Pensions net pay arrangements: giving tax relief to lower paid workers

1 The Net Pay Action Group – about us

1.1 This briefing paper has been produced by the Low Incomes Tax Reform Group (LITRG) (part of the Chartered Institute of Taxation) working together with Baroness Ros Altmann and a coalition of organisations from across the pensions industry. This 'Net Pay Action Group' (NPAG) consists of pension providers, lawyers, tax specialists, payroll specialists, employers, consumer groups and policy experts. The members (see appendix) are all concerned that non-taxpayers saving into net pay pension schemes are losing a significant amount of money (see below for explanation) and that this could damage confidence in pensions and auto-enrolment.

1.2 Having looked at various potential options, the NPAG has concluded the proposal below is that which provides the most suitable and straightforward solution.[1]

2 Executive Summary

2.1 Tax relief on pension contributions may be given to individual scheme members in two different ways: relief at source (RAS) and net pay arrangements (NPA). This is set out in Finance Act 2004, Part 4. The difference in operation between the two methods means that a significant number of people are not getting tax relief where others are.

2.2 Under RAS, it is established government policy to give non-taxpayers basic rate tax relief on relievable pension contributions, but this is not available to non-taxpayers in NPA schemes. The individual has no control over which form of tax relief is used. Requiring all employers with low-paid staff to move to RAS arrangements would be burdensome, costly, and highly complex for employers and pension providers.

2.3 Auto-enrolment is widely regarded as a policy success. One of the consequences of its roll out across UK businesses is that increasing numbers of workers are paying into NPA pension schemes. An estimated 1.75 million workers earning below or just above the personal income tax allowance do not receive tax relief on some or all their contributions because their employer's pension scheme uses NPA; this makes pension saving up to 25% more expensive for them as compared to a worker contributing to a RAS arrangement.

2.4 This unfairness disproportionately affects groups with protected characteristics under equality law. Of the affected population, over 75% are female.[2] Others who are statistically more likely to be in low-paid or part-time work such as ethnic minorities, disabled people and carers are also likely to be affected. The inherent risk of a breach of equality law points to the urgent need for a review of the underlying policy and implementation of a solution.

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[1] Further information about the NPAG's background considerations can be made available or discussed on request. Other potential solutions were not favoured due to being piecemeal, complex, and burdensome/costly for employers and/or the pensions industry.

[2] Parliament written questions and answers, HL15963, June 2019 (using 2016/17 data): https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2019-06-04/HL15963/

2.5 The social injustice of the lowest earners in auto-enrolment having to pay up to 25% extra for their pensions is an issue of significant concern to the NPAG, who have worked together to develop potential solutions for policymakers. It is in the interests of all parties to retain the success of and confidence in auto-enrolment.

2.6 The problem would be exacerbated by the proposed extension of auto-enrolment to 18-year-olds (bringing in a further 900,000 young people) and removal of the lower earnings threshold for contributions (bringing an extra £2.6 billion a year into pension saving).[3]

2.7 We believe the solution lies with HM Revenue & Customs (HMRC) using the annual reconciliation of individuals' Pay As You Earn (PAYE) data to identify low-income workers making pension contributions under NPA schemes. HMRC could then provide tax relief equivalent to that which would have been received via RAS.

2.8 We urge the government to implement our proposed solution as a matter of urgency.

3 The problem – an unequal system of pensions tax relief for low earners

3.1 Under legislation in Finance Act 2004, Part 4, tax relief on pension contributions can be given in two ways:

1) **Net pay arrangements (NPA)**
   The pension contribution is deducted from each worker's salary before tax is calculated, so taxpaying workers receive immediate tax relief.
2) **Relief at source (RAS)**
   The pension contribution is deducted after tax is calculated and HMRC later send basic rate tax relief to the pension scheme for all members.

3.2 This difference means that many low-earning individuals contributing to NPA schemes do not receive tax relief on their pension contributions (as explained below) whereas they would be entitled to it in RAS schemes. The introduction of auto-enrolment has increased the number of people affected and this is likely to increase further in future.[4]

3.3 Employers must automatically enrol qualifying staff into a pension scheme where they earn over £10,000 a year. Automatically enrolled staff may opt out. Equally, staff not eligible to be automatically enrolled may opt in, or join, their employer's scheme. The worker usually has to contribute[5] 5% of their 'qualifying earnings', from £118[6] up to £962 per week for 2019/20.

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[3] Automatic Enrolment Review 2017: Maintaining the Momentum (see, *inter alia,* pp 17): https://www.gov.uk/government/publications/automatic-enrolment-review-2017-maintaining-the-momentum

[4] With auto-enrolment being extended to 18-year-olds, for example. See para 1.5 above.

[5] If their employer contributes more than the required employer minimum amount, but less than the total minimum, they only need to make up the shortfall.

[6] This lower earnings threshold may be removed from the mid-2020s. See *'Automatic enrolment review 2017: maintaining the momentum'* (DWP): https://tinyurl.com/ycrjjzf9

3.4 Many auto-enrolment schemes chosen by employers use NPA, so their low-paid non-taxpayers miss out on tax relief, making their pension contributions 25% more expensive. This affects those whose earnings are below the income tax threshold (£12,500 in 2019/20) and applies to private as well as public sector schemes. The latter overwhelmingly operate NPA.

Example 1 – qualifying earnings

Penny's annual salary is £11,130. Her employer scheme bases contributions on 'qualifying earnings' which is the auto-enrolment minimum.
Her **2019/20** pension contribution under each type of scheme would be:

Scheme type	Calculation of contribution	Amount Penny pays in	Tax relief added	Amount invested in pension
1) NPA	(11,130 – 6,136) x 5%	£250	-	£250
2) RAS	(11,130 – 6,136) x 4%	£200	£50	£250

The amount going into Penny's pension for the year is the same in both cases, but the cost to her of paying into scheme 1 is £50 more than scheme 2.

3.5 The above illustration assumes that qualfiying earnings (a band of earnings between £6,136 and £50,000 for 2019/20) is used when calculating contributions. Many schemes use total earnings which, even taking into account the lower minimum contribution levels that apply when calculating contributions in this way, siginficantly increases the cash cost to the member, as illustrated below.

Example 2 – total earnings

Alexia's annual salary is £11,130. Her employer scheme bases contributions on total earnings.
Her **2019/20** pension contribution under each type of scheme would be:

Scheme type	Calculation of contribution	Amount Alexia pays in	Tax relief added	Amount invested in pension
1) NPA	11,130 x 4%	£445	-	£445
2) RAS	11,130 x 3.2%	£356	£89	£445

Again, the amount going into Alexia's pension for the year is the same in both cases, but the cost to her of paying into scheme 1 is £89 more than scheme 2.

3.6 The extra amounts that have to be paid by low earners in NPA schemes, as a result of lost tax relief, clearly will amount to a significant sum over many years. Even without taking into account inflationary factors, over the course of a 45-year working life, Alexia's contributions would cost her some £4,000 more into an NPA scheme than if paid under RAS.

4 Who is affected?

4.1 Figures from HMRC indicated that in 2015/16, 1.22 million people were likely to have been affected. Royal London obtained from HMRC an update for 2016/17 of 1.33 million. 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. Therefore, Royal London estimate that 1.75 million workers could be affected for 2019/20.[7]

4.2 This population is likely to comprise multiple groups with protected characteristics under equality law. For instance, we know that over 75% of those affected are female.[8] Ethnic minorities, people with disabilities and carers are also likely to be disproportionately disadvantaged, as they tend to include more low earners than the general population.[9]

4.3 Failure to address the issue creates a risk of challenge to the government on discrimination grounds and also a risk to confidence in pensions and auto-enrolment.

5 Proposed solution

5.1 Our proposed solution requires HMRC to use the data they already collect via PAYE real-time information (RTI) to identify, after the year end, those who have contributed to an NPA scheme and who have not earned enough to qualify for tax relief. HMRC could then provide that tax relief via the informal P800[10] process (or those in Self Assessment could claim relief via their return). This would result in a tax refund being issued, or that refund being offset against a tax liability.[11]

5.2 HMRC already annually reconcile individuals' PAYE data. While they collect information on contributions made by individuals to employers' pension schemes through the RTI process,[12] HMRC do not currently include such data in that annual reconciliation. Our proposal, simply, asks that they do.

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[7] As reported, for example by Money Marketing on 8 April 2019, see https://tinyurl.com/y2hwsatj

[8] Written question HL15963 (answered 18.6.2019) using 2016/17 figures (1m women as against 1.3m total), up from an estimated 74% in 2015/16 - HL11217 (answered 19.11.2018). See https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2019-06-04/HL15963/ and https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-11-05/HL11217/ respectively.

[9] See for example, Resolution Foundation *'Low Pay Britain 2019'*, published 30 May 2019: https://www.resolutionfoundation.org/publications/low-pay-britain-2019/

[10] For people 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).

[11] A change to the legislation outlining the income tax calculation (Income Tax Act 2007, Part 2, Chapter 3) would need to be made to give this additional relief.

[12] See data item 61: https://tinyurl.com/yy7kudzg

5.3 Our proposed solution has the following benefits:

5.3.1 It will work for all individuals.

5.3.2 It is a dynamic solution, so that if a person's situation changes (for example on a change of job, or increase/decrease in earnings), it will always work. Similarly, it caters for people in multiple concurrent jobs.

5.3.3 The individual should not need to make a claim for relief, they would only need to check HMRC's calculation.

5.3.4 It builds on HMRC's existing processes and makes use of data they already hold.

5.3.5 HMRC are already working on plans to pre-populate individuals' tax records with data they hold,[13] so this solution is a logical part of those plans.

5.3.6 This mechanism could give automatic pension tax relief for higher earners in RAS schemes, and indeed 21% intermediate rate taxpayers in Scotland could be given the extra 1% relief automatically.

5.3.7 It could be programmed to cope with further devolution of tax rates, for example with Welsh income tax, thus future-proofing the system.

5.4 The proposed solution places the NPA contributor in a comparable position to the RAS contributor. There is a manageable complication for those claiming universal credit. Those individuals receiving a tax refund must declare it to the Department for Work and Pensions (DWP) for inclusion in their income calculation for the period in which it is received. The NPA contributor therefore sees an adjustment to their universal credit claim at a later point than the RAS contributor. The process of making such adjustments could be smoothed by HMRC passing tax refund data to the DWP in real time for universal credit claimants.[14]

5.5 The NPAG has considered whether tax refunds generated by the proposal might be paid directly to the pension scheme rather than to the individual. This was agreed to be complex to administer and would not result in equalising the position between NPA and RAS scheme members, nor reimburse the member for the extra payments they have made.

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[13] HMRC *'Single departmental plan'*, updated 12.7.2018, see section 2.3: https://tinyurl.com/y68xveqk

[14] This is not currently done, see Written question 237574, answered 1 April 2019: https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2019-03-27/237574/

6 Conclusion

6.1 We contend that it is a matter of simple fairness that the playing field should be levelled for all pension contributors. After all, the principle of non-taxpayers receiving tax relief on pension contributions is well established.[15]

6.2 Giving tax relief to those low-paid pension scheme members who currently do not receive it might be seen as a cost to the Exchequer. There would also be a cost to building the capability with HMRC's computer systems to deliver the lost tax relief. However, we do not believe that cost should be used as justification for allowing the unfairness to continue. Addressing the issue boils down to two factors:

1. Ensuring social justice and compliance with equalities legislation; and

2. Protecting the success to date of auto enrolment and confidence in pensions, thus encouraging people to make provision for their retirement.

6.3 We therefore call on the government to implement this solution as a matter of urgency.

The Net Pay Action Group
September 2019

[15] Those with no relevant UK earnings can still receive tax relief on annual contributions up to £3,600 gross (FA 2004, s 190) to RAS schemes – a policy intended to help people on low incomes to save for retirement (see for example Hansard, Finance Bill Debate, 15 June 2004, c561 – Ruth Kelly, then Financial Secretary: https://www.theyworkforyou.com/pbc/2003-04/Finance_Bill/16-0_2004-06-15a.6.0).

Appendix – signatories

CIO Low Incomes Tax Reform Group A voice for the unrepresented	Ros Altmann Baroness Ros Altmann CBE	cipp the chartered institute of payroll professionals leading the profession
AgeWage	NOW: Pensions	the people's pension
PENSIONS AND LIFETIME SAVINGS ASSOCIATION	TISA The Investing and Saving Alliance	ABI
TUC Changing the world of work for good	age UK	Steve Webb Director of Policy ROYAL LONDON
Smart Pension	PASA assess | aspire | achieve	Chris Leslie Christopher Leslie MP