Office of
Tax Simplification

Closer alignment of income tax and national insurance:

a further review

Cm 9354

November 2016

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Tax Simplification

The closer alignment of income tax and national insurance:
a further review

Presented to Parliament by the
Financial Secretary to the Treasury
by Command of Her Majesty

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Foreword

Is the closer alignment of Income Tax and national insurance realistic? This question has often been asked, and the Office of Tax Simplification (OTS) has now been exploring it for some time. In March this year the OTS published its first report on the issues involved and recommended a 7 step plan including that, from a simplification perspective, employees' Income Tax and National Insurance contributions (NICs) should be calculated in the same way, and employers should pay a charge based on their overall payroll.

However that report also demonstrated that such changes to employees' NICs could result in many millions being adversely impacted, as well as there being many millions of gainers. Similarly, replacing the complexity of employers' NICs with a simple payroll charge could have significant implications for some industry sectors. So, at the request of ministers, the OTS has been drilling down further into the numbers to get a fuller picture of the potential impacts of these options.

In this second report we present our further findings and, for employees' NICs, we highlight that:

- from a simplification perspective some changes need to be made
- we live in a changing business environment, with diverse ways of working, and there are a growing number of people who combine self-employment, multi jobs and freelancing
- the current system was built for yesterday and not for today, let alone for tomorrow

But from a policy perspective any change will be challenging for government.

For individuals, the OTS is clear that the simplest approach to the NICs system would be one that runs in the same way as PAYE does for Income Tax. That would enable an individual's total employment income in the year to be taken into account in calculating their annual NICs liability, rather than each weekly or monthly earnings period from each employer being considered in isolation. Our initial analysis on the gainers and losers of this new approach gave the following results:

- some 40% of the working population could see some change if this was adopted
- the gainers would generally be part-time employees, women, those under 35 years old and those in lower paid service industries
- losers would typically be paid more than £20,000 annually and are generally multi jobbers or, at the higher income levels, are men in industries with bonuses. The interplay with the social security system would mitigate the loss for some of those adversely affected who are in lower income households

Turning to employers' national insurance, the OTS is clear that from a simplification perspective there should be a simple charge applied to total payroll costs (including all benefits). One result of such an arrangement would be to equalise the position of full-time and part-time work so far as employers' NICs are concerned. Potentially this parallels the definition of payroll for the Apprenticeship Levy and it should be possible to integrate an employers' NICs replacement with this. However:

- the simplest of the various possible approaches which we have outlined, is a 10% rate applied to total payroll without any thresholds or allowance; but this could impact particular industries and regions disproportionately and so we do not recommend that route
- a variety of more palatable options have been set out in this report for consideration, but none are clear cut

Here again there is a very significant policy challenge for government.

So, given these potential transitional issues and impacts, can anything be done? Or should we just limp on with the current arrangements?

First, we should stress the high level of support we have found for making changes, from OTS stakeholders. These include employers, businesses of all sizes, tax and payroll professionals, unions, those representing the low paid and academics; they seek change to get a system that is more logical, transparent and potentially fairer. Although there will be a transitional cost, there are potential administrative savings in the longer term. Second, a vital ingredient for any change is the timetable. If simplifications of the kind outlined in this report are to be made effectively, without significant adverse impacts, and in a way which takes advantage of HMRC's Making Tax Digital program, then they would need to be carefully programmed over several years, with the impact studied at each stage.

The OTS hopes this review will stimulate a fuller and more informed debate on what changes are necessary and what are advisable; how they can be made and with what sort of timetable. Now is the time to broaden the discussion, so we can build a system truly fit for the future and which is fair for everyone.

The project team

The OTS has been fortunate to have many of the team who produced the March report continuing into this second phase: Angela Brown as project manager, Marian Drew (leading the ACA work) and John Hampton. Long-term OTS member Andy Richens has led the employers' NICs work and we have also been able to draw on Justine Riccomini's input again. All have worked with great energy, well beyond their nominal commitments, to produce this report.

We must also thank the many stakeholders who have contributed, including our Consultative Committee members, and colleagues in HMRC and HM Treasury, especially HMRC's Knowledge, Analysis and Intelligence (KAI) team who have produced a lot of enormously valuable analyses. In a new venture for us, we have commissioned the Resolution Foundation to do further economic analyses to complement the KAI work. We are also very grateful to the Low Incomes Tax Reform Group for providing interesting examples of how individuals may be affected.

Angela Knight

Chair
Office of Tax Simplification

John Whiting

Tax Director
Office of Tax Simplification

Income Tax and National Insurance Alignment

Currently

Two complex regimes tax similar earnings of employees with some distortionary outcomes, and the self-employed face their own differences; while the administrative and legislative links between the two taxes creak.

Simplification requiring policy development

A structure for employee NICs that mirrors Income Tax and a payroll based charge in place of employers' NICs.

Some may pay more, others less. Clarity about who they are, the implications and acceptance that change is necessary.

Uniform treatment for expenses and benefits in kind across both taxes.

Simplification steps that can be made now

Align definitions and other differences in the taxation of employee earnings.

Establish a legislative process to secure convergence.

Upgrade HMRC guidance and handling in one place for taxpayers.

Two taxes fit for future working patterns

Simplified so employees are taxed in the same way for both taxes on the same earnings and employers pay a payroll based charge; few differences between the treatment of the employed and self-employed; a fully joined up approach to the two taxes across policy and administration, clarity for individuals and reduced administrative burdens for businesses and HMRC.

Executive summary

Closer alignment of Income Tax (IT) and National Insurance contributions (NICs) is a constant call from OTS stakeholders. Many go further and simply argue for merger between the two taxes. The reasons people are looking for such changes include:

- greater logic and fairness in the system
- improving understanding and transparency
- easier administration for employers and HMRC
- reduced scope for errors
- better positioning the system for changing work patterns
- taking advantage of investments in software, online filing and general 'e systems'

But change on the scale contemplated by closer alignment of IT and NICs – acknowledging that merger is not on the agenda – has profound implications. It would impact all employers; a significant number of taxpayers in terms of the amount they pay; for many of those taxpayers also aspects of benefits entitlement; and of course HMRC who collect and administer the taxes.

It is against this backdrop that for the last 15 months the OTS has been carrying out a major review of how greater alignment could be achieved and the implications of such moves. Our March report concluded that alignment was both possible and desirable and set out a 7-stage programme to achieve it:

- move to an annual, cumulative and aggregated (ACA) assessment period for employees' NICs on employment income, similar to PAYE IT
- base employers' NICs on whole payroll costs to make it easier to understand and reduce distortions created by the current system,
- more closely align the NICs position for the UK's 4.8 million, and rising, self-employed with that of employees
- to help make closer alignment possible, NICs needs to be a more transparent system, better understood by taxpayers
- align the legislation for IT (relating to employment income) and NICs so that the scopes of the charges are the same, and taxpayers benefit from identical reliefs for IT and NICs purposes
- bring taxable benefits in kind (BiKs) into Class 1 NICs and abolish Class 1A NICs
- a fully joined up approach to the two taxes across policy and administration with alignment of legislation and procedures, and where possible the matrix of rates and thresholds

Given the scale of this programme, which we have always been clear would be a long term project, there were many aspects that would require further investigation. We were asked to do more work on the first two of them by the Chancellor, under formal terms of reference (see Annex E), and this report now sets out our findings on those two areas:

- moving employees' NICs to an annual, cumulative and aggregate basis (ACA)
- changing employers' NICs to a payroll levy

We have been particularly focussed on analysing in fuller detail the impacts of such reforms. For ACA this has meant a great deal of digging into the numbers affected and the monetary impacts. On employers' NICs we have developed further options beyond the simple flat-rate payroll levy we showed in the March report. For both aspects we have been probing the administrative implications: what costs and savings could result?

In presenting our findings and conclusions we need to stress three things:

- a key aim of our work is to expose for wider debate the impact of reforms: decisions on whether and how to proceed will be for Ministers but there needs to be informed public debate on the impacts and general implications
- we have continued to find almost universal support for reforms from tax and payroll professionals, business and employers, unions and those speaking for the low paid; concerns are about timing and extent, about the need to make sure there is proper understanding and time to prepare, not about the desired direction of travel
- our conclusion remains that reforms in the area of closer alignment of IT and NICs is desirable from a simplification perspective and offers scope for a more efficient and transparent tax system. But we also recognise that there are significant impacts and difficult policy decisions for government

In saying all of this, neither we nor those stakeholders underestimate the scale of change that is needed, but initial costings of those changes are encouraging and should not deflect the ambitions. We think it is realistic to aim for our 7-stage closer alignment plan and have put forward an indicative 5 year plan (see Box 1.A page 13).

Annual, cumulative and aggregate NICs (ACA)

As noted above, we found in the work for our March report that changing to an ACA basis would impact many individuals. Our further work has led to a much greater understanding of the overall figures and the sort of people who would be affected. Some 5.5 million people could lose (pay more NICs) – and 7.6 million people gain (pay less NICs). The summary is set out in Chart 2A on page 25. It is still the case that gainers tend to have lower incomes than losers. The annual average gain is £169 and the average loss £242.

Some of these gainers and losers are impacted only in a single year; though many would see changes compared with the existing system on an ongoing basis. At the moment, ascertaining such patterns is beyond the data analysis that is possible.

What we have done is to look more closely at the people affected and some interesting results emerge: for example there are more female gainers than male – see paragraph 2.31. We have done our best to set out our analysis but the emerging picture is complex and we would urge stakeholders to study all our findings rather than focus on one aspect, to ensure they get a balanced picture.

Although many will focus on the gainers/losers in terms of the impact on immediate NICs liabilities, there are other major aspects that policymakers will have to consider. These include:

- gainers/losers can also be viewed as correcting previous unfairness: some of those who 'lose' may have paid less than others with the same overall income whereas the proposed system will produce even bills
- NICs link to contributory benefits – access to these benefits may be affected by a different structure for NICs payments
- as NICs paid impacts on net pay, changes will have an impact on Universal Credit entitlement and other benefits linked to net income

Consideration of changes to benefits and credits is outside the scope of the OTS's remit but, as in previous projects such as our "Review of pensioners' taxation",[1] it would be wrong of us not to look in general at the impact of our proposals on benefits; it is impossible to come to any proper conclusion without taking these into consideration. How such matters are resolved is beyond the remit of the OTS but we think we have identified most of the issues and, importantly, we do not see that these throw up insuperable barriers to constructive reform.

We are grateful to the Low Incomes Tax Reform Group who have provided us with a series of scenarios to illustrate the impacts on individuals. A selection of these are set out as paragraphs 2.74 to 2.81 and these have been very helpful in showing the people behind the broad numbers.

Another major issue is the question of the administrative impacts of reforms. Again, this is a two stage matter:

- preparation and transition costs – the one-off costs
- running the new system – the continuing costs

Costs here must be considered for both employers and HMRC; there is also an impact on individual taxpayers.

At this stage it is impossible to put a firm cost figure on these reforms. However there are some conclusions to be drawn:

- employers do not see that changing to ACA will create significant costs, as payroll software will deal with the changed calculations; indeed there would be some slight savings through improved year-end procedures
- the key requirement is that software changes would need a two year lead time
- employers suggest transitioning will represent a cost, but less seismic than RTI
- all of this is largely on the assumption that moving to ACA means that NICs will parallel PAYE Income Tax: as employers deal with PAYE changes and procedures already, calculating NICs in parallel rather than under separate routines must be easier
- there would be a significant exercise needed to inform taxpayers of the changes and implications – this is more for government/HMRC than employers, though there will be an impact on the latter

[1] https://www.gov.uk/government/publications/taxation-of-pensioners-review

- there will be a significant transitional impact on HMRC who will have to make major system changes. The cost of this is estimated in the low tens of millions of pounds (see paragraph 2.93)
- on the surface, there would be a need for HMRC to perform many more end-of-year NICs reconciliations under ACA than at present. This would clearly create considerable extra burdens. However, our assumption, which we believe is accepted by HMRC, is that anticipated automation will mean the burden of these increased reconciliations would be much reduced. We do not want to ignore concerns but we think that any extra net burden could be absorbed in the general reforms that are currently under way to HMRC's IT systems.

There is one other interested party in ACA reforms that we must not forget and that is the Exchequer. Would there be a net gain or loss in revenues? HMRC's estimate is that moving employees' NICs to an ACA basis would be broadly revenue neutral.[2] A similarly comprehensive estimate of the impact on benefits (contributory or non-contributory) needs to be done but we are encouraged that initial estimates on NICs appear to be modest.

Our conclusion from our further ACA work is that the case for reform remains strong. There are many issues to address in the reform programme but we think that the case is clear to take forward our recommendations.

Employers' NICs: changing to a payroll levy

The argument we put forward in our March report is for employers' NICs to be replaced by a general payroll levy. We found considerable support for this idea, given that employers' NICs do not link to the individual employee's NICs in terms of entitlement to benefits. There is of course a link to employee NICs in terms of calculation, as the same base income figure is used, but the prospect of changing to an ACA basis for employees could break this link and makes it sensible to look at reforming employers' NICs.

We noted at the outset that the simple idea of switching to a payroll levy has significant implications for employers of part-time and low paid workers. We therefore wanted in the second stage of the work on this idea to probe and test:

- alternative ways of framing a payroll levy
- what would be the impact on the workforce and employers
- the administrative costs and savings of changing

Our work has identified 8 options with a ninth more radical possibility. All have the aim of remaining revenue neutral for the Exchequer. In outline the main options are:

1. a simple flat rate payroll levy, with no employer's secondary threshold, but in four different ways and incorporating different employment allowances
2. replacing the employer's secondary threshold with a cumulative annual employee allowance per employment
3. link to a specified percentage of employee NICs

[2] The context for this is that employees' NICs revenues for the year 2016 to 2017 are forecast to be £57.3 billion. OBR http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2016/

4. retain existing system

5. replace the secondary threshold with a full-time equivalent employee allowance

The way the levy is framed does offer possibilities of mitigating the impacts on sectors of the workforce and in Chapter 3 we have set out the options and impacts.

We do not think there is a clear 'winner' in terms of the options, as there are varying benefits and challenges. We do rule out the simple 10% levy with no allowances that we used in the March report to illustrate the idea: as we noted then, it has major sectoral impacts. However, in simplification terms there are some options which would improve on the burden of the current system. We think option 2 above is perhaps the most promising but we believe the key is to have a proper informed debate about the options.

Our conclusions are that:

- reform offers some modest administrative savings for larger employers, mainly because of the scope for combining or paralleling the new Apprenticeship Levy, something many employers call for
- changing to a payroll levy basis does mean a more logical system; employers often tell us that employees have no appreciation of the extra tax paid on their behalf by their employer
- changing to a payroll levy would not mean that the current system of some 80% of NICs going to the national insurance fund (NIF) would have to change; a similar percentage of the payroll levy could still be paid into the NIF
- policymakers need to review the options we have set out, and fully assess the impacts on the workforce and employers

We do think that the case for reforming employer NICs remains and we recommend that the options we have set out are carefully reviewed, assessed and debated.

Conclusions

Nothing in the further work that we have carried out alters the overall conclusions in our March report: there is a need and an opportunity to reform the NICs system. We think the benefits are clear, though it is impossible to put a value on the greater transparency and understanding that will result from a reformed system to set against the actual (relatively modest) costs of change.

We do not underestimate nor seek to diminish the amount of work that will be needed to effect the changes we propose, nor their impact. We believe the case has been made, in seeking to build consensus for a reform program that will deliver a NICs system aligned more closely with income tax and that is fit for everyone in the 21st century working environment.

1 Introduction

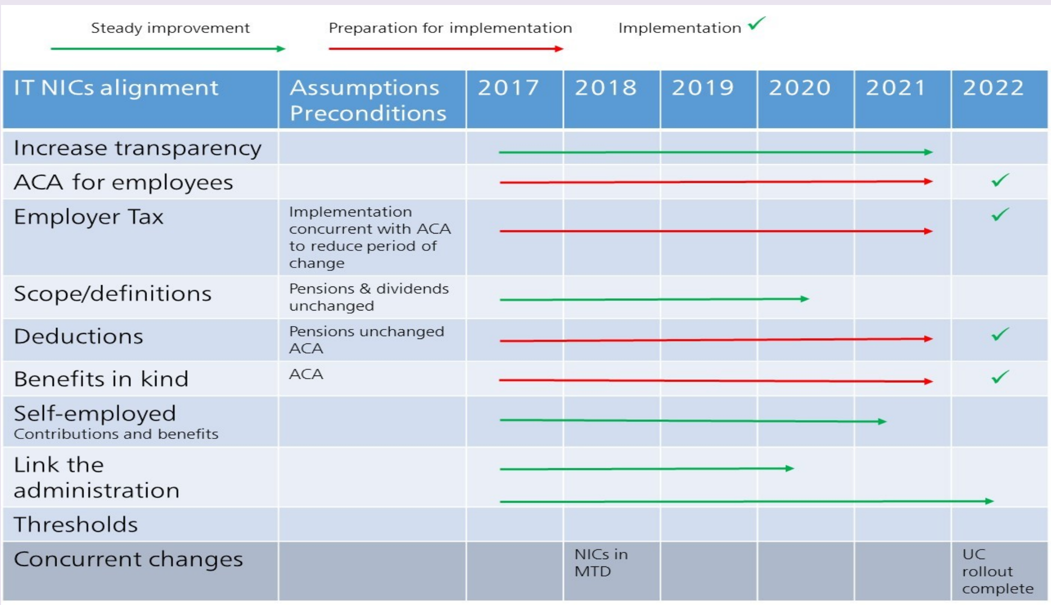
Background to this report

1.1 Ever since the OTS came into being, stakeholders have repeatedly commented on confusion and practical difficulties caused by the differences between Income Tax (IT) and National Insurance contributions (NICs). This has been reflected in a number of our reports. Essentially the two taxes are both applied to the same kind of income but they operate in very different ways, leading in some cases to demonstrably odd, and arguably unfair outcomes for individuals.

1.2 Our March 2016 report on Closer Alignment of IT and NICs[1] framed its recommendations around 7 key steps to closer alignment, recognising the scale of what is needed and the time it is likely to take. We recognised that the history and structure of the two taxes means that there are no easy answers, not least because any change will result in many paying more, or less, NICs. Equally, changing work patterns means the number of taxpayers affected by the differences in the two taxes is going to increase and so now is the time to start taking the first steps towards a system better equipped for the future.

1.3 The full recommendations of the March 2016 report are set out in Annex B. The previous Chancellor of the Exchequer asked the OTS to explore two of the recommendations further and these are the subject of this report: moving employees' NICs to an annual, cumulative and aggregated basis (ACA) and changing the structure of employers' NICs (the Terms of Reference are in Annex E). The other recommendations are already being considered by the government. We remain convinced that taken together the recommendations will achieve a major simplification of the tax system. Box 1.A suggests an indicative timetable for achieving this.

Box 1.A: Indicative path to IT/NICs alignment



The full recommendations from the March report are set out in more detail in Annex B

[1] https://www.gov.uk/government/publications/closer-alignment-of-income-tax-and-national-insurance-contributions

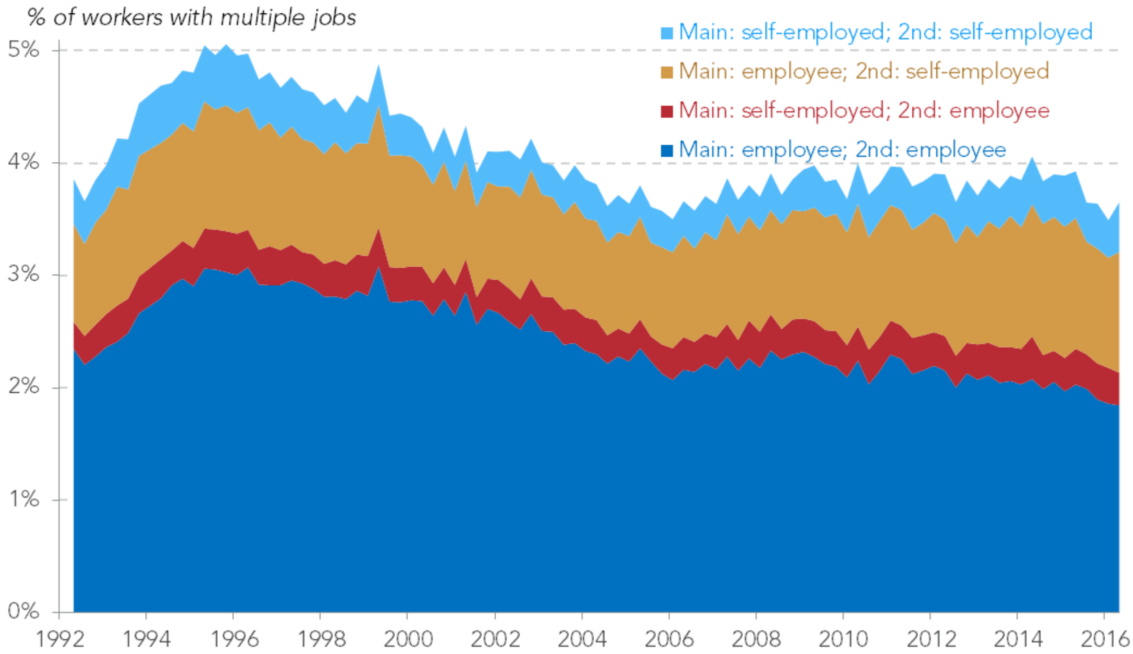
1.4 The timetable we suggest implements simultaneously in 2020 the change to an ACA basis for employees and a new structure for employers' NICs. ACA will be complex to introduce, requiring time to design well. For many employees there are also interactions between the implications of ACA for individuals and the effect of Universal Credit (UC) - see paragraph 2.68. We feel the changes will be more easily understood in an environment where UC is applied across all or most of the United Kingdom. Although it would be feasible to change the structure of employers' NICs before moving to ACA, employers have consistently emphasised to us the desirability of confining change into short periods, and for this reason we would not recommend two substantial changes in different years.

The workforce environment

1.5 We describe later on how working patterns can affect the amount of NICs paid by an individual. Shifts in the economic environment cause changes in the pattern of employment within the workforce as a whole – changing the attractions or disincentives for taking on one or multiple jobs, or providing labour services as an employee, or through self-employment. A sustainably structured tax on employment income would be resilient to fluctuations in working patterns, delivering the same amount of tax[2] paid by individuals on their comparable employment income regardless of the pattern of work they undertake.

1.6 The OTS commissioned Resolution Foundation (RF) to review the number and make up of people with multiple jobs.[3] Changes in working patterns over the last 30 years are illustrated in the following charts.

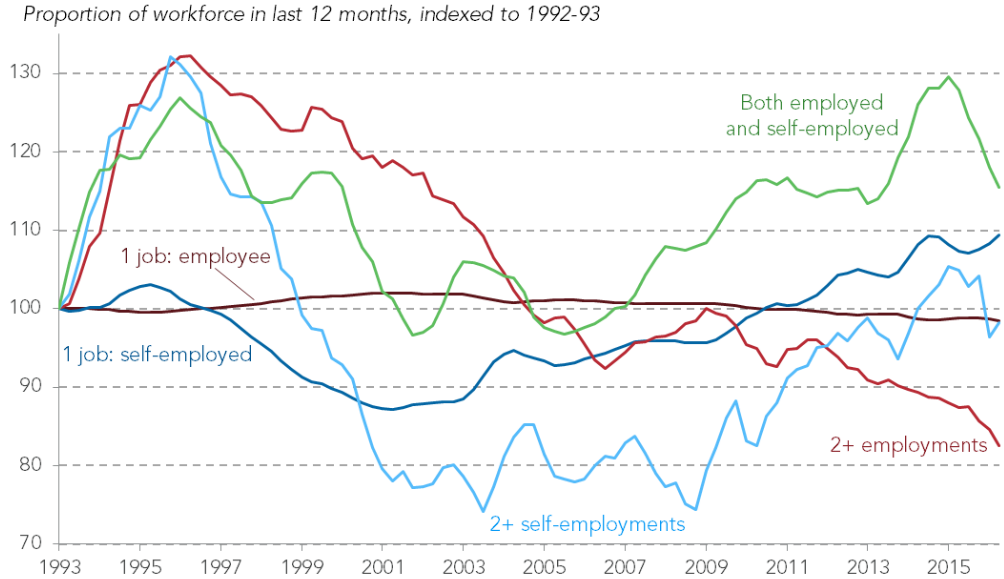
Chart 1.A: The proportion of workers with multiple jobs over the past 24 years



Source: RF analysis of Labour Force Survey

[2] We would repeat something we said at the start of our March report: that we regard NICs as a tax and references to '…amount of tax paid by individuals…' need to be read as '…amount of Income Tax and NICs paid by individuals…'.
[3] RF's report is published at www.resolutionfoundation.org

Chart 1.B: Self-employment and mixing employment with self-employment have grown in popularity

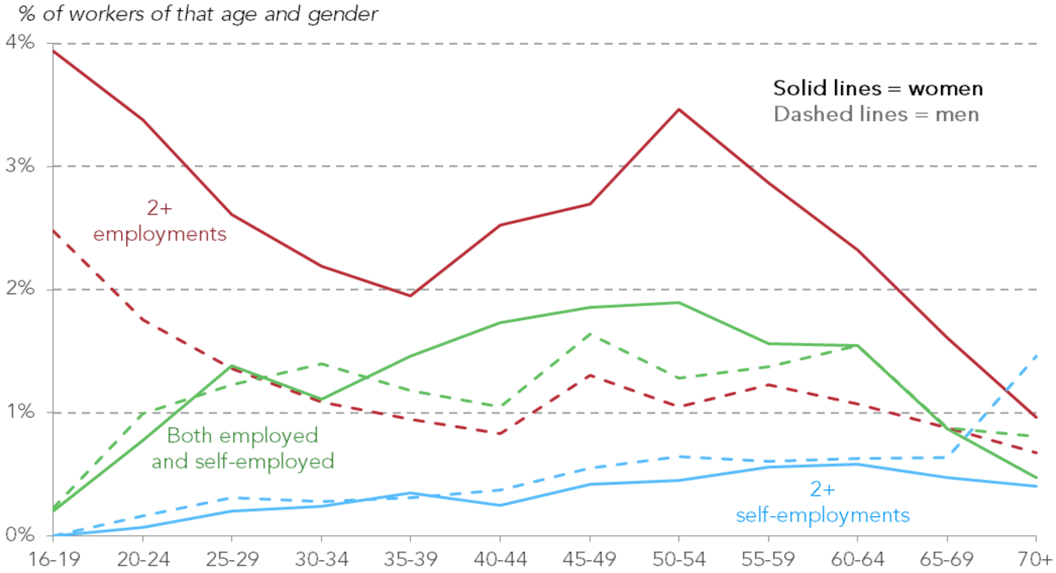


Source: RF analysis of Labour Force Survey

1.7 It is clear from these charts that patterns of employment are in a constant state of flux. While the proportion of the workforce with multiple employments has declined steadily following a sharp increase in the early 1990's, the proportion combining employment with self-employment has increased. Anyone moving between different forms of employment moves to a different employee NICs payment, even if their income remains the same.

1.8 In addition, differences in working patterns, and therefore also the current structure of NICs, impact some parts of the population (defined by gender or age) more than others. The chart which follows shows that a much greater proportion of women have multiple employments, with a prominent peak for those aged 50 to 54. We are not aware of a policy rationale for a tax structure which has an in-built gender and age bias.

Chart 1.C: Gender and age breakdown of individuals with multiple employments or self-employments



Source: RF analysis of LFS Q3 2015 – Q2 2016

1.9 Even for those who have a single job (who represent a fairly constant proportion of the total workforce) the current structure of employee NICs produces strange results for those with fluctuating income or who are joining or leaving the workforce (see Box 2.B, page 23).

Interplays within and beyond NICs

1.10 There are complex interplays between different types of NICs (including NICs charged on employers and NICs on the employed and self-employed), the IT system and PAYE, and the benefits system. If any part is changed, as we recommend, there must be adequate recognition of the other related elements of the overall system. Some of the key connections are:

- for employees, IT and NICs are collected together through PAYE
- employees' NICs and employers' NICs are closely connected but not identical. They serve different purposes: employees' NICs have a contributory link but employers' NICs do not and are in nature closer to a simple tax.[4] Some of the ideas explored for employers' NICs move it further away from employees' NICs and it is appropriate to test whether the notional 'NICs link' between them should be broken
- IT and NICs for the self-employed are collected together through the self-assessment process
- employees' NICs are the basis for some contributory benefits, so changes to these may impact both the tests for entitlement to benefits and the benefits actually received
- self-employed NICs also form the basis for access to some benefits, and changes in the benefits tests for employees should be considered in conjunction with those for the self-employed

[4] At its origin employer's NICs was regarded as an essential element binding employers into the new social security arrangements, see page 86 in the March 2016 report.

- as well as employment-based NICs there are other routes to contributory benefits (voluntary NICs and NICs credits) which may be impacted by changes to employment based benefits tests
- NICs and associated contributory benefits are applied uniformly across the UK, while some aspects of IT are devolved to Scotland (Wales is also due to gain devolved powers over parts of IT). We do not think our proposals create any difficulties with this, given that they are geared towards modernising and simplifying the NICs system in particular. However, it would naturally be something to keep in mind as our proposals are progressed and as further devolution of fiscal powers takes place
- the NICs system links to other countries through many Social Security Agreements, so, it will be necessary to keep in mind possible impacts on these arrangements of any changes

1.11 Employees' NICs and employers' NICs affect many millions of individuals and employers, requiring complex administrative systems for taxpayers, employers and HMRC. Any change therefore will be complex to introduce, requiring good communication, comprehensive systems and, crucially, sufficient time to ensure a successful transition. There will be costs in doing this well.

Simplification

1.12 Having set a somewhat challenging picture, why do we recommend embarking on such a significant change? There are three key reasons:

- the current misalignment of IT and NICs is confusing for almost all and unfair for many
- the differences in definitions and procedures add administrative burdens and costs, and create scope for errors
- shifting patterns of employment and self-employment mean that the working population impacted by the current illogicality and unfairness will constantly change

1.13 This review is focussed on understanding more about those who would gain or lose from changing the structure of employees' NICs and on setting out the options for improving employers' NICs. We acknowledge that there are also many related issues which will need detailed exploration if a decision is taken to proceed. Of those, we suggest that priority should be given to developing the changes which would be required to the contributory benefit system (to marry the proposed annual payment approach with the current weekly based entitlements) and international implications for mobile employees.

Merging IT/NICs

1.14 As we noted in our previous report, the Terms of Reference for our project rules out any consideration of the merger of IT and NICs, or of extending NICs to such areas as pensions or savings. Despite this, we have continued to receive a great deal of unsolicited comment in favour of merger (which usually recognise the difficulties merger would bring). Many stakeholders argue that merger would be the obvious simplification for taxes on earnings. While noting such comments, we have continued to emphasise that merger is simply not on the agenda but we would be failing our stakeholders if we did not note these views. We have not, of course, tested how widely such views are held nor attempted in any way to assess the implications.

1.15 In our previous report we recommended that NICs transparency be enhanced to improve taxpayers' understanding and engagement with the regime. This would make it clear to individuals how much they are paying, where their taxes go, and what their linked entitlements are. In turn, this greater transparency may lead to a better informed public debate on whether a merger, as a much simpler and cheaper system, is desirable as a longer term aspiration.

2 Changing the structure of employee NICs: aggregated, cumulative and annual basis (ACA)

What is the complexity?

2.1 At present there are fundamental differences in the periods of assessment[1] for IT and employees' NICs:

- employees' NICs is usually calculated for each weekly or monthly earnings period in isolation, without regard to other pay or NICs deductions in the same tax year. It applies individually to each of an employee's jobs. Normally no annual reconciliation is required
- IT is calculated annually after aggregating income from all employments (and other income sources). It is collected on a provisional basis during the year using a PAYE code, and taking account of previous pay and tax deductions in the tax year. A reconciliation at the end of the year ensures that the right IT is charged on total income and appropriate additional payments or repayments of tax are made

These differences lead to two areas of complexity:

- the two regimes tax essentially the same employment income[2] but in different ways
- the current structure of employees' NICs (unlike IT) leads to different outcomes if a) income is received from one employer, in contrast with the same total income from multiple employers; or b) income received unevenly across the year, compared with the same income received spread evenly through the year

What is an annual, cumulative and aggregated (ACA) basis?

2.2 In the March 2016 report we suggested that employees' NICs should operate on an annual, cumulated and aggregated (ACA) basis of assessment in essentially the same way as IT.

2.3 This means that:

- all earnings across all employments in the year, however small, would be taken into account in calculating the employee's annual liability to employees' NICs
- earnings from previous earnings periods in the same tax year in the same employment would be taken into account in calculating the employee's primary NICs

2.4 Through the PAYE system, deduction of employees' NICs from gross pay would follow the same cumulative process that applies for IT, taking into account previous pay and the

[1] An assessment period is the period of time in respect of which the amount of tax payable is calculated.
[2] Though with many differences in the definitions of income and expenses, as set out in Annex G of our March report.

employees' NICs paid to date, including any previous employees' NICs deductions made by a previous employer in that tax year.

2.5 The annual Primary Threshold (PT) for NICs would apply to all earnings in the year, aggregated across all employments. Consequently, the amount of NICs collected through PAYE in one employment would need to take account of earnings from other employments too. This implies introducing a NICs code similar to the current PAYE code.

2.6 Moving to an ACA structure for employees' NICs would be a simplification as it would mirror the existing structure for PAYE IT, removing differences between the two structures. It would also address the current distortionary outcomes for individuals with multiple jobs or fluctuating income.

Process implications

2.7 The process by which ACA could be put into operation is set out in the diagram at Annex A on pages 77-78. This changes the current NICs collection process for all stakeholders (employee, taxpayer, employer, HMRC, DWP, software providers) but the ongoing impact on employers' administrative burdens and on employees is thought to be minimal and, in some cases, neutral or negative (further details on admin burdens are set out at paragraph 2.82).

2.8 ACA NICs would mirror the process for PAYE IT, removing differences between the two, and become a payment on account of final liability. Before each tax year HMRC would issue a NICs code to both the employee and the employer, and this would operate from 6 April. During the year this code may fluctuate as employees change employments or take on another employment, with the potential to operate on a week one / month one basis. HMRC would split the annualised 'allowance' or threshold between employments, or as the taxpayer directs. The employer would add ACA NICs deductions to the RTI submissions 'on or before' payment. Once a year HMRC collates RTI data for each taxpayer and would calculate the annual NICs liability (reconciliation), showing ACA NICs due and paid. Under or overpayments would then be advised. Employers would issue a P60, as now.

2.9 If benefits in kind are not payrolled, NICs due would follow the current P11D process. It's worth noting that the process for employees may change, as HMRC develops the Personal Tax Account (PTA) - see Box 2.A).

2.10 A key element of the new process would be the NICs code. Employers would need to know whether all or part of the Primary Threshold is available to an employee in the same way as the PAYE code tells them about the employee's personal allowance and other income position. A NICs code, like the PAYE IT code, acknowledges an employee's other activities. The March 2016 Report considered whether NICs code information could be included within a combined IT and NICs code or if a dedicated NICs code would be needed. It was thought preferable to introduce a dedicated NICs code: a single code would be complex because:

- the IT code takes account of income which is not subject to NICs
- the IT and NICs thresholds are different
- at present the definition of employed earnings is not the same for IT and NICs

In a separate note[3] we have set out the options for the design of a NICs code, and how underpayments of NICs should be collected.

[3] A separate note on a NICs code is published at www.gov.uk/government/organisations/office-of-tax-simplification

Box 2.A: Coding problems and solutions

Concerns have been raised that the current problems generated by the PAYE IT code are a warning not to introduce anything similar for NICs. These concerns are primarily about HMRC's past customer service levels and accuracy or currency of information.

The current IT coding mechanism cannot always operate or react in real time, to bring information about a taxpayers circumstances together to ensure their tax is right during the year. Also, some information is not available until after the year end. This means that about 6 million IT reconciliation notices are issued to taxpayers each year. There is a concern that this number, and its associated problems, will increase under ACA.

HMRC will be transforming the customer services that deliver PAYE in the next 5 years:

- HMRC is increasing its capacity to collate and analyse taxpayer information during the tax year, including RTI data, which means that in the future more taxpayers will have paid the right tax by the end of the year. This will reduce the need for taxpayers to engage with HMRC after the year end. However, it will also mean that HMRC may issue more coding notices during the year, if a taxpayers circumstances fluctuate (for example multi jobbers)
- To improve its customer service, HMRC is delivering well publicised digital services for customers. In time, this will mean that current forms, such as the coding notice that some customers find confusing, could be replaced by information in on-line Personal Tax Accounts that is easier to understand, and supported by web chat and other targeted information services

We consider that within the 5 year timescale we are proposing for the introduction of ACA there will be a far more accurate and timely process for collecting the right tax in each year, and a transformation in the way that taxpayers engage with HMRC to exchange information. Improved and increased online systems will ensure that almost all PAYE, and by implication NICs, reconciliations are automated. Over the timescale, therefore, some of the additional resource required for NICs work would be covered by reducing burdens on IT/PAYE.

Implications of ACA for individuals – who are the gainers and losers?

2.11 As we identified in the March 2016 Report, moving to an ACA basis for NICs would create many gainers (taxpayers who will pay less NICs) and losers (taxpayers who will pay more NICs). The reasons for gaining or losing are shown in the diagram at Box 2.B and illustrated in case studies – see paragraph 2.74. This report seeks to understand more about these impacts, using a model developed by HMRC.[4]

2.12 It is important to appreciate that in this section we are looking at gains and losses solely in terms of NICs amounts paid. Changes in amounts and frequency of NICs payments may affect entitlement to contributory benefits; as NICs paid affects net pay, there will be impacts on some

[4] Information on the data source and its limitations in relation to modelling ACA is given in Annex D. New projections are based on the 2013 to 2014 Survey of Personal Incomes ("SPI") - the figures in the March 2016 Report were based on the 2012 to 2013 SPI. The projections are to the year 2018 to 2019, taking account of all known policy changes, and economic assumptions consistent with the OBR's March 2016 economic and fiscal outlook. This includes a projection of CPI affecting thresholds for that year. The significant forecast thresholds consistent with this are the Lower Earnings Limit £5,876 pa/£113 pw; Primary Threshold £8,268 pa/£159 pw; Upper Earnings Limit £45,790 pa/£881 pw.

non-contributory benefits such as Universal Credit which is linked to net income. We explore these aspects later in this chapter.

2.13 The notion of "losing" needs to be treated with some care. The "loss" arises on a move to a fairer system of taxation. As we have commented before, we have never found a policy reason for the gain which the current structure gives to certain parts of the working population.

2.14 The figures given represent the forecast impact in 2018 to 2019 on those receiving employment income (although HMRC's analysis does not include self-employment income, this is considered below at Box 2.C). Unless stated otherwise all references to income in this section relate to employment income. The model does not reflect any changes in employee or employer behaviour which may result from a move to ACA.

2.15 On the basis illustrated in this report the impact on the Exchequer would be broadly neutral.

2.16 HMRC's analysis allocates taxpayers into three broad categories of employment (part year workers, workers with fluctuating income and those with multiple jobs) reflecting the main reasons ACA would produce different NICs outcomes. For example, an individual may work for part of the year and in multiple jobs during that time. If the total number of payment periods exceeds a year the individual will be categorised as a multi jobber, but if the total number of pay periods is less than a year, the individual will be categorised as a part year worker. A consequence of this approach is that many who one might naturally regard as multi jobbers are categorised here as part year workers: there are more individuals with two or more jobs (consecutively or concurrently) in the past year worker category (2.7 million) than there are in the multi job category (2.4 million).

The reasons for individuals gaining or losing on a change to ACA

2.17 Gaining or losing depends on where an individual's income falls in relation to two key thresholds. The rate structure of NICs (unlike Income Tax[5]) is a "sandwich": the highest rate (12%) is applied to a wide band of income levels between the Primary Threshold ("PT") and the Upper Earnings Limit ("UEL"), income less than the PT is not taxed, income above the UEL is taxed at 2%. At present these thresholds apply to weekly or monthly income (depending on the payment period used by the employer) from each employment. Under ACA the thresholds would apply annually and for all employments. In consequence some taxpayers would find some income not being taxed, or taxed at a different rate. The impact of this is illustrated below, with projected thresholds assumed for 2018 to 2019 (see footnote 4 above).

2.18 The diagram in Box 2.B below illustrates why some gain or lose on a switch to ACA. The definitions are those used for HMRC's modelling of impacts (as explained in paragraph 2.16 individuals who could be allocated to more than one category are allocated according to the dominant reason for ACA causing a gain or loss):

Part year workers - Workers who do not work for a full year.[6] This includes part year workforce entrants (for example school leavers starting work) & leavers (for example on becoming a pensioner), and long term seasonal workers.

Fluctuating income - Workers whose income from a single employment fluctuates during the year, including those receiving commission, bonus, pay rise on promotion, change jobs with

[5] Income Tax does have some problematic income levels where a combination of rates and the removal of allowances causes similar impacts to the NICs rate/threshold structure, but these affect a much smaller population.
[6] So have fewer than 52 weeks'/12 months' pay periods in total whether from a single or multiple employments.

different levels of pay, change of number of hours worked (for example full time to part time and part time to full time).

Multi jobbers - Workers who hold jobs with more than one employer in a single tax year.[7]

Box 2.B: This table shows the dominant reason for ACA causing some to gain and some to lose. The arrows below show in green why some gain and in red why some lose, and the numbers show how many individuals would be affected. Key: Gainers Losers

RATES & THRESHOLDS	7.2m PART YEAR WORKERS	3.5m FLUCTUATING INCOME	2.4m MULTI JOBBERS
2% UEL £45,790	Income above UEL for periods in year	Income fluctuates around UEL so some at 2%	
12%	Pulled into 12% on annual basis 0.4m Income above PT for periods in year	Pulled into 12% on annual basis 2.7m Income fluctuates around PT so some at 12%	Pulled into 12% on aggregated basis 2.4m
PT £8,268 0%	Drops into 0% on annual basis, accessing more PT 6.8m	Income fluctuates around PT so some at 0% Drops into 0% 0.8m	Income under PT for some jobs so taxed at 0%

[7] Everyone with more than 1 employment **and** more than 52 weeks'/12 months' pay periods is treated as a multi jobber. Jobs may be consecutive or concurrent.

Box 2.C: Self-employment

In the March 2016 Report we recommended that ACA should apply across all of an individual's income, whether from employment or self-employment. This remains our view. This approach requires consideration also of the different rates, thresholds and entitlements which apply to self-employment income.

Unless contributions rates and entitlements were aligned for both types of income, a fully aggregated approach would need to include a method of apportioning the annual NICs free sum between the different kinds of income, in order to establish the appropriate class of NICs payment and the ensuing entitlements.

The modelled effects of ACA described below only include employment income, they do not reflect aggregation across employment and self-employment income.[8]

Overall impact on individuals of a change to ACA

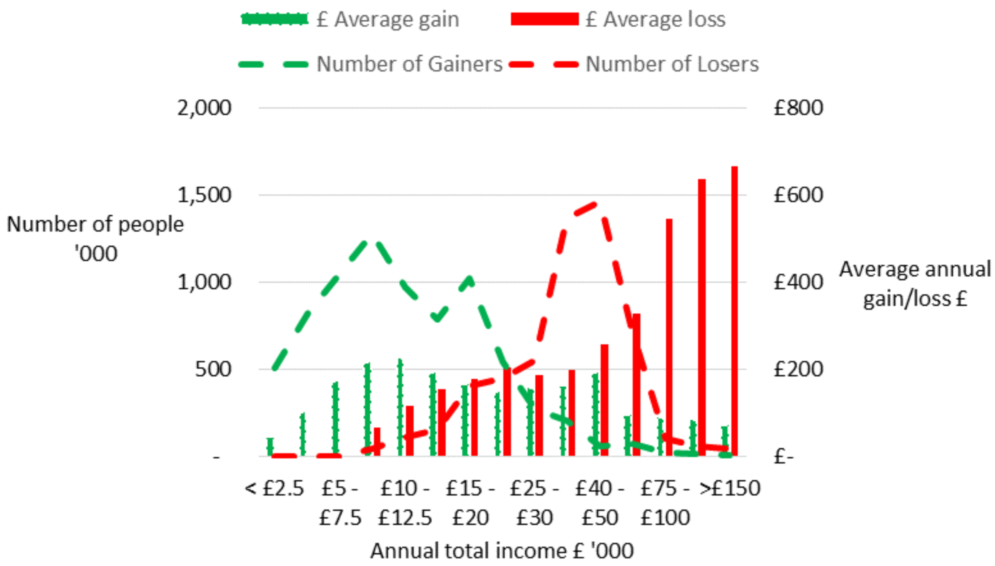
2.19 Based on HMRC's model a change to ACA would cause 40% of all employees paying NICs to pay more or less than they pay under the present rules: Gainers tend to have lower incomes than losers.

Table 2.A: ACA gainers and losers within total NICs paying population[9]

	Employee NICs payers 2018-19 (m)	% of total
Employed NICs payers		
Gainers	7.6	24%
Losers	5.5	17%
Unaffected	18.8	59%
Total	**31.9**	**100%**
Source: HMRC		

[8] Households with employment and self-employment income are included in the data discussed in paragraphs 2.70 to 2.73.
[9] This and the following table look at the tax year in isolation

Chart 2.A: Indicative overall "gainers" and "losers" from moving to an annual and aggregated basis, showing the number of people impacted at different total income levels and the average annual gain or loss at these income levels



Source: HMRC

2.20 The two populations of gainers and losers have contrasting patterns of employment, with widely varying annual gains or losses.[10]

Table 2.B: ACA gainers and losers - employment pattern and average gain or loss

	Gainers		Losers	
	% of all gainers	Average annual gain	% of all losers	Average annual loss
Employment pattern				
Part year workers	89%	£185	7%	£769
Fluctuating income	11%	£34	48%	£172
Multi jobbers	-	-	45%	£237
	100%	£169	100%	£242

Source: HMRC

The average total annual Income Tax and NI burden of gainers will fall from £1,710 to £1,540, while on average the burden for losers will increase from £9,830 to £10,100.

2.21 At this point it is worth flagging the risk that using average figures may mask significant variations. Also, the impact of a gain or loss will depend on the overall level of income, for example the high average annual loss of part year losers shown above reflects their higher average income – see Chart 2.E, page 30. For many individuals small value falls in net income may cause real difficulties (even after taking account of the buffering impact of Universal Credit described at paragraph 2.68).

[10] All numbers are rounded to 3 significant figures and may not sum due to rounding.

2.22 We look below at the income levels of those impacted and, for the first time, consider whether there are noticeable gender, age, location and industry sector impacts. We have also sought to distinguish the key elements within the three main categories – part year workers, fluctuating income and multi jobbers – so that we can identify situations where the outcome of the current non-ACA basis seems most problematic.

2.23 One area where the data provided by HMRC cannot assist the understanding of gainers and losers, is the extent to which gains or losses might be a one off, sporadic event in a working life, rather than something which will recur. For example 'part year workers' includes individuals who do not work a full year because they are entering or leaving the labour market - they are not long term part year workers. However, for someone who is a seasonal worker year by year the gains will be long term. Similarly, the working arrangements which may underlie some low fluctuating income (for example zero hours contracts or repeated short term contracts) are likely to persist long term, so the gains for individuals with this type of income would be long term too. Whether a pay rise or bonus (which is categorised as fluctuating income in this analysis) is repeated long term or is a once off will vary between individuals.

2.24 The income levels indicated by the data may also be distorted by the working pattern: someone entering the workforce part way through the year on a reasonable pay scale will appear as lower paid as only part of a year's pay will be included.

Figure 2.A: Summary of some of the main impacts[11]

KEY IMPACT	CAUSE	More information, para
General		
Gainers tend to have lower incomes than losers	Gaining generally occurs when ACA enables individuals to access a full annual PT. The PT is at a low level of income, £8,268. For part year workers losing generally occurs when ACA results in income being taxed at 12% rather than 2%. The threshold for this change (the UEL) is a higher level of income	Chart 2.A
There are more gainers than losers	Lower income is more prevalent than higher income, so the gaining impact described above will occur more often than the losing impact.	Chart 2.A
Gainers, typically:		
Part year workers	A significant proportion of the working population does not work throughout the year, under ACA they would be able to access a full year's PT.	Chart 2.D
Women	A greater proportion of women than men are low paid part year workers.	Chart 2.F
Aged under 35	People joining the workforce on leaving education and students working for part of the year help lower the age balance of gainers.	Chart 2.G
In non-financial service industries	These tend to be lower paid industries	Table 2.C
Losers, typically:		
Paid more than £20,000 pa and are multi jobbers with two or more jobs,[12] or	These at present benefit from a PT for each job	Chart 2.E
….at higher income levels, men with fluctuating income	More men are employed at higher income levels in industries with income peaks (bonuses)	Chart 2.E
In service sectors, education and manufacturing	These tend to be lower paid industries	Table 2.C

Income levels

2.25 For this report, in looking at the income levels of those impacted we have considered:

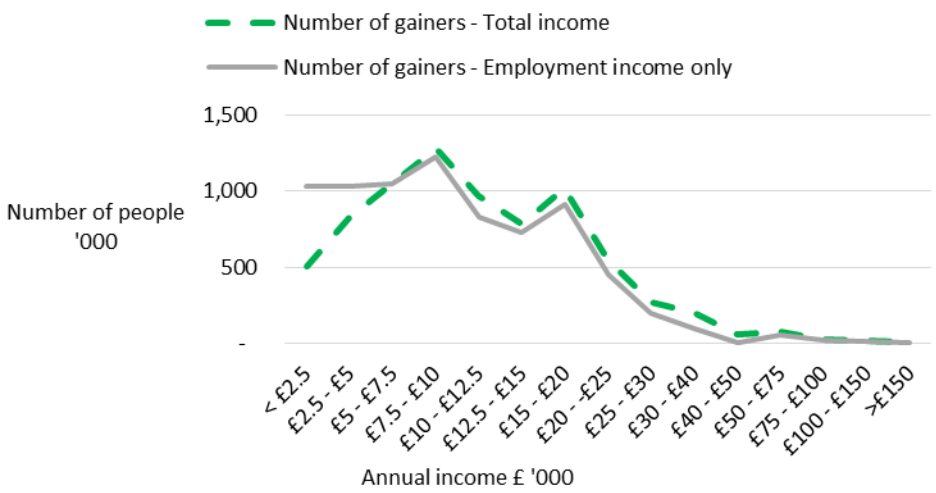
- total income subject to IT and/or NICs (which would include non-employment sources of income as well as self-employed income)
- employment income subject to employee NICs

While at first sight "gaining" for those at lower levels of income is beneficial there are potential knock on impacts on entitlement to benefits (see paragraphs 2.43-2.69).

[11] The underlying data is not cross tabulated (because of limitations due to the sample size) so it is not possible to give a composite picture, for example a woman **and** part time **and** in the north east.
[12] Two-thirds of multi jobbers have two jobs, one-third have three or more.

2.26 Looking at employment income only, although the overall numbers of gainers and losers if ACA is adopted for employee NICs of course remains the same as for total income, the income patterns of the affected individuals reveal that a significant number of the gainers are in receipt of non-employment income (see chart 2.B). There are about 0.7 million more people at NICs income levels below £5,000 than there are with total incomes below £5,000. These are people with non-employment sources of income in addition to their employment income. The number of gainers with such non-employment and self-employment sources of income is fairly evenly spread through the income range from £10,000 to £40,000.

Chart 2.B: Indicative overall "gainers" from moving to an annual and aggregated basis, showing the number of people impacted at different levels of total income and employment income.

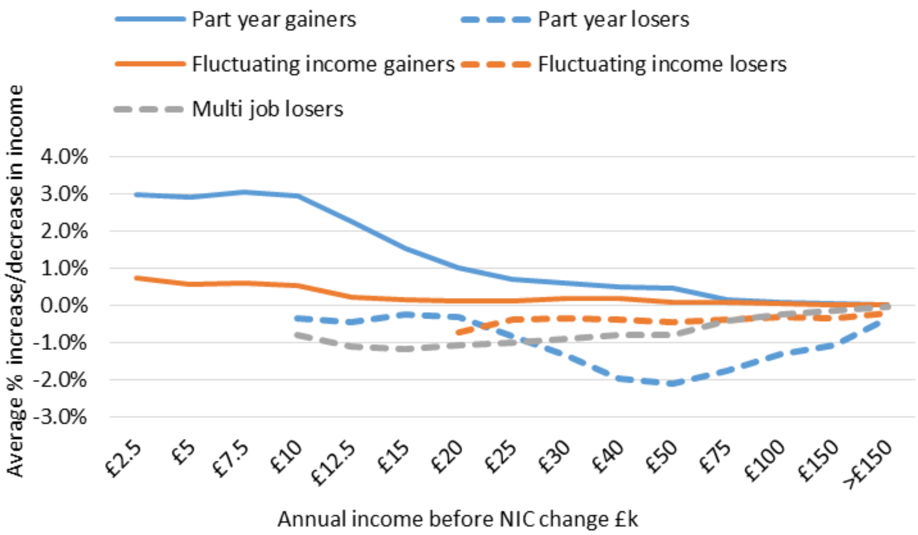


Source: HMRC

2.27 For the losers there is no marked difference if the data is analysed by reference to total income or NICs employment income.

2.28 The cash impact for an individual may have a very different impact relative to overall income: at higher levels of income the same cash loss will be less noticeable than for those on lower incomes. At the lowest levels of income there are only gainers (and at the very lowest levels up to a 3% increase in gross income - subject to the impact of benefits, see paragraph 2.68); at slightly higher income levels multi jobbers may lose about 1% of their income on average. The greatest percentage losers are higher earning part year workers – potentially those moving into retirement.

Chart 2.C: Average percentage increase or decrease in income for gainers and losers by main reason for gain or loss from ACA

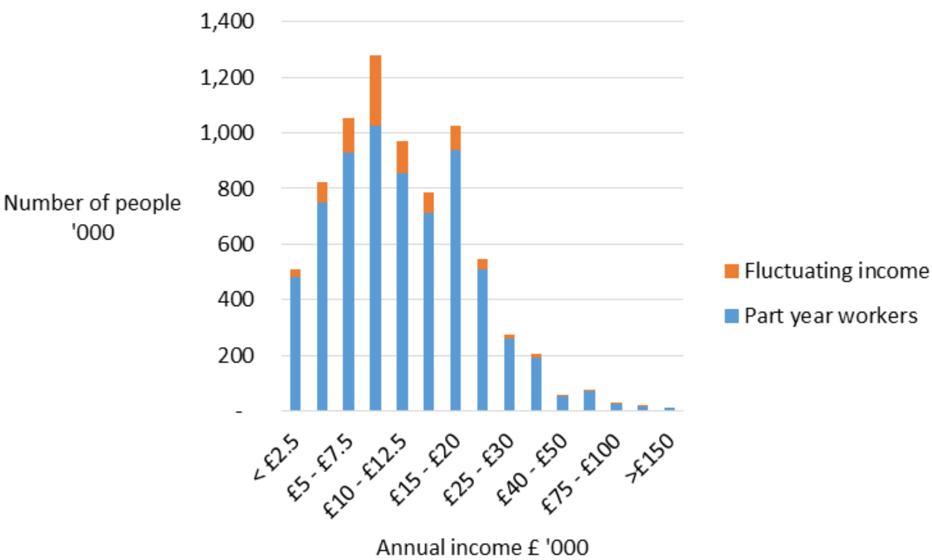


Source: HMRC

Working patterns

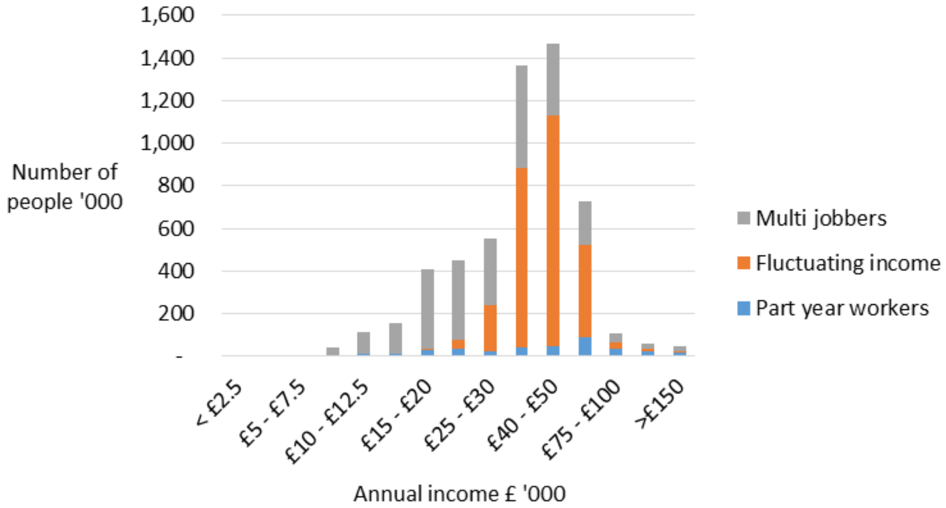
2.29 The annual gains or losses vary with income (driven by the industry sector and nature of the role) and by the pattern of employment. The main reason for the gainers and losers are illustrated below:

Chart 2.D: Gainers - Main reason for gain from ACA and annual income of gainers, cumulative



Source: HMRC

Chart 2.E: Losers - Main reason for loss from ACA and annual income of losers, cumulative



Source: HMRC

2.30 As explained in paragraph 2.23 the working pattern may in some cases mean that any gains or losses are likely to be repeated year on year, in others that the gains or losses may be once off events.

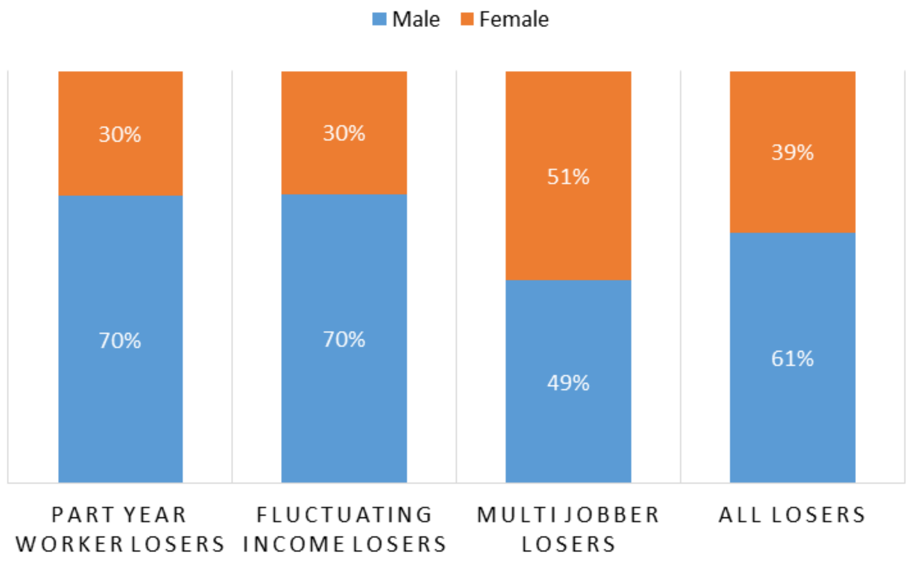
Gender

2.31 The 2018 to 2019 projection is that the employee NICs paying population will be 51% male and 49% female. Against this benchmark some notable variations would emerge on a move to an ACA basis. A marked preponderance of the fluctuating income gainers are women, but average annual gains for this group are modest (female £35, male £32). In contrast the majority of losers are men.

Chart 2.F: Gender of gainers and losers by main reason for gain or loss from ACA

Gainers

Losers

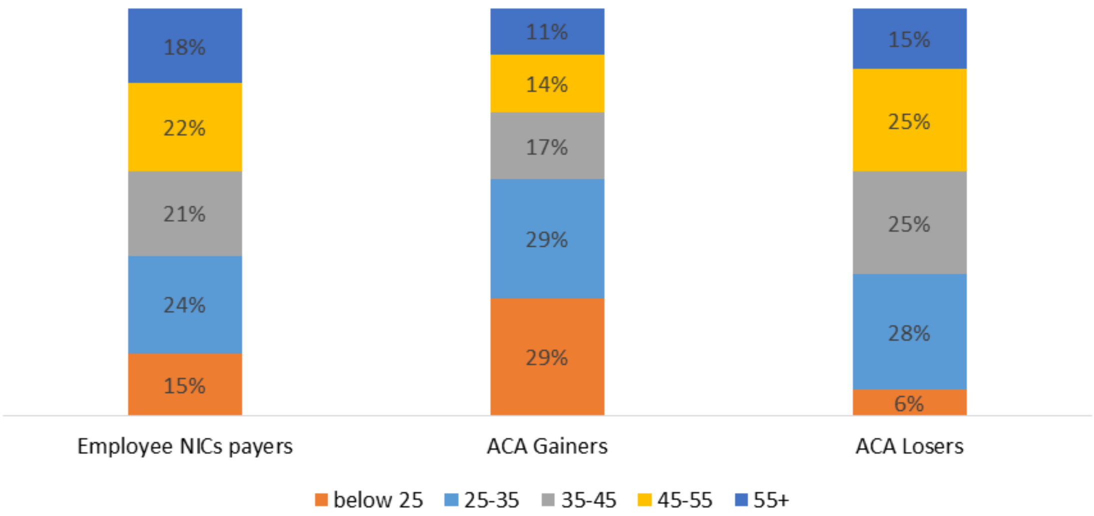


Source: HMRC

Age

2.32 There are stark variations in the age profiles of gainers and losers, with losers more closely reflecting the working age population as a whole:

Chart 2.G: Age distribution of all employee NICs payers, and gainers and losers from ACA (% of populations in each age band)



Source: HMRC

2.33 While 58% of the gainers are under 35 (including 29% who are under 25, representing over half the employed workers in that age group), 65% of the losers are over 35 and only 6% of losers are under 25. A large proportion of the population aged under 25 will be affected by an annual basis for assessment, as they join the workforce or move in and out of it as students.

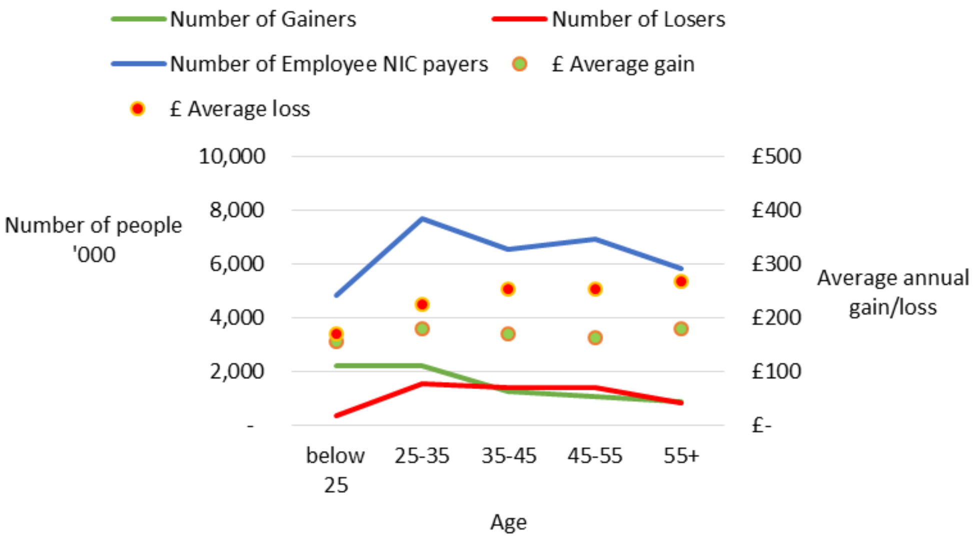
2.34 At the other end of the working age spectrum the movement of individuals out of the workforce and into retirement triggers treatment, for this analysis, as part year workers in the tax that this occurs. Part year workers comprise half of those affected by ACA in this age range. The proportion of all taxpayers over 55 affected by a move to ACA is just 10% as Employee NICs are only paid by those under the state pension age ("SPA").[13]

2.35 Multi jobbers are fairly evenly spread through the central age bands of 25 to 55.

2.36 The charts which follow give further information on the age characteristics of the gainers and losers.

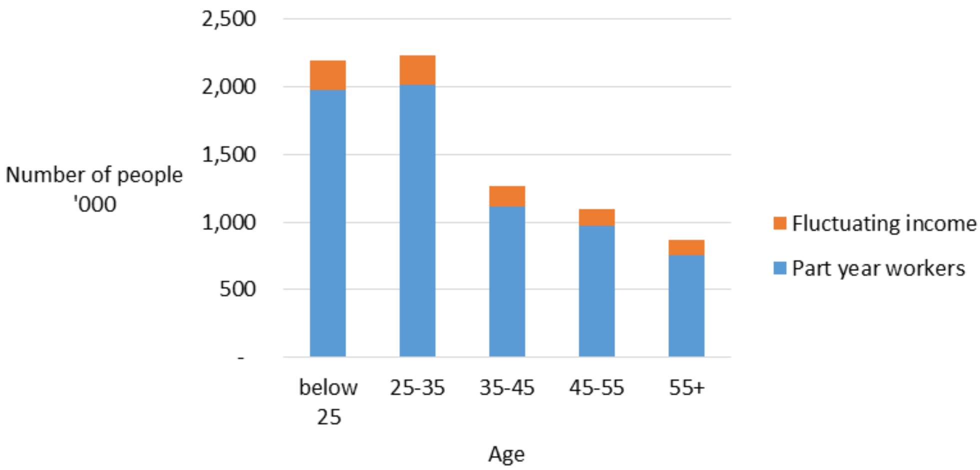
[13] In 2013 to 2014, 1.2 million individuals over SPA received employment income, amongst 6 million who received taxable income: HMRC Survey of Personal Incomes 2013 to 2014, Table 3.12. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/510927/National_Statistics_T3_12_to_T3_15_Publication.pdf

Chart 2.H: ACA - Age profile of gainers and losers from ACA with average gain/loss, compared with all Employee NICs payers



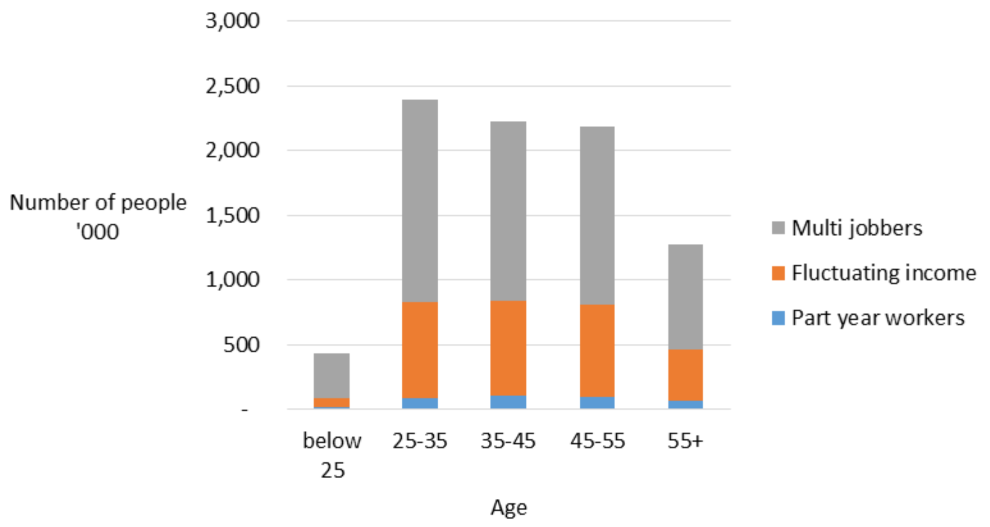
Source: HMRC

Chart 2.I: ACA – Age and main reason for gain from ACA, cumulative



Source: HMRC

Chart 2.J: ACA – Age and main reason for loss from ACA, cumulative



Source: HMRC

Industry sector

2.37 There is a concentration of gainers and losers within certain industry sectors.[14] The 4 sectors with most gainers employ 53% of all the gainers, the 4 sectors with most losers employ 44% of all the losers:

Table 2.C: ACA gainers and losers – major industry sectors

	Main reason for gain or loss from ACA	Number of Individuals (m)
Industry sectors with gainers		
Wholesale and retail trade; repair of motor vehicles and motor cycles	Part year	1.2
Accommodation and food service activities	Part year	0.9
Administrative and support service activities	Part year	1.2
Human health and social work activities	Part year	0.8
Other industries		3.5
Total		**7.6**
Industry sectors with losers		
Manufacturing	Fluctuating	0.7
Wholesale and retail trade; motor vehicle repair	Fluctuating - multi job	0.6
Education	Multi job	0.5
Human health and social work activities	Multi job	0.6
Other industries		3.1
Total		**5.5**
Source: HMRC		

2.38 In the main, this reflects the key role of those sectors as major employers, and it was noted at paragraph 2.19 that 40% of all NICs paying employees would see a change in the NICs they pay. Those sectors are also generally lower paid. However, some industries are impacted out of proportion to their employee numbers: about half of those employed in agriculture and associated activities (of whom gainers 75%), construction (52% losers), transport and storage (63% losers), accommodation and food services (80% gainers), and approaching 60% of those in the administrative and support service sector (76% gainers).

2.39 Sectors with more highly paid employees (finance and ICT) have about 40% of employees impacted, in line with the overall position.

[14] HMRC attributes taxpayers to 23 industry sectors based on the ONS Standard Industrial Classifications 2007 (SIC07) . The sector is based on the sector given in respect of the main source of employment, so does not take account of differing sectors for those with multiple jobs. It is based on the sector of the PAYE scheme the employment information is generated from rather than being specifically linked to the individual.

Location[15]

2.40 Overall, as we have seen, there are more gainers than losers, and this pattern is repeated across the UK, with no nation or region varying significantly from the countrywide proportions of gainers and losers. Similarly no nation or region has significantly different employment patterns amongst the gainers and losers.

2.41 The average annual gain or loss in London and the south east is significantly greater than elsewhere in the UK, probably reflecting underlying wage levels.

Other matters

2.42 In meetings stakeholders have expressed interest in two areas which we briefly comment on below: whether thresholds affect wage patterns and how the data provided through RTI can improve understanding of the taxpaying population.

Box 2.D: Do NICs thresholds impact wage patterns?

During the preliminary work for the March 2016 Report a point often made was that the thresholds in the NI structure invite 'gaming' with

- employers seeking to offer pay rates and/or hours of work at levels where the Secondary Threshold ("ST") is not breached (so no employer's NI is due)
- employees incentivised by the tax structure to achieve earnings above the Lower Earnings Limit ("LEL") (to trigger entitlement to contributory benefits) but below the Primary Threshold ("PT") so that no employees NI is due.

Some have also suggested that at low income levels there is also an incentive for employees to limit the weekly hours of work offered to 16 hours at the national minimum wage ("NMW") so that current benefit receipts are not reduced. In 2013 to 2014, using the October 2013 NMW rate for those aged over 20, annual income would be £5,250.

There are complex reasons for remuneration levels, including the points made above. The influence and impact of each element is difficult to determine.[16]

HMRC provided us with information from the 2013 to 2014 SPI dataset, looking at potential clustering around the PT, ST and LEL in that year. As the dataset is based on a sample, pay bands of £250 around the thresholds were explored. At first sight the data presented in Chart 2.K and Chart 2.L does indicate bunching at these thresholds. However, there is a caveat[17] on the underlying data and it may also be influenced by other factors. For example, the incentives to work through a personal service company ("PSC") include the fact that NICs are not charged on dividends or capital gains, and the optimal remuneration strategy for a PSC is close to the PT/ST. This is likely to be reflected in the bunching seen at these thresholds.

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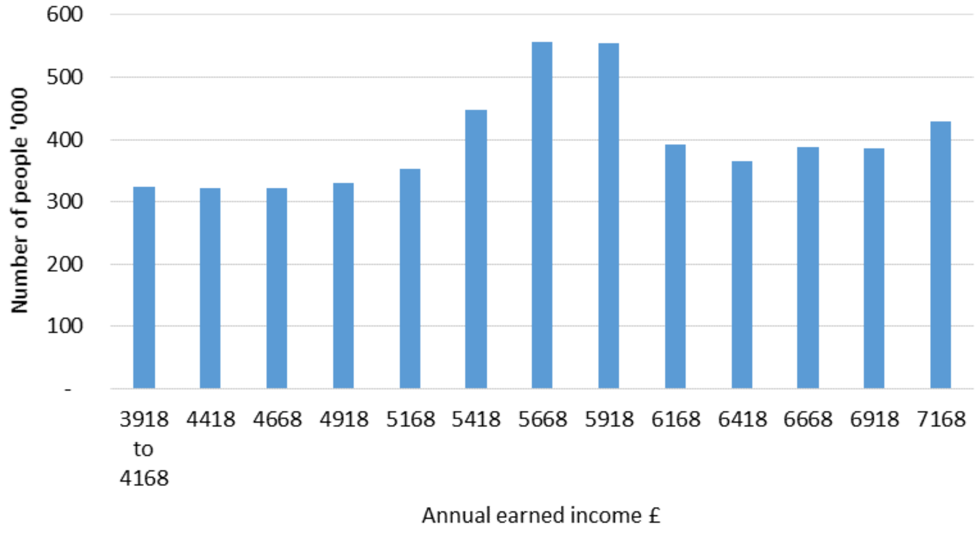
[15] Location is based on the taxpayer's home address.

[16] For a recent paper see Tazhitdinova, Ailsa, Behavioural Responses to Payroll and Income Taxes in the UK (November 12, 2015). Available at SSRN: https://ssrn.com/abstract=2689879 or http://dx.doi.org/10.2139/ssrn.2689879 Ongoing research at the Institute for Fiscal Studies is analysing data since 1975 for bunching at tax thresholds.

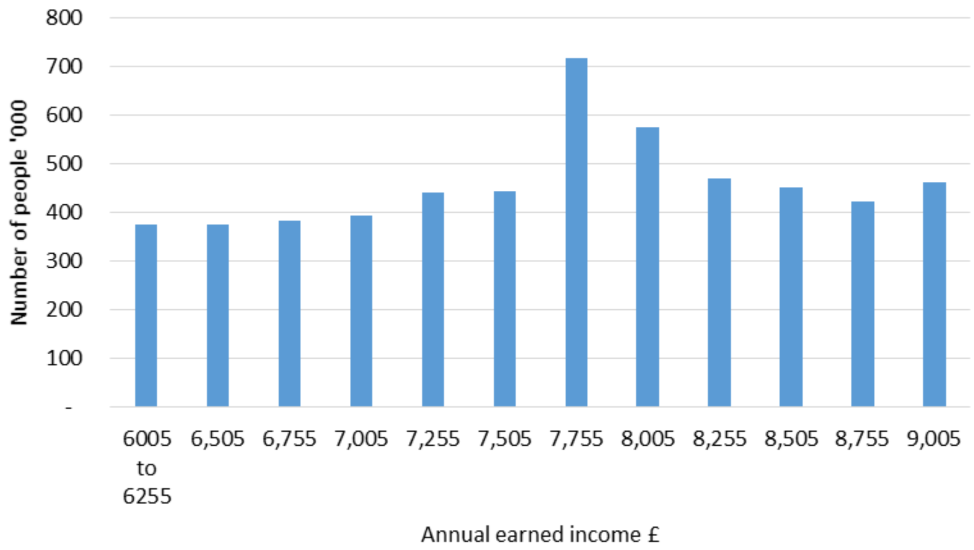
[17] There is a significant caveat to the data because of the periodic basis for NICs (which of course we seek to change): as NICs is currently on a periodic basis any clustering will occur period by period. The SPI data is however based on annual income. An individual may be paid for 11 months between the LEL and the PT not generating a NICs charge, and for one month may be paid over that threshold. They would show annually above the PT, when in fact they are clustered below for the majority of pay periods.

Chart 2.K: Potential clustering at the 2013-14 Lower Earnings Limit, £5,668



Source: HMRC

Chart 2.L: Potential clustering at the 2013-14 Primary Threshold £7,755/Secondary Threshold £7,696



Source: HMRC

Box 2.E: A note about RTI

HMRC receives a massive amount of data (currently over 65 million employer submissions each month) through Real Time Information ("RTI"), which was introduced in stages between 2012 and 2014. We asked HMRC to comment on the potential to use this data both to understand what happens now and to enhance the quality of data used for modelling. Its comments follow:

"The analytical feed of RTI data is a new source of data that provides significant opportunities to improve modelling of personal incomes and tax and NICs payments made through PAYE. The size and complexity of the data make it quite challenging and resource intensive to work with, and so far most analysis has focused on using RTI data to support HMRC operationally. We are in the early stages of a programme of work to exploit the information for modelling potential policy changes and to improve the monitoring and forecasting of tax and NICs receipts. This project will require a substantial amount of development work and – combined with the need to bring RTI data together with other sources of information on personal incomes (for example, Self-Assessment) - we anticipate that it will take at least two to three years before RTI data is fully incorporated into the forecasting and policy costing process."

Entitlement to benefits and statutory payments

2.43 NICs are one part of the National Insurance system. This section considers the other side – individuals' entitlement to contributory benefits and statutory payments, briefly setting out the current system and how ACA may affect this. The impact of NICs also goes deeper into the benefits regime, affecting also some non-contributory benefits, and we touch on this too.

2.44 Workplace pensions are distinct from the state pension which is accessed through NICs contributions (see paragraph 2.46). The requirement to auto enrol employees into workplace pensions is based on pay criteria established in respect of each job and nothing outlined below would change that.

Complex link between NICs and contributory benefits

2.45 The interplay of the NICs system with entitlement, together with the lack of accepted use of terms such as "entitlement" and "benefit" (for example in relation to the State Pension) was identified in the March 2016 report as an area where greater transparency would help with the understanding of NICs. There is evidence that individuals have a poor understanding of how NICs link to benefits,[18] and the distinction between contributory benefits and other benefits. This is not surprising given that the existing entitlement tests typically have a number of different conditions, and use obscure terminology (for example, qualifying years and earnings factors). There are various ways of achieving a satisfactory NICs record (paying NICs based on employment or self-employment income, volunteering to pay NICs, being treated as having paid NICs, and receiving NICs credits), which adds to the complexity.

[18] See for example PWC Taxation in the UK, A citizen's view, 2014 http://www.pwc.co.uk/issues/futuretax/assets/pwc-tax-citizens-jury-final-report300631.pdf

The current system

2.46 Entitlement to some contributory benefits (State Pension and Bereavement Allowance[19]) is determined by the number of qualifying **years** an individual builds up through the payment of NICs during their working life.

2.47 Entitlement to other contributory benefits is determined by a variety of tests and conditions, in part based on a requirement to have paid NICs (or be treated as having paid – see Box 2.E) for a specific number of **weeks**. The benefits concerned are Contribution-based Job Seekers Allowance (CJSA), Contributory Employment Support Allowance (CESA), Maternity Allowance and Bereavement Payment.

2.48 For employees, only earnings on which Employee NICs are paid, or treated as being paid, at the main rate of 12% count as earnings for a qualifying week or year.

2.49 The Department for Work and Pensions (DWP) uses an individual's contributions record (maintained by HMRC) to determine the amount of contributory benefit that is payable to each individual who makes a claim, with reference to the entitlement tests for each benefit.

2.50 An individual's earnings are also used to determine access to statutory payments.[20] Entitlement usually depends upon whether an individual has earned enough in a recent period of weeks by reference to the LEL. Like NICs, statutory payments are assessed by reference to individual employments.

2.51 Further detail on qualifying years is set out in the box below, bringing out the present importance of the notion of a weekly contribution.

[19] Bereavement Allowance will be replaced by Bereavement Support Payment from April 2017.

[20] Statutory payments include sick pay, maternity pay, paternity pay, adoption pay and shared parental pay,

Box 2.F: Contributory benefits tests – earnings factors

Eligibility for contributory benefits is based on earnings, contributions and qualifying periods. Qualifying periods may be a specified number of weeks or a year.

Contributions generate a person's "earnings factor" (a term which is unhelpful to the transparency and ease of understanding of the contributory benefits system), in effect grossing up the contribution to a level of income. To achieve a qualifying period a person's earnings factor must reach 26, 50 or 52 (depending on the specific benefit test) x the Lower Earnings Limit (LEL - currently £112 a week).

Employees' NICs

The LEL is equivalent to 15½ hours a week work at the National Living Wage.[21] The LEL represents the point at which employees gain access to benefits as they are treated as paying NICs for benefit entitlement purposes, even though NICs are not payable on earnings until they breach the Primary Threshold (currently £155 a week).

Self-employed Class 2 NICs and Class 4 NICs

The self-employed pay Class 2 NICs and Class 4 NICs. Every Class 2 contribution (£2.80 per week) that is paid is given a value of 1 x the LEL. Class 4 NICs do not count towards contributory benefit entitlement. The government has consulted on the intention to abolish Class 2 NICs and the potential reform of Class 4 NICs to introduce a benefits test.

Voluntary Class 3 NICs

Class 3 NICs (£14.10 per week) count towards entitlement to new State Pension and bereavement benefits. Individuals who are not liable to pay NICs and who are not eligible to receive credits may make voluntary payments of NICs in order to ensure they have an adequate contributions record. Every Class 3 contribution that is paid is given a value of 1 x the LEL. With the abolition of Class 2, the government is also considering the potential for payment of Class 3 in certain circumstances to count towards benefit entitlement which presently are not counted.

NICs credits

NICs credits are awarded for each week in which certain state benefits are payable to an individual or the individual is otherwise entitled to a credit, for example because they are a carer or are required to undertake jury service. Every credit that is paid is given a value of 1 x the LEL and, depending upon the type of credit, will count towards certain contributory benefits.

Mixed years

People can often be employed and self-employed in the same year or they may claim benefits or need to pay voluntary Class 3 contributions, so the current calculation allows a mixture of Class 1, 2, 3 NICs and credits to be added together to gain a qualifying period.

[21] National Living Wage for workers aged 25 and over is £7.20 from April 2016 to April 2017.

2.52 The split between weekly and yearly determined entitlements in 2015 to 2016 was as follows.[22]

Table 2.D: Weekly and yearly determined entitlements 2015-16

	£bn	% of Total
Benefits based on weekly entitlements	5.3	5%
Benefits based on yearly entitlements	89.8	95%
Total	95.1	100%

The impact of an annual NICs system

2.53 An annual NICs system would impact contributory benefits in two broad areas:

- design of the benefits tests
- access to benefits

Benefits tests

2.54 With continuing contributory benefits, an annual NICs payment system brings into question whether there need to be consequential changes to the benefits tests. It would in theory be possible to maintain weekly entitlement tests alongside annual payments, but it may instead be appropriate to develop tests which cater for a NICs assessment based on years rather than weeks. As a result, the basis of some tests would change from weekly to annual, or other solutions established. There would be knock on impacts for the operation of voluntary NICs and NICs credits, which also currently operate on a weekly basis.

2.55 Given that an annual NICs system may lead to a change in the operation of these tests, there is perhaps an opportunity (though clearly beyond the remit of the OTS) to consider whether entitlement to contributory benefits itself could be simplified. At a minimum, it is probably desirable for the tests to work on an annualised basis or some other basis and it may be possible to create a set of tests that are easier to understand than those currently in place.

[22] Report of Government Actuary on the National Insurance Fund, January 2016

Box 2.G: Contributory benefits tests – what is behind the different NICs tests?

Both CESA and CJSA have a number of rules to determine entitlement, including a two-pronged test of NI contributions, with:

a) an element focussing on consistency of paid employment by establishing a reasonable link with the labour market (NICs paid to produce an earnings factor of at least the LEL in 26 individual weeks, not necessarily consecutive, in 1 of the 2 tax years prior to the current benefit year)

b) an element focussing on longer term employment potential (NICs paid or credited to produce an earnings factor of at least 50* LEL in both of the previous 2 tax years)

The 26 individual weeks requirement in a) was introduced in 2010 as a modernisation. Previously it was possible to build the 26[23] week entitlement in a single week or month. In effect the earlier approach was a form of semi-annualisation, and it still applies for b) where it remains possible to build the 50 week entitlement in a single week or month.

2.56 A feature of the current contributory benefits tests is that the period tested is in most cases a tax year that has already ended (this contrasts significantly with the non-contributory Universal Credit). For CESA and CJSA there is at least a 10 month gap between the end of the tax year and a potential claim. This will make it easier to design an annual based test.

2.57 Recent discussion of changes to the treatment of the self-employed on the abolition of Class 2 contributions (such as moving to the notion of a qualifying year) show that alternatives to weekly contribution requirements can be found.[24]

2.58 Different entitlement tests may, of course, have cost implications.

Access to benefits – Contributory benefits

2.59 In this section we are conscious that we are dealing with aspects of the benefits system – contributory and non-contributory – which are outside the OTS's remit. We are doing so in an attempt to show that we have considered some of the impacts of our ACA proposals, which we feel we have to do so that we can present them in a rounded context. We also feel we need to do enough analysis to show that although some changes will be needed, and thus burdens placed on those responsible for the benefits systems, we do not believe our proposals will present insurmountable difficulties.

2.60 As described above the LEL is a crucial threshold for determining access to contributory benefits. Box 2.B, page 23 illustrates how ACA can move an individual's income above or below the primary threshold, potentially increasing or decreasing NICs payments. It would have a similar effect around the LEL. Aggregation may place people into the LEL to PT band, triggering entitlements without additional NICs payments.

2.61 Access to the state pension for people with multiple very low paid jobs has been reviewed by the Department for Work and Pensions (DWP).[25] Estimates produced by DWP indicate that

[23] Up to 2010 25 weeks.
[24] https://www.gov.uk/government/consultations/consultation-on-abolishing-class-2-national-insurance-and-introducing-a-contributory-benefit-test-to-class-4-national-insurance-for-the-self-employed/the-abolition-of-class-2-national-insurance-introducing-a-benefit-test-into-class-4-national-insurance-for-the-self-employed
[25] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/405850/LEL-and-mini-jobs-Feb-15.pdf

around 50,000 people have concurrent low paid jobs, which if earnings were aggregated would exceed the LEL and trigger a qualifying year's entitlement for the state pension. While the number of people has remained broadly static over the last 15 years, the population changes so many may build up sufficient entitlements at other times in their working career through paid or credited contributions. There are no circumstances where someone gaining access to the State Pension under the current structure of Employee NICs would lose out on a move to ACA.

2.62 The design of annual entitlement tests for the other contributory benefits should seek to ensure that a move to ACA will not disadvantage access to these benefits.

2.63 At present the weekly/monthly basis for Employee NICs payments means that the impact on entitlement for the 'weekly-linked' benefits can be established immediately. With an ACA basis the final amount of Employee NICs may not be established until a reconciliation is done after the end of the tax year. There is the potential for any over or underpayment of NICs after the end of the tax year to impact entitlements. There are various possible approaches to this issue:

- entitlements could be based on NICs paid in the tax year, regardless of any subsequent adjustments
- recognising the gap between the end of the tax year and any related claim for CESA or CJSA (see Box 2.G) most reconciliations and subsequent cash adjustments should be complete before the benefits come into payment, so that appropriate benefits can be paid

2.64 A further issue arises if ACA is applied across employment and self-employment income. A mechanism would be required to show how much of an aggregated NICs payment record is made up of which class of NICs (see Box 2.E), as they offer entitlement to different contributory benefits. This suggests the standardisation of benefit entitlements accruing from the different classes – a point which was frequently made to us in the research leading to the March 2016 report.

Access to benefits - Statutory payments (SP)

2.65 SPs are paid per job so a multi jobber accruing the necessary entitlements (which are by reference to pay equal to or greater than the LEL) in more than one job receives multiple SPs.[26] All other benefits are on a per individual or household basis rather than a per job basis.

2.66 Statutory sick pay is fully borne by the employer, the other statutory payments are wholly or partially refunded (by the employer netting against the monthly NICs payment).

2.67 Possible implications of aggregating income for NICs assessments include:

- potential for less SP entitlement than at present. Should aggregation of income lead to aggregation of SP entitlement? For example, statutory sick pay (SSP) is paid at a flat rate which does not depend on the hours worked or the pay rate (provided normal weekly earnings are equal to or exceed the LEL) and at present a multi jobber may receive multiple SSP. One possibility would be to restrict this to a single entitlement
- potential for SP entitlements where they do not exist at present. Aggregation of NICs will lead to situations where an individual currently with many jobs each below the

[26] There is an element of restriction, for example an individual with 2 employers can receive multiple statutory maternity pay (SMP), but cannot, generally, receive SMP from one employer while continuing active work with another employer.

LEL could, on an aggregated basis, become equal to or exceed the LEL. That could lead to an aggregation of entitlements to statutory payments

- in the situations outlined above, if there is aggregation of entitlement how would the payment (and any associated recovery) be allocated between the employers? There are already some circumstances where this is required[27]

Non-contributory benefits

2.68 Income based benefits, crucially Universal Credit (UC) (which is assumed would be fully or almost fully rolled out by the time of a switch to ACA), are based on income net of IT and NICs. A change to ACA, which will impact the NICs paid by many, may therefore change an individual's UC. For UC the effect of IT and NICs is reflected in a 65% taper, and not £1 for £1, so that an increase in NICs of £10 for an individual in receipt of UC would lead to a reduction in overall income (including UC) of £3.50; conversely a reduction in NICs of £10 would lead to an increase in net overall income of £3.50 (also including UC impact). This is explored further in a report commissioned by the OTS from Resolution Foundation (RF)[28] and is illustrated in examples provided by The Low Incomes Tax Reform Group at paragraphs 2.74 to 2.81.

2.69 Fluctuations in income are (almost) immediately reflected in fluctuations in UC, these fluctuations include IT refunds and this is likely to be the case with NICs refunds as well.

Another perspective on the impact of ACA for multi jobbers[29]

2.70 Multi jobbing, whether multiple employments or a combination of employment with self-employment, has an important place in the pattern of workforce engagement. It can also lead to different NICs outcomes for the same overall income when compared with single employment or employment and self-employment. We asked RF to explore the potential impact of ACA on multi jobbers and the charts and quotations which follow are from their report. Their report looks at the impact on households and assumes that Universal Credit has been fully rolled out. As explained above, for those in receipt of UC it has a buffering effect on the impact of ACA.

2.71 As background RF show that "Over half of families containing someone working multiple jobs (57%) are part of the richest 40% of households compared to under a quarter (23%) living in the poorest 40% of working-age households, while under a quarter (23%) are part of the poorest 40%."

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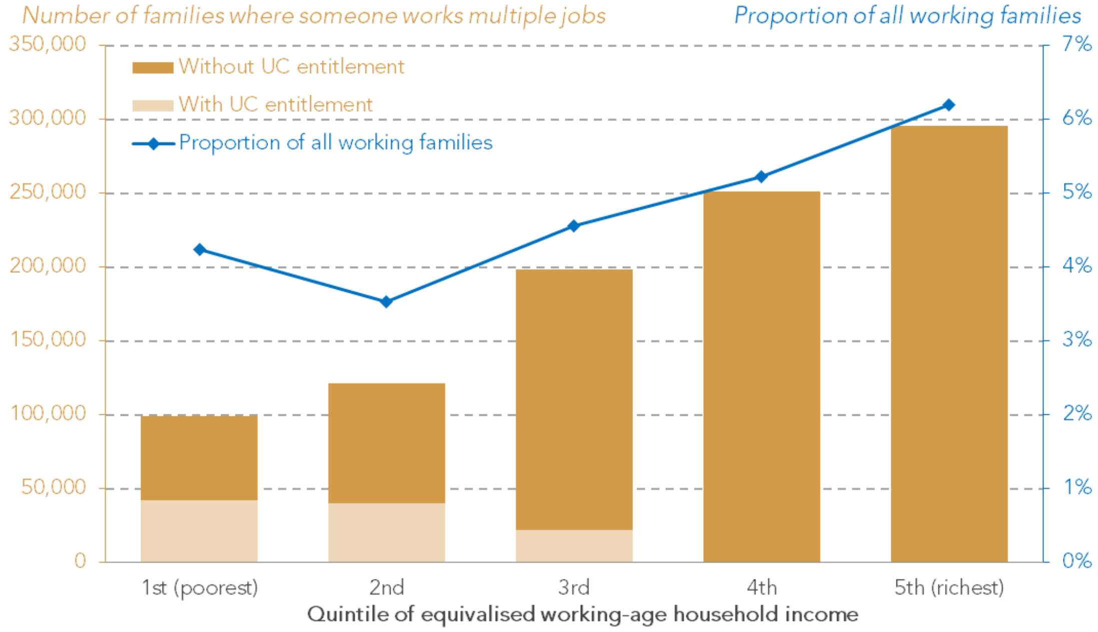
[27] This is in the restricted circumstances where even under the current NIC rules earnings from different jobs are aggregated to determine Employees' NICs liabilities: if an employee has separate jobs with closely connected employers.

[28] The report is available at www.resolutionfoundation.org

[29] There are a number of reasons why the perspectives in the models used by HMRC and RF differ and in addition the base years are not the same. HMRC's base data is from a sample of actual individuals' tax records, using a strictly mechanical definition for a multi jobber: if an individual has a NIC payment record in more than 12 months or 52 weeks in a tax year, they are recorded as a multi jobber. By contrast RF's base data is the Family Resources Survey. This uses an individual's own description of their circumstances at a particular point in time not having regard to their situation at other times in the same year. HMRC's model is focussed on individuals and reflects ACA across all employments but it does not give a single primary threshold in circumstances where there is employment and self-employment. RF's model considers households and aggregates employment with self-employment income (making various assumptions set out in RF's report).

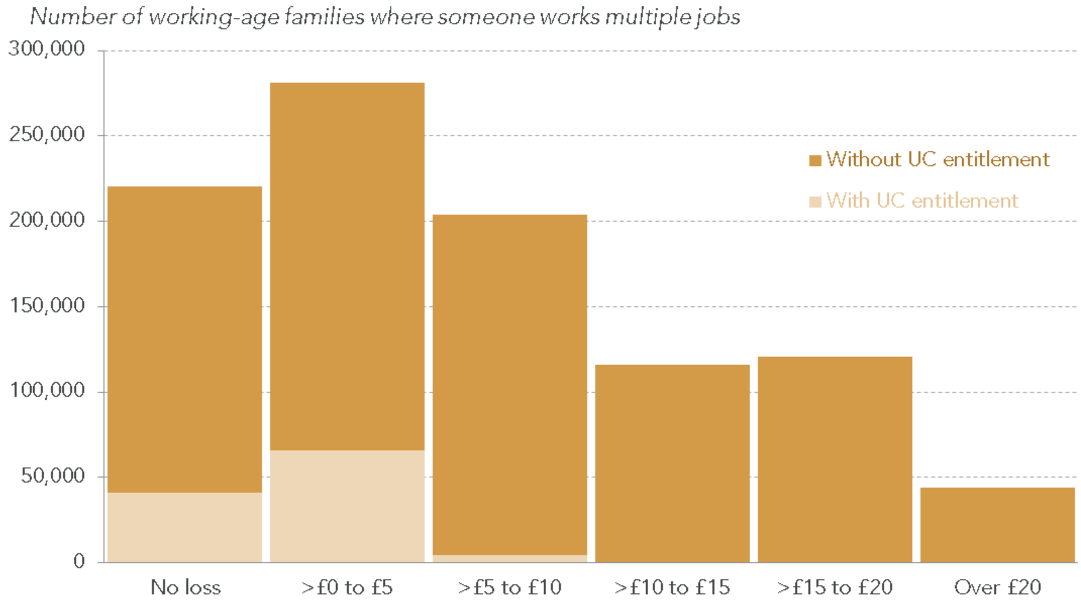
Chart 2.M: Number and proportion of in-work working age families with at least one person with multiple jobs, by equivalised working age net household income quintile



Source: RF analysis of FRS 2014-15, including use of IPPR tax-benefit model

2.72 The chart below shows the net loss per week arising from ACA for working-age families where someone has multiple jobs. RF comment "...of the almost one million families containing an individual with multiple jobs over 200,000 (22%) earn too little from their employments to be affected by aggregation. That is their total gross earnings were less than the Primary Threshold (£8,060 a year). This includes over a third (37%) of those families who are also entitled to Universal Credit."

Chart 2.N: Number of working-age families where someone works multiple jobs, by size of net loss per week from aggregating NI in isolation



Source: RF analysis of FRS 2014-15, including use of the IPPR tax-benefit model

2.73 RF also consider the impact of ACA for multi jobbers for the population as a whole (so not just those affected by the loss). While for the individuals affected, these losses may be significant the aggregate impacts are very small as a relatively small proportion of people have second jobs, particularly among poorer households. The distribution of workers with multiple jobs also means that the overall impact falls on higher income families more than lower income ones, both in absolute and proportional terms.

Individual examples

2.74 The effects of a move to ACA are set out above in overall terms, describing different populations by income, gender, location and so on. It is easy to lose sight of the impact on individuals and so we illustrate in the boxes below what ACA would mean for people in particular circumstances. We are grateful to the Low Incomes Tax Reform Group for providing these examples, some of which go beyond the direct tax impact and look also at how an individual's entitlement to state benefits could change.[30]

2.75 In understanding these examples, it is important to note that Universal Credit (UC) is calculated on net income after deduction of Income Tax and NICs. The following abbreviations are used: "PT" refers to the primary threshold, above which NICs are paid; "Taxes" refers to the combination of Income Tax and NICs; "LEL" is the lower earnings limit below which contributory entitlements are not accrued (see Box 2.F, page 40); "CJSA" is contributions based job seekers allowance; "NLW" is national living wage.

2.76 The first example, in Box 2.H, shows how ACA could impact an individual with a low fluctuating income.

Box 2.H: Fred has fluctuating income and no Universal Credit (UC) entitlement

Circumstances

Fred aged 25 has a single job paid at NLW. As his contract changes during the year his income fluctuates: for the first 26 weeks he is contracted to work 40 hours per week (£288 per week) and for the next 26 weeks he is contracted to work 20 hours per week (£144 per week). His annual earnings are £11,232.00 and he is not entitled to UC.

Present rules

Fred pays Income Tax of £46.40 (£232 @ 20%) and NICs of £414.96 (NICs are only due in the first 26 weeks on £288 less the PT £155, £133 @ 12%).

Annual net income after all taxes is £10,770.64.

As Fred's income exceeds the LEL in each week of the year he gains maximum contributory entitlements.

With ACA

Fred pays the same Income Tax of £46.40 but his NICs reduce to £380.64 (NICs are due on the whole year's income above the PT, £11,232 - £8,060, @ 12%).

Annual net income after all taxes is £10,804.96

No change to contributory entitlements

Change

Fred's annual net income increases by £34.32

[30] The examples given are illustrative only. They are based on the benefits system rules in the 2016 to 2017 tax year. Benefits are complex and sometimes assumptions had to be made, for example about timing of income and any tax or NICs refunds, which influence the value of benefits used in the examples. This is most apparent in the examples of Kim and Jon.

2.77 In the next example, Box 2.I, the same overall income is earned by an individual who earns during **part of the year** only. It illustrates the current distortion: that the same income earned in a different employment pattern leads to different NICs (under the present rules Fred pays £414.96 and Kim pays £864.24). It also shows the effect of ACA on a part year earner.

Box 2.I: Kim works part of the year and is then unemployed. She has no entitlement to UC while she is employed, but she does have some entitlement while unemployed.[31]

Circumstances

Kim is single, with a full time job for the first 6 months of the year earning £11,232 (the same as Fred earned in a full year) and she is then unemployed for the next 6 months during which she receives £1,827.50 CJSA which is taxable and UC which is not taxable.

Present rules

Kim pays Income Tax of £411.90 (£11,232 plus £1,827 50 less £11,000, @ 20%) and NICs of £864.24 (NICs are only due in the first 26 weeks on £432 less the PT £155, £277 @ 12%).

During the 6 months unemployment Kim receives £1,827.50 CJSA which is topped up by £200.20 UC.

Annual income after all taxes and including benefits is £11,983.56

As Kim's income exceeds the LEL for the first 6 months and she receives NIC credits from CJSA for the second 6 months she gains maximum contributory entitlements.

With ACA

Kim pays the same Income Tax of £411.90 but her NICs reduce to £380.64 (NICs are due on the whole year's income above the PT, £11,232 - £8,060, @ 12%).

During the 6 months unemployment Kim receives £1,827.50 CJSA which is topped up by £200.20 UC.

Annual net income after all taxes and including benefits is £12,467.16

No change to contributory entitlements

Change

Kim's net income increases by £483.60

[31] This example, and the example of Jon in box 2.J, assume that any refunds of tax and/or NICs, as a result of Kim's or Jon's periods of unemployment (as the case may be), take place on the last day of the tax year (5 April).

2.78 In the example below, Box 2.J, the individual earns the same income as Kim (and Fred), but he also receives Universal Credit which affects the impact of the reduction in NICs on a move to ACA.

Box 2.J: Jon works part of the year and is then unemployed, but he has 2 children so he is entitled to some UC while working

Circumstances

Jon's circumstances are the same as Kim's but he also has 2 children so he receives more UC. He is single, with a full time job for first 6 months of year earning £11,232 and is then unemployed for next 6 months during which he receives £1,827.50 CJSA which is taxable and UC which is not taxable.

Present rules

Jon pays Income Tax of £411.90 (£11,232 plus £1,827 50 less £11,000, @ 20%) and NICs of £864.24 (NICs are only due in the first 26 weeks on £432 less the PT £155, £277 @ 12%).

During the first 6 months employment Jon receives UC £517.32 and during the 6 months unemployment Jon receives £3,058.75 UC and £1,827.50 CJSA.

Net income after all taxes and benefits is £15,359.43

As Jon's income exceeds the LEL for the first 6 months and he receives NICs credits from CJSA for the second 6 months he gains maximum contributory entitlements.

With ACA

Jon pays the same Income Tax but his NICs reduce to £380.64 (NICs are due on the whole year's income above the PT, £11,232 - £8,060, @ 12%).

During the first 6 months employment Jon receives UC £517.32 and during the 6 months unemployment Jon receives £2,744.41 UC and £1,827.50 CJSA.

Net income after all taxes and benefits is £15,528.69

No change to contributory entitlements

Change

Jon's net income increases by £169.26

2.79 Jon's net income increases by less than Kim's (£169.26 instead of £483.60) because 65% of the reduction in NICs paid is clawed back by a reduction in UC received.

2.80 The next example, Box 2.K, shows the impact of ACA on an individual with **multiple jobs**.

Box 2.K: Fanya has 2 jobs but does not receive UC due to the level of her income

Circumstances

Fanya, aged 25, has two jobs - both are zero hour contracts. Overall she works 30 hours per week - 20 hours in one job at £9 per hour (£180 per week, £9,360 per year) and 10 hours in the other at NLW (£72 per week, £3,744 per year). Total earnings[32] for the year are £13,104.

Present rules

Fanya pays Income Tax of £420.80 (£13,104 less £11,000, @ 20%) and NICs of £156 (NICs are only due for the higher paid job on £180 less the PT £155, £25 @ 12%).

Net income after all taxes is £12,527.20

As Fanya's income exceeds the LEL in the higher paid job throughout the year she gains maximum contributory entitlements.

With ACA

Fanya pays the same Income Tax but her NICs increase to £605.28 (NICs are due on the whole year's income above the PT, £13,104 - £8,060, @ 12%).

Net income after all taxes is £12,077.92

No change to contributory entitlements, as Fanya's combined income exceeds the LEL throughout the year.

Change

Fanya's net income decreases by £449.28

[32] Calculated assuming paid at the same rate for the full 52 weeks of the year, though it is appreciated that with zero hour contracts there may be complexities in terms of annual leave and paid holiday entitlements.

2.81 In the final example, Box 2.L, the individual earns the same income from multi jobbing as Fanya, but also receives UC which affects the impact of the increase in NICs on a move to ACA.

Box 2.L: Paula has 2 jobs and 2 children so she receives UC

Circumstances

Paula's circumstances are the same as Fanya's but she also has 2 children so she receives UC. She is aged 25 and has two jobs. She regularly works 30 hours per week - 20 hours in one job at £9 per hour (£180 per week, £9,360 per year) and 10 hours in the other at NLW (£72 per week, £3,744 per year). Total earnings are £13,104.

Present rules	With ACA
Paula pays Income Tax of £420.80 (£13,104 less £11,000, @ 20%) and NICs of £156 (NICs are only due for the higher paid job on £180 less the PT £155, £25 @ 12%).	Paula pays the same Income Tax of £420.80 but her NICs increase to £605.28 (NICs are due on the whole year's income above the PT, £13,104 - £8,060, @ 12%).
Paula receives UC £4,872.84 based on her net income.	Paula receives UC £5,164.80 based on net income.
Net income after all taxes and benefits is £17,400.04	Net income after all taxes and benefits is £17,242.72
As Paula's income exceeds the LEL in the higher paid job throughout the year she gains maximum contributory entitlements.	No change to contributory entitlements, as Paula's combined income exceeds the LEL throughout the year.

Change

Paula's net income decreases by £157.32

On a move to ACA, Paula's net income decreases by less than Fanya's (£157.32 instead of £449.28) because 65% of the increase in NICs paid by Paula is offset by an increase in the UC she receives.

ACA implications for employers

2.82 ACA is perceived by employers to be more difficult to transition than RTI (which was not visible to employees), because it will impact the NICs paid by employees. However, it does deliver a higher degree of simplification – a benefit which makes ACA easier to manage over the long term. Indicative views from employers, agents, software producers, payroll providers and sector bodies are summarised as follows:

Software

2.83 RTI and pensions Auto-Enrolment have already created a one-off significant burden. However, aligning the IT/NICs definitions will reduce ongoing process costs and make upgrading and software patches less costly because the basis on which both taxes will be calculated and assessed will be the same.

2.84 Software developers should be involved in any change process from the outset to avoid repeating difficulties that arose during RTI implementation. They also consider that a two year lead in time would be required as a minimum. Provided this is the case, we have not heard that there would be a problem in developing software solutions.

2.85 At the same time as implementing other changes, HMRC could take the opportunity to streamline the joiners/leavers and multiple sources of income processes.

Admin burdens including transition

2.86 The administrative burden for ACA NICs is acknowledged to be a 'one off', because all the changes are front-ended and non-recurring. Once the change to ACA is made, there would be no further administrative costs to businesses of maintenance as such and most feel that the system would be marginally easier to run (though almost all simply say that software takes care of such things).

2.87 Some employers have said to us that it should not be necessary to rely on software to work out a tax liability – this should simply be a convenient calculation tool and employers and individuals should each understand how the tax is assessed. A measure of this might be whether the calculations can be done by hand: currently this is not always possible as payroll calculations can be very complex.

2.88 In measuring potential impacts on the administrative burden for employees HMRC have regard to the number of employers who will need to change their payroll software, together with familiarisation and training costs. Although a fully detailed analysis of potential costs cannot be done without a comprehensive design for the new processes, HMRC estimate that the transitional costs would be significant, in excess of £150 million. This is about half of the estimated costs of the transition to RTI and is of course spread amongst all employers.

International issues

2.89 Employers consider that if ACA is introduced, all necessary modifications to international and share-related matters should be resolved simultaneously. Issues such as social security agreements, short term business visitor issues and modified payrolls should be fully explored before ACA is launched.

ACA implications for HMRC

2.90 ACA would introduce provisional collection of NICs and this would create overpayment and underpayment outcomes at the year end. Currently, HMRC reconciles 42 million PAYE taxpayer records annually, of which about 20% need manual intervention, and the rest are automated. There are about 6 million notifications sent to taxpayers advising over or underpayment.

2.91 Whilst NICs reconciliations would on the surface create extra tasks for HMRC, these would be automated and the impact managed to a minimum. For underpayments, notification and collection would mirror the work required for tax underpayments. Collection of NICs underpayments through the NICs code or PAYE code is possible (see the separately published note on a NICs code) but would need careful explanation to taxpayers and a process to link to the individual's NI account.

2.92 Initial estimates for HMRC operations for the introduction of ACA NICs is that it would need additional staff, largely in response to a forecast increase in NICs customer contact and queries; there may also be additional staffing costs from the increase in manual reconciliation work required. However, this is in the context of longer term staff reductions across HMRC. Overall, staff requirements will be dependent on the extent to which customer services and information can be delivered through the digital account for customers (the PTA), and other improvements to PAYE, via RTI exploitation.

2.93 The move to ACA NICs will require some large IT changes for HMRC, which it estimates to be in the low tens of millions of pounds. The scale of the costs will depend on the final policy design and requirements, but could be part and parcel of the wider IT transformation.

2.94 Employers and other groups have commented in quite strong terms that any changes which are made to NICs would need to be fully supported by HMRC to ensure a smooth transition. HMRC/DWP must demonstrate that they have made suitable resources available to deliver the changes under a shared agenda, not one driven by HMRC alone.

2.95 There were also suggestions that some amendments to the 64-8 (agent authorisation) process is needed to allow employers to hold dialogue with HMRC on behalf of the employee, or for agents to speak on behalf of employer's employee. This would help streamline the process.

Conclusion: is ACA a simplification? Is the simplification worth the cost?

2.96 ACA for NICs is a neat simplification in principle; the similarity with ACA for Income Tax, and the modernisation of an outdated and obscure NICs charging structure. A challenge throughout our work has been whether it would be simpler in practice. Would individual taxpayers and their employers feel it to be a simpler tax regime? Here it is important to distinguish between the period of design and implementation (both of which must be carried out with full consultation), and the future steady state when ACA NICs is operational.

2.97 ACA would make employees' NICs a simpler tax because it would be similar in structure to IT. Employee NICs would become more transparent, easier for employees to understand and for employers to explain. No attempt has been made to value these intangible benefits which can be set against the costs of transition and on-going administration.

2.98 ACA also delivers a fairer tax, eliminating the current bizarre situation (for which we have never found a policy justification) where the pattern of payment determines the amount of tax paid, and replacing it with one where total income however it is paid results in the same NICs liability, just as for IT. The current structure of NICs has an inbuilt incentive to fragment jobs. Changing work patterns mean that the working population impacted by the current structure of NICs will change, so this is the time to start taking the first steps towards a system better fitted for the future.

2.99 Significantly, ACA is not just a simplification in itself, it is also a key element of the overall alignment of NICs with IT. ACA would be a step change towards that, enabling a common treatment of deductions and benefits in kind.

2.100 A concern is that the proposed structure of a NICs code and an annual reconciliation may mean that more taxpayers will need to engage with HMRC. Whilst it seems likely that many of these individuals will already be engaged in relation to IT, there will be additional ongoing administrative costs to HMRC as a result of ACA NICs generating increased taxpayer contact. This may be partly offset by developing practices, in particular the use of on-line personal tax accounts (PTA), which should make this interaction less problematic than at present. Looking further ahead, the idea of presenting taxpayers with 'codes' may no longer be needed. These exciting administrative moves to simplification mean that the time is right to simplify the structure of NICs.

3 Reforming employers' national insurance

Rationale for change

3.1 The March 2016 report set out evidence suggesting that employers' class 1 NICs currently adds little administration burden to the operation of employees' NICs, because it is calculated on the same earnings period basis, based on the same earnings and paid in parallel through PAYE.[1] However, it is clearly important that the OTS explores ways of reducing this burden, or look at ways to prevent other changes increasing it.

3.2 If employee NICs change to an ACA basis, then the operation of employer NICs would bring an additional burden if it were still based on earnings periods. We do not consider this to be a reason against proceeding with the ACA recommendation, but a change to ACA presents an opportunity to consider modernising employer NICs in parallel.

3.3 The March 2016 paper also set out anecdotal evidence that the existence of the secondary threshold distorts the labour market by providing an incentive to employers to employ individuals on a part-time basis with earnings within the secondary threshold. We have continued to hear of the growth in part-time employment with earnings just below this threshold (see also Box 2.D, page 36). Any incentive effect may also arise in relation to the primary threshold, and these thresholds may act as incentives to the employer and/or the employee.

3.4 A further argument for reform is that of transparency, as stakeholders report that employer NICs are invisible to employees and not well understood in their amount or purpose.

Design

3.5 The current charge is seen by many that we have spoken to as 'a tax on jobs', with little understanding of the employer's role in in relation to the social security regime. Features of a good employer tax (indeed any tax) would include clear and understood aims, transparency, certainty and general ease of operation for all concerned.

3.6 The OTS has long heard the message that maintaining two separate systems of taxation of earned income is one of the drivers distorting business behaviour, in particular in relation to profit extraction from limited companies and hiring decisions around employment status. A good employer tax would not increase the motivation for incorporations purely for taxation reasons. Finally, the charge should be straightforward to operate for the employer and administer for HMRC, with limited need for anti-avoidance provisions.

3.7 The March 2016 report set out three summary options for simplification of employer NICs:

- employers' NICs continues to operate on an earnings period basis, see table 3.G, page 72

[1]The government propose one change to this principle in the case of termination payments – it is proposed from April 2018 employer NICs will be chargeable on the amount of a termination payment in excess of £30,000 in line with the Income Tax treatment, but no employee NICs will apply. The OTS understand from the 10 August 2016 consultation document that employee NICs are not being changed to minimise the impact on those employees losing their jobs, but feel opening up such a difference is not a simplification for employers.

- an annual basis for employers' NICs, see table 3.E, page 68
- payroll flat rate, potentially with an employer allowance, see tables 3.A, 3.B and 3.C below

3.8 It would clearly be necessary to define payroll for the purposes of a flat rate charge on payroll, and indeed such a definition could also apply for the other options. The March 2016 report stated it would be desirable if the payroll (and hence pay bill) definition for employers NICs was the same as the definition for the Apprenticeship Levy (AL), and that remains our view.

3.9 The definition of pay bill for the AL is set out in Finance (No 2) Act 2016 as the total amount of earnings in respect of which the person incurs liabilities to pay secondary class 1 contributions, or would incur but for the operation of the secondary threshold (ST).

3.10 Such a definition for employers' NICs would follow this closely, although if the ST were removed (as would be the case with some of the options we set out) some rewording would be necessary - such as:

> 'Sum of earnings liable to primary NICs, or which would be so liable but for the operation of the primary threshold'.

3.11 The legislation could make provision for incentives such as exemptions for employees under age 21, or apprentices under age 25, to remain in place.

3.12 With many employers already voluntarily payrolling benefits in kind for Income Tax purposes, our stakeholders broadly agreed that it would be consistent to include these benefits within the employers' NICs charge, and thereby removing the need to complete form P11D(b) and to make a Class 1A payment on these benefits in the July following the tax year. The implication is that this move would mean an acceleration of the NICs due on benefits but employers did not see this as a significant issue.

3.13 That would leave those benefits that are not currently being payrolled remaining subject to the class 1A NICs charge, an additional complexity. The OTS believes that an indicative timescale for introducing changes to employers' NICs is 5 years. Within that timescale, almost all, if not all, benefits will be in the ambit of voluntary payrolling. Thus it is anticipated that this should disappear as an issue for all or most employers.

3.14 Our 7-stage reform programme (see Box 1.A on page 13) includes bringing taxable benefits in kind into Class 1 NICs and abolishing Class 1A NICs. So we propose that the definition of pay bill for the employers' NICs include all taxable benefits in kind, thereby removing the Class 1A charge altogether.

3.15 For those benefits where it is not possible currently to arrive at the cash equivalent at the time of the pay period, an estimate could be made - with a payroll end of year adjustment where a correction is necessary. But extending voluntary payrolling should encompass developing routines to deal with such issues.

3.16 In our March 2016 report we noted a degree of support for this increase in NICs liability, on fairness grounds, removing the differences in NICs treatment between differently structured reward packages.

3.17 PAYE Settlement Agreements (PSAs) were introduced in the 1990s and enable employers to apply to HMRC for certain specified benefits in kind to be removed from the P11D/PAYE and for the employer instead to meet the tax and NICs on behalf of the employee. Employers' NICs on the grossed up benefits are payable under Class 1B and form part of the settlement for payment by 19 or 22 October (depending on the form of payment) following the tax year. In 2012 to 2013, 23,000 employers paid over £204 million in Class 1B in this way.[2]

3.18 Following OTS recommendations in the Employee Benefits and Expenses review,[3] streamlining the process for PSAs is currently subject to an HMRC consultation.[4]

3.19 The OTS recommend that the earnings within the payroll definition include the sums liable to Class 1A and Class 1B NICs to get to a 'total payroll' amount. In the timescale we set out above, the definition of payroll for the Apprenticeship Levy (AL) could be brought into line with this definition, and it would presumably be possible to design the employers' NICs replacement to fold in the AL.

Options for charging structure

3.20 Closer alignment of Income Tax and employee NICs leaves employers' NICs as an anomaly, there being no equivalent charge under Income Tax. During the course of this review we continued to hear calls for outright merger and indeed for employers' NICs to be abolished and instead form part of the merged tax on employees.

3.21 On grounds of simplicity and transparency, this would form a favoured option, and would also address many of the distortions in behaviour encountered around employment status and profit extraction. However, in view of the scale of employer secondary contributions to the Exchequer[5] and the significant shift in taxation that would result from its abolition, we have not pursued it within the options below.

3.22 Our employment status report published in March 2015[6] floated the concept of a contractor levy to be paid by the hirer of the self-employed and possibly personal service companies, which could similarly take the heat out of the employment status distortions raised above. Unsurprisingly when raised at stakeholder discussions, this idea continues to be seen as undesirable. An HMRC consultation into 'Off-payroll working in the public sector – reform of the intermediaries' legislation'[7] closed on 18 August 2016 with feedback currently being analysed and again, we have not pursued this further during the course of this report.

3.23 The options that we considered for simplifying employers' NICs are set out in Box 3.A below. The analysis that follows offers a perspective on the other impacts involved and whether these outweigh simplification considerations. The role of taxation in incentivising employers on employment choices remains a policy decision for the government, and the potential wider issues are set out in the tables below in order to assist in deciding which one to pursue.

[2] HMRC (KAI) data

[3] www.gov.uk/government/uploads/system/uploads/attachment_data/file/275795/PU1616_OTS_employee_benefits_final_report.pdf

[4] www.gov.uk/government/consultations/simplifying-the-paye-settlement-agreement-psa-process

[5] Estimated in Closer alignment of Income Tax and national insurance March 2016 report as £64.8 billion in 2015 to 2016

[6] www.gov.uk/government/publications/employment-status-review

[7] www.gov.uk/government/consultations/off-payroll-working-in-the-public-sector-reform-of-the-intermediaries-legislation

Box 3.A: Options considered for the simplification of employers' NICs

1. Flat rate of payroll total, removal of secondary threshold (ST), remain revenue neutral
   a. 10% rate, no ST, no employment allowance (EA)[8]
   b. 10.4% rate, no ST, EA of £3,000
   c. 11.8% rate, no ST, EA of £46,500
   d. 13.8% rate, no ST, EA of £332,200
2. Replace the ST with an annual cumulative employee allowance
3. Link to a specified percentage of employee primary NICs
4. Retain existing system
5. Replace the ST with a full-time equivalent employee allowance

3.24 We are grateful to HMRC's analysts for providing data and projections to 2019 to 2020 on options 1 and 2, as a basis to analyse the gainers and the losers by reference to the size of employer, the industry sector and the region of the UK.[9] Each option has potential wider implications which are set out in the tables below.

3.25 In the tables and charts below 'gainers' are those employers who would pay less NICs and 'losers' are those employers who would pay more NICs.

[8] The EA is available per employer, to be set against the employer's NICs liability. In the current year the EA is set at £3,000, certain employers are ineligible and only one allowance is available in the case of multiple PAYE schemes.
[9] The location of employers is denoted by the address of their PAYE scheme and may not always correspond to the address where the employments are situated.

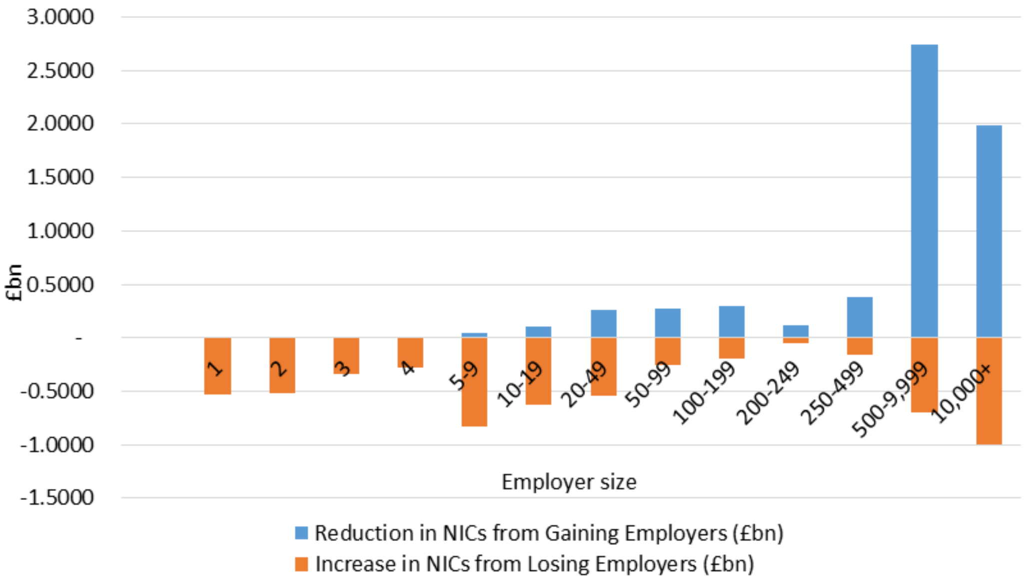
Table 3.A: Option 1a

Flat rate 10% of payroll, no secondary threshold (ST), no employment allowance (EA), revenue neutral
Is it a simplification? Yes – the current ST creates potential distortions which this option would remove, a flat rate tax would be simple to calculate and straightforward to operate for the employer, with software facilitating the process.
How would it work? Employers would aggregate total payroll, using the Apprenticeship Levy earnings, and additionally including cash value of benefits payrolled, and apply a 10% rate. There would be a year-end calculation to include 10% of the cash value of residual P11D benefits. Reporting and payment would be as now, but without the P11D (b) which would be removed. Class 1B NICs on PAYE Settlement Agreements would similarly be included as part of the year end calculation.

Potential wider implications:
• a net increase in employers' NICs for employers with less than 50 employees (Chart 3.A)[10]
• chart 3.B shows a net NICs increase for all industry sector employers except the following having a net NICs decrease:
    ◦ financial and insurance
    ◦ manufacturing
    ◦ information and communication
    ◦ professional, scientific and technological (Chart 3B)[11]
• a net increase in employers' NICs for all UK regions except London, the South East and Scotland (Chart 3.C)
• compared to the present system, employers will pay more NICs on those employees earning below £30,800, and less NICs on those earning above – 76% of employments earn below this figure. For example on £10,000 earnings, employer pays £740 more NICs, on £1,000,000 earnings employer pays £36,880 less NICs[12]
• for 2019 to 2020, removing the ST and employment allowance is projected to bring 997,000 further employers into the tax base
• the removal of the ST could have an impact on employment choices above or below the current threshold

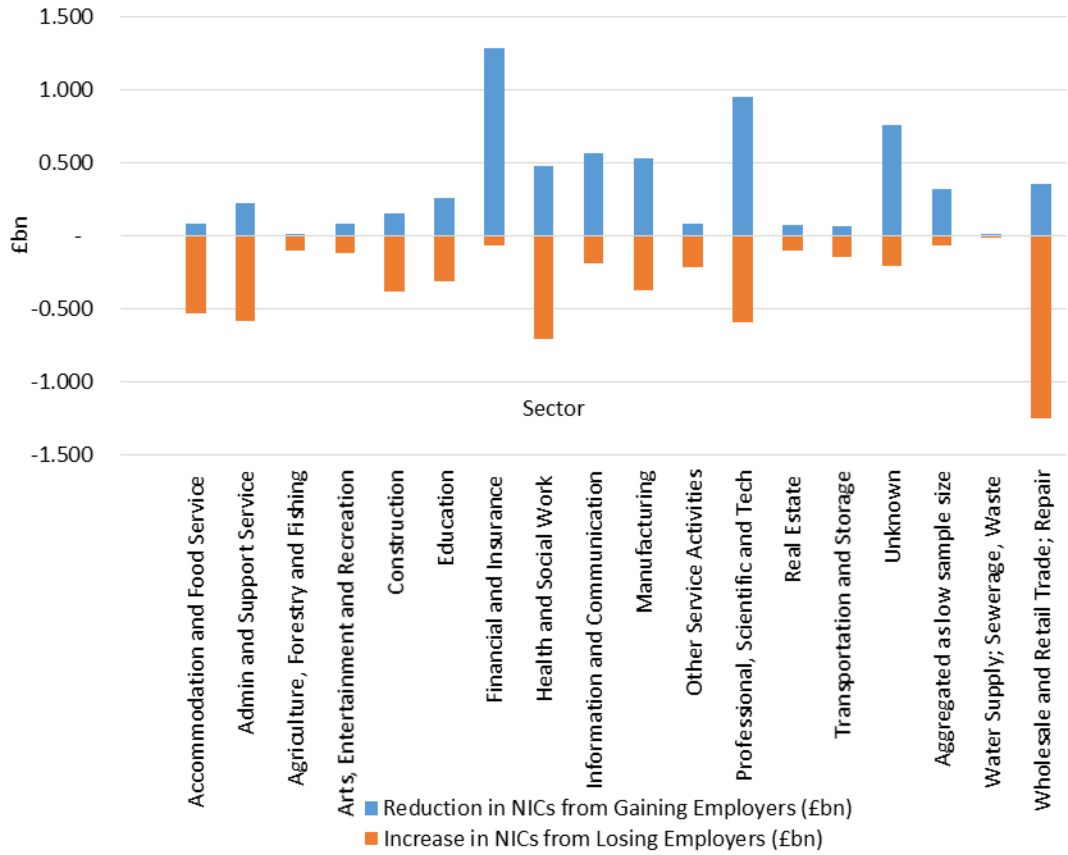
[10] These charts do not reflect potential behavioural shifts following these rule changes
[11] Each sector consists of many different employments, and further drilling down would be necessary for a full picture across these industries
[12] The £10,000 v £1m example is based on 2016 to 2017 thresholds and rates, remaining data is projected to 2019 to 2020

Chart 3.A: 10% flat rate – amount of gain or loss by employer size.
This chart illustrates the distributional effects by employer size, and shows a net increase in employer NICs for smaller employers.



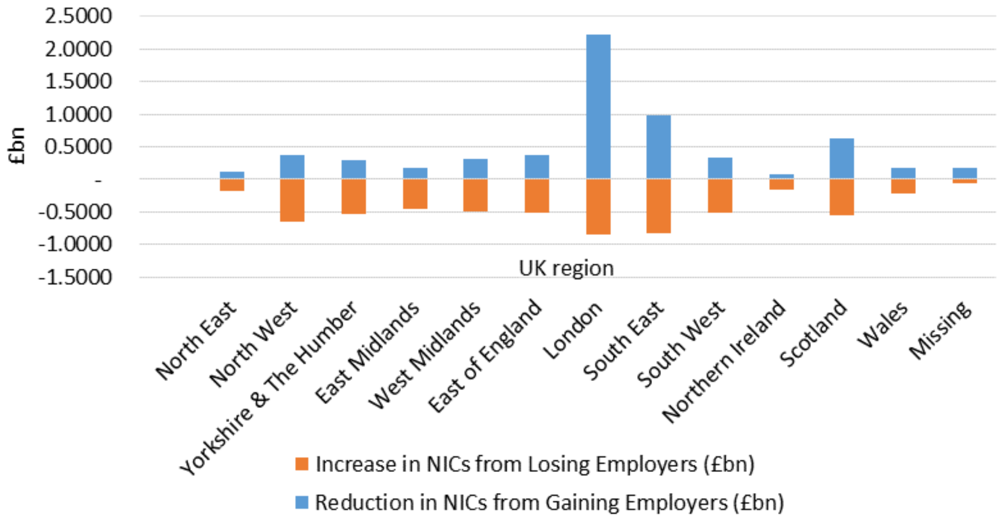
Source: HMRC

Chart 3.B: 10% flat rate – amount of gain or loss by sector. This chart illustrates the distributional effects by industrial sector, and shows a net increase in employer NICs for all sectors except financial, IT, manufacturing and professional / hi-tech.



Source: HMRC

Chart 3.C: 10% flat rate – amount of gain or loss by UK region. This chart illustrates the distributional effects by UK region, and shows a net increase in employer NICs for all regions except London, SE and Scotland.



Source: HMRC

Table 3.B: Option 1b

Flat rate 10.4% of payroll, no ST, £3,000 employment allowance (EA) – revenue neutral

Is it a simplification?
Yes – the current ST creates potential distortions which this option would remove, a flat rate tax would be simple to operate for the employer, with software facilitating the process.

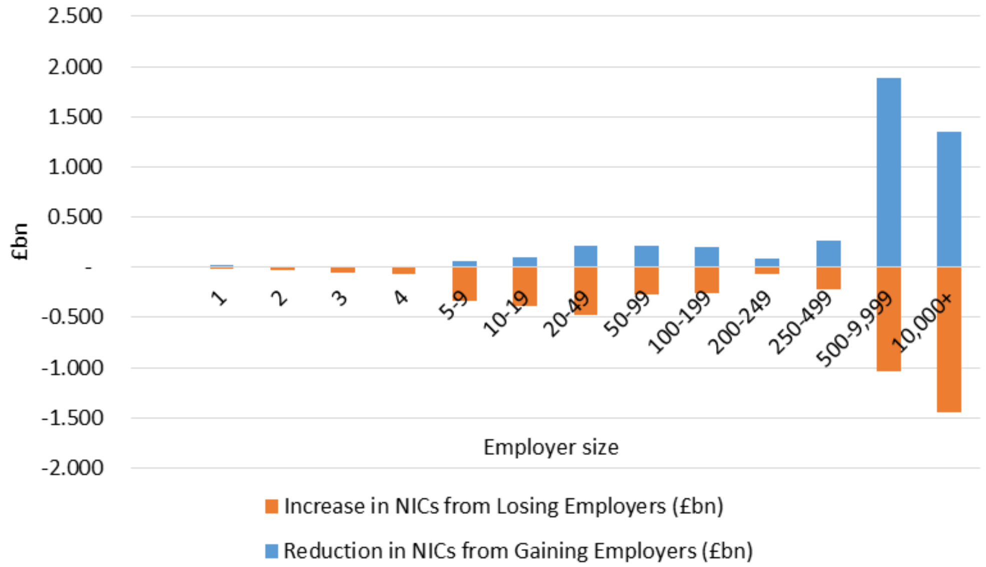
How would it work?
Employers would aggregate total payroll, using the Apprenticeship Levy earnings, and additionally including cash value of benefits payrolled, apply a 10.4% rate and deduct the £3,000 EA. There would be a year-end calculation to include 10.4% of the cash value of residual P11D benefits. Reporting and payment would be as now, but without the P11D (b) which would be removed. Class 1B NICs on PAYE Settlement Agreements would similarly be included as part of the year end calculation.

Potential wider implications:
once above the EA level, employers will pay more NICs on those employees earning below £34,400, and less NICs on those earning above – broadly, 80% of employments projected to fall below this figure. For example on £10,000 earnings, employer pays £848 more NICs, on £1,000,000 earnings employer pays £32,880 less NICs.[13]

- smallest employers (up to 3 employees) have no net change due to the EA, but net employers' NICs increase for employers with between 4 and 50 employees (Chart 3.D)
- net employers' NICs increase for all industry sector employers apart from:
  - financial and insurance
  - manufacturing
  - information and communication
  - professional, scientific and technological
- net employers' NICs increase for all regions of UK other than London and the South East (Chart 3.E)
- projected to bring a further 145,000 employers into the tax base
- the removal of the ST could have an impact on employment choices above or below the current threshold

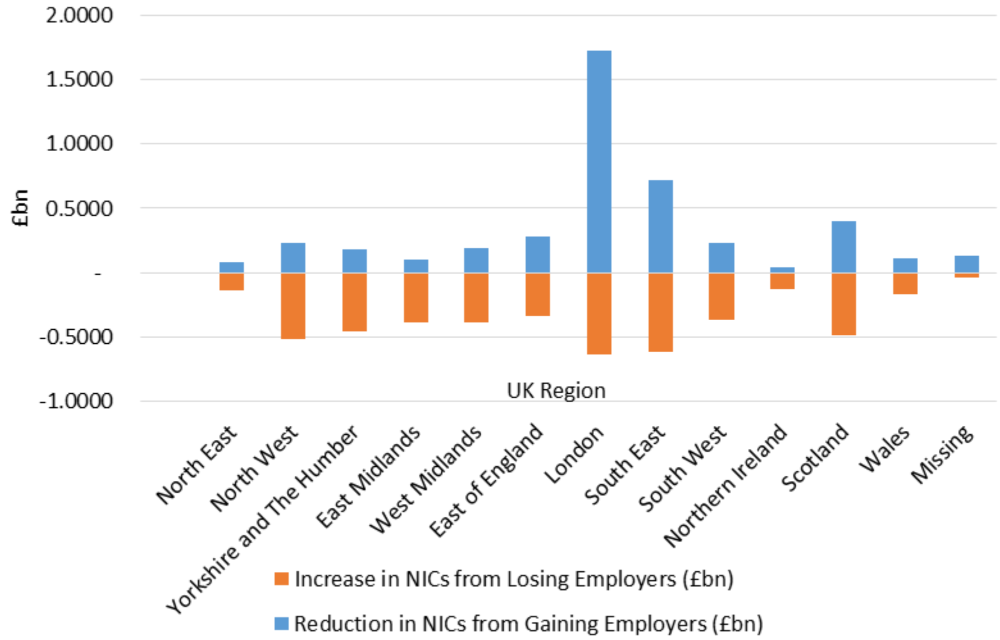
[13] The £10,000 v £1m example is based on 2016 to 2017 thresholds and rates, remaining data is projected to 2019 to 2020

Chart 3.D: Flat 10.4% rate, No ST, £3000 EA – amount of gains or loss by employer size. This chart illustrates that the smallest employers (up to 3 employees) would have no net change as a result of the £3000 EA, but there is a net increase in NICs paid for employers with between 4 and 50 employees.



Source: HMRC

Chart 3.E: 10.4% rate, no ST, £3000 EA – amount of gain or loss by UK region. This chart illustrates the distributional effects as a net increase in employer NICs for all regions of the UK except London and the South East.



Source: HMRC

Table 3.C: Option 1c

Flat rate 11.8% of payroll, no secondary threshold (ST) £46,500 employment allowance (EA) - revenue neutral

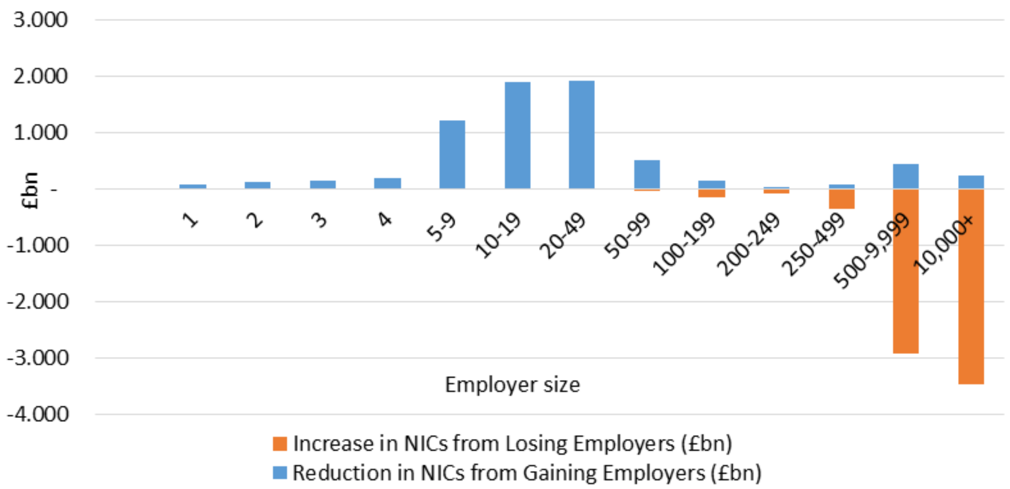
Is it a simplification?
Yes – the current ST creates potential distortions which this option would remove, a flat rate tax would be simple to operate for the employer, with software facilitating the process. However, the considerable increase in EA over the current level may introduce other choices for the employer such as limiting growth in employment once the level is reached.

How would it work?
Employers would aggregate total payroll, using the Apprenticeship Levy earnings, and additionally including cash value of benefits payrolled, apply an 11.8% rate and deduct the £46,500 EA. There would be a year-end calculation to include 11.8% of the cash value of residual P11D benefits. Reporting and payment would be as now, but without the P11D (b) which would be removed. Class 1B NICs on PAYE Settlement Agreements would similarly be included as part of the year end calculation.

Potential wider implications:
the tax base would be narrowed – only the 116,000 of the largest employers would remain chargeable

- employers with less than 100 employees have no net change or net decreased NICs (Chart 3.F)
- where the NICs liability is higher than the level of EA, employers will pay more NICs on those employees earning below £58,500, and less NICs on those earning above – broadly, 93% of employments projected to fall below this figure. For example on £10,000 earnings, employer pays £920 more NICs, on £1,000,000 earnings employer pays £18,880 less NICs[14]
- although the majority of employers across the sectors have a net decrease in NICs, net increases occur in education, human health, wholesale and retail, and admin support (Chart 3.G)
- the removal of the ST could have an impact on employment choices above or below the new threshold
- potentially positive impact on employment of workers where employer is within the EA. This could create a new distortion
- HMRC have expressed concerns over employer practice of fragmenting in order to obtain the EA

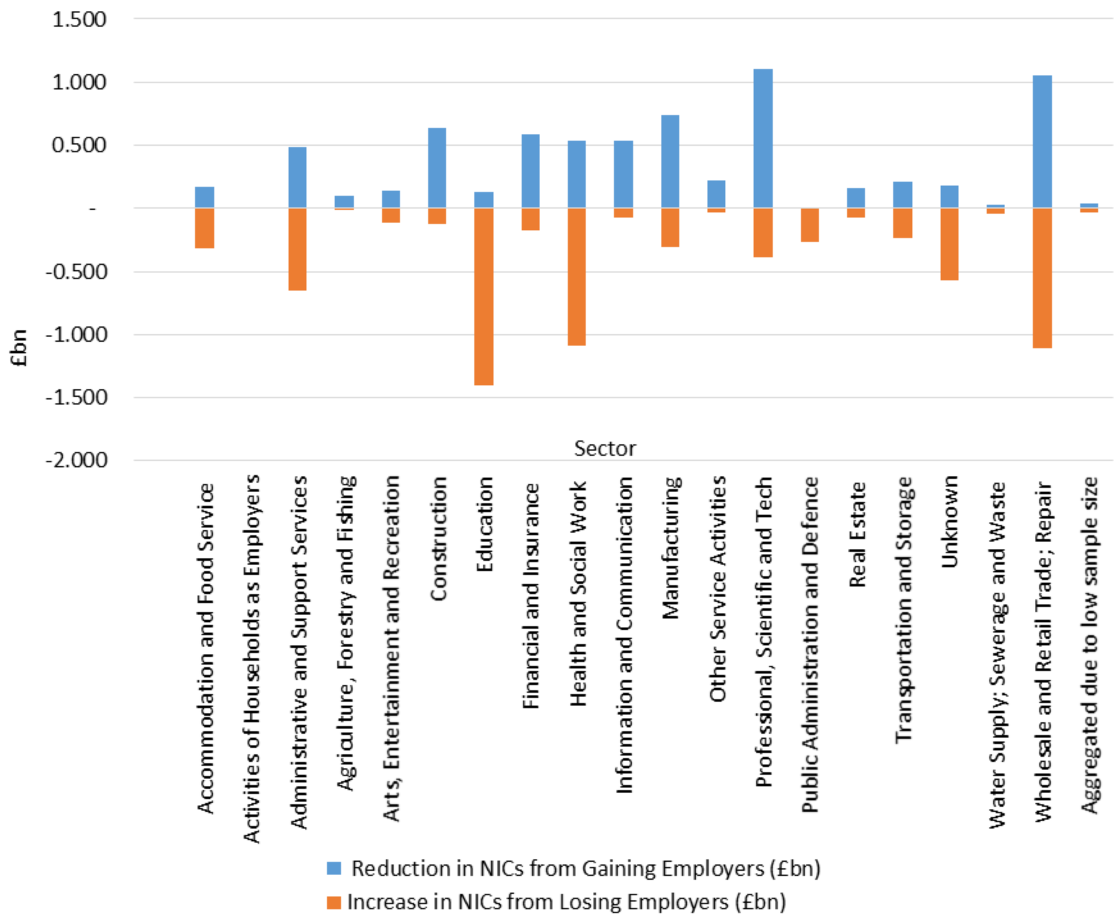
Chart 3.F: 11.8% of payroll, no ST, £46,500 EA – amount of gain or loss by employer size. This chart illustrates the distributional effects by employer size, and shows that employers with less than 100 employees have no net change or net decreased NICs to pay



Source: HMRC

[14] The £10,000 v £1m example is based on 2016 to 2017 thresholds and rates, remaining data is projected to 2019 to 2020

Chart 3.G: 11.8% of payroll, no ST, £46,500 EA – amount of gain or loss by sector. This chart illustrates the distributional effects by industrial sector and shows that, although the majority of employers across the sectors have a net decrease in NICs, net increases occur in education and human health

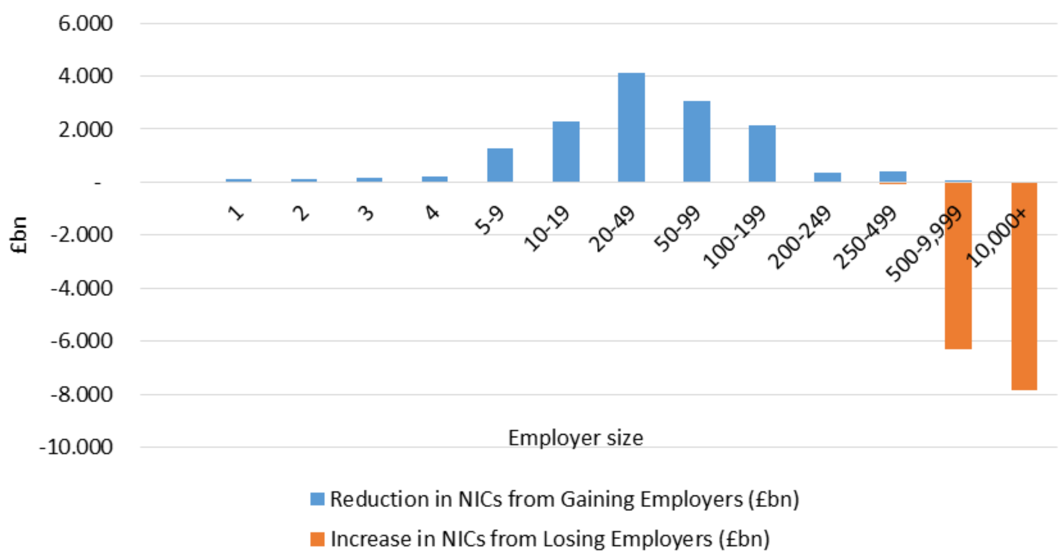


Source: HMRC

Table 3.D: Option 1d

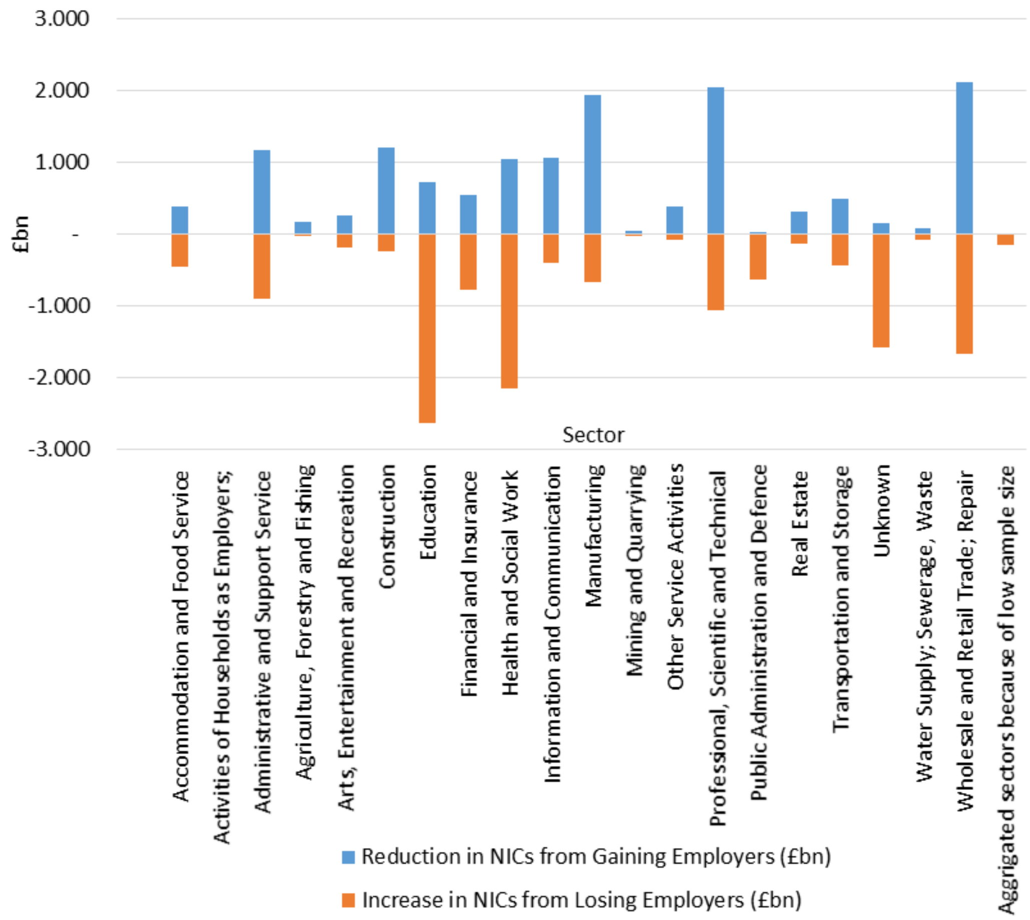
Flat rate 13.8% of payroll, no secondary threshold (ST), £332,200 employment allowance (EA) – revenue neutral
Is it a simplification? Yes – the current ST creates potential distortions which this option would remove, a flat rate tax would be simple to operate for the employer, with software facilitating the process. However, the considerable increase in EA over the current level may introduce other choices for the employer, see below.
How would it work? Employers would aggregate total payroll, using the Apprenticeship Levy earnings, and additionally including cash value of benefits payrolled, apply a 13.8% rate and deduct the £332,200 EA. There would be a year-end calculation to include 13.8% of the cash value of residual P11D benefits. Reporting and payment would be as now, but without the P11D (b) which would be removed. Class 1B NICs on PAYE Settlement Agreements would similarly be included as part of the year end calculation.
Potential wider implications: • tax base would be narrowed – only the 24,000 largest employers would remain chargeable • employers with fewer than 500 employees have no net change or net decreased NICs (Chart 3.H) • only employers with a payroll in excess of £2.407m will incur NICs – potential to merge with the Apprenticeship Levy (threshold £3m) • although the majority of employers across the sectors have a net decrease in NICs, net increases occur in education and human health (Chart 3.I) • the removal of distortions around the ST potentially may have an impact on employment of workers below the ST • potentially positive impact on employment of workers where employer is within the EA • there would be potential concerns over employer fragmentation to obtain the EA under this option

Chart 3.H: 13.8% rate, no ST, EA £332,200 – amount of gain or loss by employer size. This chart illustrates that employers with fewer than 500 employees have no net change or net decreased NICs



Source: HMRC

Chart 3.I: 13.8% rate, no ST, EA £332,200 – amount of gain or loss by sector. This chart illustrates the distributional effects by industrial sector and shows that, although the majority of employers across the sectors have a net decrease in NICs, net increases occur in education and human health

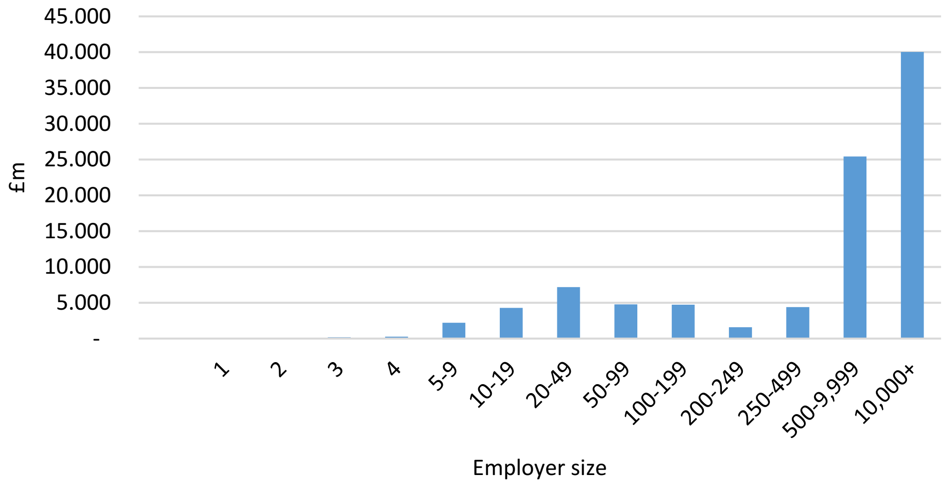


Source: HMRC

Table 3.E: Option 2

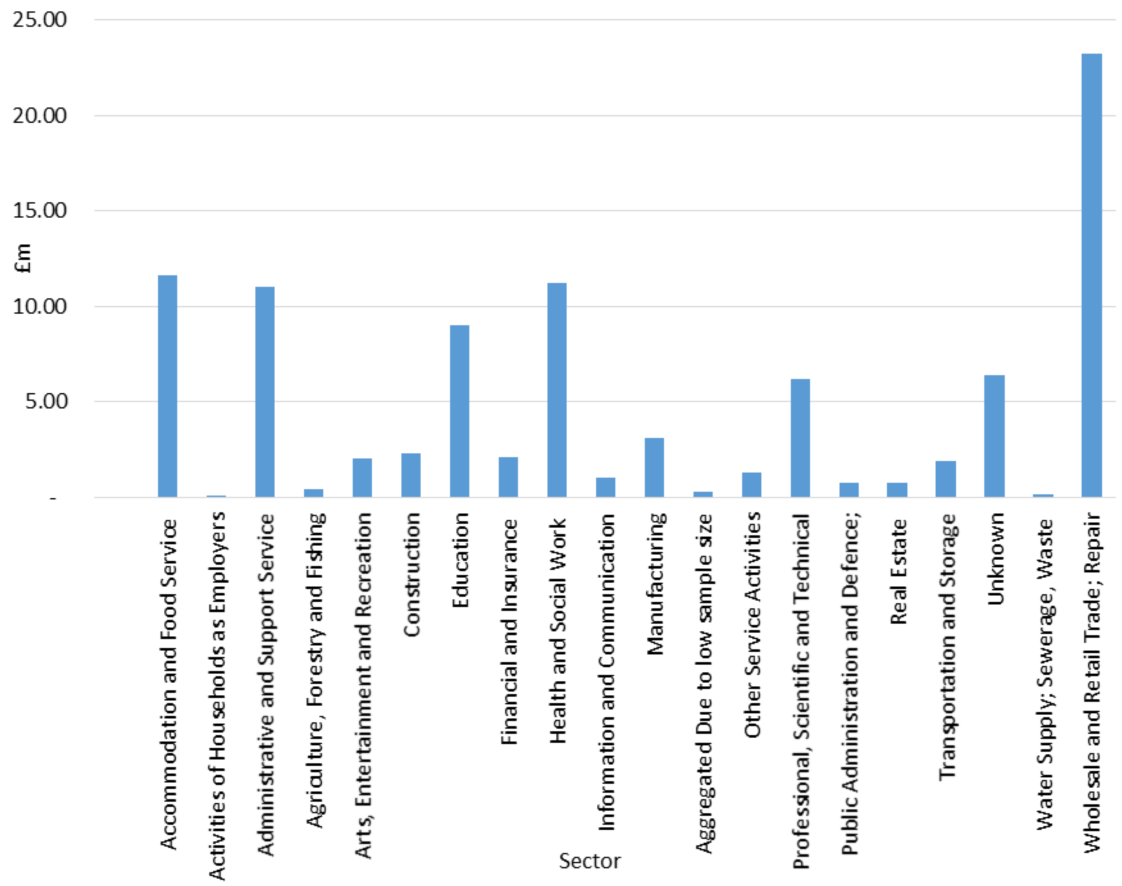
Replace the Secondary Threshold (ST) with a cumulative annual employee allowance. Rate remains at 13.8% with a £3,000 employment allowance
Is it a simplification? Yes - This is a move to more closely align to the Income Tax system operated by the employer, and removes unfairness around fluctuating incomes by creating parity over the year with those on equivalent annual earnings. As with option 1, it is a payroll tax, whereby a rate is applied to pay period aggregated payroll, unlike the current granular system. Simple to operate for employer with software facilitating the process.
How would it work? Employers would apply an annual allowance per employee, operating cumulatively and allocated over the pay periods. This would be deducted from each employee's earnings (including payrolled benefits) before applying the 13.8% charge to the aggregated figure at each pay period. Aggregation across employments is not possible as there is no fair system to allocate between them, therefore joiners and leavers in the tax year would receive an apportioned allowance. Any excess allowance from one employee is not available to set against other employees' earnings. Reporting and payment would be as now, but without the P11D (b) which would be removed. Class 1B NICs on PAYE Settlement Agreements would similarly be included as part of the year end calculation.
Potential wider implications: • under or overpayment of earnings could be corrected in a following pay period • no employers lose out, larger employers show the highest reduction in NICs and comprise the majority of employments (chart 3.J), smaller employers more likely to have no change in liability due to the EA effect • this time employers in education and human health/social services, along with administration and wholesale/retail sectors would have the highest gains in decreased employers' NICs (Chart 3.K) • employers in London, the South East and Scotland show the highest reductions in NICs, with those in the North East and Wales having the smallest reductions (chart 3.L) • net cost to the Exchequer (approximately £100m) • may require anti-avoidance provisions around manipulation of start/end dates of employment to counter potential mischief in obtaining increased allowance

Chart 3.J: Reduction in NICs from gaining Employers (£m) by employer size – this chart illustrates that no employers lose out, and larger employers show the highest reduction in NICs and comprise the majority of employments, smaller employers more likely to have no change in liability due to the EA effect.



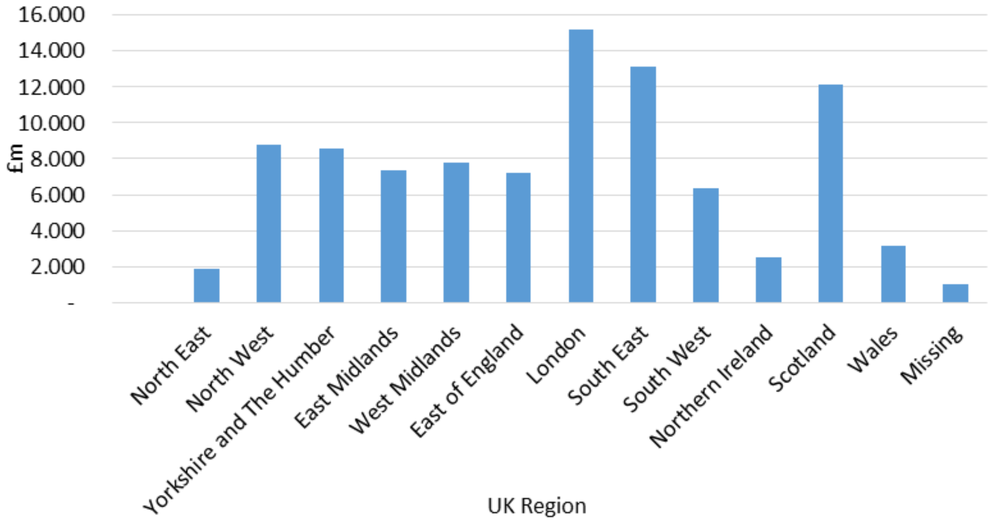
Source: HMRC

Chart 3.K: Reduction in NICs from employers who gain, by sector (£m). This chart illustrates the distributional effects by industrial sector and shows that no employers lose out – this time employers in education and human health/social services, along with administration and wholesale/retail sectors would have the highest gains in decreased employers' NICs.



Source: HMRC

Chart 3.L: Reduction in NICs from gaining Employers (£m) by UK region – this chart illustrates that employers in London, the South East and Scotland show the highest reductions in NICs, with those in the North East and Wales having the smallest reductions



Source: HMRC

Table 3.F: Option 3

Link to a specified percentage of employee primary NICs
Is it a simplification? Yes – limited additional admin burden as the charge follows the primary NICs calculation, with software facilitating the process. However, may present employment choices by the employer based on whether potential employee has full primary allowance available. How would it work? Employers would simply apply a % rate to the total employee NICs for the pay period. Potential wider implications: • under the move to ACA, only one primary threshold is available to an employee – one employer would 'lose out' to another in the case of multiple employments • potential influence on employment of workers with full primary threshold availability, over those with reduced or no PT available (due to allocation to another employment)

Table 3.G: Option 4

Retain existing system
Is it a simplification? No – system stays the same, but familiar, well understood, absence of change
How does it work? Employers deduct the secondary threshold from each employee's weekly or monthly pay (class 1A NICs paid on P11D (b) under the current system), then apply a 13.8% charge. These amounts are aggregated and paid over to HMRC.
Potential wider implications: • if primary NICs basis changes to ACA, the employer would be operating both the new ACA basis and old earnings period basis • potential distortions around the ST remain in place

Table 3.H: Option 5

Replace ST with a full-time equivalent employee allowance
Is it a simplification? No – increase employer's involvement before operation of the software process. Recording of hours for the working tax credit is not being retained within Universal Credit, so this would represent a retrogressive step.
How would it work? Employer would apply an allowance based on the full time equivalent amount, deducted from the employee' earnings (including payrolled benefits) before applying the 13.8% charge to the aggregated figure at each pay period. Whilst this would remove potential behavioural decisions around the secondary threshold, the employer needs access to further information before operating payroll
Potential wider implications: • potential to remove employment distortions around the ST • this option would increase employer's involvement before the operation of the software process, and was not popular when raised at stakeholder meetings

3.26 In addition, a different and more radical route has been suggested to us, demonstrating that there are a number of different approaches to the design of an employer levy. This more radical route acknowledges that Employers' NICs and Employees' NICs have essentially the same base and seeks to reallocate the formal liability of the tax, though not the ultimate burden. The suggestion is to:

- abolish the ST
- retain the rate of 13.8%
- with a modest employment allowance of £5,000 to protect the smallest employers

The absence of the ST would result in a considerable gain to the Exchequer (£23.6 billion), borne by all employers other than the smallest (taken out by the EA). The gain would be recycled to employees by raising the PT, so reducing employees' NICs. Potentially this paves the way for aligning the NICs and Income Tax thresholds.

The proposal is based on the idea that employers would recover this increase to employees by way of reduced gross pay and that the employees would remain in the same net after NICs position as they would benefit from the higher PT.

One of the recommendations from the March 2016 report was alignment of the primary threshold with the personal allowance for Income Tax. This would cost an estimated £10.2 billion. If the overall increase in employers' NICs mooted above was to raise this amount it could take the form of:

a) a reduced rate of employer NICs

b) retain part of the ST (£4,600)

A rudimentary review of the impact of the above scenario shows those industry sectors where employers are incurring the highest increases in employers' NICs broadly are the same industry sectors where employees have the highest gains in reduced primary NICs.

We have included this idea for completeness, but clearly considerable further research would be necessary to determine whether behavioural change by employers would result in adjusted earnings in the manner set out. The impact on contributory benefits would also have to be studied.

3.27 We have set out a number of options and their wider impact, some of which will create a simpler system than we have currently. In considering the relative complexities of these options, we have followed the principles incorporated in the OTS complexity index.[15] Whilst option 1a appears the simplest levy to operate in view of its absence of reliefs, and likely shortening of legislation and guidance, this benefit is likely to be outweighed by the substantial increase in the number of employers brought into the charge, together with the major sectoral impacts set out, and we therefore would not recommend this option. Options 1b – 1d appear more complex than 1a, potentially involving anti-avoidance provisions around the higher employment allowance, and also carry the wider implications as set out.

3.28 Option 2, with a cumulative employee allowance, has the advantage of improving fairness for those employers with employees on fluctuating incomes, remains simple to operate in terms of operational information necessary for the employer and would represent a move towards closer alignment with Income Tax. Options 3 and 5 face the practical difficulties set out, and retaining the current system (option 4) would be less desirable in our view than the cumulative allowance (option 2), which appears to be the option with the most potential.

Administrative burden for employers

3.29 The information which payroll professionals must assimilate to arrive at the total pay bill for Apprenticeship Levy (AL) purposes has increased the admin burden. We also understand that the AL has created difficulties relating to the apportionment of allowances across corporate groups. However, a potential payroll tax wouldn't require additional work in addition to the AL, and would break the link with individual earnings periods, so overall would not increase the admin burden and may well reduce it. Employers have requested that the AL earnings and any replacement for employers' NICs are aligned, so that they are based on the same definitions.

3.30 Employers have noted that it should not be necessary to rely on software to work out a tax liability – this should simply be a convenient working method. Employers understand how the tax is assessed (and a measure of this could be the ease of working it out by hand). Currently this is not possible as payroll is so complex.

3.31 The final process will depend on which option is chosen, and that will drive the admin burden for employers. Overall we think this will not increase, particularly if the Class1A is brought within employers' NICs and P11D (b) processes are removed. There may be some

[15] https://www.gov.uk/government/publications/office-of-tax-simplification-complexity-index

additional end of year work for HMRC, as the benefit in kind position may not be known until after the year end.

Impact on HMRC's costs

3.32 Whilst there would be some costs associated with the option to abolish the Secondary Threshold, these would be relatively small (in the low millions) given that this would be a rate and threshold change within the existing structure of NICs. Of more significance are the costs relating to the Payroll tax options, which would change the structure of employer NICs.

3.33 The impact of this change would largely be for employers, and not individual taxpayers, so the operational impact would be lower than for ACA. However HMRC analysis suggests it would need to recruit additional staff to administer this charge.

3.34 If the move to a Payroll Tax was announced alongside ACA NICs then the delivery would be included within an overall programme for ACA, and adopt the same timescales (with the reforms being delivered for April 2021 on the proposed timetable developed by the OTS).

3.35 If a payroll tax was announced in isolation, by April 2017, this could potentially be delivered for April 2019. This would be dependent on draft legislation being made available soon after the announcement.

Compliance Considerations for HMRC

3.36 In a system that requires large sums to be aggregated, it is possible that the precision of individual calculations that currently exists may be eroded. HMRC considers that it might be difficult to check whether the correct amount of tax has been paid on an aggregate of all earnings, particularly for larger employers.

3.37 The Payroll Tax options involving large employment allowances have the potential to create incentives for firms to artificially suppress or manipulate earnings figures to reduce the amount of Payroll Tax due. For example, employers with large pay bills may attempt to fragment into small companies to take advantage of multiple allowances. As some employers fragment for perfectly legitimate reasons, it may be difficult for HMRC to determine whether a company has fragmented simply to avoid paying the Payroll Tax.

Statutory Payments – the role of the secondary contributor

3.38 Currently, employers can claim 92% of the value of any statutory payments they make back from the government, with the exception of SSP, which has been fully funded by employers since 2014. Small employers can claim 100% plus an additional 3%. Claims are offset against Class 1 NICs due.

3.39 Some of the options described above include a large employment allowance. The interaction of this with the recovery of statutory payments will require consideration if the option is taken forward.

3.40 The opportunity exists currently for employers who may be on the cusp of the £45,000 (2016 to 2017) threshold to dip into small employer regime and be eligible to claim back additional relief for statutory payments made, benefitting by an additional 11%. However, the potential has always been there to do this.

Student loan deductions

3.41 We noted in our March 2016 report that the position of the employer as a secondary contributor carries additional responsibilities, and we have had discussions with the HMRC student loan (SL) team. Whilst the proposed inclusion of taxable benefits in kind within the definition of payroll for the employers' NICs charge would create a difference to the current definition of earnings for student loan repayment purposes, it was considered this difference could be accommodated by way of a minor change within the student loan regulations, and overall SL would not prevent wider NICs changes.

Rebranding employer's NICs

3.42 The March 2016 paper asked the question whether employers' NICs should be rebranded. A lot of stakeholders were of the view that the link to NICs held out by the term 'employers' NICs' was spurious and should be broken. They felt that giving the impression that there was a link to the NICs that employees are paying was wrong, though they accepted that the majority of the proceeds goes into the National Insurance Fund. We still think 'payroll levy' is an acceptable working title; in any event, if the charge is to be reformed we think a new title would be an important signal.

3.43 We do not think a change of this nature would have any implications on the various social security double contribution agreements.

Conclusion: is this a simplification? Is it worth the cost?

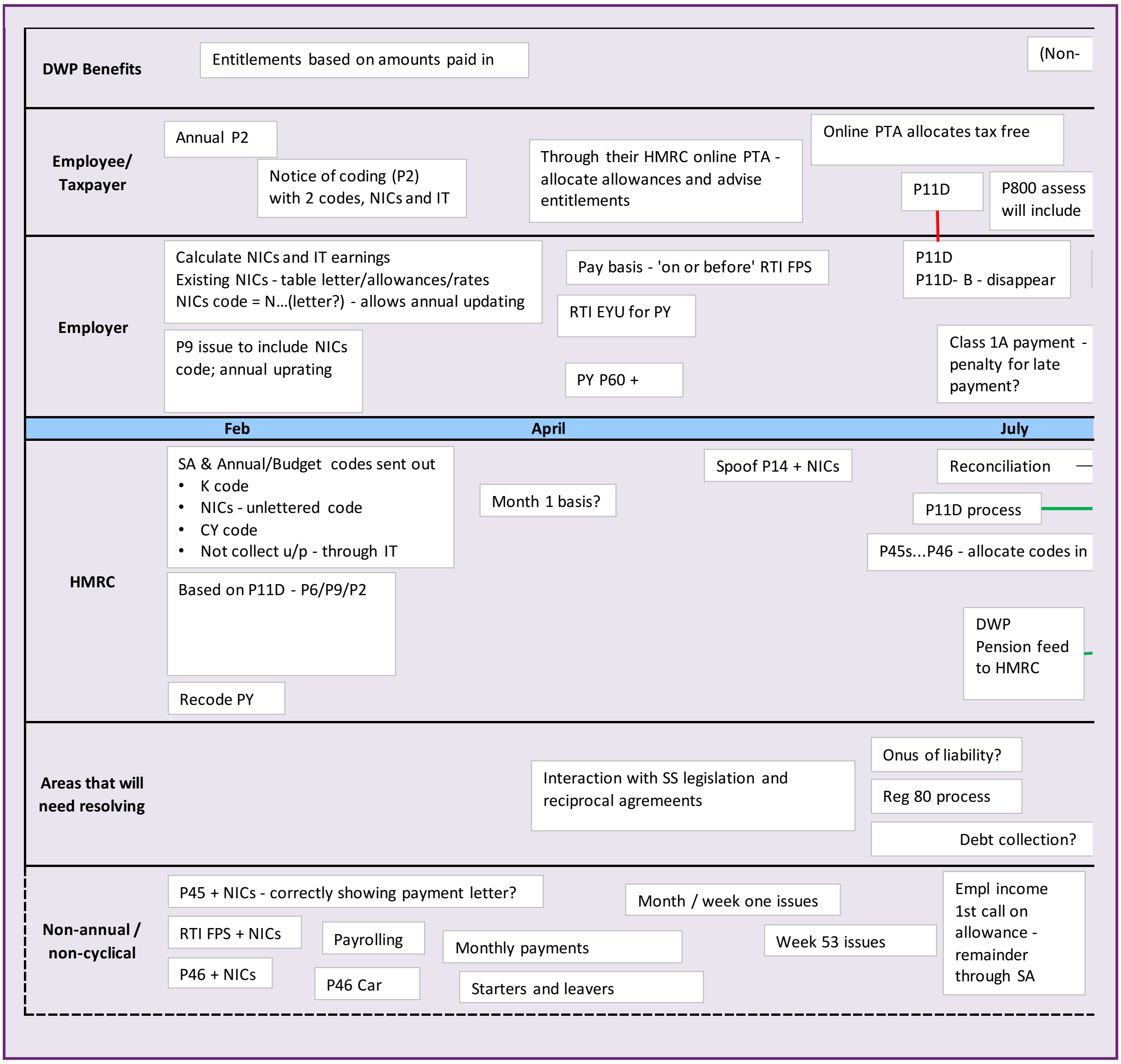
3.44 In terms of the administration burden of introducing one of the options on employers, the steady state impact is considered to remain the same, with payroll software facilitating the process. Over time, additional burdens are not thought to be significant. Transition costs for employers on changes to employers NICs are estimated as mid-tens of millions of pounds, and for HMRC low-tens of millions of pounds.[16]

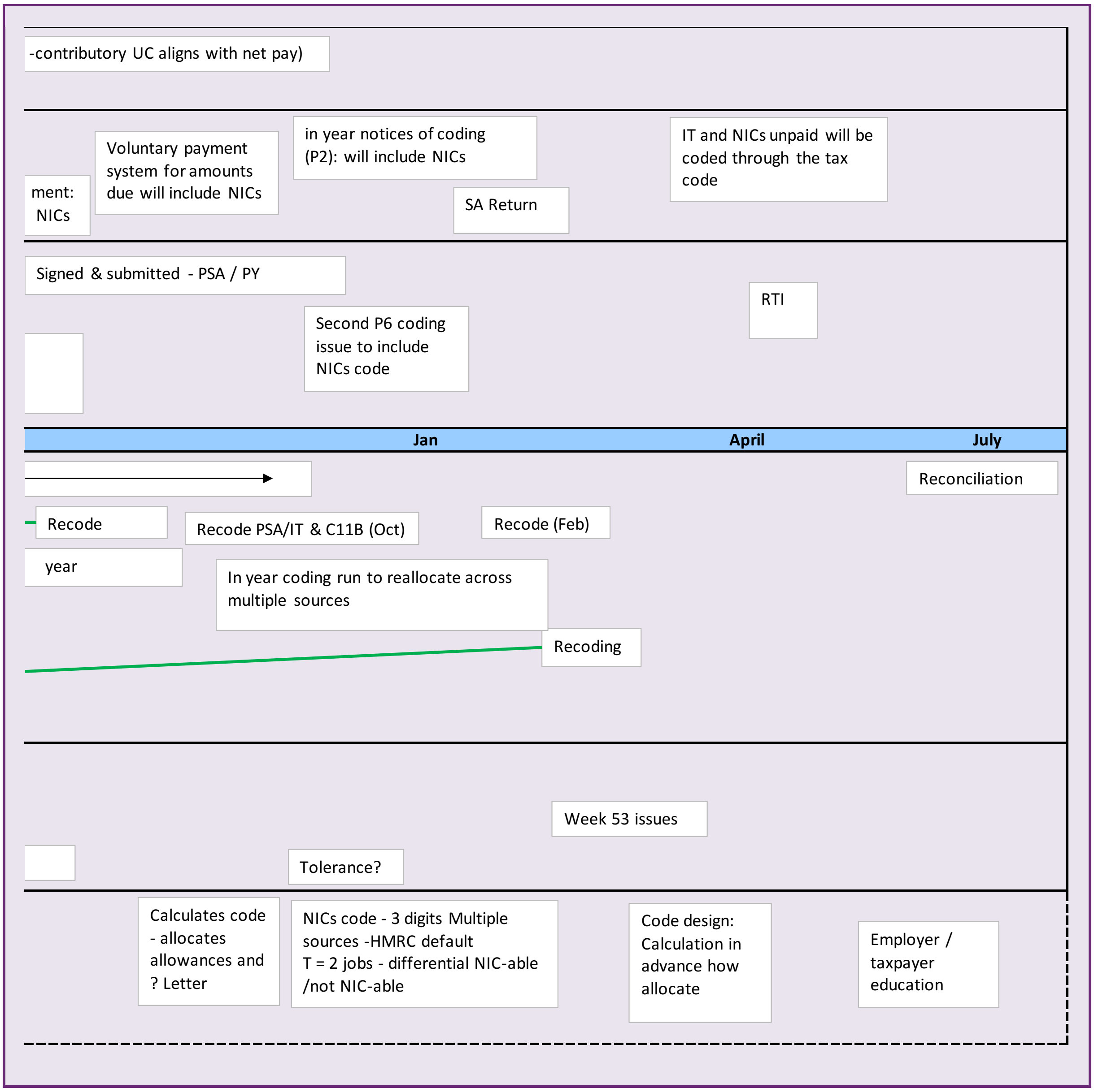
3.45 The OTS believe the move of employee NICs to an ACA basis presents an opportunity to modernise employers' NICs, and we have not altered our opinion that a tax based on total payroll earnings would be more transparent and address potential distortions that exist under the present system. The options for reform set out in tables 3.A to 3.H and summarised in paragraph 3.27 and 3.28 above carry wider implications, a matter for policymakers to consider further, but we believe the case for change remains.

[16] Based on HMRC data

A Proposed delivery process

A.1 The diagram that flows across the next two pages sets out the proposed new delivery process for alignment of Income Tax and ACA NICs, over an annual reporting cycle, for different stakeholders.





-contributory UC aligns with net pay)
ment:
NICs
Voluntary payment system for amounts due will include NICs
in year notices of coding (P2): will include NICs
SA Return
IT and NICs unpaid will be coded through the tax code
Signed & submitted - PSA / PY
Second P6 coding issue to include NICs code
RTI
Jan
April
July
Reconciliation
Recode
Recode PSA/IT & C11B (Oct)
Recode (Feb)
year
In year coding run to reallocate across multiple sources
Recoding
Week 53 issues
Tolerance?
Calculates code - allocates allowances and ? Letter
NICs code - 3 digits Multiple sources -HMRC default
T = 2 jobs - differential NIC-able /not NIC-able
Code design: Calculation in advance how allocate
Employer / taxpayer education

B Recommendations for a simpler system

The recommendations made in the OTS report Closer Alignment of IT and NICs published 7 March 2016.

1	**Increasing Transparency, and the contributory principle**
a	Enhance NICs transparency for taxpayers to improve understanding and allow informed choices. Greater visibility can be achieved through HMRC's Personal Tax Accounts – see 1c.
b	In time, a critical examination of the Contributory Principle and debate about it based on an informed (public) understanding of the facts.
c	Understanding of NICs would be greater if the online tax account provided more information, by showing IT and NICs separately and showing the destination of the two taxes as well as the current combined figures. The potential for providing information on entitlement to non-pension-related contributory benefits should be reviewed so that taxpayers are better informed.
2	**ACA: changing the structure of employees' NICs**
	Annual, cumulative and aggregated assessment ("ACA") as a way of achieving simpler, more equitable and thus fairer system OTS to continue work to fully explore the impact on individuals, businesses, the Exchequer and HMRC, setting out options and choices
3	**Employers' NICs**
a	Employers' NICs charge based on a whole payroll cost to make it easier to understand and reduce the incentive for employers to offer fragmented hours OTS to continue work to fully explore the impact on individuals, businesses, the Exchequer and HMRC, setting out options and choices
b	Change the name from Class 1 secondary NICs, perhaps to payroll levy
4	**Scope and definitions: aligning the tax bases for employees**
	Scope of the charges
a	HMRC and HMT should commit to the principle of aligning the definitions of 'earnings' and the scope of IT and NICs charges for employees over a period, and should ensure no new divergences are introduced, to make it easier for individuals and employers to understand, and to improve compliance.
	Expenses deductions and other reliefs
b	HMRC and HMT should commit to the principle of aligning expenses deductions and other reliefs for IT and NICs (apart from very limited defined exceptions such as pension contributions) over a period and should ensure no new divergences are introduced.

Benefits in kind

c Commitment to harmonising the NICs treatment of BIKs and cash rewards over a suitable period, with the need to fully explore the impact on individuals, businesses, the Exchequer and HMRC, setting out options and choices and linking in with Employment Allowance and Apprenticeship Levy where appropriate

5 Self employed

a The planned cross government working group on status to be expanded to include OTS and also considers the position of the self-employed to consider harmonising rules and procedures

b More closely align the NICs position for self-employed with employees, to remove complexity and potentially to converge benefits

c Ensure that what is liable to IT for the self-employed is also liable to NICs

d Where the above is not possible, a reason should be given as to why not (whether now or in the future)

e Review whether the Categorisation of Earners Regs remain appropriate. Publish and regularly update the policy justifications.

f Remove the notion of Classes of NICs and simply have four categories: employees, self-employed, voluntary and employers, to keep the concept easy for taxpayers to understand

g Provide greater flexibility for the self-employed to make more frequent payments on account through YTA

6 Legislative and administrative alignments

Enhancing the legislative and administrative links between IT and NICs, and within NICs

a Pages in HMRC guidance that deal with IT issues should link to the NICs consequences, and vice versa

b Policy outcomes should demonstrate that there had been IT and NICs collaboration to achieve greater alignment. TIINs should show that both IT and NICs have been considered

c Amend NICs legislation by cross-referencing to IT provisions, or provide an explanation where this is not possible

d HMRC to raise awareness of both IT and NICs in customer facing staff. HMRC should assure that multi digital channels will present IT and NICs issues together

e Review the NICs refund mechanism for individuals to ensure it is easy, timely and reasonable

f Increase NICs engagement on taxpayer forums, in particular dialogue on issues that are causing employers difficulties

Enforcement

g Reproduce the IT discovery assessment provisions for Class 1 NICs, with any necessary modifications

h Amend the legislation so that the time limits for recovery of a NICs debt are aligned with those for IT,

Rates and thresholds

i New thresholds should not be introduced in circumstances where existing ones can serve the same purpose j Existing thresholds should be reviewed to establish those which can be aligned and then remain linked, in a given time frame. Primary and secondary thresholds would be a helpful place to start

Legislation

k Change NICs legislation in such a way that future IT changes automatically apply to NICs

C Who we met

We are very grateful to the wide range of bodies, businesses and individuals who gave their time to meet with us, and for the submissions we have received. Many of the organisations listed below arranged round tables and forums for us, enabling us to reach a very wide range of impacted stakeholders. We have listed them below and apologise to any that we have inadvertently omitted.

Consultative Committee	
Stuart Adam	Institute for Fiscal Studies
Alex Rowson	Business Application Software Developers' Association
Colin Ben-Nathan	KPMG
Helen Hargreaves	Chartered Institute of Payroll Professionals
Belinda Johnson	Work Lab Ltd
Richard Exell	Trades Union Congress
Stephen Relf	CCH and Applause Accountancy Services Ltd
Paul Tucker	Smith & Williamson
Robin Williamson	Low Incomes Tax Reform Group (LITRG)

Stakeholder organisations
Administrative Burdens Advisory Board
Aspen Re
Association of British Insurers
British Computer Society (Payroll)
Bishop Fleming
Chartered Institute of Payroll Professionals
Chartered Institute of Taxation
Confederation of British Industry
Federation of Small Businesses
HMRC stakeholder forums; TDSF, EPG, IReeN
Institute for Fiscal Studies
Institute of Chartered Accountants in England & Wales
Low Incomes Tax Reform Group
Midlands HR
National Living Wage foundation
Payroll Alliance
Resolution Foundation
RTI Taskforce forum
Social Security Advisory Board
TUC

D Data source for ACA modelling

2013 to 2014 Survey of Personal Income (SPI)

D.1 The data is based on a representative sample of records from HMRC operational computer systems for individuals who could be subject to IT/NICs for the tax year. The model uses a projection of the data to 2018 to 2019 based on the Office of Budget Responsibility's (OBR's) latest published economic forecasts. Projections from the SPI base data are used in order to provide a more up-to-date assessment of the distributions for taxpayers and their liabilities for this analysis. While the projection methods aim to capture where possible the most important likely influences on taxpayer numbers and liabilities, projection of the base SPI survey data to later years inevitably means that these projections are subject to greater uncertainties and potential error margins than outturns for 2013 to 2014 and earlier years.[1] Information in the charts and tables in paragraphs 2.11 to 2.42 of this report is derived from this model.

Data limitations relating to annual and aggregated NICs

D.2 The output is created using a micro simulation model for NIC-able earnings at an individual level which is simulated on a pay period basis using annual data. The model then simulates an alternative scenario where NICs is charged on an annual cumulative aggregate basis to show the impact of the change. The modelled output is confined to impacts on individuals and on the overall NICs proceeds. It does not build in the impact on individuals' benefit entitlements or the overall cost of the impact on benefits. Modelled data on part year workers includes individuals who do not work a full year because they are entering or leaving the labour market permanently, as well as those who would like to work but are only able to find work for part of the year.

D.3 As explained in paragraph 2.16 HMRC's analysis allocates taxpayers into three broad categories of employment. These are derived as follows:

Fluctuating income

D.4 The micro simulation models uses the SPI data to model NICs for individuals on a per employment basis (as opposed to aggregate earnings across jobs), using an employment level dataset. Similarly, P14 level liabilities are evaluated against effective pay period NIC thresholds (as opposed to annual thresholds) using imputed SPI data items. For example, the micro simulation model computes the effective level of the primary threshold at employment level as the product of the case's pay period equivalent PT (e.g. weekly) and their imputed pay periods (e.g. weeks) worked.

D.5 The model estimates the breakdown of annual earnings falling between each Class1 threshold on a per employment per pay period basis taking into account the possibility of fluctuations in earnings between pay periods during the tax year. For example, an individual with total earnings below their effective UEL may nonetheless have earnings above the pay period UEL in some pay periods. This is modelled using a linear regression approach to simulate

[1] Methodology and quality indicators for the sampling and projection process which underpins this analysis can be found within the following publication: https://www.gov.uk/government/statistics/income-tax-liabilities-statistics-tax-year-2013-to-2014-to-tax-year-2016-to-2017

fluctuation probabilities as a function of the proximity of total annual earnings to the NIC threshold. The model also estimates NICs liabilities on an annual, cumulative and aggregate basis enabling the comparison of the two methodologies.

Part year workers and multi jobbers

D.6 These groups of workers are identified from the number of pay periods reported on their employment records. Based on the total earnings reported between the four NIC thresholds (LEL/PT/UAP/UEL) it is possible to infer the payment frequency and the minimum number of pay periods they have had for each employment. From this the multi jobbers are identified where the number of employment records exceeds one and the number of weeks worked exceeds 53 (and so at least one week must have been worked across 2 separate jobs, therefore receiving more than the annual equivalent of the PT allowance). For these purposes, part year workers are those who have worked fewer than 52 weeks when considering all their employment/NIC records (while they may have had one employment or several employments, consecutive or concurrent through the year, as evidenced from the number of employment records, the key factor is that they worked for fewer than 52 weeks in total).

E Terms of reference

Closer alignment of Income Tax (IT) and NICs

Introduction

The differences between IT and NICs have often been cited as a major source of complexity in the UK's tax system, and in July 2015 the OTS was asked by the Chancellor to consider the impacts, costs and benefits and the steps necessary to bring the two taxes on employment / self-employment closer together to create a simpler and more modern system.

The full report, published in March 2016, is available online[1] and concludes that bringing IT and NICs closer together would create a simpler and more equitable system for taxpayers, better fitted for current and emerging working patterns.

In it, the Office of Tax Simplification (OTS) proposes a number of steps towards closer alignment, but cautions that the impacts need to be carefully understood and considered. In particular, the OTS recommends that further work should be done to understand the impact of proposed structural changes to the Class 1 NICs system - both to primary (employee) and secondary (employer) NICs.

During the review it became apparent that the options to align the two charges, and simplify the overall system, should focus on reform of NICs rather than IT; two core issues with NICs being that:

- the same annual earned income, derived from different working patterns, could result in a different NICs outcome. For example, two part time jobs against one full time job
- the charge on employers is directly related to individual employees, but does not impact their contribution record

In its report the OTS proposed that it more fully explore both these areas.

The government has since commissioned this work by way of two further reviews into the impact of proposed structural changes to NICs, within the terms of reference below, and to publish its findings in advance of Autumn Statement 2016.

The government will then respond in full to the OTS's work in this area.

Terms of Reference for the further reviews

The government has asked the OTS to undertake two further reviews, building on the work and recommendations in its earlier reports:

1. a review on the impact of moving employee NICs to an annual, cumulative and aggregated basis ('ACA') similar to PAYE IT. NICs is currently calculated on a pay period basis
2. a review on the reform of employer NICs to a payroll based charge

[1] www.gov.uk/government/publications/closer-alignment-of-income-tax-and-national-insurance-contributions

Whilst these structural changes could be considered in isolation, if the basis of assessment for Employees' NICs moves to ACA, it would be natural to review the basis for Class 1 secondary NICs at the same time.

The OTS will publish a further report ahead of Autumn Statement 2016. The government will then respond in full on all the OTS's proposals to bring IT and NICs closer together.

The merger of IT and NICs, the extension of NICs to non-earned income or to pension income, and international cross-border issues, are outside the scope of these specific reviews. However, the OTS has received (and will no doubt continue to receive) a range of views on these issues, and may reflect these where they contribute to future debate on simplification.

Aims and objectives

1. ACA: further explore the impact of ACA, as a simpler and more inclusive system, on individuals, business, the Exchequer and the administration, with a view to setting out options and recommendations for consideration prior to implementation.
2. Payroll based tax: further explore the impact on, employers (including the sectoral impact), the Exchequer (with the assumption that overall receipts would remain the same) and the administration of a move to a payroll based tax, with a view to setting out options and recommendations for consideration prior to implementation.

The report will set out who might pay less and who might pay more (the 'gainers and losers'), and the benefits and challenges of an ACA system of employee's NICs and a payroll tax system of employer NICs including implementation and transitional issues.

The report is contingent on the availability of new data within the timescale, either based on deeper analysis of existing sources or on commissioning new data sets.

The report will enhance understanding and engagement with these issues with all impacted parties.

Framework for the reviews

The review will consider evidence already available, and commission and publish new analysis and data on these impacts, to encourage an informed public debate on the issue.

The OTS will consider the impact of trends affecting the economy, business structures and working patterns, and will consider the opportunities offered by HMRC's Making Tax Digital.

The options and recommendations will:

- aim to make the administration of the NICs system simpler to deal with for individuals, businesses and advisers
- improve understanding and transparency
- be cost effective for business and individuals (admin burden) and HMRC (operating costs) and be attainable in the medium term (5 years)

The OTS will have regard to the wider Exchequer implications, including the consequential impact on benefits entitlement.

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

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