Office of Tax Simplification
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Consultation on Simplifying the PAYE Settlement Agreement (PSA) process

Response by the Office of Tax Simplification

1. Introduction and summary

1.1 The focus of the OTS is on simplification of the tax system. That encompasses two broad arms: technical simplification (simplifying the legislation and rules) and administrative simplifications (making the tax system easier to deal with). PAYE Settlement Agreements (PSAs) are widely seen by employers as offering a useful and practical way to deal with matters that would otherwise take disproportionate time to deal with. We very much support the objective of the reforms outlined in the consultation but are, however, disappointed that the proposals do not go further in widening the scope of PSAs.

1.2 As the consultation acknowledges, the OTS proposed reforming PSAs in our second report on Employee Benefits and Expenses (EBE)[1]. Our recommendations, as always, were based on the evidence we had gathered, particularly from employers, and noted that there were two key requests from employers:

- Voluntary payrolling to be introduced (introduced in FA 2015)
- PSAs to be considerably widened and made administratively simpler

We included these in our six-point plan to largely eliminate P11Ds and generally make the whole area of EBE simpler and easier to operate for employers, employees and HMRC. We think it is important to reiterate this context: a reformed PSA system will make a real difference to this area, to the benefit of all concerned by reducing the administrative burdens of the tax system.[2]

1.3 We are encouraged with the proposals for improving the administration of PSAs which largely reflect our recommendations. The proposed new system is far more appropriate in the era of self-assessment.

1.4 We are disappointed at the lack of significant loosening of the rules on what can be included in a PSA. We can understand that the simplest route of allowing anything to be included (as requested by businesses) has not been followed for the sort of reasons we referred to in our report. Although the proposed changes to the criteria may have the effect of allowing more items to be included in a PSA, we think this is insufficient and a wider reform is necessary. Concerns about abuses, if that is what is preventing reform, can be managed as we have suggested in the past. We would urge that further consideration is given to extending the

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/275795/PU1616_OTS_employee_benefits_final_report.pdf

[2] It is also important to note at the outset that reform of PSAs has the potential to *increase* tax revenues. Many employers tell us that PSAs are more expensive for them than operating PAYE/NICs, even allowing for the tax paid on behalf of the employees, but they prefer pay higher tax bills for the convenience.

scope of PSAs, possibly as a second stage to a full reform. Concerns about possible abuses by a small number of smaller employers should not prevent reforms that will help the great majority of employers, especially larger ones.

2. The Office of Tax Simplification

2.1 The OTS is an independent office of HM Treasury, established in 2010 to provide independent advice to Ministers on ways of simplifying the UK tax system. In developing our recommendations, we carry out extensive evidence gathering from all those involved with the tax system – businesses large and small, individuals, representative bodies, advisers and HMRC. Our recommendations cover both technical and administrative aspects of the tax system.

2.2 The OTS is now established on a statutory basis by FA 2016 with an expanded remit. As well as researching specific areas of the tax system as requested by Ministers, our new remit now puts greater onus on the OTS to actively seek areas of complication and responding accordingly. And it is in that context that we comment on this consultation.

3. Responses to the consultation questions

3.1 The existing PSA application process

We endorse the issues with the current system as set out in chapter 2 of the document. As might be anticipated, we think this chapter should have discussed the restrictions on what can be put in a PSA and the problems created.

3.2 Proposed new process

We naturally endorse the discussion and proposals in chapter 3, as they closely parallel our own recommendations. In particular:

- Removing the requirement for annual agreement between employers and HMRC simplifies procedures, saves time for employers and HMRC, and is more in keeping with the ethos of self-assessment;
- The PSA procedure should be made digital, to tie in with RTI and wider moves to digital;
- We note that para 3.7 invites reasons for enabling more frequent PSA submissions. We think that simplification should mean that there need to be reasons *not* to allow more frequent submissions. If an employer's systems mean it is more convenient to make returns monthly or quarterly (or to tie in with particular events that give rise to PSAs) why should the tax system prevent the employer completing the PSA at that point?[3][4]

[3] It would be for discussion whether payment of an interim PSA would be required (say) within a month after its submission or all on the current October date. It is not something we have tested with employers; simplification probably means interim returns should be followed by interim payments and we suspect that employers would endorse that as they would be submitting interim returns by choice.

[4] In saying what we have done, we do acknowledge that interim submissions may not be practical as employees' marginal tax rates can only be ascertained once the tax year has ended. For regular pay the cumulative basis of PAYE ensures that for most people peaks and troughs in remuneration are of course smoothed out by the end of the year. It may well be few would use the facility beyond in-year leavers or employees whose tax position is clear but it should remain an option.

Turning to the questions:

Qi. Do you agree that removing the requirement to agree the items in a PSA will provide simplification for employers? Please give your reasons.

Yes; please see the OTS report for our evidence and basis of our recommendation.

Qii. Are there reasons why the formal agreement element of a PSA should be retained? If so, what changes should the government consider to an agreement based system so that it is easier to administer?

We can envisage that some employers will want to retain at least the option of a formal agreement so that they have certainty. It is difficult to reconcile this with self-assessment principles. It seems to us that the perceived need for agreement will be over the items that can be included within the PSA rather than a check on the accuracy of the calculation (which certainly seems unnecessary). The perceived need for agreement on content could of course be obviated if there was freedom to PSA whatever the employer wished but that is clearly not on the agenda. Instead, we think a good compromise would be a commitment from HMRC to answer specific queries about what can be PSA'd from employers while the new system is bedding down, coupled with keeping relevant guidance up to date.

Qiii. Do you agree that a having a digital PSA return would be simpler for employers to administer rather than the current PSA1 paper return? Please provide your reasons.

Qiv. A digital return would reduce error rates. Are there other changes the government should consider to reduce these further?

We agree that digital returns are a logical step forward that should make processes simpler and less susceptible to error. However, it should not be assumed that PSA forms will be automatically populated from payroll systems. The nature of PSAs means that there will often, particularly for large employers, be a process of assembling details from a variety of departments. Much of that is likely to involve manual processes. But an electronic form/process, capable of being completed in stages and saved, will help employers and could eliminate the sort of calculation errors referred to in the consultation.

Qv. Would aligning the PSA payment date with the Class 1A NICs payment deadline cause any employers particular hardship? Please provide your reasons

Although this is an obvious simplification step, we do see potential problems in accelerating the PSA return and payment date for the reasons set out in our previous comment. HMRC needs to discuss the practicalities of such a change with large employers, including perhaps whether a staged move to a July return date would be practical to give employers time to adjust.

Qvi. Do you agree that this approach would be proportionate?

We agree with the outline procedure which is what we had in mind. It does of course depend on HMRC keeping guidance up to date to reflect developments/wider agreements, as we commented above.

Qvii. Do you have any other comments about the proposed new PSA process?

Not at this stage.

3.3 Defining what can be included in a PSA

As set out in our report, the general message that we heard from employers, which continues to be echoed in meetings since we published our report, is that employers should be free to include whatever they wish in a PSA. As para 4.19 notes, we duly recommended that as the simplest approach. However, in doing so we readily acknowledged that such freedom might create scope for abuse;

- Low-income employees could be 'PSA'd and so be able to claim higher benefits
- Higher income taxpayers could sidestep such things as high income child benefit charge or withdrawal of personal allowances

In discussions with the OTS, employers generally dismissed such possibilities as they would simply not be able to do such manipulation for HR reasons. However, we do see it remains a possibility with small or unscrupulous employers and so had suggested a way of managing the situation with a 'main purpose' anti-avoidance provision. The key is that we believe concerns about possible abuse by a small minority should not stymie reform that would help the great majority.

As we were aware of HMRC's opposition to such widening, we therefore proposed that HMRC should, rather than define what could be in a PSA, instead set out what could not be in a PSA. That is the origin of the suggestion ascribed to us at para 4.5 in the condoc. This possible route has been popular with employers when we have tested the idea with them. We feel that it offers a complement to payrolling: basically saying that PSAs cannot be used for items that can be payrolled could be a good route to explore.

We continue to believe that HMRC has not made the case for why PSAs *cannot* be widened beyond the current restrictive rules. Widening offers scope for simplification to the benefit of all parties. We would refer to the origins of PSAs and Ministerial statements: see the Annex to this submission.

A key criteria for the OTS and for many employers we have heard from is that a reformed PSA system should make it possible for employers to settle the tax due on excess mileage allowances. The current rate of 45p a mile is widely seen as too low: a number of employers accordingly pay more. They naturally do not wish the extra amount to constitute a benefit with a tax charge for employees and so settling the tax due via a PSA is logical. Currently that is not possible; the current proposals do not seem to encompass such payments. We think that is disappointing and a missed opportunity. If HMRC is not ready to extend PSAs to cover such innocuous items, there needs to be a commitment to return to the issue next year when the current administrative improvements are established.

Turning to the questions:

Qviii. In light of the new trivial BiKs exemption, would the removal of 'minor' pose any problems for employers? Please provide reasons for your answer and examples of BiKs which this would cause difficulty for.

We agree with reviewing the definition of what can be included in a PSA in the light of the new trivial benefit exemption. But we note that there will remain some 'work related' benefits which although within the £50 limit will not count as trivial. They would often be things that the employer wishes to PSA.

Qix. Are there items which you include in your current PSA which are 'minor' and which are not either 'irregular' or 'impracticable' as well?

An example of a benefit that is minor, but neither irregular nor trivial, is the provision of company-paid healthcare for a short period or periods to employees who would not normally be entitled to such healthcare. This can and does occur where such employees are sent on short-term assignment to a country or countries where public health provision is rudimentary or non-existent. The employer in such circumstances is providing healthcare cover for the duration of the assignment in discharge of a duty of care. Indeed, if healthcare were not provided the employer would find difficulty in persuading people to undertake the assignment. The provision of healthcare is thus made purely for business purposes and certainly with no intention of conferring any sort of reward or profit. Given that, it is quite wrong for the employee to have to meet the tax liability, so the employer would expect to put the cost of the healthcare through the PSA.

Qx. Do you agree that these principles should guide what can/cannot be included in a PSA as an 'irregular' item?

Qxi. Are there any other principles which you think should be considered?

Qxii. Do you have any other comments about how 'irregular' is interpreted?

The principles around 'irregular' in the box after para 4.13 seem reasonable. However, we wonder how the excess mileage allowances example we cited earlier as our key test would fare?

Qxiii. Do you agree that these rules provide clarity? Would their application pose any difficulties for employers?

Qxiv. Are there any other types of 'impracticability' which the government should consider?

The guidelines in the box (after para 4.16) are reasonable up to a point but much depends on how HMRC interpret 'impractical'. We have heard from employers that too often HMRC equate this term with 'impossible'.

Also, the qualification in terms of the employer's software raises some concerns: does HMRC interpret that as meaning that the employer could acquire much enhanced payroll software that would deal with the matter so the test is not met? If so, that seems inappropriate, at least for small employers.

It seems to us that if the employer's payroll software deals adequately with requirements under RTI, then the test should be clearly against that system. Impractical should be in terms of '….impractical without considerable or disproportionate extra administrative effort…'.

Qxv. Should the government consider an exemption/cap in respect of office holders? Please provide reasons for your answer.

We have argued in one of our reports that the rules around office holders should be subsumed into the general rules on employments, or at least fully harmonised so they operate in the same way. Accordingly, we think that simplicity demands no separate rules for office holders: they should be dealt with in the same way as employees.

Qxvi. What other safeguards could/should be considered to guard against possible abuse of PSAs?

As noted above, we think that bringing in a 'main purpose' form of anti-avoidance rule would allow relaxation of the rules around what can be included in a PSA.

Qxvii. Are there any compelling reasons/scenarios which do not fit into the rules as set out above that employers feel the PSA process should be amended to include? Please provide reasons/examples.

The assessment of these reforms should be whether everyday examples of benefits for employees *that on any reasonable assessment do not constitute a benefit* (such as accommodation provided when away from base working on commissioning a new production plant) or which have a *clear business purpose* (such as payment of excess mileage allowances) can be covered by a PSA. Particularly with more flexible employments, employers need to have greater freedom to settle tax on what they and their employees do not see as benefits. We think that is in keeping with simplification.

3.4 Assessment of impacts

We will be interested to see the assessment of impacts. We would point out that PSAs can result in additional tax being paid to HMRC and ask that such impacts are also included.

The Office of Tax Simplification
17 October 2016

Annex: Some background to the introduction of PSAs

The introduction of PSAs has to be seen in the context of the introduction of income tax Self-Assessment (SA). FB 95 contained the primary legislation for SA. Clause 101 dealt with PSAs and gave the Commissioners of Inland Revenue power to make PAYE Regulations governing their operation. The Clause as drafted contained a cap to the effect that a PSA could not be used where recurrent benefits were likely to exceed 5% of an individual employee's cash earnings. Thus, low-paid individuals would be likely to trigger the cap. Such cases would require to be identified so that P11ds could be produced. If the employer wished to keep the individuals whole the employer would have to calculate the likely tax liability and put a grossed-up sum through the payroll for each individual affected. This would make the whole thing very unwieldy and administratively time-consuming. In the debate on 15 February 1996 in Standing Committee E, at least two Committee members were very concerned about this. One of them had been briefed by the CIOT as to the potential problems. The Government undertook to consult. Presumably as a result of that consultation the cap disappeared and the eventual solution was that for an emolument to be included in a PSA it had to be:

a) minor, or
b) irregular, or
c) if cash, such that PAYE could not readily be operated, or
d) if a shared benefit, provided in such circumstances that apportionment between the employees sharing the benefit was impractical

That solution was contained in Regulation 4 of the Income Tax (Employments) (Amendment no.6) Regulations 1996 SI 1996/2631 which inserted a new Chapter V in the Principal PAYE Regulations SI 1993/744. That became on consolidation Chapter 6 of the PAYE Regulations SI 2003/2682.

Against that background it is interesting and illuminating to read Hansard's record of what the Financial Secretary to the Treasury (Rt Hon Michael Jack MP) said in response to members' concerns. The record is at HC/OF/SC/356 Volume III Columns 317-320.

At column 319 Mr Jack said

".. it is not our aim to do away with the benefits of the discussions that currently take place between companies and the Revenue. The flexibility and the informality are of benefit to the 2500 employers who have that type of agreement (i.e. the then *Annual Voluntary Settlement*) and we do not intend our proposals to remove that."

"The essence of the arrangements will remain unchanged; it is the legal framework within which they will operate that will change."

"It will still be possible to negotiate the arrangements with the Revenue. The benefits of the flexibility, informality and understanding that exist between individual inspectors and companies will not be lost under the arrangements."

At column 320 Mr Jack said

"The clause is not intended to be an onerous and complex measure that lacks flexibility….We want flexibility to be retained in the current (*sic*) system. The present arrangements have particular benefits, which can be tailored to an individual company's needs."

Presumably in the first sentence of this last quotation Mr Jack was trying to say that the Government want the flexibility of the AVS regime to be retained in the proposed regime for PSAs.