What is the "net-pay anomaly" and does it matter to UK pensions?

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UK government spending on pensions and top-up benefits for pensioners amounts to 5.9 per cent of GDP – and this figure is projected to increase to 6.3 per cent over the next half century. In addition, the Government also spends another 1.8 per cent of GDP on tax relief which is designed to encourage people to save. Incidentally, this still puts us considerably behind the levels of state spending seen in other EU countries, and demonstrates that there is no crisis of sustainability in our system.

These tax reliefs represent a considerable state investment towards retirement saving and should in theory reward and reinforce the kinds of actual saving behaviour we wish to encourage. But are they doing the job that is needed? Three areas must be examined.

Firstly, do these tax reliefs actually work as incentives? Is there evidence that they encourage people to begin to save, or to save more? Or would the people who receive them have chosen to save in any case?

Secondly, do these reliefs incentivise the right people into the right forms of saving? Do they have any positive effect on those people who are currently under-saving for their retirement? And do they encourage people to save into vehicles which are appropriate for their needs?

And finally, is the distribution of these incentives fair? To what degree should wealthier individuals benefit from incentives compared with others on low and average incomes? How far, if at all, should we be concerned that 55 per cent of tax relief goes to the 2.5 million higher rate taxpayers who make up only around 10 per cent of taxpayers?

The system by which pension saving incentives have been distributed over the past 50 years has remained consistent. People get an incentive to save when they contribute (tax relief on contributions), an incentive to remain invested (tax-free growth) and a further incentive at claim (a quarter of money saved can be drawn without tax and all pensions are paid without liability to national insurance.

There is one area where this consistent approach has not been adopted, it is in the payment of Pension Tax-relief at Source (PRAS). When Stakeholder Pensions were introduced in April 2001, non-tax payers were able to claim tax relief at basic rate even if they were not paying tax - so long as their pensions administrator claimed on their behalf. This is the relevant statement from HMRC

A member making a contribution to their pension scheme will get tax relief at the relevant basic rate. The amount paid to the scheme is treated as having had an amount equivalent to basic rate tax deducted.

The scheme administrator claims the basic rate tax relief from HMRC and adds it to the pension pot. This applies whether or not the member pays tax.

For example, if the relevant basic rate was 20%, and a member wants to make a £100 contribution they'll only need to pay £80 into their pension scheme. The scheme administrator reclaims £20 from HMRC and puts this into the scheme making up the pension contribution to £100.

https://www.gov.uk/guidance/pension-administrators-reclaim-tax-relief-using-relief-at-source

The payment of tax relief where no tax is paid only applies to PRAS, it does not apply to "net pay pension schemes". This has created an anomaly – known as the "net pay anomaly".

Net pay schemes grant tax-relief at contributions by deducting contributions from someone's gross pay. This grants immediate tax-relief in full to anyone paying tax but gives no tax-relief to those not paying tax.

To begin with, the grant of tax-relief to non-tax payers was confined to contract based schemes but things got more complicated when occupational schemes were allowed to operate using PRAS. NEST decided to use PRAS, some mastertrusts – most notably People's Pension allowed employers to choose between PRAS and "net-pay".

The complication became even greater once auto-enrolment got underway. Originally it had been seen as very unlikely that anyone would contribute into an occupational pension if they paid no tax so the "net-pay anomaly" wasn't an issue. But auto-enrolment changed that. People are swept into contributory pensions whether they were tax-payers or not.

This is because while originally the Government set the minimum income threshold to be auto-enrolled in line with the nil-rate tax band, the threshold has not been increased and the nil rate band has. This has opened up a gap into which the low paid fall. From April 2019, the AE threshold will remain at £10,000 but the starter rate for paying income tax will increase to £12,500. The gap between the two will increase to £2,500. Importantly – it is not just people who consistently earn on a periodic basis above the AE trigger, but people who occasionally earn more than £833 pm or £192 pw who get triggered into saving. It is possible to postpone the event – but it takes a very vigilant payroll officer to postpone every time it happens and once someone is "in" – it is not possible for an employer to get them "out".

It is reckoned that the net pay anomaly could affect up to 1.2m pension savers.

So, the number of people potentially caught by the net pay anomaly is increasing. It should be noted that all Government pensions operated under net pay and the anomaly means that those in defined benefit pension schemes but not paying tax are being denied the Government Incentive just as those in net pay workplace schemes operating under net pay. Most large occupational DC plans are net pay, they include some master trusts - NOW Pensions, the Pensions Trust and Smart Pensions for instance, as well as single employer schemes such as Whitbread.

The net-pay anomaly is not only wider in scope but deeper per individual. This is because personal contributions under auto-enrolment rose from in April 2018 and are due to rise to 5% in April 2019. The Government originally advertised to all enrolled that the contributions for auto enrolment would be 3+4+1% - with the 1% being called a "Government Incentive". This changed when Ros Altmann was Pensions Minister as Government recognised that the 1% incentive , would only apply to those not-tax-payers enrolled in PRAS schemes.

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The extra cost to someone saving 5% of AE relevant earnings below the tax threshold is reckoned to be £62 per person from April 2019. This is a significant extra cost for someone who is unlucky enough to be in a net-pay rather than a PRAS scheme. Consequently considerable political momentum is building up among unions and campaigners for tax-fairness for the low-paid. It is focusing currently on an opportunity to sort out the anomaly while HMRC is sorting out issues with the marginal differences in basic rate tax-relief in Scotland.

So far, the campaign to end the net pay anomaly, which calls for low-earning net pay savers to be credited with their "incentive" via a year-end sweep of earnings and a pay-code adjustment, has not met with success.

However, campaigners continue to ask the three questions at the top of the article and focus in particular on the issues of equality in the third question. They argue that the distribution of incentives is not fair to low-earners and should be normalised to the position that the Government originally announced. Everyone saving through auto-enrolment should – according to campaigners – be eligible for the 1% incentive, regardless of the tax-relief system their employer and their provider have agreed.