

Contracting out

Member pension benefits

For pensioners who reached their State Pension Age (SPA) before 6 April 2016, the State Pension Scheme comprised the Basic State Pension (BSP) and the Additional State Pension (ASP). If a salary-related pension scheme was contracted out of the ASP element of the State Pension Scheme, it meant that the members of that scheme received the BSP from their State Pension Age (with the amount being dependent on their National Insurance credits history) but no ASP for their contracted-out period.

Contracted-out members paid lower National Insurance contributions than non-contracted-out members and, in return, the scheme guarantees to pay a minimum level of benefits broadly equivalent to the ASP that they would have built up had they not been contracted out.

In respect of benefits earned between 6 April 1978 and 5 April 1997, the broad pension equivalent of the ASP foregone is known as the Guaranteed Minimum Pension (GMP). For this contracted-out period of service, if a member's scheme pension at 'GMP due date' (age 60 for females and age 65 for males) is less than the GMP at this date, the scheme must uplift the member's scheme pension so that it covers the GMP as a statutory minimum.

There is a requirement to split out a member's GMP for the contracted-out period between 6 April 1978 and 5 April 1988 (pre-1988 GMP) and 6 April 1988 and 5 April 1997 (post-1988 GMP). This is due to the different increase rates that apply to the pre-1988 GMP and the post-1988 GMP from 'GMP due date' and, also, to enable the spouse's GMP to be determined in cases where a pre-1988 spouse's GMP does not apply (see below).

With effect from 6 April 1997 (when GMPs ceased to accrue), the Pensions Act 1995 introduced new requirements for contracting out. Essentially, a scheme that wished to contract out from 6 April 1997 had to meet a statutory standard and provide benefits from this date broadly equivalent to (or better than) this statutory standard. This is known as the reference scheme test. The actuary to the scheme had to confirm that the benefits under the scheme were sufficient to meet the test.

Contracting out ceased altogether with effect from 6 April 2016 with the introduction of the new single-tier State Pension.

Spouse pension benefits

If a member dies and leaves a spouse, the scheme must provide a spouse's GMP for the contracted-out period between 6 April 1978 and 5 April 1997.

For a male member with a female spouse, the amount of the spouse's GMP must be 50% of the member's total GMP (split between pre-1988 GMP and post-1988 GMP).

For all other members (e.g. female members, members who are in a civil partnership or same-sex married members), the amount of the spouse's GMP must be 50% of the member's post-1988 GMP.

Where the statutory standard for contracting out applied from 6 April 1997 until 5 April 2016, schemes must additionally provide for a spouse's benefit of at least 50% of the member's pension built up from this date.

Member cash benefits

A member's pension at 'GMP due date' (or actual retirement date, if later) can never be less than the GMP at this date (or actual retirement date, if later). It is therefore possible that, in order to meet GMP requirements, the maximum tax-free cash sum permitted by the scheme will not always be allowed to be taken.

Where a member retires before 'GMP due date', many schemes will estimate the minimum amount of residual pension that can be paid (taking into account assumed future pension increases) to ensure GMP requirements can be met at 'GMP due date'.

If the member's residual pension after calculating the maximum tax-free cash sum is less than the estimated minimum amount of residual pension that can be paid, the member must give up some of the cash entitlement.

The example below explains how the tax-free cash sum may have to be restricted:

1. Full pension at 'GMP due date' = £900.00 p.a. (GMP = £500.00 p.a.)

Tax-free cash sum = £6,050.00 (commutation factor = 11.00)

Residual pension = £350.00 p.a.

2. The difference between the full pension at 'GMP due date' and the actual GMP at this date is £400.00 p.a. (which means that only £400.00 p.a. can be commuted to provide a tax-free cash sum)
3. With a commutation factor of 11.00, the maximum tax-free cash sum available would therefore be £4,400.00 (£400.00 p.a. x 11.00) and the residual pension would be £500.00 p.a. (i.e. the actual GMP).