 2017.

New employers setting up business from 1 April 2012 and up to and including 30 September 2017 will have automatic enrolment dates between, and including, 1 May 2017 and 1 February 2018. All employers will be automatically enrolling their eligible employees from 1 February 2018. Any new employer setting up business from 1 October 2017 onwards will be required to comply immediately if paying earnings which attract PAYE deductions in respect of any worker.

Minimum employer contributions will be phased-in starting at a minimum 1% of band earnings in October 2012. The increase in minimum employer contributions from 1% to 2% will begin on 1 October 2017. Contributions will then increase to 3% from 1 October 2018.

Auto-enrolment test
With the introduction of auto-enrolment and NEST in 2012, the Government will set an exemption test for deciding whether an employer-based pension scheme is of a high enough standard to allow the employer

[120] The tax relief may be higher for those people who pay higher-rate tax

to be exempt from auto-enrolling eligible employees into NEST.[121] In order to qualify as an auto enrolment scheme, a pension scheme must:

- Allow contributions to be made by the employer,
- Be "registered", this means the type of scheme that receives tax advantages under the Finance Act 2004,
- Defined Contribution schemes must have employer contributions of at least 3%, and total contributions of at least 8%, of qualifying earnings,
- Defined Benefit schemes must be contracted out, or satisfy the Test Scheme standard for all active members,[122]
- Hybrid schemes must satisfy either the money purchase requirement or the Defined Benefit requirement as appropriate according to rules set out by the Secretary of State.

[121] This was implemented as a consequence of the provisions legislated in the Pensions Act 2008 related to the introduction of automatic enrolment into private pensions and the rolling out of NEST from October 2012.
[122] Test Scheme is a scheme that provides a pension from age 65 of 1/120 x average qualifying service over the last 3 tax years before retirement for each year of qualifying service.

Third tier: Individual pension arrangements

From 1956 individual pension arrangements were available in the form of retirement annuities. These were then replaced in 1988 with personal pensions. Even though a new retirement annuity contract cannot be bought, regular contributions can still be made to existing contracts. The contribution to these contracts may also be changed.

Prior to 2001, personal pensions were only available to individuals while they were self-employed, or were not members of an Occupational Pension scheme. In April 2001, stakeholder pensions were introduced which widened access further,[123] and from April 2006, individual pension arrangements are open to everyone under age 75.

Stakeholder pensions are a form of personal pension that must meet a number of Government standards. The main difference between these and other types of personal pension are that management charges in each year are limited by a maximum charge cap.

For people who joined a stakeholder pension after 6 April 2005, the maximum fund management charge is 1.5% for the first 10 years, thereafter reducing to 1%. For stakeholder plans that were opened before this date, the previous maximum charge of 1% will continue to apply.

Individual pension arrangements are in the form of a money-purchase arrangement - i.e. the contributions, from the individual member or, when applicable, an employer will be invested and the accumulated fund will be used to provide a tax-free lump sum plus a pension.[124]

Contributions to personal pension schemes are subject to the lifetime and annual allowances.[125]

[123] Between April 2001 and April 2006 members of an occupational pension scheme earning less than £30,000 per annum had an alternative 'concurrency' option. This allowed them to contribute up to £3,600 per annum into a stakeholder or personal pension. The £30,000 limit applied to each employment. So for example, it was possible for someone with more than one employment to have a concurrent pension even if his or her total earnings were above £30,000.

[124] Prior to 6 April 2006, the tax-free lump sum was limited to 25% of the accumulated fund for personal and stakeholder pensions, whereas for retirement annuities it depended on the annuity rates available at retirement and varied between 18% and 30%

[125] RN on Tax treatment of private pension provision

Third tier: Options for pension withdrawal

With both state pensions and Defined Benefit Occupational Pension schemes there is some degree of certainty about the level of income an individual will receive once pension payments commence.

In comparison, the actual level of income from a Defined Contribution occupational scheme or personal pension arrangement cannot be accurately predicted in advance. The level of pension is only known on the actual day benefits commence.

Contributions are invested and used to build up a pension fund on behalf of the individual. The ultimate size of this fund will vary, depending on a number of factors including:

- Level of contributions.
- Number of contributions.
- Timing of contributions.
- Underlying investment returns – which in turn depend on the choice of fund manager, the choice of underlying investments – for instance managed, equity, property, gilts, overseas equity, cash – and investment performance until the date the fund is actually cashed.
- Charges levied against the fund.

The Finance Act 2004 raised the minimum age at which people can withdraw their pension benefits from age 50 to age 55 from April 6 2010. It also introduced the option of more flexible retirement –people can continue working whilst taking pension benefits – where occupational pension scheme rules allow it. However, in the Budget 2014 it was announced that this will rise to 57 in 2028.

Prior to April 2006, upon reaching retirement age individuals could take a 25% tax free lump sum leaving the rest invested in an income drawdown account, within limits. By age 75, any remaining pension pot balance had to be annuitised. Individuals with a pension pot below the trivial commutation limit were allowed to take the whole fund as a lump-sum.

Between 2006 and 2010, if a person had private pension savings above the trivial commutation limit and had not opted for an annuity by the time they reached age 75 they were required to begin withdrawing their pension benefits, either by purchasing an annuity <u>or</u> by the additional option of an alternatively secured pension (ASP), primarily for those who had a principled religious objection to buying an annuity.

From April 2011, the requirement to purchase an annuity by age 75 was removed. When individuals opt to withdraw some of their pension saving, they can choose one or a combination of four options:

- **Cash lump sum.** 25% of a pension fund can be taken as a one-off tax-free lump sum, though for members of occupational pension schemes, the exact amount people can take may depend on the rules. If an individual's entire pensions savings (including the value of pensions already in payment) are less £30,000 from 27 March 2014 onwards, it may be possible to 'trivially commute' and take the whole fund as a lump sum, with up to 25% being tax-free and the remainder being taxed as income under PAYE. The Trivial Commutation limit used to be set as 1% of the Lifetime Allowance, however, these were decoupled from 2012.
- **Annuity.** An insurance product that pays an income from the date of purchase until the date of death.[126] Annuity payments are usually taxed as income.
- **Income withdrawal or 'drawdown'.** Also known as an Unsecured Pension Arrangement (USP). This allows an individual to draw an income from their pension fund whilst leaving the remaining fund invested. The minimum and maximum amounts available for withdrawal are set by Government. From 27 March 2014 the maximum amount is 150% of an equivalent annuity.
- **Flexible Drawdown:** Individuals demonstrating that they can satisfy a Minimum Income Requirement (MIR) by demonstrating that they have a secure, lifetime income of at least £20,000 per year, are able to draw down unlimited amounts from their income drawdown product, subject to income tax at their marginal rate. The purpose of the MIR is to ensure that an individual entering Flexible Drawdown has sufficient income to avoid subsequently falling back on the state.

An individual can 'trivially commute' and take the full value of their pension benefits as a cash lump sum, providing the individual is over age 60, and the value of benefits from all the individual's pension arrangements is less than the trivial commutation limit, £30,000 from 27 March 2014 onwards. Where the fund being taken as cash has not vested, 25% of the lump sum is tax free,[127] with the balance being taxed as income in the year the individual receives it. The value of any vested benefits being commuted is fully taxable as income in the year the individual receives it.

To ease the administration of making certain trivial commutation payments, the previous Labour Government changed the rules in Budget 2008 regarding small 'stranded' pension pots in occupational pension schemes. From 1st June 2009 people have been allowed to take funds of £2,000 or less as a lump sum, even if an individual has multiple pension funds worth more than the trivial commutation limit[128] (£18,000 in

[126] An annuity insures against an individual's money running out because he or she lives longer than expected
[127] Protection exists for individuals who would have been entitled to a larger tax-free lump sum prior to the April 2006 changes
[128] The Taxation of Pension Schemes (Transitional Provisions) (Amendment) Order 2009 www.opsi.gov.uk/si/si2009/pdf/uksi_20091172_en.pdf

2012/13.) From April 2012, this option has also been extended to members of DC schemes (personal pensions, group personal pensions and SIPPs). From 27 March 2014 the government extended this rule to funds of £10,000 or less.

Budget 2014
The Government announced in the 2014 Budget that, from April 2015, individuals will be able to withdraw the whole of their pension pot. The 25% tax-free lump sum will remain in place while any withdrawals over this amount will be taxed at the individual's marginal rate.

Annuities
Most annuities purchased are level; meaning that once the annuity is purchased, the level of income an individual receives from it is then set for the remainder of the individual's life.

The cost of an annuity depends on the following factors:
- Long-term interest rates prevalent in the market at that time
- The age and gender of the individual
- The health and lifestyle of the individual - for example those in poor health may be able to get a higher income from their fund
- The type of benefits chosen – for example those increasing in line with RPI, or incorporating a spouse's pension are more expensive
- Expenses of the provider, including any profit margins.

From April 2006 rather than having to buy a lifetime annuity, there is the option of taking a short-term or limited period annuity. This is a fixed-term annuity which provides an income for a set period whilst the rest of the pension fund remains invested. People also have the option of taking a Value Protected Annuity (VPA) which allows them to leave their unclaimed pension to their estate should they die early. This 'cash back' is subject to 35% tax.

A minority of annuities sold are investment-linked, where the payments are linked to the value of the underlying assets. The income, as with all pension income, is taxable as earned income.

Third tier: The Pension Protection Fund

A key feature of Defined Benefit schemes is that the employer is assumed to pay sufficient contributions to ensure that the promised benefits are paid. However, this is not guaranteed.

The Pensions Act 2004 established a Financial Assistance Scheme (FAS) to offer help to members who have lost benefits through Occupational Pension schemes that are underfunded when they begin to wind up and/or where the employer is insolvent or no longer exists.[129] Members from under-funded pension schemes that started winding up between 1 January 1997 and 5 April 2005 are potentially eligible for help from the FAS.[130]

In addition, the Pension Protection Fund (PPF) became operational in April 2005.[131] It has been designed to protect members of certain eligible Defined Benefit occupational schemes and the DB parts of hybrid schemes. The PPF aims to pay some of the pension to members of schemes who lose out when the employer running their scheme becomes insolvent and the pension fund is underfunded.

The PPF is managed by an independent Board, who pay compensation, calculate annual levies and oversee the investment of the fund assets.

The PPF pays out 100% of the current level of pensions already in payment, and 90% of the pension owed for people not yet receiving a pension. Pensions in payment are increased each year in line with the rise in the Consumer Prices Index (CPI) capped at 2.5%. Compensation payments are subject to an overall cap. The standard amount of the cap is age related, for example, from April 2013 the standard amount of the cap at age 65 is £36,401.19 for current pensioners (£32,761 for a 65-year-old not yet receiving a pension), and is adjusted depending on the age that the pension comes into payment.[132] These factors may mean that pensions received from the PPF are smaller than some members had expected to receive from their original scheme.

[129] DWP Pension Reform – Financial Assistance Scheme www.dwp.gov.uk/lifeevent/penret/penreform/fas/
[130] Extensions to FAS were announced in December 2007. The Pensions Act 2007 provides part of those extensions and the rest will be brought forward in regulations. The changes raise the rate of assistance to 90% of accrued pension at the date of commencement of wind up, revalued to their retirement date. This will be subject to a cap of £26,000 per annum. Assistance will be paid from the scheme's normal retirement age (but not before age 60). To be eligible to get payments from FAS a person needs to be or have been a member of a qualifying pension scheme (or the survivor of such a member). The extensions to FAS remove the age criterion for eligibility. Members of qualifying schemes no longer need to have been within 15 years of their normal retirement age on or before 14 May 2004 to qualify for assistance; the new, more generous level of assistance will be received by all qualifying members, regardless of age. Schemes belonging to solvent employers may now also be eligible.
http://webarchive.nationalarchives.gov.uk/+/http://www.dwp.gov.uk/lifeevent/penret/penreform/fas/pensions-hoc-statement-17-12-07.pdf
[131] www.pensionprotectionfund.org.uk for further information on the PPF
[132]http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/Compensation_cap_factors_Apr_2014.pdf

Increased compensation cap for long service
In June 2013 the Pensions Minister announced that the compensation cap would be increased for employees with long service. For each year of service over 20 years the cap would be uprated by 3% of the standard amount for a person of their retirement age. The enhanced cap is subject to a maximum of twice the standard amount. These new rules would apply to existing and future beneficiaries from the PPF. Compensation would be reassessed for people currently receiving pension payments from the PPF but would not be backdated. These measures have been included in the Pensions Act 2014.[133]

Compensation payments are partly funded by compulsory annual levies contributed by eligible schemes. Since 2006/7, the annual levy comprises an administration levy and a pension protection levy. The administration levy is set in statute and covers the PPF's initial start-up and running costs. The pension protection levy is set by the PPF Board based on scheme and risk-based factors. Scheme-based factors take into account the level of liability owed to the scheme's members. The risk-based element relates to a scheme's funding level and the risk of becoming insolvent. When the PPF takes responsibility of a scheme, it will also acquire the remaining assets of that scheme to help pay for member's compensation.

[133] *Pensions Act 2014* http://www.legislation.gov.uk/ukpga/2014/19/contents/enacted

Third tier: Pension fund regulatory framework

The Pensions Act 2004 introduced a number of changes to the regulation of Occupational Pension schemes.[134]

This included the introduction of The Pensions Regulator which replaced the Occupational Pensions Regulatory Authority in April 2005. This independent body aims to protect members of work-based private pension schemes, to promote good scheme administration practices and to reduce the likelihood of members having to claim compensation from the Pension Protection Fund.[135]

The Regulator has new powers to tackle under funding and will focus its investigative powers on schemes that are at risk from fraud or poor management and administration.

A second role is to reduce the burden of regulation compliance on well-run schemes, allowing them more flexibility.

Most occupational pension schemes are established as trusts, so the pension scheme's assets are managed separately from the sponsoring employer's control. A trustee is a person or company who is responsible for running the pension scheme properly and securing members' benefits.

The role and duties of trustees are set by various laws and acts of Parliament supported by guidance from the Pensions Regulator.[136]

In addition, the Pensions Act 2004 introduced new regulations on the management and governance of pension schemes.

There are two main requirements:

- For at least a third of trustees in every scheme to be nominated and selected by members.
- Obligations of trustees to have knowledge of scheme documentation, pensions and trust law and principles of investing and funding.

One of the responsibilities of trustees is to ensure that their schemes are adequately funded. The Pensions Act 2004 replaced the minimum funding requirement (MFR) with more scheme specific requirements. Additional legislation includes:

- Trustees to publish a Statement of Funding Principles, setting out funding strategies and strategies to tackle funding deficits.
- Better information for scheme members regarding funding.

[134] Outlined in DWP (2003) Simplicity, security and choice: Working and saving for retirement action on occupational pensions
[135] www.thepensionsregulator.gov.uk
[136] Trustees and the Pensions Regulator http://www.thepensionsregulator.gov.uk/trustees/

- Powers for the Pensions Regulator to resolve disputes between trustees and sponsoring employers.

Provisions under the Pensions Act 2004 have given trustees more flexibility in how they run their schemes, enabling them to adapt their scheme to changing circumstances. Schemes are now able to modify the benefits that members have already accrued as long as they have consulted with the members or are replacing benefits with an actuarially equivalent value.

Greater protection for scheme members has also been factored in. Sponsoring employers are now obliged to consult scheme members before making certain changes to scheme rules. The Pensions Regulator is responsible for enforcing this, with the power to issue fines for non-compliance. Changes to future pension arrangements which would require consultation include closing the scheme to new employees and changes in employer contributions.

Third tier: Tax treatment of private pension provision

The tax treatment of private pension provision is generally expressed as EET – Exempt, Exempt, Taxed. Contributions into a pension fund are exempt from tax, the accumulation of the fund is partially exempt from tax and the majority of the proceeds are taxable.

As a tax-free lump sum can be taken instead of some of the pension income, the final 'T' is only partial. The accumulation is also not fully 'E'. The extent of taxation on the fund accumulation depends on the mix of investments within the pension fund, and the marginal tax rate paid by the individual. The roll up of funds invested directly in bonds, property or cash is completely tax-free. However, since 1997, dividend income from equities has been taxed at a Corporation Tax rate, although capital gains remain tax-free.

Prior to April 2006, contributions to and benefits from pension schemes qualified for tax relief according to limits which were closely related to how much an individual earned.[137] There were 8 different regimes, depending on the type of pension scheme in operation.

The Finance Act 2004 introduced measures to simplify the tax treatment of private pensions.[138] From April 2006 there is one single regime, which is the same for all types of pension. The key features of this regime are the introduction of the annual allowance and lifetime allowance, which limit the amount of tax relief received.[139]

Contributions – 'Exempt'

Employer contributions are paid gross by the employer and if they are treated by HM Revenue and Customs as an eligible expense, the employer will get full relief against Corporation Tax. Making pension contributions on behalf of employees has an additional tax advantage for the employer, as employers' pension contributions are not eligible for National Insurance contributions.

Employee contributions up to the greater of £3,600 and 100% of earnings can be offset against income tax – individuals receive tax relief at their highest marginal rate. In some cases full relief is available immediately

[137] For contributions of more than £3,600 a year

[138] Inland Revenue (IR) (2003) *Simplifying the taxation of pension: the Government's Proposals* http://webarchive.nationalarchives.gov.uk/20100104203713/http:/hmrc.gov.uk/consult_new/pensions_consult.pdf and Her Majesty's Treasury (HMT) (2004) *Prudence for a purpose: A Britain of stability and strength*, Budget report, http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/media/1/B/Budget_2004.pdf

[139] RN Third tier: Overview of private pension provision

whereas in other cases basic rate relief is given immediately and higher rate relief is reclaimed through the end-of-year tax return.

From April 2006 there is no limit to the amount of contributions that can be paid into a pension scheme (although some pension schemes may not accept contributions from individuals that do not qualify for tax relief).

In any year, if the total contribution made to Defined Contribution schemes and/or the increase in value of benefits under Defined Benefit schemes for an individual are more than the annual allowance (AA) of £40,000 in 2014/15, the contributions in excess will be taxed at the rate of 40% on the excess.[140]

Under the provisions of the Finance Act 2011, which reduced the annual allowance from £255,000 to £50,000 from 6 April 2011, individuals are able to carry forward any unused allowance from the three preceding years. For Defined Benefit schemes, the valuation factor used to calculate the value of Defined Benefit pension savings has increased from a factor of 10 to a factor of 16.

Upon accessing benefits in retirement, an individual's total pension savings will be tested against a lifetime allowance (LTA), whose purpose is to regulate the amount of tax relief individuals get over their working life. In 2014/15, the LTA is £1.25 million. Any excess over this limit will be taxed at 25% if the benefits are taken as a pension or 55% if they are taken as a lump sum.

Fund Accumulation – mainly 'Exempt'
The pension fund accumulates in a tax-favoured environment – there is no tax on interest or income received gross and no tax on any realised capital gains. However, since 1997 pension funds have not been able to reclaim Advance Corporation Tax (ACT) on UK dividends.[141]

From April 2006, an individual can build up their pension funds tax-free until the total exceeds the lifetime allowance, £1.5 million in 2012/13.

Proceeds – mainly 'Taxable'
From age 55, up to 25% of Defined Contribution pension savings can be taken as a tax-free lump sum. The remainder of the fund can be used to provide an income through any, or a combination of, the following options: purchasing an annuity, investing some or all of the fund into an income drawdown account with a withdrawal cap of 100% of an equivalent annuity, or the fund can be withdrawn 'flexibly' (with no limit on withdrawals) if the fund holder meets the Minimum Income

[140] See: http://www.hmrc.gov.uk/pensionschemes/understanding-aa.htm
[141] PPI (2005) Briefing Note Number 22 Is £5 billion being taken from pension funds each year? http://www.pensionspolicyinstitute.org.uk/default.asp?p=124&publication=0193

Requirement of £20,000 per year. On funds below the lifetime allowance, this pension is taxable as earned income.

Pension funds in excess of the lifetime allowance can still be taken as pension benefit, but they are subject to a different tax rate. When taken as a cash lump sum, the excess is subject to 55% tax. When taken as a pension benefit, the excess is subject to 25% tax, with the income payments taxable as earned income.

Death prior to retirement
If an individual dies before converting their pension savings into an income, the accumulated fund, plus any insured lump sum death benefit, can be paid out tax-free up to the member's available lifetime allowance. Any additional lump sum would be subject to a tax charge of 55%, payable by the recipients of the benefit. Any widow(er)'s or dependant's pensions are not tested against the member's lifetime allowance but will be taxable as earned income.

Acknowledgements and contact details

This document is intended to provide a description of the UK pensions system for the purpose of considering pensions policy. It should not be used to make individual pensions decisions.

Every effort has been made to avoid error, but in such a complicated field unintentional errors and omissions may remain. Please contact the PPI if any data appears to be out-of-date, or to suggest additional subjects for Reference Notes.

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Contact:
Chris Curry, Director
Telephone: 020 7848 3744
Email: info@pensionspolicyinstitute.org.uk

Pensions Policy Institute
King's College
26 Drury Lane
London WC2B 5RL

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