HM TREASURY

HM Revenue & Customs

Integrating the operation of income tax and National Insurance contributions

A call for evidence

July 2011

HM TREASURY

HM Revenue & Customs

Integrating the operation of income tax and National Insurance contributions

A call for evidence

July 2011

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

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

ISBN 978-1-84532-893-1
PU1184

Contents

Foreword

A competitive tax system is a precondition for growth. The Government is committed to making the reforms necessary to support its ambition for a more predictable, stable and simple UK tax system.

Our corporate tax reforms aim to deliver the most competitive business tax regime in the G20. We have set up the Office of Tax Simplification to reduce complexity in the tax system and we are taking forward programmes such as Real Time Information which will make our tax system more fit for the 21st century. But we need to go further still. Budget 2011 therefore announced that the Government would consult on the integration of the operation of income tax and National Insurance contributions (NICs).

For decades, we have operated income tax and NICs as two fundamentally different systems with different periods and bases of charge. The resulting anomalies impose costs and complexity on employers, and cost the taxpayer through the administration burden on HM Revenue & Customs. We believe that greater integration of the two systems has the potential to remove economic distortions, reduce burdens on business, and improve fairness across individual earners.

The Office of Tax Simplification (OTS) interim report of March 2011 highlighted, amongst other issues, these distortions and costs and the appetite among small businesses and tax practitioners for these systems to be simplified. The Mirrlees review of the UK tax system by the Institute for Fiscal Studies made similar recommendations last year. Furthermore, a number of representatives of UK businesses have also called for action to reduce the costs of running the two systems.

However, we recognise that income tax and NICs were introduced for different reasons, and believe that they continue to have different rationales. As stated at Budget, the Government will maintain the contributory principle that underpins the National Insurance system, and ensure that this will be reflected in any proposed reforms. In addition, we will not extend NICs to individuals above State Pension Age or to pensions, savings and dividends.

In the autumn we plan to consult further on the reform options. But, as a first step, we want to make sure we have the best evidence available on the impact of the current systems on all interested parties. We believe businesses and other stakeholders can and should play a key role in developing and testing tax policy. For that reason, we are publishing this call for evidence and I would encourage all those with an interest to respond to the questions set out.

David Gauke, Exchequer Secretary to the Treasury

July 2011

1 The current situation and rationale for reform

The current system of income tax and NICs

1.1 Income tax and National Insurance contributions (NICs) are different systems with different purposes which have developed separately over the years. Income tax receipts are used to fund general expenditure while NICs are part of the UK's social insurance scheme and provide entitlement to contributory benefits, such as Jobseekers Allowance, Employment and Support Allowance (ESA), the state pension and bereavement benefits. A proportion of NICs also helps fund the National Health Service. Although there is a great deal of alignment between the two systems, their different purposes mean that there are still some significant differences. These are summarised in table 1.A and discussed further in this section.

Table 1.A: Comparison of income tax and NICs paid by employees

	Income tax	Employee National Insurance
Who pays?	No age limit	16 to State Pension Age
What is it paid on?	On all income including earnings, pensions and income from savings or investments and benefits in kind.	On most earnings from employment, but not on most benefits in kind.
Period of assessment	Assessed on total annual income. Liability finalised following the end of the tax year.	Assessed on earnings in each earnings period. Liability finalised at the point that the earnings are paid.
Cumulative or non-cumulative collection	Earnings from separate employments aggregated (cumulative)	NICs liability calculated on each employment in isolation (non-cumulative)
Structure of charge	Above the personal allowance, tax is applied at three rates (rising as income rises) on different bands of income	Applied at two rates on different bands of earnings above the primary threshold with the rate for the higher band lower than that for the lower band.
Entitlements provided	Funds general expenditure	Entitlement to contributory benefits, such as State Pension; also helps fund the NHS.

Source: HMRC/HMT

Income tax

1.2 Income tax is paid by individuals on the basis of their total annual income including earnings, pensions, and income from savings and investments. Every individual is entitled to a 'personal allowance'[1] which is an amount of income on which they are not required to pay tax. There are also exemptions and reliefs from income tax. For example, relief from income tax is given on payments of contributions to registered pension schemes. There are three main rates of income tax, though special rates apply to certain income such as savings.

1.3 The vast majority of income tax payable by employees and pensioners is collected by employers or pension providers through the Pay As You Earn (PAYE) system, which allows for the collection of income tax on account of annual liabilities. Income tax collected through the PAYE system is calculated on a cumulative basis and offers a certain amount of flexibility because it spreads the individual's personal allowance across the tax year. Employees also pay income tax on benefits in kind from their employment. These benefits and certain expenses are generally reported through the P11D process which requires the employer to provide details to HMRC (and to the employee) after the end of the tax year. The liability is then paid by the employee through a system of self assessment and/or adjustments to the amount of tax they pay in the following year. The self employed also pay income tax on the profits from their business. This is collected twice yearly through the self assessment system.

National Insurance

1.4 NICs are paid by individuals on earnings, with each employment considered separately. NICs are assessed on earnings in each earnings period, with a threshold in each period below which NICs are not due. There are two main rates of NICs on earnings, but there are also separate rates, for example, for those who are contracted out of the state second pension. Unlike income tax, NICs are not paid on all types of income. For example, no NICs are paid on pension income or interest from savings. NICs are not paid by those above State Pension age, or below the age of 16. NICs can also be paid on a voluntary basis.

1.5 Like income tax, NICs on earnings from employment are collected through the PAYE system. To administer this, the employer needs to know whether and at what rate to apply NICs (for example, they need to know if the employee is above State Pension age in which case no employee NICs applies). However, the employer does not need to take account of other earnings as a separate NICs threshold applies for each pay period for each employment. As NICs are not calculated cumulatively no account needs to be taken of earnings in other pay periods. Unlike income tax, employee NICs are not payable on most benefits in kind from employment (for example company cars and fuel and private medical insurance).

1.6 As well as the employee's liability for NICs, the employer has a separate liability for employer NICs. This is calculated in the same way as employee NICs, but is charged at a single rate (though again there is a separate rate for employers who operate occupational pension schemes). Again this is collected through the PAYE system. Employers are also required to pay NICs on the benefits in kind that they provide to their employees. These are collected annually through the P11D process, which requires employers to report to HMRC the benefits in kind that they have provided to their employees.

Self Employed

1.7 The self employed pay NICs based on the taxable profits of their business and these are collected through the self assessment system. This alone does not give them entitlement to

[1] For 2011/12 the personal allowance is £7,475. Personal allowances reduce on income above £100, 000 - by £1 for every £2 of income above the £100,000 limit, so that for 2011/12 individuals with income above £114,950 do not get the allowance.

contributory benefits. The self employed also pay a further weekly fixed amount of NICs, which can provide them with access to contributory benefits.

Contributory principle

1.8 Unlike the income tax system, individuals' payments of NICs are underpinned by a 'contributory principle'. Individuals contribute to the scheme while in work in order to receive financial support while out of work, whether through illness or unemployment or in retirement.

1.9 For individuals, the payments of NICs therefore need to be recorded over their whole working life as they prove entitlement to access contributory benefits, particularly the state pension. Entitlement to some contributory benefits, such as the state pension and bereavement benefits for the individual and their spouse, is determined by the number of qualifying years that an individual has built up through the payment of NICs during their working life. All payments of NICs are entered for each individual on their National Insurance record and the Department for Work and Pensions (DWP) uses this to determine the amount of contributory benefit that is payable to each individual who makes a claim.

Real Time Information

1.10 As set out, PAYE is the mechanism through which most income tax and NICs are collected.[2] Currently, employers calculate the amount of tax and NICs that each employee needs to pay, they deduct this sum from the earnings they pay to their employees and they send this, together with their own employer NICs, to HMRC on a monthly or quarterly basis. At the end of the tax year employers report the earnings they have paid and the deductions they have made to HMRC. Almost all employers are now required to file this information online.

1.11 Progressively, from April 2013, there will be significant changes to employer payroll processes with the introduction of Real Time Information (RTI). Instead of requiring information at the end of the tax year employers will be required to submit information whenever they pay their employees, whether that is weekly, monthly etc. There will be no change in the date for paying amounts to HMRC.

1.12 As well as reducing the burdens of operating the current end of year processes RTI will improve the flow of information between employers and HMRC when people start and leave employment. This in turn should enable the correct amount of tax to be paid in-year in more cases. For more information on plans on improving the PAYE system through RTI please visit http://www.hmrc.gov.uk/news/improve-paye.htm.

1.13 While RTI will reduce the administrative burdens of operating payroll, the differences between the tax and NICs structure outlined above continue to place administrative burdens on the employer. This call for evidence seeks to gain a greater understanding and fuller evidence base regarding these burdens.

The rationale for reform

1.14 The Government is committed to creating a fair and responsible tax and benefit system that rewards work and promotes economic competitiveness. The closer integration of the operation of income tax and NICs has the potential to deliver benefits in four areas:

2 Employers also use the PAYE system to make payments under the Construction Industry Scheme (CIS) and Student Loan deductions and administer the various statutory payments, such as statutory maternity pay.

- **Reducing burdens on employers.** As described, employers are required to understand and comply with two different systems and two different sets of rules. Integration has the potential to make compliance simpler and cheaper.
- **Removing distortions in the economy and improving transparency**. As the OTS noted, maintaining two systems leads to a number of anomalies that provide incentives to distort behaviour.[3] More generally, many individuals may find it hard to understand how much they will pay under the two systems. A more integrated system may be more transparent, helping individuals make better decisions regarding their employment.
- **Fairness.** The current systems deliver different outcomes depending on the nature of a person's employment. In short, individuals with similar circumstances and income may pay different amounts and receive different benefit entitlements. Greater integration may be able to improve the fairness of outcomes by making it more likely that individuals with similar circumstances pay similar amounts and gain similar contributory benefit entitlements.
- **Cutting administrative costs for government.** Each year operating PAYE costs private sector employers and pension providers £0.7 billion and HMRC spends around £1 billion on PAYE administration. Any changes to the current system will entail up-front costs. But if closer integration can reduce complexity (for employers and for government), it may be able to reduce the likelihood of error and HMRC's overall costs of collection in the longer term.

[3] Small Business Tax Review (Office of Tax Simplification March 2011)

2 Evidence sought

2.1 Below are 14 questions covering the areas on which the Government would like to gather evidence. A formal consultation document will be published in the autumn. But, as a first step, it is important to ensure that Government has the best evidence available on the impact of the current systems on all interested parties.

2.2 The questions are divided into two sections. While the majority of the questions are focussed on the burdens employers and payroll professionals face in the day to day operations of income tax and NICs there are also questions with a more general interest. Respondents should address any of the questions where they feel they can make a contribution. It would be helpful to indicate what type of organisation you are in your response and, if a representative body, whom your organisation represents.

2.3 Please provide further comment if there are areas not covered by this call for evidence of which you think we should be aware. A cover sheet for responses can be downloaded from the Treasury website; further documents can be attached where appropriate.

2.4 Where possible, please provide supporting evidence and/or data with your response. Government analyses convert all costs and benefits into comparable monetary terms; so information on the staff/time costs spent on activities and other resource costs required for meeting income tax and NICs obligations would be helpful.

Section 1: General Interest

1 The Government believes that integrating the operation of income tax and NICs may have the potential to remove distortions, reduce burdens on business and improve fairness. Do you have any comments on these objectives?

2 Of the differences between income tax and NICs listed in Table 1.A (or any others that you consider important) which do you see as the most significant in terms of their impact on:

- a economic distortions;
- b burdens on employers;
- c fairness?

3 What do you think are the most important steps that could be taken to reduce the effects on:

- a economic distortions;
- b burdens on employers;
- c fairness?

Section 2: Employers and Payroll Professionals

General

4 Under the current system, how much staff time and/or other resource is required to carry out income tax and NICs processes? Please give a score on a scale from 1 to 5 where 1 is only a small amount of time/resource and 5 is a great deal of time/resource for each of the following:

a) Familiarisation: understanding HMRC's requirements, legislation and guidance.

b) Retrieval of information: obtaining the information required to run a PAYE payroll.

c) Record keeping: maintaining the records needed for income and NICs purposes e.g. keeping copies of returns/letters where necessary.

d) Calculation: calculating and checking income tax and NICs due (including in-year and end of year processes).

e) Provision of information to HMRC: reporting of information to HMRC e.g. P45s for new employees.

f) Provision of information to employees: reporting and providing information to employees e.g. year end P60s.

g) Payment of liabilities: paying income tax and NICs to HMRC.

5 Which aspects of the current income tax and NICs process work well for your business?

6 Do you carry out income tax and NICs obligations together? Are there any elements you carry out separately?

7 What effect do differences between income tax and NICs have on wider payroll processes such as expenses and benefits, statutory payments and student loans deductions?

8 Which of the differences between income tax and NICs are dealt with largely automatically by payroll software and which require significant manual working? Where manual working is required how straight forward is this?

Issues and Errors

9 Are there particular issues that occur in the calculation of income tax and NICs?

10 How often is it necessary to correct income tax or NICs calculations and which are the most time consuming to correct?

Software

11 Do you have any comments about difficulties in designing or using software resulting from the differences identified in Table 1.A (or any others that you consider important)?

International

12 What do you see as the main differences between income tax and NICs in relation to employees you have who work internationally?

13 Which of the differences outlined in question 12 are dealt with largely automatically by payroll software and which require significant manual working? Where manual working is required how straightforward is this?

Interaction with other reforms

14 Do you have any views on how the introduction of Real Time Information (RTI) may affect the cost and benefits of income tax and NICs integration?

3 Next steps

3.1 The deadline for responses to this call for evidence is 19 September 2011. Representations by email are preferable, and should be sent to incometaxnics.simplification@hmtreasury.gsi.gov.uk. Hard copy responses should be sent to Income Tax NICs Simplification, 2/E2, HM Treasury, 1 Horse Guards Road, London SW1A 2HQ.

3.2 Information provided in response to this call for evidence will be dealt with in accordance with the access to information regimes. These are primarily the Freedom of Information Act (2000), the Data Protection Act (1998) and the Environmental Information Regulations (2004). Please note that unless confidentiality is specifically requested, each representation has the potential to be made public.

3.3 The responses from this call for evidence will be used in policy development for a stage 1 consultation in the autumn. Further details on HM Treasury's approach to tax policy making can be found in *Tax policy making: a new approach* on the HM Treasury website.

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

ISBN 978-1-84532-893-1

9 781845 328931 >