

Media Brief

Pensions tax relief

June 2020

Note: This paper is intended as background information for the media. It is not intended as a comprehensive policy paper for The People's Pension.

Automatic enrolment is a real success story, with more than 10 million people now saving towards their retirement and benefiting from what's effectively a pay rise, as their employer also pays into their pension pot.

On top of that extra contribution, people receive tax relief, a top-up to their pension pot from the Government to encourage them to save.

What is pensions tax relief?

Pensions tax relief is a tax break for pensions saving. Most people, most of the time can make contributions into their pension free of income tax.

Tax relief is paid on pension contributions at the highest rate of income tax paid. It is subject to a series of allowances, which depend on an individual's income, whether they have taken money from their pension in the past and how much they have in their pension fund.

What is the annual allowance?

The annual allowance is a limit to the total amount of contributions that can be paid to defined contribution pension¹ schemes and the total amount of benefits that can be built up in defined benefit pension scheme each year.

Currently, the annual allowance is capped at £40,000, although a lower limit of £4,000 may apply if a saver has started accessing their pension. An individual can carry forward unused allowances from the previous three years, providing that they were a member of a pension scheme during those years.

Who is eligible for what?

Tax relief is paid on pension contributions at the highest rate of income tax an individual pays:

- Basic-rate taxpayers – people who earn between £12,501 and £50,000 - get 20 per cent pension tax relief.

- Higher-rate taxpayers – those who earn between £50,001 and £150,000 can claim 40 per cent pension tax relief.
- Additional-rate taxpayers – higher earners on salaries above £150,000 can claim 45 per cent pension tax relief.

So, if a basic-rate taxpayer were to contribute £100 from a salary into a pension, it would actually only cost them £80. The government adds an extra £20 on top – what it would have been taken in tax from £100 of salary. Higher-rate (40 per cent) and additional-rate (45 per cent) taxpayers only need to pay £60 and £55 respectively to achieve the same £100 of pension savings.

In Scotland, income tax is banded differently, and pension tax relief is applied in a slightly alternative way.

- Starter rate taxpayers pay 19% income tax but get 20 per cent pension tax relief.
- Basic rate taxpayers pay 20 per cent income tax and get 20 per cent pension tax relief.
- Intermediate rate taxpayers pay 21 per cent income tax and can claim 21 per cent pension tax relief. Higher-rate taxpayers pay 41 per cent income tax and can claim 41 per cent pension tax relief.
- Top rate taxpayers pay 46 per cent income tax and can claim 46 per cent pension tax relief

The different ways of paying tax relief

There are two ways to claim tax relief on a workplace pension – net pay and relief at source. The People's Pension operates both systems for their members.

Relief at Source:

Relief at source means your contributions are taken from your net pay (after your wages are taxed). Then your pension provider automatically claims tax relief for you from HM Revenue & Customs (HMRC), adding the basic tax rate of 20 per cent to your pension contributions.

Individuals eligible for higher or additional rate relief can then receive the full amount they are entitled to through self-assessment.

Net Pay:

A net pay arrangement means your pension contributions are taken from your gross pay (before your wages are taxed). So, you only pay tax on what's left – therefore you receive your full tax relief straightaway.

If you're a basic, higher and additional taxpayer, you'll automatically save 20%, 40%, or 45% respectively in tax relief. However, if the individual doesn't pay any tax, this method means they won't receive tax relief despite being eligible. This is known as the net-pay anomaly.

What is the net pay anomaly?

An estimated 1.7 million low earners miss out on much needed tax relief on their pensions, due to the 'net pay anomaly'.

Members of pensions schemes who do not earn enough to pay income tax – because they are on salaries of £12,500 or below - are granted 20 per cent tax relief on up to £2,880 of pension contributions, meaning that HMRC will top up a maximum net contribution to £3,600. However, if a pension provider operates a net pay scheme, these members will not receive the tax relief they are entitled to.

This means that the lowest paid eligible workers, the majority of whom are women, are missing out on much needed contributions to their pension pots. It is estimated that, on average, the net pay anomaly can cost low paid workers £8,000 in pension contribution across their working life.

Ahead of the 2019 General Election, The Conservative Party included a pledge to fix the net pay anomaly in its manifesto¹. In March 2020, the Chancellor of the Exchequer Rishi Sunak announced a review into the net pay anomaly as part of the Budget.

The Tax taper

In 2016, in a bid to control the cost of pensions tax relief, the then Government introduced the Tapered Annual Allowance for individuals with a "threshold income" of over £110,000 and an "adjusted income" of over £150,000.

These new rules reduced what people earning more than £150,000 could put into their pension in a tax year, known as the annual allowance (which is £40,000 for most of the working population), and still gain tax relief on contributions.

The rules dictated that those earning below £110,000 would not be caught by the taper rules, while those earning above would have to calculate the adjusted income. For those earning £150,000 or more, the allowance falls by £1 for every £2 of income between £150,000 and £210,000. For incomes of £210,000 or more, the allowance was £10,000.

The taper is extremely complex, and this came to a head in 2018 and 2019 after doctors' leaders argued that higher earning members of the profession were often seeing growth on their Defined Benefit (DB) pension pot – which is classed as income - exceed their annual allowance, meaning they were at risk of an unexpected tax bill.

The issues led to reports of doctors declining overtime or extra work, reducing their hours or even leaving the NHS, leading to fears that it would impact on patient care and waiting list times². There were calls to scrap the taper completely, leading the ruling Conservative Party to include a pledge in its manifesto¹ to fix the tax taper within 30 days of it winning power at the General Election in December 2020.

As a result, Chancellor the Exchequer Rishi Sunak used his March 2020 Budget to announce of April 2020 the Tapered Annual Allowance would apply to individuals with threshold income of over £200,000 and adjusted income of over £240,000.

Why pensions tax relief needs reforming

There are different ways of looking at tax relief. Traditionally, pensions are seen as income deferred and received later in life. In that worldview, it makes sense to pay tax on income when it is actually received and can be spent. With pensions that may be many years in the future.

Some, including us, question that worldview, partly because many people earn and pay tax in the here and now at a higher rate than they pay in retirement. Many benefit from this differential, receiving tax relief at a higher rate in their working life than they go on to pay in retirement. Only a tiny minority, pay higher or additional rate tax in retirement.

This sort of skewing of the benefits of tax relief is typical of the taxation of pensions as a whole. As pensions tax relief is paid at an individuals' marginal rate, those in higher tax bands who pay higher pension contributions receive more in tax relief than others. Of the £37.2bn gross cost of tax relief, just over half goes to people paying higher and additional rate tax who only make up around one in ten of the population in work.

A majority of adults do not have a good idea (59 per cent) of how tax relief works⁴. This means that it does not function as an incentive to save. Rather, it encourages people with surplus capital to assign that capital to the most tax efficient way of saving. For those that understand it, tax relief doesn't increase the overall volume of saving, it just incentivises people to move money in a tax efficient way.

For these reasons, people are increasingly asking why it is fair for tax breaks to be focused so narrowly on higher earners and whether it would be fairer to adjust the pensions tax system so that tax relief is shared more equally.

What The People's Pension is calling for:

- A full review to examine the complexities of pension tax relief, which should be overseen by a new independent Pensions Commission.
- A fairer flat rate of pension tax of 30 per cent, enabling the lower paid to benefit more from pension tax relief.
- The end of the 'net pay anomaly'; an issue which threatens to damage public confidence in auto-enrolment and lets down those who need to increase their retirement savings most.

Footnotes:

1. A defined-benefit plan provides a specified payment amount in retirement. A defined-contribution plan allows employees and employers to contribute and invest funds over time to save for retirement.
2. In its pre-General Election manifesto, The Conservative Party committed to fixing both the tax taper and the net pat anomaly: <https://www.conservatives.com/our-plan>
3. NHS 'tax trap' pensions causing frontline shortages, doctors warn, The Guardian, Tuesday, November: <https://www.theguardian.com/society/2019/nov/05/nhs-tax-trap-pensions-causing-frontline-shortages-doctors-warn>
4. In September 2015 YouGov conducted a survey on behalf of The People's Pension designed to find out more about the population's understanding of pensions tax relief. <https://bandce.co.uk/tax-relief/>