Low Incomes Tax Reform Group (LITRG)

Budget 2018 representation

Net Pay Arrangements for lower paid workers

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 (currently £11,850) and who are enrolled in a net pay 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 up to £2,880 a year, bringing the value of their contributions up to £3,600. 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 Notwithstanding that from April 2019, the employee contribution rate will increase from 3% to 5%, this 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 have obtained from HM Revenue & Customs (HMRC) indicate that in the 2015/16 tax year, 1.22 million workers in net pay arrangements (which will include those in occupational as well as auto enrolment trust based schemes) received no tax relief on their pension contributions because they were non-taxpayers. On the basis auto enrolment has now fully rolled out and the personal allowance has increased from £10,600 in 2015/16 to £11,850 in 2018/19, we believe this figure will have grown significantly.

1.7 We have, for some time, been raising the 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 and easily implementable solution to this problem.

1.8 We now 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[1]) through an annual reconciliation process – whether that is through self-assessment or – as is more likely – the informal P800[2] process.

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.

1.10 The change could be effected by a simple amendment to s23 Income Tax Act 2007,[3] cross referring to some amended provisions in Chapter 4 of Finance Act 2004.[4]

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

[2] 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).

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

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

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 doing nothing here. Indeed, it appears to us that auto enrolment was originally costed on the basis that all savers get tax relief. The unfairness (between those in net pay arrangements and relief at source schemes) and the potential for auto enrolment policy to be undermined, justifies 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 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[1] (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 will make it easier for people to start saving for their retirement.

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

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. £10,000 a year translates into a £192 threshold for weekly paid employees and £833 for monthly paid.
- 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[1] be required to contribute a certain percentage of their 'qualifying earnings'. In 2018/19, qualifying earnings are those from £116 per week up to an upper limit of £892 (£503 and £3,863 a month; £6,032 and £46,350 per year).

3.5 The table below demonstrates the phases of contribution increases:

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%

3.6 There are two ways that tax relief on an employee'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 employee 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,

[1] Note that if their employer contributes the total minimum contribution then they 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.

some interesting recent research[1] 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 (£11,850 in 2018/19).[2] (Naturally as the personal allowance increases, the numbers of workers affected will grow.) It is likely to affect women and ethnic minorities disproportionality, as these groups tend to have more lower earners than the general population.[3]

4.3 Under RAS arrangements, members of pension schemes who do not pay income tax are nonetheless permitted to basic rate tax relief (20%) on pension contributions up to £2,880 a year. In practice this means that HMRC will top up a net contribution of £2,880 to a gross £3,600.[4]

4.4 However, this tax relief is not available to non-taxpayers for NPA schemes.[5]

4.5 ***Example***

4.5.1 Jo earns £950 per month. Her employer pays the minimum amount into her workplace pension scheme, so Jo must put £13.41 of her pay into it every month (£950 - £503 @ 3%). The pension scheme operates under NPA, so her employer deducts the pension contribution before calculating tax (but after calculating National Insurance). This means Jo's earnings are taken to be £936.59 for tax purposes instead of £950. However, as Jo's earnings fall below the threshold for paying income tax, this reduction in taxable income makes no difference and she gets no tax relief on the contributions paid.

4.5.2 If Jo was in a RAS scheme, her taxable employment income would be £950 a month. She would still not pay any tax, but she would only have to put 80% of £13.41 (i.e. £10.72) of her pay into her

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[1] 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/

[2] 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.

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

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

[5] S190(2) relief denied to those in NPA by s191(7) FA 2004: https://www.legislation.gov.uk/ukpga/2004/12/section/191

pension pot – the rest is paid into it for her by the government. She is therefore £2.68 a month, or £32.18 a year, better off under a relief at source scheme.

4.6 Some figures that we have obtained from HMRC[1] indicate that in 2015/16, 1.22 million people were likely affected by this issue (this will include workers in occupational schemes as well as auto enrolment trust based schemes). It is not hard to see that in 2018/19 – as auto enrolment is now business as usual and as the personal allowance is £11,850 rather than £10,600 – this figure will have grown substantially.

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.[2] Smart pensions have also recently taken the decision to offer RAS schemes, as well as NPA as a potential solution to the NPA issue,[3] 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 is £34.91 (i.e. on earnings of £11,850).[4] From April 2019 when contribution rates increase to 5% this £34.91 pension 'penalty' will increase to £58.18 (assuming all else remains the same).

5.2 The DWP's recently announced ambitions for auto enrolment[5] (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) means the extent of the problem will increase – in terms of both numbers of people affected and the amount they are losing out on.[6]

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[1] Via an FOI request: *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.

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

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

[4] £11,850 - £6,032 x 3% = £174.54 (NPA contributions) as compared to £11,850 - £6,032 x 2.4% = £139.63 (RAS contributions).

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

[6] Once QE threshold is removed (we are looking at 2025/26 for this – by which time the PA 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. Along the way we have examined and rejected solutions such as preventing all non-taxpayers receiving relief; abolishing NPA altogether and simply running RAS; leaping ahead and introducing flat rate relief; doing nothing, etc.

6.2 We think there probably is an 'easier' 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 RTI data includes NPA contributions.[1]

6.3 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.

6.4 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.

6.5 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 NPA (apart from the cash flow disadvantage accruing to those who get their tax refunds via the P800 process).[2]

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[1] 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

[2] 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.

6.6 We include as an Appendix, a graphic explaining how this process – which could be fully automated provided HMRC's systems are appropriately calibrated – works. We have extensively tested the logic we have developed and given the P800 calculation is a full and complete reconciliation of the person's position at the tax year end, it seems to work even with perceived complexities – multiple employments/deductions/adjustments/incorrect tax codes, etc.

6.7 The change could be effected by a simple amendment to s23 Income Tax Act 2007,[1] cross referring to the amended provisions in Chapter 4 of Finance Act 2004[2] (in particular the removal of s191(7)(b) which disapplies the £3,600 non-taxpayer relief to those in net pay arrangements).

6.8 For non-P800 cases, e.g. where an employee also has self-employment income, a mechanism to claim the relief, could be built into the self-assessment/simple assessment processes.[3]

6.9 With a few tweaks, we think a process could be developed to deal with the different rates that apply to Scottish taxpayers[4] – 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%.[5]

6.10 In the longer term, we think there is scope for a similar mechanism to be rolled out to give automatic pension tax relief for higher earners in relief at source schemes.

7 Why would the government not want to do this?

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

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

[3] 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 – e.g. a single contribution at the end of the tax year.

[4] 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

[5] The Scottish logic could look something like this:

- 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%.

7.1 The most obvious reason is cost. However we do not believe that cost should be used as justification for allowing the unfairness to continue.[1]

7.2 It appears that auto enrolment was originally costed on the basis that people would be getting tax relief – the fact that low earners in NPA do not as a consequence of the divergence of the auto enrolment threshold and the personal allowance, is an anomaly.[2]

7.3 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.'[3]

7.4 Indeed, even now, official communications[4] give the message the tax relief is a foregone conclusion, which is highly misleading:

7.5 *'WHAT IS A COMPANY/WORKPLACE PENSION?*

'A company or workplace pension scheme is a pension set up by your employer. You will be required to make regular pension contributions based on a percentage of your salary. Your employer will also pay into it and the government will pay into it in the form of tax relief.'

7.6 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.

LITRG
21 September 2018

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[1] It is however, possible that savings could be made available in the benefits system to offset some of the cost, as certain benefits like Universal Credit allow claimants to deduct certain pension contributions they make from their income. Further analysis is required.

[2] 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.

[3] 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

[4] http://www.pensionawarenessday.com/

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)