Low Incomes Tax Reform Group (LITRG)

Net Pay Arrangements for lower paid workers – a proposed solution

Updated paper, May 2019

1 Executive Summary

1.1 Auto enrolment is widely regarded as a policy success.[1] However, this success is at risk of being undermined by the fact that increasing numbers of workers are not receiving any tax relief to help make up the contribution amount required under auto enrolment legislation. This essentially makes auto enrolment 20% more expensive for them, as compared to workers that do receive tax relief.

1.2 The issue affects employees who earn at or above the £10,000 needed to trigger auto enrolment, but below (or not very much above) the personal allowance (£12,500 for 2019/20, up from £11,850 in 2018/19) and who are enrolled in a net pay arrangement pension scheme rather than a relief at source scheme. Naturally, as the personal allowance increases, the numbers of workers affected will grow.

1.3 Under relief at source arrangements, non-taxpayers are nonetheless given basic rate tax relief (20%) on pension contributions, provided their contributions are eligible for tax relief (that is, up to the level of their relevant earnings, or £3,600 gross – whichever is the greater amount). However, this same tax relief is not available to non-taxpayers in schemes that operate net pay arrangements.

1.4 We believe the current situation for low-paid earners under net pay arrangements is very unfair, particularly given the fact that they have no control over the pension scheme that their employer

[1] For example: https://www.instituteforgovernment.org.uk/blog/not-blunder-why-automatic-enrolment-working

chooses for them and, indeed, that many of them will have been encouraged into auto enrolment on the basis that they pay in, their employer pays in **and the government pays in**.

1.5 From April 2019, the unfairness is compounded as the employee contribution rate has increased from 3% to 5% (gross). This increase in contribution rate might in itself cause lower paid workers to opt out, an issue which is likely to be exacerbated by the lack of tax relief for those in net pay schemes. This could erode the success of auto-enrolment, and of course also means that affected workers will miss out on employer contributions. The unfairness looks set to increase further with the potential extension of auto enrolment to 18-year-olds and the removal of a minimum income threshold on contributions. Combined, these changes will see more lower earners in net pay arrangement schemes, with all of their earnings coming into play (rather than just the amount above a set threshold).

1.6 Figures we obtained from HM Revenue & Customs (HMRC) indicated that in the 2015/16 tax year, 1.22 million workers in net pay arrangements (including those in occupational as well as auto enrolment trust-based schemes) received no tax relief on their pension contributions because they were non-taxpayers. Royal London has obtained from HMRC an update on this figure for 2016/17 of 1.33 million. On the basis auto enrolment has now fully rolled out and the personal allowance has increased from £11,000 in 2016/17 to £12,500 in 2019/20, this figure will have grown significantly. Royal London's estimate is that some 1.75 million workers could be affected for 2019/20.[2]

1.7 We have, for some time, been raising this issue with HM Treasury and HMRC but no progress has been made so far due to perceived difficulties in finding an appropriate solution. We do not accept this and have been engaged in further study to try and identify a practical solution to this problem.

1.8 We believe we have found such a solution, which would see HMRC using Pay As You Earn (PAYE) Real Time Information (RTI) data to identify those making pension contributions under net pay arrangements. They could then provide tax relief (where appropriate[3]) through an annual reconciliation process, whether that is through Self Assessment or – as is more likely – the informal P800[4] process.

[2] As reported, for example by Money Marketing on 8 April 2019, see https://www.moneymarketing.co.uk/pension-tax-relief-goes-begging-for-low-paid-workers/?cmpid=amalert_7898345&utm_medium=email&utm_source=newsletter&utm_campaign=mm_daily_news&adg=106B01E5-1DB7-4EfffF7-BD93-C9CE0631176F#

[3] There is no issue for people whose pay is high enough to have a sufficient tax liability.

[4] For those taxpayers who do not need to complete a tax return, HMRC automatically reconcile their tax position at the year end, issuing a form P800 where the amount of tax paid by the employee is incorrect (with a demand for more tax or notification of a refund as appropriate). It would also be possible for HMRC to use 'Simple Assessment'. This is a statutory process (Taxes Management Act 1970, sections 28H-28J) and may in fact be preferable to the informal P800 method; however, for the time being HMRC have paused its rollout (see https://www.att.org.uk/hmrc-reprioritisation-simple-assessment-dynamic-coding-paused).

1.9 As part of the P800 'solution', HMRC would have to look at an individual's total income, the amount of pension contributions paid and the amount of tax free allowances due (information that is readily available to them), in order to identify the amount of unrelieved pension contributions. This amount would then become eligible for a 20% tax refund. We enclose as an Appendix a graphic showing how this solution would work in practice, using an example for the 2018/19 tax year.

1.10 The change could be effected by an amendment to Income Tax Act 2007, section 23,[5] cross referring to some amended provisions in Chapter 4 of Finance Act 2004.[6]

1.11 This P800 reconciliation process could also be used to deal with the anomaly that exists in Scotland whereby 19% taxpayers in relief at source arrangements get 20% tax relief, whereas 19% taxpayers in net pay arrangements only get 19% tax relief.

1.12 We do not believe that 'cost' should be a justification for inaction. Indeed, it appears to us that auto enrolment was originally costed on the basis that all savers get tax relief. However, some are not getting the relief purely because their employer has chosen a scheme that works on a net pay arrangement, which in turn – anomalously – means they are denied the relief. This unfairness (between non-taxpayers in otherwise identical financial circumstances), and the potential for auto enrolment policy to be undermined, justify much of the additional cost in our view.

1.13 This is a very important issue, given the central role that tax relief plays in building pension savings and the significance that government places on people making more and adequate provision for income in their retirement, and action should be taken as soon as possible.

2 About Us

2.1 The LITRG is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.

2.2 LITRG works extensively with HMRC and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.

2.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration

[5] https://www.legislation.gov.uk/ukpga/2007/3/section/23

[6] https://www.legislation.gov.uk/ukpga/2004/12/part/4/chapter/4

and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3 The current system

3.1 Under provisions in the Pensions Act 2008[7] (which came into effect in 2012), every employer in the UK must put qualifying staff members into a pension scheme and, where appropriate, pay contributions. This is called 'automatic (or auto) enrolment'. The intention is that this makes it easier for people to start saving for their retirement.

3.2 Employers choose the pension scheme they provide, which must meet certain criteria. If the staff member does not want to be in the pension scheme, they must actively choose to opt out.

3.3 Currently, to be 'eligible' to be auto enrolled, workers must meet the following criteria:

- They are not already in a qualifying workplace pension scheme.
- They are at least 22 years old and are below state pension age.
- They earn more than £10,000 a year – we understand that the limit will be frozen at £10,000 for the foreseeable future. This £10,000 a year translates into a £192 threshold for weekly paid employees and £833 for those who are paid monthly.
- They work or ordinarily work in the UK (under their contract).

3.4 If a worker has been auto enrolled into a workplace pension, they will probably[8] be required to contribute a certain percentage of their 'qualifying earnings'. In 2019/20, qualifying earnings are those from £118 per week up to an upper limit of £962 per week (£512 and £4,167 a month; £6,136 and £50,000 per year).

3.5 The table below shows the phased contribution increases, which is now complete:

Date effective	**Employer minimum contribution**	**Staff contribution**	**Total minimum contribution**
Until 5 April 2018	1%	1% (0.80% with tax relief)	2%
6 April 2018 to 5 April 2019	2%	3% (2.4% with tax relief)	5%
6 April 2019 onwards	3%	5% (4% with tax relief)	8%

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[7] https://www.legislation.gov.uk/ukpga/2008/30/contents

[8] Note that if their employer contributes the total minimum contribution, the worker will not be required to contribute anything (unless they want to). If their employer contributes more than the required employer minimum amount – but less than the total minimum amount – then they only need to make up the shortfall between the total employer minimum and the total minimum contribution.

3.6 There are two ways that tax relief on a worker's pension contributions can be given, depending on the type of pension scheme chosen by their employer:

1) Under 'net pay' arrangements (NPA) where the pension amount is deducted before tax is calculated (meaning the worker receives tax relief there and then); and

2) Under 'relief at source' arrangements (RAS) – where the pension contribution is deducted after tax is calculated and HMRC later send the tax relief to the pension scheme.

3.7 Despite RAS being the 'default' route, many auto enrolment schemes are NPA. Employers generally prefer NPA schemes and they are widely accepted as being easier to administer. Indeed, some interesting recent research[9] shows that only 3 out of 20 top auto enrolment trusts offer RAS – NEST, Legal & General and The People's Pension.

4 What is the problem?

4.1 The issue is that of NPA as against RAS schemes – the former of which sees the lowest paid miss out on tax relief. In effect, this makes pension contributions 20% more expensive for them.

4.2 The issue affects those who earn at or above the £10,000 needed to trigger auto enrolment, but below (or not very much above) the income tax threshold (£12,500 in 2019/20).[10] Naturally as the personal allowance has increased, the numbers of workers affected has grown. It is likely to affect women and ethnic minorities disproportionately, as these groups tend to have more lower earners than the general population.[11] It also affects those who are eligible to opt in to, or join, their employer's scheme.[12]

4.3 Under RAS arrangements, members of pension schemes who do not pay income tax are nonetheless permitted to receive basic rate tax relief (20%) on pension contributions that are eligible for tax relief (i.e. contributions up to the level of the individual's relevant UK earnings, or £3,600 gross a year, whichever is the higher).[13] This means that if a worker automatically enrolled

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[9] https://www.hymans.co.uk/news-and-insights/news-and-blogs/news/tax-anomaly-could-deny-hundreds-of-thousands-of-lowest-paid-the-right-to-20/

[10] In the context of auto enrolment, the issue was first created in April 2015 when the lower AE threshold was held at £10,000 but the nil point rate tax band was raised to £10,600.

[11] For example, as discussed here: https://www.resolutionfoundation.org/publications/the-great-escape-low-pay-and-progression-in-the-uks-labour-market/

[12] Information about who can opt in to, or join, an employer's scheme are discussed on The Pensions Regulator's website: https://www.thepensionsregulator.gov.uk/en/business-advisers/automatic-enrolment-guide-for-business-advisers/7-assessing-and-enrolling-staff/opting-in-and-joining

[13] As permitted under s190(2) FA 2004: https://www.legislation.gov.uk/ukpga/2004/12/section/190

into a RAS scheme contributes £80, HMRC will top it up to £100, adding £20 of tax relief to the pension.

4.4 However, this tax relief is not available to non-taxpayers for NPA schemes.

4.5 ***Example***

4.5.1 Jo earned £950 per month in the 2018/19 tax year. Her employer pays the minimum amount into her workplace pension scheme, so Jo had to put £13.41 of her pay into it every month (£950 - £503 @ 3%).[14] The pension scheme operates under NPA, so her employer deducted the pension contribution before calculating tax (but after calculating National Insurance contributions). This means Jo's 2018/19 earnings were taken to be £936.59 per month for tax purposes instead of £950. However, as Jo's earnings fell below the threshold for paying income tax[15], this reduction in taxable income made no difference and she got no tax relief on the contributions paid.

4.5.2 If Jo was in a RAS scheme, her taxable employment income would have been £950 a month. She would still not have paid any tax, but she would only have to have put 80% of £13.41 (i.e. £10.72) of her pay into her pension pot – the rest would have been paid into it for her by the government. She would therefore have been £2.68 a month (£32.18 for the 2018/19 year as a whole) better off under a relief at source scheme. Over the course of a working lifetime of 45 years or more, the net pay contributor would be almost £1,500 worse off. This is without taking into account any investment return that they might have lost, or that contribution rates might increase in future and 'band earnings' could be replaced with an 'every pound counts' basis of calculating contributions.[16]

4.6 Some figures that we obtained from HMRC[17] indicated that in 2015/16, 1.22 million people were likely to have been affected by this issue (including workers in occupational schemes as well as auto enrolment trust-based schemes). Royal London has obtained from HMRC an update on this figure for 2016/17 of 1.33 million. On the basis auto enrolment has now fully rolled out and the personal allowance has increased from £11,000 in 2016/17 to £12,500 in 2019/20, this figure will

[14] Figures based upon 2018/19 tax year. Contribution increases for 2019/20.

[15] £987.50 a month for 2018/19, using a personal allowance of £11,850 for the year.

[16] See for example 'Automatic enrolment review 2017: maintaining the momentum' (DWP): https://www.gov.uk/government/publications/automatic-enrolment-review-2017-maintaining-the-momentum

[17] Via an FOI request, 3 December 2018: *Please could HMRC provide me with any available figures (since the 2015/16 tax year) on the numbers of people that are contributing into a pension scheme via Net Pay tax relief arrangements, who aren't benefitting from full tax relief on their contributions, because their earnings are below (or only slightly above) their tax-free personal allowances.* Answer: HMRC estimates for 2015-16, based on the Survey of Personal Incomes that HMRC produces, are that 1.22m people with earnings below the personal allowance contributed into a pension scheme via net pay tax relief arrangements.

have grown significantly. Royal London's estimate is that some 1.75 million workers could be affected for 2019/20.[18]

4.7 This unfairness has led at least one pension company – NOW: Pensions – to top up their non-taxpayers' pensions pots out of their own pockets to offset the shortfall.[19] Smart Pensions has also recently taken the decision to offer RAS schemes, as well as NPA, as a potential solution to the NPA issue,[20] however we understand that this approach is unlikely to be adopted more widely due to the significant costs associated with changing systems/processes.

5 How much are we talking?

5.1 In 2018/19, the maximum annual loss for those who have been auto enrolled in an NPA pension was £34.91 (i.e. on earnings of £11,850).[21] This maximum loss for the same person earning £11,850 in 2019/20 increases to (taking into account the increased Lower Earnings Limit and escalation in contribution rates) £57.14.[22] However, since April 2019, more people are likely to be affected due to the increase in the personal allowance to £12,500. The maximum annual loss then becomes £63.64.[23]

5.2 The DWP's recently announced ambitions for auto enrolment[24] (to remove the lower level of qualifying earnings so that every saver makes pension contributions from their first pound of earnings, and to lower the age threshold from 22 to 18) mean the extent of the problem will increase – in terms of both numbers of people affected and the amount they are losing out on.[25]

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[18] As reported, for example by Money Marketing on 8 April 2019, see https://www.moneymarketing.co.uk/pension-tax-relief-goes-begging-for-low-paid-workers/?cmpid=amalert_7898345&utm_medium=email&utm_source=newsletter&utm_campaign=mm_daily_news&adg=106B01E5-1DB7-4EfffF7-BD93-C9CE0631176F#

[19] https://www.nowpensions.com/press-release/now-pensions-top-non-taxpayers-pension-pots-offset-net-pay-income-tax-relief-shortfallsecond-year/

[20] https://www.autoenrolment.co.uk/press/smart-pension-relief-at-source

[21] (£11,850 - £6,032) x 3% = £174.54 (NPA contributions) as compared to (£11,850 - £6,032) x 2.4% = £139.63 (RAS contributions).

[22] (£11,850 - £6,136) x 5% = £285.70 (NPA contributions) as compared to (£11,850 - £6,136) x 4% = £228.56 (RAS contributions).

[23] (£12,500 - £6,136) x 5% = £318.20 (NPA contributions) as compared to (£12,500 - £6,136) x 4% = £254.56

[24] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/668971/automatic-enrolment-review-2017maintaining-the-momentum.PDF

[25] Once the qualifying earnings threshold is removed (we are looking at 2025/26 for this – by which time the personal allowance will also have moved) it could jump to around £143.20.

5.3 There have been growing calls for a solution to be found to the manifest unfairness of the net pay 'problem'. However, in the recent Department for Work and Pensions' (DWP) review of auto enrolment it was stated:

'The government recognises the different impacts on pension contributions for workers earning below the personal allowance. To date, it has not been possible to identify any straightforward or proportionate means to align the effects of the net pay and relief at source mechanisms more closely for this population.'

6 Our solution

6.1 We do not accept the DWP's position and have been engaged in our own study to find a feasible and economical solution. In so doing, we have considered and rejected the following alternatives: a) preventing all non-taxpayers receiving relief; b) abolishing NPA altogether and simply running RAS; and c) extending the use of schemes which achieve a 'half and half' situation by using RAS but giving certain members the immediate tax relief from NPA by way of salary sacrifice[26] (or, in the alternative, allowing employers to run both RAS and NPA schemes and move members between the two to best fit the individual's tax position). We explain in turn below why these are not suitable solutions.

6.2 The first of these – preventing all non-taxpayers receiving relief – would be an unpopular move, given that auto enrolment has been promoted on the basis that individuals benefit not only from their contribution, but also an employer contribution and tax relief from the government. To remove tax relief from all low earners would of course redress the balance in terms of fairness amongst that population, but it would hardly send the right message in terms of encouraging retirement savings. The right result would be to ensure that all non-taxpayers get the benefit of tax relief on eligible contributions. It is clearly unfair that those paying under RAS get the relief but those in NPA schemes do not.

6.3 The second – abolishing NPA altogether and simply running RAS – would not work, because we understand from pensions industry representatives that it would prove prohibitively expensive for existing master trust schemes set up on an NPA basis to move to RAS, even if it were logistically possible. RAS is also unpopular amongst higher and additional rate taxpayers who need to claim their 'extra' tax relief from HMRC.

6.4 The third solution we have rejected is extending the use of schemes which achieve a 'half and half' situation by using RAS whilst giving many of their members the immediate tax relief that would have been available from a NPA scheme by way of salary sacrifice. Those paid beneath the personal allowance make their contributions under RAS, thus preserving their entitlement to tax

[26] By using salary sacrifice, the member opts to take a lower amount of salary in favour of their employer making a greater contribution direct to their pension. This also saves Class 1 secondary National Insurance contributions for the employer, which are not chargeable on pension contributions. Some employers pass on part of this NIC saving to the employees by further enhancing the pension contribution.

relief. We understand from industry representatives already using this type of solution that they aim to move scheme members between RAS (at the lower earning/non-taxpaying end of the scale) and salary sacrifice (for taxpayers) as appropriate, and this is done with the aid of software and the payroll capability of large companies. It is not an achievable or appropriate solution for small employers. Careful management of such schemes is required, otherwise they risk falling foul of National Minimum Wage regulations, and employees engaged in salary sacrifice can lose out in other ways, such as Statutory Maternity Pay. Complications also arise where the scheme member has more than one part time employment (or any other income such as self-employment), as the employer can only evaluate whether the member should be in RAS or salary sacrifice based upon the member's earnings with them. This means their evaluation of which method would be better for the member may be wrong.

6.5 For similar reasons (imperfect results and disproportionate employer burdens), we have rejected the possibility of allowing employers to set up both RAS and NPA schemes and move individuals between them.

6.6 Furthermore, we do not believe it is right that the solution lies in the hands of employers and / or pension providers. Most employers are choosing pension schemes blind to the NPA problem and there is no specific outreach or educational work being done by the authorities to counter this. In any case, it is not clear that there is an easy answer for employers or indeed pension providers, as RAS has its own problems as described above.

6.7 We therefore think there is a better solution that would work for the vast majority of those affected (given employment income is likely to be their only or main source of income), built around the fact that compulsory PAYE RTI data includes NPA contributions.[27]

6.8 Under the RTI system, every time an employee is paid, their employer gives HMRC details of how much income they have received, how much tax they have paid, the amount of pension contributions deducted, etc.

6.9 Using some of this information, HMRC carry out an automatic reconciliation at the end of each tax year for those people not in Self Assessment (or Simple Assessment). This means that they put together all of the pay and tax information they have received to work out whether or not an employee has paid the right amount of tax. The computer-generated P800 calculation is the result of this exercise.

6.10 It should be possible to build in an extra step to the P800 'process' whereby a check is done for any unrelieved NPA contributions. A 20% tax refund could then be generated on any unrelieved NPA value – this would equalise the out-of-pocket positions between those under RAS and those under

[27] See data item 61: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/683210/RTI_2018_to_2019_v1.3.pdf

NPA (apart from the cash flow disadvantage accruing to those who get their tax refunds via the P800 process).[28]

6.11 We include as an Appendix, a graphic explaining how this process – which could be fully automated provided HMRC's systems are appropriately calibrated – could work, using a 2018/19 tax year example. Given the P800 calculation is a full and complete reconciliation of the person's position at the tax year end, it should work even with perceived complexities such as multiple employments/deductions/adjustments/incorrect tax codes, etc.

6.12 The change could be effected by a simple amendment to s23 Income Tax Act 2007,[29] cross referring to the amended provisions in Chapter 4 of Finance Act 2004[30].

6.13 For non-P800 cases and non-Simple Assessment[31] cases, for example where an employee also has self-employment income, a mechanism to claim the relief could be built into the Self Assessment process.[32]

6.14 With appropriate legislative provision, we think the process could also be used to deal with the different rates that apply to Scottish taxpayers[33] – i.e. that 19% taxpayers in net pay arrangements get tax relief at 19%, whereas those in relief at source mechanisms get tax relief at 20%.[34]

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[28] Another option would be for the tax refund to be paid directly to the pension scheme. However, this would result in another point of difference between the two populations, and again – potential unfairness, so this would need to be carefully considered.

[29] https://www.legislation.gov.uk/ukpga/2007/3/section/23

[30] https://www.legislation.gov.uk/ukpga/2004/12/part/4/chapter/4

[31] See paragraph 1.8 above, footnote 4.

[32] We note that s193(2) FA2004 already gives those in NPA the ability to claim 'extra relief' via Self Assessment where an employee wants to make a contribution that cannot be supported by the earnings in the pay period – for example, a single contribution at the end of the tax year.

[33] https://www.gov.uk/government/publications/pension-schemes-relief-at-source-for-scottish-income-tax-newsletter-february-2018/pension-schemes-relief-at-source-for-scottish-income-tax-newsletter-february-2018

[34] The Scottish logic could look something like this (using 2018/19 rates and allowances):

- Gross earnings more than £13,850 – full relief given. No further action required.
- Gross earnings + NPA contribution amount less than £11,850 – no relief given at all. Add in tax relief @ 20% of NPA value.
- Gross earnings + NPA contribution amount more than £11,850 (but gross earnings amount less than £11,850) – partial relief given. Add in tax relief as follows: (Gross earnings + NPA contribution amount) less £11,850 @ 1% and (£11,850 less gross earnings) @ 20%.
- Gross earnings more than £11,850 (but gross earnings + NPA contribution amount less than £13,850) – partial relief given. Add in tax relief @ 1% of NPA value.
- Gross earnings + NPA contribution amount more than £13,850 (but gross earnings amount less than £13,850) – partial relief given. Add in tax relief as follows: (£13,850 less gross earnings) @ 1%.

6.15 Similarly, there is scope for this mechanism to be rolled out to give automatic pension tax relief for higher earners in relief at source schemes, and indeed for 21% intermediate rate taxpayers in Scotland to be given the extra 1% relief if a means of giving it to them direct, without a claim being made, is not found in the meantime.

7 Overcoming potential barriers to making this change

7.1 *Cost of tax relief*

7.1.1 The most obvious objection to change is additional cost. That is, the government would have to give tax relief to scheme members who are currently losing out on it. It is hard to quantify the exact cost, but a broad estimate might be found by taking the estimated 1.75 million who we understand to have missed out on relief, which is based upon extrapolating the 2016/17 figure obtained from HMRC (see paragraph 4.6 above). If we assume that each of them is missing out on relief of, say, £30 a year, this amounts to £52.5 million a year of unpaid tax relief. As noted at paragraph 5.2 above, this figure could increase over time with further changes to auto enrolment.

7.1.2 However, we do not believe that cost should be used as justification for allowing the unfairness to continue. We believe that this is relief that scheme members were always intended to receive, given that it appears auto enrolment was originally costed on the basis that people would be getting tax relief. The fact that low earners in NPA do not receive it, as a consequence of the divergence of the auto enrolment threshold and the personal allowance, is an anomaly.[35] The estimated sum is also minuscule relative to the cost of income tax and NIC relief on pensions as a whole, quoted by HMRC as £41 billion for 2016/17.[36]

7.1.3 In any event, not doing anything is breaking the promise made by the government in the original policy paper – that 'Individuals who choose to save will also benefit from an employer contribution. The government will contribute in the form of tax relief.'[37]

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[35] The original impact assessment can be found here: http://webarchive.nationalarchives.gov.uk/20130125095321/http://dwp.gov.uk/docs/impact-assessment-240408.pdf – no mention is made of the possibility that workers will not get tax relief.

[36] See for example para 110, Treasury Committee 19th Report – 'Household finances: income, saving and debt', HC 565, published 26 July 2018: https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/565/56508.htm#_idTextAnchor053

[37] The original policy paper can be found here: https://www.gov.uk/government/publications/2010-to-2015-government-policy-automatic-enrolment-in-workplace-pensions/2010-to-2015-government-policy-automatic-enrolment-in-workplace-pensions

7.1.4 Indeed, up until recently, official communications gave the message that tax relief is a foregone conclusion. However, we note that this has changed in recent months, guidance has begun to reflect the net pay anomaly.[38]

7.1.5 Given the central role that tax relief plays in encouraging pension saving and the high importance that government places on people making more and adequate provision for income in their retirement, we think it is vital that action is taken to deal with this thorny issue as soon as possible.

7.2 ***Interaction with state benefits***

7.2.1 LITRG is always keen to point out that there can be impacts on individuals' state benefits entitlement when there is a change in the tax system. We must therefore consider this alongside the change proposed in this paper. This is particularly as we are referring in the main to the availability of tax relief on pension contributions made by people who are earning around or below the personal allowance. It follows that they may well be claimants of in-work support through state benefits. The main exception to this is likely to be those lower earners who are part of a higher earning household, given that entitlement to income-related state benefits is assessed looking at household income.[39]

7.2.2 The exact impact will depend on individual claimants' circumstances, but we outline below in broad terms the impact for claimants of tax credits and universal credit, the main benefits supporting people in work.

7.2.3 In the context of the cost of giving additional tax relief discussed at 7.1 above, one point outlined below is of particular note. This is that the cost of giving tax relief to low-income workers in net pay arrangements could be partly offset by those workers who are claimants of universal credit becoming consequently entitled to a lower amount of benefit. Therefore, the above estimated cost of giving tax relief is likely to be too high, although this is difficult to quantify without knowing what proportion of those affected will also be claimants of universal credit.

Tax credits

7.2.4 For tax credits, a claimant who is in a net pay arrangement does not need to make any adjustment to their taxable income figure from their P60 in respect of pension contributions as that figure already takes account of the pension contributions paid. Tax credit claimants in a relief at source scheme need to deduct the grossed up pension contributions from their taxable income when reporting it to HMRC.

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[38] See for example: https://www.gov.uk/workplace-pensions/what-you-your-employer-and-the-government-pay

[39] Note, however, that there are different definitions of what constitutes a couple, for example between tax credits and universal credit. It might therefore be that two people are considered to be a couple for one purpose (and hence have to make a joint claim) but not for another (and would have to make two single claims).

7.2.5 It follows that the income used to calculate tax credits will be the same no matter the type of scheme. Any tax refund generated by our proposed solution would be ignored for tax credit purposes as these are calculated on a gross rather than net income basis.

Universal credit

7.2.6 The UC legislation[40] (reg 55, SI 2013/376) allows deductions of 'relievable' pension contributions when calculating net earned income for UC purposes. 'Relievable contributions' has the same meaning as s 188 FA 2004, ie the gross amount[41]. So, for a universal credit claimant with gross income of £1,000 a month making a pension contribution of £24.40[42], their net income for the purposes of calculating their UC entitlement would be £975.60[43].

7.2.7 For those contributing to a net pay scheme, the PAYE RTI data sent from HMRC to DWP will therefore show the net income of £975.60 as the full contribution will have been deducted from the claimant's pay.

7.2.8 Under our proposed solution to the NPA problem for non-taxpayers, the individual would be likely to receive a tax refund. This would most likely be treated as earned income for UC (assuming they are still receiving UC when it is paid) and reduce their UC income at that point. This is by virtue of Reg 55(4A) SI 2013/376 which says:

> '(*4A) A repayment of income tax or national insurance contributions received by a person from HMRC in respect of a tax year in which the person was in paid work is to be treated as employed earnings unless it is taken into account as self-employed earnings under regulation 57(4).'*

7.2.9 The worker will have paid £292.80 gross into their net pay pension by the end of the 2019/20 tax year. If, under the proposed solution, they were to be given a basic rate tax repayment on that amount, they would receive £58.56 (£292.80 x 20%). This would likely be paid to them at some point in the 2020/21 tax year, depending on when HMRC issue their P800 calculation.

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40 Universal Credit Regulations 2013

41 As an aside, we would mention that we are querying the wording of the UC Regulations with the DWP. We don't think it is appropriate to work out the claimant's net income for UC purposes by deducting the gross pension contribution for those in relief at source schemes. The purpose of calculating benefits entitlement on a net basis is to identify how much income a person has left after all deductions have been accounted for. For someone in a relief at source pension scheme, the wording of the regulations has the effect of allowing a deduction for the tax relief on their pension contribution, which is not a cost they have directly suffered. This does therefore not give a true representation of the net income in their pocket.

42 £1,000 - £512 (LEL) = £488 x 5%, using 2019/20 figures equals £24.40 a month pension contribution by the worker

43 We have not accounted for national insurance deductions in these figures – in practice, national insurance contributions paid in an assessment period can also be deducted when calculating net income for UC purposes.

7.2.10 In the month of receipt of that tax repayment, the individual would need to advise the DWP that they have received it and their universal credit claim for that period would be adjusted accordingly. As the UC taper rate is 63%, their UC award would go down by £58.56 x 63%, ie £36.89. The net gain to the individual (which is of course also the net cost to the Exchequer of the tax relief) is £21.67.

7.2.11 There are some timing difference issues with this proposal, which could result in some minor differences in treatment of individuals. For example, if the above-illustrated individual was no longer claiming universal credit by the time they receive their tax repayment, they would 'win' in that they would receive the full tax repayment but without a UC adjustment. The opposite scenario is that some might 'lose' if they are not a UC claimant at the time the pension contribution is made but they are at the time the tax repayment is issued. In that situation, the individual would have their UC award adjusted later by reference to something that happened earlier.

7.2.12 This is, however, no different to the treatment of any other tax refund under UC, with the aim of the benefit looking to support people by reference to their current means.

7.2.13 This adjustment of UC for the tax refund received does impose a reporting requirement for the individual, to advise the DWP of the amount received. This is because the DWP does not receive automatic information regarding a tax refund if it is paid directly by HMRC to a UC claimant.[44] Again, this is no different than for any other tax refund.

LITRG
May 2019

[44] See Parliamentary written question 237574, answer dated 1 April 2019: https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2019-03-27/237574/

Net pay arrangements (NPA) tax relief via P800 process

Filter out all employees with NPA contribution deductions showing in RTI data

Reconcile all pay and taxes as normal

If gross earnings for tax are at or above the personal allowance – full tax relief on NPA contributions has been given. No further action required.

If gross earnings for tax + the amount of NPA contributions made, total less than £11,850 – no tax relief has been given. Add in tax relief at 20% of NPA contribution amount

Full tax calculation for Mr Pension (£11,600 gross salary, £167 NPA contributions)
Tax Reference 400/P1001
National Insurance number XX123456A
For tax year 2018-19

		Income Tax
Income		
Employments	£11,433.00	£0.00
Total income	£11,433.00	£0.00
Deductions	£0.00	
Total Income	£11,433.00	
Allowances		
Personal allowance	£11,850.00	
Total taxable income	£0.00	
Income Tax rate		
Basic rate at 20% on	£0.00	£0.00
Adjustments	£0.00	
Total Tax payable		£0.00
Tax you already paid		£0.00
Pension Tax Relief		£33.40
Tax HMRC owes you		**£33.40**

If Mr Pension had of been in a RAS scheme, his pension contributions would have cost him £133.60 at point of pay, with £33.40 sent in by HMRC. Giving him £33.40 tax relief now, equalises his out of pocket position (albeit with slight delay).

Full tax calculation for Mrs Pension (£11,870 gross salary, £175 NPA contributions)
Tax Reference 400/P1001
National Insurance number WW123456A
For tax year 2018-19

		Income Tax
Income		
Employments	£11,695.00	£0.00
Total income	£11,695.00	£0.00
Deductions	£0.00	
Total Income	£11,695.00	
Allowances		
Personal allowance	£11,850.00	
Total taxable income	£0.00	
Income Tax rate		
Basic rate at 20% on	£0.00	£0.00
Adjustments	£0.00	
Total Tax payable		£0.00
Tax you already paid		£0.00
Pension Tax Relief		£31.00
Tax HMRC owes you		**£31.00**

If Mrs Pension had been in a RAS scheme, her pension contributions would have cost her £140, with £35 sent by HMRC. However, her total income for tax purposes, would have been £11,870, resulting in a £4 tax liability. Giving her £31 tax relief now, ensures out of pocket parity.

For all others (i.e. those with gross earnings of just above the personal allowance) – partial relief given. Further tax relief due (personal allowance – gross pay for tax @ 20%)

Produce and send P800 calculation (if refund equals less than £10, this may need to be triggered manually)