

Saving for a pension

(Lectures P1182/ P1183 – 17.22/ 19.14 minutes)

An important report

Late last year, the Office of Tax Simplification (OTS) published a 92-page report entitled 'Taxation And Life Events: Simplifying Tax For Individuals'. In this context, the OTS explored individuals' experiences of engaging with tax – essentially income tax and NICs – in relation to a wide range of significant life events such as having a child, entering the workplace, changing jobs, saving for a pension, drawing a pension in retirement and helping others who are less able to look after their own affairs. This chapter examines their thoughts on the pension saving landscape.

A little history

The Government launched the first old age pension – for men over 70 – in 1908. Then, in 1921, they came up with the idea of tax relief for pension contributions. A universal state pension was introduced in 1948. As the number of pension savers and providers grew over the course of the next few years, the area, in the words of the OTS, 'attracted more regulation to promote greater fairness across the population and to protect savers from misappropriation of their pension savings'.

Occupational pension schemes (i.e.. schemes provided by employers) are of two main types:

- defined contribution (DC) schemes where the savings accumulate over time so that, when the individual retires, they can either buy an investment (known as an annuity) which will pay out a set amount each year or keep the investment and 'draw down' sums as and when needed, with the amount of the potential pension being dependent on the size of the accumulated fund; or
- defined benefit (DB) schemes where the savings secure the right to a pension equal to a specified amount, based on, say, the employee's final salary or a career average calculation (DB schemes are still common in the public sector, but most private sector DB arrangements have closed, at least for new entrants).

In addition, individuals can have a personal pension – this operates on a DC basis. It is the only type of pension available to someone who is self-employed. An individual enrolled in an occupational scheme may also contribute to a personal pension.

In 2006, a comprehensive reform of pensions and taxation took effect to rationalise the tax system as it applied to pensions. This was in response to criticism that the regime for pension saving had become so complex that it was actually discouraging individuals from providing a pension for themselves. The OTS commented:

'The outcome was one income tax regime across all individual and occupational pensions (previously, there had been eight). Individuals with existing pension savings had the option to opt out entirely from the new regime or to go into it with some protection for funds over the new limits.

As part of (these) 2006 reforms, limits were placed on annual and lifetime pension saving through the mechanism of the annual allowance (AA) and the lifetime allowance (LTA).’

For 2019/20, the AA is £40,000, although this can reduce on a sliding scale to a minimum of £10,000 once a threshold of £150,000 is exceeded (this depends on the individual’s level of income and pension saving). The LTA for 2019/20 is £1,055,000.

Despite the ostensible simplification in 2006, pension saving and related tax issues have become increasingly complex for many pension holders over the last 14 years, mainly as a

Another difficulty has been the introduction of the money purchase annual allowance (MPAA) in 2015 which was brought in to limit future relief for pension contributions where an individual had flexibly accessed their pension pot in certain circumstances. The MPAA was initially set at £10,000 per tax year, later reduced to £4,000 for 2017/18 onwards.

It is now time to examine some of the problem areas.

NIC interaction

NICs are paid by employees and employers, based on the employee’s salary. Pension contributions made by employees do not affect the amount of NICs which they pay, although such payments have a beneficial knock-on effect on the employee’s income tax liability. Intriguingly, it has always been the case that employer pension contributions are not included in the base on which NICs are calculated. This misalignment, as the OTS pointed out in 2016, means that employees and employers often enter into salary sacrifice arrangements, as a result of which the employee reduces their gross salary and the employer increases their pension contribution accordingly. This salary reduction leads to lower NIC costs for both employee and employer, which in turn could be used further to boost the amount saved into the individual’s pension.

Given that this arrangement has a very high exchequer cost, one wonders whether we might be in line for a change in the rules before too long.

‘Relief at source’ and ‘net pay’ schemes

When providing pensions for their staff, employers have a choice between operating what is known as a ‘relief at source’ scheme or a ‘net pay’ scheme (Ss192 and 193 FA 2004). For employees with earnings at or below the level of the personal allowance (currently £12,500), the different way in which these arrangements work means that someone in a ‘relief at source’ scheme effectively pays less for their pension than someone in a ‘net pay’ scheme, even though they both end up with the same amount in their pension pot. As the OTS explain, ‘this anomaly arises from the interaction between the mechanics of the tax relief and the personal allowance’.

Unfortunately, many employers tend to choose ‘net pay’ schemes, given that the administration for these arrangements is rather more straightforward – see Illustration 7 below.

Example 1

Kate works for Anmer Enterprises Ltd, earning £12,500 in 2019/20. Under auto enrolment, her employer operates a 'net pay' scheme to which Kate's contribution is £625. All of this is deducted from her pay – in other words, her annual salary becomes £12,500 – £625 = £11,875. However, because Kate's full income was already covered by her personal allowance, she receives no benefit from the tax relief available on her contribution.

With a 'net pay' scheme, Kate would never have to claim tax relief separately, even if she were liable to pay at higher rates, and Anmer Enterprises Ltd's pension fund does not need to recover basic rate tax from HMRC on Kate's contribution. Note the comment above about easier administration.

Kate's friend, Megan, is employed by Wizard Solutions Ltd which operates a 'relief at source' scheme. She receives exactly the same salary as Kate, but, instead of paying £625 out of her qualifying earnings into the scheme, Megan makes a net contribution of £625 less 20%, i.e.. £500. The pension fund recovers this 20% from HMRC, regardless of the level of Megan's income.

Consequently, Megan is £125 per annum better off than Kate as a result of Wizard Solutions Ltd choosing to operate a 'relief at source' rather than a 'net pay' scheme.

Government statistics show that a very large number of employees – well in excess of 1,000,000 – are affected by this issue. It seems anomalous that, for some people, the availability of tax relief depends not on their tax status but rather on which type of scheme has been adopted by their employer.

AA and LTA charges

There are two restrictions which are intended to limit the amount of pension tax relief available to any one individual:

1. the AA; and
2. the LTA.

The AA sets an upper limit on how much an individual's pension savings can grow from one year to the next with the individual continuing to benefit from full income tax relief. The way in which this growth is determined varies between DC and DB schemes, given that the modus operandi of each is very different. Growth in the context of a DC scheme is measured by the amount saved into the pension fund. For DB schemes, the calculation is much more complicated: it is necessary to work out, by reference to a special formula, how much the individual's pension entitlement has changed over the last 12 months.

Remember that any unused AA can be carried forward for up to three years. In other words, it may be possible to have available more than the standard £40,000.

If the growth limit is exceeded, a free-standing income tax charge is triggered at the taxpayer's highest marginal rate(s). This is known as an AA charge.

The OTS say:

‘Knowing that an AA charge exists is not obvious. The rules are complex and widely misunderstood. HMRC’s guidance is unclear and open to interpretation. At one point, it recommends that taxpayers go to a financial adviser specialising in tax and pensions.

An individual must be warned by their pension provider by 6 October if their contributions into a particular scheme have exceeded the AA for the previous tax year. They may also be warned that they are in danger of incurring an AA charge in some other circumstances. However, in general, no warning will be received if the person has more than one pension scheme, though some public sector scheme administrators give members a statement for each of their schemes that a member is in, if they exceed the AA when looking across those schemes.

The calculation is different depending on whether the scheme is a DB or DC scheme. Guidance on www.gov.uk is comprehensive and includes a calculator, but is difficult to navigate and the distinction between the different calculation methods for DB and DC pensions is not made clear. It lacks examples to illustrate the various terms. A flow chart to guide people through the calculation is essential.’

So the OTS are not that impressed with HMRC’s assistance!

Once calculated, the AA charge can be paid in one of two ways:

1. direct to HMRC through self-assessment; or
2. through the pension fund by a process known as ‘Scheme Pays’.

This latter alternative is always voluntary for the taxpayer, but it goes without saying that ‘Scheme Pays’ necessarily reduces the individual’s entitlement to a future pension, given that some of the value of the fund is being used to meet the charge.

There is no limit to how much can be saved by an individual into one or more pension funds over their lifetime. However, if the value of their pension entitlement exceeds the LTA, another form of stand-alone income tax charge will be incurred. This is called the LTA charge. It applies to the total value of all pensions from registered schemes of which the individual is a member. Both DC and DB schemes are covered. It does not require the state pension to be included.

The calculation of the aggregate value of an individual’s pension depends on the type of scheme:

- For DC pensions, it is the value of funds saved and accumulated by investment growth.
- For DB pensions, the value is arrived at by multiplying the annual pension by 20 and adding any cash lump sum.

With DB arrangements, savers usually receive an annual statement showing the value of their pension. The possibility of exceeding an individual's LTA can therefore readily be spotted. By contrast, with DC pensions, it is not easy to make such a forecast. This is because DC pensions increase in value not only through regular and irregular saving of money but also because of the growth in value of the fund's investments. This growth is impossible to predict and so savers into DC pensions may find themselves subject to the LTA charge through no decision of their own.

The MPAA

The MPAA rules are intended to prevent the practice of 'recycling' where earnings saved into a DC pension (which have already attracted tax relief) are taken out and subsequently invested into another DC pension, qualifying for further relief. Of course, this became much more of a practicable proposition following the introduction of the 'pension freedom' arrangements in 2015.

The legislation works by creating a revised annual limit (£4,000 for 2019/20) on the amount which can be saved into DC pension schemes where the saver takes money out of any other DC pension scheme which they have. Unfortunately, many people who have more than one personal pension and who access one of their pension pots under the 'pension freedom' rules seem to be unaware that their ability to continue to save tax-efficiently into, say, their main pension may now be significantly restricted. They can also be subject to HMRC penalties for not notifying their other pension providers that they are subject to a greatly reduced AA. See Illustration 8 below for an example of the sort of problems which the MPAA in its current form can create.

Case study - Karen

Karen is 57. Since leaving school at the age of 18, she has had a variety of jobs. Karen's parents struggled financially in their retirement, but Karen does not want to be in that position. As a result, she has always tried to put money aside for her old age. She has several pension pots from different employers and has also been saving separately into a personal pension scheme since her 35th birthday.

One year ago, the retail business where Karen was working went into administration and she was made redundant. Fortunately, she found another job three months later and hopes to continue working until state pension age which, in her case, is 67.

When Karen was made redundant, she took stock of all her pension funds. One of them contained only £11,000 and so, in order to tide her over, she took out £3,000 as a lump sum, using a flexible access drawdown arrangement. She did some research before going ahead with this withdrawal and saw that people were being encouraged to take professional advice. However, as this was a small pot and not really material to her overall savings, Karen did not think that there would be much point in spending money on tax and financial advice.

She subsequently discovered that, as the £3,000 represented more than 25% of the fund's total of £11,000 ($25\% \times £11,000 = £2,750$), she would have to pay income tax on the excess £250, but this modest tax bill seemed a small price to pay.

Karen's new job pays her a good salary and so she wants to increase the amount which she saves each month. She has 10 years left in which to build up this latest pension pot and the money column which she reads in the Daily Mail encourages people to save as much as they can, even in their 50s and 60s, because of the tax relief which provides another 20%.

Karen plans to save around £650 per month in total. She is shocked when she is informed that she will not receive tax relief on much of this money. She is told that something called the MPAA means that anyone who takes a lump sum from a pension pot (where they are liable to pay income tax on all or any part of it) can only obtain tax relief on future contributions of up to £4,000 in any one year.

To say the least, Karen is surprised. Having taken just £3,000 rather than £2,750 means that, over the next 10 years, she will lose around £7,600 in tax relief (assuming that she continues to contribute at the present rate until she is 67). This figure is worked out by taking 20% of the excess of her annual payments over £4,000 for a 10-year time frame. Thus:

| | £ |
|---------------------------------|---------------|
| 12 x £650 = £7,800 for 10 years | 78,000 |
| Less: MPAA (x 10) | <u>40,000</u> |
| | <u>38,000</u> |
| 20% thereof | £7,600 |

Karen is informed that the MPAA rule is intended to stop people from abusing the system. She does not understand why the restriction should apply to her. She thought that the new system was meant to be more flexible than before and to allow people to make better use of small pension pots.

Conclusions

The OTS feel that:

1. the Government should consider the potential for reducing or removing differences in outcomes between 'net pay' and 'relief at source' schemes, especially for employees on modest incomes;
2. HMRC should ensure, sooner rather than later, that their guidance on the tax consequences of particular pension arrangements and choices is fuller and clearer than it currently is;
3. the Government should review the impact of the AA and LTA rules and consider how the deliver against the legislation's policy objectives; and
4. the Government should assess the operation of the MPAA, given its very real possibility for producing unfair results.

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