ASSOCIATION OF CONSULTING ACTUARIES

Association of Consulting Actuaries Limited · First Floor (129) · 40 Gracechurch Street · London · EC3V 0BT
Tel: +44 (0)20 3102 6761 · Email: acahelp@aca.org.uk · Web: www.aca.org.uk

Pensions and Savings Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

By email to Pensionstaxreliefadministrationcfe@hmtreasury.gov.uk

13 October 2020

Dear Team

Pensions tax relief administration: Call for Evidence

I am writing on behalf of the Association of Consulting Actuaries in response to the call for evidence on pensions tax relief.

We provide our overall comments and more details on each question, in the attached Appendix.

We would be happy to discuss this matter further. Please contact Karen Goldschmidt on karen.goldschmidt@lcp.uk.com… or on 020 7432 6621, or Tim Sexton on tim.sexton@pwc.com or on **07841 494194**.

Yours faithfully

Karen Goldschmidt
Chair of the Pensions Tax Committee
On behalf of the Association of Consulting Actuaries Limited

*
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/902338/Pensions_tax_relief_administration_CfE_docx.pdf

About the Association of Consulting Actuaries

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes. Members also advise thousands of smaller pension arrangements and individuals (many in self-employment) as well as advising life and general insurers.

Appendix

We start with what we consider to be key drivers for this consultation. We then consider the detailed questions.

OVERALL KEY POINTS

A The group affected and the drivers to a solution

The "low paid RAS versus net pay" issue has grown in size principally as an unintended consequence of a long-term government policy designed to significantly reduce the number of people paying income tax (as it interacts with the success of Auto-Enrolment). Some key observations around the current impact are:

- Given the current personal allowance of £12,500, the issue under consultation would now potentially affect a very large cohort of employees, for example almost any part time worker on the minimum wage (a full-time worker on the adult minimum wage would earn around £15,870 pa). These individuals will currently be disadvantaged if they are in a net pay arrangement compared to the position if they were under RAS.

- The numbers affected will continue to rise to the extent that the personal allowance grows further relative to the auto-enrolment threshold. Current trends also mean the demographics affected are likely to be disproportionately groups such as the young, women and individuals who have sought to reduce their working hours (potentially in the run up to retirement).

- However, for affected individuals, the quantum of the impact is also generally small. For example, we show in the next page that relative disadvantage could be around £38 p.a. under "net pay" for an employee earning £10,000 p.a. and paying contributions on Auto-enrolment qualifying earnings. The cost of proposed solutions should be viewed from this perspective.

Arguably the disadvantage to individuals on low pay from net pay schemes is more than offset by the much larger recent gains to affected individuals from recent increases to the personal allowance.

However, from a fairness standpoint, the relative difference between the systems does appear problematic. For example, if the government believes it is important to incentivise retirement saving consistently, across each income and demographic group, obtaining clear greater consistency of approach is desirable.

However, from a forward-looking perspective, we think that any approach that is used to resolve the anomalies between net pay and RAS, must be consistent with the government's anticipated long-term direction of travel on pensions tax. We note the consultation specifically does not invite comments on how the tax system should be used as part of the incentives to save for pension and so we have not commented further on these here. However, we note that depending on the desired long-term approach, this should strongly guide the preferred administrative solution adopted to this issue.

B How the situation has arisen, and the group affected

It is worth considering the quantum of benefit involved. The difference has arisen and become wider spread "accidentally" – the credit of basic-rate tax regardless of the member's tax position was designed to make RAS easier to operate. It is the growth in Personal Allowance that has increased the anomaly ie more employees do not trigger income tax so are in scope for the credit under RAS.

Its widespread actual impact primarily arises because of the success of Auto Enrolment, and the fact that the Personal Allowance has risen above relevant Auto-Enrolment bands.

We have provided further figures to support these considerations in that context. Firstly, it is important to note that the difference relates to income tax paid on employee contributions only. The differences for two sample members are set out below, in typical employer-sponsored arrangements:

Annual figures (2020/21 tax year)	Member 1 – typical minimum Auto-enrolment (AE) scheme. - Earning £10,000* pa - Paying a 5% contribution on AE qualifying earnings	Member 2 – simplified A/E scheme - Earning £10,000* pa - Paying a 5% contribution on all earnings
Employee total contribution	£188	£500
Income tax relief (net pay)	£0	£0
Income tax relief (RAS)	£38	£100
Difference	£38	£100

Simplified example. Only income tax (and not other reliefs) are considered to show a comparison.

We note that the proportionate impact for these sample members is 0.4% or 1% of total earnings respectively (and will be lower for those with even lower earnings and hence lower personal contributions). In absolute terms the amounts involved per se are small (especially relative to the potential cost of some approaches to resolution) but we appreciate that they are potentially significant for the very low paid.

*We have used £10,000 rather than £12,500, the full personal allowance, given that some employers allow employee contributions to be paid using Smart/Salary sacrifice which tends not to be used at lowest income levels because of the impact on welfare benefits (but at say £10,000, sacrifice delivers a National Insurance saving to the employee, currently of the 12% that would normally apply for the excess over £9,500, as well as delivering NI savings for the employer which might be shared); and using salary sacrifice, the question of tax bonus applying for RAS but not net pay goes away.

C A proportionate approach

A complex or significant adjustment to the method of delivering net pay or RAS pension tax relief would arguably be an inefficient way to address issues of encouraging adequate pension savings for lower paid employees. There might be simpler and more efficient ways to do this. For example, HMRC incentivising employers using net pay to make a small increase in employer contributions for the very low-paid workers might cover the shortfall compared to RAS but at much lower administration cost (albeit the employer has to meet this). This would avoid the consequential complications identified in the various ideas discussed in the call for evidence paper.

D Avoid mandating an approach

We suggest no (new) mandation of one approach or the other – except in the context of any planned longer-term changes for the pensions tax regime.

There are a range of trust-based DC schemes/sections of schemes. Switching from net pay to RAS is likely to be costly (particularly for smaller schemes, with none of the advantages of scale that insurers or the bulk providers can manage). It is therefore disproportionate solely as a route to resolving the issue under consultation.

E Avoid mandating two schemes

We think the proposal to require an employer to operate two occupational pension schemes (OPS) may add a lot of complexity, it may put pressure to achieve an unachievable precision by way of midyear switching and also increase likelihood of confusion and error. (The few master trusts that offer both methods of tax relief specifically set these up as separate schemes for employers to choose between once-off and do not operate switching).

Inevitably the lowest earners will be part-timers which adds to the likelihood of uneven patterns of working and hence there is real difficultly to match the appropriate relief system in real time; as well as the possibility that they have other employments that change the status away from one that is apparent to the employer (a PAYE code is an indicator but just an estimate not a fine tuned measure, it works best for stable incomes).

F Appropriate easements

One easement should be made available – that an OPS that still has a contributory open DB section and that also has a DC section within the same trust, should be able to operate RAS for all of one section, and net pay for the other (we believe that this is currently only possible for fully "sectionalised" schemes as per https://www.gov.uk/hmrc-internal-manuals/pensions-tax-manual/ptm044230).

Similarly, in order to support an employer with an OPS with both DB and DC (which would currently be operating net pay) that wished to get to a system of operating RAS for the DC element, easements should be made in tax law to remove pitfalls for separating DC arrangements out of mixed schemes (whether by transfer of DB or DC), such that the DC is provided from a separate scheme. We would be happy to discuss these further.

G Increase in costs

Increase in administration would inevitably increase running costs – to the extent this feeds back to (all) members (within allowed A/E caps) it would erode the benefit being supported.

More detail on each of the specific questions raised

Question 1: What are the factors that influence a pension scheme in its choice between using net pay or RAS for their members?

There are a number of scheme and employer specific reasons, for example:

- **History, consistency and inertia.** The structure is usually a result of a corporate decision, often taken many years ago. In the past, net pay was the only option for OPS and RAS was the only option for personal pension schemes. Where a choice did exist, cost, ease and resilience of administration and governance requirements are likely to have been primary factors, with the tax basis a secondary consideration. Given the cost and effort of changing this structure many schemes will have maintained the selection made at the outset.

  Where new schemes have been set up, we would expect the basis of tax relief to be an important factor if an employer has taken advice. However, many employers do not take advice on scheme selection, particularly smaller employers (to the extent that they use an OPS – many might use NEST), and some employers may have preferred to apply a consistent approach to their existing schemes in order to not disrupt or add significantly to payroll processes.

  We note that NEST operates RAS but this may reflect a desire by NEST or the DWP for it to able to provide a service to the self-employed as a possible future development of auto-enrolment.

  Very few master trusts operate a RAS vehicle – perhaps given the commercials of this market (one of the larger master trusts running net pay adds top up contributions to make up for the shortfall compared to RAS), so when employers look to move from an OPS to a master trust, there is a limited market to choose from. They will consider this issue if they have a lot of low paid employees (perhaps part timers) but it may be outweighed by other factors.

  (Anecdotally many employers already operate both systems albeit with heavy weighting one way or another (eg due to legacy DC schemes, one-off arrangements for individuals etc.) when the advice was different at different times; and anecdotally we have been told of auditors seeing net pay incorrectly applied for RAS amongst smaller employers.)

- **Necessity.** Some arrangements must use one structure or the other (for example the self-employed who will always use relief at source).

- **Systems, costs and practicalities.** In general, we would expect RAS to be more complex and costly to administer.

- **Profile of earners.** Pension schemes with a larger number of higher and additional rate taxpayers may prefer a net pay structure in order to reduce the administrative burden for those that need to manually reclaim tax (and noting that some of this relief goes unclaimed). Those with a larger number of non-taxpayers may have preferred the RAS structure due to the existing difference, to maximise the tax relief for the lower paid, however this has only been a significant issue since 2015 when the Personal Allowance exceeded the auto-enrolment trigger.

Question 2. How do pensions providers currently engage with employers around the differences between net pay and RAS for their employees? Is the method of tax relief a scheme operates a relevant factor in the employer's decision (either directly, e.g. when considering employees' financial positions, or indirectly, e.g. through an impact on provider fees)?

See Q1.

Question 3: Are there ways that this approach [Suggested approach 1 – paying a bonus using RTI data] could be delivered that would not engage the issues identified above, namely the challenges in ensuring consistency across all taxpayers for all aspects of the tax system in a timely fashion, and additional burdens for scheme members and scheme administrators?

The outcome of this approach is the most attractive. However, HMRC would need to take on a considerable role and has said this is unlikely to be practical and so we have not commented further.

Arguably, a more efficient rearrangement of this ("Approach 1 A") might be by way of HMRC incentivising those employers using net pay to make a small increase in employer contributions for the very low-paid workers, to cover the shortfall compared to RAS but at much less administration cost. This would avoid the consequential complications identified in the various ideas discussed in the call for evidence paper, better achieving the targets of simplicity deliverability and proportionality.

Question 4: We would welcome views on whether equalising outcomes by removing the top-up for non-taxpayers [Suggested approach 2 – standalone charge] would represent a fair solution to this issue? If possible, it would be useful to understand the impacts on schemes and providers from any such change.

The question of whether it is fair to remove a current incentive to save (albeit one that arises as a consequence of an anomaly of the tax system) is a political question, and the ACA is politically neutral; but we feel that it is likely to be inconsistent with the "long term target" that we describe at the start of this response.

The mechanism potentially involved includes using a free-standing tax charge, which would be a complex message for savers.

This approach would also increase administrative complexity for schemes as they do not currently need to manage records differently depending on the marginal tax rate of each member. The scheme is unlikely to know the member's tax status. The employer might have more knowledge but even the employer would not be certain of the member's tax status (e.g. whether the employee also has a second job or other income). It is likely that the cost of additional administration will ultimately be passed on to members through a higher administration charge, leading to worse member outcomes.

Question 5: We would welcome views on whether this approach [Option 3 – employers operate multiple schemes] would:

- **reliably mitigate the potential difference in outcome for low earners on a consistent basis**
- **be a deliverable, affordable and proportionate solution for small employers with a high proportion of low-earning employees**
- **be appropriate for low earners who are members of defined benefit pension schemes**

We are not in favour of mandation. This might be an option some very large employers might choose to follow, but it introduces a whole new layer of expectations/challenges and costs - see our main front section, and further below.

This solution is complex. Pension schemes are already a significant administrative cost for employers and the additional complexity would not be welcomed, in particular by small employers who we believe would struggle to administer such an arrangement cost effectively.

It is also possible that the cost of additional administration may ultimately be passed on to employees through a higher administration charge, leading to worse outcomes (or eroding some of the benefit for those that benefit from this arrangement).

More specifically, auto-enrolment requires the employer to put the employee in a named pension scheme on Day 1 and to pay contributions promptly and regularly to that scheme. Since lower paid employees might have variable earnings it may not be clear on Day 1 which of a net pay or a RAS scheme would be better. Moving an employee from one scheme to another as pay altered up or down would create two small pension pots for the worker, with two sets of administrative charges and a challenge of communicating all this to the individual. Operating a two-scheme approach is probably not practical and would give a significant risk of mistakes around selecting the wrong scheme, or the person accidentally ending up in neither scheme or both schemes.

One easement should be made available (as noted above) – that a scheme that still has a contributory open DB section should be able to operate RAS if it wishes for a DC section within the same trust.

Question 6: What would be the impacts on schemes and providers of requiring all DC schemes to use RAS? Would this represent a proportionate decision, given potential benefits to some employees and employers?

Arguably, this increases the likelihood of higher rate tax payers losing out on their relief (there is already statistical evidence of this happening because of individuals not taking the steps necessary to reclaim the relief) – but in practice many employers use salary sacrifice for these individuals, so that the higher rate relief does flow through automatically.

Bulk pension providers of personal pensions have economies of scale and systems.   The majority of trust-based DC schemes do not have this sort of scale, so could be overwhelmed by the overwhelming additional paper burden. HMRC will also receive many more claims from a substantial number of schemes without economies of scales and systems.

It would multiply the problems arising for Scottish and potentially Welsh residents, currently managed by a patch (schemes claim 20% credit from HMRC for all members despite the Scottish starter rate of 19%; as for the top-up from the 20% credit up to the Scottish intermediate rate of 21%, the member can claim this but it would be via their return; employers have to provide some separation of data submitted to HMRC– and other complexities).

If such a change were mandated – which we would hope would only ever be in the context of a more holistic change, not solely to manage the low earner problem - enough time should be allowed for an orderly transition.

The wider consistency between DB and DC schemes (and implicitly, consistency between public sector schemes - which are largely DB in nature - and private sector schemes - which are more typically DC in nature) should be considered -but see our further comments below on (8).

Question 7: Would requiring all new providers of DC pensions to operate RAS represent a fair solution to this issue? The government would welcome views on the longer-term implications of such a requirement, for example whether this would result in existing schemes re-evaluating their arrangements.

The problems outlined in the previous answer would also apply for new schemes and so we believe that it would not be appropriate to mandate RAS for new DC schemes.

In any event, mandating the use for DC schemes in future would appear a slow way to tackle the issue, especially noting that due to auto-enrolment many employees are already in existing pension schemes that would sit outside of this requirement. In the meantime, a large number of members would be in a position of disparity.

While some schemes may voluntarily re-evaluate their arrangements, we would expect similar barriers to change to apply as for the current position. Employers can already choose to move to a relief at source structure (combined with salary exchange for additional and higher rate taxpayers to avoid the need for them to manually reclaim tax). However, we are not aware of many doing so, despite the increased focus on this issue in the industry and wider press.

8. Views on whether there would be any benefit in extending RAS to all DB schemes as well as DC schemes would be welcomed. Alternatively, the government is interested to collect evidence on challenges that prohibit such an approach.

As far as we are aware RAS is already available to DB schemes but is challenging so we are not aware that any use this.

The same problems as outlined above would also apply for DB schemes as for DC schemes. In addition, there would be further complexities for DB schemes.

It would seem particularly disproportionate to impose RAS on the few remaining private sector pension schemes open to accrual, they have systems already in place. The option is already open to schemes to do this if they wish; but there is not a natural way to deliver the relief. (Would the approach be that the relief collected would go to the fund – so the scheme would need to rebalance the contribution rate eg from 5 down to 4? As noted elsewhere, the higher paid would need to collect their top up relief via their tax return, but this could be short cut by using salary sacrifice. Other differences of arrangement could give rise to further complexity eg for balance of costs schemes, perhaps CDC, issues such as secondment).

We note the local government pension scheme ("LGPS") uses the net pay approach. Moving to RAS would increase the administrative burdens and cost on both HMRC and the scheme administrators (i.e. local councils funded by council taxpayers) to process RAS claims which, at the moment, are not needed under the net pay arrangements used by LGPS.

We have no comments on the subsequent questions beyond what appears above.

This 'paper/document' is intended to provide general information and guidance only. It does not constitute legal or business advice and should not be relied upon as such. Responding to or acting upon information or guidance in this 'paper/document' does not constitute or imply any client /advisor relationship between the Association of Consulting Actuaries and/or the Association of Consulting Actuaries Limited and any party, nor does the Association accept any liability to any person or organisation relating to the use of such information or guidance.

Produced by the Association of Consulting Actuaries Limited 13 October 2020