The perfect mix?

Lee Muter and David Paul throw some light on some of the current topical aspects surrounding pensions and the related tax and National Insurance implications.

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Tax and pensions are both undoubtedly complex subjects and combining them together can be challenging and fraught with danger.

In this article we will explore the general rules around tax relief, the changes which are due to be in place by April 2024, and issues faced by employers.

Note that in this article we use 'rest of UK' tax rates. The tax position for Scottish taxpayers will differ, due to the divergence of tax rates.

Pensions and tax relief

Tax relief on pensions is a valuable benefit for employees. The way that tax relief is provided for occupational schemes is dependent on the method adopted by the employer with their registered pension scheme. This will depend on whether the pension scheme operates as a 'relief at source scheme' or a 'net pay' scheme. The terminology of these schemes can be confusing so a brief explanation is as follows.

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Relief at source

One method used for most registered pension schemes is relief at source (RAS). In this method, employee pension contributions are deducted from the employee's net salary (after tax and National Insurance (NI) have been deducted under PAYE). This means that the employer is only required to deduct 80% of the employee's total pension contribution from the employee's salary. The pension scheme provider then obtains the 20% (basic rate tax relief), back from HMRC. Employees who are higher rate or additional rate taxpayers can separately claim higher or additional rate tax relief personally, either through their tax return or by making a claim to HMRC.

Readers will note that legislation does not provide NI relief. This is because there is no equivalent for employee pension contributions. This is important when we later consider the subject of salary sacrifice which effectively enables NI relief.

Net pay arrangements

As an alternative, pension schemes may use a net pay arrangement (NPA) which provides employees with tax relief. In an NPA, all of the employee contributions are deducted from the employee's gross salary. This means that employees pay tax and NI on their salary after their pension contribution is deducted. So employees pay tax on a salary which is 'net' of their pension contribution, meaning they automatically receive tax relief at their highest rate of income tax, (whether that is higher or additional rate).

Key points

- Tax relief for occupational schemes depends on the method adopted by the employer with their registered pension scheme - a 'relief at source scheme' (RAS) or a 'net pay' arrangement (NPA).
- The employer must ensure the pension scheme is set up correctly on its payroll system to avoid making errors in tax relief.
- New measures are being introduced from April that will affect individuals who save into an occupational pension under NPAs, but whose total taxable income is below the personal allowance.
- Advantages to employer and employee of using salary sacrifice for pension contributions.

Common mistakes made on pension contributions

The way that tax relief should be claimed is dependent on the method outlined in the employer's registered pension scheme. In order for the employee to receive the correct tax relief on their pension contributions, it is the responsibility of the employer to ensure the pension scheme is set up correctly via payroll. However, in HMRC's August 2023 *Employer Bulletin*, it was highlighted that tax relief on employer pension contributions is an area where errors are most likely to be made.

As there are two methods of obtaining tax relief on pension contributions depending on the type of pension scheme in place, this can and does cause some confusion for employers.

A common error highlighted in the *Employer Bulletin* is where employers report a pension contribution using tax relief

at source, as a contribution made under an NPA. This can occur if employers report their payroll information and incorrectly input contributions into the data fields for an NPA. Following this, the pension scheme provider would obtain tax relief based on this incorrect employer data. The result is an incorrect amount of tax relief in an employee's pension, as a consequence of the employer's payroll error. It is important to note that the employer would be liable for the tax under deducted and remitted to HMRC. As errors are typically discovered some years afterwards, the eventual tax liability could be sizable.

Avoiding mistakes

In our experience, errors have occurred where those involved with setting up payroll configuration have limited experience of pension scheme tax or where there has been insufficient communication about the type of scheme. To help avoid making these mistakes, employers who are uncertain of the method of tax relief used by their pension scheme, should contact their pension scheme provider to confirm how the scheme is registered.

A recent experience we had with a client involved an employer discovering (via our employment tax review) that they had set up their pension deductions incorrectly for the previous 14 years, leading to a disclosure to HMRC of more than £350,000.

Additionally, if the method used is RAS, employers should ensure that their payroll is not configured to report relief at source contributions in the reporting field for NPAs. If employers find this to be the case, it should be corrected. Additionally, any errors identified from previous periods should be reported to HMRC using its digital disclosure facility – tinyurl.com/hmrcdisclosurefac.

The fact that this is included in the *Employer Bulletin* highlights that this is a real risk area and can involve significant amounts of tax. We have seen a number of HMRC driven reviews of this matter, based on intelligence and data it holds, so voluntarily checking and correcting any issues may reduce the risk of penalties.

Higher rate and additional rate taxpayers

Through the use of relief at source and NPAs, all employees will receive some tax relief irrespective of the method used by their pension scheme. However, higher rate and additional rate taxpayers in a relief at source scheme will need to claim their full tax relief by completing a self-assessment tax return. Basic rate tax relief will usually be added to an employee's contribution, but the additional 20% or 25% tax relief is not automatically given. Thus, it is the responsibility of the taxpayer to make a claim.

It is, however, clear that not all eligible employees are claiming this extra tax relief, therefore missing out on some valuable tax savings. In fact, research suggests that as many as two-thirds of eligible pension savers haven't claimed relief that they are entitled to, so have missed out on an estimated £1.3bn of tax relief in the five years to 2020-21.

Employees can receive pension tax relief on personal contributions they make, up to 100% of salary, capped at £60,000 for 2023-24 for most taxpayers. Those eligible for tax relief could also use pension carry forward, which allows individuals to use any unused allowance from the three previous tax years, as long as they were a member of a registered pension scheme during the relevant time period.

In financial terms, higher rate taxpayers leave behind an average of £245m each tax year, while in the case of additional rate taxpayers, an estimated £18m went unclaimed every year between 2016-17 and 2020-21. If a pension saver is a higher or additional rate taxpayer and has missed out on tax relief above the 20% basic rate, they can claim relief for four closed tax years.

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After a recent meeting where we explained the issue to a large employer, an alert to their employees led to more than 35% of eligible taxpayers making claims for backdated tax relief, with the average tax refund being in the region of £600 a year (excluding interest).

Changes for 2024-25 – NPAs

Up to the tax year 2023-24 employees who don't pay income tax will only get tax relief if they participate in a RAS scheme as mentioned above. If they participate in a scheme that uses NPAs, such employees will not get tax relief and so will effectively pay 20% more for their pension.

However, new measures are being introduced that will affect individuals who save into an occupational pension under NPAs, but whose total taxable income is below the personal allowance. It is estimated that 1.2 million individuals will receive additional top-up payments under these measures. The measure will come into force for the tax year 2024-25, with payments to be made by HMRC as soon as possible after the tax year in which the contribution is paid.

Position up to 2023-24

While RAS and NPAs give broadly the same outcomes for most employees, for low earners with taxable incomes below the personal allowance the amount of net pay can depend on the type of pension scheme they are in. Employees contributing to NPA pensions have historically been unable to obtain tax relief on their pension contributions if their income is below the personal allowance. By contrast, employees contributing to an RAS scheme do receive tax benefits, even if they are a non-taxpayer.

In 2020, a call for evidence set out three reform principles for pension changes: simplicity, deliverability and proportionality. As a result of the responses, the government committed to addressing this anomaly by giving a commitment to introduce a top-up payment to low earners in NPA schemes, aiming to broadly align the take-home pay with comparable low earners in RAS schemes.

Legislation contained within Finance (No 2) Act 2023, s 25 introduced a new section (s 193A) into FA 2004. The legislation will apply where an individual is entitled to relief in accordance with a net pay arrangement scheme and where

there is no amount in respect of which the individual is liable to pay income tax in the year in which the contribution is paid.

HMRC will calculate these top-up payments using data available to them – for example real time information for PAYE. The payments will be calculated after the end of the relevant tax year.

The legislation stipulates that HMRC 'must make arrangements to secure that, so far as reasonably practicable and subject to provision made under subsection (5), they pay to the individual the appropriate amount'.

It also sets out that 'arrangements must secure that an amount which the commissioners are required to pay in relation to a contribution is paid as soon as reasonably practicable after the tax year in which the contribution is paid'. The legislation is therefore silent on timescales and doubtless there will be some differences in opinion on the interpretation of the term 'reasonably practicable'. HMRC has estimated that its budget to deliver IT changes and support delivery of the project will be £38m.

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Practical issues

This puts the onus on HMRC to identify those eligible individuals based on information already provided so will not be employee led, although we understand that employees will be able to appeal against any HMRC decision. However, individuals will need to confirm or provide their payment details via a digital service for the top up payment to be made.

As a result of this change, low earning pension savers, with total taxable incomes below the personal allowance, should receive similar outcomes regardless of how their pension scheme is being administered for tax purposes.

This is a good outcome for low paid employees, but one which will put more of a burden on HMRC, so it will be interesting to follow the accuracy and speed of the top up payments.

Salary sacrifice for pension contributions

Many readers will be aware of the potential primary employees' and secondary employers' NI advantages of using salary sacrifice in respect of pension contributions. The idea relies on an employee reducing their salary prior to their entitlement (usually the date of payment) in exchange for their employer making all, employee as well as employer, pension contributions.

The result is that both the employee and employer achieve NI savings based on the marginal rate of NI they would have paid had there not been a salary reduction.

HMRC accepts that this is not an aggressive tax avoidance arrangement and, while some types of salary sacrifice schemes have been legislated against, this is one of several that is still effective in providing savings.

The example below is for a basic rate taxpayer earning £30,000 a year (based on tax and NI rates and thresholds in the 2024-25 tax year and using qualifying earnings as a basis for calculating pension contributions with employee contributions at 5% and employer contributions 3% under an RAS scheme).

Before salary sacrifice	£
Salary	30,000
Tax	3,486
NI (employees)	1,743
Employee pension contribution (net)	950
Take home pay (net)	23,821
Employers' NI	2,884

After salary sacrifice	£
Revised salary	28,812
Tax	3,248
NI (employees)	1,624
Employee pension contributions (net)	0
Take home pay (net)	23,939
Employers' NI	2,720

The annual NI savings for the employee (£119) and the annual employer savings (£164) do not extend to any overall tax savings. This is because of the different methods of obtaining tax relief on the employee pension contributions which, prior to salary sacrifice are provided by the pension provider claiming the 20% tax relief for the pension payment, whereas under salary sacrifice, the amount which is taxable has been reduced giving immediate tax relief on the same income.

The use of salary sacrifice is a way therefore for an employee to obtain NI relief on their pension contributions while the same amount is paid into the employee's pension scheme.

Potential errors

Once a salary sacrifice scheme is in place, it should run without further adjustments, although a periodic review is recommended to keep abreast of any legislative changes. However employers should be aware of some common errors once the scheme is in place:

- There are strict criteria relating to salary sacrifices being effective. In particular there needs to be a restriction to employees being able to opt in and out of schemes at will, although it is possible to change where there is a lifestyle changing event. Changes to contracts and other documentation needs to support the position that an effective sacrifice has taken place.
- Advising the pension provider that the contributions made continue to be employee contributions rather than employer only, leading to overpaid tax relief.

- National minimum wage issues for those employees either close to the hourly rates following a pension salary sacrifice or alternatively when they are part of more than one salary sacrifice scheme (such as an electric car salary sacrifice scheme).
- Earnings issue where employees try to sacrifice a larger part of their salary in one particular month and triggers minimum wage issues.
- The treatment of pension contributions where an employee takes maternity/paternity leave and receives statutory maternity pay.

Higher rate taxpayers

The position of a higher rate taxpayer can be more difficult to understand due to the method of obtaining the extra tax relief which is due on their pension contributions, particularly under an RAS scheme.

Tax relief is obtained on employee pension contributions for both higher rate and additional rate taxpayers via an extension to the basic rate threshold with the position under salary sacrifice for an employee earning £60,000 a year being as follows (the same assumptions as in the basic rate example on the previous page).

Before salary sacrifice	£
Salary	60,000
Tax	10,992
NI (employees)	3,965
Employee pension contribution (net)	1,761
Take home pay	43,283
Employers' NI	7,024

After salary sacrifice	£
Revised salary	57,799
Tax	10,551
NI (employee)	3,921
Employee pension contribution (net)	0
Take home pay (net)	43,327
Employers' NI	6,720

Although the annual employee savings (£44) are relatively modest, in contrast the annual employer savings (£303) is significant, particularly where there are a reasonable number of employees within the pension scheme.

As the amount of higher rate and additional rate tax relief is not always understood or highlighted, and required taxpayers to make their own claim (it is not given automatically) a significant amount of relief often goes unclaimed each tax year. It should be noted that taxpayers can make retrospective claims for tax relief.

Conclusion

Clearly, the complexities and integration between pensions and tax can be complex. Where things go wrong, the impact on both the employer and employee can be resource consuming, emotive and result in tax issues which are not easily resolved. The proposed new rules for tax relief appear to represent efforts to rectify an issue which has been known for some time and which has disadvantaged the very people who would benefit the most for tax relief.

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On the other side of the scale, it is disappointing that such a valuable tax relief for the higher paid is not more widely known and the take-up is so low. As the proposed new rules for obtaining tax relief for the lower paid rely on an individual making a claim we hope that this is not a disincentive for obtaining such a valuable tax relief.

On the positive side, salary sacrifice schemes are still an effective way of obtaining added savings by way of NI reductions. Such schemes have been in existence for more than a quarter of a decade and are still popular. Indeed, businesses with smaller workforces are increasingly looking into such schemes, to provide some cost savings during the cost-of-living crisis. ●

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