

Income tax and national insurance alignment: an evidence-based assessment

October 2007



HM TREASURY

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insurance alignment:
an evidence-based assessment**

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EXECUTIVE SUMMARY

Although income tax and national insurance contributions (NICs) are different systems that serve different purposes, there are often calls from those who operate the systems to align them more closely. It is argued that alignment would reduce administrative burdens, provide considerable simplification and potentially improve outcomes for the low paid. That is why the Government announced at Budget 2006 that it would review the case for closer alignment of income tax and national insurance.

In the interest of openness and transparency, this document sets out the outcome of the review. Its conclusions have been based on detailed analysis of the income tax and NICs systems, which has been informed by discussions with industry and other key stakeholders.

The review has examined ways of improving the administrative alignment of the two systems for employers, and examined the impact this might have on individuals. It has taken the current policy framework as a given, namely that each system serves a different purpose, with NICs providing entitlement to contributory benefits. Therefore it has not looked at merging income tax and NICs into one charge. Instead, it has focused particularly on a proposal that has often been advanced by business and other commentators: to make NICs operate in a similar way to tax by moving it onto an annual basis and collecting it cumulatively.

Aligning tax and NICs in this way has a variety of implications for employers, individuals and Government. The review found that:

- net savings for employers depend on the extent to which they continue to move away from manual processing but are smaller than might have been expected. Maximum estimated savings are around 4.5 per cent of the costs of operating the payroll taxes by 2012, which is the earliest year by which changes could be introduced. One-off transitional costs of alignment would be around £200 million;
- while approximately 5 million people would save an average of £120 per year in NICs, 1 million individuals, including some low earners, would pay up to £550 more NICs per year; and
- the Exchequer costs would be around £340 million per year.

Therefore, the Government has concluded that on balance the benefits of administrative alignment do not outweigh the costs.

However, even though the review is not recommending administrative alignment, a number of areas have been identified where improvements to the current systems could be made, particularly benefiting business by reducing administrative burdens. These include consulting on:

- collecting tax on benefits in kind and expenses through the payroll;
- improving and aligning information and guidance on tax and NICs; and
- improving collection of NICs for the self-employed.

Publication of this review provides the opportunity for open and constructive dialogue between Government, employers and individuals. In taking forward the review's conclusions, the Government wants to develop a shared understanding of the analysis and key trade-offs in order to ensure policy is based on robust and tested analysis. The Government welcomes comments on the analysis and conclusions that have been reached in the review.

REVIEW OF INCOME TAX AND NICs ALIGNMENT

Since Martin Taylor's report on work incentives in 1998^a, the Government has continued to bring the income tax and national insurance contributions (NICs) systems closer together. This process has been underpinned by principles of improving fairness and coherence, and reducing administrative burdens.

Building on the Taylor report, the Government's approach to improving outcomes for the low paid has seen a range of measures introduced, from the National Minimum Wage and a system of targeted tax credits, to the pensions reforms set out in last year's Pensions White Paper^b. Significant progress has also been made on simplification for business, including structural reforms to the NICs system. Most recently, the Government announced in Budget 2007 that the Upper Earnings Limit for NICs will be aligned with the higher rate tax threshold from April 2009. The Government has also put in place stretching targets for reducing administrative burdens more widely.

The Government has continued to receive representations from employers and interest groups that further alignment of income tax and NICs could contribute towards greater administrative and operational simplification for businesses and benefit the low paid. The Government has considered the case for further alignment of the tax and NICs systems against the background of these representations, and its objectives to reduce burdens for business and to promote fairness and opportunity for individuals. The findings of the review are set out in this document.

^a *Work Incentives: A Report by Martin Taylor (HM Treasury), 1998.*

^b *Security in Retirement: Towards a new Pension System; Department for Work and Pensions, 2006*

INTRODUCTION

1.1 Income tax and national insurance contributions (NICs) are very different systems, with very different purposes. While income tax receipts fund general expenditure, NICs provide entitlement to contributory benefits, such as the State Pension. These systems have developed separately over a number of years, and the Government believes that their different purposes require them to remain separate. However, in the light of continuing representations that aligning the income tax and national insurance systems more closely could improve outcomes for the low paid and reduce burdens on employers, the Government announced at Budget 2006 that it would review the case for doing so, whilst recognising that this would present difficult challenges.

Box 1.1: Budget 2006 announcement

There is a case for building on previous work to align, for low paid workers, income tax and national insurance systems, in order to improve outcomes for the low paid and to reduce burdens on employers, especially smaller employers. While recognising that aligning two very different systems with very different purposes presents difficult challenges, the Government will conduct a review in time for consultation after the Pre-Budget Report.

Source: Budget 2006: *A Strong and Strengthening Economy: Investing in Britain's future*, paragraph 5.87.

The review process **1.2** This review has drawn upon a range of sources, including previous government work on alignment, external studies, and wider work on reducing administrative burdens. It has considered in detail the representations that the Government has received in writing and in discussions with stakeholders. These are outlined in the next chapter.

I.3 The Government has considered a range of proposals for change, including options for significant administrative reform of the income tax and NICs system and for operational change and simplification. These options are set out and analysed in this report.

Challenges I.4 In considering the case for further alignment of tax and NICs there are a number of challenges and factors that must be taken into account, including:

- the likely impact on employers, the Government and individuals;
- the risks to collection as well as the overall effect on the Exchequer;
- the scale of change required to deliver any simplification; and
- the overall costs and benefits in the context of the magnitude of change required.

I.5 Against the background of these challenges the review has not considered the possibility of merging fully income tax and NICs. This is because, as well as disturbing the separate objectives of the two systems, such a change would have a significant impact on the amounts payable by individuals depending on their circumstances, particularly for those over State Pension age, who currently do not pay any NICs.

I.6 The publication of the findings of this review provides an opportunity for open and constructive dialogue between Government, employers and individuals about the analysis of the potential costs and benefits, and the key trade-offs, from administrative alignment of the tax and NICs systems.

OVERVIEW OF THE INCOME TAX AND NICs SYSTEMS

Income tax paid on all income I.7 Income tax is paid by individuals on the basis of their total annual income including earnings, pensions, and income from savings or investments. Every individual is entitled to a 'personal allowance', an amount of income on which they are due to pay no tax. There are also exemptions and reliefs from tax. For example, relief from income tax is given on payments of contributions to approved pension schemes. Individuals' payments of income tax go towards funding general public expenditure, although access to public services is not directly dependent on payment of income tax by an individual.

NICs paid on earnings I.8 NICs are paid by individuals on earnings from employment or profits from self-employment rather than on all income. Unlike tax, NICs are not paid on pension income or interest from savings. NICs are not paid by those above State Pension age, or below the age of 16. In addition, NICs are assessed on earnings in each earnings period, with a threshold below which NICs are not due for each earnings period.

1.9 Individuals' payments through NICs are underpinned by the 'contributory principle': that individuals contribute to the scheme while in work and receive financial support while out of work, whether through illness or unemployment or in retirement.¹ For individuals, these payments need to be recorded over their whole working life as they provide access to contributory benefits.² Entitlement to these benefits, for the individual and their dependants and/or spouse, is determined by the number of qualifying years that an individual has built up through the payment of NICs during their working life. All payments of NICs are entered for each individual on their national insurance record and the Department for Work and Pensions (DWP) uses this to determine the amount of benefit that is payable to each individual who makes a claim. Annex A contains more detail on entitlement to contributory benefits.

**Differences
between tax and
NICs**

1.10 There are, therefore, some significant differences between the income tax and NICs systems. Income tax does not provide entitlement to contributory benefits. It applies to all income from any source received by an individual, regardless of their age, and is assessed over the whole of the tax year with an annual allowance below which no tax is paid. NICs on the other hand provide entitlement to contributory benefits. They apply specifically to earnings and profits from employment, with each employment considered separately. NICs have upper and lower age limits, and have a weekly, monthly or annual allowance applied to each separate pay period rather than across the whole tax year. A detailed explanation of the working of the systems and the practical differences is set out in Annex A, with the major points outlined below in Box 1.2.

¹ National insurance contributions also contribute to the funding of the National Health Service. Those contributions made on earnings above the Upper Earnings Limit and Upper Profits Limit, and a percentage of other contributions, fund the NHS rather than the National Insurance Fund, but the majority of NICs payments go to the NIF. In 2005-06 78 per cent of NICs payments were to the NIF.

² These include short-term benefits – Incapacity Benefit, Jobseeker's Allowance and Maternity Allowance – and long-term benefits – state pensions and Bereavement Benefits.

Box 1.2: Major differences between income tax and national insurance paid by employees in 2007/08

	Income tax	National Insurance
Who pays?	Individuals on all income above their personal allowance	Individuals with earnings above the Primary Threshold who are “16 and over” and under State Pension age. A secondary charge is also paid by employers
What is it paid on?	Total income – including from interest on savings, investment income, and pensions	Earnings from employment only
Period of assessment	Annual income	Earnings in the pay periods
Cumulative or non-cumulative collection	Deduction in each pay period usually takes account of pay to date and tax paid to date in the year	Deduction in each pay period is based simply upon earnings in that period
Structure of charge	Above the personal allowance, tax is applied at three percentage rates on different bands of income*	For most employees, NICs is applied at two percentage rates on different bands of earnings above the Primary Threshold. For employers, there is one percentage rate

Source: HM Treasury/HM Revenue & Customs

*See paragraph 1.23

PAYE: Collecting tax and NICs

1.11 Employers deduct income tax and NICs from employees’ pay packets. Both are collected through the Pay As You Earn (PAYE) system, so that the appropriate amounts are deducted from salaries before they are paid out to employees, and then sent to HM Revenue and Customs (HMRC). A key feature of the PAYE system is that tax is collected on a cumulative basis so that each tax calculation and payment throughout the year takes into account previous earnings and tax already paid. This means that for the majority of employers the correct amount of tax has been paid at the end of the year.

Scale of income tax

1.12 There are over 31 million taxpayers and the majority have at least some of their tax deducted from their earnings or pensions through the PAYE system. The total amount of income tax collected in 2006-2007 was around £143 billion, about 87 per cent of which was collected through nearly 2 million PAYE schemes operated by employers and pension providers.

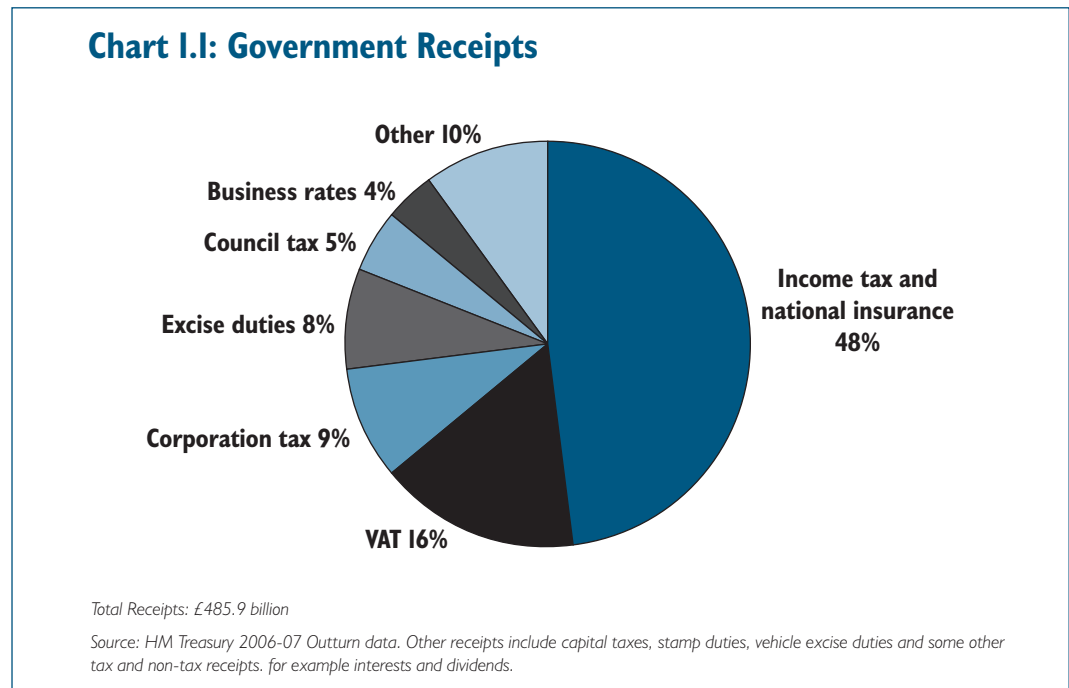
1.13 In terms of the administrative scale of PAYE, the system generates 28 million forms a year about changes of jobs, handled by HMRC and employers. In addition, over 9 million tax coding notices are issued to employers in advance of the tax year and 13 million during the tax year.

Scale of NICs

1.14 Around 29 million people pay NICs each year. Some 26 million of these are employees, whose employers deduct NICs through the PAYE system alongside income tax. A further 3 million self-employed people pay their NICs outside the PAYE system. The total NICs collected in 2006-2007 was around £87 billion with over 97 per cent, some £85 billion, collected through the PAYE system.

PAYE: the primary system for collecting revenue

I.15 In 2006-2007, income tax and NICs contributed 30 per cent and 18 per cent respectively to total public sector receipts, as shown in Chart 1.1. As we have seen, most of this, some £210 billion in tax and NICs revenue is collected via PAYE.



I.16 Collection of income tax and NICs through PAYE involves:

- **employers** – who calculate and collect the amounts to be paid;
- **the Government** – which has responsibility for overall public finances, providing and ensuring compliance with the regulatory framework, managing individual tax codes and recording tax and contributions paid by individuals; and
- **individuals** – employees and pensioners, who are the end users of the system, paying tax and NICs and drawing support from contributory benefits or State Pension in times of reduced income or retirement.

I.17 Any proposed change to the income tax and NICs systems has the potential to affect one or more of these groups. This means that, although some changes genuinely reduce the total burden of collection, others merely move a burden from one group to another. Such changes must therefore be assessed carefully in respect both of their impacts on each of these groups and of the overall risks to delivery, given the potential implications of any disruption of the flow of revenue to the Exchequer.

REFORMS TO TAX AND NICs SO FAR

Challenges in three key areas **I.18** The Government has responded to the administrative challenges facing businesses and employers by introducing changes to income tax and NICs in three key areas:

- institutional reform;
- policy reform; and
- simplifying administration of the systems.

Institutional reform

I.19 In 1998, Martin Taylor published a report³ which examined the impact of the income tax and NICs system on work incentives. In response, the Government introduced a number of institutional changes, moving responsibility for NICs policy from DWP, and operational functions from the Contributions Agency into the then Inland Revenue. This integration of responsibility for tax and NICs has increased the opportunities for further operational and policy alignment of tax and national insurance.

Policy reform

Simpler system for employers **I.20** The Taylor report also made recommendations to simplify the system for employers. Budget 1999 announced changes to the structure of employer NICs, removing a complex system of four stepped contribution rates and replacing them with a single rate.

Better outcomes for the low paid **I.21** The Government has also made changes to improve outcomes for the low paid. Most working-age individuals pay income tax and NICs throughout their working lives. The Taylor Report found that the NICs system placed a relatively heavier burden on the low paid because NICs were payable at a lower level of earnings than tax. The ‘entry fee’⁴ at the Lower Earnings Limit (LEL), the point at which NICs started to be paid, also created high marginal tax rates, some over 100 per cent, for some low paid workers.

I.22 In response, the Government introduced reforms that have improved outcomes for the low paid, by:

- abolishing the ‘entry fee’ in employee contributions;
- raising the threshold for paying NICs by introducing the Primary Threshold (PT), aligned with the income tax personal allowance;
- retaining a lower earnings limit below the PT to protect entitlement to contributory benefits; and
- significantly reducing the rate of Class 2 NICs to benefit the self-employed who make low profits.

³ *Work Incentives: A Report by Martin Taylor* (HM Treasury, 1998).

⁴ When earnings reached the level of the LEL NICs were paid (2 per cent when the charge was abolished) on all earnings up to the LEL.

Pensions reform – fairness for the low paid **I.23** The Government has announced further reforms to benefit the low paid in its White Paper on pensions: *Security in Retirement*.⁵ Most of the proposals on State Pension reform, have been enacted in the 2007 Pensions Act. The proposals will make it easier to obtain a full State Pension by reducing, from 2010, the number of qualifying years required to receive a full State Pension; and by introducing a new Carers Credit. As a result, by 2025 it is expected that over 90 per cent of people reaching State Pension age in the UK will do so with a full State Pension. This will give fairer outcomes, for those who, under the current NICs system, are most likely not to build up entitlement to a full State Pension. Alongside the existing national insurance credits, this will help to protect the benefit entitlement of significant numbers of individuals, including carers, women and people on low incomes.

Personal tax reforms at Budget 2007 **I.24** Budget 2007 announced a major package of reforms to modernise the personal tax and benefit system. From April 2008, the Government will remove the starting rate of tax for non-savings income, instead specifically targeting support on pensioners, families and low income workers, and create a simpler two rate structure of income tax. The basic rate of tax will also be reduced to 20 per cent, the lowest for over 75 years. In April 2009, the Upper Earnings Limit will be aligned with the point at which higher rate tax begins to be paid, meaning that tax and NICs rates will, for the first time, apply to the same bands of income, making it easier for individuals to understand their tax and NICs liabilities. In addition to these institutional and policy reforms, the Government has introduced a number of process simplifications over recent years.⁶

Reducing burdens

I.25 The Government is committed to reducing administrative burdens on business. To better understand the level of administrative burdens on business, it commissioned a study to examine and identify all of the information obligations that tax legislation requires of business. KPMG conducted analysis on around 1,000 businesses and their agents to estimate the burden of compliance. This used a methodology known as the Standard Cost Model (SCM) and estimated that the total burden on UK employers of the income tax and NICs system at £759 million per year or 15 per cent of the total obligations imposed on employers by HMRC.

I.26 The Government remains keen to maintain the pressure on reducing the burdens on business and announced new targets in Budget 2006 to reduce the administrative burden of dealing with HMRC forms and returns and audit and inspection. It is in this context that this review has been conducted.

⁵ *Security in Retirement: Towards a new Pension System* (Department for Work and Pensions, 2006).

⁶ A detailed list of administrative alignments can be found in Annex B.

2

CURRENT INCOME TAX AND NICS SYSTEMS AND REPRESENTATIONS FOR ALIGNMENT

This chapter describes the operation of the current income tax and national insurance contributions (NICs) systems for both employers and individuals, and the areas in which differences between tax and NICs can cause difficulties for each group. For employers, some of these differences can create extra work, although the implications vary significantly between those employers that operate manual payroll processes and those who do not. For individuals, the differences may affect the amount of tax or NICs paid or the benefit entitlement which is built up.

The representations that the Government has received for further alignment of these systems, both to reduce burdens on employers and to improve outcomes for individuals, are also outlined. These have included proposals to calculate NICs liability annually and cumulatively, in line with income tax; to allow benefits in kind to be taxed through the payroll; to align HMRC guidance on tax and NICs; to simplify employers' decisions on the correct NICs table letter for their employees, and to improve the outcomes of the NICs system for low paid workers.

IMPACT OF CURRENT TAX AND NICS SYSTEMS ON EMPLOYERS AND INDIVIDUALS

Employers 2.1 Employers are required to understand and operate two different systems, and use Pay As You Earn (PAYE) to account for both tax and NICs deducted from employees' pay. This chapter considers the main differences between the two systems, and the difficulties they can cause for employers. In doing so, employers' processes are considered at two stages:

- activity during the year, including calculation; error correction; recording; dealing with changes of employments; handling employees' queries; and
- activity at the end of the year, including reporting cash and non-cash earnings and tax and NICs deductions.

Individuals 2.2 Differences between the current systems are also reflected in the amount of tax and NICs that individuals pay, and in their resulting entitlement to contributory benefits, based on their particular circumstances, including whether they:

- work for part of the year;
- earn below the 'entry level' to the benefit system;
- have fluctuating earnings;
- have more than one job; or
- are self-employed.

THE CURRENT SYSTEM: EMPLOYERS' IN-YEAR PROCESSES

2.3 Discussions with employers' representatives have suggested that the main in-year activities where differences between tax and NICs can cause difficulties can be grouped under the following headings:

- calculating the tax and NICs to deduct from employees;
- correcting errors that have been made in these calculations or in deductions from employees;
- recording the tax and NICs that have been deducted; and
- dealing with changes of employment – such as taking on new employees, or existing employees leaving.

2.4 Additionally, employers also often find they have to handle queries from employees about their tax and NICs affairs. While many of these could be referred to HMRC helplines, employer representatives have suggested that many employers prefer to be able to answer them themselves. Employers suggest that differences between tax and NICs can lead to a greater volume of queries from employees.

The way employers operate payroll

2.5 Whether employers use manual or automated payroll processes has a considerable impact on the size of their administrative burdens. The majority of employers use payroll software, calculators on the HMRC CD-ROM, or outsource their payroll activity, and this reduces burdens in certain areas including calculating, recording and reporting tax and NICs. This is explained in more detail in paragraphs 2.32 to 2.38.

Calculating tax and NICs manually

2.6 The number of employers using manual processes is falling each year and we estimate that around 210,000,¹ out of about 1 million employers overall, currently operate their payroll manually. This section describes the in-year activities, and the actions that an employer using manual payroll processes would need to take for tax and for NICs; it also explains the main differences between the two systems in these areas.

Differences in calculating tax and NICs

2.7 Although the most obvious difference between the two systems lies in their different rates and thresholds, the more important factor for employers is that tax is calculated on a cumulative basis, whereas NICs is calculated separately in each pay period. This means that the two calculation processes need to be carried out separately, even in cases where the taxable pay and earnings liable to NICs are the same, and that employers are required to understand two different systems. Box 2.1 shows the different steps employers need to undertake when making the calculation manually.

¹ For explanation see paragraph 3.67

Box 2.1: Employer steps in manually calculating tax and NICs

Income tax	NICs
Identify amount of earnings liable to tax in the pay period	Determine NICs table letter for employee
Add this to total taxable pay to date	Identify amount of earnings liable to NICs in pay period
Use tax table and tax code to determine the amount of tax free pay due to date	Use appropriate NICs table to give amount of employee and employer NICs due in each pay period
Deduct tax free pay from total taxable pay to date figure to give the amount of pay subject to tax in the pay period	
Use further tax table to determine tax due to date	
Deduct tax due to date from tax paid to date to give amount of tax due in the pay period	

Calculating tax 2.8 Employers calculate the tax due from each employee for a particular week or month by using a system of PAYE tax codes and tax tables. This involves following a number of carefully sequenced steps. Employers begin by identifying the correct code for each of their employees, usually provided by HMRC. The PAYE codes² inform:

- employees of the tax-free allowances and deductions making up the amount of income they can have tax-free; and
- employers of the annual tax-free pay due to employees, without telling them what the individual allowances and deductions are.

2.9 To enable employees to benefit from the full annual tax allowance, employers must take into account any earlier earnings and tax paid in the tax year on a cumulative basis when payments are made. To calculate the income tax deduction to be made an employer must:

- identify the amount of taxable pay for the pay period (which can differ from the amount liable to NICs);
- add this to earlier payments to give the total pay to date;
- use tax tables and the employee's tax code to identify the amount of tax free pay due to date;
- deduct tax free pay from total pay to date to give taxable pay to date;
- use a further tax table to identify the total income tax due to date; and
- deduct tax paid to date to arrive at the tax to be deducted in the pay period.

² PAYE codes are explained in more detail in Box A.1 in Annex A.

2.10 Box 2.2 summarises the different tax tables employers use, and explains the way in which employers use these to determine the tax-free pay and the amount of tax to deduct.

Box 2.2: Tax tables

Having used the PAYE code to establish employees' annual tax-free pay, the employer uses the tax tables to establish their cumulative tax-free pay in each tax week, and so their taxable pay.

Firstly, the employer uses Table A, which cross-references annual tax-free pay and tax weeks to allow employers to determine the relevant amount of free pay in the appropriate tax week. The employer deducts the free pay indicated by Tables A from the employee's pay to arrive at the amount of pay liable for income tax, known as taxable pay.

The employer then turns to taxable pay tables. He can use either the calculator table or tables SR and B – D, which allow the taxable pay to date and tax period to be used to establish the total amount of tax to deduct.

These tables are currently as follows:

- **Table SR:** starting rate 10%²
- **Table B:** basic rate 22%²
- **Table C:** basic and higher rate
- **Table D:** higher rate 40%

Calculating NICs 2.11 For NICs, the first step is for the employer to determine a table letter based on the employee's particular circumstances. The table letter directs the employer to the correct set of NICs tables to use. These tables then inform employers of the correct amount of employee NICs to deduct from employees – and of employer's NICs to pay – in each pay period.

2.12 Employer (secondary) Class 1 NICs are paid at a standard rate of 12.8 per cent on all employee earnings above the Secondary Threshold, currently £100 per week. This rate is reduced for the earnings of employees who are part of an employer's occupational pension scheme, although the reduction only applies to earnings between the Lower Earnings Limit (LEL) and Upper Earnings Limit (UEL).

2.13 In addition to calculating their own contributions, employers calculate and deduct those of their employees. All employees aged 16 or over and below State Pension age pay primary Class 1 NICs on earnings from employment above the Primary Threshold (PT), which is aligned with the income tax personal allowance. The standard rate is generally 11 per cent, with 1 per cent charged on earnings above the UEL. However, this rate can vary, depending on the employee's circumstances.

2.14 To take account of the variations in the standard rate for both employers' and employees' NICs, there are a number of NICs 'table letters'. Employers determine the appropriate table letter for each employee, on the basis of their circumstances. This is discussed in more detail in paragraphs 2.22 to 2.23 below.

² As described in paragraph 1.24, from April 2008 the starting rate will be removed and the basic rate will be reduced to 20%.

2.15 Having determined the correct table letter, the employer can then use the relevant table to work out the amount of NICs to be deducted. All payments within a pay period are considered together but each pay period is considered separately, without taking into account other payments in the tax year. To calculate the employer and employee NICs due the employer must therefore:

- determine the correct table letter for the employee;
- identify the amount of pay liable to NICs (which may differ from the amount of taxable pay); and
- use the appropriate table to identify the NICs to deduct.

Correcting errors

For income tax 2.16 The different periods for calculation of income tax and NICs mean that there is a significant difference for employers in the work involved in correcting errors on tax and NICs, with NICs errors significantly more time-consuming to put right. Employers sometimes have to correct errors that they have made, for example in deducting the incorrect amount of tax from an employee. For tax purposes, this is relatively simple. Because calculations are cumulative and on an annual basis, the tax in any pay period can be adjusted to correct previous errors in the year quite straightforwardly.

For NICs 2.17 For NICs, correcting errors is significantly more difficult. Because contributions are calculated in each earnings period, and need to be correct in each period to allow benefit entitlement to be determined, it is not possible to correct an error (such as using the wrong NICs table letter) in a subsequent pay period. Instead the employer must go back to correct the error in the appropriate pay period and amend the relevant PAYE records.

Recording

Recording income tax 2.18 The information recorded by employers about income tax at each pay period is intended to allow an annual calculation of earnings and tax deducted to be carried out throughout the year, so that the employee will pay the correct amount of tax in the year. This means that the information from earlier pay periods must be incorporated and recorded in each pay period. There are six figures to record:

- pay in the week or month;
- total pay to date;
- tax-free pay to date;
- taxable pay to date;
- tax due to date; and
- tax deducted or refunded in the week or month.

2.19 Furthermore, if the employee's deductions exceed their allowances (i.e. they have a K code) there are four additional figures to record: additional pay to date; tax due at the end of the current period; regulatory limit; and tax not deducted owing to the regulatory limit.

Recording NICs 2.20 For NICs purposes, the amounts that need to be recorded are the earnings and NICs deducted in a particular pay period. The earnings information is recorded in three earnings bands:

- earnings at the LEL;
- earnings above the LEL, up to and including the PT (which corresponds to the income tax personal allowance); and
- earnings above the PT, up to and including the UEL.

Employers also record the total of the employee's and employer's NICs.

Changes of employment

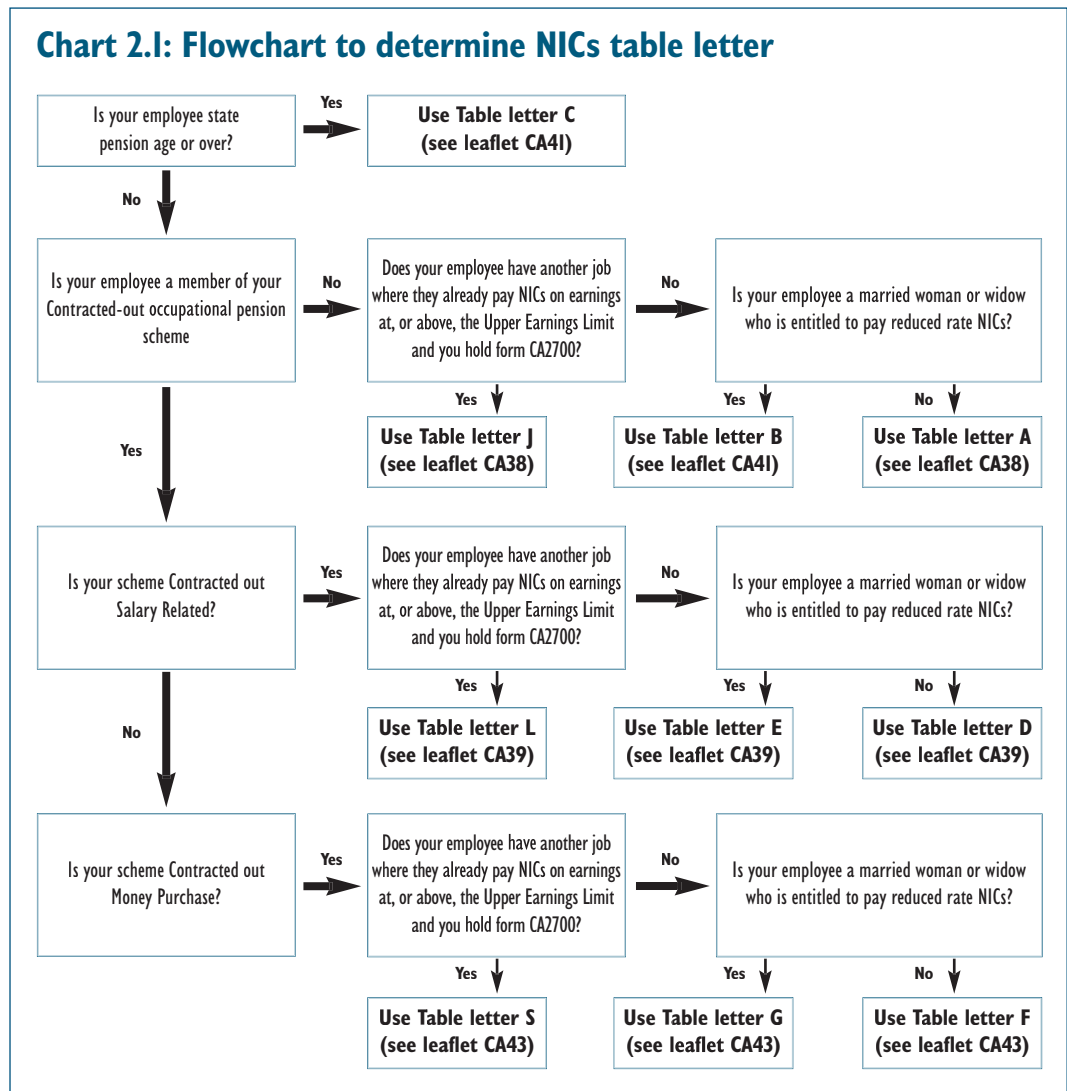
Changes of employment for income tax 2.21 When an employee starts a new job, the employer is able to identify the correct PAYE code for them from a form provided by the employee (a P45 or P46), a notice of coding from HMRC, or by following a set of standard instructions. The employer then forwards the form P45 or P46 to HMRC and, if necessary, HMRC confirm the correct PAYE code for tax purposes by issuing a form P6 to the employer.

Changes of employment for NICs 2.22 For NICs, when a new employee starts the employer must decide which of ten possible table letters is the appropriate one to use³ depending on whether the employee is:

- above State Pension age;
- a member of an occupational pension scheme run by their employer;
- an employee who already pays NICs on earnings above the UEL in a separate job; or
- a married woman who elected, before 1977, to pay reduced rate NICs.

2.23 HMRC provides a flowchart to assist employers with this decision: see Chart 2.1.

³ There are also a further nine table letters for mariners. Further details can be found in Annex A. The Pensions White Paper, *Security in Retirement*, set out the Government's intention to change the treatment of Contracted Out Money Purchase Schemes from 2012, which will reduce the number of non-mariners table letters to seven.



Differences when employment changes **2.24** The major difference in dealing with changes of employment between tax and NICs is that, whereas employers are generally provided with a PAYE code for tax, employers need to decide the NICs table letter themselves.

EMPLOYERS' CURRENT END OF YEAR PROCESSES

2.25 The end of year processes for employers relate to reporting information to HMRC on the payments to, and deductions from, individual employees during the tax year. There are separate requirements for cash payments and for non-cash earnings such as benefits in kind. The activities that an employer using manual payroll processes would have to follow, and the differences between income tax and NICs that affect these processes, are described in this section.

End-of-year reporting

Earnings for tax **2.26** Employers make end-of-year tax and NICs reports at the same time and on the same forms, using the information recorded throughout the year. For income tax the employer takes the final figures from in year records which, because they are kept on a cumulative basis, provide the final figures for the year. The employer copies the final pay to date and tax to date figures from the in-year record to an end-of-year summary.

2.27 If there has been a change of employment during the year, the employer subtracts the previous employment figures from the totals and separately records figures for each employment. The figures from the end-of-year summary are transferred to the end of year return form, form P14. The P14 is completed with the employer's name and address, HMRC reference and office name, employee's name, national insurance number and date of birth. Once completed, information from each employee's P14 is recorded on a form P35 which lists details of the employer's employees and summarises payments for the year.

Earnings for NICs 2.28 For NICs, in-year records follow the basis of assessment and are recorded separately for each pay period. This means that, at the end of the year, the employer must add up the five separate figures from each earnings period in the year to establish the totals to transfer to the end-of-year summary and form P14. As for tax, employer and employee NICs are recorded on form P35. Both the tax and NICs figures are reported to HMRC, together, after the end of the tax year. Employers are obliged to file end-of-year returns by 19 May following the tax year, and to give form P60 to each employee who was working for them at the end of the tax year by 31 May.

Non-cash earnings for tax 2.29 Most non-cash earnings will attract a tax charge, in order to ensure that individuals who receive earnings in this way will pay broadly the same amount of tax as those who are paid solely in cash. The employer reports to HMRC the value of the non-cash earnings that have been provided to each employee on form P11D or P9D, after the end of the tax year. Employers are required, on these forms, to provide a breakdown of the different benefits or expenses they have paid; to send completed forms HMRC by 6 July following the end of the tax year; and to provide copies of the information returned to their employees. Employers can agree to meet the employees' tax and NICs liability on non-cash payments that are minor, irregular or that are difficult to operate PAYE on, through arrangements with HMRC called "PAYE settlement agreements".

Non-cash earnings for NICs 2.30 Where there is a tax charge on non-cash earnings there is also a corresponding NICs liability. This may be either for Class 1 (employee and employer) or Class 1A (employer only), and the employer is required to determine which Class is applicable. Class 1 NICs liability is generally on non-cash earnings that can be exchanged for money, goods or services and, as with other Class 1 NICs, this is collected in-year through the PAYE process. Class 1A liability, which only the employer pays at a rate of 12.8 per cent, is generally on non-cash earnings commonly referred to as "benefits in kind",⁴ that cannot be readily converted to cash or have money's worth. The Class 1A liability is reported on form P11D(b) by 6 July and paid by 19 July following the end of the tax year. On any earnings included in a PAYE settlement agreement (PSA), employers pay Class 1B NICs at 12.8 per cent at the same time as the tax due is paid, which must be no later than 19 October following the end of the tax year to which the PSA relates.

Differences in reporting for tax and NICs 2.31 While the reporting requirements for income tax and NICs on cash earnings are broadly the same, other than the requirement for non-cumulative NICs figures to be totalled at the end of the year, there are differences in the reporting of non-cash earnings. In particular, the NICs on non-cash earnings that are subject to Class 1 will be collected during the year, through the PAYE system, while the tax on these items will be reported after the end of the tax year, meaning that the employer will need to deal with them twice. There is also a decision for employers to make on the correct treatment of non-cash earnings for NICs purposes, whereas there is generally not for tax.

⁴ In national insurance legislation, these non-cash earnings are referred to as 'payments in kind', but these are the equivalent of 'benefits-in-kind' in tax legislation.

IMPLICATIONS OF DIFFERENCES FOR EMPLOYERS

Manual payroll 2.32 In summary, the misalignments between income tax and NICs cause varying levels of difficulty and complexity for employers. For employers using manual payroll processes, and therefore performing the activities described above, there can be particular complications as a result of the differences in calculation, with one system cumulative and the other not; this also means that employers have to understand the differences between the two systems. The need to identify the correct NICs table letter for employees can also be burdensome for employers. Yet, because NICs are not dependent on earlier earnings or NICs paid previously, the employer can deduct the correct amount of NICs straight away which is often not the case for tax. The differences between tax and NICs may increase the number of queries from employees that employers have to deal with. The reporting of some non-cash earnings after the end of the tax year for tax purposes also creates extra work for employers, by creating an additional peak of activity.

2.33 These aspects of employers' processes appear, from discussions with representatives, to be those in which differences between income tax and NICs cause the greatest difficulties for employers using manual processes.

2.34 While we estimate that around 210,000 employers continue to operate manual payroll processes described above, many choose to use payroll software, or the calculators on HMRC's Employer CD-ROM, or to outsource the operation of their payroll to bureaux or other agents. This decision will clearly affect the administrative implications for employers of differences between income tax and NICs.

Outsourcing payroll 2.35 For those employers outsourcing their payroll, these misalignments will have no direct impact, although the additional work created by dealing with them using payroll software would be passed on to the employer in costs from the bureau or agent.

Payroll software 2.36 The implications of misalignments will also be significantly reduced for those employers using payroll software. For example, in terms of calculation, an employer who manually calculates the income tax and NICs due would follow the process described in paragraphs 2.8 to 2.15. If an employer uses software, however, they would only need to enter the amount of taxable pay and earnings liable for NICs for the period, the tax code and NICs table letter. The software would then perform the relevant calculations and provide the information to report to HMRC. This would mean that the employer would not need to understand the differences between the income tax and NICs systems in as much depth.

2.37 Using software would reduce the work involved for an employer in the different recording requirements for tax and NICs. It would also help to reduce the additional work caused by having to deal with some non-cash earnings in-year for NICs purposes, but at the end of the tax year for income tax.

2.38 However, payroll software does not remove all of the difficulties for employers caused by income tax and NICs misalignment. For example, correcting errors made in employees' NICs remains difficult, as this generally requires the employer to make these non-cumulative corrections manually. Software also does not, for example, remove the need for employers to identify the correct NICs table letter for their employees, or to determine whether non-cash earnings should be subject to Class 1 or 1A NICs.

REPRESENTATIONS FOR ALIGNMENT

2.39 The Government regularly receives representations from employers and their representative bodies that further alignment of the income tax and NICs systems could reduce burdens for employers. These representations cover a variety of proposals, but the most consistent has been that NICs, like income tax, should work on an annual basis of assessment and be collected cumulatively through the year. This is referred to throughout this document as ‘making NICs annual and cumulative.’ It has been suggested that this would remove the difficulties of calculating tax and NICs on different bases, make correcting errors easier for NICs, and better align recording and reporting requirements between tax and NICs.

Representations for reducing in-year burdens

Calculation 2.40 A significant number of employer representatives have suggested that making NICs annual and cumulative would reduce the calculation difficulties caused by the current differences between the systems, and remove the need for employers to understand the different basis of each of the two systems. The British Chambers of Commerce, for example, suggested that the Government should “put NICs on the same earnings basis as PAYE, and calculate liabilities on an annual basis.”⁵

Correcting errors 2.41 Such a change could also help to address the fact that NICs errors are currently significantly more difficult to put right than those for tax. This issue has been highlighted by a number of representative groups suggesting “It is easier to make mistakes on NICs than Tax – it should be easier to get it right than wrong”; “error correcting is harder for NICs than tax”; and “It is difficult to correct NICs later where the wrong table letter has been inadvertently used.”

Recording 2.42 Making NICs annual and cumulative has also been proposed as a way of reducing recording requirements for business, in particular by avoiding the need to record three bands of earnings for NICs purposes, where only an overall figure is required for income tax.

Changes of employment 2.43 A number of representatives have suggested that it would be easier for employers to determine the correct NICs table letter for their employees if the number of table letters was reduced. Suggestions for such simplifications have included abolishing the Married Women’s Reduced Rate.

Employees’ queries 2.44 Some employers and representative bodies have also suggested that improvements to HMRC’s guidance on tax and NICs could make it easier for employers to operate the two systems, and to answer queries from employees. In particular, using consistent, shared language and conventions across tax and NICs, as well as highlighting the differences between the systems more explicitly, could help to make the guidance more user-friendly.

Representations for reducing end of year burdens

Reporting earnings 2.45 Making NICs annual and cumulative would remove the need to report NICs earnings figures for three separate bands of earnings and for employers to total the figures at the year-end before reporting them to HMRC.

Reporting non-cash earnings 2.46 The Government has also received a significant number of representations related to the process for reporting non-cash earnings. Many of these have suggested that the

⁵ *A New Tax Horizon: how to simplify Britain’s payroll tax system*, British Chambers of Commerce, 2004

arrangement for reporting these earnings on forms P11D and P9D, separately from the PAYE system and after the end of the tax year, is burdensome, and that these forms should be abolished. Some have proposed that employers should instead collect the tax and NICs due on non-cash earnings through the payroll (known as ‘payrolling’). This would mean that the tax and NICs on non-cash earnings would be dealt with at the same time that the benefit or expense is paid.

2.47 Finally, a number of representative bodies have proposed that all benefits in kind should be subject to Class 1A NICs, rather than some being liable for Class 1 in order to remove the need for employers to determine the correct treatment when providing non-cash earnings to their employees. The Confederation of British Industry, for example, has written that it is “inevitable” that time will be wasted “when there is doubt about the precise treatment of a particular item.”⁷

THE CURRENT SYSTEM: DIFFERING OUTCOMES FOR INDIVIDUALS

2.48 Unlike tax, the NICs which individuals pay (or are deemed to have paid or been credited with) build entitlement to contributory benefits. These NICs contribute towards an individual’s earnings factor for each tax year, and the level of this determines whether the individual will accrue a ‘qualifying year’ for benefit entitlement purposes. More detail is provided in Annex A.

2.49 The NICs system also differs from the tax system in that a given amount of annual earnings can result in different benefit entitlements, depending on the pattern of those earnings and the number of jobs they relate to.

Working for part of a tax year

Different outcomes of allowances

2.50 Individuals who work for only part of a tax year still benefit from the full tax-free allowance because tax is calculated on income for the year after deducting the allowance, irrespective of when the income arises in the year. By contrast the NICs-free amount of earnings is provided in each earnings period by reference to the Primary Threshold (PT) for the week or month. So an employee who works for ten weeks in 2007-2008 earning £500 each week will not pay any tax on these earnings, as the annual total of £5,000 does not exceed the annual tax allowance of £5,225. However, using the same example, the employee will pay NICs on these earnings as the amount earned in each of the ten weeks exceeds the weekly PT of £100 a week.

⁷ CBI to Inland Revenue, June 2004.

Earning below the ‘entry level’ to the benefit system

Protecting benefit entitlement **2.51** When the Primary Threshold (PT) was introduced in 2000 and aligned with the income tax personal allowance the following year, raising the level at which employees paid NICs, the Government maintained a lower level from which benefit entitlement would be built up: the Lower Earnings Limit (LEL). Individuals whose earnings are above the LEL but below the PT are treated as having paid NICs for the purpose of their earnings factor, and to protect access to benefit entitlement.

Earnings below the LEL **2.52** However, individuals whose earnings are below the LEL in any earnings period will not have these counted towards their earnings factor. Although it is still possible for these individuals to build up entitlement to certain contributory benefits by paying voluntary Class 3 NICs, a small number of low paid workers, often those with fluctuating earnings and more than one job, do not build up benefit entitlement.

Fluctuating earnings

2.53 The earnings period basis of the NICs system, and the fact that earnings below the LEL will not contribute towards individuals’ earnings factors, can disadvantage employees whose earnings fluctuate during a tax year – for example because of overtime payments in some weeks or months or changes of employment.

2.54 Unlike income tax, it is possible for individuals with the same amount of earnings during a year to pay different amounts of NICs, for example where an individual earns an annual amount equivalent to the LEL, but in some periods during the year earns less than the LEL. Such fluctuations in pay can result in a failure to gain a qualifying year of benefit entitlement even where total annual earnings exceed the LEL.

Multiple jobs

Impact on NICs paid **2.55** Another difference between the tax and NICs systems that can affect outcomes for individuals is the treatment of multiple jobs. For tax, all sources of income (including earnings from multiple jobs) are aggregated together across the tax year, and the personal allowance applies to the total income. NICs, however, are calculated separately on the earnings from each job⁸ so that individuals working in concurrent multiple jobs are able to benefit from a PT in each job. Again, this means that individuals with the same total earnings may pay different amounts of NICs, but would pay the same amount of tax.

Impact on benefit entitlement **2.56** This feature of the NICs system can also have implications for benefit entitlement. In the same way that earnings are not aggregated across jobs for the calculation of NICs, they are also not aggregated for the calculation of individuals’ earnings factors. This could mean that an individual working in multiple jobs, and earning below the level of the LEL in each, would not accrue benefit entitlement through their earnings – even if, when aggregated, these would be above the LEL.

⁸ Unless the employments are with the same employer or employers who carry on business in association with each other – in which case the employments are treated as one.

Self-employed

2.57 The self-employed pay tax on the same basis as employees, but are subject to a different system of NICs, paying Classes 2 and 4.

Class 2 NICs 2.58 Class 2 is flat-rate regardless of profits, and provides the same benefit entitlement as employees' Class 1 NICs, apart from contribution-based Jobseeker's Allowance and State Second Pension. Those with profits below the Small Earnings Exception⁹ can opt out of paying, and those who are already paying NICs up to the UEL in another employment need not pay. Class 2 is paid direct to the National Insurance Contributions Office in HMRC, either monthly by direct debit or through quarterly bills.

Class 4 NICs 2.59 The self-employed also pay Class 4 NICs, which are profit-related, and do not provide benefit entitlement. No Class 4 is paid on profits up to the Lower Profits Limit (LPL), which is aligned with the PT. Between the LPL and the Upper Profits Limit (UPL), which is aligned with the UEL, Class 4 is paid at 8 per cent. On profits above the UPL, Class 4 is paid at 1 per cent. Class 4 contributions are reported and paid through the Self-Assessment system, alongside income tax, with payment finalised after the end of the relevant tax year.

Two separate classes 2.60 The existence of these two separate classes of NICs means that the self-employed are required to understand and pay two different charges, through two different processes.

REPRESENTATIONS FOR ALIGNMENT TO IMPROVE OUTCOMES FOR INDIVIDUALS

2.61 The Government has also received proposals from a number of bodies for ways in which outcomes of the current NICs system for individuals, and particularly those with low incomes, could be improved.

2.62 These representations have generally acknowledged that the Government has made significant progress in this area by removing the distortions in the amount of NICs that low earning individuals pay, and continues to make progress on improving the State Pension outcomes of the NICs system through ongoing work on pensions reform. Representations have therefore tended to focus upon the possibility that some low paid workers may fail to build up entitlement to contributory benefits because of some of the differences between tax and NICs outlined above. One of the most common proposals made by stakeholders has been for NICs to be moved to an annual basis, rather than based upon earnings periods.

Working for part of the year 2.63 Making NICs annual has also been proposed as a way of removing the different treatment for tax and NICs for those who work for part of the year, but earn below the tax personal allowance or the PT for NICs over the year as a whole. This would make it possible to obtain NICs refunds in the same way as for tax.

The 'entry level' to the benefit system 2.64 Finally, the Government has received some representations to lower the LEL, in order to allow some earnings below its current level to be counted towards benefit entitlement. Although this would also lower the qualifying earnings factors for contributory benefits, it has not been considered in this review, as the level of the LEL is currently statutorily linked to that of the basic State Pension.¹⁰

⁹ The level of earnings for self-employment below which a self-employed can elect not to pay Class 2 NICs.

¹⁰ As part of the pensions reform, when pensions increase in line with earnings the link between the LEL and the State Pension will be broken.

3

MAKING NICs ANNUAL AND CUMULATIVE

This chapter describes how a system of annual and cumulative NICs might operate, and examines the impact that this could have for employers, individuals and the Government.

For **employers**, the impact would vary depending on their specific circumstances; in particular, those using payroll software, the HMRC calculators on the employer CD-ROM, or outsourcing their payroll to bureaux or agents would benefit less from making NICs annual and cumulative than employers handling their payroll manually. This means that the potential for administrative savings reduces over time, as the number of employers using manual payroll processes declines.

For **individuals**, there would be mixed outcomes; while some would pay fewer NICs as a result of making NICs annual and cumulative, others – including some on low incomes – would pay more, especially those with more than one job.

And for the **Government**, there would be significant Exchequer costs, and additional costs for HMRC, in making NICs annual and cumulative.

3.1 Chapter 2 outlined the operation of the current income tax and NICs systems for employers, and outcomes for individuals, and reviewed suggestions for further alignment put forward by representatives of employers and of the low paid. The most consistent proposal has been to make NICs, like tax, annual and cumulative.

3.2 This review has undertaken a detailed study of how an annual and cumulative system for employees' NICs could work, and the practical difference this would make for employers' in-year and end of year obligations. This chapter outlines the model used, and presents analysis of the savings and costs for employers of an annual and cumulative Class 1 NICs system and the consequences that this change would have for employers, individuals and the Government.

HOW AN ANNUAL AND CUMULATIVE SYSTEM WOULD WORK

Annual NICs 3.3 An annual basis of assessment for employees' NICs would give individuals an annual Primary Threshold (PT) that would work in a similar way to the income tax personal allowance. This would mean that NICs would be assessed on earnings over the whole tax year with an annual NICs-free allowance rather than an allowance in each pay period. Other NICs thresholds would also be annualised, including the Lower Earnings Limit, which could mean that all earnings in the year could be counted towards benefit entitlement. As with tax, earnings across all employments would be aggregated. This would affect the amount of secondary NICs employers would pay. Options for how employer NICs could work are considered in paragraphs 3.27 to 3.33.

Cumulative NICs 3.4 An annual basis of assessment for employees' NICs on its own would not align the process for calculating and deducting NICs with that for income tax. To do this, NICs would also have to be collected cumulatively over the year. This would mean that in calculating NICs cumulatively employers would need to take into account pay liable for NICs to date, and NICs paid to date, at each pay point through the year. To allow for NICs information from previous and concurrent employers to be available, it would need to be included on form P45, which enables tax to be collected cumulatively.

3.5 In order to minimise administrative burdens on employers, this cumulative NICs charge could be collected through PAYE alongside tax. The easiest way to achieve this would be for employers to be given a single PAYE code that would tell them how much tax-free and NICs-free pay was due for the year.

3.6 This would make the NICs system much more like the income tax collection system with both being based on:

- an annual period of assessment;
- a cumulative collection process;
- a PAYE code; and
- a P45/P46 process.

Remaining differences

3.7 The expectation is that these changes would reduce the level of complexity associated with operating two systems and provide compliance savings for employers. However, the systems would not be identical. Because this review has been carried out on the basis that the policy framework would remain unchanged, some key differences between the systems would remain, for example:

- NICs would remain a charge on employment income only and not extended to pensions or interest from savings;
- NICs would continue to be collected from people aged 16 or over and below State Pension age;
- NICs relief would not be introduced to mirror the tax relief provided to items such as pension contributions; and
- the current range of NIC rates would continue to be applied to earnings.

3.8 These continuing differences between the two systems would to some extent limit the expected reduction in administrative burdens from the proposed alignment. The ways in which this proposal would affect employers' in-year and end-of-year processes are described in the following sections.

Employers' in-year processes

3.9 Making NICs annual and cumulative would have significant implications for employers' in-year processes. Both the calculation of NICs and the information recorded for NICs would become more aligned with those for tax, but could also become more difficult for employers, as information would be required about previous earnings liable for NICs and previous NICs paid, in the same way as for tax. Other significant changes would be the inclusion of NICs in the process for movements of employees, in order to maintain cumulative collection, and the use of a single PAYE code for both tax and NICs.

Calculating tax and NICs

3.10 The calculation of annual and cumulative NICs would become more like the current process for tax, with combined tax-free and NICs-free pay calculated in each pay period and then the appropriate NICs rate applied to the earnings liable for NICs.

3.11 This means that NICs would be collected cumulatively throughout the year as tax is now, although it would add some additional complexity to the individual NICs calculations because they would need to take account of previous earnings. The employer would continue to have to determine the correct rate of NICs for their employees, as described in paragraph 2.22. The PAYE code would provide the annual amount of free pay for both tax and NICs and set of tables would provide the free pay to date for the week or month, in the same way as the current Pay Adjustment Tables.¹

3.12 With cumulative NICs, the NICs tables would need to be redeveloped so that instead of providing the figure of NICs due in an earnings period, they would provide the cumulative NICs due based on the earnings liable for NICs to date. This would work in the same way as existing tax tables, which provide for figures of tax due on taxable earnings to date.²

3.13 Box 3.1 shows how the process of calculating tax and NICs could differ under a system of annual and cumulative NICs, for an employer operating a manual payroll system.

Box 3.1: Calculating tax and NICs in-year, with annual and cumulative NICs	
Current process	New process
Employer calculates tax and NICs and completes the deductions working sheet columns 1a – 1e for NICs and 2 – 8 for tax	Employer would complete the deductions working sheet with new NICs columns
Employer may be required to refund overpayments or recover underpayments of tax in year. NICs are finalised in each earnings period	Employer may be required to adjust NICs as well as tax to refund overpayments or recover underpayments
Employer pays tax and Class 1 NICs together to HMRC monthly	Employer would pay tax and Class 1 NICs to HMRC as now

Correcting error 3.14 Correcting errors in NICs calculations would be easier with an annual and cumulative NICs system, as most errors could be rectified when the next payment is made rather than having to correct the error in an earlier pay period.

Recording tax and NICs 3.15 The recording of earnings, tax and NICs on the deductions working sheet would be different, with the NICs requirements more closely aligned to those for tax. Box 3.2 sets out what the new working sheet columns could be and how they would differ from those at present. A number of new deductions working sheet columns would be required to operate NICs cumulatively, and overall the number of NICs columns would increase from 5 to 6.

¹ The current tables are known as Tables A.

² The current tax tables are tables SR and B–D

Box 3.2: Possible PII working sheet columns, with annual and cumulative NICs

Current PII NICs columns	Example new PII NICs columns	Commentary on differences
Ia: Earnings at the LEL (where earnings are equal to or exceed the LEL)		The breakdown of earnings in columns Ia and Ic would not be required on an earnings period basis as recording of earnings at the LEL would be extracted from the annual earnings figure (the final total pay liable to NICs to date figure)
Ib: Earnings above the LEL, up to and including the PT		
Ic: Earnings above the PT, up to and including the UEL	Pay in the week or month subject to NICs	A single figure of all earnings in the period that are liable for NICs would be recorded, removing the need for employers to break the figure down between the NICs thresholds.
	Total Pay to date subject to NICs	
Id: Total of employee's and employer's contributions – mark minus amounts "R"	Total NICs-free pay to date	This would be the same figure as currently recorded for tax
	Total pay liable to NICs to date	
Ie: Employee's contributions due on all earnings above the PT	Total employee's NICs due to date	To enable cumulative operation of NICs, year to date figures would be recorded
	Employee's NICs deducted or refunded (R) in the week or month	This would essentially be the same figure as recorded now but the employer would refund any overpaid NICs from previous periods
	Employer's NICs in the earnings period	
		Employers' contributions would not be calculated cumulatively and would be recorded separately

Changes of employment for tax and NICs

3.16 In order for NICs to operate cumulatively across employments held during the year, a process similar to that for tax would be required when individuals changed job. This would mean increasing the amount of information that employers would need to provide on form P45 so as to include information about the NICs-free pay due and NICs paid from any previous employment in the year. This means that new employers would receive information about earnings and NICs paid up to the employee's date of leaving their last job. Employers taking on someone who is already in employment, which will be continuing, would need to use the tax coding notice provided by HMRC to determine the NICs-free pay they can apply to earnings.

3.17 Box 3.3 sets out how the process for employees moving between jobs could work with annual and cumulative NICs, following a process similar to that for tax.

Box 3.3: Process for employees starting or leaving, with annual and cumulative NICs

	Current process	New process
Employee starting	Employee gives the employer information about their previous earnings, tax paid and tax code (form P45); or indicates whether their new job is their first employment and whether it is their only or main employment (form P46); to enable the employer to establish the code to use	Form P45 would include additionally pay liable to NICs, NICs paid and NICs table letter
	Employer identifies correct NICs table letter	Employer would identify whether previous NICs table letter remained correct
	Employer prepares P11 deductions working sheet (or substitute)	Employer would prepare P11 deductions working sheet (or substitute)
	Form P45 or P46 completed and returned to HMRC as necessary	Form P45 or P46 would be completed and returned to HMRC as necessary
	HMRC confirm PAYE code for tax purposes (issue of form P2 to employee; P6 to employer)	HMRC would confirm a single PAYE code for both tax and NICs purposes. Any tax allowances or deductions in the code that were not applicable to NICs would be adjusted
Employee leaving	Employer reports to HMRC (copy to the employee) on form P45 information including PAYE reference, date of leaving, PAYE code, year to date of leaving figures for earnings and tax paid	Employer would need to include, additionally, on the P45, year to date of leaving figures for pay liable to NICs, NICs paid, and NICs table letter

A single code for tax and NICs

3.18 The employer would still need to determine the appropriate NICs table letter for each employee but would receive a single code for both tax and NICs. Since the Personal Allowance and Primary Threshold are already aligned, a single code reflecting the PA/PT would provide the correct free pay figure for the employer. However, if the code included allowances or deductions which applied for tax but not for NICs (such as to relieve expenses or collect unpaid tax) the code would need to be adjusted to ensure that overall, the single code provided the right amount of free pay across tax and NICs. The way in which this could work is shown in Box 3.4.

Box 3.4: Example of how coding adjustments could work for tax and NICs

Employee A's annual earnings are £10,000. Their PAYE code includes deductions to collect tax due on £100 untaxed interest and £150 of unpaid tax from the previous year.

Personal allowance:	£5,225
Deductions:	
£100 untaxed interest:	£100
£150 unpaid tax:	£682 ⁴
Total deductions:	£782
Net allowances	£4,443⁵
Code:	444L

This code, 444L, would collect the correct tax from Employee A. If applied to NICs, however, it would collect excessive NICs of £86. To prevent this, an adjustment could be made as follows:

Personal allowance:	£5,225
NICs adjustment:	£261⁷
	£5,486
Deductions (as above):	£782
Net allowances:	£4,704⁸
New code for tax and NICs:	470L

3.19 Such PAYE adjustments are not a new concept. Adjustments are used in existing codes to collect or refund tax that would otherwise be over or underpaid from employment earnings. However, the requirement to regularly adjust the single code for tax and NICs would mean that PAYE codes would be significantly more complex under an annual and cumulative system, and this would make it more difficult for individuals to understand their code.

Employers' end-of-year processes

Reporting earnings for tax and NICs

3.20 The end-of-year reporting process would be broadly the same under annual and cumulative NICs as now. The end of year forms (P35 and P14) that provide details of the earnings liable for tax and NICs, the tax paid and the NICs paid would remain in place but the information provided on NICs will be different from now. Box 3.5 outlines how the current and new requirements would differ.

⁴ The adjustment would be £682, because this would collect £150 of unpaid tax ($£682 \times 22\% = £150$).

⁵ This is the personal allowance, £5,225, minus the total deductions, £782 ($£5,225 - £782 = £4,443$).

⁶ This is the total deductions, £782, multiplied by the NICs rate, 11% (this assumes that Employee A's earnings are below the UEL). £86 has been rounded to the nearest whole pound.

⁷ The adjustment would be £261, because this would provide an adjustment of £86 at a marginal rate of 33% (11% NICs and 22% of tax) – ($£261 \times 33\% = £86$).

⁸ This is the personal allowance after the NICs adjustment, £5,486, minus the total deductions, £782 ($£5,486 - £782 = £4,704$).

Box 3.5: The end-of-year reporting process, with annual and cumulative NICs

Current process	New process
Employer completes end of year returns (P35 and P14) from deductions working sheet and submits to HMRC by 19 May following the end of the tax year	The end of year return would additionally include figures for earnings liable to NICs and NICs paid during the year, including from previous employments

3.21 Under a system of annual and cumulative NICs, the figures would be totalled through the year and the total earnings liable to NICs and the total NICs paid would be entered on the end of year returns P35 and P14. If there were earnings and NICs paid from a previous employment, these would also need to be recorded on the end of year return, in the same way as currently required for tax.

When cumulative NICs will not work

3.22 Cumulative NICs will not work in all circumstances and the calculation of contributions would sometimes have to revert to a non-cumulative basis. Cumulation can already break down for income tax, particularly when an employee has had a break in employment or the PAYE code decreases in-year. Including NICs in the cumulative process would mean that breakdowns in cumulation would increase, in particular where changes in the applicable NICs rate occurred. There would also be problems with operating employers’ NICs cumulatively across employments.

NICs rate changes

3.23 The current NICs system allows for employees and employers to pay a range of different NICs rates during the tax year. The most common reason for a change in rate is an employee moving in or out of a contracted-out occupational pension scheme, either within the same employment or when changing employment. Around 1.6 million employees⁹ have more than one NICs rate each tax year.

3.24 For such employees, a change of NICs rate during a year would mean that cumulation would break down if different NICs rates applied to different parts of the earnings during the year.

3.25 Since the system would work on the basis of a single PAYE code applied for both tax and NICs, a breakdown in cumulation for NICs would also mean that tax could no longer be calculated cumulatively. This would impose an additional reporting burden on the employer, as they would have to submit two separate end-of-year returns to HMRC at the end of the tax year.

3.26 It is assumed, therefore, for this review that if there were a change of Class 1 NICs table letter during the year for any reason, the employer would have to revert to a non-cumulative code for both tax and NICs. This is not uncommon for tax and is known as the “week 1/month 1” basis. However, unlike the present system where cumulative tax collection resumes once the employer receives the correct tax code, this would not be possible under a cumulative NICs system since the change in NIC rate is what caused cumulation to break down. Employers would also have to make separate NICs returns on forms P14 and P35 where more than one table letter had been used in a tax year. Where aggregation of earnings rules apply, because the employee works for more than one employer but the employments are connected employments, these rules would still apply to the calculation of employers’ NICs and a new process would be needed to link separate P14 returns.

⁹ HMRC.

Employers' Class I NICs

Employers' Class I NICs 3.27 Annual and cumulative operation of secondary (employers') NICs would be complex. If employer NICs continued to mirror the system for the employee's liability under an annual and cumulative system, the amount the employer paid would be affected by the employee's individual circumstances. For example, if an employee had two employments and used their full NICs Primary Threshold in one job, they would pay NICs at the main applicable rate on all of their earnings from the other job.¹⁰ If employers' NICs were to follow the same arrangement, only one employer would benefit from the NICs-free allowance. This would create perverse incentives which would distort the labour market compared with now, penalising some employers with employees with more than one job.

3.28 A further complication could occur if an employer wanted to take on a new employee part way through a tax year. One candidate for the job might have unused allowances if he had been out of work, and would benefit from these allowances in the new job. But if the new employer was to benefit similarly from allowances accumulated before the employment began, it could distort the employer's decision about who to employ.

3.29 The review has considered various options for how employers' NICs could operate alongside annual and cumulative NICs for employees including:

- replacing employers' NICs with a flat-rate payroll tax on aggregated earnings of all employees;
- introducing a flat rate payroll tax on total aggregated earnings of employees, as in the first option, but with an allowance per full-time equivalent employee at the level of the Primary Threshold; or
- retaining earnings periods for secondary NICs (no change to now).

Flat-rate payroll tax 3.30 A flat-rate payroll tax would apply a single percentage to all the earnings an employer paid in each earnings period, and so would not relate directly to individual employees' payroll calculations. This could be set at a level so as to be revenue-neutral overall.

3.31 However, this would have significant distributional effects as it would potentially benefit firms who employ higher-paid full time employees (for whom the rate would be likely to be set lower than now) and increase NICs for firms employing those on lower salaries or who work part-time. (These are individuals who effectively benefit disproportionately at present from the secondary threshold). Those who would lose would be likely to include many smaller businesses.

¹⁰ Until their total earnings liable to NICs reached the UEL.

Box 3.6: Employer NICs based on flat rate payroll charge

	Employer with 20 employees earning £200 a week	Employer with 20 employees earning £1000 a week
Current employer NICs – 12.8 per cent above PT of £100 a week	£256 a week $((£200-£100)*12.8%)*20$	£2,304 a week $((1000-100)*12.8%)*20$
Flat rate payroll tax – assuming 8 per cent rate on all earnings.	£320 a week $(£200*20)*8%$	£1,600 $(£1,000*20)*8%$
Difference in employer NICs per week	£64 increase in NICs	-£704 decrease in NICs

Flat rate payroll tax, with allowances 3.32 The second option would lessen the distributional impact by more closely replicating the current system, allowing a NICs-free amount per full-time employee. But this would still have a significant impact on employers with a higher proportion of part-time staff. It would also mean a new and significant administrative burden on all employers to calculate the NICs-free amount appropriate to their part-time staff.

Retaining earnings periods 3.33 This analysis suggests that leaving employers’ NICs largely as they are now, based on individuals’ earnings and earnings periods, would be the most workable option. However, a consequence of this would be to reduce the deregulatory gains from aligning the systems for employees’ NICs and tax, as the employer would still have to understand and operate two different systems: while tax and employees’ NICs would be more closely aligned, employees’ and employers’ NICs would need to be calculated separately.

Box 3.7: Summary – a model for annual and cumulative NICs

Under the most practical model of a system of annual and cumulative NICs, therefore:

- NICs would be calculated on a tax-year basis with annual thresholds – the LEL, PT and UEL;
- employers would calculate employee NICs cumulatively, like tax;
- a single PAYE code would be used for both tax and NICs purposes; and
- the current system of non-cumulative employers’ NICs would be retained.

SAVINGS AND COSTS FOR EMPLOYERS

3.34 Having established how an annual and cumulative NICs process could work, this section looks at the savings that this could deliver for employers. The estimates presented here are as far as possible based on the standard methodology used for assessing operational impacts. The assumptions used to calculate the savings and costs have been informed by discussions with representative bodies and business and also reflect HMRC data on employer PAYE activities.

Different methods of operating payroll

3.35 The impact of any change on particular employers of making NICs annual and cumulative would depend on whether they operate manual payroll (calculating tax and NICs and completing forms manually) or either outsource their payroll or use software. As explained below, the difference in impact between these two groups would be significant, and so this section considers the savings for each in turn.

3.36 However, the Standard Cost Model, which has been used as the basis for these estimated savings does not provide separate costs for manual and software payroll users, instead it contains an underlying assumption of the number of employers operating manual payroll processes. As such, it is difficult to separate savings identified by this model between those for employers using manual payroll and those using software or outsourcing their payroll. Therefore, additional estimates of savings that the SCM would not capture have been included in the analysis to give as full an estimate as possible of the potential savings and costs.

Box 3.8: Administrative burdens of the tax system – using the standard cost model

The standard cost model (SCM) was used to derive an estimate of the costs to business of complying with HMRC obligations. The model considers which activities a business has to undertake to comply with HMRC obligations and requirements, how frequently compliance must occur and the number of businesses affected. It considers the relative size of businesses, whether compliance activity is undertaken in-house or outsourced, and it also differentiates between businesses which use e-solutions and those which do not. The SCM does not consider one-off costs or transitional costs of a change in policy, nor does it make allowance for the deadweight costs of compliance (costs which a business would have incurred anyway had the relevant HMRC obligation or requirement not existed). The SCM does not consider any wider compliance cost issues, such as the costs of business uncertainty or cashflow costs, errors or any psychological or irritation costs.

The SCM provides the only consistent internationally recognised methodology for measuring administrative burdens and is therefore the appropriate baseline for the Government's targets for reducing administrative burdens set out below. The measurement of costs and savings for changes discussed in this chapter builds upon the SCM, but seeks to assess a wider set of factors, including costs associated with ease of understanding, dealing with employee enquiries and error correction.

Breakdown of estimated savings for manual users: in year processes

Calculation and recording **3.37** For employers using manual payroll processes, making NICs annual and cumulative would deliver savings in their calculation and recording of tax and NICs deductions in a number of ways:

- in-year recording on the deductions working sheet would become quicker for some employees;
- it would be easier to calculate NICs when making irregular payments to employees; and
- there would no longer be a separate system of directors' NICs for employers to understand.

3.38 However, there would also be a small additional cost for employers, in having to record some additional information on employees whose NICs rate changed during the year. These different effects are set out in the following paragraphs.

Quicker in-year calculation and recording

3.39 The most significant saving from making NICs annual and cumulative for employers using manual payroll processes would be from changing the basic calculation and recording process for NICs each pay period. Aligning the way that tax and NICs are calculated would simplify the tax calculation for employees whose taxable pay was the same as that liable to NICs. Making NICs annual and cumulative would mean that employers using manual payroll processes would spend less time completing the in-year working sheet for such employees. It is estimated that the costs would change as follows:

- when the employee's salary changed, the employer would save on average 10 minutes compared to the present system; and
- for ongoing payroll operation, the employer would save about 2 minutes per employee per pay period.

3.40 As the savings for simplifying the P11 process are incurred only by these employers and are calculated on a per pay period and per employee basis, it is important to distinguish between the number of employees affected and the number of employers affected. It is assumed that the 210,000 employers estimated to be operating manual payroll employ around 1 million employees. Using this figure, the reduced time spent making manual calculations and completing the working sheet for these employees would deliver savings of around £32.7 million for employers operating manual payroll.

Irregular payments

3.41 There would also be savings for employers paying employees on an irregular basis. At present, calculating the NICs due in this situation is not simply a matter of consulting the relevant table; the employer has to make additional adjustments to calculate the NICs liability every time they make a payment to the employee.

3.42 Under the new system employers would be able to make more extensive use of the tables provided in working out the NICs that are due, even when the employee is paid irregularly, as the only figure that would be required to make the calculation would be the earnings to date. It is estimated that:

- 36,500 employees are paid on an irregular basis¹¹;
- they receive eight payments on average over the course of the year; and
- making NICs annual and cumulative would save about ten minutes each time a payment is made.

3.43 On the basis of these assumptions, estimated savings from irregular payments becoming easier to handle are around £0.1 million.

Directors' NICs

3.44 Further savings in calculation and recording of NICs could arise because directors' NICs would no longer be treated differently to those of other employees. At present, directors' NICs liability is generally calculated on the basis of an annual pay period, allowing for all earnings in the year to be aggregated. Making NICs annual and cumulative for all employees would make this different treatment redundant, so that employers would no longer have to understand two different systems.

¹¹ HMRC sample of PAYE taxpayers.

3.45 The most significant savings would be from a reduction in end-of-year adjustments, rather than in-year calculations and it is estimated that the savings for manual payroll operators from a reduction in the time spent dealing with directors' NICs would be around £2.9 million per year.

Calculating and recording: increased costs **3.46** There would be an additional cost for employers where there is a change to an employee's NICs rate during the year, for example where they join or leave an occupational pension scheme. There are around 1.6 million¹² changes to NICs rates for individuals each year and the employer will need to complete a new deductions working sheet and a new end of year return for these employees. The change will not require any additional calculation, training, familiarisation or assessment costs, but there will be additional cost in reporting the information. The additional costs are estimated to be around £0.3 million for employers using manual payroll processes.

Correcting errors **3.47** There would also be savings because a cumulative system of NICs would make it easier to correct NICs errors; these errors would no longer need to be corrected within individual pay periods, but could instead be corrected in subsequent months in the same way as tax errors. The potential saving from this is difficult to identify, but assuming that on average employers make one mistake in calculating employee NICs for between five per cent and ten per cent of their employees in each year, and that the average time to correct an error is 30 minutes for small and medium employers and 20 minutes for large employers, savings could be between £1.3 million and £2.5 million for manual payroll operators.

Changes of job **3.48** A system of cumulative NICs would mean that employers would need information about the NICs that any new employees they took on had paid in their previous job in the tax year. This would mean extending the information currently provided for tax purposes on forms P45 to include similar but separate information on earnings and NICs paid to date. This would allow NICs to continue cumulatively in the new employment in most circumstances.

3.49 There are approximately 13 million P45 forms completed each year in respect of employees changing jobs or commencing new employment. Assuming that the NICs information would take about 5 minutes to gather and complete on average, it is estimated that the additional costs would be around £2.5 million.

Employees' queries **3.50** If tax and NICs were more closely aligned, with NICs annual and cumulative like tax, it is likely that employees would more easily understand them, reducing the number of queries to employers. The impact of queries under the new system could mean that:

- queries from employers to HMRC national call centres could be reduced by around 200,000, and queries to local HMRC offices by a further 200,000;
- 50 per cent of employees changing job currently raise a query; these would be removed because the system would be easier to understand;
- a further ten per cent of other employees raise queries at present that would not be required if NICs were made annual and cumulative;
- each of the queries removed by making NICs annual and cumulative would have taken ten minutes to deal with;¹³
- there will be a 25 per cent increase in NIC queries in the first year of the change;

¹² HMRC.

¹³ Based on average length of calls to HMRC contact centres.

- the introduction of more complicated PAYE codes, explained in paragraph 3.18, would increase the number of NICs queries and this will broadly offset the reduction in queries from both systems operating in a similar way; and
- that in the years following introduction of the change there would be a 25 per cent reduction in the inflated total of queries.

3.51 On this basis, the estimated savings from reduced employee queries are around £0.4 million but with an initial cost in the first year of around £1.3 million.

Breakdown of estimated savings for manual users: end of year processes

Simpler end of year returns **3.52** The simplified process for completing the in-year working sheet, is set out in paragraphs 3.39 and 3.40 above. There would be savings for employers in completing the associated end-of-year returns. These are estimated to be around £6.5 million for the 210,000 employers using manual payroll processes.

Easier payroll reconciliation **3.53** Simplification of the tax and NICs systems could reduce the time spent by employers checking their payroll each pay period. It is assumed that fewer payroll checks would be necessary as the initial calculations are more likely to be correct, and that:

- the Standard Cost Model attributes approximately £283 million of administrative burdens each year to NICs in completing payroll;
- five per cent (£14 million) of this cost arises from employers having to check that the NICs calculations are correct every month; and
- possibly between 10 per cent and 50 per cent of checking time may be saved from more closely aligning tax and NICs processes.

3.54 On the basis that around 13 per cent of the savings fall to employers using manual processes the estimated savings could be in the region of £0.2 million to £0.9 million.

3.55 In summary, the estimated annual savings for manual payroll users from making NICs annual and cumulative are set out in Table 3.1 below. The majority (almost 75 per cent) of savings for employers using manual processes will be realised through quicker in-year calculation and recording of NICs deductions.

Table 3.1: Breakdown of estimated annual savings for manual users of making NICs annual and cumulative

Reason for saving/cost	Estimated saving/cost (costs shown in blue)
Calculating and recording: quicker in-year calculation and recording	£32.7m
Calculating and recording: irregular payments	£0.1m
Calculating and recording: directors' NICs	£2.9m
Calculating and recording: increased costs	-£0.3m
Error correcting	£1.3m to £2.5m
Changes of employment	-£2.5m
Employees' queries	£0.4m
Reporting: simpler end-of-year returns	£6.5m
Reporting: easier payroll reconciliation	£0.2m to £0.9m
Total net annual savings	£41.3m to £43.2m

Breakdown of estimated savings for software users: employers' in-year processes

3.56 The savings for employers using payroll software will be significantly less than for those using manual payroll processes. Discussions with employer representatives confirm that employers using payroll software would not see any savings in calculating and recording NICs in each pay period, as software would do this in any case. However, they would see savings in other areas, especially in relation to correcting errors where, unless the software is fairly sophisticated, the employer will have to make the adjustments manually.

Savings 3.57 It is assumed that employers using software will not save any time in calculating and recording employee NICs in each pay period, as the core data that will be entered into the payroll software will not change. However, software users will benefit from a reduction in the time spent on dealing with directors' NICs and irregular payments, with estimated savings of around £5.9 million and £0.7 million a year respectively.

Costs 3.58 There would be an additional cost for employers where there is a change to an employee's NICs rate during the year. As with manual processing, the additional cost would be for reporting extra information, estimated to be around £2 million.

Correcting errors 3.59 Employers using software would benefit from cumulation making NICs errors easier to correct, as the majority of software is not able to do this automatically. The estimated savings as a result of this for employers using payroll software are £8.4 million to £16.9 million.

Changes of employment 3.60 But there would be a cost associated with providing additional information on forms P45 where employees move between employments, and this is estimated at around £16.6 million.

Employee queries 3.61 Employers using payroll software could expect similar reductions in queries from employees about their tax and NICs affairs and it is estimated that this could provide savings of around £1.4 million a year with an initial cost of around £5.7 million in the first year.

Breakdown of estimated savings for software users: employers' end-of-year processes

Reporting 3.62 Employers using software to meet their end-of-year reporting requirements would not see any savings from making NICs operate like tax. However, there would be a reduction in the time spent on payroll reconciliation. This would provide an estimated saving of between £1.2 million and £6.1 million.

Table 3.2: Breakdown of estimated annual savings for software users of making NICs annual and cumulative

Reason for saving/cost	Estimated saving/cost (costs shown in blue)
Calculating and recording: quicker in-year calculation and recording	£0m
Calculating and recording: irregular payments	£0.7m
Calculating and recording: directors' NICs	£5.9m
Calculating and recording: increased costs	-£2.0m
Error correcting	£8.4m to £16.9m
Changes of employment	-£16.6m
Employees' queries	£1.4m
Reporting: simpler end-of-year returns	£0m
Reporting: easier payroll reconciliation	£1.2m to £6.1m
Total net annual savings	£-1.0m to £12.4m

3.63 For software users, the main savings are provided by reductions in calculating and recording directors' NICs and by the process for correcting errors being simplified. However, there will be significant additional costs from NICs information being included on P45 forms when employees join or leave.

Overall savings from annual and cumulative NICs

3.64 The estimates of the savings and costs shown above illustrate how there will be significant variations in potential savings, and costs, between employers who operate their payroll manually and those using software, with significantly greater savings for employers using manual payroll processes.

3.65 The total estimated compliance cost savings for both manual and software users if NICs were to move to an annual basis now would be around £40 million to £56 million per year, as shown in Table 3.3.

Table 3.3: Breakdown of total estimated annual savings for employers of making NICs annual and cumulative

Reason for saving/cost	Estimated saving/cost* (costs shown in blue)
Calculating and recording: quicker in-year calculation and recording	£32.7m
Calculating and recording: irregular payments	£0.9m
Calculating and recording: directors' NICs	£8.7m
Calculating and recording: increased costs	-£2.3m
Error correcting	£9.7m to £19.4m
Changes of employment	-£19.1m
Employees' queries	£1.8m
Reporting: simpler end-of-year returns	£6.5m
Reporting: easier payroll reconciliation	£1.4m to £7m
Total net annual savings	£40.3m to £55.6m

* Totals may not sum from previous tables due to rounding

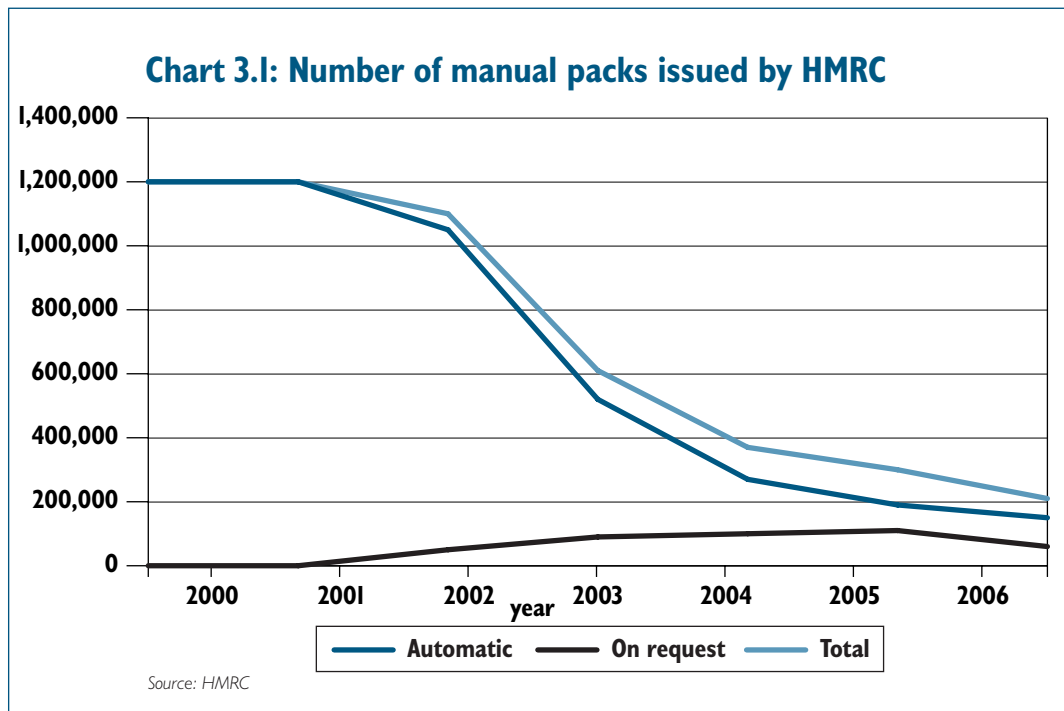
Change in overall savings over time

3.66 Moving Class 1 primary NICs to an annual and cumulative basis would require substantial changes to employers' and HMRC's software and processes, and would require primary legislation. It is anticipated that it might take some four to five years from the date of any decision to introduce such a substantial change in systems which would be 2012 at the earliest.

Number of employers operating payroll manually

3.67 Current estimates of the number of employers using completely manual payroll processes are based upon evidence from the number of employers that received HMRC's Employer Pack (rather than just receiving a copy of the HMRC CD-ROM) over recent years, which includes the NICs tables required for manual calculation.¹⁴ Around 210,000 employers received this pack in 2006, and it is estimated that this is the number of employers currently using entirely manual payroll processes. This figure has been used in calculating the above estimates.

3.68 As shown in Chart 3.1, the number of manual packs issued by HMRC has been falling in recent years. This supports other evidence that an increasing number of employers are using payroll software of some kind, as IT equipment becomes more affordable and working electronically becomes the norm.



3.69 HMRC estimate that the number of employers using manual payroll processes will continue to fall over the coming years, and could drop to around 25,000 by 2012. Because of the uncertainty of the projection it would be reasonable to consider a range of between 25,000 and 100,000 employers using fully manual payroll processes in 2012.

3.70 By the time that it would be feasible to introduce a new system, this trend towards automated payroll would reduce the compliance cost savings that could be expected from making NICs annual and cumulative to between £4 million and £34 million¹⁵, as shown in Table 3.4.

¹⁴ While these tables can also be downloaded from HMRC's website, it has been assumed that employers doing so would also be likely to have access to some payroll software, or to use the HMRC Employers' CD-ROM.

¹⁵ In today's prices.

Table 3.4: Breakdown of total estimated annual savings of making NICs annual and cumulative in 2012

Reason for saving/cost	Estimated saving/cost (costs shown in blue)	
	Lowest	Highest
Calculating and recording: quicker in-year calculation and recording	£3.8m	£15.5m
Calculating and recording: irregular payments	£0.9m	£0.9m
Calculating and recording: directors' NICs	£7.1m	£7.7m
Calculating and recording: increased costs	-£2.3m	-£2.3m
Error correcting	9.7m	19.4m
Changes of employment	-£19.1m	-£19.1m
Employees' queries	£1.8m	£1.8m
Reporting: simpler end-of-year returns	£0.8m	£3.1m
Reporting: easier payroll reconciliation	£1.4m	£7.0m
Total net annual savings	£4.1m	£34.0m

3.71 The lowest estimated savings in Table 3.4 are based on 25,000 employers using manual payroll in 2012, and on the lowest assumptions about savings in relation to error correcting and end of year reconciliation. The highest savings figures assume 100,000 employers using manual payroll in 2012, and the higher assumptions for error correcting and end of year reconciliations. This gives a range of estimated savings between £4 million and £34 million if the change were introduced from 2012.

Transitional costs of making NICs annual and cumulative

3.72 Although there would be savings for some employers from making NICs annual and cumulative, there would also be transitional costs for all employers, both from the requirement for staff training and familiarisation with the new rules and from IT costs.

Staff training 3.73 One cost associated with moving to a new system is the cost of employers familiarising themselves with the new system, either by attending formal training courses or reviewing material provided by HMRC. This is estimated to be a one-off additional cost of around £130 million across businesses.^{16, 17}

IT costs 3.74 In addition to the costs of training, it is also likely that there would be some increase in acquisition costs for payroll software in the first year that this change was introduced. These costs would vary between employers who operate manual payroll processes, use software, or outsource their payroll to bureaux or agents. It is difficult to predict what would happen to these costs. Where employers outsource payroll or have a software provider, the costs may be felt indirectly, through reduced options for the same money or delayed software upgrades, but it has been assumed that there will be no direct acquisition costs for micro, small or medium businesses.

3.75 However, the largest employers are unlikely to use basic software packages to complete their payroll obligations. In order for these firms to provide a smooth transition for their employees, they would be likely to need a project team, working for several weeks and undertaking extensive testing. An average cost of £10,000 for each average large employer has been assumed, giving an additional cost of around £60 million.

3.76 It is therefore estimated that the transitional cost for all employers would be around £200 million based on the assumptions used, but could range from around £150 million to £250 million depending on the actual time spent on training and IT costs.

SUMMARY OF EMPLOYER SAVINGS AND COSTS

3.77 Making NICs annual and cumulative would deliver savings for employers. However, these savings would vary between different employers, and would be significantly greater for those employers using manual payroll processes rather than payroll software or outsourcing their payroll. Manual payroll users would benefit most from the change, but as the number of such employers is decreasing and will have fallen considerably by the time such a substantial change could be introduced, the potential employer savings from making NICs annual and cumulative are lower than they appear at present.

3.78 Because many employers would not see significant savings from making NICs annual and cumulative, the level of savings that could be delivered by this change is not as great as might have been expected. The level of potential savings is also expected to fall further over coming years, as the number of those employers using manual payroll processes continues to decline: from perhaps 210,000 at present, it is estimated that this number will have fallen to between 25,000 and 100,000 by 2012. This translates to a reduction in estimated savings from between £40 million and £56 million now, to between £4 million and £34 million in 2012, assuming current trends persist. In addition there would be one-off transitional costs of around £200 million but could range from between £150 million to £250 million.

¹⁶ To estimate the one-off transitional costs associated with this it has been estimated that the time taken to complete the necessary training would be 1 day (8 hours) for all businesses who complete payroll 'in house' and a nominal 2 hours (for familiarisation) for those businesses who outsource.

¹⁷ It has been assumed that for micro employers only one (i.e. the owner) employer would require training; for small firms an average of 1.5 people; for medium firms 2 people; and the very largest employers (some of which are likely to have their own payroll department) an average of 25 employees may potentially require training.

IMPLICATIONS FOR INDIVIDUALS OF THIS MODEL OF ANNUAL AND CUMULATIVE NICs

3.79 As well as having an impact on employers, making NICs annual and cumulative would have implications for individuals. At present, individuals' contributions and benefit entitlement are determined on the basis of their earnings in each pay period in each employment. Under an annual system, NICs would be calculated on the basis of an annual NICs-free allowance, equivalent to 52 times the current weekly PT. Similarly, the basis for calculating the earnings factor that determines benefit entitlement would be calculated differently. Earnings across employments would also be aggregated, meaning that individuals no longer received the benefit of a separate PT in each employment. The UEL would apply across annual pay, and not when pay reached the limit in individual earnings periods. These changes to the structure of the NICs system would have both financial and benefit entitlement implications for individuals.

Working for part of the tax year

Financial impact 3.80 In an annual and cumulative system, employees would no longer have a PT for each pay period. Instead, there would be an annual NICs-free 'allowance', similar to the personal allowance for tax. This would mean that individuals working for part of the year would receive the full benefit of their annual allowance; such individuals would therefore pay less NICs under an annual system than at present. An estimated five million people would benefit from this each year, with an average annual saving per person of around £120.

Fluctuating earnings

Financial impact 3.81 The introduction of an annual UEL, rather than a UEL in each earnings period would also mean some individuals paying additional NICs. Those whose annual earnings are between the LEL and UEL, but who receive earnings in one or some earnings periods over the UEL (for example as a result of overtime or bonus payments) would no longer pay NICs at 1 per cent on those earnings above the UEL in certain pay periods. Instead, NICs would be charged upon these earnings at 11 per cent. It is estimated that around 400,000 individuals would pay an extra £200 on average each year in NICs as a result of this change.

Benefit impact 3.82 At present, employees' total pay in earnings periods in which earnings have met or exceeded the LEL contributes to their earnings factor. If NICs were made annual and cumulative, however, all earnings could count towards the earnings factor.

3.83 This could allow around 250,000 individuals each year to improve their earnings factors sufficiently for them to reach the qualifying earnings factor, so accruing a year of entitlement to basic State Pension, when they would not have done so under the current system. However, the White Paper on pensions: *Security in Retirement* includes proposals to make it easier for people with incomplete NICs records to obtain a full State Pension. It is expected that around 90 per cent of people in the UK reaching pension age in 2025 will receive a full State Pension. This means that it is less likely that particular individuals would gain from all of their earnings counting towards the earnings factor.

More than one job

Financial impact 3.84 Annualising the PT would, as set out above, reduce the amount of NICs paid by those employees who work for part of the year. However, while these individuals would gain from receiving an allowance for the full year, those with more than one job would no longer be able to receive several allowances, as they can at present. This is because NICs are currently calculated in each job, with no aggregation of earnings across jobs.¹⁸

3.85 It is estimated that around 600,000 individuals who work in more than one job would pay more NICs as a result of this change. The average increase in NICs would be £300 per year, but some individuals could pay up to £550 per year extra, with no change in their benefit entitlement position.

Benefit impact 3.86 Of the 600,000 people who work in more than one job, the majority already build up entitlement to contributory benefits because they earn above the Lower Earnings Limit in one of their jobs. If all earnings from each job counted towards benefit entitlement, around 20,000 employees would be brought into the benefit system and would start to build up benefit entitlement.

SUMMARY OF IMPLICATIONS FOR INDIVIDUALS

3.87 Moving the structure of NICs to an annual and cumulative basis would mean that around 5 million individuals who work for part of the year would pay on average £120 a year less NICs and around 270,000 individuals might gain increased entitlement to contributory benefits. However, around one million individuals, including some with low earnings, would pay additional NICs of up to £550 per year.

¹⁸ Unless jobs are with the same employer or employers who carry on business in association with each other – in which case the jobs are treated as one and earnings are aggregated.

COST TO THE EXCHEQUER OF MAKING NICs ANNUAL AND CUMULATIVE

3.88 A significant number of individuals would gain from the introduction of an annual NICs 'allowance', in place of the PT for each pay period. These gains would have a substantial cost to the Exchequer, estimated at around £600 million. While there would be some yield from those individuals who would pay increased levels of NICs, the net effect on the Exchequer of making NICs annual and cumulative would be a cost to the public purse of £340 million.

CONCLUSIONS

3.89 Making NICs annual and cumulative would have a variety of implications for employers, individuals and the Government, both positive and negative. Any changes to the operation of the tax and NICs systems must be considered carefully in the light of the impacts on these three stakeholder groups. Any prospective benefits should be proportionate to the possible impact on employers and on individuals. Potential change must also be measured against risks to delivery, given the fundamental links to general public expenditure and social security systems, as well as the overall effect on the Exchequer.

3.90 The administrative cost savings from moving to annual and cumulative NICs are estimated to be around £4million to £34 million at the earliest point at which the reforms might be introduced. This is a modest proportion of the expected total administrative cost faced by employers. This is because the benefits from the change would mainly accrue to employers who continue to use manual payroll processes and the number of such employers is continuing to decline steadily. The estimated transitional cost of around £200 million of moving to a new system would, however, impact on all employers.

3.91 Making NICs annual and cumulative would also mean that around 270,000 individuals would have their benefit entitlement position improved, while 5 million others would pay reduced NICs. But around one million individuals would pay increased NICs, in the majority of cases without receiving any additional benefit entitlement.

3.92 This reform would also have an Exchequer cost of £340 million resulting from an overall reduction in the amount of NICs collected.

3.93 Overall, the Government has concluded that the benefits of administrative alignment do not outweigh the costs and is therefore not persuaded that there is a robust case for change of the kind outlined. In taking forward the review's conclusions the Government wants to develop a shared understanding of the analysis and key tradeoffs with the view to ensure policy is based on robust and tested analysis.

3.94 The Government would welcome comments on the analysis and conclusions presented in this chapter. Comments should be sent to:

Income and Earnings Team
HM Treasury
Room 2/SE
1 Horse Guards Road
London
SW1A 2HQ
or email: taxsnics.review@hm-treasury.x.gsi.gov.uk

4

CONSIDERING OTHER REPRESENTATIONS ON ALIGNING INCOME TAX AND NICs

Suggestions for further alignment of the tax and NICs systems have not been exclusively focused on the basis of assessment of Class 1 NICs or how it is collected. This chapter examines other proposals that have been put forward, and explains that HMRC will:

- **consult in the autumn on how best to improve guidance on income tax and NICs to ensure that it more closely meets business needs;**
- **issue a consultation document in November 2007 on how best to introduce a system to collect tax on benefits in kind and expenses through the payroll; and**
- **consult in the autumn on ways of improving the processes for collecting Classes 2 and 4 NICs from the self-employed.**

4.1 Chapter 2 outlined the representations that the Government has received for further alignment of the tax and NICs systems. Chapter 3 examined how such a system might work, concluding that the level of estimated savings for employers is not sufficient to justify the expected transition costs for employers generally and the significant impacts on individuals and the cost to the Exchequer. This chapter looks at the other representations that have been made for further aligning tax and NICs systems or improving their operation.

OTHER REPRESENTATIONS FOR REDUCING BURDENS ON EMPLOYERS

Guidance

4.2 There is a large amount of tax and NICs guidance currently available. The existing guidance tends to treat the two systems separately, and generally takes the legislation as its starting point rather than the tasks and responsibilities of employers and individuals. The guidance still reflects its origin in the work of two previously separate departments (the Inland Revenue and the Contributions Agency) that previously had responsibility for tax and NICs respectively.

4.3 It has been proposed that there is scope for improving the structures, presentation and clarity of the guidance which would result in significant savings for employers, both in reducing the risk of employers making errors in calculating employees' tax and NICs liability, and by making it easier for them to deal with queries from employees.

4.4 Significant steps have already been taken to improve and simplify the guidance HMRC provides to employers on tax and NICs. These have included improvements to the HMRC employers' CD-ROM, in particular the P11 calculator, as well as online combined tax and NICs guidance on benefits in kind.¹ These changes have generally been well received by employers. Box A.8 in Annex A sets out the current range of guidance on HMRC's employers' CD-ROM.

4.5 However, HMRC recognises that there are areas where there is scope for further improvement including:

- through shared and consistent use of language to describe the two systems, to make it clear whether the advice applies to tax only, to NICs only, or to both;
- shifting the focus of the guidance from the legislative framework to the tasks and responsibilities of employers and individuals;
- improving the lay-out and presentation; and
- greater cohesiveness and clarity, including more practical examples.

4.6 Making significant changes to the structure and format of HMRC's guidance is sensible only where the changes will genuinely aid employers. The Government does not want to disrupt guidance that employers find useful, and recognises that different employers will have different preferences.

4.7 **HMRC will consult in the autumn with employers and businesses about priority areas for improving its guidance by better aligning the material on tax and NICs to make it clearer, more accessible and cohesive to better meet business needs.**

Reporting benefits in kind and expenses

Reporting benefits and expenses for tax and NICs

4.8 Forms P11D and P9D returns, that employers use to report to HMRC benefits in kind and expenses that they have provided to employees, are due to be filed by employers shortly after the main PAYE returns are made to HMRC each year. As explained in Chapter 2, some employer representatives have suggested that completing and filing these returns adds an administrative burden that could be avoided if benefits in kind and expenses could be accounted for through the payroll for both tax and NICs purposes when they arise. In addition, HMRC's Administrative Burdens Advisory Board has identified this separate process as one of the major irritants for employers in meeting their HMRC obligations. Initial analysis suggests that including benefits in kind and expense details on forms P14 and P35 and withdrawing the separate requirement for forms P11D and P9D could reduce the costs to employers of meeting administrative obligations by between £14 million and £21 million. Further administrative savings in the region of £850,000 per year could be realised by removing the £8,500 earnings threshold for taxing benefits in kind.

¹ www.hmrc.gov.uk/employers/ebik/index.htm

4.9 Some employers already have informal agreements with their local offices to tax benefits through the payroll but, as there is no statutory basis to do so, such agreements do not remove the requirement for employers to file end of year P11D/P9D returns for these items.

4.10 The Government thinks that a more formalised statutory scheme for taxing expenses and benefits in kind through the payroll could help to align the process of accounting for tax and NICs and to reduce the number of separate end of year processes by abolishing the P11D/P9D forms and rationalising the number of filing dates. Where payments are liable to Class 1 NICs the process for dealing with tax and NICs would be more fully aligned although the Government has no plans to fully introduce a Class 1 charge on benefits in kind that currently attract a Class 1A charge. Introducing a new statutory scheme would involve estimated one-off costs for employers of between £15 million and £35 million.

4.11 HMRC will issue a consultation document in November 2007 on how best to introduce a system to tax benefits in kind and expenses through the payroll. The consultation will also include a proposal to remove the £8,500 threshold.

Class 2 and Class 4 NICs

Access to benefit entitlement **4.12** The self-employed currently pay two separate classes of NICs (2 and 4) through two separate systems. Some representations have asked for these two classes of contribution to be merged into one charge, while others have suggested that collection arrangements might be simplified.

4.13 The Government's analysis suggests that a single NICs charge (based on profits) would be likely to result in some self-employed people with low profits either paying increased amounts of NICs, or being excluded from benefit entitlement. The Government does not believe that merging Class 2 and Class 4 NICs would benefit those who are self-employed and have low levels of profits, for whom Class 2 contributions (currently £2.20 per week) offer an affordable way of ensuring that they are able to accrue contributory entitlements, in a way that could not be provided under a single charge.

4.14 The Government does recognise that the two separate Classes of self-employed NICs collected through two separate HMRC processes can be confusing to operate for the self-employed. **It will therefore consult in the autumn on ways of improving the processes for collecting Classes 2 and 4 NICs from the self-employed.**

SUMMARY

4.16 This chapter highlights ways in which employers' administrative obligations could be made simpler, without radical reform to the structure of income tax or NICs, delivering real benefits to business. In particular, there could be scope to reduce administrative burdens by between £14 million and £21 million through changing the way benefits in kind and expenses are reported, removing the end of year reporting process and dealing with all payments of earnings, expenses or benefits in kind in a single payroll process.

4.17 The Government announced in the 2007 Pre-Budget Report that HMRC will:

- **consult with business, in the autumn, on how best to improve guidance on tax and NICs to ensure it more closely meets business needs;**
- **issue a consultation document in November 2007 on how best to introduce a system to tax benefits in kind and expenses through the payroll; and**
- **consult, in the autumn, on ways of improving the processes for collecting Classes 2 and 4 NICs from the self-employed.**

5

CONCLUSIONS

5.1 The Government is committed to reducing the costs to business and individuals of administering the tax and national insurance system where that is consistent with its wider policy objectives, such as maintaining a system of State Pensions based on the contributory principle as set out in the recent Pensions White Paper.¹

5.2 There has been significant progress against these objectives as a result of:

- introducing recommendations made in the Taylor report;
- introducing improvements and simplifications since the merger of the Contributions Agency and Inland Revenue (now HM Revenue and Customs);
- the proposals set out in the Pensions White Paper; and
- most recently the announcement in Budget 2007 of the next stage of tax and national insurance reforms, as part of a rebalancing of the tax system to offer more support for work and families. This will simplify the tax system and as a result, from April 2009, the level of earnings at which the higher rate of tax and the additional rate of NICs become payable will be aligned for the first time.

5.3 In response to representations from business and on behalf of the low paid, the Government announced it would consider the case for further alignment of the tax and NICs systems. The review has considered all representations put forward but focused on the suggestion that NICs should move to an annual and cumulative basis, like tax.

5.4 Careful and detailed analysis has been undertaken to identify the practical implications for employers of operating such a system; the impacts on individuals, both in financial and in benefit entitlement terms, and the cost to the National Insurance Fund of introducing such a change.

Outcomes for employers

5.5 The extent to which the current system for NICs imposes an administrative burden on employers over and above that which occurs in operating PAYE for tax, depends on whether the employer operates their payroll manually or uses automated systems such as HMRC's employers' CD-ROM or payroll software. For employers who use automated systems, the NICs earnings period basis does not add a significant burden because the software enables the NICs calculation to be made without work on the part of the employer. If the basis of assessment for NICs were changed these employers would still need to input the same information about the employee's earnings and NICs table letter as they do now.

¹ Security in Retirement: Towards a new Pension System (Department for Work and Pensions 2006).

Outcomes for employers using payroll software

5.6 Chapter 3 identified that there are potentially some benefits for employers using automated payroll systems in moving NICs to an annual and cumulative basis, not in reducing the amount of information they are required to record and report, but in reducing the time they may spend correcting errors and answering employee queries. Annual and cumulative NICs could make it easier for employers to understand the NICs system as it would work in a way that is more closely aligned to how income tax operates under PAYE and there would not be different NICs rules for company directors.

5.7 However, there would also be some areas where new complexity would be introduced especially in relation to: additional reporting requirements on form P45 when an employee changes job; and where changing NICs rates in-year means cumulation breaks down and new reporting requirements are introduced for end of year returns. This limits the estimated net cost savings for those who use automated systems to a relatively modest figure of around £10m per year.

Outcomes for employers using manual payroll systems

5.8 For employers who choose to use manual payroll systems (paper-based forms and tables) the administrative savings are potentially greater. This is because employers calculate tax and NICs due manually from tables and record the information step-by-step on a paper working sheet, so that the difference between the two systems is more apparent. At the end of the year, while a cumulative total for tax can be transferred to the annual report, the employer has to add up NICs from each earnings period. For employers using software most of the calculations on the working sheet and the end of year summary are done automatically.

5.9 The estimated savings for employers operating manual payroll systems are around £41 million to £43 million per year if annual and cumulative NICs were introduced now. This takes account of the extra time needed for the calculation of NICs in each earnings period and the manual completion of forms. As there are obvious administrative savings from operating the current systems using software rather than manual processes, it is hardly surprising that there is a clear trend towards using software. This has been further encouraged by the Government policy on electronic filing of returns and significant advances in support and calculation tools provided in HMRC's CD-ROM. The review estimates that by the time the Government could realistically introduce annual and cumulative NICs (in around 2012) the numbers of employers still using manual payroll systems will have declined further from 210,000 currently, to between 25,000 and 100,000 employers. This means that the estimates of the prospective benefits from annual and cumulative NICs need to be reduced to reflect this expected decline in numbers using manual payroll processes.

Estimated administrative savings

5.10 Overall, the review concludes that the administrative savings that would be made from annual and cumulative NICs are between £40 million and £56 million if introduced immediately, but reducing to between £4 million and £34 million per year by the time the changes could be introduced. These figures must be taken in the context of the overall administrative cost of operating payroll taxes which stands at around £759 million and excludes costs incurred (such as training, advising employees, and making and correcting errors) which are not associated with employers' statutory obligations.

5.11 Additionally, there would be significant transitional costs for employers of moving to a system of annual and cumulative NICs. These are upfront costs that would arise in learning how the new system works and in upgrading existing software. The review estimates this cost to be around £200 million (within a range of between £150 and £250 million), meaning that, on average, employers would not recoup the cost of their investment in making the change, through net reduction reductions in administrative costs, until some years after the system had changed.

5.12 The Government has carefully considered the case for moving to annual and cumulative NICs and on the basis of this analysis and the level of disruption to all employers, and the limited benefits for many, it believes the case is not compelling.

Outcomes for individuals

Helping the low paid **5.13** The review also looked at the impact of moving to annual and cumulative NICs in terms of improving outcomes for low paid individuals. It found that there would be around 5 million financial gainers who would pay on average around £120 less NICs a year. This would include people earning above the higher rate threshold and those joining or leaving the workforce, through starting their first job or retiring. The latter would benefit from a whole year's NICs allowance when they start or leave, but while working would not necessarily be low paid.

5.14 It is estimated that around 270,000 people could gain benefit entitlement because it would be easier to achieve the qualifying earnings factor for a year if annual pay is taken into account rather than earnings from the LEL to UEL in each earnings period. This does not, however, take into account national insurance credits or Home Responsibilities Protection that help protect contributory benefit entitlement. The Government's State Pension reforms will also make it progressively easier for people with incomplete or broken national insurance records to qualify for a full State Pension.

5.15 The review has found that annual and cumulative NICs would also adversely affect around 1 million employees. Of these, around 600,000 people who have two or more concurrent jobs would be worse off by on average £300 per year, and some up to £550 per year. These may often be people in relatively low paid part-time jobs, who arrange the hours they work to fit in with family or caring commitments. Such people currently only start to pay NICs when earnings from each employment individually reach the Primary Threshold in the earnings period. With annual and cumulative NICs, they would have a single annual NICs threshold or allowance that would have to be allocated to one of their jobs or apportioned between them.

5.16 The remaining 400,000 people (who receive lump sum payments or bonuses) would be worse off by on average £200 per year. This is because any lump sum payments that currently exceed the UEL in an earnings period are subject to 1 per cent NICs only. With annual and cumulative NICs such payments would count towards the employee's annual earnings and an annual UEL. If the overall earnings for the year are within the UEL such payments would be liable for NICs at the full rate of up to 11 per cent.

5.17 The review concludes that annual and cumulative NICs would therefore have the unintended consequence of worsening the position for a significant number of employees. They could not be compensated without adding a new administrative burden for employers and significantly increasing the overall cost of the reform.

5.18 The cost to the Exchequer of moving to annual and cumulative NICs, in the absence of any compensating measures, is therefore estimated at around £340 million (£600 million in reduced NICs paid due to providing an annual allowance, less £260 million extra receipts from those adversely affected).

Conclusion

5.19 The review concludes that the analysis of annual and cumulative NICs does not provide a compelling case for reform. While there are some identified administrative savings for employers and potential benefits for individuals in terms of financial savings and possible benefit entitlement, the Government does not consider the initial disruption to all employers, the adverse outcome for around 1 million employees in the absence of compensating measures and the cost to the National Insurance Fund are justified.

5.20 The Government remains committed to simplifying administrative obligations on business and helping the low paid. Chapter 4 set out some specific areas where the review has identified that there may be scope for introducing improvements to help business; collecting tax on benefits in kind and expenses through the payroll; simplifying processes for the self-employed; and improving guidance on tax and NICs. The Government announces in the 2007 Pre-Budget Report a commitment to consult on each of these issues and would also welcome views on the detail of the analysis in Chapter 3.

A

THE CURRENT INCOME TAX AND NICS SYSTEMS

What is income tax?

A.1 Income tax is an annual charge upon all of an individual's income, although there are some specific exemptions and reliefs. It raises more revenue than any other tax, with receipts for 2007-08 forecast to be £146 billion, and this is credited to the consolidated fund to pay for general expenditure.

A.2 Income tax was introduced in 1799, although it has been repealed and reintroduced at several points since then, and continues to be renewed annually by Finance Acts.

The current income tax system

Tax allowances A.3 Income tax is paid by individuals on the basis of their total annual income. Every individual receives a 'personal allowance', an amount of income on which they will pay no tax; in 2007-08 this is set at £5,225 for the large majority of individuals, but £7,550 and £7,690 for those with modest incomes between 65 and 74, and over 75 respectively.

A.4 There are exemptions and reliefs from tax. For example, tax is not paid on pension contributions to approved pension schemes, on certain employment-related expenses, and on certain donations to charity.

Rates of income tax A.5 On the first £2,230 of taxable income above the personal allowance, tax is charged at 10%, followed by 22%¹ on the next £32,370 of income. Above that band of income, tax is charged at the higher rate, 40%. Some sources of income are charged at different rates, including interest on savings, on which tax is charged at 20%, but generally income from all sources is aggregated to calculate one liability and, unlike National Insurance, the tax system is cumulative; each individual's liability is based upon their income for the full year from all sources, rather than for specific earnings periods or from specific employments/investments.

How tax is collected A.6 Most income tax charged on employees is collected through the Pay As You Earn (PAYE) system. PAYE uses a system of codes which are either, notified to employers by HMRC directly, taken from form P45 by the employer or employers can establish the correct tax code to use by following standard procedures set out in HMRC guidance. This process is explained in more detail in paragraph A.7 below. The codes allow employers to deduct the correct amount of tax directly from employee's salary throughout the year. Codes can take account of previous under or overpayments, benefits in kind, and other income e.g. from other employments. The variety of basic codes in use is explained in more detail in Box A.1 and Box A.2 gives some examples of codes in operation.

¹As described in paragraph I.24, from April 2008 the starting rate (10%) will be removed and the basic rate (22%) will be reduced to 20%.

Box A.1: PAYE codes

PAYE codes also allow for in-year adjustments to be made to the free-pay due. These adjustments enable the calculation of tax to be made on earnings as it accumulates through the year; in-year repayments to be made by employers; and underpayments to be calculated and collected throughout the subsequent year.

Tax codes

Most tax codes are made up of a number followed by a letter (suffix codes); this letter informs employers of the changes to make to the amount of annual tax-free pay following the Budget. Codes with a K prefix, known as 'K Codes', indicate that deductions exceed the allowances and that a sum needs to be added to the employee's earnings before calculating the tax due. 'Letter codes' – codes without a number, such as BR, D0, 0T, NT and FT, indicate that the employee is entitled to no free pay, and direct the tax rate (if any) to apply.

Examples of tax codes:

Suffix codes provide tax-free pay – e.g. 522L means £5,225 free pay

K-codes mean the employer needs to add on additional pay – e.g. K100 means £1000 additional pay

Letter codes just tell the rate to apply – e.g. BR = basic rate, 22%

Emergency codes

If an employer doesn't have a code to use for an employee he follows standard instructions to determine which 'emergency' code to use, which can be cumulative or non-cumulative. The employer will then operate the emergency code, until HMRC are able to provide a correct code if required.

Examples of emergency codes:

522L – the standard code (changes each year) if it's the employee's first job

522LX – if it's the employee's only or main job. The 'X' means the employer works out the tax every pay period as if it was week 1 or month 1

BR – if it is not the employee's only or main job the employer operates the basic rate of tax (22%) on all earnings

Tax codes are designed to facilitate cumulative tax deductions, but in some cases it may not be possible for cumulative calculations to be made – for example after a break in employment, or where the employer has not received information about an employee's previous job. If a code cannot be used cumulatively, the employer calculates tax in each tax week as if it were the first of the year, known as the 'Week 1 or Month 1 basis.'

Box A.1: PAYE codes (cont'd)**Adjustments to suffix codes**

The allowances that make up a suffix code can be adjusted to take account of additional tax-free allowances (for example for certain expenses) or deductions that reduce the amount of tax-free pay represented by the code. Deductions can be made in order to collect additional tax from the employee's earnings that may be due on other forms of income, for example untaxed bank or building society interest, other untaxed earnings, income from property or non-cash benefits-in-kind. Deductions can also be used to recover unpaid tax from a previous year and Self Assessment liabilities up to £2,000.

Example of an adjusted code:

Allowances	Deductions	
Personal allowance £5,225	Untaxed interest	£100
Flat rate expenses £50	Company car	£2,000
	Unpaid tax (£22.00)	£100*
Total allowances £5,275	Total deductions	£2,200
Net allowances £5,275 – £2,200 = £3,075		
Code 307L		

*The adjustment would be £100, because this would collect £22 of unpaid tax (£100 x 22% = £22).

Box A.2: employees' income tax examples

Example 1: John has earnings from employment £20,000 in 2007-08; code 522L

- Tax due £20,000 – £5,225 free pay = £14,775; £2,230 x 10% = £223 plus £12,545 x 22% = £2,759.90. Total tax due £2,982.90

Example 2: Sue has earnings from two concurrent employments in 2007-08; £15,000 from job 1 and £5,000 from job 2. Code 522L and code BR used respectively

- Job 1 – £15,000 – £5,225 free pay = £9775; £2,230 x 10% = £223 plus £7,545 x 22% = 1659.90. Total from job 1 = £1,882.90
- Job 2 – £5,000 x 22% (basic rate as per tables B) = £1,100
- Total from both jobs £2,982.90

How PAYE codes are passed from employment to employment

A.7 When an employee leaves an employment they are given a form P45 which includes details of their taxable pay and tax paid in the year to date, the date of leaving and the PAYE code used. When the employee starts their next job they hand the P45 to their new employer and this enables the new employer to continue the cumulative operation of PAYE by adding taxable pay to the pay to date figure. The P45 process works when an employee moves relatively quickly from one job to the next and passes the form on. This often does not happen in reality, either the P45 is out of date (it refers to a previous tax year) where there has been a gap in employment or it has been lost. In these circumstances, employers provide new employees with a form P46 to complete. The P46 asks the employee to declare whether the job is their first employment or only or main employment. If the employee declares the job is their first, the employer applies a default emergency code (made up of the basic personal allowance) on a cumulative basis to give the employee the benefit of the tax-free allowances accrued in the year to date. If the declaration is that the job is the employee's only or main employment, the employer applies the default emergency code on a week 1 / month 1 basis

(each payment treated as if it was paid in week 1 or month 1 of the tax year). If the job is not the employee's only or main employment, the employer applies a default basic rate coding.

A.8 The emergency or P46 procedure will in many cases provide the correct default code for the employee. Where it doesn't HMRC provide a notice of coding (P2 to employee and P6 to employer) with the correct code for the year. The code may need to be corrected for a number of reasons, most commonly, where adjustments may need to be made to the net allowances in the code e.g. for previous unpaid tax, benefits in kind or other income. HMRC also issue codes in-year where week 1/month 1 basis codes can be changed to a cumulative basis, for example where HMRC obtains missing P45 figures from a previous employment.

Self Assessment

A.9 Income tax is also collected through the Self Assessment (SA) system, generally for individuals who are self-employed, or have incomes that are high or from a large number of sources. Under SA, payments on account are made in January during and July after the relevant tax year, with a balancing payment the following January.

What are national insurance contributions (NICs)?

A.10 National insurance is part of a contributory system, through which individuals pay contributions while in work and receive benefits when unable to work due to illness, unemployment or retirement. The system was introduced in 1911 and was significantly extended in 1945. Contributions were originally flat rate, but an element of graduation was introduced in 1961 and NICs became largely earnings related in 1975.

A.11 Contributions from employed earners are made on the basis of earnings, rather than (as with income tax) income as a whole. NICs are therefore not paid on pension income or interest from savings, for example. NICs are also not paid by those above State Pension age, or below the age of 16. Provision is made for employed earners to contract-out of part of the State pension scheme in favour of receiving an occupation pension from their employer. Where such a choice is made, both the earner and their employer pay a low rate of NICs or receive a minimum payment.

A.12 National insurance contributions are credited to the National Insurance Fund (NIF), from which contributory benefits, including the State Pension, contribution based Job Seekers Allowance and Incapacity Benefit, are paid. There is also provision for any shortage in the NIF to be met by a Government grant. Since 1948, a proportion of NICs have been allocated to the National Health Service, and this was increased in 2003 with around 22 per cent of NICs helping to fund the NHS. Both contributions and contributory benefits are calculated on a weekly basis, although provision is made to apply longer periods where necessary.

The current national insurance contributions system

A.13 There are currently six classes of national insurance contributions (NICs): Classes 1, 1A and 1B for employees and/or their employers; Classes 2 and 4 for the self-employed; and voluntary Class 3 contributions. Receipts of National Insurance in 2006/07 were around £87 billion with the majority coming from Class 1 contributions.

Employees' contributions **A.14** Class 1 NICs are paid on cash and certain cash equivalent earnings above the Primary Threshold (PT), of £100 per week in 2007-08, by employees aged between 16 and state pension age (currently 60 for women and 65 for men) . Employees' Class 1 NICs are paid at

11% on earnings between the PT and the Upper Earnings Limit (UEL), of £670 per week, and at 1% above the UEL. Although employees start to pay NICs on earnings above the PT those who earn between the LEL and PT are treated as having paid NICs on earnings to protect their benefit entitlement.

Contracted-out A.15 The rate is reduced for employees that ‘contract out’ of the State Second Pension in favour of a salary-related or money purchase occupational pension. The reduction is 1.6%.

Married woman’s reduced rate NICs A.16 Before 1977, married women could elect to pay a reduced rate of NICs and receive a basic State Pension based on their husband’s contributions. The right to pay the reduced rate was removed from May 1977 but women who made their election before this date retained their right to pay at a reduced rate unless they :

- divorce or their marriage is annulled
- have two consecutive tax years during which they:
 - have no earnings, as an employee, on which Class 1 contributions are payable or treated as having been paid, and
 - have not been self-employed
- are widowed (the right to the reduced rate ceases at the end of the tax year in which widow’s bereavement benefit ends)
- choose to cancel it.

Deferment A.17 There is a maximum amount of standard rate Class 1 NICs that an employee can pay in a tax year. If an employee has more than one job and expects to pay NICs on earnings at or above the Upper Earnings Limit in that job they can apply to defer paying NICS at the standard rate in another job or Class 2 and 4 NICs if self-employed. However, they will still be liable to pay NICs at 1% in the other jobs on all earnings or profits above the PT or Lower Profit Limit.

Employers’ contributions A.18 Employers pay Class 1 NICs at 12.8% on their employees’ earnings above the Secondary Threshold, including above the UEL. The Secondary Threshold is also set for 2007/2008 at £100. Employers also pay a reduced rate of NICs where the employee contracts out of the State Second Pension. Box A.3 gives some examples of employees’ and employers’ NICs.

Contracted-out A.19 Where an employer runs an occupational pension scheme they are entitled to a reduction in NICs between the Lower Earnings Limit and the Upper Earnings Limit. This is 3.7 per cent for Contracted-out Salary Related schemes and 1.4 per cent for Contracted-out Money Purchase schemes.

Box A.3: Employee and Employer NICs examples

Example 3: Oliver has earnings from employment in 2007-08 of £200 per week; not contracted out of the State Second Pension

- Employee NICs £200 – PT £100 = £100 x 11% = £11 primary Class I NICs
- Employer NICs £200 – SR £100 = £100 x 12.8% = £12.80 secondary Class I NICs

Example 3: Jean has earnings from employment in 2007-08 of £200 per week; contracted out in favour of a Company Salary-Related pension scheme

- Employee NICs £200 – PT £100 = £100 x 11% = £11.00 less £200 – LEL £87 x 1.6% = £9.19 primary Class I NICs
- Employer NICs £200 – ST £100 = £100 x 12.8% = £12.80 less £200 – LEL £87 x 3.7% = £8.62 secondary Class I NICs

Example 5: Hasan has earnings from employment in 2007-08 of £800 per week and is not contracted out of the State Second Pension

- Employee NICs – 11% due from the PT (£100) to the UEL (£670) and 1% above the UEL. (£570 x 11%) + (£130 x 1%) = £64.00 primary Class I NICs due
- Employer NICs – £800 – ST £100 = £700 x 12.8% = £89.60 secondary Class I NICs due

Employees over state pension age **A.20** Although employees don't pay NICs if they are above state pension age their employers pay secondary NICs at 12.8 per cent on earnings above the secondary threshold.

Box A.4: Employee and employer NICs – over State pension age

Example 6: Matthew has earnings from employment in 2007-08 of £200 per week; not contracted out of the State Second Pension. Employee over State Pension age.

- Employee NICs nil
- Employer NICs £200 – SR £100 = £100 x 12.8% = £12.80 secondary Class I NICs

Table letters **A.21** There are a range of different NIC rates that apply in a range of circumstances. And to enable employers to calculate the correct amount of NICs due there are 10 table letters to cover each possible scenario (see Table A.1 for details).

Class 1A and Class 1B NICs **A.22** Class 1A NICs are paid by employers, but not by employees, on income in non-cash forms, primarily taxable benefits in kind such as provision of company cars or private medical insurance. Class 1B NICs are paid by employers on the value of certain items included in a PAYE settlement agreement and on any tax payable under the agreement.

Self-employed contributions **A.23** Classes 2 and 4 NICs are paid by the self-employed. Class 2 is a flat-rate charge, of £2.20 per week, which is payable by all self-employed although those whose profits are expected to be below the Small Earnings Exemption (SEE) of £4,635 can apply not to pay Class 2. Class 2 NICs are paid to the national insurance contributions office either monthly by direct debit or by quarterly bills. Class 4 contributions are charged at 8 per cent on taxable profits, between the Lower Profits Limit (LPL) and Upper Profits Limit (UPL), which are aligned with the PT and UEL across a year at £5,225 and £34,840. Class 4 is paid at 1% on profits above the UPL. Class 4 contributions are collected through the Self-assessment system. Box A.5 gives examples of self-employed NICs.

Box A.5: Self-employed NICs examples**Example 7:** Barbara has self-employed profits in 2007-08 of £20,000

- Class 2 NICs due of £2.20 per week; plus
- Class 4 NICs on £20,000 less LPL £5225 = £14,775 x 8% = £1,182

Example 8: Sam has self-employed profits in 2007-08 of £50,000

- Class 2 NICs due of £2.20 per week; plus
- Class 4 NICs on LPL (£5,225) – UPL (£34,840) £29,615 x 8% = £2,369.20; plus
- 1% x profits over UPL = £15,160 = £151.60

Voluntary contributions **A.24** Class 3 NICs are voluntary contributions that can be paid, at a rate of £7.80 a week, in order to provide benefit entitlement.

How NICs are calculated

A.25 Class 1 NICs are calculated on a pay period by pay period basis usually weekly or monthly and equivalent amounts are set for each of the NICs thresholds (LEL, PT and UEL). This means that the Class 1 liability of an individual is based upon what they are paid in any given pay period without any reference to earlier payments in the tax year, on a non cumulative basis. Earnings are also not cumulated for NICs purposes across employments, so NICs will be based upon the earnings in each separate employment and an employee benefits from a separate thresholds in each job. There is, however, a maximum amount of contribution liability for those earners who have more than one job with an additional 1 per cent payable in excess of the UEL.

A.26 Payment of Classes 1, 2 and 3 NICs is used to determine entitlement to contributory benefits.

Box A.6: Employee and employer NICs in multiple concurrent employments**Example 9:** Mark has two concurrent employments in 2007-08; £150 per week in job 1 and £50 per week in job 2

- Job 1 – employee NICs £150 – PT £100 = £50 x 11% = £5.50 primary Class 1 NICs
- Job 1 – employer NICs £150 – ST £100 = £50 x 12.8% = £6.40 secondary Class 1 NICs
- Job 2 employee and employer NICs nil (under PT/ST)

Income tax and NICs guidance

A.27 There is a large amount of income tax and NICs guidance currently available. Significant steps have been taken to supplying the guidance that HMRC provides to employers. Table A.2 sets out the current range of guidance on HMRC's employers' CD-ROM.

Table A.1: NICs table letters

Letter:	Who it is for:	Rates (2007/08)
A	Not contracted-out	Employee: 11% on earnings between PT – UEL plus 1% over UEL Employer: 12.8% on earnings over ST
B	Not contracted-out and married women’s reduced rate (MWRR)	Employee: 4.85% on earnings between PT and UEL plus 1% over UEL Employer: 12.8% over ST
C	Employee at State Pension age or above	Employee: No NICs Employer: 12.8% on earnings over ST
D	Contracted-out salary-related scheme	Employee: 11% on earnings between PT and UEL with 1.6% rebate from LEL – UEL plus 1% over UEL Employer: 12.8% on earnings above ST with 3.7% rebate from LEL – UEL
E	Contracted-out salary-related scheme and married women’s reduced rate	Employee: 4.85% on earnings between PT and UEL plus 1% above UEL Employer: 12.8% on earnings over ST with 3.7% rebate from LEL – UEL
F	Contracted-out money purchase scheme	Employee: 11% on earnings between PT and UEL with 1.6% rebate from LEL – UEL Employer: 12.8% on earnings above ST with 1.4% rebate from LEL – UEL
G	Contracted-out money purchase scheme and married women’s reduced rate	Employee: 4.85% on earnings between the PT and UEL and 1% above the UEL Employer: 12.8% on earnings above the ST with 1.4% rebate from LEL – UEL
J	Not contracted-out and form CA2700 held (employee already paying Class I NICs to the UEL)	Employee: 1% on all earnings above the PT Employer: 12.8% on all earnings above the ST
L	Contracted-out salary-related scheme and form CA2700 held (employee already paying Class I NICs to the UEL)	Employee: 1% on all earnings above the PT Employer: 12.8% on all earnings above the ST with 3.7% rebate from LEL – UEL
S	Contracted-out money purchase scheme and form CA2700 held (employee already paying Class I NICs to the UEL)	Employee: 1% on all earnings above the PT Employer: 12.8% on all earnings above the ST with 1.4% rebate from LEL – UEL

Table A.2: Current main HMRC guidance on tax and NICs

<i>Title</i>	<i>Tax, NICs or both</i>
P49: Paying someone for the first time	both
E10: Finishing the Tax Year	both
E11: Starting the Tax Year	both
E12: PAYE and NIC Rates and Limits	both
E13: Day to Day Payroll	both
CA44: National Insurance for Company Directors	NICs
P7X: Tax codes - post Budget	tax
P9X: Tax codes from 6 April	tax
CWG 2: Employer Further Guide to PAYE and NICs	both
CWG5: Class IA National Insurance Contributions on benefits in kind	NICs
480: Expenses and Benefits. A Tax Guide	tax
490: Employee Travel – a Tax and NICs Guide	both
CA33: Class IA National Insurance Contributions on Car and Fuel Benefits – A Guide for Employers	NICs
E18: How you can help your employee with childcare	both
E24: Tips, Gratuities, Service Charges and Troncs	both
EECI: Expenses and Benefits Returns on Magnetic Media	tax
PIID Guide	both
PIID (Int): Expenses and Benefits. Details of Official Rates of Interest	both
PIID WS1: Expenses and Benefits Working Sheets – living accommodation	both
PIID WS2: Car and Fuel Benefit	both
PIID WS3: Vans for private use	both
PIID WS4: Interest free/low interest loans	both
PIID WS5: Relocation expenses payments and benefits	both
PIID WS6: Mileage Allowance Payments and Passenger Payments	tax
P46 (Car): Car provided for the private use of an employee or a director	tax
Expenses payments and benefits in kind – how to save yourself work	both

B

PROGRESS IN INCOME TAX AND NICs ALIGNMENT

Taylor Alignments B.1 Since Martin Taylor's report in 1998 there have been significant steps taken to align the tax and NICs systems. In response to that report, the Government made a number of policy changes, including aligning the level of earnings at which individuals begin to pay tax and NICs; these changes are described in more detail in Chapter 2. In addition, the Government also made a series of administrative and technical alignments, including:

- introducing (for the first time) an independent appeal right on NIC decisions to the same body that hears tax appeals – the Tax Commissioners;
- aligning penalty regimes, including the removal of powers and certain NIC only offences;
- extending Class 1A NICs, not only based on the tax rules for determining the cash equivalent of BiKs, but with a single reporting and payment process (P11D and P11D(b)) for both tax and NICs;
- introducing Class 1B NICs in 1998 to collect NICs on items included in a PAYE settlement agreement, and making this apply to the same items on which PSA tax is payable, with aligned reporting and payment processes; and
- aligning the tax treatment of notional payments in respect of tax where no deductions are possible (section 122 ITEPA 2003).

NICs changes B.2 The Government has continued to review how the tax and NICs systems impact on employers and sought to simplify the arrangements where possible. This work has included changes that have been welcomed by employers, including:

- the ability to allow an employer to transfer his secondary liability onto an earner in relation to certain types of employment income; and
- extending the period of time over which an employer can recover under deducted primary NICs from an employee.

Legislative alignments B.3 The Government has a continuing commitment to reduce the administrative burden on employers of operating tax and NICs systems and has, since implementation of the Taylor reforms, continued to review tax and NICs legislation in order to align the rules where possible. Significant progress has been made with NICs legislation introduced to align the following tax and NICs rules. Box B.1 sets these out.

Box B.1: technical NICs alignments

Statutory Instrument / Act	Alignment measure
SI 2001/2412	<ul style="list-style-type: none"> aligned the NICs treatment on certain non-cash vouchers which can be used to obtain meals aligned the treatment of payments made as rewards for the recovery of lost or stolen cards
SI 2002/307	<ul style="list-style-type: none"> alignment, as far as possible, with the new authorised mileage allowance scheme introduced for income tax full alignment with tax treatment of payments in respect of cycles full alignment with tax treatment of passenger payments in employee-owned cars
SI 2003/1059	<ul style="list-style-type: none"> alignment with the tax valuation rules for the acquisition of certain shares
SI 2003/2085	<ul style="list-style-type: none"> further alignments in connection with securities and options for securities
SI 2003/2340	<ul style="list-style-type: none"> disregarding of payments made by way of Incapacity Benefit Return to Work Credits
SI 2003/2958	<ul style="list-style-type: none"> alignment with tax treatment of certain payments included in the calculation of profits chargeable as business profits. alignment of vouchers exemption for disabled employees home to work transport provision of cars for disabled employees certain transport home, car sharing and late night working arrangements works transport services support for public bus services
SI 2003/2958	<ul style="list-style-type: none"> cycles and cyclists' safety equipment travelling and subsistence during public transport strikes annual parties and functions
SI 2003/2958	<ul style="list-style-type: none"> armed forces leave subsidised meals staff suggestions long-service awards small gifts disregarding of payments made to participants in Return to Work Credit Schemes

Box B.1 continued

- | | |
|--------------|---|
| SI 2004/770 | <ul style="list-style-type: none"> • alignment with tax treatment of payments in respect of: • travel between employments where duties performed abroad • travel costs and expenses where duties performed abroad • travel costs of visiting spouses, civil partners and children where duties performed abroad • costs of foreign accommodation and subsistence costs – overseas employment • alignment with income tax of payments in respect of Working Neighbourhood Pilots • alignment with income tax treatment of payments for car parking facilities at or near a place of work • alignment with income tax treatment of payments in respect of subsistence allowances paid by the European Commission to detached national experts |
| SI 2005/728 | <ul style="list-style-type: none"> • alignment with tax of payments made in respect of employee’s attendance for long-term training |
| SI 2005/778 | <ul style="list-style-type: none"> • alignment with tax of childcare exemption – £50 per week and further increases |
| SI 2006/2003 | <ul style="list-style-type: none"> • alignment with tax of treatment for vouchers in respect of eye-care and mobile phones |
| SI 2006/2829 | <ul style="list-style-type: none"> • alignment with tax on new taxation regime for pension schemes |
| SI 2006/2924 | <ul style="list-style-type: none"> • alignment with tax on new HM Forces operational allowances |

Administrative easements B.4 In addition to significant legislative changes, HMRC has introduced administrative changes to reduce the burden of operating tax and NICs and to make it easier for employers to comply with their obligations. Examples of such easements are included in Box B.2.

Box B.2: Administrative easements

- alignment of employers’ dispensations (agreements not to return benefits or expenses where no liability arises) so that they equally apply for NICs as well as tax
- enabling mistimed payments to be accounted for in the first available earnings period
- the introduction of a modified NICs system to match PAYE arrangements for employers who employ higher paid expatriate employees that are fully tax equalised. This gives employers longer to account for PAYE and NICs without incurring penalties and particularly helps employers who have a payroll in the UK but where employees also receive benefits from overseas.
- the integration of HMRC’s banking and dept management systems
- the integration of HMRC’s compliance processes including combined tax and NICs employer compliance reviews
- steps taken so far by HMRC to integrate tax and NICs guidance

Budget 2007 B.5 changes Budget 2007 announced the next stage of tax and national insurance reforms, as part of a rebalancing of the tax system to offer more support for work and families. These changes will simplify the tax system and result, from April 2009, in closer alignment of tax and NICs with tax and NICs being charged on the same bands of earnings for the first time. The changes include from April 2008:

- removing the 10 per cent starting rate band for tax;
- reducing the basic rate of income tax from 22 per cent to 20 per cent; and
- significantly increasing the upper earnings limit and then fully aligning it with the higher rate threshold for income tax from April 2009.

Key external studies

C.1 Studies conducted on employers' administrative burdens/tax and NICs alignment from which the review has drawn include:

- Administrative Burdens: HMRC Measurement Project – KPMG, March 2006
- Proposals to reform National Insurance – Robert Maas, November 2005
- A New Tax Horizon – how to simplify Britain's payroll tax system – British Chambers of Commerce, February 2004
- Review of Payroll Services – Patrick Carter, September 2001
- The Tax Compliance Costs for Employers of PAYE and NI in 1995-96 – Centre for Fiscal Studies, University of Bath, November 1998

Representative bodies seeking further tax and NICs alignment

C.2 Representative groups who have asked the Government for better regulation, including a reduction in employers' administrative burdens or improvements in outcomes for the low paid in the last two years include:

- British Chambers of Commerce – Budget representations in 2006; 2007;
- Greater Manchester Chamber of Commerce – Budget representations in 2006; 2007
- London Chamber of Commerce and Industry – Budget representations in 2006; 2007
- North Staffordshire Chamber of Commerce and Industry – Budget representations in 2006; 2007
- Confederation of British Industry – Technical tax proposals in 2006
- Institute of Chartered Accountants of England and Wales – Budget representations in 2006; 2007
- Chartered Institute of Taxation – Budget representation in 2007; pre-Budget representation in 2006
- Department for Trade and Industry – Budget/Pre-Budget representations in 2006 and 2007
- Quoted Companies Alliance – Budget representations in 2006; 2007
- Forum of Private Businesses – Budget representation in 2006
- Federation of Small Businesses – Budget representations in 2006; 2007
- Small Business Service – Budget representation in 2006
- Institute of Directors – Budget representations in 2006; 2007

- International Association of Bookkeepers – Budget representations in 2006
- The Unquoted Companies Group – Budget representations in 2006; 2007
- UK200 Group Tax Panel – Budget representation in 2006
- Association of British Insurers – Budget representation in 2006; 2007
- Law Society of England and Wales – Budget representation in 2006
- British Retail Consortium – Budget representation in 2007; pre-Budget representation in 2006
- Engineering and Machinery Alliance – Budget representation in 2006
- British Plastics Federation – Budget representation in 2006
- British Rubber Manufacturers Association – Budget representation in 2006
- Industrial Films Association – Budget representation in 2006
- Flexible Packaging Association – Budget representation in 2006

Meetings with stakeholders

C.3 During the course of the review, HM Treasury officials met with various interested parties to gain a better understanding of the issues with tax and NICs, both in terms of the impacts on employers' administrative burdens and effects on low paid workers. The representative groups met were:

ADMINISTRATIVE BURDENS

- Institute of Payroll Professionals
- Confederation of British Industry
- Institute of Chartered Accountants of England and Wales
- British Chambers of Commerce
- Federation of Small Business
- Forum for Private Business
- British Computer Society

Low PAID INDIVIDUALS

- Equal Opportunities Commission
- Trades Union Council
- Low Income Tax Reform Group

D

GLOSSARY

Note: this glossary defines terms as they are used in the main body of the document and not as they appear in existing legislation. Words may have different meanings in other contexts or documents.

- Administrative burdens** The cost to employers of complying with information obligations imposed by the Government
- Administrative Burdens Advisory Board** A panel set up by HM Revenue and Customs to look at how administrative burdens can be reduced
- Aggregation of earnings** Where earnings from multiple concurrent employments are added together
- Allowance** An amount of income an individual can receive before they begin paying income tax
- Annual** a tax year, 6 April to 5 April inclusive
- Basic State Pension** the pension of currently £87.30 per week earned from a full contributions record
- Basis of assessment** the rules which determine how income tax or NICs are calculated by reference to specified periods or events
- Benefit entitlement** what State contributory benefits an individual has earned from the national insurance contributions they have paid or been credited with
- Benefit year** 1 January to 31 December inclusive
- Benefits in kind** non-cash income
- Bereavement benefits** Benefits payable to those widowed since 9 April 2001. From 5 December 2005 extended to include civil partners. Includes a non-taxable lump sum bereavement payment, widowed parent's allowance and bereavement allowance
- Category letter** identifies the appropriate rate of Class 1 NICs
- CD-ROM** refers to a CD-ROM provided by HMRC to employers which contains full guidance, tables and calculators for operating specific payroll functions including tax and NICs obligations
- Class 1 NICs** national insurance contributions payable on cash and non-cash earnings from employment by employees and employers. Employees' contributions earn entitlement to all contributory based benefits, including the Basic State Pension, State Second Pension, Jobseeker's Allowance, Incapacity Benefit and bereavement benefits
- Class 1A NICs** national insurance contributions payable only by employers and some third parties on benefits-in-kind
- Class 1B NICs** national insurance contributions payable by employers only on PAYE Settlement Agreements
- Class 2 NICs** Flat rate national insurance contributions paid by self-employed individuals to gain entitlement to a more limited range of contributory benefits, including Basic State Pension, Incapacity Benefit and bereavement benefits

- Class 3 NICs** voluntary flat-rate national insurance contributions paid to fill gaps in an individual's contribution record. They can be paid up to 6 years after the relevant contribution year
- Class 4 NICs** profit-related national insurance contributions paid by the self-employed
- Contracted out contributions** a reduced rate of Class 1 NICs applying to earnings from employments with approved occupational pension schemes in place of State Second Pension provision
- Contracting-out** the system by which individuals can choose to opt out of State Second Pension and use a proportion of their National Insurance contributions to build up a funded pension
- Contribution record** the record held by the Department for Work and Pensions (DWP) of the amount of national insurance contributions paid by an individual
- Contributory benefits** State benefits earned from the payment of national insurance contributions
- Contributory principle** that people pay insurance contributions while they are in work in order to receive support when they are not working or retired on the basis of those contributions
- Cumulation** a method of calculating the amount an employee is liable to pay in each pay period where there is an annual charge by reference to an accumulating or running balance
- Deduction** where an amount is taken away from a figure of earnings to arrive at a figure of taxable pay
- DWP** Department for Work and Pensions – the Government department responsible for providing contributory benefits
- Disregard** where a figure of earnings is ignored when assessing the amount of national insurance contributions payable
- Earnings** any remuneration or profit derived from employment
- Earnings factor** the criterion for judging whether a person is entitled to contributory benefit, whether they need to pay voluntary Class 3 contributions and their level of entitlement to State Second Pension. Earnings factors are calculated by reference to the amount of national insurance contributions that a person pays or is credited with and, where the person is employed, the level of their earnings
- Earnings period** a period to which earnings are deemed to relate, irrespective of the period over which those earnings are earned. They are used to assess the amount of Class 1 contributions payable and are calculated by reference to the intervals at which earnings are paid
- Earnings Threshold** the level of earnings at which Class 1 NICs become payable
- Emergency code** PAYE code operated by an employer where previous code information is not available for a new employee
- End-of-year returns** The report of earnings, tax and NICs, student loans, statutory payments and contracting out scheme details at the end of each tax year made by employers to HMRC
- Exemption** an amount of earnings not liable for income tax
- Expenses** Amounts paid by employers to employees to meet specific personal or business expenditure incurred

Free pay	the amount of earnings an employee can receive before they begin paying income tax
HMRC	Her Majesty's Revenue and Customs – the Government department that deals with income tax and national insurance contributions
Incapacity benefit	contributory benefit paid to individuals who cannot work due to illness or incapacity, due to be replaced by the new Employment and Support Allowances in 2008
Income tax	system for raising revenue for general Government expenditure
Jobseeker's Allowance	that part of the Job Seekers Allowance that is contributory based and paid to employees with the required contribution record during periods of unemployment
Lower Earnings Limit	The level of earnings at which an employee is treated as if they had paid national insurance contributions but only for the purpose of judging entitlement to contributory benefits. The LEL is currently equivalent to the weekly rate of the Basic State Pension
Lower Profits Limit	The annual amount of profits from self-employment from which Class 4 NICs is due to be paid
Manual payroll	where employers use paper working sheets and tables to calculate income tax deductions and NICs payments on earnings
National Insurance Contributions	contributions paid by employees, employers, the self-employed and others on earnings to maintain the National Insurance Fund
National Insurance credits	a contribution which a person is entitled to have added to his or her contribution record without any payment being made, for the purposes of bringing his or her earnings factor up to the level needed to gain benefit entitlement. Credits are awarded most commonly when a person is in receipt of Jobseeker's Allowance or Incapacity Benefit
National Insurance Fund	a fund into which receipts from national insurance contributions are placed and which is then drawn upon to fund current expenditure on State benefits and pensions. The NHS allocation is diverted before reaching the Fund
PAYE	Pay As You Earn – the system administered by employers and HMRC to collect income tax and national insurance contributions from earnings
PAYE Settlement Agreement (PSA)	agreements between employers and HMRC where the employer chooses to pay the income tax and NICs liability on expenses or benefits that are irregular, small or difficult to operate within reporting structures
PAYE tax code	a combination of letters and numbers which informs the employer of the annual tax-free pay the employee is entitled to receive (or the amount to be added to the taxable pay). It usually consists of the net sum of an individual's tax-free allowances less income or liabilities to be collected through PAYE
Pay period	see earnings period
Payroll software	information technology systems or programmes used to electronically calculate tax and NICs deductions and other payroll functions
Payrolling	term used to describe the process of taxing payments of earnings or benefits through the payroll

- Primary National Insurance contributions** contributions of 11 per cent paid by employees on earnings between the Earnings Threshold and the Upper Earnings limit and 1 per cent on all earnings above the Upper Earnings Limit
- Primary Threshold** see Earnings Threshold
- Rate** the relevant income tax or NICs percentage charge
- Secondary National Insurance contributions** contributions of 12.8 per cent paid by employers on all earnings from the Earnings Threshold
- Small Earnings Exception** the level of earnings from self-employment (currently £4,465 per year) below which a self employed individual can elect not to pay Class 2 NICs
- Standard Cost Model** the method used by HMRC to measure administrative burdens
- State Second Pension** the additional State Pension added to the Basic State Pension that is based on an employee's earnings on which Class 1 NICs have been paid between the Earnings Threshold and the Upper Earnings Limit throughout their working life
- Suffix code** A PAYE code made up of a numerical sum (the tax-free allowance) and a letter that informs what changes the employer makes to the free pay following Budget changes
- Table letter** see category letter
- Taxable pay** the amount of earnings liable to income tax after tax free pay has been deducted
- Upper Earnings Limit** the threshold up to which employees pay Class 1 contributions at the main rate. Class 1 NICs of 1% are payable on all earnings above the UEL
- Upper Profits Limit** the threshold up to which the self employed pay Class 4 contributions on profits at the main Class 4 rate of 8 per cent. Class 4 NICs of 1 per cent are payable on profits above the UPL

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