Office of
Tax Simplification

Review of employee benefits and expenses: second report

January 2014

Office of
Tax Simplification

Review of employee benefits and expenses: second report

January 2014

Official versions of this document are printed on 100% recycled paper. When you have finished with it please recycle it again.

If using an electronic version of the document, please consider the environment and only print the pages which you need and recycle them when you have finished.

ISBN 978-1-909790-71-1
PU1616

Contents

Foreword

This is the second stage of the OTS's journey of exploration and discovery in the world of Employee Benefits and Expenses. Like any good set of explorers, after a time of making new discoveries, we have moved on to bringing back ideas for how to use them to make improvements. That is the aim of this report: it builds on the interim report[1] of August last year and develops recommendations in some of the main areas.

Taxable benefits generate more than £3.3 billion of tax and NICs for the Exchequer; but that takes some 4.4 million P11Ds and a huge administrative effort all round. Over 4 million individual benefits were reported to HMRC; but the number of employees concerned with Employee Benefits and Expenses will be much greater as all those who claim travel expenses are in the ambit. Everyone we have spoken to on this project knows and accepts that giving someone a benefit means there will usually be a tax liability: that is fair and just. The trick is to get to that liability (or an exemption) quickly, efficiently and with certainty.

The current system doesn't really pass those criteria and our aim in this report is to improve matters. HMRC have a significant part to play and we want to see employers supported in their efforts to get things right. Employers have constantly told us that their goal is to settle their liabilities and get on with their businesses: they want to reward their people properly, not to manipulate rules for seeming gain. We want to help them, though we know that there must be appropriate, balanced safeguards against possible abuse.

We now present what we see as the way forward in three of the main areas of this project:

- 'big picture' ideas – longer term, structural reforms;
- HMRC administration; and
- travel and subsistence.

In doing this work, we have been challenged by all those who are interested in our project – Ministers, businesses, advisers and HMRC – to be radical in our thinking so as to try and make a real difference to the administrative burdens in particular. We have done that and this report does point up some radical thoughts: for example, Class 1 national insurance contributions (NICs) on all benefits, a significant widening of PAYE settlement agreements (PSAs) and a general exemption for qualifying business expenses.

But we have not been radical just for the sake of it: on travel and subsistence we have sought and tested radical options to get to a new system that would be better for all concerned. But that philosopher's stone does not seem to exist; whilst we have pointed up one possible route that we think is worth further exploration, our conclusions accord with what most businesses and commentators have said: that the current system does work reasonably well and what is needed is to improve that, not to go through the disruption and uncertainty caused by junking and starting again.

One thing to stress is that the recommendations that follow blend together to achieve our goals: our report is broken down into chapters to make it easier to follow, but there is a good

[1] Available online at the following web address: https://www.gov.uk/government/publications/review-of-employee-benefits-and-expenses-interim-report

deal of overlap and meshing together across chapters and themes. For example, payrolling, the qualifying business expenses exemption and a standard trivial benefits rule all push in the same direction: less reporting and more streamlined processes. NIC reforms would also facilitate this.

In framing our recommendations we have responded to the evidence we have found in another wide ranging set of meetings and workshops and the many comments and submissions received (for all of which we are very grateful): We found that we have had views from almost all of the FTSE 100 companies, directly or indirectly; at the other end of the scale the ideas we had from a third year group of students at the University of Central Lancashire, developed during their degree course, were creative and valuable. We think our recommendations provide a balanced, progressive, modernising package which can be summarised as a goal of reducing the current number of P11Ds from around 4.4 million a year to a much smaller figure; perhaps a target of a 99 per cent reduction?

That gets us to an overriding point we need to make about our conclusions. We think there is a need for HMRC to take a more facilitative, encouraging and constructive approach in these areas. In a number of areas we have suggested there is a need for HMRC to develop guidance and illustrations – and then commit to keeping those examples and helpsheets up to date as new points come up. The current rules have a tendency to put the entire onus on the employer to research rules and take decisions on what is to be taxed. That only works up to a point: Employee Benefits and Expenses needs to be seen as an area for joint responsibility and working. We are not in any way saying that HMRC has been shirking its responsibilities, but there has been a tendency (perhaps influenced by pressure on HMRC resources) to revert to a passive, checking and controlling stance. We think that investment of modest resource in producing more live and current guidance may cost some HMRC time and money initially but it will lead to a real payback in a short timeframe.

So what happens next?

We have not finished our work in this area. We want to do more on topics such as accommodation and termination payments. There are ideas in this report that will no doubt attract input and comment and we want to be involved in how our recommendations are taken forward, which we expect will be by formal consultation. But for the moment we are pleased to submit this report to the Chancellor and Treasury Ministers for their consideration and decision on how to proceed. We look forward to their responses, potentially in Budget 2014.

This report could not have been written without the efforts and support from the many people we have met, questioned and debated with, and who have sent us such a range of thoughts and experiences. HMRC staff are among that group of active participants: we have benefited from their front-line knowledge in the same way that we have drawn so much from the views and experiences of employers. We thank them all but we thank especially our Consultative Committee who have continued to be a valuable source of guidance and challenge. But most of all we thank the team who have done the work: our four secondees, Tracey Bowler, Theresa Dendy, Suzy Giele and Michael Wilson plus the tireless input, support and coordination of Jayesh Patel. Well done all.

Rt Hon Michael Jack

Chairman

John Whiting

Tax Director

Executive summary

Introduction

This is the second report of the OTS project on employee benefits and expenses (EBE), following our interim report[1] published in August 2013. As part of that report, we set out 43 'Quick Wins' – minor changes that we thought could be implemented quickly, but that had the potential to make big differences.[2]

We have built on our interim report by undertaking further research, including speaking to businesses of all sizes, from a range of sectors, located up and down the country. The additional work has helped to identify in more detail why the current rules and processes are complex and burdensome.

However, our work during the second stage of the review has been focussed on identifying and developing solutions, especially in response to areas of the employee benefits and expenses system where change is long overdue. We have set out our recommendations throughout eight chapters.

We have not had time to look again at two areas of complexity highlighted in our interim report – accommodation benefits and termination payments. We will publish reports on these in the next few months.

The size of the issue

It is worth restating some of the statistics from our interim report, to give an indication of the size and importance of the area we are dealing with. HMRC figures for 2012-13 show:

- taxable benefits generate more than £3.3 billion of tax and NICs for the Exchequer;
- over 4 million individual benefits reported (500,000 of which were for under £100);
- 4.4 million P11D forms filed annually; and
- it is impossible to measure how many individuals are affected due to exemptions.

Employers and their staff are well aware that if a benefit is provided, then a tax liability will result, unless it qualifies for exemption. They want to be able to settle that liability efficiently and with the minimum amount of reporting and administration. HMRC need to be able to police the system. Accordingly, the overall objectives for this stage of our work have been:

- to look for ways of modernising the systems and ensuring they are in tune with the employment patterns of today; we have also tried to think about emerging employment trends;
- to reduce administrative burdens all round: to streamline (or preferably eliminate) procedures that can be delivered more efficiently; and

[1] Available online at the following web address: https://www.gov.uk/government/publications/review-of-employee-benefits-and-expenses-interim-report

[2] An update on our 'Quick Wins' can be found at the following web address: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263822/Quick_Wins_Annex.pdf

- to increase certainty for employers in the rules and regulations that govern the Employee Benefits and Expenses system.

The target we have in mind is to reduce very substantially the numbers of P11D forms that are completed. That is not the only change we want to achieve, but it is a way of measuring our potential impact. We think the changes we propose could eliminate 99 per cent of today's P11Ds, saving vast amounts of time and effort for employers, agents and HMRC.

Collective effects

Below is a summary of the main recommendations in each chapter. Whilst each recommendation or each chapter can be considered individually – and would still create a more simplified system when implemented individually – collectively our recommendations dovetail and complement each other, combining to create additional gains.

An example is our longer term recommendation to look at applying Class 1 National Insurance to all employee remuneration (whether cash or benefits in kind). This corresponds synergistically with another proposal to ease restrictions on the ability of employers to payroll benefits. Another synergy is that our recommendation to introduce a small benefits exemption limits the number of people that might have concerns about consulting on the best way to remove the £8,500 threshold, and removing the threshold also makes payrolling of benefits easier.

Revenue impacts

We are mindful of the general guideline the OTS has of coming up with a balanced package of recommendations in revenue terms. Decisions on which of our recommendations to take forward are of course up to Ministers, and at that stage there will be careful consideration of revenue impacts. We therefore aim to produce recommendations that have regard to revenue impacts. In this report, we are well aware that a number of our proposals will have revenue impacts, possibly significant, for example:

- if all benefits are subjected to Class 1 NICs, that would naturally increase NICs take but that could be matched by a pragmatic cut in NIC rates;
- introducing a general trivial benefits exemption would cost the Exchequer some income, but would save considerable administrative effort all round;
- widening PSAs would potentially bring in some extra income for HMRC but would have some limited impact on taxpayers' positions over benefit entitlements; and
- our proposals for travel expenses could involve a revenue cost, depending on which options are taken forward.

We hope we have given sufficient recognition to the revenue implications to enable decisions to be taken on which items to take forward. The next stage would then include more formal costings of the ideas.

Chapter 1 – Voluntary payrolling of benefits

At the moment, all taxable benefits have to be reported by employers to HMRC after the end of the tax year. This involves employers sending in around 4.4 million forms P11D every year which have to be processed by HMRC and used to amend PAYE tax codes.

The overwhelming feedback we have received from employers is that they want to be able to process more benefits via monthly payroll rather than the current process of submitting end of

year P11D forms. **Our recommendation is to introduce a legislative framework to permit employers to payroll some or all of their benefits and expenses on a voluntary basis.**

This raises three key questions, all on a theme of 'all or choose':

- should payrolling be compulsory for all employers?
- if an employer payrolls, should it be compulsory for all benefits?
- if an employer payrolls a benefit, should it be compulsory for all relevant employees?

We think that the answer to two of these questions is clear; the other is more nuanced:

1 employers must be able to choose; payrolling will not work for all;

2 again, there must be a measure of choice as payrolling for some benefits (e.g. loans) would be difficult. However, whether there should be a 'set list' is more debateable – on balance we think this should be a free choice; and

3 if an employer chooses to payroll a benefit (say medical cover), it must be payrolled for all employees who receive that benefit.

Employers would be able to continue to pay Class 1A NICs in respect of the payrolled benefits after the end of the tax year, but legislation could be introduced which would permit them to pay the Class 1A NICs on a monthly basis, as part of the payrolling process.

This new framework should be supported with clear HMRC guidance, including detailed information on how employers could payroll specific benefits. There would also be a streamlining of HMRC processes to remove benefits more quickly from the employee's tax code when HMRC has been notified that the benefit is either being payrolled or is no longer being received by the employee. The general stance should be one of encouragement and facilitation to employers to move to payrolling, but without any suggestion of compulsion.

This is a simplification because it would lead to employers having to complete and submit fewer P11Ds and HMRC having to process fewer P11Ds. Moreover, the process would be easier for employees to understand. It is a natural complement to Real Time Information (RTI).

From May to October 2013, HMRC operated a pilot with four large employers to try and understand the most efficient approach for payrolling benefits and expenses. **The pilot has produced positive findings, but to take this recommendation to the next level, we would welcome extending the pilot.**

It is worth noting that our target is for the great majority of benefits and expenses to be payrolled, with this approach becoming the norm. It is also worth noting that once an employer begins payrolling it would not be operationally easy for them to revert back.

Chapter 2 – Broadening PAYE Settlement Agreements

A PAYE Settlement Agreement (PSA) essentially allows an employer to make one annual payment to cover all the income tax and NICs due on employees' taxable expenses or benefits which are minor or irregular. We have been told by many businesses – particularly large employers – that, despite the fact that PSAs are expensive (due to having to gross up the tax on the benefit) they find PSAs extremely helpful. However, we have heard widespread criticism of both the scope of PSAs and the process and guidance for employers in agreeing them with HMRC.

Our recommendation is that the scope of PSAs should be widened to permit employers to settle any tax liability on benefits and expenses. This has to be the simplest rule.

Furthermore, we recommend that the process for employers entering into PSAs should be streamlined, by adding PSAs to HMRC's PAYE Online service for employers and offering standardised categories of expenses and benefits which are capable of being included in a PSA. In essence **there should be no need in this era of self assessment to seek HMRC prior approval for what can be included in a PSA**. Prior approval also seems to be in conflict with today's self assessment ethos, as we discuss further in Chapter 3, 'An exemption for qualifying business expenses'.

However, we recognise that allowing employers to PSA almost everything has a potential impact at both ends of the income scale. Tax free childcare, tax credits, tax on child benefit and withdrawal of personal allowances could all be affected by a decision to PSA a benefit. We think that concerns that employers deliberately engineer advantages to their employees by PSAs (a possibility widely derided by employer groups) are manageable with a simple anti-avoidance measure. That would penalise an employer who enters into a PSA with the sole or main purpose of enhancing an employee's entitlement to benefits. We suggest an alternative route if this risk is shown to be too great.

Overall, we think that PSAs are generally something businesses find helpful and HMRC's stance should be to help businesses use them and justify items that cannot be included in PSAs, rather than permit inclusion of specified items.

Chapter 3 – An exemption for qualifying business expenses

Currently unless an employer goes through the process of applying for a P11D dispensation they have to report all expenses not covered by a specific exemption on the employee's P11D, regardless of whether a deduction is available. Unless the employee makes a corresponding claim for tax relief, the expenses will be included in the employee's PAYE code. So even if there is ultimately no tax due, two forms have to be completed and processed for that position to be reached.

Dispensations are in principle a way of streamlining the process. However, they are not a universal panacea:

- they can quickly become outdated with changing circumstances;
- they still require employers to carefully monitor their expenses so as not to breach the terms of the dispensation;
- dispensations that have been issued are not consistent (with regards to which items are allowed);
- they are not (contrary to what many employers believe) an HMRC 'stamp of approval' on their systems; and
- some employers don't understand this concept.

Overall, employers would find it easier to have sufficient guidance to help them determine which expenses are taxable and only have to report those to HMRC. Accordingly, **we recommend that an exemption is added to the legislation for qualifying business expenses paid for or reimbursed by an employer**. The aim is to replace the dispensation process with a more modern, practical approach. The exemption should be written to cover all the routine business expenses that can currently be included in a P11D dispensation. This could be a simple piece of legislation that

makes reference to the sections of the legislation that already allow a deduction for qualifying expenses. The primary legislation or regulations should then set out the minimum record keeping required by employers for the exemption to apply.

The exemption should apply to all employers and employees who meet the minimum record keeping requirements. Employers would no longer need to apply for a P11D dispensation.

Employees who do not have their business expenses paid for or reimbursed by their employer should still be allowed to claim a deduction as allowed by current legislation.

This recommendation relies on HMRC increasing the support and guidance available to employers, especially during the early years of the new policy being introduced, and developing the guidance as new questions and issues emerge. Removing the dispensation process should free up HMRC resources that could provide the extra support required.

Chapter 4 – Abolition of the £8,500 threshold

This threshold prevents employees earning below this annual rate from being taxed on certain benefits in kind. It also results in two different tax regimes, because employees earning below the threshold require their benefits and expenses to be submitted on a P9D form, whereas for the vast majority a P11D form is used.

As outlined in our interim report, the £8,500 threshold has remained at the same level since 1979, when £8,500 was considered to be broadly equal to the level at which a married man started paying tax at the higher rates. This is clearly no longer the case, and with the personal allowance due to rise to £10,000 in April 2014, the reason for retaining the threshold is even less relevant. Indeed, most employers have told us that they no longer use P9Ds due to the burden of conducting a separate threshold calculation for those employees who might fall below the threshold, and having to complete a rarely used unfamiliar form.[3]

Its abolition is an obvious simplification and our interim report said as much. Our work since then has been orientated towards researching groups of employees who would really be affected. We are well aware that in principle employees would end up paying more income tax and NICs, but who are they – and what are their circumstances? Chapter 4 details the groups that might be adversely impacted – as well as some of the potential mitigating actions. The groups discussed in the chapter include part-time employees and carers, volunteers, and ministers of religion. We note that as far as volunteers are concerned (a particular issue for the charity sector) the answer is a better definition on when someone is a volunteer, and what expenses can be paid to them – this is not really an issue around the £8,500 limit.

Overall, we recommend that the £8,500 threshold should be abolished, but with some simple mitigating steps to help some of those affected, and a consultation to confirm the mitigating steps.

Chapter 5 – Trivial benefits and other administrative burdens

We have heard time and time again from businesses that what counts as trivial is not defined clearly enough and that various restrictions lead to inconsistent practice. **We recommend redefining in law a short, easy to understand 'principles based' definition of a trivial benefit, incorporating a per item cap** (e.g. £50).

[3] HMRC statistics suggest around 15,000 P9Ds are completed annually.

Whilst such a proposal carries a risk that businesses will provide extra benefits to their employees, in reality commercial common sense is likely to rule, and rules could be implemented to prevent or limit abuse. A 'principles based' definition could, for instance, be something along the lines of "infrequent provision" to guard against a perceived risk that employers might start to avoid tax by giving repeated small benefits.

Essentially, clearer and more rational rules about what counts as a trivial benefit could simplify decision making for employers, dramatically reduce the number of P11Ds employers are required to submit, and the amount HMRC need to process.

We have learnt that some employers submit 'nil P11Ds' as a way of informing HMRC that a benefit has ceased. Chapter 5 suggests alternative less burdensome methods.

Chapter 5 also suggests ways in which the usage and processing of flat rate expenses (FREs) can be improved.

We discovered that there was a lack of awareness among smaller employers in particular about employee benefits and expenses. Chapter 5 suggests how to improve this situation.

Chapter 6 – Travel and subsistence

Chapter 6 sets out some pressure points within the current system and recommendations to address these (summarised in the paragraphs below). This accords with our main finding in this area:

- that the system does work in most cases for most employees;
- but that there are difficulties in areas such as the '24 month rule' and employees attending multiple workplaces; and
- overall, employers do not want a major change but think that steady improvement of the existing system is the best route.

Increasingly, employees are required to attend more than one company office or site – frequently and/or infrequently. But the current rules for such situations are not easy to interpret. We recommend that a clearer definition of a permanent workplace is brought into the legislation. **Our preference from a simplification point of view is to have a rule that says an employee can have only one permanent workplace, being the place where they spend the greatest part of their working time. However, if costings show that this route would be too expensive for the Exchequer, we recommend amending Section 339 ITEPA 2003[4] to redefine "permanent" and "temporary" workplace by introducing a statutory percentage test, probably at 30 per cent.**

At the moment, if an employer sends an employee on assignment to a different location (a temporary workplace), the deductibility of travel and subsistence expenses associated with temporary workplace depends on the intention at the start of the assignment rather than the actual final length. To provide more clarity and certainty, and **provided the conditions of Section 339(3) ITEPA 2003 are met, we suggest permitting a deduction for the first 24 months regardless of the intended length of the assignment**.

Homeworking is an area currently dealt with by a combination of different tax provisions (listed in Chapter 6). **Our recommendation is to implement a specific code for homeworkers with one**

[4] Income Tax (Earnings and Pensions) Act 2003.

clear definition of homeworking for all tax purposes. The code would distinguish between employees who work from home because they can, and those who have a genuine business need. Where there is a genuine business need to work from home, relief for travel expenses would follow our proposal above regarding the definition of a permanent and temporary workplace. A further recommendation is to remove the facility for employees to claim the cost of expenses in working from home not covered by employers e.g. telephone bills, internet, utility bills, but provide an uplifted homeworking allowance (to £10 a week for example). This would be payable free of tax/NICs where the employee meets the definition of a homeworker.

Stakeholders have expressed concern that there is no legislation relating to the payment or reimbursement of subsistence expenditure. We therefore recommend that a section is added to ITEPA 2003 referring to 'accommodation and subsistence expenses'. For example, to permit a deduction from earnings for accommodation and subsistence if an employee is obliged to incur and pay them as a holder of the employment, and the expenses are necessarily incurred in relation to Sections 337 and 338 of ITEPA 2003.

The current legislation does not allow living accommodation in employer owned or rented accommodation to be included in a P11D dispensation. This is problematic when accommodation is provided for an employee attending a temporary workplace. We recommend that where a deduction is available for attendance at a temporary workplace, living accommodation should be included in a P11D dispensation whether provided through hotel accommodation or use of a company flat (or equivalent).

In addition to the above, Chapter 6 puts forward a number of recommendations to improve guidance. These are:

- updated guidance, particularly a new version of HMRC's guidance on travel expenses, booklet 490, to be taken forward by a working group representative of industry bodies; and
- in relation to benchmark scale rates, the guidance around ongoing checks is amended to remove the requirement for employers to retain receipts and only require them to be able to demonstrate that the employee is attending a temporary workplace. However, the current checking regime should remain where the payment of benchmark scale rate payments are used as part of a salary sacrifice arrangement.

A number of radical solutions are discussed, but we believe that only one of these might be worth exploring further. This is to remove the current system and introduce a completely new legislative system whereby all travel and subsistence expenses[5] would be allowable if reimbursed by the employer. We would be interested in reactions to this possible reform. We have tested it during some of our meetings and the comments received indicate an interest in considering it properly. We recommend a formal, comprehensive study is carried out on this possible radical change to test the issues further and assess its potential impact.

There are some areas, for example foreign travel rules, where we have not been able to do sufficient work to arrive at recommendations. We propose to consider these further in the next phase of our work.

[5] (Possibly not including ordinary commuting.)

Chapter 7 – Simplifying NICs – what more can be done?

Many of the complexities in the current EBE system derive from the two systems of NICs and income tax. We believe two proposals – both with a lot of potential to achieve simplification – are achievable longer term ambitions. In putting these forward we are in effect reiterating recommendations we have made in the past,[6] but refining and focussing aspects of our previous proposals.

One proposal is to explore further the case for applying Class 1 NICs to all employee remuneration (whether cash or benefits in kind). At the moment, having a separate Class 1A is seen by many people as distorting, unfair, and administratively complex. It is questionable whether different treatments of types of reward by the tax system is appropriate. Of course, such a change would have an impact on the amount of NICs some employees pay and would increase the NICs take. Work needs to be done on determining the real impact on employees and how the basis for compensating adjustments could be made (the simplest possibly being a pragmatic cut to NICs rates).

Another proposal is the alignment of the underlying definitions of income and expenses. This means aligning the bases on which income tax and NICs are calculated, such that the basis for charging NICs should replicate as far as possible that for income tax. Where the rules are currently applied in the same way the NICs and income tax guidance should be consistent and ideally say the same. If there are differences, these should be clear and well understood; the principle must be that the definitions dovetail and that there is a commitment not to introduce any new differences. Chapter 7 sets out some of the main situations that this change is designed to help, for instance, when accounting for mixed used assets. We also remain of the view that a major simplification benefit would result from resolving the time period differences (the fact that NICs are weekly and non-cumulative and income tax is annual and cumulative): this could facilitate our other proposals (for example payrolling). However, even without this, further alignment of the underlying rules would simplify the system for employers and employees.

These proposals would lead to simplification because they address the differing ways in which income tax and national insurance are applied to benefits – so that payments are easier to calculate, the system is simpler to understand, and outcomes are fairer.

Chapter 8 – A fundamental policy review?

We have heard from many people that confusion is caused by the current system applying different tax treatment to the same benefit simply as a result of the underlying mechanics used to provide the benefit. We have also heard of various instances where an employee is liable for tax on some things which neither the employer nor the employee (nor the man in the street) would call a "benefit". Examples are staying in basic accommodation whilst carrying out a job on-site, or private health insurance for people asked to travel to countries where there is only very basic public health care. In other cases, relief enabling a benefit to be provided in one set of circumstances is seen as distorting in other cases, or it is seen as being out of line with modern working. One particular example we explore is the treatment of training costs.

Chapter 8 analyses the situation, using examples, in more depth. **We recommend a fundamental review of the government policy on what is and what is not a taxable benefit. This should look at whether the way a benefit is provided should determine how much tax is paid on it, and whether a principle could be developed to enable items which should not be treated as taxable**

[6] See our report on small business available at the following web address: https://www.gov.uk/government/publications/small-business-tax-review

benefits to be excluded from charge. We also recommend that a review is undertaken by HM Treasury and HMRC of specific policy based reliefs to determine whether the policy objectives are still being met. More specifically we recommend a review of the treatment of training expenses.

Next steps and outcomes

Our recommendations provide a programme of work – across the short, medium and long term horizons. We envisage that some of the recommendations are likely to be taken forward as part of the Budget 2014 process, whilst others are longer term issues to be taken forward in the next parliament.

Throughout the project we have liaised closely with HM Treasury and HMRC – to discuss if what we are proposing is politically, financially and operationally feasible – and we will continue to liaise with both organisations to check on how our recommendations have progressed.

In the longer term we will know if our package of measures has worked, because the amount of P11Ds and queries to HMRC regarding benefits and expenses should significantly reduce. The ideal might be to set a target that the number of P11Ds is reduced by (say) 99 per cent by a set date.

List of main recommendations

HMRC administration (Chapters 1 to 5)

- A legislative framework to permit employers to payroll some or all of their benefits and expenses on a voluntary basis (Chapter 1);
- The scope of PSAs should be widened to permit employers to settle any tax liability on benefits and expenses (Chapter 2);
- Exemption to be added to the legislation for qualifying business expenses paid for or reimbursed by an employer (Chapter 3);
- The £8,500 threshold should be abolished, but with some simple mitigating steps to help some of those affected, and a consultation to confirm the mitigating steps (Chapter 4);
- Redefining in law a short, easy to understand 'principles based' definition of a trivial benefit, incorporating a per item cap, probably at £50 (Chapter 5);
- We make a number of recommendations to reduce the number of 'nil P11Ds', including that the form should allow employers to indicate if a benefit is a one-off (Chapter 5);
- Flat rate expenses (FREs) need to be reviewed and updated, and employers allowed to include employees' claims through the payroll (Chapter 5); and
- HMRC's website should have a simple initial guide to employer's obligations with all relevant links (Chapter 5).

Travel and subsistence (Chapter 6)

- Legislation stating an employee can have only one permanent workplace, being the place where they spend the greatest part of their working time. However, if costings show that this route would be too expensive for the Exchequer, we recommend amending Section 339 ITEPA 2003 to redefine "permanent" and "temporary" workplace by introducing a statutory percentage test, probably at 30 per cent;
- A deduction for travel and subsistence expenses associated with a temporary workplace for the first 24 months regardless of the intended length of an assignment;
- A specific code for homeworkers with one clear definition of homeworking for all tax purposes;
- Remove the facility for employees to claim the cost of expenses not reimbursed by employers in working from home, but provide an uplifted homeworking allowance, for example £10 per week;
- A section added to ITEPA 2003 referring to 'accommodation and subsistence expenses';
- In relation to benchmark scale rates, the guidance around ongoing checks should be amended to remove the requirement for employers to retain receipts;

- Consideration is given to an exercise to modernise the rules for workplace lunches and canteens to improve consistency;
- Where a deduction is available for attendance at a temporary workplace, living accommodation should be included in a P11D dispensation whether provided through hotel accommodation or use of a company flat (or equivalent);
- A formal, comprehensive study is carried out on the possible radical idea of all travel and subsistence expenses (possibly not including ordinary commuting), being allowable only if reimbursed by the employer; and
- A formal review of tax reliefs for travel and subsistence should take place every ten years to make sure the system fully recognises changing work patterns.

Longer term projects: structural changes (Chapters 7 and 8)

- Alignment of the underlying definitions of income and expenses for income tax and NICs. This means aligning the bases on which income tax and NICs are calculated, such that the basis for charging NICs should replicate as far as possible that for income tax (Chapter 7);
- The process should also look properly at the arguments for moving NICs onto an annual, cumulative basis (Chapter 7);
- The HMRC guidance provided for NICs and income tax should be reviewed and made consistent where possible (Chapter 7);
- Explore further the case for applying Class 1 NICs to all employee remuneration (whether cash or benefits in kind) (Chapter 7); and
- Fundamental review of the government policy on benefits. This should look at whether the government wants to tax cash or cash equivalents differently, whether the way a benefit is provided should determine how much tax is paid on it, and the question of what is a benefit and what is not (Chapter 8).

1 Payrolling of benefits

Recommendation

1.1 **Our recommendation is that a legislative framework is introduced specifically to permit employers to payroll some or all of their employee benefits (including expenses not covered by an exemption or dispensation).** Under this, employers would be free to choose whether to payroll or not: there would be no compulsion either way. However, if they did choose to payroll, they would in principle have to payroll the benefits for all their employees. The target should be that the great majority of benefits are payrolled.[1]

1.2 Alongside this the legislative framework would be revised so that employers would no longer be required to file a form P11D in relation to benefits which are being payrolled (although employees will still need to be provided with a clear notification from their employer of the benefits that they have received during the tax year).

1.3 This broad recommendation raises some important issues that will need to be explored more fully during consultation on the mechanics:

- Should employers have a free choice which benefits to payroll? This would be the preference of most employers we have spoken to, but consultation needs to test whether (initially at least) there will need to be a list of 'payrolled benefits' and 'non payrolled benefits' until experience is assimilated on all sides;
- Should payrolled benefits be subject to Class 1 NICs or (as now) Class 1A NICs? This chapter proceeds on the basis that Class 1A will continue to apply; we discuss this issue in more detail in Chapter 7; and
- Should the Class 1A contributions be paid in line with normal PAYE/NICs during the year or (as now) after the year end? We think logic and simplicity means that the Class 1A NICs should be paid on a monthly basis, as part of the payrolling process. However, employers could continue to pay their Class 1A NICs in respect of the payrolled benefits after the end of the tax year.

1.4 **This new framework would be supported with clear HMRC guidance, including detailed information on how employers could payroll specific benefits. There would also be a streamlining of HMRC processes to remove benefits more quickly from the employee's tax code when HMRC has been notified that the benefit is either being payrolled or is no longer being received by the employee. The mechanics for payrolling benefits should include a clear process for handling errors and an effective integration with Real Time Information (RTI).**[3]

Background

1.5 By 'payrolling', we mean a process whereby the value of a taxable benefit in kind is added to salary and charged to PAYE/NICs as part of the normal process. The tax (and probably the NICs)

[1] Note that if medical cover, cars/vans and motor fuel are payrolled, that covers 81 per cent of the income tax and NICs revenues from employee benefits.

due is collected as part of the usual payroll routines. The employee will lose cash monthly instead of paying the tax on the benefit after the year end – though in most cases, once PAYE codes have caught up, there is no real difference in the employee's monthly tax payments.

1.6 There is a general consensus among those we spoke to that if employers were able to payroll benefits, that could offer considerable administrative savings for employers, HMRC and also employees. This treatment would be simpler and in many ways more logical for employees; employers could dispense with reporting the benefits on form P11D; HMRC would no longer have to process the P11Ds, change tax codes and collect tax outside the immediate PAYE system on many benefits.

1.7 Despite the fact that there is currently no legislative framework which specifically provides for payrolling benefits, business practice is already forging ahead with this, with a significant number of employers choosing to payroll benefits because they have recognised that it offers reduced administration for them and increased clarity for their employees. We understand from HMRC that over 3,000 employers already payroll some of their benefits (whilst also complying with their existing obligations to complete P11Ds in relation to these benefits).

1.8 The overwhelming feedback that we have received is that more employers would like to be able to payroll at least some of the benefits that they offer.

Benefits of payrolling

1.9 As highlighted in our interim report, the current system of reporting and taxing employee benefits and expenses presents some major problems, many of which would be alleviated if they were payrolled instead.

1.10 We have been told that payrolling of benefits has proved popular with employees, as it is easier for them to understand how and when they pay tax on their benefits, particularly as the concept of paying tax at the time that they "enjoy" the benefit is in line with the approach of paying tax via PAYE.

1.11 The current system of coding benefits into the employee's tax code is opaque and subject to time delays. Where a benefit starts being paid part-way through the year and there is a long delay in adjusting his or her tax code, the result can be that the employee is suddenly faced with perhaps two or three years' of tax being imposed at the same time in relation to that benefit. Similarly, if the employer stops providing the benefit or if the employee leaves the employment, then the benefit often remains in the tax code for some time. If the benefit is payrolled, then it can be removed from the employee's tax affairs immediately, and as a result the current problems and confusions which arise from the benefit being in the employee's tax code will no longer apply.[2]

1.12 For many employers there is a huge administrative burden from May to July each year in completing P11Ds, with companies having to devote extra resources to this (whether through diverting staff from their normal roles in order to concentrate on this, or getting extra staff in, or outsourcing it). This tends to be costly financially and/or costly to the business.

1.13 We think the concept of payrolling fits naturally with RTI.[3]

[2] We have heard from agents and employers that there can often be problems in practice in getting HMRC to remove an item from the tax code, with delays of as much as a year before the tax code is adjusted. At a minimum, the process is time consuming all round and prone to further errors over timing. If payrolling is not taken forward, this issue needs to be addressed as part of our recommendation.

[3] RTI will result in monthly reporting of employee information by employers. Under RTI, payrolled benefits are notified as a separate information item (under paragraph 26 of Schedule A1 of The Income Tax (Pay As You Earn) Regulations 2003 (SI 2003/2682)) and do not count towards certain state benefits.

HMRC voluntary payrolling pilot

1.14 From 1 May to 31 October 2013, HMRC's Personal Tax and Large Business Service has operated a pilot with four large employers who already operated PAYE on their employees' benefits via payroll. The purpose of the pilot was to test possible ways to reduce costs and administration by removing the P11D reporting requirement in relation to payrolled benefits and to understand the most efficient approach for payrolling benefits and expenses for companies generally. The pilot process included looking at which benefits the pilot employers chose to payroll, how they valued them, and any issues which arose for their employees. HMRC has since been asking those employers for their feedback, which we understand has been positive, with reports of reduced administration for employers, and increased clarity for employees.

1.15 This pilot has assisted in identifying what steps need to be taken in order to allow for voluntary payrolling on a widespread basis, and has highlighted the cost savings involved, particularly as a result of no longer needing to file a P11D.

Obstacles to payrolling benefits and expenses

Obstacles for particular employers

1.16 As we noted in our interim report, HMRC's previous consultation on payrolling employee benefits in 2007-08 primarily failed because it proposed that payrolling of employee benefits was introduced on a mandatory basis. Although for many businesses, payrolling benefits will be a huge simplification, there will be some employers for which payrolling will present a greater administrative burden as it requires them to deal with benefits in real time on a monthly basis rather than after the end of the tax year. This is particularly likely to be the case for smaller businesses and this issue led to the dropping of the previous payrolling proposal.

1.17 Although, as we have highlighted above, business practices have moved on considerably since then, and payrolling is becoming more popular, it is clearly still the case that for many employers, particularly the smaller businesses, it will not be practical to payroll any benefits at present. For this reason we are recommending that payrolling of benefits is introduced on a voluntary basis. In simple terms employers would either payroll or not.

1.18 We think as experience is accumulated with payrolling, it will be seen as a simple process and more employers will want to join. We therefore recommend that HMRC take an encouraging stance to payrolling, ensuring simple guidance on procedures is generated and made available. However, we would stress that we do not recommend compulsory payrolling, or envisage it will become compulsory in the foreseeable future, though we envisage that in time most employers will embrace it.

Employee views

1.19 Employers who already payroll some benefits told the OTS in meetings that they have found no problems with employees. They acknowledge that there is a communications issue – and this is particularly key in relation to employees who only have some of their benefits payrolled, where there might otherwise be scope for some confusion. However, employees generally find it easy to understand what is going on. Paying tax on benefits monthly seems logical.

1.20 Paying the tax directly through the payroll is clearer and easier to follow for many than through tax code adjustments. However much effort HMRC put into producing clearer coding notices – and we readily acknowledge the strides that have been made – most employees still do not really understand them and their implications.

1.21 There is also a significant benefit for employees who are able to choose benefits through salary sacrifice or similar arrangements. Finding that their employer has reported the benefit on a P11D often leads the employee to feel they are being charged twice for the benefit. Again, payrolling is more transparent.

1.22 Having said that, some employees will feel that they are being asked to pay the tax on their benefits more quickly through payrolling. The alternative may be perceived as a tax bill after the year end.

1.23 This could be an issue for those employees who are lower paid and may have particular cash flow problems if they receive a one-off benefit which is then taxed through payroll. If an employer is considering whether it will be appropriate to payroll a benefit, it will always need to consider the impact on its workforce and any HR implications.

1.24 However, the reality is that for established benefits, tax is paid monthly already via the tax code. This needs to be pointed out to any concerned employers/employees/representative bodies. The 'one off' issue is acknowledged: the simple answer may be that such benefits are not suitable for payrolling and will be an item for the residual P11D process.

1.25 It has also been suggested to us (by HMRC) that allowing employers to choose whether or not to payroll will cause confusion among employees, particularly when an individual changes employers who may have different payrolling practices. We have discussed this with employers and they confirm our view that this would not be an issue. Employers, through their HR function (however rudimentary) will explain to employees their pay and benefits package; it would be a simple additional sentence (orally and in the employment contract) to say whether benefits paid are payrolled or not together with the tax consequences.

Impact of the £8,500 threshold

1.26 The existing £8,500 threshold may present an obstacle to payrolling of benefits for some employers, due to the regime which imposes different tax treatment for employees earning above and below this amount. As a result of this regime, the liability to tax can sometimes only be determined at the end of the tax year when an employee's total taxable pay is known and it can be determined whether he or she is a higher or lower paid employee. If payrolling of benefits was introduced then situations could arise where an employer payrolls a benefit but then, at the end of the tax year, finds that the employee was a lower paid employee and that therefore the benefit should not have been taxed at all.

1.27 Many employers may feel more able to payroll benefits if they were no longer faced with these complexities which arise from the existing £8,500 threshold.

1.28 However, our research throughout this project has shown that the vast majority of employers we spoke to ignore this outdated limit. Such employers would therefore not see an issue with the threshold. We consider the question of formally abolishing the £8,500 threshold in Chapter 4 of this report; our recommendations may, if implemented, provide further encouragement to employers to payroll some of their benefits.

Obstacles for particular employees

1.29 Apart from the question of the employees who are paid under £8,500 a year, there may be other employees for whom payrolling would be difficult. There are two immediate situations that we think will need to be explored further as payrolling is taken forward.

1.30 Some employers have suggested to us that there will be difficulties in applying payrolling to some short-term expatriate employees. This could apply to both incoming and departing staff, probably those who are tax-equalised.[4] We have not, in the time available, been able to explore this question fully but if there are practical difficulties in payrolling benefits for some staff, we think that a procedure should be available to allow employers to payroll generally but omit defined staff, specifically those who are on a "modified payroll"[5] if the employer wishes to do so. Although employees on a modified payroll already have their benefits payrolled on an estimated basis, it is not clear whether it would be appropriate for their benefits to be payrolled under the proposed new legislative framework. This issue should therefore be examined in the consultation.

1.31 We also note the issue of employees who are paid mainly by benefits, with little actual cash pay, where payrolling would consume most or all of their available cash pay. We suspect that such instances will be few and will probably be mainly family members in small companies who may therefore choose not to payroll at all. A possible 'easement' might be to have a procedure capping the amount of tax that could be taken by payrolled benefits in similar manner to 'coded out' tax, though we can see that this would add to complexities rather than simplify.

1.32 Employees who join or leave during the year may be seen as causing difficulty. We do not see a reason for concern here. As noted, a joiner would be told of their pay and benefits entitlement on joining; they would also be told that the benefits would be payrolled. That process would start naturally with the first payday. A leaver would have appropriate details on their P45, including benefits.

National insurance contributions treatment

1.33 Benefits are generally subject to Class 1A National Insurance Contributions (NICs) (which is an employer only liability, paid after the year end) rather than Class 1 (which is an employee and employer liability, normally paid monthly).

1.34 Some employers have expressed deep concern to us that widespread payrolling of benefits will ultimately result in those benefits becoming subject to Class 1 NICs, leading to an increase in charges for employees. It is interesting to note that some employers who are already payrolling benefits (on an 'unofficial' basis) are, we are told, mistakenly (but consistently) applying Class 1 NICs to these.

1.35 There is a wider question over whether benefits should automatically be charged to Class 1 NICs rather than Class 1A. We consider this question more fully in Chapter 7 but at this stage would note that simplicity would suggest that Class 1 should apply – in parallel with general pay in the payroll.

1.36 For the remainder of this chapter, we will assume that the charge to NICs remains Class 1A. Whether Class 1 or Class 1A NICs should apply to a benefit may impact upon whether an employer would find it easier to payroll. In order to encourage payrolling as much as possible, we think that the same class of NIC should apply to a benefit regardless of whether it is payrolled or reported on form P11D. We consider that any change from Class 1A to Class 1 NICs in relation to benefits would not be appropriate **at this stage** but should be considered in the longer term as part of a general move to charge benefits to Class 1 NICs.

1.37 If some items on the payroll are charged to Class 1 NICs and some not, but to Class 1A, that clearly has implications for payroll processes and software. We have been told informally by

[4] Tax equalisation is the offsetting of any such difference so that working abroad is tax neutral for the worker.

[5] For the purposes of Appendix 6 of HMRC's Employment Procedures Manual.

payroll professionals (on our Consultative Committee) that this should not be a problem, provided, of course, that sufficient time is allowed to make changes.

1.38 A second issue around Class 1/1A NICs is the timing of paying over payrolled Class 1A NICs. We have received feedback that some employers would like to be able to pay Class 1A NICs to HMRC monthly, in the same way as PAYE tax. At the same time, we have heard from many employers that they would prefer to keep paying at the end of the year, for both cashflow and administrative reasons.

1.39 At present it is not possible for Class 1A NICs to be collected in the payroll and paid over on a monthly basis. We recommend that legislation is introduced to allow employers to pay their Class 1A NICs monthly. If this is legislatively possible, the issues around administration will mostly fall away: it will surely be simpler to pay over the resulting Class 1A as it is calculated rather than trying to keep a separate running total. We acknowledge the cash flow issue but believe that the loss would be compensated by the gain from generally simpler administration. We think, therefore, that the route to follow is to require Class 1A NICs to be paid monthly along with other NICs for employers who choose to payroll. However, as many would undoubtedly opt to pay Class 1A after the year end, as now, we would suggest this is considered during consultation as an option.

Encouraging payrolling – helping with valuations and other support

1.40 In our view, there need to be minimal hurdles or restrictions for employers to encourage them to make the change to payrolling.

1.41 Those benefits which have fixed or known values are more straightforward to payroll than others. An example of this is private medical insurance, the most common benefit offered by larger employers, which we anticipate many such employers will choose to payroll if they are relieved of the obligation to complete a P11D in relation to them.[6]

1.42 Those benefits which have a value that is not known until the end of the tax year will be more difficult to payroll. An example is beneficial loans, where the rules for calculating the benefit are particularly complex and it is difficult to calculate the value of the benefit for a tax month due to changing amounts of loan and possibly interest rates.[7]

1.43 Cars are the second most frequently provided benefit and it is clearly desirable that they fall easily into payrolling. Some employers have suggested that payrolling cars would cause difficulties but on probing, it seems to us that the main issue is when cars are changed during the year, with the benefit amount changing. Employers are concerned that they would have to instantly change the car benefit figure in the payroll or face penalties for any delay in so doing. It seems to us that the solution is to allow employers a reasonable period – perhaps three months – to make adjustments. If that went across a year end, so be it. The procedures would cause no more difficulties – and probably fewer – than the current routines around notifying changes and coding adjustments.

1.44 There is also the question of the annual change in 'CO_2 percentage charge'. Once a car value figure is established, that would be the core figure for the period of the car's availability; it is the 'multiplier' that changes. These changes are decided well in advance and have to be dealt

[6] This is the usual example of a benefit that is already – unofficially – payrolled by employers.

[7] One change that would facilitate payrolling beneficial loans would be to change the rules on the official rate of interest so that rates would only be set in advance of a tax year and would remain fixed for the coming year, whatever happened to actual interest rates. This would clearly be something of a 'swings and roundabouts' change and we would have to accept that it produced winners and losers. It might be applied only to balances at the start of the tax year, so any new loans or additions to existing loans would be charged at a new rate, if, say, interest rates went up significantly and the government decided in, say, November that the rate for the next tax year would be at least X per cent.

with through existing reporting and changes to tax codes. We do not see that payrolling would introduce any greater difficulties; indeed, once again we think there is an overall administrative saving. Many employers outsource their car fleets in any case and their management firms would supply relevant figures as a matter of routine. Those employers who deal with their own cars would have a recalculation at the start of the tax year but the additional work would be matched by savings over the returns that had to be made during the year.

1.45 Depending upon their own processes and policies it is possible that some employers may find that they are able to payroll these more "complex" benefits. If this is the case then we feel that those employers should ideally be offered the flexibility to payroll those benefits if they wish to do so:

The choice seems to be between:

- having a list of benefits that are required to be payrolled if an employer elects to payroll any of its benefits at all; and
- allowing employers to have a free choice on which benefits to payroll.

There is a parallel choice between:

- requiring employers who choose to payroll to payroll for all employees; and
- allowing employers to choose which employees are payrolled.

1.46 Although the 'employer choice' route is our natural inclination, we are mindful of the implications for HMRC's controls and risk management. We therefore think that payrolling has to be an 'all employee or none' (subject to the points about particular employees, noted above). This ensures consistency and also assists HMRC concerns regarding control and risk management. The 'fixed or flexible' on benefits is more nuanced.

1.47 If employers are allowed to choose which benefits to payroll, the route will be seen as more attractive to those starting down the route and who want to be sure of the procedures and implications. Once experience is accumulated, the employer is likely to be willing to payroll more benefits. On the other hand, HMRC is likely to prefer that, at least initially, a 'fixed list' route is followed, under which there is a list of benefits that are required to be payrolled if an employer elects to payroll any of its benefits at all. This is more likely to discourage some employers from payrolling, however.

1.48 Making payrolling of benefits as open to choice for employers and free from restrictions as possible will increase the number of employers who are prepared to take it up.[8] Therefore, our view is that further consultation is needed in relation to the question of whether or not a "fixed list" approach is necessarily required. The stance should be that it is for HMRC to establish that any restrictions are necessary, and demonstrate why.

1.49 We also consider that, as part of the flexible approach to payrolling benefits, an employer's decision to payroll benefits should not be irrevocable, and that the employer who has chosen to payroll benefits should nevertheless be free to opt out of this in future tax years if necessary. We note, however, that it could be problematic for HMRC and employees if employers were to stop payrolling during a tax year, as tax codes would need to be revised in order to include the benefit. Therefore it is likely to be most practical for employers to only stop payrolling benefits

[8] One good reason for flexibility rather than a 'fixed list' concerns the employer who gives medical care to all employees but just a handful of cars. They would probably like to payroll medical benefit, but would not see cars payrolling as worth the effort. The risk is that a fixed list approach would probably mean that they would have to do both or neither – and will probably choose neither.

from the start of a new tax year (with suitable advance notifications), rather than in-year. This issue should also be explored further as part of a consultation.

1.50 There is clearly a link between payrolling and HMRC's Real Time Information programme (RTI). The latter has been a significant additional administrative burden for many employees. It may be that some flexibility from HMRC on how payrolling is allowed would be seen as some compensation for that effort by employers – and also a demonstration of how RTI can deliver those benefits.

Changes that would need to be made in order to permit payrolling

1.51 If voluntary payrolling of benefits is introduced and employers are no longer required to submit P11Ds in relation to payrolled benefits, the following points need to be considered. Note that some points already need to be dealt with under the current system: this is not a list of new procedures and rules.

- legislation needs to be amended to formally allow payrolling, supported by changes to HMRC guidance. This is most likely to involve changes to both primary and secondary legislation. This legislation would need to include rules on:
    - how the benefit should be calculated/spread over the year;
    - timing requirements for payrolling and reporting benefits. There needs to be sufficient leeway, particularly so that agents/payroll departments can collect the relevant information in time to report it. It is likely to be necessary for the benefit to be reported in the month after it is received, rather than it being reported on or before the day of payment. A relaxation in RTI rules is therefore likely to be needed;
    - what happens if there is insufficient cash to pay the PAYE tax on benefits;
    - the manner in which the employer is to notify HMRC that an existing benefit is going to be payrolled (presumably as part of RTI);
    - notification requirements to employees in their payslip and after the end of the tax year (for example, by means of an adjusted P60), so employees can prepare their tax returns – and new joiners regarding benefits that have been paid to them and how the tax has been paid on these;
    - how the employer should update/true-up[9] at the end of the tax year, for example to reflect the final value of the benefit that has been spread over the year;
    - what happens for leavers if the benefit is not payrolled before they leave;
    - a possible exemption for employees on a modified payroll[10] from the requirement of having to treat all employees receiving a benefit in the same way;
    - what happens where something goes wrong. Our view is that the legislation would need to follow PAYE legislation so that the onus is on the employer; and
    - whether all companies in the same group need to do the same thing.
- HMRC's approach to penalties in relation to payrolling should also be revisited in order to give employers greater confidence that they can introduce payrolling of

[9] (Bring to the correct balance.)

[10] For the purposes of Appendix 6 of HMRC's Employment Procedures Manual.

benefits without facing unreasonable penalties in the event of errors while they adjust to the new system. For example, there needs to be clarity on the difference between carelessness and making a reasonable mistake and some leeway allowed for making adjustments (say three months);

- if Class 1A NICs are to be collected through payroll, the legislation needs to be amended in order to allow for this;
- Regulation 85 of the Income Tax (PAYE) Regulations 2003 needs to absolve employers from having to complete P11Ds in relation to benefits that they have payrolled;
- steps need to be taken to ensure that employers are made aware of the implications of payrolling benefits in relation to Universal Credit, and as to what the income figure is for DWP. Employer's software needs to be set up specifically to exclude benefits from Universal Credits[11];
- HMRC should improve its current processes in removing payrolled benefits from the tax code once the benefit has been fully taxed for earlier closed years;
- steps should be taken to revisit how certain benefits are valued in order to make them easier to payroll; and
- HMRC would need to provide detailed guidance on the operation of the new legislation, including details of how employers should payroll specific benefits.

1.52 The box below sets out the steps which would need to be taken by an employer who wishes to start payrolling a benefit. This reflects the experiences of employers who are already payrolling benefits.

[11] There is clearly a wider issue of whether benefits should be excluded from Universal Credit considerations. This is outside the scope of the OTS's remit but is inevitably an issue that we have to touch on and do so in the next chapter.

Box 1.A: Suggested mechanics for an employer who wishes to start payrolling a benefit

- The employer will need to communicate the change to employees well in advance of payrolling taking place, and may need to consult with unions/employee representatives in relation to this;
- There will need to be a separate one-off notification to HMRC that the benefit is being payrolled and should be taken out of the tax code;
- HMRC will then need to remove the value of the benefit from the tax code;
- Employers must revise their processes and documentation for employees so that:
  - the payslip makes clear what has been payrolled and what deductions have been made; and
  - at the end of the tax year employees are provided with a detailed confirmation of what benefits they have received, the taxable value of those benefits and what tax has been paid and how it has been paid. New joiners are provided with a clear explanation of how their benefits will be taxed and reported.
- On the basis that Class 1A NICs will continue to apply to a benefit, software also needs to make clear that the benefit is subject to tax but not NICable in the payroll;
- The employer will complete an end of year Full Payment Submission (FPS), but will need to keep truing up[12] payrolled benefits during the tax year. They will need to be able to produce a reconciliation in order to provide the employee with their P60. The Earlier Year Update return will be available to them to correct any errors found after the final FPS has been submitted. Benefits which were not payrolled would still need to reported on form P11D; and
- The employer would have to establish a pay element in the payroll system that is subject to tax but not payable, i.e. a notional payment (considering that the implications for Class 1 v Class 1A still remain). The employer's software will also need to have the facility to process notional payments and include the value of the payrolled benefit in the Full Payment Submission (FPS) to HMRC. The payroll reporting, payslip formats and accounting journals will also need to be amended to take into account notional elements processed in the payroll.

Our understanding is that in practice this process is likely to take more than 12 months to complete, in order to start payrolling a particular benefit. However, in the long term it will nevertheless result in simplification for all parties.

[12] (Bringing to the correct balance.)

2 Broadening PAYE Settlement Agreements

Recommendations

2.1 **Our recommendation is that the scope of PSAs should be widened to permit employers to settle any tax liability on benefits and expenses.** The OTS's recommendations in other chapters, particularly the review of the circumstances in which an employee should be treated as receiving a taxable benefit (see Chapter 8), may slightly lessen the need for a widening of PSAs, but that will take time and broadening PSAs is a quick and easy win that will help business and will remain necessary despite action in other areas.

2.2 There is a valid argument for there to be no restrictions on what can be subject to a PSA. This would be the simplest route and we therefore prefer it.

2.3 However, complete freedom for employers would create certain problems which we explore below, mainly around implications for employee benefits. It has been suggested that this might be a reason for employees to manipulate PSAs, though given the cost of PSAs we do not think this is a serious risk and it can be managed. **If this is felt to be an unacceptable risk, we recommend widening to permit the following additional types of payment to be included, possibly as an interim stage:**

a commercial payments which are not intended to confer any benefit or reward on the relevant employee, including travel and subsistence in excess of agreed dispensation amounts; and

b "other" low value payments which shall be set out in a new schedule to the PSA.

2.4 In addition, **HMRC guidance on what can be included in a PSA should be improved and updated** to include a detailed list of items which specifically cannot be included in a PSA. This should include a published and maintained list of items that HMRC has agreed with individual employers may be included in their PSA. Essentially, we think that as PSAs are generally something businesses find helpful, HMRC's stance should be to help businesses use them and justify items that cannot be included in PSAs, rather than only permit inclusion of specified items.

2.5 **We also recommend that the process for employers entering into PSAs should be streamlined.** Whilst we accept that HMRC need to understand what is included in a PSA, we see no real reason for the scope of a PSA to be pre-approved. That seems to be in conflict with today's self assessment ethos, as we discuss further in Chapter 3 on 'An exemption for qualifying business expenses'. **We recommend this is put into effect by adding PSAs to HMRC's PAYE Online service for employers, offering standardised categories of expenses and benefits which are capable of being included in a PSA, and which the employer can choose to report under, without needing to seek HMRC agreement in advance.**

2.6 Overall, any restrictions on extending PSAs need to be justified as **necessary**.

Background

The purpose of a PSA

2.7 A PSA allows an employer to make one annual payment to cover all the income tax and NICs due on employees' taxable expenses or benefits which are minor or irregular, or where it is impractical to apply PAYE or to work out the value of the relevant benefit. An item which is included in a PSA does not need to be put through payroll, nor is it included in the P9D and P11D, and no Class 1 or 1A NICs will be due on it (as the employer pays Class 1B NICs as part of the PSA instead). It is a requirement that HMRC must agree in advance which benefits or expenses can be included in the PSA for a tax year, otherwise limitations will apply to the items which can be covered by the PSA for that year.

Feedback that we have received on PSAs

2.8 We have been told by many businesses – particularly large employers – that, despite the fact that PSAs are expensive (due to the need to gross up the tax on the value of the payment, especially when the employer does not really consider that a real "benefit" has been provided) they find PSAs an extremely helpful way of simplifying the settlement and reporting of tax for employee benefits and expenses. However, we have received widespread criticism of both the scope of PSAs and the process and guidance for employers in agreeing them with HMRC.

2.9 Employers and their agents have told us that PSAs are potentially very valuable where:

- the employer feels that it would be unfair for an employee to bear tax costs on a benefit or where it is too difficult to explain to an employee why there is a tax charge (for example, the costs associated with a secondment of more than two years); and
- at the end of the tax year there is a need to "sweep up" any benefits or expenses which have been overlooked, to ensure full compliance from an employer tax perspective.

2.10 There is a widely held view that the rules on what can be included in a PSA are too restrictive, particularly when businesses are faced with the issues described above, and that employers should be able to include almost any benefit or expense in a PSA in order to address this. This is justified by arguments that PSAs pay grossed-up tax and employer NICs in a single payment, saving HMRC considerable efforts.

2.11 Many employers and agents have also told us that the PSA approval process is too cumbersome, and query why it is necessary for an employer to go through the PSA approval process each year, especially if it continues to provide the same benefits year on year. HMRC guidance is also felt to be confusing and HMRC are considered to be inconsistent between employers as regards which benefits can be included in a PSA.

Widening the scope of PSAs

2.12 We think that there is an overwhelming case for significantly widening the scope of PSAs. Our instinct is to make the process available without restriction to employers as that is the simplest route.

2.13 However, we can see difficulties with a totally 'free range' PSA system around the implications for state benefits. We also acknowledge the concern that opening PSAs completely might be seen as condoning sloppy PAYE procedures during the year.

The interaction of PSAs and state benefits and reliefs

2.14 The effect of the PSA is that it transfers the employee's tax liability to the employer. Therefore, if an employee receives a benefit which is dealt with under a PSA, then it is not included in the payslip or P60 or P11D. This is relevant in the context of state benefits (such as tax credits, income support, housing benefit and Universal Credit), entitlement to which depends upon the earnings shown in the payslip and certain benefits in kind.

2.15 An employee who receives a benefit which is dealt with under a PSA will not have that benefit taken into account and may therefore receive a higher level of state support than they should otherwise be entitled to. How significant an issue this is for Universal Credit (UC) is debatable: as UC generally depends on pay ignoring benefits, this may not generally be an important question. Possibly of more significance is that there would be no NICs paid to the employee's 'account' for PSA items;[1] but again as state pension is tending to a flat amount, this may not really be important.

2.16 There may be more of an issue higher up the income scale. An employee may be able to obtain tax free childcare, avoid the high income child benefit charge or retain personal allowances at a time when they would not otherwise have been entitled to this had their full benefits in kind been taken into account.

2.17 When we discussed these issues in our meetings with employers and representative groups, the issues were acknowledged but largely dismissed as minor considerations. They did not believe employers would deliberately use PSAs to boost employees' child benefit (or whatever) claims because of cost for the employer and the possibility of discrimination among employees. However, we have to acknowledge the issue and note that most of the employers we spoke to were larger businesses: this possible manipulation may be more of an issue in small businesses.

2.18 We think that the risk of such manipulation can largely be guarded against, with a form of anti-avoidance provision. However, there is clearly a need to investigate further the risk and to discuss the position with the DWP over their view on the implications for such a move. We have not been able to hold such discussions in the time available; it would in any case be better to take the issue forward as the details of Universal Credit are finalised.

2.19 We therefore conclude that a complete freeing of PSAs may not be thought appropriate at the present time, notwithstanding calls from businesses to do so. We think this should be the ultimate aim and in the meantime, to look at what prevents a major widening of the scope of PSAs, **we also recommend**:

- **discussions are held with the DWP to ascertain how much of an issue the UC and state pension really is; and**
- **consideration is given to an anti-avoidance measure in the PSA rules that penalises an employer who enters into a PSA with the sole or main purpose of enhancing an employee's entitlement to child benefit etc.**

Commercial payments which are driven by business need – long term solution

2.20 It is clear that by allowing employers to include more items in a PSA – particularly if it is in combination with payrolling and self-assessing expenses (see our recommendations in Chapters 1 and 3) – there could be a significant reduction in the number of P11Ds which employers need

[1] Although this is only relevant in relation to benefits which would ordinarily have been subject to Class 1 NIC rather than Class 1A.

to produce, and therefore a corresponding reduction in administration for HMRC. This would be a major simplification.

2.21 However, a key driver for businesses wishing to extend the scope of PSAs is that employers often find themselves making commercial payments, the prime purpose of which is the needs of the business, rather than in order to confer a benefit on the employee. An example of this is the costs of an employee's accommodation next to the office in order that the employee can work late and maximise the time that is spent on a particular project. Notwithstanding that the employee is unlikely to see this as really beneficial, such a payment is nevertheless treated as a taxable benefit by virtue of the current tax legislation. In our view, this is a failing of the current system for taxing employee benefits and expenses.

2.22 Although the PSA offers a potential way of ensuring that such payments are not taxed in the hands of the relevant employee, it is an expensive approach for the employer and also does not address the fact that business practices have moved on. We consider that this issue is better dealt with outside of the PSA framework, and that the taxation of benefits should be looked at more widely to ensure that purely commercial payments such as these are no longer treated as taxable benefits at all. These issues are examined in more detail in Chapter 8.

Commercial payments which are driven by business need – an immediate solution

2.23 However, any such review of the current system will take time and we therefore propose that, pending such a review, PSAs are widened in scope to allow employers to include any commercial payments which are not intended to confer any reward or profit on the employee. This will make an immediate difference to employers who are currently finding that the system as it stands is getting in the way of their business needs and are prepared to bear the additional expense of including the item on a PSA.

2.24 This should specifically include travel and subsistence amounts paid in excess of amounts agreed in dispensations or covered by an exemption, provided they pass the 'business purpose' test. A main example would be paying business mileage at (say) 60p a mile, rather than the standard 45p a mile.

Using the PSA as a sweep up tool to ensure compliance

2.25 In order to address the concern that the PSA has insufficient scope to be used as a sweep up tool in a wide enough range of circumstances, we also recommend that a new "other" section is permitted to be included in PSAs. This should cover payments which do not fit within the current restrictive definitions of minor or irregular or where it is impractical to work out the value of the benefit or apply PAYE.

2.26 This recommendation has two broad situations in mind:

- allowing employers to include small items that could be put through 'normal' procedures but whose value means the effort hardly seems worth it; and
- covering items that have simply been missed during the year but which are collated during post-year end work.

2.27 Concern has been expressed to us that widening PSAs significantly could be used by employers as a means of in effect covering up poor PAYE procedures during the year. That risk is to a degree managed by the cost of the PSA settlement (and see further discussion below about the rate of Class 1B NICs). It could also be managed by having a broad restriction on PSAs in that they could not be used for regular benefits (such as medical cover or car benefits), or that they could only be used for 'minor' benefits (with examples given on the meaning of that term).

However, this sort of restriction would make the procedure less useful to employers and might mean that they could not use it for all the benefits they would wish.

2.28 Keeping this category as applying only to 'minor' items may give sufficient control but may then not be as flexible as employers want. Accordingly, it may be necessary for the items included in this section to be subject to a value cap. This could be set in a variety of ways:

- a maximum of £X for each individual item covered under this heading;
- a maximum of £Y per employee; or
- a maximum of £Z for the employer, perhaps set at a percentage of the employer's annual PAYE/NIC bill.

2.29 If this route is pursued, for simplicity, we recommend that this could be calculated by reference to the employer's overall number of employees, though we can see that this middle option might be vulnerable to significant payments in respect of a few employees. In any event it would add further complexity to the procedure so we therefore note it without recommending it, though this issue could be explored further as part of the consultation process for extending PSAs. It would be for HMRC to justify why such a control is necessary.

2.30 If a form of cap is imposed, we think that employers should have the ability to agree with HMRC that items which exceed any cap can be included in the "other" section, particularly in the early days of this extension. A detailed breakdown might need to be provided by the employer which gives details of each employee involved and the value of the benefit received. This will ensure that HMRC can still monitor which employees are receiving larger benefits for the purposes of state benefits and reliefs which may otherwise be available to them. But we question how much would really be achieved by such routes.

PSAs and NICs: what price Class 1B?

2.31 A PSA is calculated to include the income tax which the employee would have paid (i.e. on a grossed up basis). NICs are not included, though Class 1B does of course substitute for the employer's Class 1 liability. It has been suggested that there is a gap here in that no employee NICs are required. This is logical in that the employee NICs cannot be credited to the employee's 'account'. It would also be extremely difficult to estimate NICs due with any accuracy because of the weekly basis of calculating NICs.

2.32 We wonder if there is an argument for increasing the Class 1B rate in a small way to recognise this lacuna. This is clearly a policy matter and outside our remit but if it was a way of overcoming resistance to widening PSAs – particularly in overcoming the concern around interaction with state benefits etc – then it may be worth considering. We readily acknowledge that there would not be any sort of perfect matching up of NIC payments and benefits but it might be a pragmatic route with simplification in mind.

PSA process and guidance

Process for including items in a PSA

2.33 The current HMRC approval process in relation to PSAs needs to be streamlined. Whilst we accept that HMRC need to understand what is included in a PSA, we see no real reason for the scope of a PSA to be pre-approved. Thus we recommend that the pre-approval of the content of PSAs is dropped; instead employers should simply report what has been included. Pre-approval seems to be in conflict with today's self assessment ethos, as we discuss further in Chapter 3 on 'An exemption for qualifying business expenses'.

2.34 **We recommend that PSAs should be added to HMRC's PAYE Online service for employers, offering standardised categories of expenses and benefits capable of being included in a PSA, for the employer to allocate the cost against the applicable category, and with each employer being free to choose to report under any category without the need for prior HMRC clearance.** Under this system, employers could select the categories relevant to them online in advance provided that they do so by 6 July following the end of the tax year for benefits to form the basis of the PSA agreement.

2.35 The system should also be revised in order to permit the PSA liability and payment to be included in the information which is fed into the Employer Compliance amounts on HMRC's Business Tax Dashboard. This is designed to give employers an overall picture of their tax position, including payments which have been made and those which are still outstanding. However, currently the Business Tax Dashboard only includes PAYE, Class 1 NIC, Class 1A NICs, and does not include PAYE and Class 1B NIC liabilities arising under a PSA.

2.36 The above recommendations are designed to reduce administration for both the employer and HMRC (as there is no need for correspondence between them in order to agree the terms of the PSA), and will also improve HMRC's ability to collect information for statistical purposes. It will also make PSAs more accessible for smaller employers.

HMRC guidance and policy on PSAs

2.37 If PSAs are not made entirely free, in line with our preference, **we also recommend that HMRC guidance on what can be included in a PSA should be improved**. This should be on the basis of updated guidance to include a detailed list of items which specifically cannot be included in a PSA, in order to provide clarity to employers. **We also recommend that HMRC publish and maintain a list of decisions regarding items that have been permitted to be included in employers' PSAs.**

2.38 This recommendation is designed to further remove some of the current uncertainty for employers, by ensuring that ongoing HMRC policy on this area is made clear and kept up to date. It will also achieve greater consistency of treatment between employers regarding what they may include in their PSAs.

2.39 Our objective in making these recommendations is that PSAs become more flexible and are seen in a positive light by both employers and HMRC. We think HMRC need in many ways to change their stance on PSAs: to see them as a useful aid to compliance and tax collection, not as a vehicle that tightly controls employers who may have failed to carry out proper PAYE compliance.

3 An exemption for qualifying business expenses

Recommendation

3.1 **We recommend that an exemption is added to the legislation for qualifying business expenses paid for or reimbursed by an employer.** The aim is to replace the P11D dispensation process with a more modern, practical approach. The exemption should be written to cover all the routine business expenses that can currently be included in a P11D dispensation, including but not limited to:

- travel, including subsistence costs associated with business travel;
- fuel for business mileage in company and pool cars;
- hire car costs;
- telephones;
- business entertainment expenses;
- credit cards used for business; and
- fees and subscriptions.

3.2 This could be a simple piece of legislation that makes reference to the sections of the legislation that already allow a deduction for qualifying expenses.

3.3 The primary legislation or regulations should then set out the minimum record keeping required by employers for the exemption to apply. Taxable expenses should then continue to be reported on form P11D or put through the payroll, as appropriate.

3.4 The exemption should apply to all employers and employees who meet the minimum record keeping requirements (which would match those currently required when a P11D dispensation is in place). Employers would no longer need to apply for a P11D dispensation. Employees who do not have their business expenses paid for or reimbursed by their employer should still be allowed to claim a deduction under Part 5 of ITEPA 2003.[1]

3.5 During our research we noted that in some other tax jurisdictions a similar approach is applied to expenses. For instance, in Ireland employers are not required to report allowable expenses as long as they keep their own records. There is no concept of a reporting dispensation.

Background

3.6 There are several reasons for putting forward this recommendation:

- currently unless an employer goes through the process of applying for a P11D dispensation they have to report all taxable expenses, not covered by a specific

[1] Income Tax (Earnings and Pensions) Act 2003.

exemption, on the employee's P11D, regardless of whether a deduction is available. Unless the employee makes a corresponding claim for tax relief, the expenses will be included in the employee's PAYE code. So even if there is ultimately no tax due, two forms have to be completed and processed for that position to be reached;

- dispensations quickly become out of date due to changing circumstances, though our researches suggest they are rarely (or slowly) updated;
- more than one employer has referred to dispensations in meetings as being something of a false security: the employer's expenses systems have not been 'cleared';
- we were told that some smaller employers don't really 'get' the concept of a P11D dispensation. It is unnecessarily complex that all expenses are in the remit of the employee's earnings unless a claim is made by the employee or they are covered by a dispensation. Employers would find it easier to simply have sufficient guidance to help them determine which expenses are taxable and only have to report those to HMRC; and
- some employers expressed concern that the dispensations that have been issued are not consistent and they suspect that some employers have items in their dispensations that other employers have been refused. This recommendation would ensure consistency.

Considerations

The need for active HMRC guidance

3.7 This recommendation relies on HMRC increasing the support and guidance available to employers. There would need to be very clear guidance on how the exemption applies and employers would need to be allowed to contact HMRC if they are in doubt as to whether it applies to more unusual expenses. Although that implies additional HMRC resources are needed, we think that once experience is gained in the operation of the new system, the guidance would take over and queries to help systems would reduce significantly. In any event, removing the P11D dispensation process would free up HMRC resources that could provide the extra support required.

We recommend that HMRC keeps updated guidance on its website that logs the more common queries so that eventually employers will be able to find most answers themselves.

A loss of assurance?

3.8 Some employers commented that a dispensation provides comfort that HMRC have approved their policies and procedures (and it could be argued that the application process allows HMRC to see what the employer is doing). We would suggest, and other employers agree, that this may be a false comfort. The dispensation does not guarantee that the employer is correctly applying its policy. Even if an employer has a dispensation, they will still have failed to meet their reporting requirements if they do not report taxable expenses and benefits.

Improving consistency and fairness

3.9 We were also told by some employers that they have individual agreements in place with HMRC that they are not required to report certain expenses. These are beyond their basic P11D dispensation. This raises issues of consistency and our proposal has as one of its subsidiary aims improving consistency in the application of the expenses rules (and so fairness). It will also eliminate some of the anomalies that we have come across in our work – see for example Box 3.A.

Box 3.A: Example of dispensations on a takeover

We were given the example in a meeting of a major business that had an existing dispensation and acquired a smaller business which also had a dispensation. On investigating, the tax director found that the new business's dispensation was wider in certain areas, covering their slightly different business circumstances. He applied to HMRC to retain this wider dispensation but HMRC refused and insisted that the 'group' dispensation had to be used.

The result was that employees in the acquired business were faced with tax on certain expenses. Needless to say, that would have been extremely difficult to manage in practice and the group decided to pay the tax on these expenses on a grossed up basis so the employees were not affected by the takeover. The result was additional costs for the business.

3.10 The employers who have existing dispensations beyond what might be seen as 'normal' were concerned that they could lose these agreements if the dispensation rules change. If our exemption recommendation is taken forward, it may be that transitional arrangements would be needed. Employers could rely on these agreements for a set period in which they would need to assess whether the new exemption covers the expenses covered by the agreement or seek a fresh agreement from HMRC. This may of course show up the need for the items to be included generally and so lead to the guidance being extended. For employers who pay simple expenses this would not be an issue. It will be more of an issue for larger complex employers. It may be that some of the items in an existing extended dispensation ultimately fail the new test but these should be few and would presumably be outside 'qualifying business expenses'. In any event, the result would be more consistency.

3.11 Currently employers can choose not to apply for a dispensation and instead report all expenses, taxable and non-taxable, on form P11D. This can potentially reduce their exposure to penalties for failing to report taxable expenses. Consideration needs to be given as to whether all employers will be required to observe the new exemption and only report the remaining taxable expenses.

3.12 Our inclination is that the new exemption would be automatic and so remove any question of reporting the expenses. Our driver is simplification and exemption has to be simpler than reporting. If it is not made compulsory, employers may need to indicate through RTI if they are applying the exemption to their employees. Currently when HMRC deal with P87 expenses claims from employees they check whether the employer has a P11D dispensation in place. If the employer has a dispensation they should only be reporting taxable expenses on the employee's form P11D and it may be necessary to question the employee's claim.

Penalties

3.13 Further thought should be given to whether this recommendation increases an employer's risk of incurring penalties and whether the liability will fall with the correct party in the event of employer error. On the face of it, it would seem the employer's risk of incurring penalties should not increase, provided the employer takes reasonable care in their compliance. There is, after all, a baseline of non-compliance now, with some employers not aware of the need to apply for a dispensation if they are not reporting taxable expenses, or using out-of-date dispensations (where circumstances have changed), or simply making errors.

3.14 If this recommendation is taken forward, we think that the answer is to ensure a balance is included through a 'reasonable care' requirement and a 'reasonable excuse' defence. But we would suggest that these are issues for probing during consultation by HMRC.

Single employee companies

3.15 We have considered whether this new rule should apply to directors or companies with one employee. We see no reason in principle why not. The key is the record keeping. Provided that the company can document and evidence that the expenses incurred are qualifying they should be able to apply the exemption.

3.16 HMRC may have valid concerns about exploitation of the rule by umbrella companies and similar arrangements. We think that the outline we have set out, including the 'reasonable care' requirement and the general principle of qualifying business expenses, should suffice. But this is clearly an area to probe further during consultation.

Salary sacrifice

3.17 The use of salary sacrifice needs due consideration in the context of qualifying business expenses. Currently some employers do obtain P11D dispensations with a view to implementing salary sacrifice schemes for travel and subsistence. (We touched on this in our interim report.) We do not expect salary sacrifice to become more prevalent if this recommendation is introduced, provided that the requirements for employers to keep records of the expense are sufficiently robust.

3.18 However, this issue should be considered further in the consultation process.

An alternative

3.19 In our view an exemption would be the greatest simplification when it comes to reporting expenses. However, there is an alternative that is not so radical and that is to introduce a universal P11D dispensation.

3.20 HMRC could publish a dispensation that all employers could consider applicable to them provided that they meet the necessary policy and procedure standards. Some employers explained that they like to have a dispensation to show to employees to explain what expenses they are willing to reimburse. A universal dispensation would have the same effect as the exemption we are proposing, but in our view is not such a clean simplification. It still leaves the dispensation concept, which some employers have not yet grasped, rather than employers being able to simply decide if an expense is taxable or not. It may not eliminate as much of the administration as our proposal.

3.21 We do recognise the employers' point about having something to show employees but feel that the proposed HMRC guidance should take the place of such a document fairly easily.

4 Abolition of the £8,500 threshold

Recommendation

4.1 Our recommendation is to abolish the £8,500 threshold which is set out under Chapter 11 of Part 3 of the Income Tax (Earnings and Pensions) Act 2003.

4.2 This threshold prevents employees earning below this annual rate from being taxed on certain benefits in kind but also results in two different tax regimes for "higher paid" and 'lower paid' employees. Its abolition would be a major simplification of the taxation of employee benefits and expenses, though we acknowledge that at present the vast majority of employers simply ignore the threshold and so the actual administrative saving may not be as great as first imagined.

4.3 We have spent some time researching those who would actually be affected by any such abolition. There are few such people; we have identified some and make recommendations to manage their situations. But formal consultation on this proposed abolition should aim to identify any further groups who would be adversely impacted by the abolition. Further mitigation may then be appropriate.

Background

The purpose and effect of the threshold

4.4 The purpose of the threshold is that employees who earn an annual rate of less than £8,500 from an employment are treated as "lower paid employees" with the result that they pay tax on a smaller range of benefits than those who earn at least £8,500, who are categorised as "higher paid employees". Higher paid employees are subject to tax on all benefits and expenses payments (and their employer is subject to associated NICs costs). Lower paid employees are only taxable on benefits which are vouchers, credit-tokens or living accommodation or any benefits of direct monetary value to the employee apart from cars, vans and loans. Benefits paid to lower paid employees are also not subject to Class 1A NICs apart from those which are taxable in the hands of the employee.

4.5 When determining whether an employee earns less than £8,500, it is necessary to take into account the value of all benefits and expenses that would be taxable if the earnings were above £8,500. The earnings from an employee's "related employments" must be added together when determining whether the threshold has been reached (and must similarly take into account the value of benefits and expenses from those related employments that would be taxable if the earnings were above £8,500).

Out of date threshold

4.6 As outlined in our interim report, the £8,500 threshold has remained at the same level since 1979, when £8,500 was considered to be broadly equal to the level at which a married man started paying tax at the higher rates.

4.7 In 1979, £8,500 represented 150 per cent of average full-time earnings at that time. In 2012-13 it only represented 35 per cent of average full-time earnings.

4.8 £8,500 is well below the income tax personal allowance (which is £9,440 for the tax year 2013-14 and in April 2014 will rise to £10,000 for those earning £100,000 or less). It is less than someone working 30 hours a week at the adult National Minimum Wage would earn. It is therefore becoming less and less relevant.

4.9 If the £8,500 limit had increased in line with inflation it would be £41,011 in December 2013.[1]

Complexities caused by the threshold

4.10 The two different tax regimes for higher and lower paid employees as a result of the threshold cause a number of complexities, particularly for employers. Employers are required to determine whether or not an employee falls above the threshold, and then calculate and report the tax due on his or her benefits accordingly.

4.11 As referred to above, some benefits are taxable on all employees, whereas others are only taxed on higher paid employees. Employers are obliged to report benefits on P9D forms for lower paid employees, but must complete P11D forms for all higher paid employees. Not all expenses and benefits reportable on the P11D are reported on the P9D. The value of the benefit which is subject to tax can also depend upon whether the employee is higher or lower paid.

4.12 These distinctions would no longer apply if the threshold was abolished.

Employers' attitudes to the threshold

4.13 The feedback that we have received from both employers and advisers is that it is standard practice for almost all employers to ignore the different rules for higher paid and lower paid employees by simply assuming that all employees are earning more than £8,500.[2] This is primarily in order to save on administration costs that would otherwise arise from having to carry out calculations to determine whether or not each employee has reached the threshold. Therefore most employers automatically complete a P11D for all employees in receipt of benefits on this basis.

4.14 This approach results in unfairness if an employee is lower paid, but is nevertheless subject to tax on benefits as if they were higher paid. It also results in additional Class 1A NICs for the employer.[3] However, employers who take this route feel that these extra costs are outweighed by the administrative savings that they make by not having to determine whether each employee falls above or below the threshold.

4.15 Many employers therefore consider that the £8,500 threshold is effectively redundant and should be abolished.

Alternative to abolition

4.16 Some have suggested to us that the £8,500 threshold should be retained but increased to reflect average earnings, or to be in line with the higher rate income tax threshold, which is broadly what inflation would suggest it should be and indeed has resonances to the level at which it was first introduced in 1948.

---

[1] Using the Retail Prices Index: Long run series: 1947 to 2013 (visit the ONS webpage at: http://www.ons.gov.uk/ons/taxonomy/index.html?nscl=Retail+Prices+Index#tab-data-tables)

[2] We would stress that we have spoken to a very wide range of employers, including a number who might be expected to have 'low paid' employees (because of part time workers). That includes two of the largest supermarket chains, hotel and restaurant groups, farming and companies involved in and the trade body for the business services sector (ie cleaning, security, maintenance etc). Only one of these, a hotel group, checked the £8,500 limit and they were probably mistaken in doing so as they had accommodation benefits in mind. Following comments on our interim report, we have followed up correspondence generated by the suggestion in the report that the limit should be abolished. That has included groups such as the Low Incomes Tax Reform Group but also some Church groups who evidenced specific concerns.

[3] By virtue of Section 10(1)(a) Social Security Contributions and Benefits Act 1992. See also NIM13070.

4.17 However, if the threshold was simply increased instead of being abolished then the complexities would continue in relation to the two different tax treatments and reporting obligations for employers. In practice, it would impose an increased administrative burden and complexity for a larger number of employers, as many employers at present do not have any employees who fall below the £8,500 threshold. There would also be a considerable cost to the Exchequer due to the reduction in the tax and employer NICs that would be payable as more people would fall below the threshold and therefore would qualify as lower paid employees.

Who will benefit from the abolition?

4.18 If the £8,500 threshold is abolished, the result will be a much simpler and more consistent system for taxing and reporting employee benefits and expenses, which will mean that it is easier to understand, and with less compliance exposure for employers.

4.19 The revised system would involve less administration for employers. Even though many employers are already ignoring their obligations to carry out a threshold calculation for those employees who might fall below the threshold, a removal of the threshold will at least mean that this obligation no longer applies and that compliance will be easier.

4.20 There will also be reduced administration for HMRC as it will no longer have to devote any resources in the processing of form P9Ds in relation to lower paid employees. There will inevitably be an increased number of P11Ds to process but there will at least be only a single process.

4.21 The abolition would be likely to provide marginally increased revenues for the Exchequer in respect of the increased tax borne by some lower paid employees and the associated increase in Class 1A NICs which becomes payable by their employers.

4.22 However, as it appears in practice that many employers are already ignoring the threshold, the amounts at stake are likely to be minimal. We therefore acknowledge that there is unlikely to be a dramatic change in relation to any of the above in terms of those who would benefit from the abolition.

Who will be adversely impacted by the abolition?

Employers

4.23 Although it appears that the majority of employers fail to operate the regime correctly, there will be an impact for the remaining employers who are complying with the current regime and who have employees receiving benefits who qualify as lower paid under the present system. These employers will be faced with Class 1A NICs which were not previously payable.

4.24 Overall, the abolition is likely to have a greater impact for smaller employers, who may be complying with the current regime in full in order to keep their Class 1A NICs costs to a minimum.

4.25 It may therefore be appropriate to combine the abolition of the £8,500 threshold with an exemption or reduction for small employers in respect of the Class 1A NICs arising on benefits received by employees earning below £8,500. One possibility would be that the criteria to qualify for this exemption or reduction should match the criteria and definitions which apply for small employers' entitlement to compensation on statutory payments, though this does risk reintroducing complexity.

4.26 However, there is a more pragmatic solution. The government is about to introduce the £2,000 annual 'employer's allowance', aimed very much at smaller businesses. It might have been logical to link the introduction to compensation for any adverse impact of this abolition. That opportunity has probably been lost but it might be considered as a factor in considering the level of the employment allowance when the time comes to uprate it.

Employees

4.27 We have naturally heard many concerns expressed over the impact of the abolition of the £8,500 threshold on low paid employees. We have tested and challenged these concerns, in an effort to identify real groups of employees who will be affected (rather than simply the theory, which is well understood).

4.28 Abolition will result in those employees who currently fall below the threshold now having to pay tax on benefits that were not previously taxable (assuming their other income takes them above the personal allowance). Given the level of the National Minimum Wage, this will be most relevant to part-time employees, who may not receive a wide range of benefits (or if they did then this is likely to take them into the higher paid category). They may well receive benefits such as private medical insurance, which we have been told is often provided by larger employers to their part-time employees as well as full-time employees to avoid any discrimination issues.

4.29 In the case of small, family run companies, there can also be employees who are spouses or other family members who only work on a part-time basis but nevertheless receive the benefit of a company car.

4.30 The latest HMRC statistics suggest there are some 15,000 P9Ds completed annually. It is these employers/employees who would be affected. We have spent some time trying to identify them. In addition to the categories noted below (carers, volunteers and ministers of religion) we think a significant proportion relate to benefits provided to family members linked to small companies just alluded to. Some of these people undoubtedly work for the businesses and draw limited reward; some, though, are probably just getting a 'perk' at minimal tax cost. If the latter are caught by the abolition of the £8,500 threshold, that would seem to be a move towards fairness rather than unfairness and should not stand in the way of this simplifying recommendation.

4.31 Groups that we have identified to date are as follows:

Carers

4.32 Many carers will be part-time workers, probably on or close to National Minimum Wage, and may therefore be earning less than £8,500 per year in relation to that job. Of these, many ordinarily receive benefits such as board and lodging as part of their role. If the threshold were abolished, any such carers who earn less than £8,500 would now be subject to tax in respect of that benefit.

4.33 Carers' employers will also have greater compliance obligations if the threshold was abolished, as at the moment there is no requirement to report expenses payments on P9Ds in relation to lower paid employees. This will clearly change if the different treatment for lower paid employees ceased to apply.

4.34 **We consider that a consultation should look at what exemptions should be made available to carers (and potentially also their employers) in relation to those benefits that they receive.** We consider this further under the mitigation heading below.

Volunteers

4.35 Certain charitable organisations have expressed concern to us that an abolition of the £8,500 threshold could result in their volunteer workers being subject to tax in relation to their benefits and expenses.

4.36 HMRC guidance on this specifies that this will not be the case provided that the relevant individual is not an employee.[4] However, difficulties can arise as there is a lack of clarity on whether an individual will in fact be an employee in certain circumstances. Case law exists where a volunteer has been found to have the legal status of an employee, for example where a volunteer agreement was in fact found to be a binding employment contract.[5] A similar issue has arisen where a charity regularly paid a volunteer's expenses payments when no expenses were actually being incurred, with the result that the payments were treated as wages for employment, and inadvertently triggered employee status for the volunteer.[6]

4.37 This uncertainty around employment status for volunteers is a wider issue. **We think the answer is clearer guidance from HMRC on this area, if necessary accompanied by a change in the law to exempt expenses payments for volunteers for what would be equivalent to 'business expenses'.** This is something that many organisations have been calling for over some years. Such a move would seem to fit with the government's aims of encouraging the 'Big Society' and would be a simplification move.

4.38 If this wider issue is tackled, we do not think that charitable organisations and their volunteers would be adversely impacted by any abolition of the £8,500 limit.

Ministers of religion

4.39 There are several thousand priests and other ministers of religion in the UK whose earnings are less than £8,500 per year. They are office holders rather than employees, but are treated as employees for tax purposes. A removal of the £8,500 threshold would result in those lower paid ministers of religion being faced with a tax charge on benefits that they receive from their office.[7]

4.40 Many receive a benefit in the form of ancillary services to tax free accommodation – such as heating, lighting and cleaning. If the threshold was abolished, those ministers who currently do not pay tax on their benefit as they earn below the £8,500 would become subject to tax in these circumstances.

4.41 **We consider that an exemption for tax in these circumstances would be appropriate, and that this should be explored further as part of the recommended consultation process.** One answer could be to simply amend the legislation to provide for tax relief for all expenses related to tax free accommodation provided by employers for ministers of religion, regardless of whether they are lower paid or not.

Standard benefit given to all staff

4.42 We did meet one employer who gives a standard benefit to all staff, including some who average only a few hours' work a week on help lines and would thus be under the £8,500 limit. The benefit relates to the company's product; employees are encouraged to use it widely (including with family members) to ensure they are familiar with all its features and can explain/recommend it to customers. This is agreed to be a benefit with HMRC; the employer is concerned with the potential additional cost for such low paid employees if the £8,500 limit is abolished.

4.43 We are sympathetic to this case but it does seem to be a one-off. We do wonder if the proposed trivial benefit exemption (see Chapter 5) would help or indeed the longer-term policy review proposed (see Chapter 8).

---

[4] See HMRC Manual ESM4530.

[5] Murray v Newham Citizens Advice Bureau UKEAT/1096/99.

[6] Migrant Advisory Service v Chaudri UKEAT/1400/97.

[7] As currently they are exempt from tax under Section 290A of the Income Tax (Earnings and Pensions) Act 2003 by virtue of being lower paid employees.

Possible ways to mitigate the impact of abolition

4.44 Alongside the introduction of exemptions from tax in respect of benefits received by certain groups, we recommend that the consultation also considers additional ways of mitigating the impact of abolishing the threshold.

4.45 It seems to us that many of the issues revolve around accommodation and the possible charge on ancillary services provided. That affects carers and ministers of religion; it may also affect the hospitality industry. Accommodation is already taxed as a benefit on all employees of course, subject to an exemption where it is customary to provide that type of employee with accommodation, or it is necessary for the better performance of their duties. The OTS wants to look further at accommodation benefits as part of the next stage of our work: as our interim report demonstrated, the rules are outdated. An idea we would like to test is whether the 'customary' exemption might also extend to ancillary services, possibly controlled by a requirement that they are 'reasonable'. Such a route may well solve most of the real concerns we have heard.

4.46 Another alternative would be to introduce a universal de minimis threshold below which benefits are neither taxable nor subject to NICs. This could be examined as part of the consultation. The de minimis could either be structured to be cumulative across all forms of benefits, or alternatively it could be applied individually to each benefit or category of benefits. The extent of the benefits which it could cover would also need to be considered. Clearly there would be a cost to the Exchequer if such a de minimis was introduced. It may also give rise to additional administration for employers as they assess whether or not the de minimis has been reached and ensure that supporting records are kept. However, in relation to those employees who only receive minimal benefits, the de minimis could have the effect that the employer has no P11D to complete at all, which would be a real simplification. These issues are considered further in Chapter 5.

4.47 Overall, we do not see any insurmountable problems in abolishing this outdated limit. We have considered carefully the specific groups which we have identified as being particularly impacted, and on which we consider that steps are likely to be needed in order to mitigate the impact on them of the threshold being abolished. There may well be others though it must be borne in mind that only 15,000 people seem to be affected, going by the number of P9Ds. Therefore, the formal consultation on our recommendation to abolish the £8,500 threshold should include seeking evidence on other employees who will be adversely impacted and whether the effects should be mitigated in relation to those groups.

5 Trivial benefits and other administrative burdens

Small benefits exemption

Current guidance

5.1 HMRC guidance sets out how to determine whether or not a benefit can be regarded as a trivial benefit.[1] It explains that cash benefits, benefits with a money's worth and non-cash vouchers, however small in amount, should not be regarded as trivial.[2] The guidance sets out the factors that HMRC take into consideration when making a decision about what can be counted as trivial.[3] These factors are the cost to the employer of providing the benefit, the reasons for providing the benefit, and the cost of processing the benefit (relative to the amounts of tax and NICs at stake). Moreover, HMRC guidance provides some examples of the types of benefits that could be considered trivial.[4]

Key drivers for change

5.2 However, we have heard time and time again from businesses that what counts as trivial is not defined clearly enough; and that the criteria as to what is or is not a trivial benefit leads to confusion.[5] For instance, a bottle of wine given to an employee for a job well done cannot count as a trivial benefit, but if, instead, it is given to celebrate the birth of the employee's child then it can be a trivial benefit. Or suppose the employee does not drink alcohol, and was provided with gift vouchers instead of wine, this could not be counted as a trivial benefit (regardless of the reason for which the benefit is provided). These types of restrictions, coupled with no clear definition of a trivial benefit, have led to inconsistent practice and work that is likely to have had cost-ineffective results for both businesses and HMRC.

Box 5.A: Example

We were given the following example by a major employer which ran a cycle to work scheme. At the end of the scheme period, employees were routinely given their bikes, resulting in a benefit. The business calculated that the maximum benefit would be £45; most would be less. The maximum tax would therefore be £9 (in one or two cases it might be £18 but hardly any affected employees were higher rate taxpayers).

The business asked HMRC to accept the resulting benefits as trivial, but HMRC insisted on full returns being made. There were 2-3,000 employees in the scheme.

[1] This information is available at: http://www.hmrc.gov.uk/manuals/eimanual/eim21860.htm (EIM21860)
[2] This information is available at http://www.hmrc.gov.uk/manuals/eimanual/eim00530.htm (EIM00530)
[3] This information is available at: http://www.hmrc.gov.uk/manuals/eimanual/EIM21861.htm (EIM21861)
[4] This information is available at http://www.hmrc.gov.uk/manuals/eimanual/eim21863.htm (EIM21863)
[5] See page 18 of our Interim report on the review of employee benefits and expenses.

Reducing numbers of P11Ds

5.3 Data provided by HMRC shows that the effect is not inconsequential. In 2010-11, HMRC report that 500,000 P11Ds with overall benefits of £100 or under were submitted by employers.

5.4 Clearer and more rational rules about what counts as a trivial benefit could dramatically reduce the number of P11Ds employers are required to submit, and the amount HMRC need to process.

5.5 It is difficult to obtain the average cost, or even the range of the typical cost, to an employer of outsourcing the processing of their P11Ds. This is because it varies depending on things such as whether there is an existing relationship between the employer and the external company to which the work is being outsourced, or whether the employer uses software or not. But it is important to note that there is a cost for both the employer and HMRC. Furthermore, as HMRC have already alluded to in guidance, the cost to government of processing a benefit should be weighed against the amounts of tax and NICs to be paid.

How could the current definition be improved?

5.6 To increase clarity, ensure consistency and avoid the risk of expensive gifts being disguised as trivial benefits, we think there needs to be a numerical de minimis set out in law. Businesses have told us that they would support the introduction of a monetary limit.[6]

5.7 To avoid confusion about what can and cannot be regarded as a trivial benefit, we think there needs to be a short, easy to understand 'principles based' definition (see Box 5.B), as opposed to a universal list of trivial benefits that are exempt. This is because it would not be practical for such a list to include all relevant items (and be updated regularly to include all relevant new items); it could also be seen as too prescriptive and unfair in situations where a new item is clearly a trivial benefit from a common sense perspective but cannot be counted because it is not on the list.

Box 5.B: Possible definition for a trivial benefit

A starting point for a 'principles based' based definition, for instance, could be to define a trivial benefit as:

- not cash but less than £50 in value; and
- provision is infrequent/irregular.

Examples of what most people would consider to be trivial benefits would fall within this definition: a specialist item of computer software, bottle of wine or bunch of flowers for a job well done, etc. A voucher should be acceptable where the employer can show it is given instead of a gift made to equivalent employees for religious or similar reasons.

However, there is further thinking required to work out special circumstances. For instance, if a company has a contract with a taxi firm for one of their employees, should each journey count as a single benefit or should the whole contract classify as a single benefit?

[6] There is an implicit assumption that the limit would be periodically revised to ensure it retains its value.

How should the limit be managed?

One item per person

5.8 This notion is simple to understand and has been introduced in Ireland, where one small benefit of up to €250 per employee per year is exempt. In Ireland, the exemption applies to the first trivial benefit received by an employee in a tax year. However, a major disadvantage to this approach is illustrated in the box below. It also requires a certain amount of record keeping to monitor which employees have had 'their' benefit each year.

Box 5.C: Example

Mark receives a bottle of wine worth £50 for a job well done.

Steven who works for a different company has also worked hard. But he receives a £30 bottle of wine and a £20 leg of ham.

Because only one item can be exempt, Steven would still be subject to tax on the £20 leg of ham, whereas Mark is subject to no tax (despite receiving an overall benefit of the same value).

5.9 The concept does allow a significant benefit to be covered by the exemption, but as only one item is covered, gives a measure of control on the Exchequer cost.

An annual cap per person

5.10 A solution to the problem identified by the example of Mark and Steven is to introduce an annual cap on the amount of trivial benefits per person. This would mean aggregating items that are considered 'trivial', which is more complicated for record-keeping purposes. Businesses have said this would be a simplification overall.

5.11 However, this approach would result in a greater Exchequer cost. For instance, taking the aforementioned example of Mark and Steven, if the cap was set even as low as £200 no tax would be due and both could be provided with another £150 worth of benefits each before being subject to any tax.

5.12 This annual cap per person approach has been adopted in other countries. For example, in Canada the first C$500[7] per employee per year for non-cash gifts and awards is excluded from the benefits rules.[8]

An annual cap per company

5.13 Some countries have adopted a per company cap in addition to a per person cap. For example, in New Zealand the annual exemption is NZ$1,200[9] per employee per year, or NZ$22,500[10] per year for all employees.[11]

5.14 Again this approach requires a fair amount of record keeping. The two caps may produce unexpected results in terms of Exchequer costs; the fixed per company maximum might be seen as giving an effectively large exemption for small businesses. Realistically there would need to be different maximum limits depending on the size of a business, which would add additional complexity.

[7] Which equates to about £273 at the time of writing in January 2014.
[8] Link to the Canada Revenue Agency: http://www.cra-arc.gc.ca/menu-eng.html.
[9] Which equates to about £597 at the time of writing in January 2014.
[10] Which equates to about £11,192 at the time of writing in January 2014.
[11] Link to New Zealand Inland Revenue: http://www.ird.govt.nz/.

A cap per item

5.15 Another proposal we have considered is allowing applicable items under a fixed amount, regardless of how many claims are made by the employer. For instance, this could be a rule to say that all trivial benefits worth £50 or under are allowable. This has the merit of simplicity and would be easy for businesses to operate.

5.16 The main concern with this approach has been suggested as offering potential for abuse. Businesses might, it has been suggested, start to give a succession of such gifts as a way of rewarding staff tax-efficiently. We have tested this point in a lot of meetings and the notion has been universally derided by large businesses: they would have no reason to do it; there would still be a cost to them; they simply have no budget to do such things. It is conceded that some small companies might try to take advantage of the exemption. However, the principles-based definition above would seem to give HMRC protection against abuse of a set exempt amount. This would also guard against salary sacrifice to obtain multiple small benefits (though we doubt that a salary sacrifice scheme would be cost-effective for a few lots of £50 tax-free).

5.17 A monetary limit means there could be a 'cliff edge'. For instance, if a level of £50 is set as the exempt amount, and an employee receives a benefit worth £55, should they be taxed on the whole £55 or just the £5? The latter option adds complexity due to an additional calculation needed, whereas the former could be seen as less 'fair'. In the interests of simplicity, we think an 'all in' or 'all out' approach should be adopted; so in this example, the employee would be taxed on the whole £55.

Recommendation

5.18 We think the best approach is to define in law the definition of a trivial benefit. We think the change should be a short, easy to understand 'principles based' definition, similar to Box 5.B above.

5.19 This should be supplemented by a set limit for a trivial benefit. In Box 5.B we have used £50 as an illustration but the level needs to be set with the types of benefit to be covered in mind. For example, many people suggest the delivered flower bouquet as the classic example of what should be covered and some have suggested that £50 only covers an ordinary bouquet. A final decision on the amount should have regard to the administrative costs of processing a P11D, looking at the threshold set by other tax jurisdictions, what would be reasonable in practice, and the effect on government revenues.

5.20 There is a theoretical risk that businesses will provide extra benefits to their employees if our recommendation is adopted. But in reality, commercial considerations will control this, as will the requirements of the principles-based definition.

Steps to reduce 'nil P11Ds'

5.21 An objective highlighted in the interim report was to identify ways of reducing the number of P11Ds submitted to HMRC that do not yield any tax – nil P11Ds. These could be P11Ds that contain expenses for which the employee will make a corresponding claim or literally 'nil P11Ds' that report no expenses or benefits. The former would be reduced by the recommendation in Chapter 3 that proposes an exemption for qualifying business expenses. As we understand it, the latter is the mechanism by which employers notify HMRC that a benefit has ceased.

5.22 We have considered what can be done so that employers can notify HMRC that a benefit has ceased. Voluntary payrolling can eliminate nil P11Ds, provided, as recommended, the requirement to report payrolled benefits on form P11D is dropped. When a benefit ceases it simply no longer goes through the payroll. There is no need to amend PAYE codes.

5.23 For those employers who are not payrolling we suggest two solutions. Firstly employers should be able to indicate on form P11D if they are providing a one-off benefit. The benefit can then be included in the employee's PAYE code for just one year. Secondly employers should be able to notify HMRC immediately in the course of the tax year if a benefit has ceased. This is a component of quick win 31, from our interim report, which HMRC will be considering in this parliament.

5.24 Under RTI, employers are required to indicate on the end of year Full Payment Submission (FPS) if they will be filing P11Ds or P9Ds. Previously they would tick a box on their P35 to indicate whether the returns were due. It was suggested that employers have been required to submit blank P11Ds if they have indicated on Form P35 that P11Ds are due. However, on closer inspection it seems that the box is only there as an indicator and not to tie employers into filing nil P11Ds. We assume that the intention is the same for the end of year FPS. In neither case does the employer specify for which employees it will be completing P11Ds. If employers erroneously indicate that they are submitting P11Ds and P9Ds, we would suggest that a better solution would be to notify HMRC of the error rather than complete nil P11Ds and P9Ds. HMRC will investigate and issue penalties if it is expecting P11Ds on the back of the employer indicating that P11Ds or P9Ds are to follow but none are submitted.

5.25 We recommend that HMRC clarify their expectations when employers indicate on the Full Payment Submission (FPS) that they will be filling P11Ds or P9Ds. It should also make clear to employers the action that should be taken if the employer concludes that there are no forms or fewer forms to complete compared to the previous tax year.

Flat rate expenses – employer involvement

5.26 The Treasury sets fixed sum allowances for repairing and maintaining work equipment, which includes tools and specialist clothing, that can be claimed by members of certain professions as a tax deduction. These flat rate expenses (FREs) can be included in the employee's PAYE code. During our early stages of research we learnt that FREs can stay in an individual's PAYE code even if they are no longer entitled to them.

5.27 We recommend that HMRC introduces a mechanism for reviewing codes for FREs (see quick win 26 in our interim report).

5.28 However, if employers were to be more involved in obtaining relief for FREs this could reduce the problem. There are two ways that employers could do this. Both would increase an employer's administrative burden and should therefore be voluntary. However, some employers we spoke to indicated that they would be interested in helping their employees secure FRE tax relief as part of their role as responsible employers.

5.29 We are aware that some employers through informal arrangements write to HMRC on an annual basis to notify HMRC of the FREs that should be included in their employees' PAYE code. We recommend that more employers are encouraged to do this by introducing formal arrangements for doing this. HMRC could remove an FRE from an employee's code if the employee is not included in the employer's list for a subsequent year, unless the employee has made a separate qualifying claim.

5.30 HMRC have advised us that there are employers who currently do this and that it allows HMRC to make sure that PAYE codes are up to date.

5.31 We also recommend that employers should be allowed to obtain tax relief for their employees through net pay arrangements, i.e. through the payroll.

5.32 Employers would need to notify employees on the payslip that they have made the adjustment. We spoke to one employer who on encouragement from the unions has set up their payroll so that their employees get a deduction for FREs through the payroll. HMRC have indicated that they are investigating this option further. This arrangement would be a natural complement to payrolling, as discussed in Chapter 1.

5.33 We recommend that both options are available to employers as an employer's preferred route for obtaining tax relief on behalf of their employees will depend on the resource they have available and the sophistication of their payroll software.

5.34 In either case employers should notify their employees that they are claiming FREs on their behalf so that the employees do not also claim the relief.

Levels of FREs

5.35 It was suggested by some employers that FREs are so low that they should be scrapped and the money saved used to raise personal allowances for everyone.

5.36 FREs represent qualifying business expenses that employees could claim under first principles. Setting a fixed amount that can be claimed for a given role represents a simplification. The alternative would be for all employees to claim an amount that they think is representative and then HMRC would have to put resource into reviewing the amounts claimed. We do not think scrapping FREs would be a simplification.

5.37 However, it is certainly the case that some FREs are very small and give very modest amounts of tax benefit. We therefore recommend a programme reviewing FREs and:

- raising FREs if they have become unrealistically low;
- abolishing any that have become outdated;
- improving guidelines on who is eligible; and
- publicising their availability.

Equipping employers

5.38 In Chapter 3, an exemption for qualifying business expenses, we have talked about how HMRC will need to increase employer support for the recommendation to be implemented successfully. We also think that it should be easier for employers to be able to locate in one place the information they need to meet their reporting and withholding obligations in respect to benefits and expenses. HMRC have introduced a range of agent toolkits which includes one on benefits and expenses. This may be useful for larger employers that have in-house expertise, but we recommend that there is a more targeted resource for employers, in particular smaller employers. It was quite apparent during the early stages of our research that a simple lack of awareness is an issue in many cases.

5.39 **We would like to see HMRC produce on its website a section that is equivalent to no more than one or two pages that sets out all of an employer's obligations in respect of benefits and expenses with relevant links that takes them to the more detailed instructions and information. New employers should be sent a link to this page when they first register for PAYE.**

PAYE online

5.40 HMRC are currently undertaking a number of projects to improve employee personal tax services – by developing online products to make engaging with HMRC easier. One of these is the PAYE online accounts exemplar. This could, among other things, lead to a simplified process

for employees to claim tax reliefs, or inform HMRC about any changes to their benefits or expenses. Whilst HRMC's digital exemplars programme of work is outside the scope of this report, it is important to be aware that progress in this area has the potential to unlock greater simplification in the future.

6 Travel and subsistence

Introduction

6.1 Our conclusions from our consultations with employer groups and stakeholders are that:

- at this present time, the current system is understood and works for a lot of employees (e.g. those who attend the same workplace each day). The majority of the complexities that arise within the current system relate to employees who are required to travel regularly to undertake their duties;
- there is no real appetite among employers for a major change: they (and they believe their employees) are concerned about the disruption and possible costs this would bring (this does not invalidate our recommendation for a study into a major change in the system as we think that the potential benefits to employers would be seen as outweighing concerns – but all that would have to be tested and it is certainly a long-term project); and
- the strong preference is to address the specific problems with the current system – in other words to build on a system that works for most people most of the time.

6.2 The interim report highlighted a number of areas where complexities are perceived to exist within the current legislation and guidance. Within this chapter, we have considered further where the complexities lie and how these issues should be addressed.

What are the complexities in the current legislation?

6.3 We have spent considerable time talking to employer groups and stakeholders about their concerns and difficulties with the current system. We have challenged them carefully about these concerns, bottoming out as best we could what the real issues are – and how best to solve them.

6.4 We have set out below three main problem areas, based on the many examples provided to us in compiling this report in an attempt to bring to life some of the main problems and complexities.

Regular attendance (and the meaning of "workplace" and "permanent workplace")

6.5 The complication arises where employees regularly or irregularly attend more than one workplace – this could be a company site or a customer site.

Example:

- Senior Manager at a bank – contract states that permanent workplace is Leeds and employee spends most working days at the Leeds office;
- the employee lives in Bradford;
- the employee travels to Head Office in London on occasions for meetings and will also visit customers when required;
- the employer asks the employee to start spending time in Manchester to identify opportunities and build relationships with customers. The employer expects the

employee to be in Manchester each week up to two days indefinitely. The employee agrees to only go to Manchester for productive meetings – no set days; and

- the employer does not reimburse home to Leeds travel but does not want the employee to be out of pocket so agrees to reimburse costs incurred in travelling to Manchester plus any associated subsistence.

Current tax/NICs treatment for travel/subsistence expenses:

- no relief would be available for travelling from home to Leeds; and
- full relief would be available for travel to temporary workplaces such as Head Office in London, customer sites etc.

There is currently no clear answer to the new scenario of travelling to Manchester up to two days a week.

The "24 month rule" and moves to sites where the journey is not substantially different

6.6 The 24 month temporary workplace rule is based on what it is "reasonable" to assume. The deductibility of travel and subsistence expenses associated with a temporary workplace depends on the intention rather than the actual final length:

1 some employers are struggling to communicate these rules to operational staff, particularly around knowing when the assignment will exceed 24 months; and

2 in addition, where an employee goes on assignment for 18 months then is moved to another temporary assignment for 18 months, it is not clear from the legislation or the guidance whether this is acceptable and how different the location must be for both sites to qualify.

Examples for the two scenarios above:

- an employee goes on secondment from their normal office in Manchester to the company's London office to assist with a project for 20 months. After 12 months, the employee's manager informs them that the assignment will run for a further 13 months; and
- a construction worker is moved from a site in the North East of England to the site in Canary Wharf, London. At the end of the project, he is moved by his employer to Heathrow for a further 18 months. Is this two separate contracts for less than 24 months so that tax relief for travel/subsistence applies throughout, or does relief stop after the Canary Wharf job because Heathrow is ostensibly the same (both being in or around London)?

Current tax/NICs treatment for travel/subsistence expenses:

- scenario 1 – after 12 months (when the employee is advised that the assignment will ultimately exceed 24 months), any payment in relation to travel/subsistence in travelling to or staying in London would be liable to tax/NICs; and
- scenario 2 – there is currently no clear answer to a situation like this and this leads to long protracted debates with HMRC.

As well as the operation of the 24 month rule discussed above, we have regularly heard concerns about the way that employees assigned to what will by definition be a temporary workplace will still end up being taxed as a 'permanent' workplace simply because the contract is lengthy. This is usually construction-related; examples given have included the Glasgow

Commonwealth Games stadium or the development of a housing estate. Both locations will cease to be workplaces in due course.

Homeworkers

6.7 Employers are unclear on the travel/subsistence expenses that can be paid to employees free of tax/NICs. Partly this is because of 'homeworking' covering two distinct scenarios:

1 the employee is based at home; there is no 'office' base; and

2 the employee is based in the office but is allowed to work at home some of the time.

Confusion is compounded by arrangements for homeworking often being made by HR departments without consideration of tax issues.

Example:

- employee accepts a job with employer and agrees to work from home for the majority of the week;
- employee is required to attend meetings at company offices but these are infrequent, no more than once a week and the location will vary;
- the employee lives in Birmingham;
- the company's offices are in Manchester and London. The employee therefore lives in between the two meaning travel to either is convenient; and
- the employee's predecessor was based in Manchester.

Under the same example above, the employer reimburses the cost of home broadband and provides conference call facilities, a laptop and a printer.

Current tax/NICs treatment for travel/subsistence expenses:

- travel/subsistence costs – travel in performance of duties or travel to a temporary workplace will be eligible for relief. The problem we have is determining if the employee should have a "permanent workplace" at any of the company offices. Even though they may only go to a company office occasionally, the employee is working at home out of choice; and
- some of the costs incurred in working at home may be tax/NICs free but this will vary based on method of payment, which party contracts with the service provider etc.

Further considerations

6.8 One of the key complexities in the current legislation is the definition of ordinary commuting, based on the artificial distinction between a **permanent** and a **temporary workplace**. As shown in the examples above, the definitions often rely on subjective tests and complex considerations such as 'regular' and 'necessary' attendance at a workplace, 'a task of limited duration', and understanding HMRC's interpretation of 'for some temporary purpose' (see legislation at Annex A).

General complexities

6.9 Further issues that are causing **general complexity** relate to the uncertainty regarding what can be claimed where home is a workplace (as per the example above) and the special foreign travel rules for workers carrying out duties abroad or workers coming to the UK from abroad.

Finally, there is currently no legislation covering subsistence expenditure. This has been raised as a concern as this leads to a reliance on opinions and judgement.

6.10 In addition to the comments and examples above, the following, specific points have also been highlighted as complexities/problems by employers:

- **HMRC's guidance** in relation to travel/subsistence is outdated, incomplete and inconsistent (booklet 490, defining a permanent workplace for non-executive directors, the definition of regions etc);
- HMRC's refusal to the use of **PAYE Settlement Agreements** for taxable travel and subsistence expenses;
- employees regularly attending **more than one workplace**;
- **living accommodation** provided when attending a temporary workplace;
- HMRC requiring employers to undertake onerous checking in relation to the use of **benchmark scale rate payments** for subsistence; and
- the removal by HMRC of the **'friends and family' overnight allowance**.

Simplifications to current system

6.11 In seeking simplifications to the current system, we have been faced with a significant challenge in that businesses do not want changes which result in further cost to their business, and HMRC do not want changes that cost the Exchequer. This has proved problematic in identifying changes that are cost neutral to both parties. We are mindful that our mandate is simplification so, whilst we have considered cost implications, we have looked for routes that will deliver simplification gains. It will be for Ministers ultimately to balance simplification gains against any revenue costs, though we think that what we are recommending in this chapter strikes a proper balance between simplification and cost.

6.12 We have set out below recommendations to address the issues above. We have separated our recommendations into two broad categories – **changes to HMRC guidance** and **legislative changes**. Clearly, if any of the legislative changes set out below can be adopted quickly, this should be factored in to any changes to HMRC guidance to avoid wasted time/resource.

Changes to HMRC guidance

HMRC guidance

6.13 Concerns have been expressed by stakeholders throughout our research regarding HMRC guidance in relation to travel and subsistence.

6.14 In this area, most people – employers, advisers and employees, and indeed HMRC staff – rely on guidance as the legislation is broad and general. Views were expressed regarding the HMRC 490 booklet being outdated and not reflecting real life or current working practices.

6.15 It was also felt that HMRC's employment income manual has become unwieldy, contradictory and difficult to navigate.

6.16 **We recommend that, in addition to the specific points raised below, HMRC produces updated guidance, particularly a new 490 booklet.** We are aware this will not be a quick process. What we are seeking is an immediate commitment to do so.

6.17 This should be given priority and proper resources allocated. The aim must be to develop new guidance in an accessible manner that will obviate problems and questions referred to HMRC – this is not just a cost for HMRC.

6.18 We recommend that this be done via a working group incorporating representative bodies and industry groups to make sure that the document is more user friendly and the scenarios and examples recognise current/modern working practices e.g. non-executive directors, managers working across sites, construction industry projects.

Defining a workplace – London and other regions

6.19 Employers have highlighted issues around itinerant workers i.e. those who move from workplace to workplace every few months. There is currently no legislation and very limited guidance regarding the distance needed for a workplace to be agreed by HMRC as substantially different to the last one.

6.20 This is particularly problematic in London given its size and the time it can take to travel from one part of London to another. The problem arises for employers when, for example, an employee is posted to a site at Canary Wharf for 18 months then at the end of this assignment is moved to Heathrow Airport for the next 18 months. We have heard regularly from employers that HMRC normally regards 'London' as a single location so it would seem these would not be two separate workplaces for tax purposes with relief available for both. Instead HMRC may deem the posting to Heathrow to be a permanent workplace based on the overall duration in 'London' being beyond 24 months.

6.21 We recommend that HMRC publish clear and consistent guidance on this issue with reference to miles and/or additional travel time that is realistic and accords with what employers expect of their employees.

6.22 HMRC should consult with employer groups and industry bodies to make sure that the guidance is fit for purpose.

6.23 This recommendation would provide clarity to employers and remove inconsistency in advice from HMRC. It would also remove the current perception that some employers are given better deals than others.

Non-executive director travel

6.24 Stakeholders raised the issue of travel and subsistence for non-executive directors (NEDs), advising us that it is not always clear where their permanent workplace is.

6.25 The role of a NED can vary immensely from one company to another as can levels of remuneration. Some employers advised us that all board meetings are held at head offices making the workplace clear. However, others advised us that board meetings are rotated around all company sites (sometimes throughout the world) and are rarely held at the same place twice. We also heard examples of NEDs who are required to work from home numerous days each year. (There is an obvious read-across to the discussion below on 'homeworking'.)

6.26 We recognise that this is a complex area and recommend that this issue is addressed under the recommendation above "HMRC guidance".

PAYE Settlement Agreements (PSAs)

6.27 A quick simplification for employers would be to allow travel (and the associated subsistence) expenditure to be included in PSAs. For example:

- costs relating to employee assignments/secondments beyond 24 months; and
- costs incurred by an employee where the employer "asks" the employee to attend a second permanent workplace on a 'regular' basis.

This is considered further in Chapter 2.

Legislative changes

More than one permanent workplace

6.28 When consulting with stakeholders, this has been the most common issue raised in terms of complexities within the travel legislation.

6.29 Increasingly, employees are required to attend more than one company office or site. This can be both frequent and infrequent and we heard numerous examples of managers having responsibility for staff at more than one company site.

6.30 The current legislation and guidance regarding the definition of a permanent workplace is seen as complex and unclear, and often does not reflect modern working life for employees who may attend more than one workplace.

6.31 Many employers currently use a test of '40 per cent of an employee's working time' to determine if a place they attend is a permanent workplace. Although this percentage derives from HMRC guidance, it is often used incorrectly by employers.

6.32 The simplest way to remove this complexity/subjectivity would be for the legislation to say that employees can have only one permanent workplace within an employment. That place would be the place where the employee spends the greatest part of their time (as a question of fact) and would if necessary be recorded by the employer.[1] If the 'greatest part' was the employee's home, the test discussed below over establishing the home as a required workplace would still need to be satisfied.

6.33 We think this 'one workplace' concept offers real scope for simplification. However, we recognise that this could present a significant cost to the Exchequer as, currently, many employees have more than one permanent workplace and do not receive relief for the costs of travelling from home to either workplace. We have not, in the time available, been able to estimate that cost and it is not the role of the OTS to finally determine costs in any event. So our recommendation is that this possible way forward is explored, but we also put forward an alternative.

6.34 The alternative OTS proposal is that a workplace can only be treated as a permanent workplace if an employee spends over a set percentage of their time there. This does, of course, formalise the HMRC guidance in many ways but we think the current guideline is too high: our tentative view is that the level should be 30 per cent of an employee's normal working week and we have used this to illustrate the following discussion.

6.35 We recommend that a clearer definition of a permanent workplace is brought into the legislation.

6.36 Our preference from a simplification point of view is to have a rule that says an employee can have only one permanent workplace, being the place where they spend the greatest part of their working time.

[1] This sort of system applies in the USA.

6.37 **However, if costing shows that this route would be too expensive for the Exchequer, we recommend amending Section 339 ITEPA 2003 to redefine "permanent" and "temporary" workplace by introducing a statutory percentage test, probably at 30 per cent (see below).**

Example:

- if an employee spends more than 30 per cent of their working time at a workplace, and this is not for less than 24 months, the workplace will be deemed to be a permanent workplace;
- if the employee spends 30 per cent or less of their time at the workplace (even if this is not for a limited duration), the location will meet the definition of a 'temporary' workplace and relief will be available;
- our recommendation for a 30 per cent test is on the basis that it would allow relief for an employee who visits a workplace once a week (assuming they work a five day week), but this percentage would not allow relief where an employee attends a workplace two days each week;
- the test should be prospective but needs to be assessed on a rolling 12 month basis to confirm whether the employee is at 30 per cent or more. The test would be based on working days, geared to the employee's normal working pattern (to cater for part-timers). Each "attendance" at an office would be a "day" for assessing the test unless it is clearly for a part of a day with another part being spent at another location, leading to a simple proportionate allocation. Although this smacks of having to maintain careful records, we do not think there is any additional burden here and that it does represent a simplification:
    - for the vast majority of employees, there will be no need to maintain detailed records setting out why they attended a workplace and what duties were performed at the workplace;
    - for all employers and employees this is a simplification as there will be a clear rule which will dictate whether a workplace is permanent or temporary;
    - for those for whom it is relevant, the decision will normally be easy to manage based on working patterns for a normal week; and
    - if there really is a borderline case, we assume that HMRC guidance would indicate how the employee could demonstrate their position – probably by compiling a simple daily log based on their diary. Such employees currently have a much greater burden in showing what duties were performed etc.

6.38 As stated above, this recommendation would not impact the 24 month rule (see further discussion below).

6.39 Whether a 30 per cent test would generate additional yield for the Exchequer is debateable. At first blush it would, as many employers currently monitor employee attendance using a 40 per cent test. Against that, employers will be clearer on the break point; many have been faced with arguments that because the employee goes to two or more sites regularly, they are all permanent workplaces. They will no doubt manage the situation better and with greater certainty – implying more employees able to claim temporary workplace relief.

6.40 One detailed point that needs to be considered is whether an employee would need to have at least one permanent workplace. This could be a supervisor who covers a wide range of sites, none of which takes up more than (say) 10 per cent of their time. Would they have to

deem one to be permanent? Or the 'travelling employee' who covers an area but comes into the office base every couple of weeks to report: would the office be their permanent workplace or would they be home based?

6.41 As part of the work taking forward this recommendation, the situation around travelling employees (or 'area workers'), covered in some detail in booklet 490, needs to be explored. In the time available, the OTS has not been able to devote enough time to this area to develop a clear recommendation and in any event, we think that the main decision needed is to agree to take forward the '30 per cent rule' or 'single workplace', with other areas following during consultation.

Box 6.A: Examples of how the 30 per cent rule would apply:

We have been cited many actual examples during our discussions where the current rules cause problems. If the proposed '30 per cent rule' is brought in, the impact would be on some of the situations raised with us:

- University staff: it is increasingly the case that universities have two or more campuses. A lecturer who was based at one campus but went to the other site to give lectures (say) three times a week would be clear whether the second site was 'temporary' on this basis.
- Council workers: we have been told by more than one council that their staff contracts are framed in terms of requiring employees to work at any of the council's locations in the city/borough. Under the 30 per cent rule, most employees would have a clear main base, with others being temporary because the travel there would not reach the 30 per cent level.
- Supervisor: the common situation where a manager covers more than one team at more than one site can be quickly evaluated – so working Monday-Wednesday at one location and Thursday-Friday at the other means two permanent workplaces. If the Thursday and Friday are actually a day at each of two other workplaces, neither would be a permanent workplace.

Temporary workplaces – the 24 month rule

6.42 The 24 month temporary workplace rule is based on 'intention' and what is 'reasonable' to assume. The deductibility of travel and subsistence expenses associated with a temporary workplace depends on the intention at the start of and during the assignment rather than the actual final length.

6.43 We recommend permitting a deduction for the first 24 months regardless of the intended length of the assignment.

6.44 Provided the conditions of Section 339(3) ITEPA 2003 are met, i.e. the employee attends the temporary workplace for the purpose of performing a task of limited duration or for some other temporary purpose, a deduction is allowed for the first 24 months regardless of the intended length of the assignment.

Example:

- If an employee attends a temporary workplace for 36 months, a deduction will be allowed for the first 24 months, regardless of whether it was reasonable to assume that the assignment would be longer or shorter than 24 months at the outset.

- If an assignment is expected to last less than 24 months, but at some stage it is extended, the first 24 months of expenses will still be allowable. Under current rules the deduction would cease to be available when the intention changes.

6.45 We believe that this recommendation would give employers clarity and certainty when sending employees on assignment. This would remove the current complexity around intention and change in intention.

There are three main concerns that we would note:

- to prevent claims for a wide range of 'temporary' workplaces that to all intents and purposes are permanent, it would have to be shown that the workplace was genuinely temporary and genuinely a workplace, an objective criteria that potentially would be decided on appeal to the Tax Tribunal;
- there may be concerns about other abuses – but these should be no more (apart from the point above) than exist under current rules; and
- this recommendation is likely to represent a cost to the Exchequer. However, we believe that the cost will be lower than expected because of the behavioural effects of the current legislation i.e. many employers already take the 24 month rule into account when setting temporary assignment periods because paying the tax/NICs liability on travel/subsistence would usually fall to the employer and this is quite often a significant cost. This may take the form of a review at the 24 month point by the employer, and an assignment extension (during which any subsistence provided and travel costs are taxable), or one employee may be replaced by another to ensure tax relief is retained. The behavioural effect of the tax rules may be overriding the commercial purpose of keeping the best person on site for the full project duration.

6.46 We accept that costing considerations may dictate setting the 'break point' at a level shorter than 24 months, but believe that 24 months should be the starting point for consultation and evaluation.

6.47 Finally, it should be noted that the recent change to the rules on establishing whether someone is ordinarily resident in the UK has moved away from an intention based rule.

Homeworkers

6.48 Homeworking has been raised as a complexity in three ways:

- defining someone who is based at home – do they work at home out of choice (i.e. because they can) or does their job role mean they have to work from home (e.g. a customer-facing sales executive)?
- claiming travel expenses when travelling to company premises; and
- expenses that can be claimed by the employee in relation to the home itself.

6.49 As noted above, there are two broad homeworking situations:

- the employee is based at home; that is their main work location; and
- the employee is based in the office; they are allowed to work some of their time at home.

Homeworking is an area which is currently dealt with by a combination of different tax provisions:

- reimbursement by employers for additional household expenses (s316A ITEPA 2003);
- claims for deduction by an employee for expenses under the general expenses rule (s336 ITEPA 2003);
- provision of office equipment by employers (s316 ITEPA 2003); and
- travel in performance of duties and travel for necessary attendance (s337 & s338 ITEPA 2003).

Recommendations

6.50 Implement a specific code for homeworkers with one clear definition of homeworking for all tax purposes.

6.51 The code would distinguish between employees who work from home because they can, and those who have a genuine business need. Where there is a genuine business need to work from home, relief for travel expenses would follow our proposal above regarding the definition of a permanent and temporary workplace.

6.52 A further recommendation would be to remove the facility for employees to claim the cost of expenses not met by the employer in working from home e.g. telephone bills, internet, utility bills, but provide an uplifted homeworking allowance (to £10 a week for example). This would be payable free of tax/NICs where the employee meets the definition of a homeworker.

Subsistence – include accommodation and subsistence in legislation

6.53 Stakeholders have expressed concern that there is no legislation relating to the payment or reimbursement of subsistence expenditure.

6.54 We recommend that a section is added to ITEPA 2003 referring to 'accommodation and subsistence expenses'. This would follow Sections 337 and 338 and would permit a deduction from earnings for accommodation and subsistence. Example:

A deduction from earnings is allowed for accommodation and subsistence expenses if:

- an employee is obliged to incur and pay them as a holder of the employment; and
- the expenses are necessarily incurred in relation to Sections 337 and 338.

6.55 Alongside the introduction of legislation for subsistence, updated guidance should be introduced to give clearer definitions of meals including specific reference to drinks with meals as there is no reference to this in guidance at present.

6.56 Finally, an aspect of subsistence is the question of costs incurred by employees working away from their normal place of work (or base location) on lunches. There are various guidelines operated by HMRC, based on distance away from base, time spent at the location etc. Sometimes P11D dispensations cover reimbursement of lunch costs in such circumstances. But these cover actual costs incurred and not costs of the employee providing their own packed lunch.

6.57 Related to this issue is the subject of 'working lunches' provided on site, where employees carry on working but are provided with sandwiches etc to facilitate that process. In many ways, this is the sort of 'non benefit' that we discuss in Chapter 8, but in strictness there can be a benefit and again P11D dispensations (or PSAs) are used to manage the procedure.

6.58 Any consideration of lunch costs also runs into the 'canteen exemption'. That is a longstanding item but it does date from a time when employees were all on one site and

employers were in effect being encouraged to provide them with a hot meal in the immediate aftermath of World War 2. Different working patterns, including part-time working, smaller office-based employment, and/or employers who operate from many sites, all serve to question how well this exemption works today.

6.59 The general issue of lunches has been brought to our attention with points being raised about fairness in the current system. For example, why should an employee seconded by their employer for 12 months to the UK from abroad receive relief for lunch, when relief is not available for the cost of lunch for a UK employee sitting at the next desk to the secondee?

6.60 We therefore wonder whether this whole area needs to be reviewed. We have not had the time to do a full review, partly because concerns around this issue were only raised with us late in our evidence gathering process. The sensitivity of the area means that any review needs to be careful and thorough. **We therefore recommend that consideration is given to such an exercise, the objective being to modernise the rules and improve consistency.**

Living accommodation provided when relief is available for attending a temporary workplace

6.61 This subject links to the discussion in chapter 8 about benefits that are not seen as benefits by employees.

6.62 If an employer paid for hotel accommodation for an employee attending a temporary workplace, this would not be a benefit and would not need to be reported on form P11D (assuming the employer holds a P11D dispensation). However, where a flat/apartment is provided in the same situation, this would need to be reported on form P11D (the living accommodation box should be used) with relief claimed by the employee from HMRC. The current legislation does not allow living accommodation in employer owned or rented accommodation to be included in a P11D dispensation.

6.63 **We recommend that where a deduction is available for attendance at a temporary workplace, living accommodation should be included in a P11D dispensation whether provided through hotel accommodation or use of a company flat (or equivalent). This would require a change to primary legislation.**

6.64 This recommendation would reduce administration, reporting and processing for employers and HMRC.

Benchmark scale rate payments

6.65 Employers are frustrated around the extent of ongoing checks, particularly regarding the collection of receipts for expenses incurred when they have elected to pay benchmark scale rates. An example provided to us by an employer was a worker seconded to another office for 12 months – to reduce administration, the employer permits the employee to claim the costs incurred for lunch using the benchmark scale rate payments (without the need to produce receipts).

6.66 The purpose of scale rates is to streamline processes. In the example given above, the employee is clearly entitled to relief for subsistence (as long as costs are incurred).

6.67 It should be noted however that there is general concern over the payment of benchmark scale rates as part of travel and subsistence salary sacrifice schemes.

6.68 **We recommend that the guidance around ongoing checks is amended to remove the requirement for employers to retain receipts and only require them to be able to demonstrate that the employee is attending a temporary workplace.**

6.69 However, the current checking regime should remain where the payment of benchmark scale rate payments are used as part of a salary sacrifice arrangement.

6.70 We understand from discussions with HMRC that this recommendation is likely to require a change to primary legislation.

6.71 We believe that this recommendation will streamline processes for employers with a genuine commercial need to pay benchmark scale rates.

Foreign travel rules

6.72 Within this chapter, we have focussed on UK travel/subsistence legislation and guidance. We have not addressed the foreign travel rules due to time constraints and the requirement to prioritise what we believe to be the main issues affecting employers.

'Friends and family' overnight allowance

6.73 An issue raised regularly during our meetings was the reinstatement of the overnight allowance for staying with friends and family. This was an amount that employees staying overnight with friends instead of in a hotel were allowed to claim (typically £25), nominally for taking their host to dinner or as a general fee. HMRC scrapped the allowance some years ago over concerns about abuse and because of the lack of evidence that the costs were incurred.

6.74 We can see the business reasons for employers to have such an arrangement: it can be very cost-effective. But it is hard to argue on simplification grounds for a blanket exemption for any such payments. However, if there is evidence of actual cost being incurred, the 'qualifying business expense' principle (see Chapter 3) should exempt a payment. In addition, our proposals around PSAs should certainly cover such items if they are not exempt.

Radical options

6.75 Aside from looking at fixes to the current system, we have also explored a number of radical options which would mean a complete change to the system of travel and subsistence expenses – effectively junking the current system and starting again. There has been cautious interest in the idea of a radically new system for travel and subsistence expenses; almost all of our meetings have elicited issues with the current system and a feeling that it has not kept pace with changing working patterns. The OTS's objective for this part of our project has been, therefore, to test whether there is a better, more modern system that would both simplify the current rules and better reflect 21st Century working patterns.

6.76 We considered initially two long term/radical options, which might be viewed as options at the ends of the 'expenses spectrum':

1 a system which provides no relief for any travel expenses; and

2 a system which provides full relief for travel expenses including ordinary commuting.

6.77 We do not believe that options 1 and 2 above should be considered further as they would lead to greater complexity and increased reporting burdens for employers and employees.

6.78 Option 1, no relief for any travel expenses would mean employees would have to pay tax and NICs on all travel expenses reimbursed by employers. There are currently around 140,000 P11D dispensations for travel and subsistence, so around 140,000 employers would face the additional burden of reporting reimbursed expenses on P11Ds or payrolling them (often grossed up to account for tax/NICs). Employers told us that employees would refuse to travel if they had to pay tax on the expenses – meaning employers would come under pressure to pay the extra tax and NICs.

6.79 HMRC estimate the total travel and subsistence expenses reported on P11Ds (i.e. not covered by dispensations) to be £580 million in 2010-11. The additional Exchequer yield from

tax and NICs on all travel expenses would be £100s of millions. Option 1 could result in savings for HMRC, removing the need to process travel expenses claims and agree dispensations, but it would greatly increase the number of P11Ds to process/items to payroll. It would be much more burdensome for employers and employees, unless PSAs became the norm (at a transitional administrative cost to HMRC).

6.80 A key objection to the Option 1 route is that it would be seen as anti-business. It must be a non-starter.

6.81 Option 2, relief for all travel expenses including ordinary commuting would mean considerable additional cost to the Exchequer. It would also not be a simplification, as many more employees would be able to claim expenses. There would be many more expenses claims for HMRC to process.

6.82 This route would distort markets in transport services and could go against environmental policy (in that it could be seen as encouraging longer travel, potentially by car). There is a possible variant which would be to allow commuting costs by public transport – perhaps only season tickets. Here we are straying into significant policy matters which are outside the OTS's remit.

6.83 There would, however, be little additional complexity for employers. Indeed, some might find the route easier as any reimbursement of travel costs would be non-taxable and so have no P11D etc implications.

6.84 Overall, this too seems to be a non-starter because of the additional cost to the Exchequer coupled with the way it would probably increase, rather than reduce administrative burdens.

6.85 Neither route really seems to offer real simplification gains.

A third (radical) way

6.86 There is a third radical approach, which we believe has potential to deliver simplification whilst recognising business needs.

6.87 This radical option would be to replace the current system with a completely new legislative framework whereby all travel and subsistence expenses (possibly not including ordinary commuting) would be exempt/allowable if reimbursed by the employer. However, no relief would be available for employees if expenses are not reimbursed by their employer.

6.88 The underlying principle for this approach is that the tax system would follow the employer's policy on reimbursing travel and subsistence expenses and would therefore be in line with business needs and objectives.

6.89 We believe that this change would lead to the following simplifications:

- there would be no need and no facility for employees to submit claims to HMRC for relief in relation to travel/subsistence expenses;
- we would expect to see a big reduction in HMRC resources devoted to this area as there would no requirement to process claims from employees and agents; and
- this system would remove the ambiguity and uncertainty over what can be claimed.

6.90 We believe that this is an attractive simplification as it leaves the decision to the business. This new system would remove all current complexities, including:

- second permanent workplace – there would be no ambiguity over the definition of a permanent workplace and 'regular' attendance, commuting, limited duration, temporary purpose etc;

- 24 month rule – there would be issue over employees exceeding 24 months and therefore no issue over itinerant workers and changes to their workplace; and
- homeworkers – there would be no consideration needed around travel/subsistence expenses for homeworkers.

6.91 This system would be a radical change and we have of course identified a number of issues which will require further consideration:

- this option is open to abuse and presents a salary sacrifice opportunity, or the opportunity for employees to forgo pay rises in exchange for employers paying for commuting costs. Legislation would need to be considered to counter such exploitation;
- there would be concern about employers who would not reimburse travel costs: employees would have no facility to claim a tax deduction and could be significantly out of pocket. The response to this is that the market would help even things up: employers who did not pay travel costs would find employees unwilling to travel for them. However, that is probably too facile an assumption: pressure could clearly be brought on employees by employers trying to control costs;
- this may be seen as a burden for small businesses and their employees, on the basis that they have less resource to devote to managing and reimbursing costs. This needs to be tested;
- this method does raise the possibility of effectively allowing a tax deduction for commuting, in that any reimbursement would on the surface be tax-free; and
- similarly, employers could also reimburse other private journeys, including holiday travel. The solution (assuming no desire to allow commuting costs) would presumably be to frame the legislation in terms of covering business journeys only. That immediately suggests that there would still be a need to carry out the sort of assessment of the travel as is now the case – i.e. 'business travel' would still be the key determinant. This needs to be probed to see how much of an issue it is: it may be possible to operate a fairly simple generic rule.

6.92 We would be interested in reactions to this possible reform. We have tested it during some of our meetings and the comments received indicate an interest in considering it properly. We therefore recommend a formal, comprehensive study is carried out on this possible radical change to test the issues further and assess its potential impact. If this is pursued, it will clearly be a long-term change and should not hold up the other reforms we have set out in this chapter.

6.93 As a supplementary recommendation we would say that there will be a need to keep the whole system of travel expenses under review against changing working patterns. A formal review every ten years would seem appropriate to test whether the rules are still working or need change. Any future review should involve full time resource from both HMRC and the private sector.

7 Simplifying NICs – what more can be done?

7.1 Many of the complexities in the current system derive from the two systems of NICs and income tax. There are various ways to address the resulting problems. Each of these offers different potential to achieve simplification. These issues have been examined by the OTS in the Small Business review[1] and many commentators, including the IFS in 2007,[2] and then more recently in the Mirrlees Report.[3] Options are:

- Full integration of the income tax and NICs system so that there is one unified tax. This is something which would reap significant simplification rewards in the long term. It would undoubtedly be complex and raises significant issues going to the heart of the current system and has many political implications. The OTS maintains that this should be a long term aim which would give rise to significant simplification of the system as well as greater transparency for taxpayers as to what charges are being applied to their employment income;
- Full alignment of the two systems. This would involve applying the same bases of income for calculation of the two charges. It would also mean no longer having NICs as weekly and non-cumulative, but having one system – the annual/cumulative basis of income tax/PAYE. There would still be two separate and distinct taxes. The contributory principle of NICs could be retained, or, as the OTS has suggested in its previous report on the area, abolished;
- Alignment of the underlying definitions of income and expenses, with some specific exceptions; the assumption would be that the same rules apply to each tax unless specified otherwise, rather than the contrary which tends to apply now.[4] The two systems would be left separate and changing NICs to an annual cumulative system could be considered separately; and
- Application of Class 1 NICs to all employee remuneration whether cash or benefits in kind.

7.2 The key point that the OTS made in its earlier report is that any of the stages offers simplification dividends; it is not necessary to commit to a full combination of income tax and NICs to achieve simplification. Whilst the first and second of the changes would offer the greatest potential for simplification, as well as other benefits regarding transparency of the tax system, we have recognised that these require further work beyond the remit of the OTS currently and are much longer term projects. The third and fourth are steps that could be considered further for implementation sooner and would offer the potential for significant simplification whilst leaving intact the fundamentals of the two separate systems. These two are considered further in this paper.

[1] See our report on small business available at the following web address: https://www.gov.uk/government/publications/small-business-tax-review.
[2] Integrating income tax and national insurance: an interim report http://www.ifs.org.uk/wps/wp2107.pdf.
[3] See Chapter 5 Tax by Design: http://www.ifs.org.uk/mirrleesreview/design/ch5.pdf.
[4] A recommendation also made as an interim step in the small business interim report.

7.3 HM Treasury published a set of objectives and principles in November 2011[5] and the OTS supports those objectives and principles. Aligning the underlying rules and/or applying Class 1 to all benefits would meet those objectives and principles in the ways indicated by Table 7.A.

Table 7.A: Objectives and principles for reforming the operation of income tax and NICs

	Alignment of underlying rules	Applying Class 1 to all Benefits in Kind
Reduce burdens on employers		
Income tax and NICs should be easier for employers and payroll agents to operate.	✓	✓
HMRC should provide an integrated service to employers.	✓	
Remove distortions in the economy and improve transparency		
The structure of income tax and NICs should not encourage employers to employ or pay their employees in certain ways.		✓
It should be easier for employers and payroll agents to understand how to calculate tax and NICs liabilities.	✓	✓
Individuals should find it easier to understand how their tax and NICs liabilities have been calculated.	✓	✓
Deliver fairer outcomes		
Employees with similar circumstances should pay similar amounts of NICs and receive similar benefits.	✓	✓
Reduce Government administrative costs		
Administration should be as efficient as possible.	✓	✓

Aligning the definitions and rules for NICs and income tax

7.4 This is a suggestion which has been made on other occasions by many taxpayers and advisers. In 2011 HM Treasury found that after a complete merger of income tax and national insurance, the second most frequent suggestion for simplifying the operation of NICs and income tax was to align the definitions and underlying rules for NICs and income tax. The different tax and NICs treatment of benefits in kind and expenses was the difference in the systems most frequently cited in the same report as the cause of increased burdens and confusion[6] and that conclusion has been borne out by what the OTS has heard from taxpayers and their advisers in the current study.

7.5 **We recommend that a review of the underlying rules is undertaken with a view to aligning the rules as far as possible. If there are to be differences, these should be clear and well-known (for example pension contributions might remain income tax deductible but not deductible for NICs, to reflect NICs not being charged on pensions). To the extent that separate and different rules are kept (for example for pensions) this should be as a result of clear policy decisions. There should be an undertaking that there will be no further differences introduced.[7]**

[5] Integrating the operation of income tax and national insurance contributions – next steps November 2011 paragraph 3.24. See http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/condoc_integration_it_nics_contributions.pdf.

[6] Ibid paragraph B.10.

[7] It has been suggested that the measure announced in the recent Autumn Statement to exempt from income tax certain payments made to employees of qualifying employer-owned companies will not be paralleled by a NICs exemption. If this proves to be the case it will be very disappointing and definitely the wrong direction for simplification.

7.6 Ideally the deductions which employees are entitled to themselves should also match. However, this is a more radical change to the NICs system as employees could then be entitled to repayment of NICs whilst employers would have no knowledge to obtain a repayment of their contributions. It is recognised that this is probably a step for a later stage of integration of the two systems.

7.7 We emphasise that aligning the underlying rules can be a separate matter from aligning the basis of calculation of income tax and NICs; i.e. the fact that NICs are calculated on a weekly and non-cumulative basis and income tax is calculated on an annual and cumulative basis. We have made the case for moving NICs to an annual, cumulative basis in a previous report and will not address those calculation bases further in this paper beyond repeating our view that such alignment is logical and simpler. However, we do note that the disparities between the two sets of rules would be easier to deal with and remove if the NICs were moved onto a cumulative, annual basis (see for example petrol allowances below). Payrolling (as discussed in Chapter 1) would be facilitated.

7.8 An obvious organisational step that would help many aspects of NICs/income tax would be to change the whole underlying basis of NICs legislation and deal with it as a tax. Following on from this would be the ability to include NICs in the Finance Bill process rather than having separate social security legislation. This may also assist in improving the quality of the legislation in this area which is notoriously unwieldy. Putting NICs through the Finance Bill process would stop the problem of having to pick up income tax changes through a separate series of provisions in social security legislation. Often when that is done the two sets of rules do not work identically and there is yet further complication added to the system.[8]

7.9 Even without making NICs a tax we would expect that aligning the underlying rules could result in a significant amount of the NICs legislation being repealed. Parts of the separate administration for NICs could also be removed.[9]

7.10 Examples of problems we have heard about which result from the mismatch in underlying definitions and rules are:

- mixed use assets;
- differing mileage allowances for NICs and income tax;
- differing rules for deduction of expenses; and
- termination payments.[10]

7.11 There are many other detailed differences (more are listed in our interim report); we have not set out all of them again for reasons of space.

7.12 Take the example of the different definitions of deductible reimbursed expenses for NICs and income tax: i.e. "wholly, necessarily and exclusively" for income tax and "specific and distinct" for NICs. The difference derives from the history of NICs which were imposed upon the "profit" of an employment. In the case of NICs the employee only needs to show that the reimbursement was for expenses incurred by them in carrying out the employment. This is less restrictive than the income tax rule. In most cases the result in practice will be the same although at times this may be because of HMRC being prepared to interpret the rules in the same way rather than the underlying legal analysis necessarily being the same. However,

[8] A recent example is the "disguised remuneration" provisions which do not fully align.

[9] The contributory basis means that there has to be some separate administration.

[10] The OTS plans to consider termination payments further in the next stage of our work on this area.

occasions can still arise when there is a difference in practice and as a practical matter the interaction between the two sets of guidance from HMRC regarding the NICs rules and income tax is complex and unwieldy for employers. One fairly minor example illustrates the problem. For NICs purposes an employee may get the reimbursed costs of hosiery excluded as non-durable items which will only be of use in the work environment, whereas a deduction for income tax purposes would not be available.[11]

7.13 While it may not be practical yet to introduce a general expenses deduction for employees which an employee could claim separately, it would seem a sensible clarification to modify the NICs reimbursement rule so that the two systems can be applied consistently by employers in making payments through payroll. If the recommendation regarding qualifying business expenses in Chapter 3 is implemented then that system should also apply for NICs purposes.[12]

7.14 The different definitions of earnings give rise to various mismatches in treatment and problems in practice: for example, round sum allowances and tips and troncs. The one we have heard most often causes confusion and complexity is mixed use assets. Box 7.A illustrates the problem.

Box 7.A: Example

An employer provides a phone at home to an employee which the employee uses for personal as well as for work purposes. The total cost for a year is £1,000: £550 is for business calls, £150 for line rental and £300 for personal calls. The employer pays the bill.

Income tax: the employer must report £1,000 on the P11D and the employee can then claim a deduction of £550 for the business use of the asset.

NICs: The employer will be subject to Class 1A contributions on £1,000 as apportionment is not generally permitted for mixed use assets.

7.15 An alignment of the definition of earnings for income tax and NICs would offer the potential for significant simplification. In the example in Box 7.A. if the definitions of earnings are aligned and the mixed use can be taken into account for both NICs and income tax, the employee would be subject to tax on the £450: £1,000 having been reported on the P11D and £550 claimed as a deduction; and Class 1A NICs on £450 would be paid by the employer rather than on £1,000. In practical terms there would need to be some mechanism for the employer to be informed about the employee's use of the phone for the NICs calculation, or for the employer to be repaid the NICs on the £550, but these do not appear to be insurmountable problems, especially as the employer Class 1A NICs are non-contributory.

7.16 A final example of mismatches is approved mileage allowance payments (AMAPs). In this case the NICs system is the simpler. For income tax purposes there are two rates: 45p per mile for the first 10,000 business miles and 25p per mile thereafter. For NICs there is only the 45p rate applied to all business miles. If an employer pays in excess of the AMAP rate, the excess is subject to Class 1 NICs but PAYE is not applied – the amount is reported on the P11D. The different NICs rules reflect the fact that for NICs there are weekly earnings periods rather than a year. The higher 45p rate for income tax is supposed to pick up the standard costs which do not relate to mileage such as insurance and MOT costs. As NICs are not annual or cumulative it is not possible to operate the two rates as income tax does.

[11] See NIM 05657.

[12] This is in line with current treatment where allowable expenses are subject to a NICs disregard.

7.17 The easiest solution would be to use one rate for both income tax and NICs and then any excess of that one amount could be payrolled for NICs and income tax as paid. Any excess is also a candidate for settlement through PSAs (considered in Chapter 2). We recognise though that this will raise issues as to the rate which is chosen which will require further analysis.

7.18 In conclusion, the OTS recommends that HMRC and HM Treasury reinvigorate the exercise set up in the wake of the previous OTS recommendations in this area. This should review the underlying rules to identify where further alignment of the underlying rules is possible. There should also be a clear commitment that no further differences will be introduced.

7.19 The process should also look properly at the arguments for moving NICs onto an annual, cumulative basis.

7.20 As a more general matter the OTS also recommends that the guidance provided for NICs and income tax is reviewed and made consistent where possible. There are numerous examples where the guidance is at best inconsistent and confusing. At other times the guidance is simply different. For example, the guidance regarding scale rate payments for the two taxes is different.

Applying Class 1 NICs to all taxable benefits

7.21 We now turn to considering the fourth of our 'NIC simplification steps': applying Class 1 NICs to all benefits in kind. This is a longer term aim. It raises some significant issues which we refer to below. It can be taken forward irrespective of decisions on other areas.

Problems with having the two classes of NICs

7.22 There are various problems which arise from having the two Classes of NICs applying to different forms of employee remuneration:

- having benefits in kind subject to Class 1A with the result that no NICs are paid by the employee on those benefits is seen by many people as distorting and unfair. This becomes an incentive to pay employees through benefits rather than salary (possibly through salary sacrifice) which does not seem appropriate;
- the differing rules for Class 1, Class 1A and PAYE are complex and confusing and lack sufficient connection with what people would commercially expect. There is a "basic" HMRC guide to Class 1A NICs which runs to 35 pages and is hard for the non-expert to follow. If the employer turns to the Appendix which lists different benefits in order to determine their treatment, they may not realise that the information set out there cannot be relied on. It states in bold "The chart is not comprehensive and has no legal force. It gives guidance only" but where else should the employer go to determine the treatment?[13] and
- at times fine distinctions of fact can determine whether Class 1 or Class 1A applies. For example, if an employer gives an employee who is a vintage car enthusiast a vintage car instead of a cash bonus where it is understood that the employee will hold onto the car for a period of time, Class 1A applies to the value of the car. Giving the same car to another employee in different circumstances may give rise to a Class 1 liability.[14] Is it appropriate for employers to be able to reward their employees in the first way with a different tax treatment?

[13] Employers are encouraged to look at the P11D to determine whether something is subject to Class 1A. The form indicates which benefits are so liable but is this the best route to help employers?

[14] Paragraph D.23 GAAR Guidance http://www.hmrc.gov.uk/avoidance/gaar-partd-examples.pdf.

7.23 Some of the distinctions between items subject to Class 1 and Class 1A indicating the current level of complexity are set out in Table 7.B.[15]

Table 7.B: Examples of the differences between Class 1 and Class 1A treatment

Type of expense or benefit		Class 1	Class 1A
Goods or services e.g. club subscriptions, clothing, school fees	Employer contracts for supply of goods or services		yes
	Employee contracts for supply of goods or services and employer reimburses	yes	
	Employee contracts for supply of goods or services and employer pays the supplier directly	yes	
	Petrol for own car bought without the litany used[16]	yes	
	Petrol for own car bought with the litany used		yes
Incidental overnight expenses exceeding the tax free amount	To the extent cash, non-cash vouchers or credit card payment	yes	
	Some other form of benefit		yes
Relocation expenses which do not fall within the income tax exemption	Excess over £8,000		yes
	Items not covered by the exemption e.g. school fees	yes	
	Items not covered by the exemption whether reimbursed or paid directly by the employer e.g. gardening services, replacement white goods where the old ones could have been used	yes, depending upon the arrangements	yes, depending upon the arrangements
	Reimbursement made after the tax year of the removal		yes
Shares and securities not covered by income tax exemption	Acquired at less than market value, where there is a resulting deemed loan		yes

7.24 Although in most cases a rough rule operates that where cash reimbursement is paid, the amount is subject to Class 1 and not Class 1A, this does not always apply. One example is the treatment of relocation expenses. The other which is frequently cited to us as a cause of complexity and confusion is where the employee contracts with the supplier of goods or services but the employer pays the supplier directly.

7.25 There are also administrative complexities caused by Class 1A. For example, if an employer pays expenses which have a fully matching deduction and no dispensation the employer puts the amounts on employees' P11Ds but Class 1A is not due so the employer has to adjust on

[15] See CWG(2) 2013 for HMRC's list of benefits and expenses subject to Class 1A.

[16] As footnote 11.

forms P11Db. If Class 1A is removed together with the reporting requirements of P11Dbs, there would be no need to identify these items.[17]

What are the issues in applying Class 1 to all remuneration?

Increased employees' NICs

7.26 The most immediately obvious issue is that only employers pay Class 1A and both employer and employee pay Class 1. Consequently, without any further change there would be an increased NICs charge for employees. This increase could be 12 per cent or 2 per cent, or a blend of the rates, depending upon their weekly earnings level.

7.27 In addition, including a cash equivalent value of benefits would increase the "earnings" taken into account for NICs purposes and would potentially push employees across the boundaries of the earnings limits and thresholds.

7.28 Those issues are beyond the scope of the OTS's work but would need to be addressed. We do note that the calculation difficulties noted above would be considerably eased if NICs were on an annual, cumulative basis.

Calculating and paying the NICs on benefits

7.29 If Class 1 is applied to benefits then, assuming no other changes are made to the operation of Class 1 in this context, that would entail accounting for NICs on the same basis as is applied to cash, i.e. on a weekly basis. The exact amounts depend on how much an employee earns and their National Insurance category (this depends on their circumstances). Employees will already have a National Insurance category for their cash remuneration and payment would be made monthly.[18]

7.30 The change to applying Class 1 NICs to all remuneration would be eased by amending the underlying rules so that they tie into the income tax rules. First, this would make them more easily understood by employers and employees and would simplify the rules in the ways described above. Secondly, it would enable deductions to be given against earnings to cater for items such as mixed use assets. Otherwise an employee would be paying NICs on the total gross value of the asset received with no deductions for genuine business expenditure (in the example above in Box 7.A, £1,000).

Impact on PSAs

7.31 One potential impact of applying Class 1 NICs to all benefits is that PSAs would become more attractive as no employee NICs are paid. Logic would suggest that PSAs would change to require payment of employee NICs, but estimating the amounts would be administratively difficult and fairness would then suggest that employee contributions should be recognised. The alternative would be to consider an increase in the rate of NICs payable on PSAs. However, employers would argue that the administrative savings for HMRC in having employers pay the tax and NICs bills under PSAs should be rewarded.[19]

[17] This links to the recommendations on payrolling and new qualifying business expenses in other chapters.

[18] If an employer estimates over the full tax year that the total payment will be, on average, less than £1,500 per month, the employer can choose to make quarterly rather than monthly payments. The employer must still submit a Full Payment Submission on or before the date employees are paid.

[19] PSAs are considered in Chapter 2

Operational issues

7.32 We recognise that there are complexities in operation which would need to be addressed and further work would need to be done to work through the appropriate solutions. In particular, we would note two operational issues which we have given some initial thought to:

- valuation of the benefits; and
- accounting for the NICs where there is insufficient cash to deduct the NICs from.

7.33 These issues would be easier to deal with if NICs moved to an annual, cumulative system, but for the reasons we note below, the problems do not at this stage appear insurmountable without that change to the calculation basis.

How should the value of the benefit be calculated?

7.34 This is a matter which has had to be grappled with already for income tax purposes. A value has to be put on a benefit, sometimes following a formula (e.g. for cars) or a general process. The question is simply that applying NICs to the benefit will potentially require:

- a value to be found for NICs purposes (presumably the same value as for income tax); and
- the value and thus NICs charge would have to be found on a weekly/monthly basis rather than on an annual basis.

7.35 Any difficulties do not seem insurmountable and will have to be solved if payrolling is to be developed. Some possibilities are noted below. These and possibly other solutions would need to be considered further.

7.36 First, there is the existing example of remuneration by way of tradeable assets or readily convertible assets. If an employer remunerates employees by way of tradeable assets or readily convertible assets, the employer is required to apply tax under PAYE and Class 1 NICs on a 'notional payment', on a 'best estimate' valuation. If that valuation later proves to be too low, the question arises whether an adjustment is required. For income tax purposes, provided HMRC accepts that the employer's valuation at the time of the transaction was not unreasonable, the additional tax is paid through self-assessment by the employee concerned. Determination of the figures depends on the form 42 and the self assessment return, for which there is over a year to settle enquiries. For NICs currently, there is no mechanism to 'correct' the position. Under the NICs regulations, the earnings figure for NICs purposes is the employer's best reasonable estimate of the market value of the readily convertible asset at the time the asset is acquired.

7.37 An alternative was considered by the HM Treasury NICs alignment working group in 2011-12. They concluded that in each pay period the employer would only need to estimate the value of the benefit and include it in the payroll in that period, finally reconciling in the last pay period in the year. It was recognised that this would be a strain on the payroll for the final period and the PAYE regulations would need to change to allow for the reconciliation.[20] This system would have enough flexibility to cater for items such as mixed use assets if the NICs system is modified to allow for the adjustments to reflect the income tax system and tax only the private use.

[20] http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/tax_income_nics.htm. Minutes of the working group 29

7.38 Another possibility is the system of annual apportionment used in Ireland.[21] PAYE and PRSI (the Irish equivalent of NICs: PayRoll Social Insurance) are applied by the employer to the best estimate that can reasonably be made of the amount of the notional pay or taxable benefit that is chargeable to income tax in respect of a benefit provided to an employee. When the employer is aware of the expense incurred in providing benefits and the value of the benefits, determining the amount chargeable will generally be relatively straightforward. It is then not necessary for the employer to estimate amounts involved. For example, where the employer pays medical insurance on behalf of an employee the precise amount to which PAYE and PRSI is to be applied will be known. In the case of benefits which are more difficult to value (such as beneficial loans) the Irish Revenue set out guidance regarding the valuation. In the case of benefits consisting of the private use of a company car or van, a preferential loan, or the use of accommodation or assets which belong to the employer, the annual taxable value of the benefit for a tax year – the notional pay – can be apportioned over the relevant pay periods for which it is available in that year.

How should Class 1 be applied to benefits where the employee does not receive enough cash to pay the tax owing?

7.39 Here the problem is that if Class 1 NICs are applied when a benefit is provided and are to be paid by employees as well as employers, the employees may not have sufficient cash paid to them from which the NICs can be deducted. Again the difficulties do not seem insurmountable.

7.40 There are currently rules dealing with the application of PAYE and NICs where there is not enough cash to pay the tax. Where an employer makes non-cash payments of earnings to an employee or an ex-employee, the employer still has to account for the right amount of employer and employee NICs, but has the right to recover an employee's share of NICs from subsequent cash payments of earnings in the same tax year where an under-deduction occurred. When the employer recovers such underpayments of NICs, the employer can only recover the employee's share of NICs in the same tax year from any further cash payments of earnings to the employee, and the amount recovered cannot exceed the contribution due on that further payment.

7.41 If non-cash payments of earnings are made and the employer could not deduct the employee's share of NICs because there were not enough cash earnings, then if the payment:

- has been made by an intermediary;
- comprises a beneficial interest in shares; or
- comprises securities or an interest in securities.

7.42 The employer has until the end of the tax year, following the one in which the non-cash payments of earnings were made, to recover the employee's share of NICs, and there is no limit on the amount that can be recovered from subsequent earnings to recover the under-deduction.[22] A similar approach could be considered for the application of Class 1 NICs generally to benefits.

7.43 In contrast, an alternative is the more penal set of provisions which apply for PAYE on non-cash remuneration where there is insufficient cash to pay the PAYE. The employer is required to deduct tax from any actual payments made in the same income tax period after the event that gave rise to the notional payment. Where the actual payment is insufficient, the employer must account for the balance of tax due. The employee must make good to the employer the full amount of the tax that the employer is required to pay, within 90 days of the event giving rise to

[21] See: http://www.revenue.ie/en/tax/it/leaflets/benefit-in-kind/paye-prsi.html.

[22] CWG2 paragrarphs 162-163.

the notional payment.[23] If the employee makes good the full amount, there are no further tax consequences. If the employee does not make good the full amount within 90 days, he or she has effectively received tax-free remuneration. Any shortfall is treated as earnings from the employment in the year in which the event giving rise to the notional payment occurred. The amount chargeable to tax must be included on the form P9D or P11D for that employee.

7.44 Another possibility would be to offer a more flexible system as is used in Ireland for PAYE. The employer still has to pay over the right deductions, but they allow the employer and employee to arrange for repayment as they choose, and any continuing underpayment becomes itself a benefit in the following tax year. If the employee has left, it becomes a P11D and tax return benefit rather than a payroll benefit.[24]

7.45 In conclusion, the operational difficulties applying Class 1 NICs to benefits in kind do not seem insurmountable. The OTS recommends that HMRC and HM Treasury reinvigorates the work previously undertaken in this area to fully analyse the issues involved, with the aim of removing the distorting and complicating effect of Class 1A.

Interaction with Universal Credit

7.46 As the tax system and benefits system become ever more intertwined it is necessary to consider the impact of this proposal on the operation of the state benefits system and in particular, the Universal Credit system. Currently benefits in kind are not included in the amounts taken into account to calculate Universal Credit. There are arguments for and against this approach but, as has been noted previously, such matters are outside the OTS's remit.

7.47 Applying Class 1 to all employee benefits does not mean that those benefits must feed into the Universal Credit calculations. It would presumably still be possible to identify those items via RTI as items which need to be excluded.

Alternatives to the merger of Class 1 and Class 1A

7.48 We note briefly that there are alternatives to the route set out above. Applying Class 1A to all non-cash remuneration would be a simplification[25] but would leave, and indeed increase, the distorting effect of payment by benefits versus cash.

7.49 Alternatively, it would be possible to abolish Class 1 and Class 1A NICs on employee benefits and have a new employer tax on cash and benefits which applies consistently. The Australian Fringe Benefits Tax (FBT) is the main example of this route. The OTS noted the FBT Route as a possibility in our interim report. We suggested it might be worth exploring further. However, it would clearly be a major shift in taxation in the UK and would be difficult to work into a contributory system. In meetings, the FBT has generally aroused interest but we do not detect any great enthusiasm for such a radical change. The feedback we have received has been that the system is not 'broken' and so does not need a major change; the preference is to improve the current system, not replace it.

[23] S222 ITEPA 2003 and EIM11804: The Finance Bill 2014 includes provisions to extend this period – changes are being made to the S222 rules following the OTS share schemes reports.

[24] See: http://www.revenue.ie/en/tax/it/leaflets/benefit-in-kind/paye-prsi.html.

[25] For an example of how this would work, see Box 8.A. If Class 1A applied to all non cash remuneration the NICs treatment of all the forms of gym provision by employer B would be the same.

8 A fundamental policy review?

8.1 We have heard from many people that confusion is caused by the current system applying different tax treatment to the same benefit as a result of the mechanics used to provide the benefit. We have also heard of various instances where an employee receives something which neither the employer nor the employee (nor the man in the street) would call a "benefit".

8.2 In this chapter we consider further how the rules are operating to determine which benefits should be taxed and at what values. We consider whether the underlying principle of taxing all benefits unless specifically exempted produces logical and understandable results for employers and employees; and we consider further how the complexities for determining both the liability and the reporting of the benefit could be simplified. We also consider further the interaction between the benefits rules and the rules for employees to deduct expenses.

The distinctions built into the system and the issues they raise

8.3 When an employee receives benefits the tax treatment of those benefits will be determined by the application of specific tax rules in the benefits code exempting specific benefits from all or part of a tax charge; and by general rules determining the tax treatment of benefits and the way in which the benefit should be reported, according to the mechanics of payment. Both the specific and the general rules produce complexity in the system. Table 8.A illustrates the complexity.

Table 8.A: The tax treatment of gym provision for an employee

Employer A offers gym facilities to all employees on-site. Employer B offers gym membership to employees at the local gym with equivalent facilities. This costs £500. In each case the cost of the gym benefit is borne by the employer. The employees of A and B receive a benefit of approximately the same value, £500, although it could be said that the employees of A also benefit from the fact that the facilities are on-site. In each case it is assumed that the employee is a basic rate income taxpayer.					
Which employer	**Mechanics of payment**	**Employee Income tax**	**Employee NICs**	**Employer NICs**	**Method of reporting/accounting**
A	Pays for the facilities on-site	None	None	None	None
B	Employer contracts with gym provider and pays provider	£100	none	Class 1A: £69	P11D Adjustment of tax code/self assessment
B	Employee contracts but the employer settles the bill directly	£100	£60	Class 1: £69	P11D
B	Employee contracts and pays and the employer reimburses	£100	£60	Class 1: £69	PAYE

8.4 There are layers of complexity illustrated by Box 8.A. First there is the distinction between the on-site and off-site gym provision. Then there are the detailed rules giving differing results as a consequence of the way in which the employer provides the off-site facility. In the case of employer B, the rules are not intuitive. It is not as simple as asking whether the payment is made

to the employee to determine the treatment. The payment to the third party gym provider where the employee has contracted for the gym membership is "money's worth" and Class 1 NICs apply.

Box 8.A illustrates the differing types of distinction in the system:

- distinctions around the question of the amount of tax and NICs due; and
- distinctions around the question of how the tax is accounted for.

The amount of tax and national insurance due

8.5 The amount of tax and NICs due depends upon whether a specific exemption applies and the distinction between Class 1 and Class 1A NICs liability. The differing treatment of the gym provision in the case of employer B derives from the Class 1/1A rules which are considered in Chapter 7.

8.6 However, the differing treatment for the employees of employer A is a result of a specific exemption to the benefits code which has introduced differing tax treatment for two employees receiving the same ultimate benefit. This can cause complexity and confusion, as well as cause a sense of unfairness. In the case of the gym membership, the exemption for off-site provision will generally discriminate against smaller employers. We are also aware of situations where an employer has a base in one location where it is possible to provide an on-site gym and another location where it is not. In order to maintain employee relations the employer has to provide gym membership off-site and pick up the extra tax cost.

8.7 A similar issue has been raised with us in relation to BYOD (Bring Your Own Device) schemes. Employers can provide a mobile phone or a computer to employees without a taxable benefit arising. Why can't we pay towards the costs of an employee's own device without a taxable benefit arising, ask employers? Increasingly BYOD schemes are being operated to save employer costs and to meet employee demands for use of their own preferred device.

8.8 **While policy decisions to reward particular activities via the tax system are beyond the scope of the work carried out by OTS, it may be appropriate for HMRC/HM Treasury to review the exemptions and consider whether the policy aims are being correctly achieved.**

8.9 The other exemption about which we have received notable comment is the training exemption. In general, training paid for by the employer is exempt from tax.[1] However, training paid for by the employee does not normally qualify for an expenses deduction although reimbursement of the cost by the employer is not taxed. This is considered further below.

How the tax is accounted for

8.10 The distinction is between items which are reported via PAYE and payroll; and the items reported on a P11D. We address those issues further in Chapters 7 and 2. The recommendations set out in those chapters address the problems caused by these distinctions.

The restrictions of the rules permitting deduction of expenses by employees with particular reference to training costs

8.11 The flip side of the rules dealing with employee benefits is the rules dealing with deductible expenses. If something is not taxed as a benefit then, to be fair, it can be argued that the expense incurred by an employee to obtain the same thing should be tax deductible. However, we realise that this fails to recognise that policy decisions may be made to encourage employers

[1] Section 250 ITEPA 2003.

to provide certain benefits; that extensions of the deductible expenses rules can be more difficult to control; and that those extensions can be hugely expensive to the Exchequer.

8.12 One area though where the limitations on employee deductions are increasingly at odds with the working environment is the area of training. As noted above, employer-funded training is not taxable as a benefit (and this includes reimbursement by an employer of employee-funded training), but training costs borne by the employee are not deductible in the hands of the employee. This even applies to the costs of continuing professional education. That is so even if participation in such activities is compulsory, and failure to do so may lead to the employee losing his or her professional qualification, and/or their job.[2] The reason is that the training is not considered to be undertaken in performance of duties but in preparation to perform duties.[3]

8.13 While a radical change of the expenses rules would raise significant issues, not least as to the Exchequer cost, we have heard a strong case for specific provision to be made for employee-funded training to provide equality of treatment regardless of the way in which the benefit is funded. Taking steps to equalise the treatment of employer and employee funded training would also deal with the increasing complexities faced by people who work as employees in tandem with being self-employed. They are faced with the complexities of the two systems when they are essentially doing the same work for both roles: one generally allowing a deduction for the training costs, and the other not.

8.14 **The deductibility of training costs is really a policy matter and thus outside the OTS's remit. However, we think that the current position is a source of confusion and complexity; there is scope for simplifying the rules to make them more logical and fairer. We therefore feel justified in recommending that the rules regarding the deductibility of training expenses are reviewed. Rather than simply trying to make adjustments to the current rules, we think that the review should start from a full consideration of the policy aims the government wishes to promote in this area. The tax rules could then be reviewed against these aims to ensure that they contribute to, rather than hinder, their achievement.**

Which benefits should be taxed?

8.15 A related but separate question to that of how a particular benefit is taxed as a result of the **way** in which it is provided, is that of **what** should be taxed in the first place. We have given further thought to the overall question, noted in our interim report, of what is a benefit and which benefits should be taxed.

8.16 We have heard of various situations where an employee receives something which neither the employer nor the employee consider to be a benefit, but which the tax system treats as a benefit. This can range from a bunch of flowers to say thank you for a job well done, to physiotherapy for a dustman who has injured his back while working. Currently the tax system works on the basis of taxing everything derived from an employment unless it is specifically exempted, or a matching deduction is provided, so both items are subject to tax even though the recipients probably do not feel they have received a 'real' benefit.

8.17 A recent example of these issues is seen in the current Finance Bill, as explained in Box 8.A.

[2] See HMRC Manual EIM32530.

[3] The decision in the case of Revenue & Customs Commissioners v Dr Piu Banerjee [2010] EWCA Civ. 843 enabled a deduction to be obtained for training costs in certain limited circumstances, but this case merely served to raise more questions about the deductibility of training costs.

Box 8.A: Finance Bill 2014 proposals

If the draft Finance Bill 2014 provisions are enacted, up to £500 of treatment could be received tax free if physiotherapy is recommended by occupational health after an absence from work (even if the absence was as a result of something which happened outside work).

However, the proposals as drafted are not a complete solution, as the relief seems only to apply to those who have time off work. If the dustman does not have time off work with his bad back he may still be subject to tax on the physiotherapy.[4] Many would argue that the system which still taxes the employee injured while doing their job is failing to correctly identify real "benefits".

8.18 There should be a better and more accurate way of determining what benefits are taxable: a way which accords more with what people would generally expect.

8.19 We have considered different approaches with consultees. One approach considered is to use a rule such as an exemption for benefits received in a workplace. This would have some rough edges, which would not of itself mean that it would be unacceptable, but it would perpetuate the differences in treatment according to the way in which a benefit was provided (as with the example of gym facilities considered above). The treatment of a benefit should not depend upon the size or resources of the employer, but the nature of the benefit itself.

8.20 At the heart of the problem is that people consider that a benefit should be excluded from tax if the personal benefit to the employee is negligible. A broad principle to determine what is taxable based upon the extent of personal benefit could be considered, but this would be too uncertain in its application without considerable amounts of guidance and lists of specific items which would not be subject to tax. Numerous questions would be raised by an overarching principle: for example, who should judge whether the personal element of the benefit is low? For example, the value to an employee of work-based accommodation will be dictated, at least in part, by their own level of accommodation.

8.21 We therefore consider that an overarching principle to define what a benefit is will not simplify matters. However, the problem could potentially be flipped around and more thought could be given to providing a more general **exclusion** from the current benefits rules.

8.22 In order to provide a rule that is on the one hand flexible enough to pick up varying situations as they develop, but which on the other hand is not open to abuse, we would envisage a statutory exclusion for certain categories of benefits which could include:

- benefits which have no or little personal value or a value of no more than a specified amount[5]; and
- where the benefit is provided to compensate the employee for specified categories of loss; for example pain or injury caused by activities carried out as part of the employee's work.

8.23 There is already a power to exempt minor benefits as well as specific exemptions for certain accommodation, supplies and services used in employment duties and deductions for certain

[4] In some cases the dustman will not be taxable, but the tests are fact specific, see EIM 21770.

[5] There is a potential link to the possible trivial benefits exemption discussed in Chapter 5.

costs of maintaining equipment.[6] The type of exclusion we envisage could be an extension of those provisions or a more general principle which would encompass those specific rules as well.

8.24 One of the items we have frequently heard about in this context is the provision of basic accommodation[7] while attending a work site away from home. Neither employer nor employee considers the accommodation to be a benefit. The limited personal value limb of the provision would provide a statutory framework for a specific exclusion for accommodation provided to attend a temporary workplace which would not then be taxable. If the accommodation was hired, it might be necessary to specify a monetary limit, possibly based on Civil Service rules for accommodation expenses claims.

8.25 There would no doubt be a need for HMRC guidance to help operate this exemption. This should be viewed positively and actively: it will help HMRC if the list works and arguments about nil benefits eliminated. The HMRC list should be the responsibility of a joint working party who aim to put out an annual update to the list before the start of each tax year. It could be updated as and when the case was made for specific items and from time to time to update values for items such as the accommodation example.

8.26 There is clearly more work to be done on the issue of which benefits should be taxed. Our discussions and researches have been sufficient to convince us that the approach has merit; we believe that there would be useful simplification benefits. **We therefore recommend that further work is carried out to develop firm proposals for such an approach.**

8.27 However, we acknowledge that there could be an Exchequer cost. Currently many of the benefits not considered to be benefits by employers or employees are provided to employees on a tax free basis with the employers picking up the additional cost either by way of a PSA or by individual grossing-up. Therefore we recognise that the cost of such a proposal needs to be identified, though as we have discussed, such tax as is collected on these 'non benefits' is arguably tax that should not be collected.

[6] See S210, S316 and S367 ITEPA 2003.

[7] We have in mind basic accommodation on-site, rather than the employee being put up in a hotel which would normally lead to deductible expenses or no benefit.

A Existing legislation – Travel and subsistence

Current legislation

A.1 For income tax, the current legislation relating to travel and subsistence has been in place since 1998 and is set out at Part 5 Chapter 2 of the Income Tax (Earnings and Pensions) Act 2003. There are currently two main categories of allowable travel expenses and three minor categories.

Main categories of allowable travel expenses

S337 The employee is **obliged** to incur and pay them as holder of the employment, and the expenses are **necessarily** incurred on travelling **in the performance** of the duties of the employment.

S338 The employee is **obliged** to incur and pay them as holder of the employment, and the expenses are attributable to the employee's **necessary attendance** at any place **in the performance** of the duties of the employment (S338(1)) and the expenses are not:

- expenses of **ordinary commuting** (S338(2));
- travel between any two places that is for practical purposes **substantially ordinary commuting** (S338(2)); or
- for **private travel**, or travel between two places that is for practical purposes **substantially private travel** (S338(4)).

Minor categories of allowable travel expenses

S340 travel **between employments with different companies in the same 51 per cent group**

S341 travel **to take up or finish an overseas employment**

S342 travel **between overseas employments**

Exceptions

A.2 Mileage expenses cannot be claimed by an employee if he or she receives them tax free from the employer. But they can claim any that are not reimbursed. (S359)

Definitions

A.3 **"Ordinary commuting"** means travel between the employee's home and a permanent workplace, or between a place that is not a workplace and a permanent workplace. (S338(3))

A.4 **"Private travel"** means travel between the employee's home and a place that is not a workplace, or two places which are not workplaces. (S338(5))

A.5 **"Workplace"** means a place at which the employee's attendance is **necessary in the performance of the duties** of the employment. (S339(1))

A.6 **"Permanent workplace"** means:

1 a place which an employee **regularly attends** in the performance of the duties of the employment, and is not a **temporary workplace** (S339(2));

2 a place which the employee **regularly attends** in the performance of the duties of the employment, if it forms **the base** from which the duties of the employment are carried out, (S339(4(a)), or is a **place where the tasks to be carried out are allocated**. (S339(4)(b)) [Note – there isn't a time aspect to this, so a "base" could be very temporary but still treated as a permanent workplace]; or

3 an **area**, if all the following apply:

   a the duties of the employment are **defined by reference** to an area;

   b the employee **attends different places within the area** in the performance of his duties;

   c none of the places attended is a **permanent workplace**; and

   d the **area** would be a permanent workplace if the other tests referred to an area rather than a **place** (S339(8)).

A.7 **"Temporary workplace"** means a place which an employee attends in the performance of the duties of the employment for the purpose of performing a **task of limited duration** or for some other **temporary purpose** (S339(3)). It does not include:

   a a workplace the employee attends in the course of **a period of continuous work at that place lasting more than 24 months** (S339(5)(a) (i));

   b a workplace the employee is likely to attend for **all or almost all of the period for** which the employee is likely to hold **the employment** (S339(5)(a) (ii)); or

   c a place the employee attends at a time when it is **reasonable to assume** it will be such a period (S339(5)(b)), but disregard any change to the place at which the duties are performed if it does not have a substantial effect on the employee's journey or travelling expenses to and from the place where the duties are performed. (S339(7))

A.8 A **"continuous period of work"** at a place is one over which the duties of the employment are performed **to a significant extent** at the place. (S339(6))

A.9 **We understand from HMRC that the broad intention behind the current rules is to give relief to:**

1 employees who travel "on the job" (S337);

2 employees who travel between workplaces (S337) although not, other than in very limited circumstances travel between workplaces where one of them is the home;

3 itinerant workers who move from workplace to workplace every few months (who may or may not have a permanent workplace) (S338);

4 short/medium term secondments i.e. less than 24 months;

5 employees with area/regional responsibilities; and

6 all employees for occasional travel from home to another workplace.

A.10 We understand from HMRC that the current rules are not intended to give relief to:

1 normal home to work travel;

2 long term secondments i.e. more than 24 months;

3 workers on fixed term contracts such as temporary workers;

4 travel from home to work for employees who move from workplace to workplace but in a limited geographical area;

5 employees who regularly travel to two or more workplaces;

6 travel to workplaces by choice and not by necessity (e.g. works in a workplace for a day or period of time because it is personally convenient rather than determined by the duties of the job);

7 travel to a base where orders are issued; and

8 travel from home to the area/region if home is outside the area where duties are defined by reference to an area.

Journeys an employee may incur

A.11 The definitions for "ordinary commuting" and "private travel" specify four different places:

- the employee's home (S338(3));
- a place that is not a workplace (S338(3));
- a permanent workplace (S338(3)); and
- a temporary workplace (S339(2))

A.12 All possible journeys between these categories are set out in the table below. We have also shown the current legislative position:

	Home	**Non-workplace**	**Permanent workplace**	**Temporary workplace**
Home	n/a	Private travel (S338(5))	Ordinary commuting (S338(3))	Business travel (subject to substantially ordinary commuting test)
Non-workplace	Private travel (S338(5))	Private travel (S338(5))	Ordinary commuting (S338(3))	Business travel (subject to substantially private travel test)
Permanent workplace	Ordinary commuting (S338(3))	Ordinary commuting (S338(3))	Business travel	Business travel
Temporary workplace	Business travel (subject to substantially ordinary commuting test)	Business travel (subject to substantially private travel test)	Business travel	Business travel

B Summary of Class 1 and Class 1A NICs

Summary of the Class 1 and 1A NICs rates for 2013-14

B.1 This is a broad overview and does not take into account contracted-out/in rates.

Class 1	
Lower earnings limit, primary Class 1	£109
Upper earnings limit, primary Class 1	£797
Primary threshold	£149
Secondary threshold	£148
Employees' primary Class 1 rate between primary threshold and upper earnings limit	12%
Employees' primary Class 1 rate above upper earnings limit	2%
Employers' secondary Class 1 rate above secondary threshold	13.8%
Class 1A	
Employer's Class 1A rate on employer provided benefits	13.8%

Background to the two sets of rules for Class 1 and Class 1A

B.2 It is informative to consider how the two systems have developed. Class 1 NICs have a payments in kind exclusion which meant that prior to the 1990s most payments in kind could be paid without attracting NICs liability. Some argued at the time that this was not necessary: the NICs system was modelled on PAYE and required contributions only when cash or "pecuniary benefits" were paid. Prior to 1988 employers had paid employees with short-dated gilt edged securities to use the payment in kind exemption and a specific measure was introduced to counteract this specific form of remuneration. A succession of blocking measures followed as employers found more and more ways of giving their employees remuneration in non-cash forms to avoid the NICs charge until more generic provisions were introduced in 1995-1998 dealing with any tradeable assets or readily convertible assets.

B.3 Meanwhile in 1991 the Government introduced Class 1A to deal with company cars (and fuel) as there was a substantial loss of Revenue from their exclusion estimated to be £550 million for 1991-92. In relation to petrol the new charge was designed to avoid the administrative complications of employers accounting monthly for petrol including an element of private use. With effect from 6 April 2000 the charge was extended more generally to benefits.

B.4 For the years up to and including 1999-00 Class1A could be collected with tax deducted under PAYE. Class 1A deductions were recorded on each employee's PAYE deductions working sheet, no later than 19 June after the end of the tax year and on that date all the Class 1A contributions were paid by the employer. However, many employers preferred to account for Class 1A outside the payroll as it was the staff preparing the P11Ds who would prepare the information and so the DSS introduced a scheme known as the "Alternative Payment Method". This formed the basis for the collection system now used through the P11Db.

B.5 Generally, Class 1A does not apply to "lower paid employees". However, any benefit or non-cash voucher awarded to an employee by a third party which has not been arranged with the employer is liable for Class 1A NICs payable by the third party, even if the employee is earning at a rate of less than £8,500 a year. The rate used is the secondary Class 1 percentage rate appropriate to that tax year. It is non-contributory although the amounts are paid into the National Insurance Fund to help finance the scheme.

B.6 Class 1 NICs is paid by employer and employee, is contributory and is collected through the PAYE system.

B.7 Since employer contributions bear no relation to benefits provided under the NI scheme, these contributions are in effect simply a payroll tax and this is most marked in relation to Class 1A where there is no employee contribution.

Summary of the differences between Class 1 and Class 1A NICs

NICs payable or collected by employers	Details
Class 1	• Payable by both the employee (primary Class 1 contributions) and the employer (secondary Class 1 contributions). • Both primary and secondary Class 1 NICs are calculated through the payroll and reported and paid via the PAYE system monthly or quarterly. • Details relating to payments of earnings, which are subject to Class 1 NICs, must be submitted to HMRC on an FPS. • Charged as a percentage of employees' earnings over certain amounts. • Also applies to a number of employer-provided expenses and benefits (including childcare vouchers over a varying threshold) subject to certain conditions. • Applies only to earnings paid to employees aged 16 or over. Employee contributions stop at State Pension age, but employer contributions continue for as long as the employee continues to work. • There are a number of Class 1 categories that apply to employees in different circumstances. • Class 1 NICs for directors are calculated slightly differently from those for other employees.
Class 1A	• Payable by employers and certain third parties on taxable benefits in kind provided to employees. • Charged as a percentage of the cash equivalent of the benefits. • No earnings limits or thresholds applied. • Paid annually.

Office of Tax Simplification contacts

This document can be found in full on our website at:
https://www.gov.uk/government/organisations/office-of-tax-simplification

If you require this information in another language, format or have general enquiries about the Office of Tax Simplification and its work, contact:

The OTS Secretariat
Office of Tax Simplification
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 6190

E-mail: ots@ots.gsi.gov.uk

ISBN 978-1-909790-71-1