



The net pay scandal

Ian Neale, director at Aries Insight, discusses this growing issue



There has been a growing scandal around low earners auto-enrolled into pension schemes using the net pay arrangement. It is a scandal that many have been aware of, yet no action is taken and the problem continues to grow, with the numbers potentially affected having just increased dramatically.

From 6 April 2019, the minimum level of contributions based on qualifying earnings into a defined contribution scheme has increased to 8%, of which 3% must be paid by the employer and the rest may be paid by either the worker or the employer.

This increase is a significant step-up from the 5% (minimum 2% from the employer) that applied from April 2018. Optimism that this will not trigger a spike in opt-out rates might be justified as the Pensions Regulator (TPR) reports that at the end of June 2018 rates of opt-out and cessation remained consistent with levels before the first planned contribution increase in April 2018 (<http://bit.ly/2WL15gO>).

However, there is a particular group of workers who might be more likely to opt out (i.e. low-paid employees in a scheme that uses the net pay arrangement), and this is the core issue at the heart of this growing scandal.

There are two methods by which an employee can receive tax relief on their contributions:

- **Net pay arrangement** – where contributions are deducted from the employee's pay before their tax liability under pay as you earn is calculated. The correct amount of tax relief is, in almost all cases, given automatically as the contributions are paid.

- **Relief at source (RAS)** – this method operates by allowing the member to make their contribution after deducting an amount equal to the basic rate of tax relief. The scheme administrator then claims the amount deducted from HM Revenue &

Customs (HMRC).

Workers who don't pay income tax will only get tax relief if their scheme uses RAS. The great majority of occupational pension schemes, including most of the leading master trusts, use the net pay arrangement. As TPR has pointed out (<http://bit.ly/2FRbjFO>), this means non-taxpaying staff auto-enrolled into a net pay scheme will need to pay 20% more for their pension.

...a scandal that some workers should be disadvantaged in this way...

In April 2015, the personal allowance (the threshold at which income tax liability arises) rose from £10,000 to £10,600, while the earnings trigger – the annual level at which a worker becomes eligible for automatic enrolment (AE) – remained fixed at £10,000. This meant that for the first time some low earners – those earning between £10,000 and £10,600 annually – who were auto-enrolled did not get tax relief on their contributions because they didn't pay income tax.

Every tax year since 2015–16 the personal allowance has risen. For tax year 2018–19 it was £11,850; and for 2019–20 it has jumped to £12,500. Throughout, the earnings trigger has stuck at £10,000. So every year the number of workers who are not getting any tax relief on their pension contributions has increased. Even before this April's hike, 1.2 million low earners were missing out.

Take a worker on minimum wage working 28 hours per week, and let's say they are lucky enough to be in regular employment for the whole year, but auto-

enrolled into a net pay scheme. With the adult national minimum wage at £8.21 per hour, their annual gross earnings total £11,953.76. At the end of the year £290.88 will have been deducted from their pay ($5\% \times (£11,953.76 - £6,136.00)$). If their scheme had used RAS, the same pension contributions would only have cost them £232.70. Looked at another way, £290.88 paid into a RAS scheme would create a gross annual contribution of £363.60.

A few might argue that £72.72 is small beer, but take investment returns over decades of scheme membership into account and the difference in fund value by retirement date could easily be many thousands of pounds. But that is not even the main argument: as a matter of principle and equal treatment it is a scandal that some workers should be disadvantaged in this way.

Perhaps even worse though, is that HMRC, HM Treasury and the Department for Work and Pensions are all well aware of the issue, and indeed have been for quite some time. The Low Incomes Tax Reform Group has proposed a costed solution (<http://bit.ly/2TY5iw9>).

In a House of Lords debate last June (<http://bit.ly/2uKq9Zt>), Baroness Buscombe said: "The government recognise the different impacts on pension contributions for workers earning below the personal allowance, but 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. However, alongside further work on the AE changes outlined in the review, the government will examine the processes for payment of pensions tax relief for individuals to explore the current difference in treatment...". This sounds a long way off a promise to fix it. Do principles still count for anything? ■