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State pensions come in two parts. The Basic State Pension which is available to all, and the State Earnings related Pension Scheme (SERPS). At the time of writing (2001/02 tax year), the Basic State Pension is:

- For a single person £75.50 per week
- For a married couple £120.30 per week

Basic State Pensions increase in line with inflation, and are not under threat. This article deals with the additional State Pension – SERPS. State Pensions are funded by your National Insurance (NI) contributions. The payments made today do not accrue a fund for you, they go to pay the pensioners of today, so no fund is accruing for you, it is just a commitment made by the government of the day.

SERPS Pension calculation

Due to the increasing age of the population, successive governments have been looking at reducing benefits under SERPS to ensure that some pension still exists. SERPS benefit has always been based on earnings between the Lower Earnings Limit (LEL) of £3,900 and the Upper Earnings Limit (UEL) of £30,420. This £26,520 was known as Middle Band Earnings.

SERPS pension used to be based on 25% of the best 20 years consecutive Middle Band Earnings (MBE). This was subsequently changed to 20% of Lifetime Average Earnings (LAE), which had the effect of a double reduction in the SERPS pension.

It has always been possible to contract out of SERPS whereby you continue to pay the same rate of NI, but the DSS rebate an annual amount into your own personal pension fund.

As from 6th April 2002, SERPS has been replaced by the **State 2nd Pension** or **S2P**. The concept of this alteration is to try to reward the lower paid members of the population.

S2P & The low earner

Anyone earning between £3,900 and £10,800 initially, will be treated as if they earn £10,800. This will benefit part-time workers and the low paid. It may also benefit company directors who choose to pay themselves a low salary. Individuals who earn in this bracket will be considerably better off with S2P than with SERPS as the pension benefit will be doubled at this level.

S2P income bands

SERPS worked on Middle Band Earnings where the benefit was always 20% of the Lifetime Average Earnings. S2P has introduced income bands. The table opposite shows the difference between SERPS benefits and the new S2P benefits. It can be quite clearly seen that the lower paid individuals will be better off. The Band 2 earners should not be significantly worse off, because of the better pension rights for their earnings in Band 1. This is a more complicated pension arrangement to understand, but it should be seen as an enhancement, if it provides better pensions for the lower paid.

	£	S2P benefit	SERPS benefit
Up to QEF	Up to 3,900	0%	0%
Band 1	3,900 to 10,800	40%	20%
Band 2	10,801 to 24,600	10%	20%
Band 3	24,601 to 30,420	20%	20%
Above UEL	Above 30,420	0%	0%

Contracting out In the same way as SERPS, it is still possible to contract out of S2P. In fact, those who are already contracted out of SERPS, will continue to be contracted out of the new S2P arrangement, unless they make an election to the contrary. The rebates offered by the two schemes are set out in the table below for selected age groups:

Taking someone aged 35 with earnings of £23,900 under SERPS, their rebate would have been 3.8% of £20,000 which is £760. Under S2P, the rebate would be calculated as 10% of £6,900 (£690) plus 2.7% of £13,100 (£353.70) therefore making a total rebate of £1,043.70 – an increase of £283.70 on the old SERPS rebate.

Age	S2P pension Band 1 earnings	S2P pension Band 2 earnings	S2P pension Band 3 earnings	SERPS Middle Band Earnings
20	8.8%	2.2%	4.4%	2.8%
25	9.2%	2.3%	4.6%	3.1%
30	9.6%	2.4%	4.8%	3.4%
35	10%	2.5%	5%	3.8%
40	10.8%	2.7%	5.4%	4.3%
45	12.6%	3.15%	6.3%	5.3%
50	19.8%	4.95%	9.9%	9%
55	21%	5.25%	10.5%	10.5%

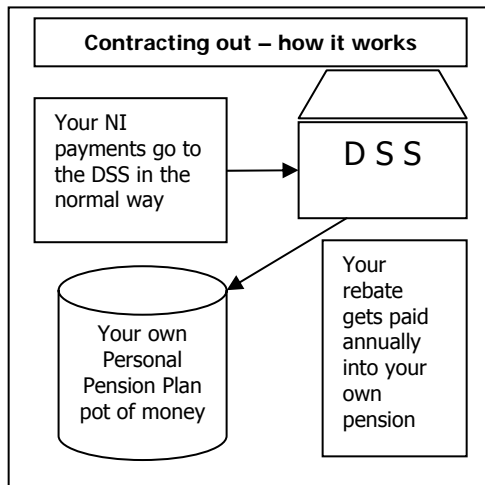
By contracting out then, you are foregoing your additional state pension benefit taking a cash rebate which is then invested in your own personal pension plan or stakeholder arrangement.

There used to be an argument that charges would impact heavily on the choice of whether or not to contract out. This is no longer the case, as charges are restricted to no more than 1% per annum under most pension policies, with no setting up charges whatsoever.

Should you contract out?

The factors that you need to consider in deciding whether you should contract out or not are:

1. Your age – it is a generally held view that once you reach your 50’s, you should contract back into the additional state pension scheme.
2. Your salary – if you earn less than £10,800 you should *not* contract out. Although the S2P scheme will treat low earners as though they earned £10,800 the rebate if you contracted out would only be based on your actual salary.
3. Your risk profile – if you wish to have little or no risk attached to your pension, you should *not* contract out. By definition, to contract out your investment based pension will receive a regular annual payment which may then go down as well as up. If you wish to have a guaranteed pension, you should remain in the state scheme as fully as possible.



4. Your view of future state pensions – governments can change policies which will affect your future pension entitlement. It is unlikely that they will be able to take back any rebated pension contributions paid via the DSS in respect of your decision to contract out. If you take the view that it is better to put this pension money under your own control, then you should contract out, certainly until you reach your early 50’s.

It is however impossible to make an accurate assessment of whether or not you should contract out. If in doubt, our general advice would be to stay in the state scheme, but there is the chance that you *may* be better off if you do contract out, and at least you then control your money. We can provide no guarantee or

assurances either way.

Is it possible to contract back in?

Yes it is. If you make the decision to contract out now, you can get back into the S2P by completing a form which cancels your contracting out mandate.

If you have any questions or need an independent review of your investment arrangements, please contact Martin Andrews to discuss your situation further. Martin Andrews & Associates Ltd is an Independent Financial Adviser authorised and regulated by the Financial Services Authority.

Information given in this document should not be taken as advice as it is intended for guidance only. If you wish to have an assessment of your own situation, you should contact the office for advice.