Technical Connection

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STATE PENSION WHITE PAPER

The Government has, at long last, published its White Paper, 'The single-tier state pension – a simple foundation for saving', which sets out its proposals for a new single-tier state pension.

The changes proposed form part of the Government's plan to restructure pension provision and are designed to sit alongside automatic enrolment benefits. The Paper says that "against a backdrop of increasing longevity, current generations of workers will have to take greater personal responsibility for saving to achieve the level of retirement income they are likely to expect. With the introduction of automatic enrolment, it is an appropriate time for Government to withdraw from the role of providing an earnings-related pension, and return to a single flat-rate state pension that keeps people out of poverty and provides a firm foundation for saving."

(1) Single-tier state pension

A new single-tier state pension will be introduced from a date still to be specified, but which the Paper says will be April 2017 "at the earliest". The pension will be set at a rate (assumed in the White Paper to be £144 per week in 2012/13 earnings terms) which exceeds the basic level of means-tested support (ie the Pension Credit guarantee credit, which is currently £142.70 per week for a single pensioner). It will apply to all individuals reaching State Pension Age (SPA) on or after the start date of the new rules.

It will replace entitlement to the Basic State Pension, additional state pension, contracted out benefits and also the savings credit element of Pension Credit.

Its main features are:

- To qualify for the full level of the single-tier state pension an individual will need to have 35 qualifying years of NI contributions (paid or credited) by SPA. For this purpose ‘qualifying year’ will be defined as at present. This is an increase on the current 30 year qualifying period introduced in 2010 for a maximum Basic State Pension and the 30 year period set out in the earlier Green Paper.

  Where an individual has less than 35 qualifying years by SPA, they will receive a proportionately reduced benefit. There will be a minimum period to qualify for any benefit. This will be set at between 7 and 10 years – the White Paper’s calculations assume 10 years.

- The entitlement to the single-tier state pension will be on an individual basis, without the current facility to inherit or derive rights to benefits from a spouse or civil partner. There will, however, be transitional provisions to recognise shared or inheritable additional state pension accrued before the start date and also for certain married or formerly married women who paid reduced rate NI contributions.

- Under existing statute, the pension must be increased at least in line with earnings. However, the decision on the actual uprating basis has not yet been taken, and in any event the Government will review the increase basis each year. The Paper’s working assumption is that the ‘triple lock’ continues, but this is not guaranteed. Where an individual has accrued state pension at the start date in excess of the full level of the single-tier state pension as a result of transitional protection (see below), the excess will be revalued to SPA and increased in payment in line with CPI inflation.

- The pension can be deferred beyond SPA, in return for a higher pension. Although the rate of deferment increase is still to be set by the Government, the White Paper has modelled this on an increase of 5.2% per annum, half the current (generous) rate. It will no longer be possible to receive the benefit of deferring state pension in the form of a taxable lump sum.

- An individual who reaches SPA before the start date of the new rules will not be able to take advantage of the new single-tier state pension by deferring taking his state benefits beyond that date.

- Transitional arrangements will be introduced to protect state pension rights accrued up to the start date of the new single-tier state pension. At the start date of the new arrangements everyone will have their pre-implementation NI record converted into a ‘foundation amount’. When determining this amount account will be taken of any state additional pension benefits while a deduction will be made where an individual has been a member of a contracted out final salary scheme. Further details concerning the calculation of the ‘foundation amount’ are set out below.

(2) Foundation amount

The transition process will translate an individual’s pre-implementation NI records into a single-tier state pension starting amount – the ‘foundation amount’. The adoption of this approach means that there is no need to carry forward differing calculations for the various generations of additional pension. However, as with any simplification, there are winners and losers.

Calculating the foundation amount

a) Where the individual has no contracted out benefits

An individual's NI record will be valued under the rules of the single-tier system. The calculation will be as follows:

$$\frac{\text{Number of pre-implementation qualifying years (maximum 35 years)}}{35} \times £144$$

b) Where the individual has any form of contracted out benefits

Where an individual has been contracted out, a deduction – the 'rebate-derived amount' – will be applied to the valuation on the implementation date to reflect the rebate of NI contributions arising from contracting out, as follows.

$$\left[\frac{\text{Number of pre-implementation qualifying years (maximum 35 years)}}{35} \times £144\right] - \text{'rebate driven amount'}$$

Unfortunately, there is no indication of how the 'rebate driven amount' will be determined and whether it will, for example, vary depending upon whether an individual was contracted out on a final salary or money purchase basis; and how it relates to the various generations of additional pension.

c) A check against accrued state pension entitlement

There will be cases where an individual's accrued state pension entitlement, under the current state pension scheme rules, would be higher than the foundation amount valuation set out above (e.g. where an individual has a significant accrued state additional pension benefit entitlement). Therefore, as a safeguard, after calculating an individual's single-tier valuation, a check will be performed to see if the current system rules would give them a higher benefit. Where this is the case, existing benefit will become their foundation amount, thereby ensuring that everyone's NI record keeps its value at implementation date.

Where an individual's 'foundation amount' is less than the full single-tier amount at the start date, each additional year of qualifying service after the start date before they reach SPA will accrue further state pension entitlement of 1/35th of the full amount of the single-tier state pension (ie £4.11per week (£144/35) in current terms for each additional qualifying year). This is subject to their aggregate entitlement not exceeding the full single-tier amount. For example, if Jill had a 'foundation amount' of £50 per week she could accrue additional state pension for each post-implementation qualifying year up to SPA subject to her aggregate entitlement not exceeding the full single-tier amount. In Jill's case this implies a further 23 years ie. £50 + (£144 x 23/35) = £144. Therefore, if she is more than 23 years away from SPA, her final years of contribution will earn no extra pension benefit.

Voluntary Class 3 NI contributions are to be retained, and it will be interesting to see what will be the cost of purchasing additional 'qualifying years'- in theory it should rise by about 15% as basic state pension accrual currently equates to about £3.58 a week for each qualifying year

Where the individual's 'foundation amount' is based on their accrued entitlement under the current state pension rules and exceeds the full single-tier amount, the excess over this amount will be treated as a 'protected payment'. Any revaluation of the 'protected payment' up to SPA and once in payment will be in line with price inflation, not earnings inflation (as is the case with revaluation of current additional pension benefits up to SPA).

(3) Contracted-out DB schemes

The introduction of the new single-tier state benefits will be accompanied by the abolition of defined benefit contracting out. This is likely to result in a number of significant problems for employers with active members of contracted out final salary schemes, and for the members of such schemes.

The abolition of contracting out will mean that employers and employees will pay the full, rather than the reduced, rate of NI contributions. This will result in such contributions increasing by 3.4% (employer) and 1.4% (members) on earnings, in current terms, of between £5,564 and £40,040.

There at present around 6.9 million active members of DB schemes, 5.3 million of whom are members of public sector schemes. It seems likely that most private sector employers will seek to mitigate the additional costs resulting from the end of contracting out. As it is unlikely that they could ask the scheme members to meet the employer's additional NI liability, employers may well seek to reduce future scheme benefits. This will be no easy matter, and will create further administrative and communication problems. Based on the latest Pension Regulator's annual review of DB Schemes, at most about 6,300 private sector schemes will be affected.

The Government has recognised that employers are likely to want to adjust scheme benefits and that this may represent a problem: many scheme rules provide that changes may only be made by the scheme trustees, or with the consent of the scheme trustees. The White Paper therefore says that "to safeguard the ongoing viability of Defined Benefit pension schemes, the Government believes it is necessary to give employers limited powers to change scheme rules for these purposes without trustee consent." This power will only be capable of being exercised in respect of benefits accruing after the abolition of contracting out. The Government goes on to indicate that it "will work with the pensions industry, employers and member representatives to determine exactly what type of change should be allowed and what safeguards will be needed."

However, the Government has confirmed that employers will still need to consult with scheme members on any such changes.

The Government is arguing that although scheme members will have increased NI contributions, the vast bulk of them will still be better off in view of their increased state pension entitlement. It suggests that "around 90 per cent of those reaching State Pension age in the first two decades after implementation will gain enough extra state pension over retirement to offset both the increased National Insurance contributions they will pay over the rest of their working lives and any potential adjustments to their occupational pension."

Although private sector employers will have the ability to adjust the benefit entitlement under their schemes, the Government is not prepared to accept any changes to benefit entitlement under contracted out public sector schemes. As part of the reforms made to date, the Government has promised a 25 year moratorium on further changes to public sector schemes. Thus the increased employer NI costs will be borne by the public sector employers (effectively with the additional costs of perhaps £5bn a year met by taxpayers).

(4) State Pension Age

The Government has confirmed that there will be a review of SPA at least every 5 years “based around the principle that people should maintain a specific proportion of adult life receiving the state pension.” The first review will be in the next Parliament and its results must be published no later than 7 May 2017. Subsequent reviews will be at least every 5 years with the results of these being published no later than 6 years after its predecessor.

The review will comprise a report by the Government Actuaries Department, which will comment on the proportion of life spent in receipt of state pension, together with a report of an independently-led review body that will consider other relevant factors, including:

- The evidence of variations in life expectancy
- The trends in healthy life expectancy
- The alternative ways of measuring life expectancy
- The impact on the labour market

If the Government decides to increase the SPA as a result of one of these reviews it is felt that 10 years notice of the change should be sufficient to enable individuals to prepare for it.

CAPPED DRAWDOWN MAXIMUM INCOME

The Government announced in the 2012 Autumn Statement that the maximum income from capped drawdown arrangements would be increased from 100% to 120 % of the relevant annuity rate determined from the HMRC/GAD tables. It has now issued the draft Finance Bill 2013 clauses regarding this, which confirm that the increased income level can apply to any drawdown pension year commencing on or after the commencement date, which is expected to be 26 March 2013. This means that:

- Any individual looking to commence drawdown in the next few months should consider whether it will be advantageous to delay this until the new provisions take effect to take advantage of the increased maximum income.

- Any individual who is already taking drawdown and is in a current three year review period, will not be able to benefit from the 120% maximum rate until the next drawdown year commencing after the effective date of the change. This is demonstrated by the following example that assumes the change will be effective from 26 March 2013. Frederick commenced capped drawdown on 10 April 2012. His maximum income was determined as £10,000 (ie 100% times his relevant annuity determined from the HMRC/GAD tables at that time). From his drawdown year commencing 10 April 2013 (and for the remainder of the drawdown years in his current three year review period) he will be able to take a maximum capped drawdown income of £12,000 each year (ie 120% of his relevant annuity determined when he commenced drawdown in April 2012). A new maximum income will be calculated at his three year review date of 10 April 2015.

PENSION MISCELLANY

Government rules out refund of micro pension pots

The Government had received a number of responses to its consultation on the transfer of dormant pension pots that had suggested that schemes should be allowed to refund the very smallest pots, as they were worth so little and could neither be managed efficiently nor transferred to another scheme cost-effectively.

The Government has considered this but has decided that automatic transfer should continue to be the basis for dormant pension pots of all sizes and that refunds will not be available in respect of micro pots. It will, however, continue to monitor the situation as automatic enrolment unfolds.

OFT undertakes workplace pensions study

The Office of Fair Trading (OFT) has launched a market study to examine whether defined contribution workplace pension schemes are set up to deliver the best value for money for savers. It expects to complete this survey by August 2013.

The market for such pensions is going through a period of significant change which, as a result of automatic enrolment, will see an expected rise in the value of annual contributions of around £11 billion by 2018.

The OFT has decided to take a forward look now to see whether competition will work in the best interests of members of workplace pension schemes to deliver low cost, high quality pension schemes. The market study will focus on value for money and the size of pension pot savers end up with at retirement. It will look at the following:

- How pension providers compete with one another and how the market may develop over time.
- Whether there is sufficient pressure on pension providers to keep charges low, and the extent to which information about charges is made available to savers.
- Whether smaller firms face difficulties in making pension decisions in the interests of their employees.
- Whether smaller firms receive appropriate help and advice in setting up and maintaining workplace pension schemes.
- Barriers to switching between schemes and a potential lack of ongoing employer engagement in setting up and managing pensions.

BEREAVEMENT BENEFITS

While most of the interest in the draft Pensions Bill 2013 has rightly focused on the single-tier pension reform, there is another reform within its pages which has a significant impact on financial planning: bereavement payments.

As a reminder, the current structure of bereavement payments (introduced in April 2001) has three parts:

- *Bereavement Payment (BPT)* A one-off tax-free payment of £2,000 payable to someone after their wife, husband or civil partner has died. The figure has been unchanged since 2001: it would be £2,845 in 2013/14, had it been indexed to RPI.

- *Bereavement Allowance (BA)* A taxable weekly benefit which is paid to someone for 52 weeks (or until State Pension Age, if earlier) from the date of death of their wife, husband or civil partner if they are age 45 or over and under State Pension Age. The rate of BA is reduced by about 7% for each year the claimant was under the age of 55 as at the date of death of their spouse or civil partner. For 2013/14 it varies between £32.49 a week at age 45 to £108.30 a week at age 55. The upper figure used to match the basic state pension, but has drifted below it because of uprating differences.

- *Widowed Parent's Allowance (WPA)* A taxable weekly benefit which is payable to a parent whose husband, wife or civil partner has died if they have at least one dependent child for whom they are entitled to Child Benefit. It is payable until Child Benefit ceases, the claimant reaches State Pension Age or upon cohabiting/remarriage/formation of a civil partnership. The rate for 2013/14 is the same as the maximum bereavement benefit - £108.30 a week. A recipient of WPA cannot also receive BA.

All three of the above benefits are not means-tested, and the draft Pensions Bill 2013 contains provisions to replace all three benefits with a single new Bereavement Support Payment (BSP). However, the single payment will have two components:

- A one-off tax-free lump sum payment, for an 'indicative amount' of £2,500 payable to a recipient without dependent children and £5,000 where there are dependent children.

- Further monthly tax-free payments, for one year only, the 'indicative amount' of which is £150, for a recipient without dependent children. The corresponding amount is £400 where there are dependent children.

The qualification criteria will be simplified for BSP, so that the full payment is made as long as the late spouse or civil partner paid National Insurance contributions for any one year prior to their death. The value of BSP will be ignored for means-tested benefits and the impending benefits cap. The draft Bill does not specify a start date for BSP, but the impact assessment suggests 2016/17 "at the earliest".

As with the single-tier pension reform, the move from the current regime to BSP will create winners and losers:

- Childless couples, where the survivor is under age 45, are obvious winners as they will receive £4,300 tax-free, against £2,000 today.

- Beyond age 45, the maths depends upon the assumed tax rate of the survivor – the crossover is 48 for basic rate taxpayers and 51 for 40% taxpayers.

- Couples with children will generally be the losers, unless their entitlement to Child Benefit is due to end within a couple of years of the death.

The winners and losers calculation is complicated by the interaction of the current benefits with other entitlements, something that will fall away for BSP. The losers under BSP will be thrown on to means-tested Universal Credit if they need additional benefits.

The DWP's cost projections show that in 2016/17 the combined cost of BSP and the legacy of the current arrangements will be £50m more than under the current regime. However, the legacy cost naturally drops over time with the result that by 2019/20 the extra total cost is just £10m. In the long term – which the DWP impact assessment carefully avoids – the cost of BSP should be much lower because of the disappearance of the WPA payments, which can run up until the youngest child reaches age 20.

COMMENT

These changes need to be incorporated into calculations of life cover requirements for families. At worst they could mean the loss of £5,500 plus of income for a considerable number of years.

THE OFFICIAL RATE OF INTEREST FOR 2013/14

The "official rate of interest" that applies to employment-related loans will remain at 4.0% for the tax year 2013/14.

If an employer makes a cheap loan to a higher paid employee (one earning £8,500 a year or more) or a director then the official rate is used to measure the benefit to the employee which is subject to tax as a benefit in kind. The benefit is the difference between the interest (if any) paid by the employee and interest at the official rate. An employer will pay Class 1A National Insurance contributions on any taxable benefit.

There is a de minimis provision which operates so that if the loan or total loans for an individual at no time in the tax year exceeds £5,000 no tax charge is made.

INCOME WITHDRAWAL RATE FOR FEBRUARY 2013

The appropriate gilt yield, used to determine the 'relevant annuity rate' from HMRC's tables for an adult member commencing income withdrawals (or reaching an income withdrawal review date), in February 2013 is 2.5%.