Widening the net

The government has proposed a solution to resolving the tax relief issue for low earners in net-pay pension scheme arrangements, but is the proposed method sufficient? Natalie Tuck reports

After bubbling under the surface for several years, the government has finally proposed a solution to resolving the net-pay anomaly that affects low earners in auto-enrolment pension schemes.

This long-known issue has impacted low earners in net-pay arrangements since auto-enrolment pension schemes were introduced. It affects those who earn over the £10,000 needed to trigger auto-enrolment but below the £12,570 income tax threshold who are enrolled in a net-pay pension scheme rather than a relief-at-source (RAS) 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. Despite the unfairness, net-pay schemes are popular with employers because they tend to have lower charges.

For many years the government declared that it was "not possible" to resolve the issue. However, the Conservative Party committed to resolving the anomaly in its 2019 election manifesto; two years later and a solution has been proposed. So, what does it entail?

The government had proposed four options in its initial call for evidence published in July. These included: Paying a bonus on real time data information; introducing a standalone charge to recover the top-up given on RAS schemes; introducing a requirement for employers to use both types of schemes (employee membership would be dependent on whether they earned above the income tax threshold); or, mandating the use of RAS for all defined contribution schemes.

Although option one (bonus proposal) was found to be the most popular option, it would have seen modifications to the P800 process to enable the bonus to be calculated. The call for evidence found that this would have introduced additional complexity for members, pensions schemes and HMRC. It was therefore deemed to be poor value for money.

Instead, the government is now proceeding with a top-up method that involves making changes to the pay as you earn (PAYE) reconciliation process, outside of the P800 process. This option will see HMRC notify savers that they are eligible for a top-up payment and then they will be invited to provide the necessary details for HMRC to be able to make the payment to them. The changes will apply to contributions made in the 2024/25 financial year, with claims able to be made from April 2025.

The move to resolve the issue has been largely welcomed by the industry but there is a consensus that the method is not the best solution. Former Pensions Minister and member of the House of Lords, Baroness Ros Altmann, who has long campaigned for the issue to be resolved, is pleased the government has "finally recognised" the problem and has "put forward some actual proposals to deal with it".

"As always, the devil will be in the detail and at the moment it is also disappointing that no change will happen before the 2024/25 tax year. So, for the coming years, low earners in net-pay schemes will continue to pay 25 per cent extra for their pension and have lower take-home pay than if their employer had chosen a different scheme that was more suitable for them. The other wrinkle is that the Treasury plans will require people to claim their refund and provide their tax details to HMRC to receive the money," Altmann says.

She believes the process of claiming may be very off-putting for low earners and also warns of the "serious danger" that people will be put off claiming because the process may well look suspiciously like a scam.

Written by Natalie Tuck