These notes refer to the National Insurance Contributions Act 2008 (c.16) which received Royal Assent on 21 July 2008

NATIONAL INSURANCE CONTRIBUTIONS ACT 2008

EXPLANATORY NOTES

BACKGROUND

Bringing forward introduction of the upper accrual point

12. In broad terms, for any given tax year state second pension accrues on the portion of an employee's annual earnings between the annual value of the lower earnings limit and the upper earnings limit for Class 1 National Insurance contributions (called the "surplus earnings factor"). This amount is revalued in line with the growth in average earnings up to the last full tax year of a contributor's working life. The accumulated surplus earnings factors are then divided by the number of years in the person's working life since 1978 to produce a "lifetime average" which is multiplied by the relevant accrual rate and divided by 52 to produce a weekly rate of additional pension.

13. For state second pension purposes earnings are split into three different bands with entitlement accruing at a different rate in each earnings band. People earning, or treated as earning, at or above the annual lower earnings limit accrue state second pension on a cumulative basis depending on the level of their earnings. Earnings above the annual upper earnings limit do not accrue state second pension.

14. Under the provisions of the Pensions Act 2007, state second pension is to be restructured to provide a simpler, flat-rate system. That Act provides for an upper accrual point to replace the upper earnings limit for the purpose of capping entitlement to the state second pension. On introduction the upper accrual point will be frozen in cash terms, leading to a gradual erosion of earnings-related accruals.

15. The upper accrual point was to be brought in along with a flat rate accrual amount of around £1.50 a week that would replace accruals on earnings between the lower earnings limit and the low earnings threshold. Taken together, it was expected (when the Pensions Bill that led to the Pensions Act 2007 was introduced) that these two measures would deliver entitlement to the state second pension on a completely flat rate basis by around 2030.

Changes

16. Following changes to align the upper earnings limit with the higher rate tax threshold as announced in Budget 2007, the Act introduces the upper accrual point from April 2009, before the introduction of the flat rate accrual amount.

17. The effect of the Budget 2007 announcements would have meant that without intervention, the level of the upper accrual point upon introduction in 2012 (as previously planned) would be significantly higher than that forecast in the Regulatory Impact Assessment provided for the Pensions Act 2007. As a consequence state second pension would have accrued on a greater amount of earnings than intended.

18. Bringing forward the introduction of the upper accrual point to April 2009, and fixing it at an amount broadly equivalent to the level that the upper earnings limit was projected to be at in 2012 prior to the Budget announcement, re-aligns with the proposals to achieve flat rate accruals by around 2030, set out in the Government White Paper: *Security in retirement: towards a new pension system*.

19. The upper accrual point will replace the upper earnings limit as the weekly upper cap on earnings when determining entitlement to the state second pension. It is set at £770 per week, the level of the upper earnings limit for 2008-09. It will be frozen in cash terms and together with the flat rate accrual amount provided in the Pensions Act 2007 will remove earnings-related accruals within the original time-span.

20. These changes affect calculations relating to the contracted-out rebate. If a pension scheme member is opted out of state second pension they receive a "rebate", which is based on the amount of state second pension foregone. The rebate is calculated on the same band of earnings on which state second pension accrues, and the Act therefore amends the rebate arrangements so as to reflect the introduction of the upper accrual point.