



**Isle of Man  
Government**

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# A Consultation Document



## Ending Contracting-Out of the State Second Pension

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# Ending Contracting-Out of the State Second Pension

## 1. Introduction

In March 2015 the Treasury published a consultation document entitled "Proposed Changes to the Manx Social Security and National Insurance Systems".

Following this consultation Treasury presented to Tynwald a set of proposals that would form the foundation of the proposed new Manx Pension to replace the existing Basic State Pension, Additional State Pension and (ultimately) the Manx Pension Supplement. These were approved by Tynwald in July 2015. One of the proposals was that the current contracting-out arrangements should cease.

In July 2016 further proposals were agreed by Tynwald including that Treasury would issue a further consultation on the impact of ending the current contracting-out arrangements following the introduction of the new Manx Pension from 6 April 2019.

This consultation seeks the views of employers and scheme trustees who operate contracted-out schemes and employees who are members of such schemes as to how Treasury can minimise any adverse impact that the ending of the current contracted-out arrangements may have.

## 2. Background

In 1978 an earnings-related Additional State Pension was introduced (known as "SERPS") based on National Insurance contributions paid by the employee. This was amended in 2002 by a scheme called the State Second Pension ("S2P") which extended coverage to certain carers and people who are incapacitated for long periods.

When the Additional State Pension was introduced many employers operated occupational pension schemes and if the occupational pension scheme met certain minimum criteria the employer could "contract-out" of the Additional State Pension. As a result of contracting-out the employer and its employees paid lower rates of National Insurance contributions. The difference between the standard rate of National Insurance contributions and the lower rate is known as the "contracted-out rebate".

Between 1978 and 1997 contracted-out pension schemes had to provide individuals with a Guaranteed Minimum Pension ("GMP"). A person's GMP was based on a similar calculation to the Additional State Pension. Currently, at State Pension Age a deduction is applied to the Additional State Pension to take into account the fact that the individual and their employer have paid lower rates of National Insurance contributions.

From 1997 a contracted-out scheme had to satisfy a minimum (rather than individual) standard known as the "reference test". Since then any contracted-out earnings are not included in the calculation of the Additional State Pension and therefore no deduction is applied.

At March 2015 there were about 7,900 individuals in contracted-out employment in the Isle of Man, the vast majority employed by Government Departments, Statutory Bodies or Local Authorities.

### 3. New Manx Pension

With the introduction of the new Manx State Pension from 6 April 2019 the Additional State Pension will cease and therefore the rationale for the current contracting-out rebate will also cease, as everyone will start to build up entitlement to the State Pension on an equal basis.

Treasury believes that ending the current contracting-out scheme will simplify the new Manx State Pension by removing the difficulty in providing accurate estimates of State Pension entitlement, reducing the number of different National Insurance rates paid by employers and employees and ensuring that all individuals build up equal entitlement to the new Manx Pension going forward.

### 4. Impact on employers of ending contracting-out

For employers the ending of contracting-out will have both cost and administrative implications, the largest of which will be the payment of increased employer National Insurance contributions. They will have to pay the same rate of National Insurance contributions as employers who are not "contracted-out", meaning an increase in respect of each contracted-out employee of 3.7% of earnings between the Lower Earnings Limit ("LEL" - currently £113 per week), and the Upper Accrual Point ("UAP" - currently £770 per week). Based on earnings information held for the tax year 2014/15 this will cost employers (including public sector employers) an estimated £7.9 million per annum in extra National Insurance contributions.

In the UK employers raised the issue that they should not have to bear the cost of higher National Insurance contributions whilst still maintaining the same occupational scheme benefits. Treasury recognises that losing the contracted-out rebate will be a financial challenge for employers and therefore propose to follow the UK and allow employers to change their pension scheme design to adjust for the additional cost that will result from the ending of contracting-out. Treasury therefore proposes to give employers powers to change scheme rules **for this purpose only** without trustee consent. Accrued benefits to that point would not be affected.

It should be noted that the additional National Insurance cost to the Isle of Man Government (as an Employer) will be managed as part of the budget process and will not amend or impact on future benefit entitlements for members of the Public Sector Pension Schemes.

#### Question 1

Do you think that it is appropriate for schemes to be able to reduce future pension benefits or increase member contributions as a result of contracting-out ending?

### 5. Impact on employees

When the single-tier new Manx Pension is introduced in April 2019 and contracting-out ends, all employees who were members of a contracted-out scheme immediately before introduction will cease to receive the "contracted-out rebate" and will start to pay full National Insurance contributions. This will mean an increase in the rate of contributions that they pay equivalent to 1.6% of their earnings (between the LEL and the UAP), bringing them into line with the rate of National Insurance that is paid by other employees. Based on the most recent median earnings

figure for the Isle of Man (£536 per week) this would result in an employee in contracted-out employment paying an extra £352.78 in National Insurance contributions per year.

However, in return for these increased NI contributions they will accrue increased State Pension rights under the new single-tier Manx Pension, in the same way as all other employees.

## **6. Impact of past contracting-out periods on the new Manx Pension**

As employees will have paid a lower rate of National Insurance contribution while they were contracted-out a deduction to reflect this will be applied at the point of implementation of the new Manx Pension. The deduction will be calculated and applied against the amount of new Manx Pension they have notionally earned as at 5 April 2019, as if the new Manx Pension had always existed. The resulting amount of new Manx Pension will then be compared with the amount of State Pension they had actually accrued under the current state scheme and they will receive whichever is the higher amount.

If the individual continues to work after 6 April 2019 they will be able to increase the amount of new Manx Pension they are ultimately entitled to by gaining further qualifying years.

### **Example**

#### Contracted-out deduction in new Manx Pension

Jim is aged 60 as at 6 April 2019  
Current State Pension Age ("SPA") = 66

At age 60 Jim has 35 IOM qualifying years for pension and has been contracted out since 1978.

Under the current State Pension scheme he has entitlement to the full Basic State Pension.

His Additional State Pension is worth £75 per week but as he has been contracted-out since 1978 this amount is reduced to zero as Jim's contracted-out deduction is also equal to £75 per week.

Therefore, under the current scheme, he would receive the basic State Pension of £119.30 per week at SPA and no Additional State Pension.

Under the new Manx Pension rules he would be entitled to £170 per week less the contracted-out deduction of £75 leaving a new Manx Pension of £95. As this is less than the £119.30 he has accrued under the existing rules the amount of £119.30 per week becomes his starting balance.

If Jim continues to work for a further six years until he reaches SPA he can earn an extra £29.16 per week of new Manx Pension, giving him a total pension of £148.46 per week.

(Note: This example does not incorporate any entitlement to the Manx Pension Supplement.)

Under the new Manx Pension the vast majority of those who were contracted-out will be able to get extra State Pension for years worked or credited after the new Manx pension is implemented. They will, however, have to pay an increased rate of National Insurance contributions.

### **Question 2**

Do you think Treasury's proposed approach to dealing with previous periods of contracted-out scheme membership in the transition to the new Manx Pension is fair?

## **7. Administrative impact**

The Treasury aims to close all open periods of contracted-out employment and update National Insurance records with minimum cost and administrative burden to both Treasury and affected pension schemes. A key operational challenge will be reconciling the information which schemes have on their members with that held by Treasury. The process currently used when a single scheme ceases to contract-out was not designed for mass closure. Treasury will, therefore, work closely with scheme administrators, considering the lessons learned from the abolition of Defined Contribution contracting-out in 2012 and the experience in the UK of contracting-out ceasing, to develop a way to close all contracted-out records with minimum impact.

### **Question 3**

How could the ending of contracting-out be best managed so as to minimise the administrative burden on schemes and Treasury?

## **8. Defined contribution and personal pension schemes**

Before April 2012 there were two other ways by which an individual could also be contracted-out of the Additional Pension Scheme. One was through their employer operating a Defined Contribution Occupational Pension Scheme, the other was by joining an Appropriate Personal Pension Scheme operated by an insurance company.

Where an individual was a member of either of these types of schemes they were treated as contracted-out of the Additional State Pension scheme in the same way as members of Occupational Defined Benefit schemes, even though the benefits provided under those types of schemes are calculated in a different manner to the Defined Benefit schemes.

Therefore, individuals who have been members of these schemes will also face a deduction from their starting amount under the new Manx Pension.

## **9. What other options are available - a new form of contracting-out or alternative regime?**

Under the proposals agreed by Tynwald in July 2015 contracting-out will end on 6 April 2019. Treasury recognise that this will impact on both employers and employees and while the introduction of the new Manx Pension will mean the current arrangements must end, Treasury is keen to explore whether there may be other options for a new form of contracting-out to be developed and would therefore welcome ideas as to how such a scheme could work in conjunction with the new Manx Pension.

Any such scheme(s) would have to be cost neutral to the Manx National Insurance Fund, whilst also not making the provision of the new Manx Pension complex or unfair.

### **Question 4**

Do you think it is appropriate to develop an alternative to contracting-out when the new Manx Pension is introduced?

### **Question 5**

What form should this alternative to contracting-out take and how would it interact with the new Manx Pension?

## **10. Submissions**

Responses to the questions raised in this document, together with any comments or suggestions concerning the proposals, would be welcomed. Anyone wishing to submit a response to this consultation is invited to do so by Friday 1<sup>st</sup> September 2017. Responses should be sent to:

David Ireland, Director of National Insurance  
Income Tax Division  
2<sup>nd</sup> Floor Government Offices  
Bucks Road  
Douglas IM1 3TX                      Email: [consultation@itd.treasury.gov.im](mailto:consultation@itd.treasury.gov.im)

In any consultation exercise the responses received do not guarantee that changes will be made to what has been proposed.

### **Confidentiality**

The information you send may be published in full or in a summary of responses.

All information in responses, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2015 and the Data Protection Act 2002). If you want your response to remain confidential, you should explain why confidentiality is necessary and your request will be agreed to only if it is appropriate in the circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding.



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