Net-pay versus relief at source schemes; the tax relief misdemeanour

The type of scheme an employee is enrolled in determines whether low-paid earners receive tax-relief on their contributions, but the government has said it is "not possible" to change this. Natalie Tuck investigates

The issue of net-pay vs relief at source schemes is one that appears to be kept very quiet within the pensions industry. Perhaps because the government remains against making any changes, stating that it is "not possible" to resolve the issue, and that for the industry to correct itself, would mean higher charges.

Despite this, the issue is not to be ignored, as it sees low earners miss out on tax relief and face paying more than 20 per cent extra for their pension. The issue affects those who earn over the £10,000 needed to trigger auto-enrolment but below the £11,000 income tax threshold, who are enrolled in a net-pay pension scheme rather than a relief at source scheme.

For those earning over the income-tax threshold, the same amount of tax relief is given regardless of the type of scheme. However, due to the way the contributions are deducted in net-pay schemes, those earning below the threshold do not receive the relief.

In a net-pay scheme, contributions are deducted from pay before any tax is applied, whereas with a relief at source scheme, the employee receives basic rate tax relief at source when they pay their net pension contribution.

The government-backed pension provider Nest uses a relief at source scheme, as does The People's Pension. However, NOW: Pensions uses a net-pay arrangement. As a general rule of thumb, group personal pension tend to be relief at source and mastertrust schemes net-pay arrangements.

It has been previously speculated that around 900,000 people are affected by the issue. However, former Pensions Minister Ros Altmann has asked the government what analysis they have undertaken to identify how many employees are saving into a workplace pension that denies them tax relief. She also asked what the effect will be on low earners in a net-pay scheme and what assessment the government has made of the challenges faced by low earners who do not receive tax-relief.

On behalf of the Treasury Baroness Neville-Rolfe answered: "The government appreciates the impacts on low-paid workers whose employers use a net pay arrangement pension scheme. However, 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."

Although there is no clear estimate of how many are affected, First Actuarial business development director Henry Tapper notes that with the current review of auto-enrolment, which is looking to bring in more lower-paid earners, the number of those caught in the net-pay trap could increase.

Furthermore, Altmann also asked what plans the government has to ensure employers and workers are told that the net pay arrangement may be unsuitable for workers who earn below the personal tax threshold, and that they face paying more than 20 per cent extra for their pension than if they were in a relief at source scheme.

Neville-Rolfe stated the government has regular discussions with the regulator on a range of issues, including workplace pensions. "Workplace pension schemes are chosen by employers and The Pensions Regulator provides guidance on this in relation to automatic enrolment. The guidance covers the choice between net pay and relief at source schemes, and the implications of net pay schemes for employees who do not pay tax. It also points out that some schemes that use the net pay arrangement may have lower charges than schemes that operate relief at source."

Written by Natalie Tuck