



THE PCS ALERT

The latest in DB Pensions

CONTRACTING-OUT - THE GOVERNMENT'S HIDDEN PENSION TAX

Dear Sid

Much has been made of the Chancellor's raid on pension schemes through the abolition of ACT relief on the equity dividends received by pension schemes. But little has been made of the fact that Government is taking almost as much from pension schemes by setting National Insurance (NI) contribution rebates for contracted-out pension schemes which are far too low. What makes this even worse is that contracting-out is optional. In effect, occupational pension schemes are paying a voluntary tax of around £3billion per annum to the Treasury.

Approximately 7 million people in the UK are members of contracted-out occupational pension schemes (in both the public and private sectors). This means that in exchange for paying lower NI contributions, they receive lower State pension benefits in retirement. In effect, occupational pension schemes are paying part of the State pension – or more precisely, part of the State Second Pension (S2P). However, the reduction in NI contributions - the NI rebate, which the pension scheme receives in exchange for replacing these State benefits - represents very poor value for money.

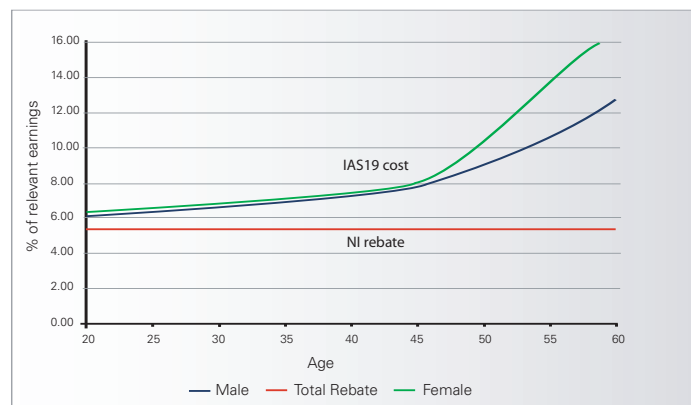
NI rebates are reviewed regularly by DWP and the Government Actuary

The NI rebates are reviewed every 5 years by the Government Actuary. The last change in NI rebates was in 2002 and the next change is due to take effect from April 2007. The report of the Government Actuary on his review of contracting-out terms was submitted to the Right Hon John Hutton, Secretary of State for Work and Pensions in January of this year. John Hutton then presented his report to Parliament two months later in March. Citing the "present fiscal circumstances" and the ongoing review of pensions policy, John Hutton commented that he did not believe it would be appropriate to accept the recommendation of the Government Actuary on the level of NI rebates from April 2007. As a result the Government proposed that the total NI rebate would be set at the seemingly arbitrary level of 5.3% of relevant earnings.

Over the summer there has been much lobbying of the Department for Work and Pensions to rethink its proposed policy on the NI rebates for 2007 – 2012. All to no avail. The DWP remains committed to its previous stated policy and NI rebates, which significantly understate the cost of the corresponding benefits.

So just how big is this Government "con"?

This problem is graphically illustrated in the charts below, which show a comparison of the total NI rebate against the cost of the corresponding State benefits given up - using current IAS19 assumptions, which is how companies must record pension costs in their accounts.



We estimate that for a typical pension scheme, the cost of providing the equivalent State benefits using current IAS19 assumptions could be 7.4% of relevant earnings. This compares with the proposed NI rebate from April 2007 of 5.3% of relevant earnings.

The comparison is even worse for pension schemes with a high proportion of female members or those with ageing populations - and many pension schemes are now closed to new entrants and therefore have an ageing employee population.

For some pension schemes, the IAS19 cost of the equivalent State benefits could be 8.5% of relevant earnings or even higher. Such employers are therefore paying an unnecessary payroll tax equivalent to more than 3% of relevant earnings – enough to make a significant difference to profitability.

This shortfall in NI rebates amounts to around £3billion per annum across the whole of the UK economy. This is money, which should be going towards improving the precarious state of pension scheme funding in the UK. Instead the Government is taking it in extra tax.

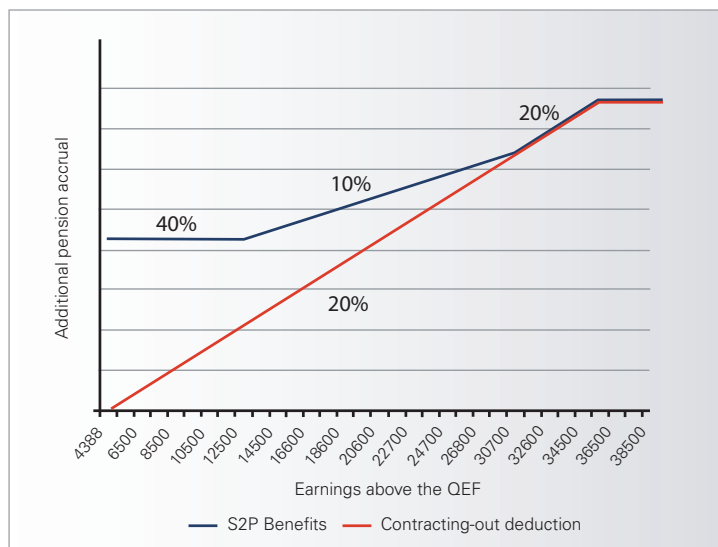
- Contracting out of the State pension arrangements is a lousy deal
- Government has ignored the recommendations of the Government Actuary in setting the NI rebate from April 2007
- HM Treasury is proposing to take around £3billion per annum in voluntary tax from contracted-out occupational pension schemes
- It is complicated and disruptive for a pension scheme to cease contracting out and a cynic might suggest that the Government is relying on this and pension scheme inertia to continue to collect this voluntary tax
- Companies should act now and review whether they should remain contracted-out

Who invented this anyway?

Another issue in this debate is why on earth would an employer want to partner with the Government in anything so outrageously complicated as S2P benefits? Most people will have a reasonable idea what their Basic State Pension entitlement is, but I challenge you to find anyone who has an understanding of their S2P benefits. This "simple" summary will demonstrate exactly why:

- S2P benefits accrue on earnings between the Lower Earnings Limit (LEL), currently £4,368 per annum, or the Qualifying Earnings Factor (QEF) as it is also known, and the Upper Earnings Limit (UEL), currently £33,540 per annum
- Earnings between the QEF and UEL are divided into 3 bands:
 - Band 1 earnings are earnings between the QEF and the Low Earnings Threshold (LET), currently £12,500 per annum
 - Band 2 earnings are earnings between the LET and $(3 \times \text{LET} - 2 \times \text{QEF})$, currently £28,800 per annum
 - Band 3 earnings are earnings between $(3 \times \text{LET} - 2 \times \text{QEF})$ and the UEL
- S2P pensions are earned uniformly over a working life to give the following maximum target pension at State Pension Age:
 - 40% of Band 1 earnings (except that all those earning less than the LET are deemed to earning the LET), plus...
 - 10% of Band 2 earnings, plus...
 - 20% of Band 3 earnings
- Those born before April 1962 earn S2P benefits at a faster rate, and for females born after April 1950, there is also the phasing in of the change to State Pension Age
- And it gets complicated when you try to work out dependents' pensions!

The contracting-out of S2P in an occupational pension scheme results in a deduction in the maximum target S2P pension of 20% or earnings between the LEL and UEL. The S2P benefits and contracting-out deduction can thus be seen graphically as follows:



This fails the "keep it simple" mantra so spectacularly it is no wonder that Government has managed to confuse all and sundry. With no reason not to change other than inertia, why should employers partner with the Government in the provision of S2P benefits?

Most employers will find many advantages in simply providing a top-up benefit, which sits above any State provision and can be much more appropriately targeted.

In summary ...

None of us likes paying tax. We especially do not like paying tax unnecessarily. Employers should immediately review whether their pension schemes should continue to contract out of the State Pension arrangements and pay this voluntary tax to the Treasury.

A decision to cease contracting-out would have significant implications for pension benefit provision and cause complications of transition. But is this sufficient excuse to allow the Government to get away with ever more complicated regulations and yet another raid on pension scheme finances?

Yours sincerely

For further information on the services PCS can offer you, please email us at solutions@pensionstrategies.co.uk or visit our website at www.pensionstrategies.co.uk to register your interest. Alternatively call Charles Cowling on 0161 242 5388 or Peter Redhead on 020 7309 8198

Whilst all reasonable care has been taken in the preparation of this publication no liability is accepted under any circumstances by Jardine Lloyd Thompson for any loss or damage occurring as a result of reliance on any statement, opinion, or any error or omission contained herein. Any statement or opinion reflects our understanding of current or proposed legislation and regulation which may change without notice. The content of this document should not be regarded as specific advice in relation to the matters addressed.

Pension Capital Strategies Ltd. Authorised and regulated by the Financial Services Authority. A member of the Jardine Lloyd Thompson Group. Registered Office: 6 Crutched Friars, London EC3N 2PH. Registered in England No 5651461. VAT No. 244 2321 96.