Low Incomes Tax Reform Group
A voice for the unrepresented

Practical Issues arising from new pensions legislation

Response from the Low Incomes Tax Reform Group (LITRG)
to the House of Commons Public Bill Committee

1 Our comments below are not in relation to policy: that is something that is decided by politicians. Instead, we concentrate on areas where, unless proper procedures are put in place, many taxpayers may find themselves with large tax bills to pay unexpectedly or alternatively having to reclaim significant amounts of tax.

2 About Us

2.1 The Low Incomes Tax Reform Group (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 HM Revenue &Customs (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 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 Executive Summary

3.1 The current PAYE system is ill-equipped to deal with the new pensions regime and this could result in thousands more interactions with HM Revenue & Customs (HMRC) by taxpayers.

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3.2 For those taxpayers who end up with a tax underpayment as a result of accessing pension funds, some may have no funds left with which to pay the additional tax due.

3.3 For those taxpayers who end up due a tax refund as a result of accessing pension funds, it is not clear how quickly those refunds may be accessed.

3.4 Increased contacts to HMRC as a result of the points above may cause severe difficulties for contact centres at peak times.

3.5 Low income taxpayers may withdraw funds without understanding the effect it might have on their state benefits.

3.6 Clear guidance is essential for all those who are considering accessing their pensions savings. This is a very complex subject and their pension fund may represent one of the largest assets in an individual's hands. Skimping on guidance and communication at implementation is likely to lead to unforeseen tax charges, unhappy pensioners and an overworked HMRC.

3.7 We recommend a 14-day cooling off period once a request for pension payment is made so that the taxpayer may be provided with full information as to the taxation consequences.

4 Background to the current Pay As You Earn (PAYE) system

4.1 The PAYE system operates by instructing the payer (normally an employer or pension provider) to deduct income tax (and National Insurance contributions (NIC) for an employee) from employees' pay on a cumulative basis over a tax year. A code number is issued to the employer or pension provider that enables them to make sure that the allowances allocated to that employee for that employment are evened out over the tax year; in some cases the employer will simply be instructed to deduct a standard rate of taxation. This latter case is often the position for a second employment or for a small pension, where all of an individual's tax free allowances are allocated to the first employment: the second employer would then deduct tax at the rate it was instructed. An issue arises because if the second employer is instructed to deduct tax at basic rate, say, but part or all of the income should have been taxed at higher rates, further tax will become due. Similarly, if the first employment does not use all of the individual's allowances, the individual may be due a refund at the year end (depending on their other income).

5 Tax deductions from pensions withdrawal

5.1 Under the "new" regime, taxpayers will be subject to income tax on amounts they receive from their accumulated pension pots, subject to 25% being tax-free. This section questions how the tax that is due (on the 75% that is taxable) is to be collected.

5.2 This new regime is intended to be flexible so that a taxpayer may withdraw more in one year than in the following year or indeed nothing in one year, and so on. A taxpayer may well have a number of pension pots and choose to access more than one at a time – or to access some in one year and some in other years.

5.3 In the simplest case a taxpayer would have no other income in the year. Accordingly he could set his personal allowance against the "pension income" (in other words the 75% of his withdrawal that is taxable). But how will the tax due on the pension income be collected? Given the number of people involved it seems likely that some deduction at source will have to be made by the pension provider.

The pension payer will not have to report any payments separately to HMRC as “this information is expected to be available to HMRC through Real Time Information”.[1] Will a pension payer be allocated a tax code? Or will a straightforward basic rate tax deduction be made from such payments? If we assume that a tax code will be issued to a pension payer:

a. Will that code include the taxpayer’s personal allowance, or will it automatically enforce a tax deduction at the basic rate?

b. Given that many taxpayers may access more than one “pension pot”, how will HMRC allocate personal allowances and/or tax rates between them?

c. HMRC intend to withhold certain Notices of Coding where a change in coding would have no effect on the taxpayer. If a taxpayer has multiple sources of income, and does not have access to all Notices of Coding, they may not be able to “piece together” how all of their allowances are being used (see also 5 below).

d. Future plans to open up the PAYE system for employees and pensioners to view and make changes online and immediately may help (or hinder?) but this will not help those who are digitally excluded or simply have no understanding of the coding system (or perhaps even the tax system as a whole) even if they can operate a computer.

4.4 If we assume that basic rate tax will be deducted by the pension payer:

a. Many taxpayers may suffer deductions that are inadequate if deductions are only at the basic rate. Will the pension payers be required to draw this possibility to the attention of the taxpayer? (See our comment above about a possible cooling off period.) Will HMRC draw this to the attention of the taxpayer, for example, by a note on the code number issued? For individuals who have now left employment and who might be tempted to spend this sum (for example, on repaying a mortgage), they may have little cash in the future to pay any outstanding tax bill.

b. On the other hand, many low income taxpayers might find that a basic rate deduction from their pension income would mean they had suffered excessive tax. Such low income taxpayers are also the ones who might most need their tax refund early. Currently most such taxpayers require to wait until after the end of the tax year to obtain a tax refund. Once their total income is known, then HMRC issue tax refunds. This could result in a delay of over a year before the tax was refunded (see section 4 below for further comments).

5.4 Having “sold” the new pensions legislation as providing easier access to pensions savings, taxpayers will assume that their pension companies will be able to make payments to them quickly so the tax system needs to accommodate this and mirror the speed and ease elements too.

6 End of year tax procedures for pensioners

6.1 Many pensioners will have had little to do with HMRC up until retirement, their tax affairs having been dealt with via PAYE. These pensioners will not be in the habit of completing a self assessment (SA) tax return – a long and complex document. Instead it is likely that HMRC will have reconciled their tax liability each year outside the SA system by issuing a form P800. To date many people will

[1] HMRC draft guidance on the Pensions Bill; Chapter 8.

have had small adjustments at the year end, resulting in small refunds or small underpayments that were collected via PAYE in a subsequent year, thus requiring no physical payment by them.

6.2 Given the many combinations of withdrawals from pension pots that pensioners might make in a year (and possibly in multiple years), almost inevitably more significant underpayments and overpayments of tax will accrue to these pensioners. We do not know how this will be administered by HMRC. Will they insist on SA tax returns being completed or will they rely on the P800 system? Consistent guidance is needed so that the expectations of pensioners can be managed.

6.3 Suddenly finding themselves in a position where they are due to pay additional tax may be bewildering and upsetting. How will any such tax be collected? Will they be given the opportunity to pay it over a period of time or will it be collected in one lump sum? Understanding the answers to these questions is crucial for pensioners. Unless they understand when any further tax bill may fall due (and the extent of that bill) some may find themselves in a spiral of having to unlock further funds from pension pots in order to pay past tax liabilities – thus generating a further tax bill. If any demand is issued via a P800, there is still the possibility of having to place the taxpayer in self assessment in order to collect the liability (if the taxpayer does not pay when asked to pay "voluntarily") and with that will come its own challenges, especially the rigid penalty regime if a pensioner misses a deadline or cannot file online.

i) For those pensioners who were previously in SA, how will the system identify those taxpayers who no longer require to be in SA and so remove them from SA as soon as possible?

ii) What guidance will be offered around all this in a clear and easy to access format, remembering that many pensioners are digitally excluded?

7 In-year tax repayments

7.1 As noted above, some pensioners may find that the tax deducted from their pension income is excessive. A mechanism needs to be available to allow early repayment of that tax, particularly to the less well-off.

7.2 Alternatively, for low income pensioners where it is clear that a basic rate tax deduction would be excessive, will HMRC introduce a system where the pension could "self-certify" that no tax would be due and so receive the payment gross (without tax deduction)? Such a scheme operates now for receiving bank interest without tax being deducted (using form R85).

8 Interaction with state pension

8.1 Already pensioners often find themselves in an underpayment situation following receipt of the state pension as it is often not coded in properly when it is first received. Taking either a lump sum or additional income might push individuals into paying tax at higher rates.

8.2 Someone who previously had one source of employment income may find themselves receiving a state pension (that is not taxed at source, but the tax on which is collected via a Notice of Coding used by an employer or pension payer), a works pension of a regular amount and various ad hoc amounts from private pension schemes. If pensioners are issued with more than one Notice of Coding, will they understand the need to check them together? We understand a unified notice of coding is being developed but in the meantime much clearer guidance will need to be provided to this group.

9 Interaction with State Benefits

9.1 Accessing a lump sum or pensions income might push some pensioners over the thresholds at which certain state benefits are paid. This is a serious issue for the lower paid, who might unwittingly both face an unexpected tax bill, but also find that they are being denied state benefits to which they would otherwise have been entitled. Clear guidance is needed for these individuals.

10 Interaction between HMRC and DWP

10.1 Because of the interactions noted above, data flow between HMRC and Department for Work and Pensions (DWP) must be such that a pensioner can rely on them cooperating and producing the correct tax codes. Should their systems fail so that a pensioner is left with an unexpected underpayment, there needs to be a clear and fair method of dealing with these underpayments (including writing them off, where necessary).

11 Pensioners moving overseas

11.1 Increasingly pensioners move overseas. Specific protocols are needed to deal with their change of circumstances, with clear guidance and support.

12 Pensioners and savings

12.1 With their lump sums and/or balance of their pension pots, many pensioners may choose to keep a nest-egg in a bank. For many of these a 0% tax rate may be applicable. How is this to be administered and publicised? How will they be made aware that taking a further tranche of pension income may cost them some or all of their 0% tax rate entitlement?

13 Some scenarios to illustrate the above points

13.1 Wilfred and Wilhemina, late 50s. He continues in employment. She, no longer working, decides to prop up the household income by starting to draw on her smallish pensions. She reckons she can afford to withdraw £5,000 a year until her State pension kicks in. She takes two payments a year. Clearly with no actual tax liability (because her personal relief coveres the pension withdrawals), must she suffer a basic rate tax (20%) deduction and reclaim each year? Can she self-certify as non-taxpayer and receive it gross? Must HMRC issue code(s) to pension provider(s)? What happens if in-year she suddenly takes out another £15,000 to pay off the mortgage?

13.2 Ernest and Brunhilde, mid-sixties, are within striking distance of receiving state pensions. He retires and starts receiving a final salary works pension, six months later claims the state retirement pension and thereafter starts drawing smallish sums from his collection of old defined contribution pension schemes in irregular amounts and at odd intervals to fund their holidays. What system will HMRC set up to collect the right amount of tax from his haphazard income? Will they tip him into the SA regime? Will they then leave him there even when he takes a couple of years off from raiding his pots? Brunhilde then claims her small state retirement pension of £5,500 a year and decides to cash in her two pots totalling £14,000 (of which 25% would be tax free, leaving £10,500 liable to taxation). How will the two different pension providers tax (or not) the taxable £10,500? Will DWP and HMRC have cooperated in time so that her state retirement pension is also taken into account when establishing any tax deduction from her lump sum?

13.3 Ron has amassed sizeable pension pots close to £1million, enabling him to drawdown a steady £40,000 a year without crossing the border into the 40% band. Deciding to build an extension, he extracts a lump sum of £150,000 in one year. How does the provider/HMRC sort out his sudden lurch into the loss of all personal allowances and the next two tax bands?

13.4 Ethel, 64, disabled and living on a small state pension, pension credit and an assortment of benefits, decides to take a trivial commutation of £25,000 from her old works pension. Who will 1) warn her of the possible impact on her benefits including any passported ones, and 2) advise DWP of her new circumstances?

LITRG

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