

14 November 2016

Closer alignment of income tax and national insurance: *report summary*

Why we carried out this review

There are constant calls for income tax and national insurance contributions (NICs) to be brought closer together. Currently these two taxes on earnings operate very differently.

We live in a changing business environment, with diverse ways of working. There are a growing number of people who work in self-employment, multi jobs and freelancing. The income tax and NICs system was built for the working patterns of yesterday and not for today, let alone for tomorrow.

It is in this context that ministers asked the OTS to review closer alignment – not merger – with a key aim of getting a more informed debate going on the implications of closer alignment.

The closer alignment of income tax and national insurance is desirable and realistic

In March 2016 the OTS published its first report on these issues, concluding that aligning the way the two taxes are calculated would create a simpler, more transparent and fairer system for taxpayers and employers. We recommended a 7-step plan to do this:

- calculating employee NICs on a similar basis to PAYE
- moving employer NICs to a payroll levy
- aligning the scope and definitions for income tax and NICs
- the self-employed to pay and receive the same contributory benefits as employees
- benefits in kind to be fully within NICs
- increase transparency and understanding amongst taxpayers
- harmonise administration and legislative procedures

However that report also demonstrated that changes to employees' NICs could result in many millions being adversely impacted, as well as there being many millions of gainers – in fact more gainers than losers.

Similarly, replacing the complexity of employers' NICs with a simple payroll charge could have significant implications for some industry sectors.

So the OTS has been drilling down further into the numbers to get a fuller picture of the potential impacts of these options. Our new report takes forward these two key aspects of the OTS's proposals. We want to ensure a more informed public debate on the implications: who would be affected and by how much?

Calculating employee NICs on a similar basis to PAYE

The OTS's key proposal is to move employees' NICs to an annual, cumulative and aggregate (ACA) basis, so that it is calculated in a similar way to PAYE income tax. This redesign could result in 5.5m employees paying more NICs and 7.6m employees paying less.

The problem with employees' NICs

Currently, an individual's sources of employment income are treated separately for NICs, so that someone with two part-time jobs can pay less NICs than someone earning the same from one full time job. PAYE income tax combines sources of income, so this difference doesn't arise.

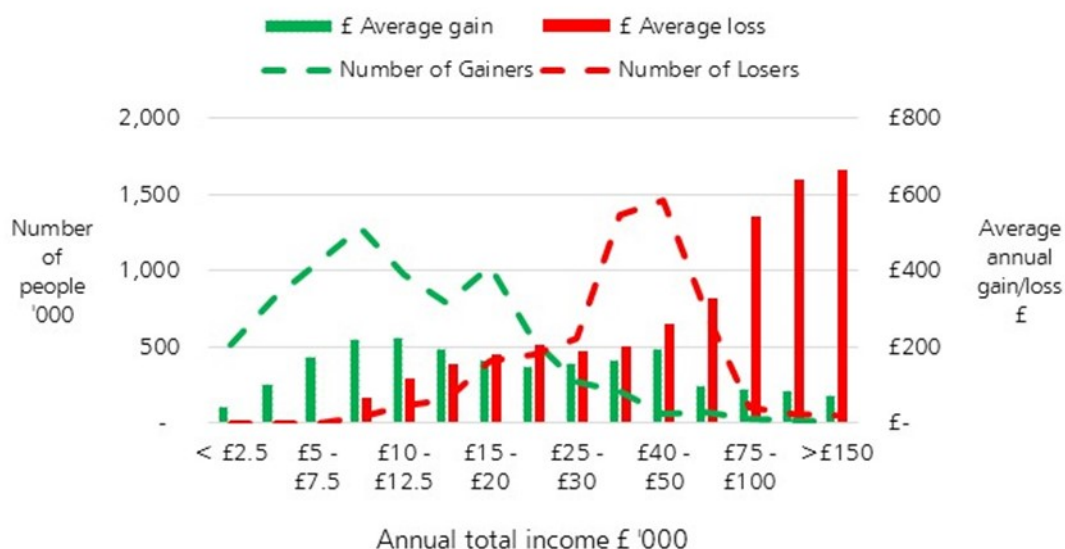
This table illustrates the distortions caused by the way NICs are calculated now:

Income for the year 2015 to 2016	IT	NICs	Total tax
£15,000 received from one employer spread equally over 12 months	£880	£832	£1,712
£15,000 received from one employer in one month with no income the rest of the year	£880	£572	£1,452
£5,000 received from each of 3 employers, spread equally over 12 months	£880	£0	£880

These different outcomes are also reflected in the benefits people are entitled to, so some do not build up pension rights. The OTS's proposal is that all employment income in the year would be combined when calculating the employee's annual NICs liability and their potential entitlement to some benefits. This annual, cumulative and aggregated ('ACA') approach would be simpler for employers to operate. It would work in the same way as income tax, be easier to understand and fairer for taxpayers.

The impact this change could have on taxpayers

The chart below indicates the gainers and losers on a move to 'ACA' NICs, showing the number of people affected at different total income levels and the average annual gain or losses involved:



Source HMRC.

Who could be affected?

- About 40% of those employees paying NICs could see some change (people with more than one job, with fluctuating income or working for only part of a year).
- Generally, those affected and who would pay less NICs would be part-time employees, women, those under 35 years old and those in lower paid service industries. About 7.6 million people could pay an average of £169 less national insurance. These tend to be lower income households

- Generally, those affected and who would pay more NICs would be multi jobbers earning above £20,000. About 5.5 million people could pay an average of £242 more national insurance. The interplay with social security could mitigate the effect for some taxpayers in lower income households. Some may have increased entitlement to contributory benefits.
- For some, these amounts would be a 'one off'. For others, the difference would repeat each year. Broadly, the Exchequer would not benefit: the changes would balance each other out.
- There will be transitional costs for employers, but it should be cheaper in the long run.
- Employees will be able to review their NICs and state pension entitlement through their on-line Personal Tax Account, to help them understand the changes.

There will be an inevitable focus on who will pay more and who will pay less (the 'gainers and losers'), simply by comparing pre- and post-change NICs bills. However, another way of looking at it is that 'ACA' NICs would ensure that individuals earning the same amount overall will pay the same NICs, regardless of how their income is earned through the year, which is not the case now.

Full details of the impact on many different groups of people can be found in Chapter 2 of the OTS's November report.

How 'ACA' NICs would work in practice

HMRC would need to issue a NICs code number to employees and employers, similar to PAYE codes for income tax. As with income tax this would operate cumulatively through the tax year and, for multi jobbers, the annual NICs allowance would be allocated between their employments. Employers would run the two systems in parallel, with payroll software managing the detail. At the end of the tax year, HMRC would reconcile both income tax and NICs in parallel. It would notify amounts overpaid or due, as happens now with PAYE income tax.

Although this looks as if HMRC will have additional work to do, planned automation will deal with the extra load; the additional cost is considered modest. Employees would be able to check both income tax and NICs, as well as the impact on state pension entitlement, through their HMRC on-line Personal Tax Account.

Moving employer NICs to a payroll levy

At present, employers' NICs are calculated at 13.8% of employees' weekly or monthly pay, generally over a threshold of £156 per week / £676 per month.

The OTS is clear that, instead, a simple percentage charge applied to total payroll costs (following the approach of the Apprenticeship Levy) but including the cash value of workplace benefits, would be less complicated. It need not affect the National Insurance Fund's operation.

However, the simplest approach to this (a 10% levy on total payroll without any thresholds or allowances) would have a major impact on those employing low paid or part-time workers, due to the loss of the £156 weekly / £676 monthly threshold, and could affect particular industries and regions disproportionately.

The OTS therefore explored 7 other options to reform employers' NICs, keeping the overall outcome revenue neutral to the Exchequer. We consider the best of these would be to replace the employee threshold with a cumulative annual employee allowance per employer.

There is no clear cut solution because each option has significant impacts. However, the OTS still recommends reforming the current process, especially if employees' NICs are changed as we propose.

To take this forward, the OTS recommends that the government further explores the wider impact of different options and choices, and the extent to which these are both desirable and achievable from both a simplification and a fiscal perspective.

Full details of the impact of different options for a proposed payroll levy, and their impact, can be found In Chapter 3 of the OTS's November report.

When changes would take place

The employment market is diverse and constantly changing and it's clear that the time to begin modernising the tax system is now.

There is an opportunity to make these changes alongside HMRC's Making Tax Digital, as business and government redesign software and think about creating a more digital relationship. The OTS have proposed an indicative 5 year timetable towards a simpler and fairer system:

		<div> <div>Steady improvement</div> <div>Preparation for implementation</div> <div>Implementation ✓</div> </div>					
IT NICs alignment	Assumptions Preconditions	2017	2018	2019	2020	2021	2022
Increase transparency							
ACA for employees							✓
Employer Tax	Implementation concurrent with ACA to reduce period of change						✓
Scope/definitions	Pensions & dividends unchanged						
Deductions	Pensions unchanged ACA						✓
Benefits in kind	ACA						✓
Self-employed Contributions and benefits							
Link administration							
Thresholds							
Concurrent changes			NICs in Making Tax Digital				UC rollout complete

Can anything really be done - what taxpayers think

Given the impacts and transitional issues, can anything really be done? Or should we just limp on with current systems, with distortions between taxpayers and complexity for everyone?

The OTS has tested these proposals with a wide variety of stakeholders and found a high level of support amongst business and employer groups, tax professionals, payroll professionals, tax charities representing low paid workers, unions and academics. There is a clear desire for a system of payroll taxes that supports changing working patterns, is easier to operate and understand, and so is fairer and more transparent. Stakeholders, especially employer groups, acknowledge that there will be set up costs and the need for a measured timetable, with extensive consultation and the impact fully understood at each stage.

What next?

The OTS believes it has made the overall case for change in its March and November reports. Careful discussion and analysis is needed on the impacts and transition. The next step is to broaden the debate and understand the wider impact on household income and benefits and to the Exchequer, to design a system that works better for everyone and is fit for the future.

There are challenging issues to resolve. But, from a simplification perspective, as working patterns change, the OTS is clear that its proposals will bring real benefits and that now is the time to start a reform programme.